



DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

Submission 4: The Regulatory Compact 12 May 2000 PUBLIC VERSION

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Note

A complete version of this submission has been filed with the Regulator at the same time. That version of the Submission contains information which is presently likely to be subject to confidentiality obligations to third parties. That information has been deleted from this version of the Submission. The information deleted pertains to dealings between the Gas Pipeline Sale Steering Committee and Epic Energy prior to the lodgement of Final Bids and goes to the content of what was lodged by Epic Energy.

1. Introduction

- 1.1 On 20 April 2000, the Office of Gas Access Regulation ("OffGAR") released a further four submissions in respect of the proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline (the "DBNGP") lodged, by Epic Energy, on 15 December 1999. In a notice accompanying the release, the Western Australian Independent Gas Access Regulator (the "Regulator") advised that he would open a further period during which submissions might be made to him concerning the proposed Access Arrangement and, in particular, matters raised in the four submissions.
- 1.2 One of the four submissions released by OffGAR was a submission from Epic Energy ("Epic Submission 1"), which among other things, described in some detail the process of the sale through which it acquired the DBNGP from the State of Western Australia. The version of that submission released by OffGAR is a modified version of the submission lodged with the Access Arrangement on 15 December 1999, which has not been released by OffGAR. The modifications are the deletion of certain information covered by confidentiality obligations. The submission sets out Epic Energy's arguments as to why the Regulator should consider, in his assessment of the proposed Access Arrangement, the way in which the DBNGP sale process was structured and executed. This has been added to by a third submission ("Epic Submission 3") which was lodged with the Regulator on 17 March 2000 and has only recently been made public.
- 1.3 Two of the other submissions were from AlintaGas, the Government's agent in the sale process, and the third was a joint submission from State Treasury and the Office of Energy. These three submissions tend to cover the majority of the points raised by other interested parties in submissions filed with the Regulator. Therefore by commenting on them Epic Energy believes it will be able to also cover most of the points raised in the other submissions. Where they have not been covered by Epic Submission 3, Epic Energy will endeavour to cover them in other submissions.
- 1.4 Epic Energy's further comments are made in six separate submissions, each dealing with a particular set of issues. Those submissions are:
 - 4 regulatory compact;
 - 5 capital base, depreciation and WACC;
 - 6 the reference service and other services;
 - 7 the reference tariff and incentive mechanism;
 - 8 the offer of a T1 Service; and
 - 9 gaining access to the DBNGP.

2. The regulatory compact

- 2.1 In Epic Submission 1 and Epic Submission 3, Epic Energy has used the term “regulatory compact” to describe the common understandings and expectations that developed between prospective purchasers of the DBNGP and the Government of Western Australia during the pipeline sale process. These common understandings and expectations were understandings and expectations about the gas market in the State, about the pipeline sale process, and about the way in which the DBNGP would operate after sale. They were not, as Epic Energy has stated in those submissions to the Regulator, the subject of formal agreements, although some aspects of them were subsequently recorded in the DBNGP Asset Sale Agreement.
- 2.2 The common understandings and expectations of the regulatory compact and, in particular, the common understandings and expectations concerning gas transmission tariffs and the path of future tariffs, were important for the bids Epic Energy made for the DBNGP. Epic Energy believes they were also important in the Government’s decision to accept its Epic Energy’s Final Bid as reflected in the Asset Sale Agreement for the DBNGP in preference to any alternatives provided by Epic Energy and the bids for the pipeline submitted by the other prospective purchasers.

