DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT SUBMISSION UNDER THE NATIONAL ACCESS CODE

Submission Public Version
(Confidential Information Deleted)
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Submission to the Western Australian Independent Gas Access Regulator

NOTE
A submission was filed with the Regulator at the time of filing the proposed Access Arrangement for the DBNGP on 15 December 1999. That Submission contains information which is the subject of separate confidentiality obligations to the State and AlintaGas, on the one hand, and Alcoa of Australia Limited, on the other. In the case of the first confidentiality obligation the State has indicated it is not prepared to consent to the public release of information covered by that obligation. AlintaGas has not been approached for its consent, as with AlintaGas' recent publication of information covered by such confidentiality obligation, Epic Energy believes their consent is no longer required. In the case of the second confidentiality obligation, Alcoa of Australia Limited has not yet been approached for its consent to the public release of information covered by that obligation.

This version of the Submission has therefore been prepared to remove references to information which may be covered by such confidentiality obligations.

1. INTRODUCTION

Under the *Gas Pipelines Access (Western Australia) Act 1998*, Epic Energy must submit an access arrangement for the Dampier to Bunbury Natural Gas Pipeline ("DBNGP") in accordance with the requirements of the *National Third Party Access Code for Natural Gas Pipeline Systems* ("Code").

The Code does not set out a standard position for every pipeline. It is structured in a way that requires consideration of the specific circumstances of each pipeline for which an access arrangement is submitted.

Epic Energy's circumstances in respect of the DBNGP are very different from those of other pipelines that have been, are being and will be looked at by Regulators. Epic Energy acquired the DBNGP through a process structured and executed by the Government of Western Australia to achieve certain public policy outcomes. These policy outcomes, and the way in which the Government sought to achieve them, must now be recognised in the Access Arrangement Epic Energy has submitted for the DBNGP.

Recognition of the Government's policy outcomes, and of the way in which they were achieved, and how those policy outcomes fit with the Code are discussed in this Submission.

In reviewing Epic Energy's Access Arrangement for the DBNGP the Regulator is required by section 2.24 to take into account:

- Epic Energy's business position and investment in the DBNGP;
- certain firm and binding obligations on Epic Energy arising at the time of its acquisition of the DBNGP;
- the public interest in the DBNGP; and
- the interests of users and prospective users of the pipeline.

To proceed in any other way would be inconsistent with the obligations the Code places on the Regulator.

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 the risk future investment in pipeline capacity required to support economic development in Western Australia.

This Submission notes Code requirements for an access arrangement, and Epic Energy's compliance with these requirements. In complying with the Code, Epic Energy has sought to honour commitments it made to the Government of Western Australia at the time of its purchase of the DBNGP. Through its securing these commitments from Epic Energy, the Government was able to achieve the public policy outcomes it sought from pipeline sale. The Submission therefore examines in some detail, the DBNGP sale process, the outcomes the Government sought from it, the “regulatory compact” of the Asset Sale Agreement between Epic Energy and the Government, and the implications for the DBNGP Access Arrangement. The regulatory compact of the Asset Sale Agreement delivered a pipeline purchase price of $2.407 billion to the Government of Western Australia. It also secured from Epic Energy a commitment to gas transmission tariffs, applicable from 1 January 2000, of $1.00/GJ for gas deliveries to Perth, and $1.08/GJ for deliveries south of Kwinana Junction. In developing its Access Arrangement for the DBNGP, Epic Energy has sought to maintain tariffs consistent with those tariffs, which are a core element of its regulatory compact with the Government.

2. CODE REQUIREMENTS

Section 3 of the Code requires that an access arrangement include, as a minimum, the following elements:

- a services policy;
- reference tariff policy and reference tariffs;
- terms and conditions;
- a capacity management policy;
- a trading policy;
- a queuing policy;
- an extensions/expansions policy; and
- a revisions submissions date, and revisions commencement date.

Epic Energy has addressed each of these elements in its Access Arrangement for the DBNGP. As required by section 2.6 of the Code, the Access Arrangement Information for the pipeline provides further information to assist shippers and prospective shippers understand the derivation of the elements, and to form an opinion on Code compliance. The Access Arrangement Information includes, in accordance with section 2.7, information in each of the categories of Schedule A to Code

In complying with the Code requirements for an access arrangement, Epic Energy has advanced a services policy for the DBNGP that is consistent with commitments made to the Government of Western Australia at the time of pipeline sale. Furthermore, it has adopted a reference tariff policy and reference tariffs consistent with the tariffs and tariff path sought by the Government in the DBNGP sale process.

3. DBNGP SALE PROCESS

Epic Energy acquired the DBNGP from the Gas Corporation (trading as AlintaGas) on 25 March 1998.

Although it was the seller of the DBNGP, AlintaGas was formally directed to make the sale, by the Minister for Energy, in accordance with section 6(2) of the *Dampier to Bunbury Pipeline Act 1997*. AlintaGas did not manage or control the process of the pipeline sale.

The legislation that enabled the sale to occur – the *Dampier to Bunbury Pipeline Act 1997* – was developed by the Government. The Government established the Gas Pipeline Sale Steering Committee ("GPSSC") to manage and control the sale process. The GPSSC comprised senior officers within government; it was not an AlintaGas committee. Although AlintaGas was the initial recipient of the sale proceeds, it was directed by the Minister for Energy to disburse the net proceeds (after retirement of DBNGP debt) to the Government.

