



DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

Submission 7: Reference Tariff and Incentive Mechanism 12 May 2000

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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. Epic Energy's reference tariff and tariff path

- 2.1 Epic Energy has maintained, and continues to maintain, that the gas transmission tariffs, and the path of future tariffs, recorded in Schedule 39 of the DBNGP Asset Sale Agreement, were key elements of the common understandings and expectations between Epic Energy and the Government of Western Australia that developed during the pipeline sale process.¹ Epic Energy has referred to these common understandings and expectations as a regulatory compact. The form of the regulatory compact was established in the Epic First Submission and in Epic Submission 1. That has been added to by Epic Submission 3 and Epic Submission 4.

¹ Schedule 39 has now been released by AlintaGas, as Appendix 2 to its *Second Submission to Regulator on Epic Energy's DBNGP Access Arrangement*.

- 2.2 For the Government, the tariffs and the tariff path of Schedule 39 were critical policy outcomes from the sale of the DBNGP. Not only were gas transmission tariffs lowered to a level consistent with the Government's expectations. The tariffs and the tariff path supported a purchase price for the pipeline that allowed the Government to deliver benefits to the broader community through debt reduction, and through education, health and infrastructure initiatives, funded from the proceeds of pipeline sale.
- 2.3 Schedule 39 of the Asset Sale Agreement sets out a number of tariff setting principles. These included:
- the capital recovery mechanism will be structured such that it is consistent with the efficient growth of the markets over the economic life of the assets;
 - the tariff structure includes zonal tariffs reflecting the cost of providing service;
 - from 1 January 2000, the tariff path is based on escalation at a percent of CPI.
- 2.4 The forward haul firm service tariff of Schedule 39 was to comprise three separate charges all of which were to be zone-distance based:
- pipeline capacity charge (MDQ) based;
 - compression charge (MDQ based); and
 - pipeline commodity charge (throughput based).
- 2.5 The proposed standard forward haul firm tariff was to be \$1.00/GJ on a combined basis (at 100% load factor) based on a receipt point upstream of the inlet side of CS1 and a delivery point at Kwinana Junction.
- 2.6 Yearly tariff increases were to be limited to 2/3 (67%) of annual inflation (as measured by the increase in the Consumer Price Index).
- 2.7 Nominal, cost reflective operating and maintenance charges were to apply in respect of shipper facilities including laterals and metering stations. Capital would be contributed if required and shippers would be charged for capital recovery for installed shipper facilities.

3. Issues raised in submissions to the Regulator

3.1 Reasonable expectations of users

- 3.1.1 Many of the submissions to the Regulator have questioned the reasonableness of the reference tariff proposed in the Access Arrangement for the DBNGP. As mentioned in Epic Submission 8, interested parties have been in the unfortunate position of having made their submissions without the opportunity of reading the Epic Submissions and hence understand how Epic Energy derived the tariffs and tariff path.
- 3.1.2 In its *Third Submission to Regulator on the DBNGP Access Arrangement*, AlintaGas notes that the section 8.10(f) of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the "Code") requires the Regulator to consider, when establishing the initial capital base for an existing pipeline, the basis on which tariffs have been (or appear to have been) set in the past. Furthermore, they say that section 8.10(g) requires that the Regulator consider the reasonable expectations of persons under the regulatory regime that applied to the pipeline prior to the commencement of the Code. AlintaGas has stated that a depreciated actual cost method was the basis for setting DBNGP tariffs in the past,

and that current expectations are for full haul tariff of \$1.00/GJ as has been indicated by the Minister for Energy. AlintaGas noted that:

"Under the Dampier to Bunbury Pipeline Regulations 1998, [the 1998 tariff of \$1.19/GJ] was further reduced in 1999 to \$1.09 per GJ in 1999 and to \$1.00 per GJ in 2000,"²

and maintains:

"... the Regulator can form a view that existing users, including AlintaGas, reasonably expect a T1-equivalent postage stamp service tariff of no more than \$1.00 per GJ under the National Access Code."³

3.1.3 North West Shelf Gas has noted that:

"During the sale of the DBNGP, statements were made that "firm full haul (Dampier to Bunbury) tariff at 100 percent load factor will fall from A\$1.19 per GJ to A\$1.00 per GJ by the year 2000. . . .

One could contend that it was the Government's intention that the A\$1.00 per GJ tariff should be applied to all full haul customers including those south of the Perth Metropolitan region. Indeed, the recently promulgated regulations for the period between 1 January 2000 and the start date of the new DBNGP AA have been set by the Minister at A\$1.00 per GJ full haul ie including Zone 10. To allow an 8% increase as a result of the AA would seem retrograde and unfair."⁴

3.1.4 In its submission, Worsley Alumina advised:

"Worsley had "reasonable expectations" with respect to pipeline tariff from the Minister for Energy's second reading speech in connection with the 'Gas Pipelines (Western Australia) Act' in which he stated that "Firm full haul tariff at 100per cent load factor will fall from \$1.19 per gigajoule to \$1.00 per gigajoule by the year 2000".

