



DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

RESPONSE TO DRAFT DECISION

Additional Information DD2: Response to the Existing Shippers' Submission on Epic Energy's "Second Class Citizens" Claim

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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 submissions and further information in response to the draft decision. 1.2 This paper forms part of a number of papers to be provided to the Regulator by Epic Energy setting out additional information.
- 1.2 On 28 August 2001 the Supreme Court of Western Australia issued an Order Nisi (matter no CIV 2166 Of 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 additional information is being made with that background and may therefore need to be adjusted or supplemented once the Full Court’s decision is known. The papers are provided on a “without prejudice” basis to those proceedings. Epic Energy advises the Regulator that it will be likely that it will need to provide further papers and make 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.
- 1.3 On 23 August 2001, the Office of Gas Access Regulation (“OffGAR”) released a submission (“2nd class citizens’ submission”) from a group of existing users of the DBNGP in response to the draft decision. This paper is in response to that submission.

2. Background

- 2.1 The 2nd class citizens' submission is a response to public comments made by Epic Energy that, if the draft decision is implemented, it will give rise to a set of circumstances that will result in any new users wanting Firm Service on the DBNGP, but which requires an expansion of the pipeline capacity, having to pay more for the same service that is being used by existing customers in relation to capacity that already exists on the pipeline ("2nd class citizens' claim"). For the purposes of this paper, these new users are classified as "second class citizens".
- 2.2 The 2nd class citizens' submission proposes a "solution" to the effect that the Code contains mechanisms which, if included in an access arrangement, purportedly will ensure that such a set of circumstances can not arise. It urges the Regulator to ensure that the final decision incorporates such mechanisms. In particular, the "solution" urges the Regulator to require that expansion costs that have system wide benefits be added to the capital base.
- 2.3 This paper seeks to:
- (1) further explain Epic Energy's 2nd class citizens' claim;
 - (2) explain how, if the draft decision is implemented, the "solution" is flawed because the Code does not contain mechanisms which provide the "solution" but that even if it does, it only provides a mechanism which would only prevent the 2nd class citizens' claim arising in relation to a very limited number of expansions; and
 - (3) explain why the Regulator is required under the Code to ensure that any approved access arrangement does not give rise to the 2nd class citizen's claim
- 2.4 It should be noted that Epic Energy will be providing more detailed information to the Regulator which deals with the likely tariffs for incremental expansion of the DBNGP in the foreseeable future¹ and the consequences of allowing an environment which will result in the creation of a set of second class citizen users². This paper however, merely focuses on a response to the "solution" proposed in the 2nd class citizens' submission.

¹ See Epic Energy Draft Decision Submission on Incremental Expansion of Capacity of the DBNGP to be filed shortly.

² See Epic Energy Draft Decision Submission on Impact on Development to be filed shortly.

3. “Solution” of the 2nd class citizens’ submission

3.1 The 2nd class citizens’ submission argues that the Code does provide a mechanism which allows for the increase in the reference tariffs payable by all users (ie users of both existing and incremental capacity) in relation to expansions which have system wide benefits. This is done by adding the capital costs of the expansion (defined in the Code as New Facilities Investment) to the capital base.

3.2 It makes the following comment:

“Section 8.16 of the Code, and in particular sections 8.16(a) and 8.16(b)(ii), allows Epic Energy to add the cost of an expansion to the capital base if:

- (i) Epic Energy is acting efficiently in accordance with good industry practice and the expansion costs are prudently incurred; and*
- (ii) The capacity expansion has system wide benefits”³*

3.3 It goes on to comment that *“in all likelihood there would be system wide benefits from expansions of the DBNGP where work on the mainline, such as looping, additional compression and various modifications to the communications and control systems is involved. All shippers would benefit from the improved reliability and security provided by such expansions of the mainline.”⁴*

3.4 Finally it is argued that the zonal pricing and cost allocation system will ensure that shippers upstream of a particular expansion and who would not benefit from the increased reliability provided by the expansion, would not have their tariff increased. This begs the question of how the costs of such an expansion can be included in the capital base if it does not have system wide benefits.

³ Section 4.1 on page 3 of the 2nd class citizens’ submission.

⁴ Ibid

4. Epic Energy's response to the "solution"

- 4.1 Epic Energy contends that this "solution" is flawed in at least three respects. However, before explaining the flaws with the "solution", it is appropriate that this paper highlight some background information.