The legal entity that sold the DBNGP was AlintaGas, but the method by which the pipeline was sold, and the final terms and conditions on which it was acquired by Epic Energy, were determined by the Government of Western Australia through the GPSSC.

The DBNGP was sold through a multi-stage competitive bidding process. The number of bidders was progressively reduced through the stages.

The Government's objectives in selling the pipeline through this multi-stage competitive process were set out in the GPSCC's letter 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. These other objectives were:

- enhancing the operating efficiency and utilisation of the pipeline;
- reducing gas transmission prices;
- reducing future demands on State capital;
- reducing the State's exposure to the business risks of the DBNGP;
- minimising the impact of the sale on the workforce of AlintaGas' transmission division; and
- reducing the potential for conflicts of interest which might potentially compromise the efficient operation of the DBNGP and the operation of a competitive gas market in the State.

The same letter also set out the form of the sale process. The process was to comprise the following three stages:

- Phase I: interested parties to register interest;

- Phase II: submission of non-binding bids; and
- Phase III: due diligence and submission of final bids.

A complying non-binding bid submitted during Phase II was to indicate, among other things:

- the price offered for the DBNGP;
- the estimated path of tariffs for the next 10 years and the principal assumptions underlying those tariffs;
- the assumed growth in demand for gas transportation capacity in the DBNGP over the next 10 years; and
- pipeline expansion plans indicating a readiness to support economic development in the State.

In evaluating the non-binding bids, and in determining the parties to be invited to participate in Phase III, the Government indicated that it would consider the bid price and the bidder's ability to best meet the other objectives set for the sale process.

Among these other objectives, a reduction in gas transmission prices was of major importance to the Government. As stated, a complying non-binding bid was required to set out the estimated path of tariffs for the next 10 years, and the principal assumptions underlying those tariffs under the Government's Transitional Access Regime, and under the new regulatory regime that was expected to govern future ownership and operation of the DBNGP. The GPSSC advised:

> *"The tariffs detailed under this requirement will not be binding upon the Acquirer but will be used by the GPSSC to evaluate the deliverability of Non Binding Bids and the consistency of Non Binding Bids with the State's objectives."* [1]

While indicating that such tariffs would not be binding, under the sale process as structured, these tariffs would become the proposed tariffs of a Final Bid unless they were expressly modified in the final bid document. As is discussed below, they would become, in accordance with part (b) of clause 9 to Schedule 5 of the Asset Sale Agreement, tariffs that the Government might freely disclose in proceedings before the Regulator.

Both the bid price, and future pipeline tariffs, were critical factors in the Government's decision making for its sale of the DBNGP.

The importance of the bid price was made clear by the Minister for Energy in a media statement issued on 22 May 1997. The Minister stated:

> *"It is imperative the Government sells the pipeline to deliver the highest possible return to WA taxpayers who have owned this asset since it was built in 1984."*

At the same, the Government was concerned with securing lower gas transmission tariffs. In his 22 May 1997 media statement, the Minister continued:

> *"As well, new regulations would enforce a set of reference tariffs for the first two years of operation under private ownership, declining over the period 1998 to 2000. This would see transport costs decline from around $1.25 per gigajoule at present to around $1 per gigajoule by the year 2000."*

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.

This view was reinforced by the Minister for Energy in the media statement that announced the issue of the sale Information Memorandum. The Minister stated:

> *"The sale of the Dampier-to-Bunbury Natural Gas Pipeline has the potential to realise the highest sale price for a State-owned asset in WA's history."* [1]

He further commented:

> *"I am confident the sale will deliver a substantial return to WA taxpayers on their investment. The price at which the pipeline eventually sells will depend on its future earnings potential as determined by the prospective bidders which have registered their interest."*

Prospective bidders were directed, by the Minister, to focus on the DBNGP as a strategic asset servicing the requirements of gas users in the State so that they might fully recognise this future earnings potential in their bid prices.

The Minister also advised:

> *"Based on preliminary work undertaken by AlintaGas and work independently commissioned by the Gas Pipeline Sale Steering Committee, it is currently anticipated that the cap on tariffs for a full haul firm service at a 100 per cent load factor will be $1.24/GJ for 1998 and $1.12/GJ for 1999. From the year 2000, the State is planning to adopt the National Access Code and tariffs could fall to around $1/GJ."*

The lowering of the gas transmission tariff to about $1.00/GJ was, in the Government's view, linked to encouraging downstream processing activities that would use gas, protecting long term gas supplies, and maintaining prices at which gas could be delivered to households and small businesses.

In its structuring and execution of the DBNGP sale process, the Government of Western Australia sought to achieve the highest possible sale price for the pipeline, and a reduction in gas transmission tariffs to about $1.00/GJ.

[1] 7 September 1997.

4. THE GOVERNMENTS REQUIRED TARIFF OF $1 PER GIGAJOULE

The Government of Western Australia was able to secure a high price from its sale of the DBNGP because it had formed a view of the reduction in the level of gas transmission tariffs necessary to stimulate the use of gas in the State. The Government believed that a full haul firm service tariff of about $1.00/GJ by 2000 was required, and made no secret about it.

A tariff of about $1.00/GJ was expected to be consistent with the tariffs that would result from application of the *National Third Party Access Code for Natural Gas Pipeline Systems* after 1 January 2000.