Worsley's expected pipeline charge at 1/1/2000 was \$1/Gj of which more than 70% would be fixed and less than 30% escalated at CPI. Worsley anticipated that it would not pay any more than this under an approved regime."⁵

3.1.5 Epic Energy acknowledges the Code requirements for the Regulator's consideration of the basis on which tariffs have been set in the past, and of the reasonable expectations of persons under a previous regulatory regime. Those requirements were, in effect, pursued through the DBNGP sale process by the Government having as an explicit objective, the lowering of gas transmission tariffs.

3.1.6 However, Epic Energy questions the degree to which it must be bound by such expectations which have been formed and in one case the reasonableness of them. An examination of public statements indicates that, during 1997 and the DBNGP sale process, the Government was signalling, to both shippers and potential purchasers of the pipeline, that it was expecting a tariff of **about** \$1.00 per GJ. A number of these statements are set out in Epic Submission 1. The future tariff was never precisely stated. There is no

² AlintaGas Third Submission, p26.

³ AlintaGas Third Submission, p26.

⁴ North West Shelf Gas Submission, p8.

⁵ Worsley's Submission, p6-7.

indication from those public statements that the Government was signalling anything as precise as a "T1-equivalent postage stamp service tariff of no more than \$1.00 per GJ". Epic Energy would question the reasonableness of forming a precise expectation about such a commercially significant matter as the level of a tariff on the basis of such public statements by members of the Government.

- 3.1.7 The Government's view on tariffs crystallised with the signing of the DBNGP Asset Sale Agreement. Schedule 39 indicated a tariff of \$1.00 per GJ for gas transportation from Zone 1 (the production/gathering zone) to Zone 9 (the Perth metropolitan area), and a tariff of about \$1.08/GJ from Zone 1 to Zone 10 (downstream of Kwinana Junction). Epic Energy questions, in these circumstances, the reasonableness of AlintaGas's claim to having formed the expectations referred to in paragraph 3.1.2 above. AlintaGas was the sole party that signed the Asset Sale Agreement as Vendor. It was clearly in possession of the Asset Sale Agreement and it itself has released Schedule 39 which sets out those tariffs. Clearly it has known what Epic Energy expected since at least March 1998.
- 3.1.8 Epic Energy totally rejects any implication in the arguments advanced by AlintaGas, and North West Shelf Gas, that the reasonableness of \$1.00 per GJ can be inferred from the \$1.00 per GJ currently applicable under the *Dampier to Bunbury Pipeline Regulations 1998*. In fact, no such tariff appears in those regulations. The \$1.00 per GJ was promulgated at 3.45pm on 31 December 1999 by the Government using the powers under the *Gas Pipelines Access (West Australia) Act 1998* to amend the "repealed access regime". That tariff was set against Epic Energy's opposition and without its agreement or any consideration being given to Epic Energy's business position. Epic Energy continues to maintain that in doing that, the State has acted contrary to its expectations and understandings. It is noted that the main recipients of the benefit of such lowering of the tariff are the Government's own two utilities, AlintaGas and Western Power.

3.2 A tariff of about \$0.84 per GJ is not appropriate

- 3.2.1 AlintaGas, in its *Third Submission*, puts forward its "estimate" of a full-haul firm tariff for a T1 service provided on the DBNGP, and submits that its tariff is sufficiently acceptable to provide a useful guide to the T1 service tariff and as such should be given due consideration.
- 3.2.2 That tariff, a purported tariff for a service only available under an access regime that will soon be withdrawn, may be acceptable to AlintaGas. It is certainly **not** acceptable to Epic Energy. AlintaGas's proposed tariff is without foundation.
- 3.2.3 AlintaGas proposes an initial capital base of \$1.0 billion and the application of a real pre-tax WACC of between 5.6 per cent and 6.5 per cent. No explanation is given for the choice of these key inputs to tariff setting. They appear to have been arbitrarily chosen to produce a "tariff" that is acceptable to AlintaGas. The essentially arbitrary nature of the inputs into the AlintaGas "tariff calculation" is clear from the range of values proposed for the WACC. In the Access Arrangement for its distribution system, AlintaGas sought a real pre-tax WACC of 8.0 per cent. AlintaGas has now indicated that it will comply with the Regulator's requirement, in his recent draft decision, to amend this to 7.9 per cent. AlintaGas considers a WACC close to 8.0 per cent to be appropriate in its own pipeline business. However, it considers a WACC below 6.5 per cent to be appropriate for the DBNGP.
- 3.2.4 AlintaGas's proposal for a "tariff" of \$0.84 per GJ is little more than self-serving exercise which deflects attention from the real issues that must be addressed in assessing the

Access Arrangement for the DBNGP, and its proposed reference tariff. It should not be given credence by the Regulator.