Background Information surrounding DBNGP expansions and proposed access arrangement

- 4.2 Pipeline capacity expansion does not automatically imply an increase in tariffs. The marginal costs of some expansions are lower than the average cost of capacity. Those expansions result in a lowering of tariffs determined on an average cost basis (the average cost basis was used under the pricing methods of the GTRs). However, not all expansions have this desirable outcome. When a pipeline is fully compressed, additional capacity must be obtained by looping (duplicating sections of the line)⁵. Initial looping typically has marginal costs which exceed the average cost of capacity and, when undertaken, increases tariffs that have been determined on an average cost basis.
- 4.3 As mentioned in Epic Energy's previous submission filed with the Regulator on 8 September 2000⁶, the DBNGP is close to being fully compressed and therefore the next expansion of the Pipeline's capacity will require looping. In fact the Stage 3A expansion (being the most recent expansion of the Pipeline) involved some looping of the southern section of the Pipeline.
- 4.4 As the pipeline must be looped to allow for the next expansion of the pipeline, the issue of a higher marginal cost of capacity, and therefore whether the tariffs and charges to be paid by prospective users seeking that additional capacity should be the same as the tariffs to be paid by users of the same service provided with the existing capacity, will be of immediate relevance as soon as there is sufficient demand to warrant the next expansion of the pipeline. If the current demand forecasts are realised, then the next expansion will be required in about 2005 to cater for an additional load of in the vicinity of 41TJ/day.
- 4.5 As indicated, details of the likely incremental tariffs based on current forecasts will be set out in a separate paper⁷. Although it should be remembered that it is extremely difficult to provide with any degree of accuracy the likely tariffs that Epic Energy would need to charge for the additional capacity, given that there is no certainty as to the amount of additional capacity that will be required or the terms on which that capacity would be contracted⁸. It is therefore very difficult to provide indicative tariffs with any degree of certainty suffice to say that, on the basis of the forecast demand growth, the demand forecast to be required after 2005 will only be able to be met by the looping of the pipeline.
- 4.6 To deal with this issue, Epic Energy's proposed access arrangement is designed to ensure that:

⁵ See paragraphs 5.18 – 5.21 of Epic Energy's Confidential Submission DD1: Financial Viability filed on 20 September 2001.

⁶ Section 4.5 of Epic Energy's Additional Paper 3: Comments on AlintaGas' Fourth Submission to the Western Australian Independent Gas Access Regulator on Epic Energy's DBNGP Access Arrangement, dated 8 September 2000

⁷ See Epic Energy Draft Decision Submission on Incremental Expansion of Capacity of the DBNGP to be filed shortly

⁸ Not only will the unit cost vary depending on the amount of capacity built at one time, but also where that capacity is required, financing costs, exchange rates and risk elements such as duration of the initial contract for the new capacity and the risk balance associated with the terms and conditions of the contract.

- (1) any additional capacity expansions would not result in an increase in the reference tariffs to all users; and
- (2) the same tariff would be payable by all users of the same service, irrespective of whether the user was using the original capacity or the incremental capacity.

Epic Energy has already submitted⁹ that under the proposed access arrangement, the tariff and tariff path (and by implication, the proposed Initial Capital Base) reflect the expectation arising from the sale of the DBNGP that substantial new investment will be required to more than double the Pipeline capacity over the next 10 years.

- 4.7 The tariff path was therefore smoothed over an extended period to reflect that the expansions will be made without increases in the tariff at the time the expansions are built (where the cost of the expansion would have ordinarily caused tariffs to increase due to the higher marginal cost of the additional capacity). True it is that where the pendulum swings the other way and the incremental expansion cost is lower, the tariff does not drop, but the whole tariff path structure took that into account in order to provide a smoothed path. The tariff and tariff path proposed by Epic Energy in its proposed access arrangement therefore already takes into consideration the fact that the marginal cost of some expansions (eg looping) is greater than the cost of other expansions (eg reconfiguration). Hence Epic Energy will for the initial expansion projects take some pain while in the later projects, it will make some gain. That in itself, given the stage in the incremental expansion cost curve the DBNGP is in, provides an incentive for Epic Energy to expand the pipeline and to gain new customers.
- 4.8 However, the Regulator's draft decision no longer allows for this to occur. By adopting the approach to the setting of tariffs used by regulators in the Eastern States who are dealing with mature pipelines facing the prospect of little expansion (ie by setting the value of the initial capital base by reference to the current configuration of the pipeline), the Regulator requires expansions, and therefore tariffs that need to be levied for that expanded capacity, to be assessed on a case by case basis. As mentioned above and as will be shown in a separate submission, the next expansion to the capacity of the pipeline will require looping and the marginal cost of that incremental capacity will be greater than the cost of the capacity of the pipeline as it is currently configured¹⁰.