3. Issues raised in submissions to the Regulator

- 3.1 The existence of the regulatory compact has been questioned in submissions made to the Regulator by AlintaGas, and by the Treasury and the Office of Energy.
- 3.2 In its Second Submission, AlintaGas noted:

“Contrary to certain claims made by Epic Energy recently, to AlintaGas’s knowledge (having been intimately involved in the DBNGP sale process) there was no “regulatory compact” or similar between Epic Energy and either the State or AlintaGas arising out of the DBNGP Asset Sale Agreement, the negotiations leading to the execution of that Agreement, or the bidding process which preceded those negotiations.”¹

- 3.3 The linkage between the initial capital base of the DBNGP Access Arrangement and the regulatory compact is examined in AlintaGas’s Third Submission:

“Epic energy does not explain why it considers the competitive bidding process to be relevant in determining the initial Capital Base. AlintaGas can identify two possible reasons, neither of which is tenable, as discussed below:

- (i) *Epic Energy may be suggesting that the competitive sale of the DBNGP was one of the factors giving rise to Epic Energy’s claimed “regulatory compact”, and presumably further that it is a term of that purported compact that the purchase price will form the initial Capital Base. This alternative is easily discarded.*

AlintaGas has indicated previously to the Regulator that there was and is no “regulatory compact” or other agreement between any Epic Energy entity

¹ AlintaGas’s Second Submission to Regulator on Epic Energy’s DBNGP Access Arrangement, 7.

and AlintaGas or, to the best of AlintaGas's knowledge, the State, dealing with tariffs or tariff setting methodologies.

Even if there was a "regulatory compact", any such compact could not be binding on the Regulator. The claim that AlintaGas or the State entered into such a compact and by doing so purported to limit the statutory discretion of the Regulator is absurd.¹²

3.4 Epic Energy notes that until the release by OffGAR of Epic Submission 1 recently, AlintaGas would not have seen the arguments put by Epic Energy in that submission as until that time it had only been seen by the Minister for Energy, Office of Energy and the Regulator. Epic Energy accepts therefore that the above statements by AlintaGas were made without understanding what was meant by a "regulatory compact".

3.5 The Treasury/Office of Energy submission to the Regulator also makes the statement that there was no "agreement", other than the DBNGP Asset Sale Agreement, which placed obligations on Epic Energy in respect of gas transmission tariffs and the tariff path:

"In the sale process there was no other agreement between the vendor and the bidder, and no other obligation placed on the bidder by the vendor, or the State, in respect of tariff rates for gas transmission or a tariff path for third party use of the DBNGP. The sole right of the vendor with respect of the proposed tariff rates and path indicated to it by the bidder is to have discretion to disclose to the Regulator those tariff rates and path as being those proposed by the bidder at the time of the sale. The effect of such disclosure continues to be viewed by the State, as providing an indication of the maximum tariff rates for gas transmission, which the bidder might be able to sustain in a regulatory process conducted by an independent Regulator. Nothing in that Agreement is viewed by the State as creating a binding obligation on the Regulator or any form of regulatory compact between the State and Epic Energy in relation to tariffs for third party use of the DBNGP."

3.6 The key points being raised by AlintaGas are, in Epic Energy's view:

- there was no regulatory compact;
- because there was no regulatory compact, Epic Energy's use of the price it paid for the DBNGP as its initial capital base for the pipeline cannot be justified in terms of it being a term of a purported compact;
- there is no compact or agreement as to tariffs or tariff setting methodologies; and
- even if there were a regulatory compact, it could not be binding on the Regulator.

3.7 The Treasury/Office of Energy submission reiterates the first of the points made by AlintaGas, and reinforces AlintaGas's the fourth point. The submission appears, to Epic Energy, to assert:

- there was no agreement (other than the DBNGP Asset Sale Agreement) between the vendor and the bidder, and no other obligation placed on the bidder by the vendor, or the State, in respect of gas transmission tariffs and the tariff path;

¹² AlintaGas's Third Submission to Regulator on Epic Energy's DBNGP Access Arrangement, 12-13.

- the tariffs and the tariff path set out by the bidders in Schedule 39 of their bids (Schedule 39 of the Asset Sale Agreement in Epic Energy's case) were the maximum tariffs that the purchaser would be entitled to;
- the Asset Sale Agreement did not create any binding obligation on the Regulator.

