DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

SUBMISSION ON DRAFT DECISION PUBLIC VERSION

Submission DD1: Financial Viability

20 September 2001

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1. Introduction

1.1 On 21 June 2001, the Western Australian Independent Gas Access Regulator ("Regulator") released his draft decision in relation to the proposed access arrangement for the Dampier to Bunbury Natural Gas Pipeline (the "DBNGP") filed by Epic Energy. In accordance with the provisions of the National Gas Access Code ("Code"), the Regulator has called for public submissions in response to the draft decision.

1.2 This submission forms part of a number of submissions to be made to the Regulator by Epic Energy. The submissions focus on different aspects of the draft decision and various consequences of the draft decision and challenges whether these aspects and consequences are consistent with the requirements and principles of the Code that the Regulator must take into account when deciding whether to approve an access arrangement.

1.3 On 28 August 2001 the Supreme Court of Western Australia issued an Order Nisi (matter no CIV 2166 0f 2001) in respect to the draft decision. The orders were made on application of Epic Energy. The grounds contained in such application, inter alia, go to the application of the Code in considering the approval of a proposed access arrangement. The matters covered by the Order Nisi have not yet been considered by the Full Court and as a result it has not yet been finally determined whether the draft decision should stand nor whether the Regulator is required to take a different approach in applying the Code in his consideration of the proposed Access Arrangement for the DBNGP. The submissions are being made with that background and may therefore need to be adjusted or supplemented once the Full Court's decision is known. The submissions are made on a "without prejudice" basis to those proceedings. Epic Energy advises the Regulator that it will be likely that it will need to make further submissions once the outcome of those proceedings are known. Although Epic Energy is progressing the proceedings expeditiously, the timing of the outcome of these proceedings is a matter outside of Epic Energy's control.

2. Background

2.1 Throughout the process with the Regulator leading up to the draft decision Epic Energy has approached the provision of information and argument to the Regulator on the assumption that the proposed Access Arrangement as filed would be approved. Epic Energy believed that the proposed Access Arrangement was consistent with the requirements of the Code and that there had been no indication from the Regulator to the contrary. Until the Draft Decision was issued Epic Energy had no appreciation that the Regulator would not approve (or at least substantially approve) the proposed Access Arrangement. At no stage was Epic Energy asked to provide information to the Regulator as to the financial impact on Epic Energy if the proposed Access Arrangement was not approved.

2.2 However, despite that, Epic Energy has put the Regulator on notice of the potential financial impact of a decision not to approve the proposed Access Arrangement right from the time of the initial filing of the proposed Access Arrangement through to just prior to the issue of the Draft Decision. This was done in a number of submissions and papers put to the Regulator as well as discussions with the Regulator and staff of and consultants to OffGAR. References to the financial issue can be found in the following papers already submitted by Epic Energy:

- Submission 1 dated 15 December 1999 – p.2 (public version dated 28 February 2000):

  "To not approve the Access Arrangement in the form put to the Regulator would fail to take into account Epic Energy's legitimate business interests, and the investment Epic Energy has already made in the DBNGP.

  To require a different structure, which would produce a lower revenue, would impose a regime in which operation of the DBNGP was no longer financially viable.

  It would place at risk future investment in pipeline capacity required to support economic development in Western Australia."

- Submission 1 dated 15 December 1999 – p.24-25 (public version dated 28 February 2000):

  "The Regulator must approve the Access Arrangement which implements Epic Energy's regulatory compact with the Government of Western Australia.

  To proceed in any other way would be inconsistent with the regulatory compact.
  …….
  It may well remove Epic Energy's financial capability to continue pipeline operation, and to meet its commitments to make the investments in the additional pipeline capacity required to support economic development in the State."

- Additional Paper 4: Regulatory Compact dated 8 September 2000 at paragraph 5.8 on page 15:

  "Only by implementing the regulatory compact, would the Regulator take into account Epic Energy's legitimate business interests and the investment its

shareholders have made in the Pipeline… … Moreover, the Regulator may well remove Epic Energy's financial capability to continue pipeline operation, and to deliver on its commitment to make the investments in the additional pipeline capacity required to support economic development in the State."

- Additional Paper 4: Regulatory Compact dated 8 September 2000 at paragraph 5.9 on page 15:

  "Were the Regulator to proceed in any other way, … … Were the State and the Regulator to now ignore the regulatory compact, Epic Energy's shareholders would be exposed to "asymmetric risk". That risk may significantly deter future private sector investment in infrastructure assets in Western Australia. Future potential investors would realise that they could be exposed to substantial financial loss while, at the same time, they had no prospect of securing the superior financial returns required to compensate for the risk of that loss."