Support for a tariff of about $1.00/GJ was obtained from Price Waterhouse, the Government's expert adviser on tariff and regulatory matters. In its August 1997 report to the GPSSC, Price Waterhouse concluded that:

> *"… a gas transmission tariff of around $1/GJ commencing at 1 January 2000 was a reasonable and supportable tariff for "firm full haul transmission capacity" under the Draft Code. The analysis suggested that the tariff could lie anywhere within the broad range of $0.71/GJ to $1.12/GJ for firm, full haul transmission capacity and that values between $0.88/GJ to $0.98/GJ could be argued."* [3]

The Price Waterhouse report was placed in the pipeline sale data rooms, and was therefore available to all parties submitting Final Bids for the DBNGP.

The report also noted that the objectives of the Code, and the objectives of the *Competition Principles Agreement* that provides the policy framework within which the Code was developed, were multiple, and trade-offs would have to be made. In particular, in view of the significant tariff reduction being sought by the Government, a careful balance would be required such that:

> *"… a purchaser of the DBNGP can be assured of acquiring an asset subject to stable regulation allowing the development of a stable and viable business."* [4]

On 3 March 1998, the Government of Western Australia announced its sale of the DBNGP to Epic Energy. The sale to Epic Energy reflected a particular balance between the Government's objectives of securing a high sale price and a reduction in gas transmission tariffs. The point of that balance is reflected in the *Dampier to Bunbury Natural Gas Pipeline Asset Sale Agreement* ("**Asset Sale Agreement**").

Epic Energy was not a party to the deliberations in which the point of balance was determined. Nevertheless, an important insight into those deliberations is revealed by the outcome of the final bidding process. Epic Energy submitted, and believes that other bidders similarly submitted, both complying and non-complying final bids. It is not possible in this version of the Submission to set out details of Epic Energy's various bids (which have been provided to the Regulator) as they are covered by confidentiality obligations to, among others, the Minister for Energy, and the Minister will not agree to Epic Energy disclosing such details to the public. As the Asset Sale Agreement reflects, the Government of Western Australia sought to maximise the proceeds from sale the of the DBNGP by accepting a particular purchase price and a particular tariff and tariff path. Epic Energy assumes that the non-complying bids from competing bidders were assessed from the same perspective.

5. THE ASSET SALE AGREEMENT

In the Asset Sale Agreement, the Government of Western Australia undertook to sell the DBNGP to Epic Energy, in accordance with the offer made by Epic Energy in its Non-Binding Bid Submission (submitted on 24 October 1997) and its Final Bid Submission (submitted on 28 February 1998), for a purchase price of $2.407 billion.

Epic Energy gave, in the Asset Sale Agreement, certain warranties as Buyer and these included warranties concerning its proposed gas transmission tariffs and future tariff path.

Clause 9 of Schedule 5 to the Asset Sale Agreement stated:

> *"The Final Bid Information contains details of the tariff rates for gas transmission and tariff path which the Buyer has indicated to the Seller it proposes to apply in the conduct of the business of the DBNGP Assets:*
>
> *(a) which, based upon all information available to the Buyer, reflect tariffs for gas transmission that will provide the Buyer with an acceptable return on investment; and*
>
> *(b) which, the Seller may (and the Buyer irrevocably authorises the Seller to) freely disclose to any Governmental Agency or generally in the course of any public enquiry or other determination process relating to tariff rates for gas transmission."*

The proposed gas transmission tariffs, and proposed tariff path, were set out in Schedule 39 to the Asset Sale Agreement. Schedule 39 cross-referred to clause 9 of Schedule 5.

The tariffs, and the tariff path, were to provide Epic Energy with an acceptable return on its investment in the DBNGP. At the same time, by including paragraph (b), the Government was clearly of the view that Epic Energy should be bound by Schedule 39, and intimated that it would hold Epic Energy to Schedule 39 in respect of any access arrangement it might seek to have approved under the Code.

6. ASSET SALE AGREEMENT TARIFF AND TARIFF PATH

Schedule 39 to the Asset Sale Agreement indicates that the tariffs and the tariff path were predicated on a number of general principles and guidelines that were incorporated in Epic Energy's Final Bid Submission. In particular:

- Epic Energy would expand the capacity of the DBNGP to meet the requirements of new loads, provided the capacity enhancements were commercially viable;
- from 1 January 2000 onwards, Epic Energy would submit, in accordance with the Code, access principles and tariffs for approval by the Regulator at scheduled regulatory reviews; and
- tariffs proposed for approval by the Regulator would provide for the recovery of prudently incurred costs, including a reasonable rate of return on investment over the full term of the asset's economic life.

In addition to the general principles and guidelines, the following more specific principles for the proposed path of future tariffs were set down:

- from 1 January 2000, the tariff path would be based on escalation at a percentage of CPI;
- from 1 January 2000, the Tranche method (introduced by *the Gas Transmission Regulations 1994*) would not be used to define capacity in the pipeline;
- new shippers, and existing shippers switching to the reference service, would be able to provide their own compressor fuel;
- certain tariff setting principles (including the capital recovery mechanism, risk premium on WACC and asset life) to be included in the DBNGP Access Arrangement would be fixed for a period which exceeds the period of scheduled regulatory reviews;
- the capital recovery mechanism would be structured so that it was consistent with efficient growth of the market over the economic life of the asset; and
- the tariff structure would include zonal tariffs which reflected the cost of providing service.

The proposed tariffs and the tariff path were to be for a forward haul firm service. In addition, Epic Energy would offer a forward haul interruptible service, an authorised overrun service, and a backhaul transportation service.

From 1 January 2000, the tariff for forward haul firm service, from receipt points upstream of Compressor Station 2 to a delivery point at Kwinana Junction (at 100 per cent load factor) would be $1.00/GJ.