4. Epic Energy's comment on issues raised in the submissions

- 4.1 Epic Energy totally rejects the view that there was no regulatory compact.
- 4.2 Without the common understandings and expectations that formed the regulatory compact, the sale of the DBNGP could not have proceeded.
- 4.3 The form of the regulatory compact was clearly established in Epic Energy's confidential submission lodged with the Regulator on 15 December 1999 (the full version of Epic Submission 1) ("Epic First Submission"). Key aspects of the position advanced in that submission are restated in Epic Submission 1 and supported by further argument contained in Epic Submission 3.
- 4.4 The position put by the Office of Energy/Treasury is even more unsustainable when other events, not previously disclosed to the Regulator are taken into account. In the lead up to lodgement of Final Bids, a number of meetings were held between bidders and the Gas Pipeline Sale Steering Committee ("GPSSC"). The GPSSC was the body charged with selling the DBNGP and essentially AlintaGas took a back seat and did as directed by the GPSSC.³ The GPSSC comprised the then CEO of the Department of Resources Development, Dr Des Kelly, the Under Treasurer, Mr John Langalount, and the Coordinator of Energy, Dr Les Farrant. The GPSSC was supported by an Executive Director, Mr Graham Baker, and various advisers. [This information has been deleted. See Note at commencement of Submission.]
- 4.5 [This information has been deleted. See Note at commencement of Submission.]
- 4.6 [This information has been deleted. See Note at commencement of Submission.]
- 4.7 Given the above it is not surprising that Epic Energy went forward with the acquisition of the DBNGP on the very strong basis that the tariffs and tariff path indicated in Schedule 39 of the Asset Sale Agreement would apply from 1 January 2000. It was clear that the Minister accepted that as represented by statements in the media at the time. For example, in the Australian Financial Review of 6 March 1998 there was the following report:

"West Australian Resources Minister Mr Colin Barnett has assured customers throughout the State of competitive gas pricing in the future despite the \$2.4 billion paid this week by US-based Epic Energy for the Dampier-to-Bunbury natural gas pipeline.

He said while the pipeline sale agreement foreshadowed a price drop of 20 per cent – from \$1.19 to \$1.00 per gigajoule – by the year 2000, beyond that time any increases were required to be less than the CPI.

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³ This position was reinforced by section 6(3) of the *Dampier to Bunbury Pipeline Act 1997* and the direction to AlintaGas regarding the GPSSC under that provision given by the Minister.

But he said real competition in the gas industry would come from more producers and consumers using the existing pipeline, with Epic committed to doubling its size by spending \$857 million over the next nine years.”⁴

4.8 Epic Energy notes that the Government of Western Australia continues to refer to the common understandings and expectations of the regulatory compact

4.9 In answer to a question from Mr Ripper on 14 March 2000 the Minister for Energy said:

“I can explain the broad background to the sale and what occurred. The bidders, including Epic Energy, were asked to bid on a number of features. One obvious one and the most important component was price; a second related to service standards and the like; a third related to the price, not only what they would pay for it but the cost of the transport of gas; a fourth related to commitments to expanding pipeline capacity. Therefore the price paid for the pipeline was by far the most important criteria. However, there were three other components: The first was the bid of \$2 407m; the second was a commitment to spend some \$875m on effectively expanding and duplicating the pipeline capacity over an eight-year period; and the third related to the transport tariff. At the time of the sale, the cost of transporting gas was \$1.19 per gigajoule to the south west. Under the bid put in by Epic, the price would fall from \$1.19 to \$1.10 to \$1, and that has happened; in other words, the bid was composed of price, top dollar, an expansion commitment on investment and a 20 per cent reduction in tariff. Yes, it is true that we could have traded off. We could have gone back to Epic and said that we would take a lower price for the State in exchange for giving transporters of gas a lower tariff.”⁵

“We made the judgment that a high price for taxpayers and the community of Western Australia was the first and most important component. If at the same time we doubled the pipeline capacity and delivered a 20 per cent cut in transport tariffs, it was a very good deal.”⁶

“The tariff schedule put in by Epic included a proposal that the price of gas would fall from \$1.20 to \$1.10 to \$1. That was a schedule that was generally put forward by government to all bidders as an expectation. That was the broad understanding.”⁷