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- ***(Deleted – Commercial in Confidence)***

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2.3 Epic Energy notes that while OffGAR asked Epic Energy to provide information dealing with sensitivities surrounding contracted and throughput volumes – which Epic Energy provided - at no stage did OffGAR seek Epic Energy to provide a sensitivity analysis on its financial viability for differing tariff assumptions.

3. (Deleted – Commercial in Confidence)

4. (Deleted – Commercial in Confidence)

5. Impact Of Draft Decision

5.1 Epic Energy has modelled the effect on its actual financial position as currently forecast if the indicative Reference Tariffs set out in the Draft Decision were implemented for all shippers (other than the Alcoa Exempt contract) with effect from 1 January 2002. The results of that are set out in Attachment 1.

5.2 ***(Deleted – Commercial in Confidence)***

5.3 If the Draft Decision were to be implemented in its current form with effect from 1 January 2002, the financial effect would be as follows.

5.4 **(Deleted – Commercial in Confidence)**

5.5 ***(Deleted – Commercial in Confidence)***.

5.6 ***(Deleted – Commercial in Confidence)***

5.7 ***(Deleted – Commercial in Confidence)***

5.8 ***(Deleted – Commercial in Confidence)***

5.9 ***(Deleted – Commercial in Confidence)***

5.10 ***(Deleted – Commercial in Confidence)***.

5.11 ***(Deleted – Commercial in Confidence)***

5.12 ***(Deleted – Commercial in Confidence)***

5.13 ***(Deleted – Commercial in Confidence)***

5.14 ***(Deleted – Commercial in Confidence)***

5.15 The ramifications of Epic Energy being forced into external administration are likely also to have much wider ramifications for the development of the entire pipeline industry. Any financier of another pipeline that may be covered by the Code would find it more difficult to provide funds for any new project because of the additional risk resulting from the regulatory approval process for the new project.

5.16 If we assume for the moment that Epic Energy is able to overcome the above serious issues and remain in business, the next most serious consequence of the implementation of the Draft Decision is the effect that it will have on Epic Energy's ability to fund "stay in business" capital. ***(Deleted – Commercial in Confidence)***. The restriction on available funds and hence maintanence of the DBNGP will clearly impact on the operational reliability of the DBNGP and the equipment on the DBNGP. That in turn will impact on the available capacity of the DBNGP. That aspect is dealt with in greater detail in a separate submission to be filed shortly[1].

5.17 Epic Energy stresses that its primary focus will be as it is and always has been, on safety and the environment[2]. Available cash will first be directed to deal with these areas ahead of other "stay in business" requirements. Despite what might be suggested by others, Epic Energy is acutely aware of its obligations under the Pipeline Licence for the DBNGP. It goes without saying that breaches of the Licence could lead to the Licence's revocation and hence the closure and removal of the pipeline. Such a consequence would not be in the public interest.

5.18 The comments concerning raising stay in business capital apply equally to raising new capital for expansions and extensions of the DBNGP. Given its parlous financial state this will be difficult for Epic Energy to do and it would be likely to require the person seeking

[1] See Epic Energy Draft Decision Submission on Capacity of the DBNGP to be filed shortly.
[2] Epic Energy has won a number of awards for its environmental excellence, which demonstrates its focus in this area.

such capacity to fund the necessary capital. The operation of the Code on this point is likely to provide a disincentive for such person to do that[3].

5.18 The above aspects aside, if Epic Energy was able to fund the necessary capital there are still issues. In short that relates to the fact that the cost of expanding gas transmission pipelines is not uniform. The DBNGP is no exception to the rule. The incremental cost of expansion varies according to stage the pipeline is at as to the type of expansion required. To take it at its simplest, when a pipeline is first built it will have a certain capacity it can deliver without any compression being done along the pipeline. This is referred to as the free flow capacity of the pipeline. Due to friction within the pipeline, the gas in the pipeline will gradually lose pressure as it travels along the pipeline and hence the capacity of the pipeline will be what can be taken out at the end for the quantity put in at the maximum pressure at the start.

