WESTERN POWER CORPORATION

Submission to Western Australian Independent Gas Pipelines Access Regulator regarding Epic Energy's proposed Access Arrangement for the DBNGP

Second post-judgment submission:

Applying the judgment to setting the initial Capital Base and other matters

8 November 2002

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1. Western Power's first post-judgment submission analysed the judgment in *Re Dr Ken Michael AM: ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 (23 August 2002) (**"judgment"**).

2. This submission is divided into two parts. Part 1 discusses how the initial Capital Base should be set for the DBNGP in light of the judgment. Part 2 discusses other matters in the Access Arrangement, apart from the initial Capital Base, in light of the judgment.

3. Western Power would welcome an opportunity to meet with the Regulator to discuss the issues raised in this submission and other submissions by Western Power and other parties. Western Power suggests that this meeting be held after Western Power has had an opportunity to consider other submissions and any further information provided by the Regulator.

Summary

4. Commencing at paragraph 191, Western Power sets out its conclusions regarding the initial Capital Base. This summary does not repeat those conclusions in full. Key points, however, are as follows:

   (a) the judgment has shown that Epic's approach to setting the initial Capital Base is fundamentally flawed and inconsistent with the Code;

   (b) the DAC valuation in the Draft Decision stands unimpeached and must be given weight as a fundamental element;

   (c) the DORC valuation in the Draft Decision stands unimpeached and must be given weight as a fundamental element;

   (d) there are a number of very serious defects in the case put forward to date by Epic for use of purchase price either as a valuation methodology in its own right or as evidence of market valuation;

   (e) the other factors of s. 8.10 tend to support a conclusion that a DORC valuation is the highest appropriate one;

   (f) in short, there is no credible evidence that s. 8.10 should produce a result any higher than DORC;

   (g) there is likewise no credible evidence before the Regulator on which to base a decision to depart from the normal band of DAC and DORC under s. 8.11;

   (h) a valuation no greater than DORC would be most consistent with the objectives in s. 8.1; and

   (i) to the extent that the s. 2.24 factors are relevant, and giving each of those factors weight as a fundamental element, the combined effect of the factors in s. 2.24 tends to a conclusion that a valuation no higher than DORC is most appropriate.

5. The judgment's finding that the s. 2.24 factors must be applied in any assessment under s. 3 of the Code, bears on matters other than the initial Capital Base. In Part 2 of this submission Western Power demonstrates that applying the s. 2.24 factors to the question of whether Epic should be required to provide a T1-equivalent Reference Service, produces an inescapable conclusion that the Regulator should reverse his Draft Decision in this regard, and should require the Access Arrangement to be amended to include such a service.

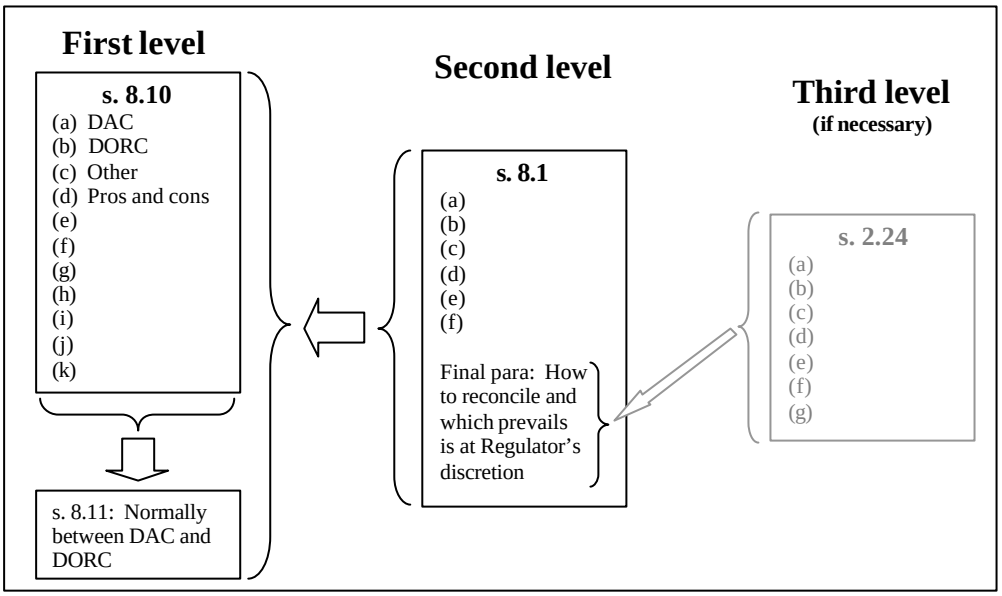
6. Equally, an analysis of the s. 2.24 factors in the context of the proposed penalty regime demonstrates that the Regulator should reconsider his Draft Decision in this respect, and should instead require amendments to the Access Arrangement which preserve the status quo for the DBNGP in which no such penalties are payable and peaking and balancing excursions are dealt with by other means.

Part 1 – Determination of Initial Capital Base, in light of the judgment

1.1 Summary of the legal framework

7. Western Power's first post-judgment submission gives a detailed analysis of the judgment's effect.

8. This can be summarised schematically as follows:



9. In summary the judgment makes it abundantly clear that the process for setting the initial Capital Base operates at three levels:

   (a) **first level:** the starting point and most important aspect is ss. 8.10 and 8.11, [1] the Regulator must give each of the factors in s. 8.10 weight as a fundamental element,[2] and must have regard to the requirement in s. 8.11 that the initial Capital Base will normally lie between DAC and DORC;

   (b) **second level:** the Regulator's policy guidance when exercising his discretion under ss. 8.10 and 8.11 comes from the requirement that the Reference Tariff and the Reference Tariff Policy should be designed to meet the objectives in s. 8.1; [3] and

   (c) **third level:** to the extent only that the Regulator needs guidance in reconciling the disparate objectives in s. 8.1 or deciding which of them is to

[1] Para 163 of the judgment
2 Para 56 of the judgment
[3] Para 84 of the judgment read with paras 162 and 185

prevail, he is to be guided by the factors in s. 2.24, [4] giving each of the s. 2.24 factors weight as a fundamental element,[5] but otherwise it is the s. 8.1 objectives which should guide the process of establishing the initial Capital Base.[6]

10. This submission is structured in accordance with this chain – starting with ss. 8.10 (heading 1.2) and 8.11 (heading 1.3), then looking to the objectives in s. 8.1 (heading 1.4), then (in the limited case of the last paragraph of s. 8.1) looking to the factors in s. 2.24 (heading 1.5).

1.2 Applying s. 8.10 to the DBNGP in light of the judgment

11. The Court confirmed that Epic's approach to determining the DBNGP's initial Capital Base was wrong.

12. Epic's Access Arrangement Information argued that because of the circumstances of the pipeline sale, the purchase price paid by Epic could be used to establish the initial capital base. Epic argued that this approach was consistent with s 8.10, and that s. 8.10 did not require the Regulator to consider DAC and DORC values.[7]

13. The judgment demonstrates that this approach was not consistent with s 8.10. Under the Code, the Regulator must consider each of the factors in s 8.10 and give each weight as a fundamental element.[8] This includes the DAC and DORC values under s 8.10(a) and (b), as well as all the other factors in s 8.10. [9]

14. Epic's proposal that the Regulator should bypass elements of the process set out in s 8.10 and treat the purchase price paid by Epic as the initial Capital Base is clearly contrary to the Code and equally clearly must not be followed by the Regulator.

15. In contrast, the Regulator is required by the judgment to consider each factor under s. 8.10 and give each weight as a fundamental element.