4.10 Epic Energy has never claimed that the regulatory compact was more than a set of common understandings and expectations. Epic Energy has not asserted, in the DBNGP Access Arrangement, in the Access Arrangement Information, or in any of the other documents it has submitted to the Regulator, that the regulatory compact was, in any sense, an agreement legally binding on the parties. Epic Energy is in agreement with the view expressed by the Treasury and the Office of Energy that there was no agreement, other than the DBNGP Asset Sale Agreement in respect of gas transmission tariffs and the tariff path. However, it does find surprising given the above and what was put in the Epic First Submission that the Treasury and Office of Energy Submission takes such a narrow and legalistic line which simply does not reflect the reality of the time, as recently acknowledged by the Minister himself. It is clear that the Minister himself did not consider

⁴ “Gas price is right despite pipeline sale” Australian Financial Review, 6 March 1998.

⁵ Hansard, 14 March 2000, page 4963, question no. 543.

⁶ Hansard, 14 March 2000, page 4963, question no. 543.

⁷ Hansard, 16 March 2000, page 5198, question no. 575.

Schedule 39 of the Asset Sale Agreement as “providing an indication of the maximum tariff rates for gas transmission”.

- 4.11 Furthermore, Epic Energy has not sought to justify its initial capital base for the DBNGP in terms of the initial capital base being a term of the regulatory compact. In this respect it is important to note the analysis carried out by The Brattle Group in its report annexed to the Epic First Submission.
- 4.12 Nevertheless, Epic Energy has argued, and will continue to argue, that the Regulator should give consideration to the common understandings and expectations, referred to by Epic Energy as the regulatory compact, in assessing the proposed DBNGP Access Arrangement. In particular, the Regulator should give consideration to the regulatory compact in assessing the way in which Epic Energy has established the initial capital base for the pipeline in accordance with section 8.10 of the *National Code for Third Party Access to Natural Gas Pipeline Systems* (the Code). Obligations on the Regulator to do so derive, not from the regulatory compact, but from section 2.24 and section 8 of the Code. Epic Energy acknowledges the view of AlintaGas that the regulatory compact is not binding on the Regulator, and concurs with the view of the Treasury and the Office of Energy that the Asset Sale Agreement did not create any binding obligation on the Regulator. However, then again they could not. This is not an issue of what is binding, but what is appropriate to apply given the circumstances in which Epic Energy acquired the DBNGP and its conduct since in respect of those circumstances.

5. Epic Energy’s position on the regulatory compact restated

- 5.1 The DBNGP was sold through a multi-stage competitive bidding process.
- 5.2 The objectives of the Government of Western Australia in selling the pipeline through this multi-stage competitive process were set out in a letter from its Gas Pipeline Sale Steering Committee covering transmittal of copies of the sale Information Memorandum to Epic Energy. The letter, dated 8 September 1997, advised that the Government was seeking to maximise the proceeds from the sale of the DBNGP within the context of pursuing certain other policy objectives. Those other objectives included reducing gas transmission tariffs.
- 5.3 Statements made by the Minister for Energy during the sale process and subsequently (see above) clearly indicated that the Government was of the view that it could achieve both a high sale price for the DBNGP, and a significant reduction in gas transmission tariffs, and was expecting those tariffs to fall to about \$1.00/GJ.
- 5.4 Through the way in which it structured and executed the sale process, the Government was able to secure a purchase price of \$2.407 billion for the DBNGP. It could have taken a different approach with respect to tariffs and received a lower purchase price. With the money it received, the Government has been able to:
- repay some \$1.8 billion of State debt and significantly reduce the burden of public debt; and
 - fund education, health and infrastructure initiatives without the need for concomitant increases in State debt.
- 5.5 At the time of sale, Epic Energy indicated to the Government that it stood ready to make further investments in the DBNGP as economic development in other sectors of the State’s economy created new demand for gas transmission capacity. At the time, based on the

Government's own forecasts, Epic Energy predicted that investments in pipeline expansion could total \$837 million by 2007. Epic Energy has already commenced delivering on this commitment. It has invested over \$120 million in additional compression plant and looping of the pipeline.