The forward haul firm service tariff would comprise three separate charges, all of which would be assessed on a zonal basis. The components of the tariff were to be:

- a pipeline capacity charge (MDQ based);
- a pipeline commodity charge (throughput based); and
- a compression charge (MDQ based).

A shipper facilities charge, recovering the costs of shipper specific laterals and metering, was also to apply.

Ten zones, the boundaries of which were defined by compressor stations, were adopted for pricing purposes. Zone 1 was to be a gas gathering (or production header) zone, and would include Compressor Station 1. Zone 9, which extended from Compressor Station 9 to Kwinana Junction, included delivery points in the Perth metropolitan area. The tariff of $1.00/GJ was to apply for gas transportation from receipt points in Zone 1 to delivery points in Zone 9.

Zone 10 extended from Kwinana Junction south to the pipeline end at Main Line Valve 157A near Bunbury. The tariff for forward haul firm service from a receipt point in Zone 1 to a delivery point in Zone 10 would be $1.08/GJ from 1 January 2000.

Forward haul firm service tariffs would be increased annually, but the increases would be subject to a price cap. Schedule 39 limited the tariff increases to no more than 67% of the increase in CPI.

Epic Energy's determination of the tariffs in Schedule 39, and of the future tariff path, were consistent with the approach that had been taken by the Government's own advisers. These determinations used the depreciated optimised replacement cost valuation of the pipeline prepared by engineering consultants CMPS+F and used by Price Waterhouse in its August 1997 report. Furthermore, they used forecasts that had been provided by the Government, and they used principles consistent with those adopted by Price Waterhouse for estimation of the cost of capital.

The tariffs and tariff path in Schedule 39 of the Asset Sale Agreement were likely to have been acceptable to the Government of Western Australia because they were consistent with the tariffs and tariff path determined by the Government's own advisers.

7. A REGULATORY COMPACT BETWEEN EPIC ENERGY AND THE GOVERNMENT OF WESTERN AUSTRALIA

Through the way in which it structured and executed the sale process, the Government of Western Australia was able to secure a purchase price of $2.407 billion for the DBNGP. 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 on all Western Australians; and
- fund education, health and infrastructure initiatives in the 1998/99 and 1999/2000 State Budgets without the need for concomitant increases in State debt.[2]

As the Minister for Energy acknowledged in a statement to Parliament on conclusion of the sale process on 11 June 1998:

> *"The sale is widely recognised as an outstanding success for this State in realising value back to the community from its substantial investment over time to establish energy infrastructure."*

For its part, Epic Energy indicated 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

[2] The importance of the proceeds from DBNGP sale for achieving a reduction in State debt was discussed by the Premier in his 1998 Budget Speech. The subsequent use the Government has made, on behalf of the community, of the proceeds from pipeline sale was discussed by the Minister for Energy in recent Parliamentary debate on the proposed sale of AlintaGas:

"Yes. We retired a significant part of direct and general government debt out of the sale of the Dampier-Bunbury natural gas pipeline. One can assume part of the proceeds will be used to retire government debt. I hope the temptation to rush out and spend it all is resisted. The proceeds should also allow some worthwhile works to be undertaken within the community. That is a decision for Cabinet to make at the appropriate time. As a result of the sale of the Dampier-Bunbury natural gas pipeline, two broader community benefits were achieved. A total of $100m was put into computers, technology and schools. We put 26 000 computers into government schools over four years and 6 000 computers into non-government schools. In a sense, the pipeline was a community-owned asset and the distribution of the proceeds went to everyone, both government and non-government schoolchildren. That program has very strong community support and is producing substantial educational benefits. It was decided to allocate $100m to the development of a convention centre for Perth. There is some controversy about that, but there is no doubt that the one piece of major tourism infrastructure lacking in this State is a convention centre. Such a facility is important to attract conferences and activities to Perth the benefits of which will then feed out into regional areas. No convention centre in Australia has been built without public support. They are in the nature of infrastructure items. Convention centres are not basic infrastructure like roads, railways and power stations, but they fall into that spectrum. A world-class convention centre is essential for the development of the tourism and convention business within the State. It will not be profitable on its own; it will require support. Given public support which ultimately may be recovered, the convention centre will be competitive in bidding for events and it will bring great economic benefits to the members of the community who use it." (Hansard, 9 September 1999.)

forecasts, Epic Energy predicted that investments in pipeline expansion could total $837 million by 2007.

Epic Energy's commitment to expansion was noted by the Premier in his media statement on the outcome of pipeline sale issued on 3 March 1998. Subsequently, the Minister for Energy advised Parliament that:

> *"Epic Energy Australia has also made a commitment to spend up to $874 m through to the year 2007 in order to double the capacity of the pipeline to meet the potential growth in the demand for gas in the mid west and south west of the State."* [3]

Epic Energy has already commenced delivering on its commitments. It is now close to completing a further expansion of DBNGP capacity requiring investment of over $120 million in additional compression plant and looping of the pipeline. The expansion will provide the gas transportation capacity needed to meet new industrial demands in 1999 and 2000.

To further support its focus on Western Australia, Epic Energy committed to moving its corporate office to Perth, and that move has now been completed. There will be further strengthening of Epic Energy's presence in Perth in the years to come.

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. The continued expansion of the DBNGP will also assist the economic development of Western Australia. Underpinning both the purchase price and the commitment to expansion is a revenue stream based on the tariffs set out in Schedule 39 of the Asset Sale Agreement, and on a price path which would see increases in those tariffs capped at 67 per cent of the increase in CPI.