(a) s. 8.10(a) - DAC

16. Under s. 8.10(a) the Regulator is required to consider the value that would result from the Depreciated Actual Cost (**"DAC"**) of the DBNGP.

17. The Regulator's preferred DAC valuation of about $874 million[10] stands as a factor that must be given weight as a fundamental element in the Regulator's decision in establishing the initial Capital Base.[11] Western Power supports that DAC valuation. The Court made no adverse finding regarding the valuation.

[4] Paras 85 and 136 of the judgment
[5] Para 55 of the judgment
[6] Para 84 of the judgment read with paras 162 and 185
[7] Epic's Amended Proposed Access Arrangement (Information) ("APAAI"), pp 31-32
[8] Para 56 of the judgment.
[9] Para 56 of the judgment.
[10] Page 126 of Part B of the Draft Decision.
[11] Para 56 of the judgment.

(b) s. 8.10(b) - DORC

18. Under s. 8.10(b) the Regulator is required to consider the value that would result from the Depreciated Optimised Replacement Cost (**"DORC"**) of the DBNGP.

19. The Regulator's preferred DORC valuation of about $1,234 million[12] stands as a factor that must be given weight as a fundamental element in the Regulator's decision in establishing the initial Capital Base.[13] Western Power supports that DORC valuation. The Court made no adverse finding regarding the valuation.

(c) s. 8.10(c) – Other well-recognised valuation methodologies

20. In the Draft Decision, the Regulator identified Optimised Deprival Value, Imputed Capital Base and Cost of Purchase as alternative valuation methodologies.

(c)(i) Optimised Deprival Value

21. Western Power makes brief submissions on this in the context of s. 8.10(d) below.

(c)(ii) Imputed Capital Base

22. Western Power makes brief submissions on this in the context of s. 8.10(d) below.

23. Western Power observes that Epic has so far failed to provide any public information that would explain the discrepancy identified by the Regulator in Epic's application of this methodology.[14]

(c)(iii) Purchase Price Valuation/Market Valuation

24. Because Epic was adopting the (now-discredited) approach of bypassing the s. 8.10 factors and going directly to purchase price as initial Capital Base, Epic's Access Arrangement Information does not make it clear exactly how purchase price relates to the s. 8.10(c) factor of "other valuation methodologies" (see discussion in Appendix 3).

25. The Regulator concluded that Epic did not demonstrate to his satisfaction that the purchase price of the assets represented a reasonable valuation by any conventional valuation methodology.[15] The judgment does not disturb this finding, and Western Power supports it.

The Court found that Epic Energy was advancing the purchase price as reflecting market value.[16] However, the Court ruled that it is up to Epic to justify to the Regulator that the price it paid represented market value at the relevant time,[17] and made no adverse comment on the fact that the Regulator was not satisfied with the case that Epic put forward.[18]

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[12] Pages 131 and 133 of Part B of the Draft Decision.
[13] Para 56 of the judgment.
[14] Page 136 of Part B of the Draft Decision. In brief, the discrepancy was between Epic's claim that this methodology produced a valuation of about $1.75 billion, and the Regulator's expectation that an application of this methodology under Schedule 39 would have resulted in a valuation closer to the Government's DORC of about $1.2 billion.
[15] Page 145 of Part B of the Draft Decision.
[16] Para 173 of the judgment.
[17] Para 189 of the judgment.
[18] Para 217 of the judgment.

26. Western Power submits that the Regulator's finding in this regard was plainly correct. Epic has provided no effective evidence:

    (a) that its purchase price reflected market value at the time; or

    (b) that in these particular circumstances of the DBNGP market value is an appropriate valuation methodology; or

    (c) why in these particular circumstances of the DBNGP that valuation methodology should be given any particular weight in the Regulator's balancing of factors under s. 8.10.

27. If Epic makes any further submissions on this point, Western Power will make submissions in response. Western Power notes that the Court considered that despite the judgment, and despite further submissions by Epic, the Regulator might reach the same outcome.[19]. Appendix 2 sets out some observations which would support the Regulator doing so.

(d) s. 8.10(d) – Advantages and disadvantages of valuation methodologies

(d)(i) DAC

28. The Regulator's findings on the advantages and disadvantages of using a DAC valuation for the DBNGP stand as a factor that must be given weight as a fundamental element in the Regulator's decision in establishing the initial Capital Base.[20] The Court made no adverse comment on the Regulator's findings on the subject in his Draft Decision.

(d)(ii) DORC

29. The same is true for the Regulator's findings on the advantages and disadvantages of using a DORC valuation for the DBNGP. [21]

(d)(iii) Optimised Deprival Value

30. Western Power supports the Regulator's findings on the advantages and disadvantages of using an Optimised Deprival Value valuation for the DBNGP, [22] which findings were not subject to any adverse comment in the judgment.

31. These findings must be given weight as a fundamental element in the Regulator's decision in establishing the initial Capital Base.[23]

(d)(iv) Imputed Capital Base

32. Western Power also supports the Regulator's findings on the advantages and disadvantages of using an Imputed Capital Base valuation for the DBNGP, [24] findings

[19] Para 190 of the judgment
[20] Para 56 of the judgment.
[21] Para 56 of the judgment.
[22] Page 143 of Part B of the Draft Decision.
[23] Para 56 of the judgment.
[24] Page 143 & 144 of Part B of the Draft Decision

which must also be given weight as a fundamental element in the Regulator's decision in establishing the initial Capital Base.[25]

33. Western Power may make further submissions if Epic seeks to rehabilitate this valuation methodology.

34. The circularity of an Imputed Capital Base methodology is confirmed by the Court's findings that:

(a) the tender process, including the information memorandum, falls short of providing an adequate factual foundation for the submission that Epic had been induced to have an understanding as to the level of the tariff;[26] and

(b) it was made clear that a feature of the anticipated Code was that tariff levels were to be fixed by an independent regulator, and it should have been evident to Epic that there was uncertainty as to what might be expected under the Code.[27]

(d)(v) "Purchase price valuation"

35. Once again, the Regulator's findings on the advantages and disadvantages of this methodology must be given weight as a fundamental element.[28]

36. As is discussed in Appendix 3, there are two possible approaches to using purchase price under s. 8.10(c):

(a) that "purchase price" is itself a valuation methodology, which is discussed under this subheading; or

(b) that "market value" is the valuation methodology, and purchase price is merely an indicator of market value, which is discussed under subheading 1.2(d)(vi) below.

37. If purchase price is itself being advanced as a valuation methodology, then the Regulator must first be satisfied that this is a "well recognised asset valuation methodolog[y]".[29] Epic has made no submission on this subject, and the Regulator has made no finding. Western Power submits that the use of purchase price as a valuation methodology is so flawed that this methodology should be disregarded.

38. However, if the Regulator finds that this is a well recognised asset valuation methodology and hence worthy of consideration under s. 8.10(c) and (d), then Western Power submits that all the advantages and disadvantages of this valuation methodology which were discussed by the Regulator under the heading "Advantages and Disadvantages of a Purchase Price Valuation of the initial Capital Base" at page 144 of Part B of the Draft Decision remain applicable. Western Power endorses the Regulator's analysis, and submits that it applies with such force to the DBNGP's

[25] Para 56 of the judgment.
[26] Para 196 of the judgment.
[27] Paras 197 and 198 of the judgment, see also Appendix 1 of this submission.
[28] Para 56 of the judgment.
[29] s. 8.10(c) of the Code

circumstances that the Regulator should regard this valuation methodology as being highly unreliable and worthy of very little weight, if any.