- 5.6 To further support its focus on Western Australia, Epic Energy committed to moving its corporate office to Perth. That move has now been completed [with the collateral benefit of additional jobs based in Perth].
- 5.7 The benefits to the broader community from the reduction in State debt, and from the Government's education, health and infrastructure initiatives have been made possible by Epic Energy's purchase price of \$2.407 billion.
- 5.8 Underpinning both the purchase price and Epic Energy's commitment to expansion was a revenue stream based on reduced gas transmission tariffs and a price path which would cap increases in those tariffs in the future. The expectations of what those tariffs and the tariff path would be were set out in Schedule 39 of the Asset Sale Agreement. They were:
- a tariff of \$1.00/GJ to Kwinana Junction;
 - a tariff of \$1.08/GJ to delivery points downstream of Kwinana Junction; and
 - a tariff path that would see tariffs rise annually by no more than 67% of the increase in CPI.
- 5.9 The Government could have structured and executed the pipeline sale process in a different way. It could have sought to lower gas transmission tariffs by reducing the emphasis it placed on achieving the highest possible sale price (as noted by the Hon Mark Neville in the debate on a Notice of Motion seeking the tabling of the Asset Sale Agreement⁸). Alternatively, it could have sought a higher price by accepting a lower reduction – or even an increase in – gas transmission tariffs.
- 5.10 In the event, the Government chose to structure and execute the DBNGP sale process in a way that delivered the sale price, and the tariffs and tariff path that supported that sale price. In accepting the sale price, and the proposed tariffs and tariff path, the Government secured a particular balance between the interests of users and prospective users of the pipeline, and the wider public interest. It made a strategic decision of the type a government is elected to make on behalf of the community.
- 5.11 It is the value the Government of Western Australia placed on the pipeline that must now be used in establishing the initial capital base for the DBNGP.
- 5.12 Issues arising from the way in which Epic Energy has sought to establish the initial capital base for the DBNGP, and from its using that initial capital base to support the tariffs and the tariff path of the regulatory compact are dealt with in:
- Submission 5: Capital Base, Depreciation and WACC; and

⁸ Hansard, 30 March 2000 at page 5734: "I have said on numerous occasions that the tender should have been let at 70¢, 75¢ and 80¢ or a selection of tariffs to see what bids we received. The pipeline should have been sold on that basis. There is a problem. I get letters and phone calls, and I read letters to the editor telling me that the Government is giving away assets at fire-sale prices. The Dampier to Bunbury pipeline should have been sold or leased for about \$1b, not \$2.4b. If that had been done, we would have locked in low gas prices and jobs in the south west. I have said continually in this House that selling the pipeline for \$2.3b plus \$100m stamp duty was grabbing the money and leaving the problems to be dealt with later."

- Submission 7: Reference Tariff and Incentive Mechanism.

6. Sovereign Risk

- 6.1 The Australian Council for Infrastructure Development Limited, in its submission to the Regulator dated 29 February 2000, raised the issue of sovereign risk. It said:

“Any attempt to subsequently amend aspects of the regime in a manner inconsistent with the terms of the sales process amounts to a unilateral repudiation of the terms of the sale to the detriment of the purchaser and ultimately the economy of the jurisdiction. In circumstances where the action is taken by or facilitated by a government which has been the recipient of assets sales proceeds, there are significant implications for the level of perceived sovereign risk within that jurisdiction and the security of assets from state sponsored confiscation.

The implications of such action for Western Australia and indeed for Australia, are significant and will be reflected in the margin implicitly demanded by investors for the sovereign risk of investment in these jurisdictions, which will have negative implications for the cost of funding future development of necessary infrastructure assets.”

- 6.2 Epic Energy is equally concerned about this aspect. In this situation the State clearly acted in a way to maximise the sale price by accepting and setting a particular environment for a tariff to apply to the asset in the future. It is not acceptable for the State or its utilities to now suggest that that should not apply and instead a lower tariff is more appropriate. For this to occur, or even the fact that a lower tariff is regulated, given the environment in which Epic Energy acquired the DBNGP and its reasonable expectations as to the tariff that would apply, has serious implications for investors' confidence in the State and the country.