Epic Energy accepts that there was no express contractual commitment between it and the Government in the Asset Sale Agreement regarding the implementation of the Schedule 39 tariff path. That is equally true of the other Epic Energy "commitments" referred to above. However, they are all part of the "regulatory compact" between Epic Energy and the Government of Western Australia arising out of the DBNGP sale process.[4] At the core of this regulatory compact are the price paid for the DBNGP, and the tariffs and tariff path that support that price.

Epic Energy accepts the risk that, at least in the short term, economic development in Western Australia might not support – and, in fact, has not supported - the substantial growth in gas demand indicated by forecasts made during the DBNGP sale process. That is, Epic Energy accepts the risk that the growth in gas demand may not yield a revenue stream consistent with the price it paid for the pipeline. Acceptance, by the buyer of an asset, of the risk that forecasts of future demand for the asset's services may not be realised, is normal commercial practice.

3 Ministerial Statement, 10 March 1998.

4 US regulatory thinking has, since 1976, used the more specific, if less legally accurate term, "regulatory contract". This term has not been used in Australia. Australian regulatory debates still appear to be conducted within the confined framework of normative analysis as positive economic theory.

The tariffs and the future tariff path are another matter. Putting to one side the negative impact of growth in the demand for gas transmission capacity not materialising as predicted, Epic Energy must be able to rely on the tariffs and the tariff path of Schedule 39 of the Asset Sale Agreement. It is those tariffs, and that tariff path, that allow Epic Energy to obtain the revenue stream consistent with the price it paid for the DBNGP. The tariffs and the tariff path are an essential part of the regulatory compact. This cannot be ignored. To do so would shift substantially the distribution of risk between Epic Energy and the Government. The Government's sale process and the success of it was anchored by the regulatory compact which enabled Epic Energy and its bankers to have a reasonable expectation that the purchase price could be supported.

Epic Energy invested $2.407 billion in the DBNGP, and gave a commitment to expand the capacity of the pipeline, on the basis of being able to rely on:

- 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 per cent of the increase in CPI.

The Government of Western Australia accepted a purchase price of $2.407 billion for the DBNGP because Epic Energy's complying bid was superior to any other bid, and was consistent with a level of tariffs expected to encourage downstream processing activities, protect long term gas supplies, and maintain prices at which gas is delivered to households and small businesses.

The Government could have structured and executed the pipeline sale process in a different way. It could have sought lower gas transmission tariffs by reducing the emphasis it placed on achieving the highest possible sale price. Alternatively, it could have sought a higher price by accepting a lower reduction – or even an increase in – gas transmission tariffs. In either case, a different regulatory compact would have been the result.

In the event, the Government of Western Australia chose to structure and execute the DBNGP sale process in a way that delivered the sale price, and tariffs and tariff path supporting that sale price, now reflected in the Asset Sale Agreement. There may have been an element of rent seeking in the way in which the sale process was structured and executed, and that may now be reflected in the balance between the purchase price and the proposed tariffs. However, as the Minister for Energy has strongly argued, this is an issue of public policy making. It is an issue that must be dealt with by the Government itself, and not by the Regulator:

> *"The role of the regulator is to be a regulator, not to be a price or policy maker. We have to be very conscious that the regulatory regime and the regulator does not start to become the policy maker. That is a province of Government, not in a selfish way, but it is something that has to reflect a range and a balance of economic and social objectives."* [5]

[5] Australian Institute of Energy. *Address by the Hon Colin Barnett, Western Australian Minister for Energy*. Perth, Friday 26 March 1999.

At the time of the DBNGP sale process, both Epic Energy and the Government of Western Australia believed that the core of their regulatory compact was consistent with the requirements of the Code. In particular, the tariffs and the tariff path were believed to be consistent with application of the Code's cost of service approach based on a common set of forecasts of future gas demand, a depreciated optimised replacement cost valuation of the pipeline, a rate of return determined in accordance with then accepted methods, and estimates which had been made of future non-capital costs.

Circumstances have now changed in a number of respects. Forecasts of gas demand have been revised downward consistent with a lower than anticipated level of activity in the Western Australian economy. The process of sale has placed a value on the DBNGP.

Nevertheless, Epic Energy's compact with the Government of Western Australia remains. Epic Energy has recognised that in the Access Arrangement submitted for the DBNGP.

8. DBNGP ACCESS ARRANGEMENT

In developing its Access Arrangement for the DBNGP, Epic Energy has incorporated the essential elements of the services, tariffs and tariff path of Schedule 39 of the Asset Sale Agreement. However, a number of modifications have been made. At the time Schedule 39 was developed, Epic Energy had limited knowledge of the pipeline, and no experience of the way in which it operated. The modifications introduced in the Access Arrangement have been made, in part, on the basis of experience subsequently acquired. They also reflect comments made by businesses having a major interest in the operation of the pipeline, and with whom Epic Energy has had discussions. Epic Energy consulted with these businesses in the course of the development of the Access Arrangement.

Epic Energy will make available to shippers and prospective shippers using the DBNGP:

- a forward haul firm service;
- a backhaul firm service; and
- an active secondary market in which spare pipeline capacity can be sold or acquired on a spot basis by both shippers and the pipeline operator (obviating the need for an interruptible service).

These were essentially the services proposed in Schedule 39 of the Asset Sale Agreement.

The forward haul firm service and the backhaul firm service are offered as a single reference service.

The Access Arrangement recognises that, due to circumstances beyond their control, shippers may, on occasion, overrun their reference service capacity entitlements.