Three Flaws with the “solution”

- 4.9 As mentioned above, there are at least three flaws with the “solution” and so the consequence of an access arrangement which incorporates the amendments in the draft decision will be that Epic Energy's 2nd class citizens' claim will become a reality.

First Flaw – Service Providers can not be compelled to expand

- 4.10 Firstly, the “solution” assumes that a Service Provider will agree to expand the capacity of the Pipeline in order to meet demand. However, as stated below, the Service Provider can not be compelled under the Code to fund any expansion to the capacity of a pipeline (see paragraphs 4.11 to 4.18 below).

⁹ Section 3.24 and 3.32 of Epic Energy submission to the Regulator “Additional Paper 5: Code Compliance”, dated 25 October 2000

¹⁰ See Epic Energy Draft Decision Submission on Incremental Expansion of Capacity of the DBNGP to be filed shortly

- 4.11 A Service Provider will only commit to incur New Facilities Investment and therefore fund the expansion costs if it is economically feasible to do so (as determined by the Service Provider). If it is not economically feasible for the Service Provider to fund the expansion costs, then a prospective user must pay either a surcharge or a capital contribution which would represent the costs over and above those that the Service Provider considers it is economically feasible to fund itself. Either way, this will result in users of the incremental capacity having to pay more for the same service that users of existing capacity have to pay.
- 4.12 It should be remembered that the objective of the Code is “to establish a framework for third party access to gas pipelines that provides rights of access to covered pipelines on conditions that are fair and reasonable for both Service Providers and Users and provides for resolution of disputes.”¹¹
- 4.13 Another objective of the Code is to encourage the development of an integrated pipeline network¹². This was one of the principal reasons why the State of Western Australia opted to appoint its own state based independent regulator of transmission pipelines rather than following the approach adopted by the other jurisdictions that have implemented the Code.
- 4.14 Consistent with these objectives of the Code, the Service Provider has an unfettered discretion under the Code on the issue of whether it should invest further in a covered pipeline. Sections 3.16 of the Code provides that the Service Provider can not be compelled to provide in its extensions/expansions policy that it will fund New Facilities, unless it agrees. Furthermore, section 6.22 of the Code also states that a Service Provider can not be compelled by an arbitrator in an access dispute, to fund any part of the expansion of the pipeline.
- 4.15 However, the draft decision will ensure that it is not economically feasible for Epic Energy to fund any further expansions, thus ensuring that the above Code objectives will not be realised. Following are the main reasons:
- The Code only allows a service provider to earn a rate of return on any capital which is required to build the additional capacity that is equivalent to the rate it is able to earn on the capacity of the pipeline as it is currently configured. The range of rates of return that have been allowed by regulators to date when assessing access arrangements under the Code ensure that any tariff that a Service Provider can charge for the incremental capacity – even if a rolled in tariff were allowed – would not allow Epic Energy to meet its internal hurdle rates for a new project.
 - Even if the Service Provider were to proceed with an expansion at a particular regulated rate of return, there is no guarantee that that regulated rate of return will remain fixed at each review of an access arrangement. This is because an access arrangement must be reviewed by the regulator in its entirety when it is reviewed¹³. This is an unnecessary risk for a Service Provider, particularly considering that an access arrangement will need to be reviewed at least each five years¹⁴ and a Service Provider normally requires longer than five years to make a project economically feasible even at Epic’s own internal hurdle rates.

¹¹ Introduction to the National Third Party Access Code for Natural Gas Pipeline Systems

¹² Ibid.

¹³ See section 2.28 of the Code.