5.19 The capacity of the pipeline can be increased by installing compressor units along the pipeline at intervals (on the DBNGP that occurs approximately every 130km) to keep increasing the pressure from that lost as it travels along the pipeline. That allows more gas to be pushed into the pipeline and hence taken out at delivery points. The pipeline eventually gets to a stage where it is fully compressed, ie no more gas can be pushed into the pipe at the compressor stations due to the size of the pipe the compressors are trying to push the gas into. That leads to the next stage of expansion known as looping.

5.20 Looping is the approach of constructing replications of the pipeline immediately downstream of compressor stations experiencing this sort of bottleneck. The length of the loop and location will determine the amount of additional capacity. Eventually the pipeline will be fully looped so that you effectively have 2 pipelines and you then move back into the compression phase again, ie increasing compression. The cost per TJ/day of capacity produced varies significantly depending on the type of expansion being undertaken. The cheapest is the early stages of compression, the most expensive is the early stages of looping.

5.21 It should be remembered that expansion is not quite as clear cut as this as it blurs around the changeover from compression to looping and vice versa. For example, the Stage 1 and 2 expansions in 1991 and 1997 respectively solely involved compression. The Stage 3A expansion in 2000 was a mixture of looping in the south and additional compression[4]. The next stage is likely to involve the completion of compression, but will mainly involve looping and will require significant capital expenditure.

5.22 The proposed Access Arrangement filed by Epic Energy, which reflected Schedule 39 of the Asset Sale Agreement, was for a tariff on a “rolled in” approach. This meant that Epic Energy committed to a set tariff and tariff path regardless of the cost of future expansion investment on the pipeline. This meant, for example, that the Zone 9 100% load factor tariff would start at $1.00/GJ in 2000 and follow a straight escalation path of 67% of CPI for all shippers, whether existing or new. This meant that all shippers and new shippers would be on the same Reference Tariff, regardless of the incremental cost of expansion.

5.23 By rejecting that (as done in the Draft Decision), the Regulator adopts the differential tariff approach. The shippers contracting the existing capacity would, in this example, pay a

[3] See sections 6.22 and 6.23 of the Code.
[4] See Epic Energy’s Additional Paper 3: Comments on AlintaGas’ Fourth Submission to Regulator on Epic Energy’s DBNGP Access Arrangement dated 8 September 2000 at paragraph 4.5.10.

tariff of $0.75/GJ escalated by 67% of CPI, which would then be reset at the end of the regulatory period (here 5 years), while a new customer would pay the incremental tariff. By way of illustration, Epic Energy has looked at the costs of expanding the capacity of the DBNGP to allow a new gas fired 250MW power station to be constructed by a power generation company in Zone 9. That power station would require additional capacity of about 50TJ/day. The 100% load factor tariff that would be charged to that shipper would be about $1.32/GJ. Subsequent new shippers would have tariffs that would get progressively lower. This aspect is dealt with in greater detail in a separate Submission to be filed shortly[5]

[5] See Epic Energy Draft Decision Submission on Response to the Existing Shippers' Submission on Epic Energy's "Second Class Citizens" Argument to be filed shortly.

6. Deleted – Commercial in Confidence

7. Conclusion

7.1 ***(Deleted – Commercial in Confidence)***

7.2 If, as detailed above, the Draft Decision is implemented, then certainly from 2005, if not before, Epic Energy would not be solvent. Its continued operation would therefore be in jeopardy. That in itself would have implications for all existing contracts, not to mention the continued safe and reliable operation of the DBNGP. But, even if Epic Energy can remain solvent, its access to capital will be severely eroded. That will make it difficult for Epic Energy to expend money on "stay in business" capital projects (such as as outlined as Capital Expenditure in the Access Arrangement Information filed with the Regulator), which would need to be limited to the absolute minimum. The next issue then is whether Epic Energy would be able to raise capital for future expansions needed for new customers. Given the financial position of Epic Energy that is likely to be extremely difficult. Hence it will not be possible to expand the DBNGP unless the new shipper provides the capital. Even if Epic Energy can somehow find the capital for the expansion, the tariff differential problem referred to above will apply.

7.3 Hence not only will the tariffs in the Draft Decision not promote competition in upstream or downstream markets, but they will also have the effect of constraining the capacity of the pipeline. Epic Energy queries how that can be consistent with the objectives of the Code and the principles for coverage under the Code in general.

8. Deleted

Attachment 1

Financial summary of Impact of Draft Decision Tariffs

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Attachment 2

Forecast Throughput

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Attachment 3

Financial Summary of Impact of Tariffs As Filed With No Expansions

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