From 1 January 2000 or approval of the Access Arrangement (whichever is the later), the reference service will be made available to shippers at:

- a tariff of $1.00/GJ (at 100 per cent load factor) to delivery points downstream of Compressor Station 9 but upstream of Kwinana Junction; and
- a tariff of $1.08/GJ (at 100 per cent load factor) to delivery points downstream of Kwinana Junction.

The Access Arrangement reference tariff will be the tariff of Epic Energy's regulatory compact with the Government of Western Australia. It will be the tariff sought by the Government through the pipeline sale process, and the tariff that supports Epic Energy's purchase price of $2.407 billion.

A zonal structure has been adopted for the reference tariff, as was proposed in Schedule 39. Ten zones are used for pricing purposes.

Zone 1 is a gas gathering or production header zone, with its upstream boundary at Dampier, as proposed in the Asset Sale Agreement. The downstream boundary has, however, been shifted from immediately upstream of Compressor Station 2 to a point immediately downstream of the compressor station. All gas expected to be supplied for transportation through the DBNGP during the period of the Access Arrangement will, in consequence, be supplied to receipt points in Zone 1, and the shippers of that gas will be able to avail themselves of the reference service.

Zone 1 has two subzones. Subzone 1a extends from Dampier to a point on the DBNGP 30 km downstream of Dampier.

The structure of pricing in Zone 1 is noted in the Access Arrangement Information for the DBNGP. In developing this structure Epic Energy has taken into consideration the structure of the exempt contract with Alcoa of Australia Limited.

Similarly, the Access Arrangement Information does not discuss, in detail, the method proposed for rebating revenue from rebatable services to shippers using the reference service. The rebate method provides for the rebating of this revenue only after a defined revenue threshold has been reached. The structure of the rebate method also takes into account the impact of the exempt contract with Alcoa of Australia Limited.

The reference tariff of the Access Arrangement comprises five separate charges rather than the three, plus shipper facilities charge, proposed in Schedule 39 of the Asset Sale Agreement. The five charges are:

- Gas Receipt Charge (MDQ based);
- Pipeline Capacity Charge (MDQ based);
- Compression Capacity Charge (MDQ based)
- Compressor Fuel Charge (throughput based); and
- Delivery Point Charge (fixed monthly, delivery point specific).

The tariff structure in Schedule 39 allowed shippers to provide their own compressor fuel. No allowance has been made for shippers providing their own fuel in the Compressor Fuel Charge of the Access Arrangement. Epic Energy is of the view that consideration of shippers providing their own fuel should be deferred until the next Access Arrangement period. A take-or-pay fuel purchase contract with AlintaGas that was assigned to Epic Energy as part of the DBNGP sale arrangements will terminate early in that period. In addition, businesses that were consulted during the development of the Access Arrangement indicated their preference not to have shippers supply their own fuel gas. However, this is a matter that Epic Energy will review during the first period of the Access Arrangement.

The Gas Receipt Charge and the Delivery Point Charge do not depend on the locations of a shipper's receipt point and delivery point. The Pipeline Capacity Charge is assessed on a zonal basis, and the Compression Capacity Charge and Compressor Fuel Charge are payable in respect of all compressor stations through which gas transported for a particular shipper must pass.

The results of these modifications are a structure of services that adds to, rather than detracts from, the services of Schedule 39, and provide a more cost reflective tariff structure.

In other respects, the tariff proposals of the DBNGP Access Arrangement follow those of the Asset Sale Agreement. In particular:

- from the commencement of the Access Arrangement onwards, Epic Energy is to submit, in accordance with the Code, access principles and tariffs for approval by the Regulator at scheduled regulatory reviews;

- tariffs proposed for approval by the Regulator provide for the recovery of prudently incurred costs, including a reasonable rate of return on investment over the full term of the asset's economic life;

- from the commencement of the Access Arrangement, the Tranche method (introduced by the *Gas Transmission Regulations 1994*) is not used to define pipeline capacity;

- certain tariff setting principles (including the capital recovery mechanism) are included in the Access Arrangement as fixed principles; and

- the capital recovery mechanism is structured so that it is consistent with efficient growth of the market over the economic life of the asset.

More fundamentally, the DBNGP Access Arrangement makes the reference service available at initial reference tariffs (excluding the Delivery Point Charge) that include:

- a tariff of $1.00/GJ (at 100 per cent load factor) for gas transmission from receipt points in Zone 1 to delivery points in Zone 9;

- a tariff of $1.08/GJ (at 100 per cent load factor) for gas transmission from receipt points in Zone 1 to delivery points in Zone 10

These reference tariffs are to increase over time, following a tariff path that would see tariffs rise annually by no more than 67 per cent of the increase in CPI.

The Access Arrangement tariff path is the tariff path of Epic Energy's regulatory compact with the Government of Western Australia. This places a tighter constraint on future tariffs than a CPI – X price path with X determined from forecast efficiently incurred capital and non-capital costs.

9. INITIAL CAPITAL BASE

Although specified gas transmission tariffs are a core element of the regulatory compact between Epic Energy and the Government of Western Australia, an initial capital base must be determined for the DBNGP because a basis must now be established for the determination of reference tariffs and tariff paths in future Access Arrangement periods.

Section 8.10 of the Code sets out the factors that should be considered in establishing the initial capital base for a pipeline that was in existence at the commencement of the Code. Section 8.11 then provides further guidance, indicating that the initial capital base normally should not fall outside the range established by:

- the depreciated actual cost of the pipeline (DAC); and
- the value obtained by applying the depreciated optimised replacement cost (DORC) method of valuation.