¹⁴ See section 3.17 of the Code

- 4.16 Epic Energy considers that there is also a greater public benefit in Epic Energy's approach in the proposed access arrangement to capacity expansions being adopted. This is not only for the reasons stated above but also because it delivers a pro-competitive outcome – it not only ensures that competitors in downstream markets who rely on gas transported on the DBNGP as their fuel source will be operating on a level playing field but that Epic Energy will have immediate incentives to further expand the pipeline given that the initial incremental expansion project will be at a higher cost of capacity than subsequent expansions. Given the public interest to ensure that there is no differential price payable for similar services and the fact that the draft decision only allows the Service Provider to earn a rate of return on any capital invested on the pipeline of 7.85% (before tax real), it will not be economically feasible for the Service Provider to fund any expansion if all it can earn is a similar rate of return.
- 4.17 Epic Energy has already provided information to the Regulator¹⁵ demonstrating that the tariff as proposed by the Regulator in the Draft Decision, if implemented, will adversely impact on the financial viability of Epic Energy such that it will not even be able to operate the pipeline, as it is currently configured, in a safe a reliable manner let alone being able to carry out any expansions.
- 4.18 As a result, a prospective user will have to fund part, if not all of the capital costs of the New Facilities Investment.

Second Flaw – reference tariffs can not be increased

- 4.19 The second flaw relates to the aspect of the “solution” which proposes that an expansion for new demand would provide system wide benefits. Therefore if the marginal cost of that incremental capacity is greater than the cost of the capacity of the pipeline as it is configured from time to time, the Code, through section 8.16, enables the reference tariffs to be increased for all users, not just prospective users of the incremental capacity, on a rolled in basis¹⁶.
- 4.20 Epic Energy submits that section 8.16 can not allow for the reference tariffs to be increased in the circumstances of an expansion to meet new demand.
- 4.21 Under section 8.16 of the Code, New Facilities Investment can only be added to the capital base in one of three circumstances¹⁷:
- (1) where “*the Anticipated Incremental Revenue generated by the New Facility exceeds the New Facilities Investment*” – section 8.16(b)(i).
 - (2) where “*the Service Provider and/or Users satisfy the Relevant Regulator that the New Facility has system wide benefits that, in the Relevant Regulator's opinion, justify the approval of a higher Reference Tariff for all Users*” – section 8.16(b)(ii).
 - (3) where “*the New Facility is necessary to maintain the safety, integrity or Contracted Capacity of Services*” – section 8.16(b)(iii).

It is appropriate to deal with each of these circumstances separately.

¹⁵ See Epic Energy's Confidential Submission DD1: Financial Viability filed on 20 September 2001.

¹⁶ See page 3 of the 2nd class citizens' submission.

¹⁷ Section 8.16(b)(i) to (iii) of the Code

- 4.22 **Section 8.16(b)(i)** – in this circumstance, the Anticipated Incremental Revenue to be generated by the expansion must exceed the capital cost of the expansion. “Anticipated Incremental Revenue” is defined in the Code as follows:
- “ the present value (calculated at the Rate of Return) of the reasonably anticipated future revenue from the sale of Services at the Prevailing Tariffs which would not have been generated without the Incremental Capacity, minus the present value (calculated at the Rate of Return) of the best reasonable forecast of the increase in Non Capital Costs directly attributable to the sale of those Services”*
- 4.23 Therefore, the revenue that the Service Provider will be able to earn for the provision of services used on the incremental capacity will be set by reference to the rate of return and the reference tariffs set by the Regulator in relation to the original capacity of the pipeline. Clearly, the tariff can not be increased in this instance.¹⁸
- 4.24 **Section 8.16(b)(ii)** – This is essentially the head that the 2nd class citizen submission addresses. In this circumstance, there is mention that the reference tariffs can be increased, but only if the Regulator is satisfied that the expansion will have system wide benefits and that the Regulator believes those benefits justify approving a higher Reference Tariff for all Users. Leaving aside the issue of how the Regulator’s discretion will be exercised (this is discussed below), a service provider will need to make an election on whether to fund any New Facilities Investment, prior to the expansion being built. For the reasons outlined below (see paragraph 4.30), neither section 8.16 nor an entire access arrangement can apply to a prospective expansion of capacity.
- 4.25 However, the Service Provider will not make an election to fund any expansion if it is not economically feasible for him to do so. As stated above (see paragraph 4.15), at the current regulated rates of return, it will not be economically feasible for a Service Provider to fund any part of the expansion of a New Facility. This therefore leaves the situation of the User having to either fund all (or at the very least that part of the costs that the Service Provider deems is not economically feasible to fund itself) or to pay a surcharge to achieve the Service Provider’s required return and therefore the User having to pay more for the capacity than users of existing capacity.
- 4.26 Even if the Service Provider were to elect to fund part or all of the New Facilities Investment, the Service Provider would not be able to ensure that all users were paying uniform tariffs because those with whom an access agreement has already been entered into could not have their terms affected by a revised access arrangement lodged by the Service Provider to include New Facilities Investment in the capital base for the pipeline (assuming that the tariff under the agreement is not tied to the reference tariffs)¹⁹.
- 4.27 The 2nd class citizen submission states that “[I]n all likelihood there would be system wide benefits from expansions of the DBNGPAll shippers would benefit from the improved supply reliability and security provided by such expansions of the mainline.”²⁰ Epic Energy has experienced the discussion on exactly this point with the proposed Access Arrangement for the Moomba to Adelaide Pipeline which is being reviewed by the ACCC. Immediately prior to issuing its Final Decision the ACCC called for further public