39. The validity and applicability of the Regulator's analysis under that heading of the Draft Decision is entirely untainted by the error of law in the last paragraph of that analysis.[30] The Court has found that the Regulator erred in thinking that the Code **required** that the initial Capital Base be consistent with potential regulated revenues, but this does not affect the validity of the Regulator's other comments in that section. The Court made no other adverse finding in relation to the Regulator's analysis on page 144 of Part B of the Draft Decision.

40. As shown above, the Court's finding that the Regulator misapprehended the task before him does not establish that the outcome arrived at by the Regulator was wrong. The Court acknowledged that it is quite possible that any further submissions by Epic on the matters in the judgment may not lead the Regulator to reach a different outcome[31] (see discussion in Appendix 2).

41. The question for the Regulator under s 8.10(c) is *what value would result* from applying other recognised asset valuation methodologies. The Regulator concluded that Epic did not demonstrate to the satisfaction of the Regulator that the purchase price of the assets represented a reasonable valuation by any conventional valuation methodology,[32] and Western Power supports this conclusion.

(d)(vi) Market valuation

42. To recap, Appendix 3 shows that there are two possible approaches to using purchase price under s. 8.10(c):

    (a) that "purchase price" is itself a valuation methodology, which is discussed immediately above; or

    (b) that "market value" is the valuation methodology, and purchase price is merely an indicator of market value, which is discussed now.

43. The Court found that Epic Energy was advancing the purchase price as reflecting market value.[33] The Court found that it falls to Epic to seek to justify to the Regulator that the price it paid represented market value at the relevant time.[34]

44. Market value is clearly a well recognised asset valuation methodology. However, neither Epic's Access Agreement Information nor the Draft Decision contain any discussion on how market value is determined (eg. is calculating NPV of future revenues a legitimate methodology?). If Epic wishes to advance the use of purchase price as evidence of market value, it is for Epic to explain why this should be the case, and then how Epic proposes to determine the Market Valuation of the DBNGP. The judgment identified some factors which are relevant to this exercise, which are discussed in Appendix 2. Western Power may make further submissions, if Epic does.

[30] Para 205 of the judgment
[31] Para 190 of the judgment.
[32] Page 145 of Part B of the Draft Decision.
[33] Para 173 of the judgment.
[34] Para 189 of the judgment.

45. Western Power emphasises that the Regulator's only error of law in his consideration of the use of purchase price (by whatever means) in setting initial Capital Base lay in thinking that the initial Capital Base **must** produce a value consistent with "future regulated revenues and efficient capital investment". This error in no way taints the Regulator's finding that purchase price may have been affected by many factors other than a reasonable market valuation.[35] There is ample evidence before the Regulator which supports the conclusion that it was.

46. Western Power submits that there were and are ample grounds for the Regulator to reach a conclusion such as the following:

> Epic has not demonstrated that the sale price is consistent with a reasonable market valuation;[36] and
>
> Epic has not demonstrated that the purchase price of the assets represented a reasonable valuation **by any conventional valuation methodology**, [37]

and that neither of these conclusions is in any way inconsistent with the judgment.

47. In fact Western Power submits that the evidence is so overwhelmingly in favour of this conclusion, that it is the only conclusion available. It is manifestly open to the Regulator to determine that Epic paid too much for the DBNGP. The difficulties and hardships this may cause for Epic and its stakeholders may be real, albeit may presently be being overstated by Epic, but nothing in the policy or provisions of the Code requires shippers to pay the price for Epic's mistake.

48. Finally in relation to market value, it has not yet been publicly submitted by Epic or anyone else that an appropriate methodology for a market valuation is to calculate the NPV of future revenues. Western Power reserves its right to comment on any arguments put forward regarding such an approach.

49. However, if the Regulator is persuaded that the NPV of future revenues is an appropriate and credible way of establishing market value, then Western Power 's first post-judgment submission clearly demonstrated that the Regulator's only error of law lay in his belief that the Code **required** that the initial Capital Base be consistent with **future** regulated revenues and **efficient** capital investment. The Court clearly left it open to the Regulator to determine in his discretion that in the specific circumstances of the DBNGP the Code's objectives were best served by adopting an initial Capital Base which was consistent with future regulated revenues and efficient capital investment.

50. Western Power's submissions elsewhere in this document make it clear that that is the only supportable outcome in these circumstances, for example because there is no reasonable basis on which Epic could have capitalised anticipated monopoly rents and because Epic knew that the DBNGP was very shortly going to be regulated by the Code.[38]

[35] Page 145 of Part B of the Drat Decision
[36] Based on the Draft Decision finding at page 144 of Part B, amended to remove the error of law.
[37] Based on the Draft Decision finding at page 145 of Part B.
[38] See Appendix 1

(d)(vii) Summary regarding advantages and disadvantages of Purchase Price Valuation and/or Market Valuation

51. Epic has not in its Access Arrangement Information or other public submissions suggested that purchase price can be taken into account under s. 8.10(c), although the Court found that this was the effect of Epic's approach. Certainly, Epic has advanced no effective evidence on why either Purchase Price Valuation or Market Value is a "well recognised" valuation methodology, on why its purchase price should be used within either of these methodologies in the particular circumstances of the DBNGP, or on what the advantages and disadvantages of those methodologies are.

52. Regardless of whether Epic does make any submissions, Western Power submits that in the particular circumstances of the DBNGP, the disadvantages of either of these approaches (including variously circularity in a regulated context, risk that purchase price was set by reference to other factors, "winner's curse", upwards spiralling of asset sale prices) are such that they should be given very little weight in comparison with the objective, arms-length methodologies of DAC and DORC.

53. Finally, even if the Regulator determines (in the face of the current evidence) that in the DBNGP's particular circumstances either Purchase Price Valuation or Market Valuation produces a credible number substantially higher than DORC, the Regulator must still balance that number against the DAC and DORC valuations produced under s. 8.10(a) and (b) and against the other factors in s. 8.10, in the context of the normal band specified in s. 8.11.

54. See the discussion of s. 8.11 in Western Power's First Post-Judgment Submission. Western Power believes that a balanced application of the relevant Code provisions cannot, for the DBNGP, support an initial Capital Base higher than DORC.

(e) s 8.10(e) – international best practice of Pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries

(e)(i) First limb: International best practice of pipelines

55. As far as pipeline valuation practice is concerned, it is difficult to see how application of an "international best practice" test could provide a value higher than DORC.

56. More generally regarding international best practice of pipelines, Western Power queries whether paying twice a recent DORC valuation (ie. the Price Waterhouse valuation published during the sale process) conforms to international best practice in asset acquisition. Part of best practice management must be to avoid over-expenditure on capital costs, just as on operating and maintenance costs.

(e)(ii) Second limb: International competitiveness of energy consuming industries

57. Excessive gas transportation tariffs, designed to recover an inflated initial Capital Base, will decrease the international competitiveness of all gas consuming industries by increasing the critical input cost of energy.

58. **Deleted under section 7.11 of the Code**.

59. **Deleted under section 7.11 of the Code**. This outcome would be completely inconsistent with the State's broader energy reform objectives including those stated

for the Electricity Reform Task Force ("ERTF"), which is tasked among other things with bringing lower prices to electricity consumers. The ERTF's terms of reference stated as the very first objective for the Task Force:

> "The main objective is to achieve, where practicable, sustainable lower electricity prices for all customers …".[39]

60. Other users of the DBNGP share this view. Worsley Alumina has expressed its concern that high tariffs for gas transportation, increasing the price of energy, will decrease its international competitiveness in the world alumina industry in which it operates.[40] The Bunbury Chamber of Commerce[41] and the Bunbury Wellington Economic Alliance[42] have also expressed this view.