Section 8.11 is indicative not prescriptive, and does not mandate an initial capital base between DAC and DORC.

As discussed earlier, the Government of Western Australia has, through the process of the pipeline sale, placed a particular value on the DBNGP. That value was sought to achieve a balance between the interests of users and prospective users of the pipeline, and the wider public interest. Strategic decisions of this type cannot be reduced to assessments based on simple calculations of costs and benefits. They are decisions that the Government is elected to make on behalf of the community.

Accordingly, it is the value the Government placed on the pipeline that must now be used in setting the initial capital base for the DBNGP.

The process through which the DBNGP was sold by the Government of Western Australia removed the initial capital base of the pipeline from the indicative bounds provided in section 8.11 of the Code.

Section 8.10(j) identifies as one of the factors that should be considered in establishing the initial capital base "*the price paid for any asset recently purchased by the service provider and the circumstances of that purchase*". Given the structure of the sale process and the way in which it was executed, the price Epic Energy paid for the DBNGP is the critical factor to be considered in establishing the initial capital base. To give precedence to some of the other factors of section 8.10 leads away from the policy outcomes legitimately sought by the Government, and away from the regulatory compact, a compact where the State has already received the benefits it sought in a variety of forms, but Epic Energy is still to receive the benefit of the State's contribution under the compact.

At the time of its acquisition of the pipeline, Epic Energy engaged valuers Edward Rushton Australia Pty Limited to establish a detailed set of asset values consistent with the DBNGP purchase price of $2.407 billion plus other costs of acquisition not included in the purchase price. This set of asset values has been used to derive an initial capital base for the DBNGP. It is reported in the Access Arrangement Information.

Using the purchase price plus acquisition costs as the initial capital base yields a reference tariff for the DBNGP with components for Zones 9 and 10 that are higher than the tariffs of the regulatory compact between Epic Energy and the Government.
Since Epic Energy is committed to delivering the tariffs of the regulatory compact, revenues from the reference service of the Access Arrangement are likely to be insufficient to recover the capital charges (asset return and depreciation) on the initial capital base, and on the capital base in subsequent years, without growth in the demand for gas transmission services.

Demand anticipated at the time of the DBNGP sale, on the basis of forecasts provided by the Government, has not materialised. Nevertheless, Epic Energy - and others - expect that this demand growth will ultimately occur.[6] At issue is the timing, rather than the magnitude, of expected growth.

In the Asset Sale Agreement, Epic Energy said that it would not use the tranche method of defining capacity in the DBNGP after 1 January 2000. An average day concept of capacity has now been adopted for the reference service of the Access Arrangement, and spare capacity is available in the pipeline.[7] There is no demand for that spare capacity at the present time, and Epic Energy does not expect any significant demand for it during the next five years. However, with further growth in gas demand as economic development in Western Australia continues, there may well be a demand for additional pipeline capacity within the next 10 years.

Epic Energy therefore expects to be able to generate additional revenues in the future without substantial increases in its costs.

Epic Energy will, in these circumstances, treat any shortfall in the recovery of its capital charges by way of "economic depreciation". It will proceed in accordance with a regulatory asset accounting model advanced by its regulatory adviser, The Brattle Group, in a report on valuation issues.[8]

Economic depreciation is determined as the difference between the revenue expected given the tariffs and the tariff path of the regulatory compact, and the sum of the return on the capital base and non-capital costs. As The Brattle Group notes, the use of economic depreciation for regulatory purposes is gaining acceptance both in Australia and internationally.

The use of economic depreciation allows postponement of recovery of a part of the capital base until that recovery is warranted by growth in demand for gas transmission services. Higher demand allows Epic Energy to receive higher revenues and recover capital without an increase in the absolute level of tariffs. The required depreciation schedule has the effect of allowing the reference tariff to change over time *"in a manner that is consistent with the*

[6] Forecasts prepared by the Australian Gas Association and made public on 18 October 1999, clearly support significant growth in gas demand, and growth in demand for gas transmission services.

[7] Details are reported in section 5 of the Access Arrangement Information.

[8] The Brattle Group's report provides support not only for the regulatory compact, but also for the use of the purchase price in determining the initial capital base, drawing on both Code requirements and experience in other regulated jurisdictions. It is submitted with this Submission on a confidential basis.

efficient growth of the market for the Services provided by the Pipeline (and which may involve a substantial portion of the depreciation taking place in future periods…)"[9]

The capital base of the DBNGP will, following the approach of The Brattle Group's model, be the sum of two components. The first of these is a physical asset account balance. The physical asset account balance is the written down value of the physical assets that form the pipeline

The second component of the capital base is a deferred recovery account balance. The balance in the deferred recovery account at the end of any year is the accumulated economic depreciation to the end of that year.

Initially, the physical asset account balance will be the total of the asset values determined by Edward Rushton Australia as being consistent with the DBNGP purchase price plus other costs of acquisition, and the deferred recovery account balance will be zero. That is, the initial capital base for the pipeline will be the physical asset account balance.

Over the period of the Access Arrangement, economic depreciation is expected to be negative. Revenue from delivery of the reference service at the reference tariff is not sufficient to recover the sum of the return on the capital base and the non-capital costs, and to cover capital expenditure on new facilities. In these circumstances, the deferred recovery account balance will rise.