¹⁸ To be fair, the 2nd class citizens’ submission does not suggest that this head has application in this situation.

¹⁹ See section 2.25 of the Code which provides that no contractual right entered into prior to the lodgment of an access arrangement will be affected by an approved access arrangement.

²⁰ See page 3 of the 2nd class citizens’ submission.

submissions and specifically pointed to this issue in its Issues Paper²¹. 9 submissions were received and made public by the ACCC. Almost without exception those submissions did not support a roll-in approach with increasing tariffs. The most detailed explanation of this opposition came from Origin Energy who said:

“Origin does not believe that any of the criteria listed in section 8.16(b) of the Code would be likely to be satisfied. Condition (i) is clearly stated by Epic not to apply and we see no reason to doubt that assessment. Condition (ii) appears to be aimed at an enhancement that, in addition to providing additional capacity for a new user, provides significant additional security of supply to all users. An example of this might be the addition of a third compressor at a compressor station. In Origin’s view, a normal increase by looping or increased compressor power would be unlikely to fulfil that criterion. We do not believe that Condition (iii) applies and we are not aware that additional pipeline development is claimed to be required to maintain safety, integrity or the contracted capacity of services by Epic or any user.”²²

- 4.28 In dealing with this point in the Commission’s Final Decision on the proposed Access Arrangement for the Moomba to Adelaide Pipeline²³ at page 174 – 175:

“Section 8.16(b)(ii) provides for a roll-in where the service provider and/or users satisfy the regulator that a new facility would result in system wide benefits which would justify higher tariffs for all users. According to Origin, system wide benefit involves enhancing the security of supply, which is unlikely to occur for an expansion of capacity. Users and the service provider have not argued that system wide benefits would be likely to occur. While the Commission has not assessed whether an expansion would result in system wide benefits, on the basis of submissions there is some doubt that it would.

There is no evidence before the Commission that an expansion is required to maintain safety, integrity or the contracted capacity of services (section 8.16(b)(iii) of the Code).

Accordingly, it does not appear that an expansion of the MAPS would be likely to satisfy section 8.16(b) of the Code at this stage.”

The capacity positions and stage in the enhancement incremental cost curve is almost identical between the two pipelines. The comments of the ACCC demonstrate that this leg, or the next leg, of section 8.16 are unlikely to be able to be satisfied by Epic Energy in relation to the proposed DBNGP expansions. That is not surprising given the purpose of the expansions would be to provide additional Firm Service capacity and is unlikely to provide “improved supply reliability and security”²⁴ as claimed in the submission.

- 4.29 **Section 8.16(b)(iii)** – given recent decisions by Regulators applying the Code, there will be very few instances where this provision can be utilised. It will be very difficult to justify that the proposed expansions can satisfy this test. Furthermore, for the very same reasons argued in paragraphs 4.27 and 4.28 above, a differential pricing regime would still arise.

²¹ See section 4.1 of the Issues Paper issued by the ACCC on the proposed access arrangement for the Moomba to Adelaide Pipeline dated 25 May 2001.

²² Page 2 of letter dated 11 July from Origin Energy Retail Ltd to ACCC on the proposed Access Arrangement for the Moomba to Adelaide Pipeline.

²³ Final Decision of the Australian Competition & Consumer Commission on the Access Arrangement proposed by Epic Energy South Australia Pty Ltd for the Moomba to Adelaide Pipeline System dated 12 September 2001.

²⁴ See page 3 of the 2nd class citizens’ submission.