61. WMC Resources Ltd has emphasized that this is "especially important in relation to the DBNGP due to the very high proportion of its throughput which is used by industries operating in internationally competitive markets" (including WMC and its associated company, Alcoa of Australia). [43]

62. Wesfarmers CSBP has submitted that increased gas transportation costs will make Western Australian gas-using industries less competitive against national and international competition.[44]

63. Cockburn Cement has submitted that the Australian Cement Industry is under threat from cheap cement imports, saying "The price of energy is the most important factor in the industry's competitiveness …. Any increase in the cost of gas transport could affect the on-going viability of clinker and lime production facilities."[45]

64. Clearly the international competitiveness of energy consuming industries in the South West will be reduced by inflated tariffs for transport on the DBNGP. But the effects will also be felt state-wide. Gas must be transported approximately two thirds of the way down the DBNGP to the Mid-West Pipeline to reach Mid-West operations such as Windimurra and Hill 60. The increase in delivered gas costs will significantly reduce the international competitiveness of these industries.

65. The Chamber of Minerals & Energy has emphasised the great importance to WA of competitively priced energy:

> *The price of energy is a key input into virtually all production processes. In WA, with its reliance on minerals extraction and further processing, energy is particularly important. This link can be clearly seen in the boost to further processing provided when gas prices were reduced following renegotiation of supply contracts in the North West. Preliminary modelling work done by the University of WA's Economic Research Centre suggests that a 25% reduction in energy prices boosts employment by over 1%, exports by around 0.5% and GSP by a similar amount. Conversely, energy price increases will decrease*

[39] ERTF Terms of Reference, p. 1, first bullet point.
[40] Worsley Alumina Submission to OffGAR of 11 February 2000.
[41] Bunbury Chamber of Commerce Submission to OffGAR of 29 February 2000.
[42] Bunbury Wellington Economic Alliance Submission to OffGAR of 17 March 2000.
[43] WMC Resources Ltd Submission to OffGAR of 12 March 2000.
[44] Wesfarmers CSBP Submission to OffGAR of 16 March 2000.
[45] Cockburn Cement Submission to OffGAR of 17 March 2000.

> *economic growth to an equivalent degree. It is important to note that these results represent the impact of final delivered energy prices. Thus an increase (or decrease) in the cost of transportation has the same result as an identical increase in the cost of supply.*[46]

66. The discussion of s. 8.11(d) demonstrates the related effect of distorting investment decisions.

(f) s 8.10(f) – the basis on which Tariffs have been (or appear to have been) set in the past, the economic depreciation of the Covered Pipeline, and the historical returns to the Service Provider from the Covered Pipeline

67. The Court stated that the Regulator is required to conduct a discretionary evaluation of what weight should be attached to each of the factors identified in s 8.10(e) to (j) in any given case.[47] Western Power submits, for the reasons set out below, that in this case the Regulator should attach little weight to the basis on which tariffs have been or appear to have been set in the past.

68. Epic's position is very different from that of an "incumbent" pipeline operator who acquired or built the pipeline before the Code was anticipated. Principles of fairness and sovereign risk require that incumbent operators who are subjected to new regulatory regimes get some protection from this shifting of the goalposts. Hence the Code takes into account historical factors such as those listed under this s. 8.10(f).

69. However in Epic's case it was not an incumbent. For the reasons set out in Appendix 1 it should be treated as though it bought the pipeline after the Code had commenced.

70. The analysis in Appendix 1 demonstrates that the Court's statement that each of the considerations in s 8.10(f) has a potential relevance in a hypothetical case where there has been a sale of the pipeline prior to the commencement of the Code,[48] need not be given great weight in the case of the DBNGP. Western Power submits that the Court was there referring to a situation where the sale occurred before the Code was contemplated.

71. For the sake of completeness, Western Power notes that in setting tariffs in the past, under both the GTRs and the DBPRs, charges for capital recovery were based on what approximates a DAC valuation, estimated by the Regulator to be about $874 million.[49]

72. Also, tariffs were previously set on a very short depreciation period of 20 years, which would have recovered the capital base of the pipeline well ahead of the end of its economic life. This over-recovery of capital in the first 20 years not only inflated tariffs in the first 20 years, but also would have produced a radically "stepped" tariff at about the 20 year mark, as is graphically illustrated in an earlier AlintaGas submission.[50] Western Power supports the Regulator's adoption of a more appropriate timetable for asset depreciation, which avoids this radical tariff step. Western Power notes, however, that adopting this longer depreciation period means that there will

[46] Chamber of Minerals & Energy Submission to OffGAR of 17 March 2000.
[47] Para 74 of the judgment.
[48] Para 168 of the judgment
[49] Page 148 of Part B of the Draft Decision.
[50] AlintaGas's Fourth Submission "Issues Related to Additional Submission", 19 May 2000, p. 15.

necessarily be a discontinuity between pre-Code and post-Code tariffs. This diminishes the validity of any simplistic comparison between the $1.00 /GJ "headline" tariff under the *Dampier to Bunbury Pipeline Regulations 1998* and the "headline" characterisation of a Reference Tariff under the Code.

(g) s 8.10(g) – the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code

73. Under clause 8.10(g) of the Code, in establishing the initial Capital Base for the DBNGP, the Regulator is required to consider the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code.

74. The Court found that the relevant persons include users as well as service providers.[51]

75. The unusual circumstances of the DBNGP sale, which occurred shortly before the Code commenced in circumstances where Epic was fully aware that the pipeline was going to be regulated by the Code (see Appendix 1), means that this factor operates differently for incumbent shippers as distinct from the Service Provider.

(g)(i) Reasonable expectations of Epic

76. Western Power submits that in this case, for the reasons set out in Appendix 1 the reasonable expectations of Epic could only have been that the regime under the Dampier to Bunbury Pipeline Act 1997 was a temporary regime that would continue in operation only until 1 January 2000, and that after that time, the determination of tariffs and service policies for the DBNGP would be carried out by an independent regulator under the Code.

77. Accordingly, the reasonable expectation of Epic under the regulatory regime that applied to the Pipeline prior to the commencement of the Code should have no effect on the Regulator's determination of the initial Capital Base.

(g)(ii) Reasonable expectations of Users

78. In contrast to Epic, users of the DBNGP would have had reasonable expectations under the regulatory regimes that applied to the DBNGP prior to the Code.

79. Most of the incumbent shippers at the sale date, and today, entered into long-term transportation contracts in 1995 and 1996, well before the Code was even contemplated, and so deserve recognition in these Code provisions which are designed to smooth the transition and to protect incumbent users' interests.

80. Under both the GTR and the DBPR regimes, tariffs were based on a capital base that resembled a DAC valuation which is estimated by the Regulator to be $874.0 million.[52] Users would have expected that the tariffs would continue to be based on a capital base that resembled a DAC valuation.

81. The Regulator should take users' reasonable expectations into account because many large commercial users of the DBNGP, including Western Power, have made very

[51] Para 169 of the judgment.
[52] Pages 148-149 of Part B of the Draft Decision.

substantial long-term business plans and have entered into binding contracts, in reliance on gas transportation costs that would be based on a capital base resembling a DAC valuation.

82. Consequently, in setting the initial Capital Base the Regulator should take into account (and give weight as a fundamental element to) the reasonable expectations of users under the previous regulatory regime that future tariffs would be based on a capital base that resembled a DAC valuation.