3.3 Other reference tariff issues have been dealt with in Epic Submission 3

3.3.1 A number of the submissions to the Regulator have raised issues about the structure and level of the proposed DBNGP reference tariff. These issues included:

- the proposed reference tariff is high relative to the current tariff;
- a much larger proportion of the proposed reference tariff does not vary with pipeline throughput;
- Pilbara charges are higher than the distance related charges of the GTR and transitional access regimes;
- the use of pricing zones does not produce an equitable result across all users; and
- the level of the proposed reference tariff makes gas less competitive to industry in the South West of the State.

3.3.2 Epic Energy has addressed these issues in Epic Submission 3.

3.4 Surcharges

3.4.1 Schedule 1 to the proposed Access Contract Terms and Conditions for the DBNGP sets charge rates for:

- failure to comply with an unavailability notice (unavailability surcharge);
- nominations variances arising when Epic Energy has ascertained that a shipper has not nominated in good faith (nominations surcharge);
- a shipper exceeding its shipper's imbalance limit (excess imbalance charge);
- gas which does not comply with a relevant specification (out of specification gas charge);
- a shipper exceeding its MHQ (peaking surcharge)

3.4.2 A number of the submissions to the Regulator have asserted that these surcharges are unreasonable, but have not provided reasons for their assertions.

3.4.3 North West Shelf Gas notes that:

*"The AA proposes a wide range of penalty charges all based on A\$15.00 per GJ. There is a concern that these are thinly disguised revenue raisers. Many of the proposed penalty charges appear unavoidable and at this very high level are unreasonable. Penalty charges should not be used as a source of punitive or extraordinary damages."*⁶

3.4.4 The legality of the penalty element in the charges has been questioned by AlintaGas:

⁶ North West Shelf Gas Submission, p12.

“ . . . AlintaGas considers that the proposed “rates and charges” are unlawful and unenforceable penalties which should not be approved for inclusion in an access contract.”⁷

- 3.4.5 While Epic Energy notes statements by the Regulator in the draft decision on the Parmelia Pipeline Access Arrangement [and on the AlintaGas Distribution system Access Arrangement] regarding the quantum of the surcharges, Epic Energy does not believe that the amount of \$15/GJ is out of the ordinary. While rates have tended to be around the 350% mark in Australia, penalty rates for systems in USA tend to be much higher and it is not unusual to find penalty rates, proportionally, in the order proposed in the Access Arrangement.
- 3.4.6 The imposition of surcharges in the situations proposed in the Access Arrangement are directed at correcting behavioural attitudes to ensure all users of the system get the maximum benefit available. It is not an issue of cost recovery as appears to have been accepted by the Regulator in the draft decision for the Parmelia Pipeline Access Arrangement. Generally the matters addressed by such surcharges are to deal with breaches Epic Energy can only become aware of after they have occurred and is not able to take preventative action. That aspect coupled with the general reluctance amongst pipeline operators to shut of gas supply to a breaching shipper, dictates the importance and need for higher amounts to deter unsatisfactory behaviour.
- 3.4.7 It is not and never has been Epic Energy’s intention to use surcharges as a revenue raiser. No amounts are allowed for surcharges in any of Epic Energy’s forecasts. They do not relate to the provision of a service and are not expected to be received, as Epic Energy would expect the shippers to honour their contracts.
- 3.4.8 Be that as it may, it may be in order to remove the perception that the charges are for the purpose, the Regulator may consider requiring any revenue received from the imposition of such surcharges to be treated as Rebateable Revenue. The Access Arrangement provides a mechanism for dealing with Rebateable Revenue. However, Epic Energy would expect that if such were required, the Distributable Revenue arising from that Rebateable Revenue should not be distributed back to the shipper paying the surcharge. That would therefore require a slightly different treatment of Surcharge Rebateable Revenue, leading to a discounting of the shipper's proportion by the amount of surcharges paid during the relevant period.
- 3.4.9 The questions raised about the legality of charging the surcharge have not been detailed. In order to avoid any legal issues the Regulator may consider requiring the Access Arrangement to be modified so that the shipper is obliged to use its best endeavours to not exceed the relevant requirement and that the shipper has a right to exceed that requirement, but if it does a surcharge will be payable.