Third Flaw – timing issues

4.30 The third flaw also relates to the aspect of the “solution” which deals with the ability of section 8.16 to allow for new facilities investments to be included in the capital base and therefore allow for a uniform tariff increase. Even were there an ability for section 8.16 to allow for tariffs to be increased or to encourage the expansion of the pipeline, the drafting of the section is such that there are timing issues which prevent the Service Provider from being able to earn a return on the capital expansion costs only until after the tariff has been approved by a Regulator following the approval of a revised access arrangement. The 2nd class citizens’ submission also refers to this problem but suggests certain options which would overcome it. These options do not allay Epic Energy’s concerns for the following reasons:

- (1) While the Code allows a Service Provider to submit a revision to an access arrangement at any time so as to initiate a tariff reset (on the assumption that a tariff reset allowing for an increase in tariffs is possible under the Code and that such tariffs would provide the necessary return on the new investment so as to make it economically feasible for the Service Provider to undertake the expansion) the Code does not allow for the assessment of a revised access arrangement relating to all or any part of a proposed pipeline. This would therefore prevent the assessment of an expansion to part of a pipeline until that expansion has been built and therefore until the expansion capital has been committed by the Service Provider. To further exacerbate the problem, a Service Provider can only begin to earn a return on the expansion capital after the revised access arrangement has been approved by the Regulator. To date the average regulatory approval timetable extends into years rather than the 6 months proposed in the Code. This delay results in a further stranding of the expansion capital for the first few years since it has been committed by the Service Provider.

As already mentioned above, a further problem with the lodgement of a revised access arrangement is that the regulator must review the entire access arrangement. This creates additional uncertainty due to the fact that the existing parameters for the calculation of the total allowable revenue are capable of being altered, not to mention the additional costs that the Service Provider must incur in having the entire access arrangement reviewed.

- (2) Section 8.16(a) of the Code only allows the Service Provide to include that amount of the expansion capital that would be invested by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of delivering Services. As a result, if any part of the expanded capacity is not contracted, the Service Provider runs the risk of not being able to earn a return on any part of the capital to which that capacity relates. This is a real concern given the approach followed by regulators to date in relation to uncontracted capacity. Again this ignores the further risk associated with the tests in section 8.16(b) and the further discretion of the Regulator under section 8.16(b)(ii) even if you get over those hurdles.

4.31 It should also be noted that the second class citizens claim was discussed at the public forum on the draft decision for the DBNGP access arrangement, held on 2 August 2001. At the forum, the following comment was made by one of the Regulator’s consultants, Dr Challen in an attempt to negate the 2nd class citizens’ claim:

“.....if new users are paying more for capacity, that also lifts the value of capacity that is held under existing contracts and which new users may also purchase through trading of capacity between users. So in effect the existing users who now own capacity of greater value face exactly the same opportunity cost for use of that capacity as new users. So in effect, the economic cost of capacity in that pipeline is actually the same for all users of the nominal tariff that they may be paying.”²⁵

- 4.32 Epic Energy contends that this actually exacerbates the second class citizens’ claim rather than solves it. In effect, all it ensures is that should a user of existing capacity not require that capacity, it can be traded, and the price for which it could be traded would be equivalent to the cost of incremental capacity. The argument is based on the assumption that there will be differential tariffs in the first place and only then can there be pricing parity – but only at the higher tariffs. This is hardly an ideal outcome consistent with the objectives of the Code, particularly as it only exacerbates the gulf between the two classes of users as the windfall profit the existing shipper earns in that case will serve to lower its average tariff further.
- 4.33 It is not intended in this paper to deal with the Public Forum comments in detail. This will be dealt with in a subsequent paper.