(h) 8.10(h) – the impact on the economically efficient utilisation of gas resources

83. The Court found that the phrase "economically efficient", as used in this section was intended to reflect the theory of economic efficiency.[53] One well recognised dimension of economic efficiency is productive efficiency, which is achieved where individual firms produce the goods and services that they offer to consumers at *least cost*.[54]

84. A DORC valuation of a pipeline approximates the efficient (least) capital cost of providing a gas pipeline transportation service. A DORC valuation is also consistent with providing the signals to investors that motivate a longer-term efficient level of investment in gas transmission assets.[55]

85. The tariff that derives from an efficient (lowest possible) initial Capital Base will lead to productive efficiency in the utilisation of gas resources by providing an incentive for the development of and use of gas sources which result in the lowest possible (forward looking) costs of gas exploration, extraction, transportation and supply to end users.[56]

86. Excessive gas transportation tariffs, which have been inflated to recover an initial Capital Base derived from Epic's overpayment, will lead to economically inefficient utilisation of gas resources by increasing the delivered cost of gas to economically inefficient levels.

87. In such circumstances, Western Power may ultimately have no choice but to turn to alternative generation options which may be more expensive or less efficient. Western Power has emphasised in its previous submissions[57], and reiterates, that this is likely to motivate Western Power to seriously consider changing fuel, transportation and generation sources and incurring the associated expense. Once again, this would be inconsistent with the State's energy reform objectives, which include the ERTF objective of maximising electricity industry productivity and efficiency.

88. For example, Worsley Alumina decided to source steam and power for its expansion from a Gas Turbine / Heat Recovery Steam Generator in preference to coal. This decision was based on projections of gas transportation costs much less than the costs

[53] Para 120 of the judgment.
[54] Para 155 of the judgment.
[55] Pages 150-151 of Part B of the Draft Decision.
[56] Victorian Office of the Regulator General, page 150 of Pt B of the Draft Decision.
[57] Western Power Submission to OffGAR No. 1 of 17 February 2000, Western Power Submission to OffGAR No. 2 of 17 February 2000, Western Power Submission to OffGAR No. 4 of 16 March 2000, Western Power Submission to OffGAR of 28 September 2001. See also Treasury & Office of Energy Submission to OffGAR of 20 April 2000 at pages 20-21.

proposed by Epic based on an initial Capital Base of around $2.4 billion. Worsley Alumina said that the "pipeline charges under Epic's proposed Access Arrangement would have had a material adverse impact on Worsley's decision to base its expansion on gas-fired steam and power".[58]

(i) s. 8.10(i) – the comparability with the cost structure of new Pipelines that may compete with the Pipeline in question (for example, a Pipeline that may by-pass some or all of the Pipeline in question)

89. In his draft decision the Regulator concluded that "comparability of an asset value with asset costs incurred, or potentially incurred by competing pipeline Service Providers is not a matter of material importance in considering valuation of the Initial Capital Base of the DBNGP".[59]

90. While Western Power does not disagree with this general conclusion, section 8.10(i) must still be given weight as a fundamental element in establishing the initial Capital Base for the DBNGP.

91. Western Power submits that this factor is another one which suggests that DORC sets a maximum value for the initial Capital Base. It certainly precludes some of the exaggerated figures advanced by Epic.

(j) 8.10(j) – the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase

92. The Court stated that what must be considered is the price paid, which in this case is $2.407 billion, but also, very significantly, the circumstances of this purchase.[60]

93. Western Power's discussion of purchase price issues in Appendix 2 applies equally to the Regulator's consideration of s 8.10(j).[61]

94. Section 8.10(j) is one of the many points in section 8 which calls for evaluation, the exercise of judgement, the formation of opinion and other exercises of discretion by the Regulator.[62] In Western Power's view, the combined circumstances of the purchase of the DBNGP must lead the Regulator to form the opinion that the purchase price recently paid for it should be given little or no weight in the Regulator's discretionary evaluation of what weight should be attached to each of the factors identified in s 8.10(e) to (j) in the ultimate establishment of the Capital Base.[63] There is no evidence that the purchase price represented the market value of the pipeline at the time of purchase, and there are indications that the purchase price was uncommercial, reckless and mistaken. There are also indications that Epic had motivations unrelated to value which might have given it reason to pay higher than true market value for the DBNGP.

[58] Worsley Alumina's submission to OffGAR dated 11 February 2000.
[59] Page 151 of the Draft Decision
[60] Para 172 of the judgment.
[61] Para 173 of the judgment
[62] Para 73 of the judgment.
[63] Para 74 of the judgment.

(k) s 8.10(k) – any other factors the Regulator considers relevant

95. By section 8.10(k), in establishing the initial Capital Base, the Regulator must consider and give weight as a fundamental element to any other factors the Relevant Regulator considers relevant.[64]

96. Western Power submits that the Regulator should consider relevant, and consequently should give weight as a fundamental element, to the Commonwealth and Western Australian Governments' policies and commitments with respect to limiting national and state greenhouse gas emissions, respectively.[65]

97. Australia is party to the United Nations Framework Convention on Climate Change, and has signed the Kyoto Protocol to that Convention, which has as its ultimate objective the stabilisation of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.[66]

98. Energy use is the dominant source of greenhouse gas emissions in Australia, contributing 55 percent of the nation's total emissions.[67] Fossil fuelled generation in Australia contributed an aggregate of 162 million tonnes of carbon dioxide equivalent greenhouse gas emissions in calendar year 1998.[68]

99. The low emission rate of natural gas compared to other fuels means that its use, instead of fuels with higher emission rates, promotes the achievement of the Governments' objective of limiting greenhouse gas emissions.

100. The Commonwealth Government's aim is that the delivered cost of gas is decreased so that it is competitive against other fossil fuels with higher greenhouse emission intensities. The National Greenhouse Strategy provides:

> *Electricity supply industry reform measures are being progressed by the COAG. Progressive restructuring of the electricity supply industry has been taking place over the last decade, leading to the introduction in 1997 of the first stage of a competitive electricity market in southern and eastern Australia. A similar process of reform is taking place in the gas industry. Australian governments are committed to enhancing competition in the natural gas sector. Reducing the cost of gas will increase its competitiveness against other fossil fuels with higher greenhouse emission intensities.*[69]

101. In other words, competition reform and greenhouse gas reform are inextricably linked. Competition reform in Western Australia for gas is implemented by the Code enacted as law in Western Australia by the *Gas Pipeline Access (Western Australia) Access Act*.

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[64] Para 56 of the judgment.
[65] Guidance Statement for Minimising Greenhouse Gas Emissions No. 12 October 2002, Government of Western Australia Environmental Protection Authority; The National Greenhouse Strategy November 1998, Commonwealth of Australia.
[66] Page 101 The National Greenhouse Strategy.
[67] The Australian Greenhouse Office.
[68] Page 3, SKM report.
[69] Page 42 The National Greenhouse Strategy

102. Government has promoted micro-economic reform in the gas market with the aim of making gas available at its efficient cost:

> *Australia has seen steady growth in the use of natural gas in the energy sector, for electricity generation and for direct use. As a result of micro-economic reforms in the electricity and gas markets, this trend is expected to continue, resulting in a lowering of the average greenhouse gas intensity of energy.*[70]

103. The Commonwealth Government has also stated that it proposes to monitor and review the operation of the competitive energy market by conducting:

> *…periodic reviews of the operation of the National Electricity Code and National Gas Access Code to ensure that they do not present barriers to sustainable energy supply and demand side options, taking into account reports of the National Electricity Code Administrator and any relevant reports by gas regulatory bodies.*[71]

104. The Government's object is that the competitiveness of natural gas is increased as against other fossil fuels with higher greenhouse emission intensities. Accordingly, its policy it that the operation of the Code must not present a barrier to reducing the cost of gas.