With future growth in the demand for gas transmission services, higher revenues will allow the recovery of capital without requiring an increase in the absolute level of the reference tariff. Economic depreciation will increase, becoming positive, and reducing the balance in the deferred recovery account.

The "economic life" of the deferred recovery "asset" can be considered the economic life of the pipeline itself. If the deferred recovery account balance is reduced to zero before the end of the economic life, there is scope for subsequent reductions in the reference tariff.

If the deferred recovery account balance has not been reduced to zero by the end of the life of the asset, a part of the price paid by Epic Energy for the DBNGP will represent an "imprudent investment" for which shareholders will not be compensated.

[9] Code, section 8.33(a).

10. COMPLIANCE WITH CODE REQUIREMENTS

The National Third party Access Code for Natural Gas Pipeline Systems does more than specify the form and content of an access arrangement.

It sets out, in some detail, principles and procedures to be adopted in developing the reference tariffs policy and reference tariffs for a covered pipeline

It also sets out principles and procedures that must be adopted by the Regulator in the process of access arrangement approval.

Epic Energy has submitted an Access Arrangement for the DBNGP that applies the Code requirements to Epic Energy's circumstances in respect of the DBNGP which are very different from those of other covered pipelines.

Epic Energy acquired the DBNGP through a competitive bidding process structured and executed by the Government of Western Australia to achieve particular public policy outcomes for the State. Through the process by which it sold the pipeline, the Government obtained a high sale price - $2.407 billion – and secured a reduction in gas transmission tariffs to about $1.00/GJ.

The way in which the Government structured and executed the DBNGP sale process was not unlike the process set out in sections 3.21 to 3.36 of the Code for determining, by competitive tender, reference tariffs for a new pipeline.

The DBNGP sale process was highly competitive, with four principal groups bidding for the pipeline (although one was to withdraw late in the process). Through this competitive process, the Government was able secure bids that would enable it to select the bidder able to deliver the lowest sustainable tariffs to shippers, when taken with the Government's other requirements.

The sale process was used to secure tariffs and a tariff path considered by the Government to be in the public interest. These tariffs were, on the advice of the Government's expert adviser on tariffs and regulatory matters, expected to provide the future pipeline owner with a revenue stream that covered its efficiently incurred costs. They were expected to encourage investment, particularly downstream investment, and to ensure that gas would continue to be supplied to Western Australian households and small businesses at competitive prices. In selecting a bid that delivered both a high sale price and a reduction in tariffs, the Government sought a future owner that had the capabilities required to ensure the safe and reliable operation of the DBNGP. It also secured, on the advice of its expert adviser, a path of future tariffs that would provide incentives for the pipeline owner to reduce costs and develop the gas market.

Through the process by which it sold DBNGP, the Government of Western Australia was able to secure tariffs and a tariff path that would meet the objectives of section 8.1 of the Code.

Epic Energy has sought, in its Access Arrangement for the DBNGP, to refine the outcomes of the sale process in ways similar to those required of a tenderer under the Code's tender process. It has:

- allocated costs to tariffs in a way which is fair and reasonable; and
- established an initial capital base, a depreciation schedule and, in consequence, a means by which a residual value can be established at the end of the access arrangement period, for subsequent redetermination of the reference tariff and its approval by the Regulator

The initial capital base has been derived from Epic Energy's purchase price plus other costs incurred in its acquisition of the DBNGP. As indicated, it has not been established in accordance with the methods referred to in section 8.10(a) and (b) of the Code. The way in which the Government of Western Australia structured and executed the DBNGP sale process removed the initial capital base from the range of values determined by those methods. Given the structure of the sale process and the way in which it was executed, the price Epic Energy paid for the DBNGP is the critical factor to be considered in establishing the initial capital base. This is consistent with Code requirements. The Code permits consideration of the price paid for assets recently purchased, and the circumstances of purchase, in the setting of the initial capital base (see section 8.10(j)). The initial capital base has been established in a way that is consistent with the terms of the regulatory compact between Epic Energy and the Government of Western Australia.

At the core of the regulatory compact between Epic Energy and the Government, established through the DBNGP sale process and reflected in the Asset Sale Agreement, are Epic Energy's purchase price, and the tariffs and tariff path supporting that purchase price. By accepting a purchase price of $2.407 billion, the Government was able to deliver a range of benefits to the broader community within the Western Australia. It was also able to secure a significant reduction in gas transmission tariffs.

At section 2.24, the Code requires that, in approving an access arrangement, the Regulator must take into account:

- the service provider's legitimate business interests and investment in the covered pipeline;
- firm and binding contractual obligations of the service provider or other persons (or both) already using the covered pipeline;
- the economically efficient operation of the covered pipeline;
- the public interest, including the public interest in having competition in markets (whether or not in Australia); and
- the interests of users and prospective users.

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 would fail to take into account Epic Energy's legitimate business interests and the investment it has already made in the DBNGP. It would fail to take account of commitments Epic Energy has made to the Government of Western Australia and, in particular, Epic Energy's commitment to further invest in the pipeline. It would fail to implement the Government's side of the 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.

Furthermore, to proceed in any other way would fail to take into account the way in which the DBNGP sale process was structured and executed by the Government of Western Australia to serve the wider public interest and, at the same time, deliver lower gas transmission tariffs in the interests of shippers and prospective shippers. That could have serious implications for the effectiveness of the Government's policies and compacts for future privatisations of its assets.

DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED REGULATORY MODEL FOR THE DAMPIER TO BUNBURY NATURAL GAS PIPELINE OCTOBER 1999

PREPARED BY THE BRATTLE GROUP

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