4. Incentive mechanism

- 4.1 The Access Arrangement for the DBNGP includes two mechanisms which provide Epic Energy with incentives to further reduce its costs and increase pipeline throughput. These are the tariff path and the rebate mechanism.
- 4.2 In a number of the submissions, the Regulator’s attention has be drawn to the fact that, in contrast to the price path for the tariff proposed under the DBNGP Access Arrangement,

⁷ AlintaGas Third Submission, p30.

the current T1 service capacity charge does not escalate, although the compressor fuel component of the commodity charge escalates at the rate of change in the cost of compressor fuel, and the remainder of the commodity charge escalates at 75% of CPI.

- 4.3 The tariff path proposed in the DBNGP Access Arrangement was derived from comprehensive modelling to support Epic Energy's final bid for the pipeline and the tariffs it proposed (those are now recorded in Schedule 39 of the Asset Sale Agreement). Epic Energy notes that, prior to the DBNGP sale, the Government's expert adviser on regulatory and tariff matters also carried out comprehensive modelling studies in respect to possible gas future transportation tariffs and possible tariff paths. Epic Energy has been advised that no financial analysis was undertaken to support the "tariff path" for the current T1 tariff. That "tariff path" was arbitrarily imposed. It was arbitrarily imposed in a process that was dominated by those who were to become future third party users of the pipeline. It cannot be taken as a benchmark against which the tariff path proposed in the DBNGP Access Arrangement can be compared.
- 4.4 In their joint submission to the Regulator, the Treasury and the Office of Energy comment that subsection 2.6 of the Access Arrangement Information may be taken to imply that the benefits of increased demand plus higher profits will be shared with users in subsequent access arrangement periods. They continue:

*"However, under the general thrust of the Access Arrangement, including the concept of the deferred recovery account, and the "predetermined tariff path", it is more likely that those profits will be used to reduce the deferred recovery account."*⁸

- 4.5 Indeed, this accurately reflects the way in which the deferred recovery account operates in conjunction with the tariff path. Epic Energy accepts the need to ensure that these matters are clearly set out in the Access Arrangement Information.
- 4.6 Epic Energy noted in its Access Arrangement Information that the "% of CPI" tariff path proposed for the DBNGP (the tariff path of Schedule 39 of the Asset Sale Agreement) places a somewhat tighter constraint on future tariffs than a CPI – X price path. This has been questioned by the Treasury and the Office of Energy in their joint submission. In Epic Energy's view, there is no issue here. In the Access Arrangement Information, Epic Energy was doing no more than indicating that the 67% of CPI tariff path taken from Schedule 39 imposed a somewhat tighter constraint on prices than a CPI – X tariff path with X determined from Epic Energy's current cost estimates. Epic Energy was not in any way asserting that a "% of CPI" price cap is, in general, superior to a CPI – X price cap. When determined from the same data, the two are likely to produce very similar paths for future tariffs, and will have the same incentive properties.
- 4.7 A number of issues on the mechanism proposed for the distribution of rebateable revenue have been raised in the submissions to the Regulator. Worsley Alumina, for example, has argued that:

"Worsley can find no basis on which 40% of the rebate can be applied to the deferred recovery account."

Worsley contends that the net revenue from rebateable services, less an appropriate proportion as an incentive for Epic, be rebated to shippers."

⁸ Treasury and Office of Energy Submission, p10.

Worsley requests the Regulator to investigate what is an appropriate incentive.”⁹

- 4.8 In the context of the distribution of rebateable revenue, the Treasury and the Office of Energy note that:

“Under section 7.3(f) of the proposed Access Arrangement the deferred recovery account balance at the end of each year is the deferred recovery account balance at the beginning of each year less the depreciation of the deferred recovery account balance for that year, plus 40% of the distributed rebateable revenue as described in the Method.”¹⁰

- 4.9 The Treasury and the Office of Energy question whether the relevant part of the distributed rebateable revenue should be added or subtracted from the deferred recovery account balance.
- 4.10 Epic Energy has adopted the concept of rebateable services from the Code as a means of identifying and pursuing ways in which the DBNGP assets might be more intensively utilised to meet the requirements of shippers. Epic Energy believes it should be able to benefit from its efforts in this respect, and has proposed a rebate mechanism that passes only 45 per cent of distributed revenue back to rebate sharing shippers (essentially users of the firm service). Epic Energy retains 15 per cent of the distributed revenue, and the balance is to reduce any deferred recovery account balance and the Access Arrangement needs to be amended to reflect that. The Treasury and the Office of Energy are correct in their view that the relevant part of the distributed revenue should be subtracted from (and not added to) the deferred recovery account balance. Epic Energy acknowledges that there is a degree of arbitrariness in establishing the incentive component of the rebate mechanism, and has been guided by mechanisms proposed in other access arrangements. There are, however, few precedents in this area.

⁹ Worsley's Submission, p9.

¹⁰ Treasury and Office of Energy Submission, p13.