105. The Regulator should not establish a high Capital Base for the DBNGP simply because Epic erred in its assessment of value of the DBNGP or had unreasonable expectations, or both, because this will result in higher tariffs which will decrease the competitiveness of natural gas with its low greenhouse emission intensity in favour of other fossil fuels with higher greenhouse emission intensities.

106. This would be contrary to Government policy and contrary to Australia's commitments in respect of the Kyoto Protocol to the United Nations Framework Convention on Climate Change.

107. Western Power has a particular interest in greenhouse gas reductions, as one of the first generators to enter into an ESAA greenhouse gas reduction agreement with the Commonwealth Government.[72] In that agreement, Western Power observed the importance, in reducing greenhouse gas emissions, of maximising the cost competitiveness of gas-fired generation compared with coal-fired. Gas transportation costs are a central component in that equation.

108. **Deleted under section 7.11 of the Code**.

[70] Page 41 The National Greenhouse Strategy
[71] Page 43 The National Greenhouse Strategy
[72] Greenhouse Cooperative Agreement between Western Power Corporation and the Commonwealth of Western Australia dated 25 March 1997.

1.3 Applying s. 8.11 to the DBNGP in light of the judgment

(a) Introduction to s. 8.11

109. Western Power's first post-judgment submission[73] demonstrated that s. 8.11 involves two elements:

(a) as one element, Epic must make a credible case that the DBNGP's circumstances justify the Regulator adopting an initial Capital Base that falls outside the "normal" bounds of DAC and DORC;

(b) as a second and logically quite separate element, Epic must establish that an appropriate weighting of the factors in s. 8.10 as fundamental elements, consistent with the objectives in s. 8.1 (guided if necessary in the last paragraph of s. 8.1 by the factors in s. 2.24), produces an initial Capital Base which is higher than DORC.

110. Neither of these is sufficient in itself. Whether or not the DBNGP's circumstances are "normal", the application of s. 8.11 will not become an issue unless Epic demonstrates that the initial Capital Base should be higher than $1.234m. The Court found that the onus rests on Epic to do this.[74]

(b) First element: Justifying a departure from the "normal" band

111. Western Power's first post-judgment submission made it clear that nothing in the judgment **requires** the Regulator to depart from the normal band in the particular case of the DBNGP. This is a matter for the Regulator's discretion.

112. The Court ruled that the Regulator **may** take into account Epic's purchase of the DBNGP and the circumstances of that purchase including the price paid, and any value according to a recognised asset valuation methodology which the price reveals, in determining this element.[75]

113. Western Power submits that for the reasons discussed above in relation to s. 8.10 (see also Appendix 2 of this submission), in the particular circumstances of the DBNGP there is no credible evidence yet placed before the Regulator to justify his forming the view that a departure from the "normal" band is necessary.

114. For example, in the DBNGP's circumstances there was no reasonable basis for Epic's purchase price to include capitalised monopoly rents.

(c) Second element: Establishing an initial Capital Base higher than DORC

115. As to the second element, Western Power submits that for the reasons given above (see in particular in relation to ss. 8.10(b), (c), (d), (h) and (i) and see also Appendix 2 of this submission), it is impossible to sustain a valuation of the DBNGP which is higher than DORC under the s. 8.10 factors, independently of the operation of s. 8.11. If Epic makes submissions on this matter, Western Power will respond.

[73] Para 39 & 40 of the judgment
[74] Para 189 of the judgment
[75] Para 223, 5th bullet point of the judgment

1.4 Applying s. 8.1 to the DBNGP (in relation to setting the initial Capital Base) in light of the judgment

116. As demonstrated in Western Power's first post-judgment submission, and summarised at the beginning of this submission, the principal provisions in setting an initial Capital Base are ss. 8.10 and 8.11, discussed above under headings 1.2 and 1.3. To the extent that the Regulator requires policy guidance in this process, he is to look to the objectives in s. 8.1, which are discussed under this heading.

(a) s 8.1(a) – providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service

(a)(i) Efficient costs

117. The Court found that "efficient costs" in this section imported the concept of economic efficiency in its accepted senses of technical or productive, allocative and dynamic efficiency, together with the ordinary notion of costs.[76]

118. One component of the efficient cost of delivering the Reference Service is a capital recovery component.

119. The Court found that the argument that only capital costs calculated on a "forward looking" basis could be taken into account in the determination of "the efficient costs of delivering the reference service" was supported by economic theory.[77] On this view, no regard is had to past actual investment. However, the application of "efficient costs" to the circumstances of a case was a matter for the Regulator. [78]

120. Western Power submits that the Regulator should have regard only to forward-looking costs in the case of the DBNGP. This is because calculating capital costs only on a forward looking basis, as supported by the theory of economic efficiency, leads to the objective that the Court found is associated with s 8.1(a), of replicating the outcome of a competitive market.[79] The Court found that there is a well-accepted association between economic efficiency and competition in a market. [80]

121. Western Power submits that a Reference Tariff and Reference Tariff Policy designed on this basis will be set at the level of efficient costs, which will derive from an initial Capital Base set at efficient level, which is approximately the DORC valuation of around $1,234 million.

122. Epic must show a good reason for the Regulator to abandon a purely forward-looking, economically efficient approach, and take a "backward-looking" analysis which takes into account Epic's past actual investment in the DBNGP, and no such reason has been shown by Epic.

[76] Para 139 of the judgment.
[77] Para 141 of the judgment
[78] Para 141 of the judgment.
[79] Para 139 of the judgment.
[80] Paras 116, 139 & 143 of the judgment.

123. In this case, as is made clear in Appendix 1, Epic knew at the time that it bid for the DBNGP that the DBNGP would be regulated under a regime with all the elements of the Code, including the Code's objective of preventing the abuse of monopoly power.[81] There is thus no justification in the specific case of the DBNGP for allowing a "backward-looking" approach in order to permit recovery of a capitalised monopoly profit component. This was the only example given by the Court for adopting a "backward looking" approach and it is clearly not relevant in this case.[82]

124. If Epic makes any further submissions on this point in an attempt to demonstrate that there is a good reason to take a "backward-looking" approach, Western Power will make submissions in response.

125. Even then, Epic would still have to demonstrate that such a "backward-looking" approach does somehow meet the statutory requirements of technical or productive efficiency, allocative efficiency and dynamic efficiency.

(a)(ii) Opportunity to earn a stream of revenue that recovers the efficient costs

126. The Court also noted that s 8.1(a) does not provide that the service provider should recover the efficient cost of delivering the reference service; the objective is merely that the service provider should be provided with the "opportunity" to earn a "stream of revenue" that recovers the efficient costs over the expected life of the assets used.[83]

127. The Court was clearly trying to emphasise that the objective of s 8.1(a) is not to guarantee that the Service Provider receives any particular sum of money. Rather, by s 8.1(a), the Reference Tariff and Reference Tariff Policy should have sufficient flexibility so that, depending on how well the Service Provider minimises its expenses in the process of generating revenue and how well it develops the market for Reference Service, it has the *opportunity* to earn a *stream of revenue* that recovers efficient costs. Of course, capital recovery is only one element of the efficient cost of providing the Reference Service, and increased efficiency by the Service Provider in, say, maintaining the pipeline would mean that the overall cost of providing the Reference Service was lower. The stream of revenue earned, whatever it was, would then be more likely to lead to the Service Provider recovering the efficient costs of providing the Reference Service.