²⁵ See DBNGP Public Forum Transcript of Proceedings, 2 August 2001, page 17

5. Why Code requires that a finally approved access arrangement must not give rise to the 2nd class citizens' claim

- 5.1 Given that the Code does not enable Epic Energy to increase the reference tariffs to reflect the higher marginal cost of providing any such expanded capacity and the associated returns Epic Energy would require to invest such new capital and that Epic Energy can not be compelled under the Code to carry out expansions at its own cost (including but not limited to situations where it is not economically viable for Epic Energy to expand), there seem to be only three alternatives for the future expansion of the DBNGP:
- (1) the Service Provider reaches an agreement with prospective users of the new additional capacity to pay the differential tariff²⁶, or at least the reference tariff together with a surcharge for the remaining costs and return that can not be recovered from the reference tariffs or the prospective user provides all of the necessary capital to fund the expansion; or
 - (2) if prospective users are not prepared to pay the differential tariff or at least the surcharge or to fund the capital costs of the expansion, then no additional capacity will be constructed on the basis that it is not economic to provide that incremental capacity which has a higher marginal cost; or
 - (3) the Service Provider elects to not treat the expansion as part of the covered pipeline in which case it would be solely a matter for agreement between the parties as to what tariffs are payable.
- 5.2 It is critical for Epic Energy, and Epic Energy submits it is a requirement of the Code that the Regulator ensure that where the capacity of a pipeline needs to be expanded, that any new user of additional capacity does not pay more than incumbent users of existing capacity. This is particularly relevant where the marginal cost of expanding the capacity of the pipeline is higher than the average cost of capacity of the pipeline as it may be configured from time to time.
- 5.3 The Regulator is required by the Code to ensure this occurs because one of the objectives of the Code is to ensure that an access arrangement promotes competition in upstream and downstream markets. If users of the additional capacity are required to pay more for that capacity than what it costs incumbent users of existing capacity, then the users will not be able to compete on a level playing field. This is exacerbated if the user and potential user are competing in the same downstream industry. One must question how such an outcome is consistent with the considerations the regulator must take into account under section 2.24 of the Code when assessing an access arrangement.
- 5.4 The need to ensure that an appropriate framework is implemented which allows for future expansion is of immediate relevance for the DBNGP for a number of reasons:
- The pipeline is currently nearly fully compressed and the majority of the available capacity is already contracted. Therefore the DBNGP will require further expansion to meet any future demand growth.
 - As the pipeline is already fully compressed, any expansion will require looping. Initial looping typically has marginal costs which exceed the average cost of capacity and, when undertaken, increases tariffs that have been determined on an average cost basis.

²⁶ This was the approach favoured by the existing incumbents on the Moomba to Adelaide Pipeline in their submissions, in that new entrants should be required to pay the higher incremental tariffs associated with new capacity to accommodate them. This was despite the barrier to entry such may pose to new entrants.

- The power generation industry is the largest industry sector that is forecast to take up additional gas demand. It follows therefore that it will be the most likely class of prospective users requiring an expansion of the pipeline. However, given that fuel costs form a significant proportion of the overall operating costs of power generators, any increase in fuel costs over and above what other competitors in that industry have to pay will give rise to an unlevel playing field in that industry, and result in a disincentive to competition in that industry.
- 5.5 Furthermore, the introduction also states that it is the aim of the Code “to provide sufficient prescription so as to reduce substantially the number of likely arbitrations, while at the same time incorporating enough flexibility for the parties to negotiate contracts within an appropriate framework.” A rolled in tariff structure as proposed by Epic Energy ensures that any prospective user seeking additional capacity will be aware of the tariff for a reference service. This further limits the potential for arbitration. The same can not be said if each expansion has to be assessed on a case by case basis (as is proposed by the draft decision).
- 5.5 Therefore if the Code combined with the final access arrangement (if it implements the amendments stated in the draft decision), can not allow reference tariffs to be increased so that all users are paying uniform tariffs for the same service, one must question whether this pipeline should be covered given that it can not satisfy one of the criteria for coverage as stated in section 1.9 of the Code – ie that coverage will significantly promote competition in an upstream or downstream market.

6. Conclusion

- 6.1 Epic Energy's proposed access arrangement was designed to ensure that all the objectives of the Code could be achieved and that there was the most efficient balancing of the interests the regulator must take into account as is required under section 2.24 of the Code.
- 6.2 The Code is required to encourage the further development of the pipeline networks and to promote competition in downstream and upstream markets. However, the Code can not compel a Service Provider to fund further expansions of a pipeline especially where it is not economically feasible to do so. The ranges of the parameters that the regulator has allowed for the total revenue calculations to date do not make it economically feasible to fund an expansion. Furthermore, the Code does not allow for a rolled in tariff where the cost of any incremental capacity is higher than the cost of existing capacity. The DBNGP is almost fully contracted and therefore additional capacity will be required for any future growth in demand. However, the cost of that next capacity tranche will be at a greater marginal cost than the cost of the existing capacity. Therefore, unless the tariff path is structured from the commencement to accommodate future expansions (as is the case for Epic Energy's proposed access arrangement) a differential tariff structure will have to be implemented. As demonstrated in this paper, one must consider how such an outcome will satisfy the requirements of section 2.24 of the Code.