128. Section 8.1(a) is not supposed to provide a guarantee of any nature to the Service Provider, merely an opportunity.

(b) s 8.1(b) – replicating the outcome of a competitive market

129. The Court found that the precise focus of s 8.1(b) is a competitive market in the field of gas transportation, the objective being to replicate what would be the outcome *if there was* competition for the transportation of gas by the pipeline in question.[84]

130. This requires the application of economic methods and theory to replicate the outcome of a workably competitive market,[85] because a workably competitive market is likely, over time, to lead to greater economic efficiency.[86]

[81] See paragraph (b) of the preamble to the GPA (WA) Act
[82] Para 141 of the judgment.
[83] Para 141 of the judgment.
[84] Para 127 of the judgment.

131. The Court acknowledged that there is no clear answer to how to determine the outcome of a competitive market.[87] It is the Regulator's task to explore this fully.[88]

132. If the DBNGP faced workable competition from another transportation service provider for the service of gas transportation from the north-west of Western Australia to the south-west (for example a parallel pipeline), this would result in a transmission tariff that was at approximately the rate of efficient cost (in the forward looking, economic sense). Each provider of the transportation service would have to keep its tariff around the level of efficient cost to ensure that it retained its market share.

133. In the context of setting the initial Capital Base, Western Power submits that to ensure that the design of the Reference Tariff and Reference Tariff Policy replicates the outcome of a competitive market, the Reference Tariff should be set at the level of efficient costs, which should derive from an initial Capital Base set at a forward-looking economically efficient level, which is approximately the DORC valuation of around $1,234 million.

134. Western Power's first post-judgment submission makes it clear that such an approach would be entirely consistent with the judgment and the Code.[89]

(c) s 8.1(d) – not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries

(c)(i) Not distorting investment decisions in pipeline transportation systems

135. The Court found that while economic efficiency requires that past actual investment be ignored,[90] s 8.1(d) does not deny the *potential* relevance of past investment decisions to the design of a reference tariff or a reference tariff policy.[91]

136. The Court noted that very substantial long-term investment decisions are required for investment in a natural gas pipeline. Investment will not be encouraged or maintained if investment decisions **which were sound when judged by the commercial circumstances existing at the time** of the investment, are rendered loss-making by virtue of future governmental intervention.[92]

137. The Court found that this might happen in a hypothetical case where a reference tariff for such a pipeline is based on a cheaper present replacement value of the pipeline and no regard is paid to the actual unrecovered capital investment in the pipeline, thus undermining the viability of the earlier investment decision.[93] The Court found that "in an appropriate case"[94] such as the hypothetical case being considered by the Court, it **may** be appropriate for the Regulator to take into account the actual investment in the pipeline when establishing the initial Capital Base.[95]

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[85] Paras 124, 126 & 127 of the judgment.
[86] Para 143 of the judgment.
[87] Para 144 of the judgment.
[88] Para 128 of the judgment.
[89] Paras 43-46 of Western Power's First Post-Judgment Summary
[90] Para 150 of the judgment.
[91] Para 152 of the judgment
[92] Para 149 of the judgment.
[93] Para 149 of the judgment.
[94] Para 154 of the judgment
[95] Para 154 of the judgment.

138. Clearly Epic's purchase of the DBNGP is very different from the hypothetical example discussed by the Court.

139. First, there is no evidence that the price Epic paid for the DBNGP was sound when judged by the commercial circumstances existing at the time.[96] The Court specifically said that reckless, mistaken or highly speculative investment decisions should not be accepted for this purpose.[97] As the Court found, the mere fact that the price was paid in a public tender is not necessarily determinative of this issue because Epic may have erred in its assessment of value or had unreasonable expectations.[98] Western Power submits that both of these were the case. Furthermore, by definition a closed tender process will tend to maximise, not minimise, the risk of a purchase price being erroneously or deliberately inflated. It rests with Epic to show that this is not the case, and it has not done so.[99] On the contrary, Western Power submits that all the evidence currently before the Regulator supports a conclusion that Epic's investment was one or more of reckless, mistaken or highly speculative (see Appendix 2).

140. Second, as the analysis in Appendix 1 makes clear, the determination of the initial Capital Base and tariffs for the DBNGP by an independent regulator under the Code cannot be seen to be "future governmental intervention". At the time of its bid, Epic was aware that tariffs for the DBNGP would be determined by an independent regulator in accordance with the Code.

141. The Court discussed a different way in which investment decisions in pipeline transportation systems might be distorted. If the purchase price paid for a pipeline as a result of a reckless, mistaken or highly speculative investment decision is taken into account in establishing the initial Capital Base, this will be recognised by other investors.[100] The Court stated:

> *Future investment decisions in pipelines might well be distorted were it the case that any price paid by a service provider to acquire a pipeline, no matter how uncommercial, mistaken or reckless, should automatically be recognised as the initial Capital Base or value of the pipeline for the purposes of the Code. This would encourage the payment of excessive and unrealistic prices to acquire a pipeline in the expectation that the purchase price would be able to be recovered over the life of the pipeline under the Code.*

142. The Court warned that it follows that a price paid for a pipeline before the Code applied to it will need to be carefully evaluated by the Regulator for the purposes of s 8.1(d). Western Power submits that the Regulator's evaluation of the price paid for the DBNGP will show that there are indications that the price paid by Epic was too high and that Epic has been unable to justify the price. Western Power submits that Epic knew that a Reference Tariff for the DBNGP would be set by an independent regulator under the principles of the Code at the time it bid for the DBNGP.

[96] This test endorsed also in para 149
[97] Para 154 of the judgment.
[98] Para 189 of the judgment.
[99] Para 189 of the judgment.
[100] Para 154 of the judgment.

143. These facts mean that if Epic's purchase price for the DBNGP is taken into account under this factor, the result will be to lead to distorted investment decisions in pipeline transportation systems in contravention of this objective.

(c)(ii) Not to distort investment decisions in upstream or downstream industries

144. A high tariff for gas transportation on the DBNGP deriving from a high initial Capital Base will lead to the cost of delivered gas being higher than the efficient cost. This will distort investment decisions in industries upstream and downstream from the DBNGP, away from what would otherwise be the optimum outcome.

145. The increased cost of delivered gas will distort investment in downstream industries *directly* because it will increase the probability that a decision will be made to use an alternative fuel for a project, such as coal and oil, solely because the DBNGP's regulated tariffs are not economically efficient. It will also increase the probability that a decision will be made to not locate a new project in Western Australia at all, or to locate it in a non-optimum position, in order to obtain gas from a source other than the DBNGP.

146. Investment in all gas-consuming industries will potentially be distorted, but the effect is likely to be greatest in commercial operations that generate their own power and heat on-site.

147. The higher price for delivered gas will distort investment decisions in downstream industries *indirectly* because it will cause Western Power's cost of fuel for power generation to increase substantially. Western Power will ultimately have no choice but to pass this cost on to consumers. Again, investment decisions will be distorted because it will increase the probability that a decision-maker will decide not to proceed with the project in Western Australia at all because of the increased cost of power, in favour of another location.

148. Western Power has emphasised in its previous submissions,[101] and reiterates, that this is likely to lead to increases in electricity prices for small consumers in Western Australia and to motivate Western Power to seriously consider changing fuel, transportation and generation sources and incurring the associated expense. As stated above, this is directly inconsistent wit the ERTF's objective of lower power prices for consumers.

149. For example, Worsley Alumina's decision to use gas in preference to coal was based on projections of gas transportation costs much less than the costs proposed by Epic based on an initial Capital Base of around $2.4 billion. Worsley Alumina said that the "pipeline charges under Epic's proposed Access Arrangement would have had a material adverse impact on Worsley's decision to base its expansion on gas-fired steam and power",[102] a classic illustration of inflated tariffs distorting an otherwise sound investment decision.

[101] Western Power Submission to OffGAR No. 1 of 17 February 2000, Western Power Submission to OffGAR No. 2 of 17 February 2000, Western Power Submission to OffGAR No. 4 of 16 March 2000, Western Power Submission to OffGAR of 28 September 2001. See also Treasury & Office of Energy Submission to OffGAR of 20 April 2000 at pages 20-21.
[102] Worsley Alumina's submission to OffGAR dated 11 February 2000.

150. Also, Worsley Alumina has expressed its concern that high tariffs for gas transportation, increasing the price of energy, reduce the attractiveness of the south west of Western Australia as the site for future expansions of the alumina industry. [103]

151. Investment decisions in upstream industries will be distorted because of the consequent reduced demand for gas. There will be less development and processing of gas resources for domestic consumption.

152. **Deleted under section 7.11 of the Code**.

(d) s 8.1(e) – efficiency in the level and structure of the Reference Tariff

153. By s 8.1(e), a Reference Tariff should be designed with a view to achieving the objective of efficiency in the level and structure of the Reference Tariff.

154. The Court found that "efficiency", as used in this section, was intended to reflect the theory of economic efficiency.[104] One well recognised dimension of economic efficiency is productive efficiency, which is achieved where individual firms produce the goods and services that they offer to consumers at *least cost*.[105]

155. Efficiency in the level of the Reference Tariff will be achieved if the tariff is derived from the lowest possible initial Capital Base.

156. A DORC valuation of a pipeline approximates the efficient (least) capital cost of providing a gas pipeline transportation service. A DORC valuation is also consistent with providing the signals to investors that motivate a longer-term efficient level of investment in gas transmission assets.[106]

1.5 Applying s. 2.24 to the DBNGP (in relation to setting the initial Capital Base) in light of the judgment

157. As demonstrated in Western Power's first post-judgment submission, and summarised at the beginning of this submission, the principal provisions in setting an initial Capital Base are ss. 8.10 and 8.11, discussed above under headings 1.2 and 1.3. The Regulator obtains policy guidance in this process from the objectives in s. 8.1, discussed above under heading 1.4.

158. The final level of guidance which may be called on, but only in the limited case of seeking guidance for the exercise of the Regulator's discretion under the last paragraph of s. 8.1, if necessary, involves looking to the factors in s. 2.24, which are discussed under this heading.

159. Western Power wishes to emphasise that its comments below should not be taken to suggest that s. 2.24 has any relevance to the process of setting the initial Capital Base outside this one, limited and indirect application.

[103] Worsley Alumina Submission to OffGAR of 11 February 2000.
[104] Para 120 of the judgment.
[105] Hilmer Report, para 91 judgment.
[106] Pages 150-151 of Part B of the Draft Decision.

160. The factors in s. 2.24 are not expressed to be listed in any priority. It is for the Regulator to assess the weight and relevance of each of the factors. As a matter of statutory interpretation the order in which the factors are printed does not suggest any order of priority.[107] If the Regulator's legal advice is to be contrary, Western Power requests the opportunity to make submissions on this point.

(a) s 2.24(a) – the Service Provider's legitimate business interests and investment in the Covered Pipeline

161. It is clear from the judgment that it is a legitimate business interest of Epic to seek to recover the actual investment it made in the DBNGP when it acquired it, together with a reasonable return on that investment. Epic's right to seek to do so is not disputed, nor is the fact that the Code recognises this interest under s. 2.24(a). This does not mean that, after all Code provisions are applied, Epic should succeed in this objective.

162. Clearly the Regulator's obligation under s 2.24(a) to consider Epic's legitimate business interests and investment in the DBNGP must be counterbalanced by his obligation under s 2.24(d) to consider society's interest in the DBNGP's economically efficient operation, together with consideration of the public interest (s 2.24(e)) and the interests of Users (s 2.24(f)).

163. Furthermore, the Court has made it clear that s 2.24 plays only a limited role in s 8.[108]

164. It can thus be seen that, contrary to the view expressed by Epic in its recent submission to the NCC,[109] Epic's legitimate business interest in recovering its purchase price should play at most a very limited, and indirect, role in the establishment of the initial Capital Base under s 8.10 and s 8.11.

165. The Court stated that the Regulator's further consideration of the price paid by Epic for the DBNGP would no doubt be undertaken differently in the light of the Court's findings on the meaning, effect, potential operation of and interrelationship between sections 2.24, 8.1, 8.10, and 8.11 as outlined above.[110]

166. The Court expressly recognised that there may well be no change in the ultimate outcome, from what is set out in the Draft Decision emphasising that whether there was is a matter for Epic's further submission, if any, and the Regulator's re-assessment and decision.

(b) s 2.24(d) – the economically efficient operation of the Covered Pipeline

167. The Court found that "efficiency", as used in this section was intended to reflect the theory of economic efficiency.[111] One well recognised dimension of economic

[107] Para 187 of the judgment.
[108] Para 85 and 136 of the judgment. See also Para 78 of the judgment
[109] APT, Duke Energy and Epic Energy submission to the National Competition Council on the relevance of the Supreme Court (WA) decision in the Epic matter to the Council's recommendation in relation to certification of the Queensland gas access regime, September 2002. Western Power may make a further submission in relation to this document.
[110] Para 190 of the judgment.
[111] Para 120 of the judgment.

efficiency is productive efficiency, which is achieved where individual firms produce the goods and services that they offer to consumers at *least cost*.[112]

168. The Court rejected Epic's argument that its interests as operator of the DBNGP were to be taken into account under this section. The Court said that while the notion of economic efficiency in this context involves specific views about costs such as capital investment, these views are from the perspective of society.[113] That is, society's interest in promoting a competitive market and preventing the abuse of monopoly power.

169. For the pipeline to operate with productive efficiency, gas transportation services must be offered to consumers at least economic cost, so they must be provided using the lowest economically sustainable capital base. The low tariffs that derive from the low capital base ultimately enhance community welfare.[114]

170. A DORC valuation of a pipeline approximates the efficient (least) capital cost of providing a gas pipeline transportation service. A DORC valuation is also consistent with providing the signals to investors in gas distribution assets that motivate a longer-term efficient level of investment in gas transmission assets.[115]

171. The Regulator must consider both society's viewpoint, and under s 2.24(a), the different viewpoint of the Service Provider, having regard to the scope and objects of the Act.[116]

172. Clearly the need under s 2.24(d) to consider society's interest in the DBNGP's economically efficient operation, together with consideration of the public interest (s 2.24(e)) and the interests of Users (s 2.24(f)), operate to counterbalance and outweigh the need under s 2.24(a) to consider Epic's legitimate business interests and investment in the DBNGP.

(c) s 2.24(e) – the public interest, including the public interest in having competition in markets (whether or not in Australia)

173. By s 2.24(e), in assessing a proposed Access Arrangement, the Regulator must take into account the public interest, including the public interest in having competition in markets (whether or not in Australia).

174. The first limb of public interest in s 2.24(e) is the general public interest.

175. The Court declined to consider Epic's submission that the public interest may extend to protecting the interests of pipeline owners and ensuring that fair and reasonable conditions are provided where their private rights are overborne by the statutory scheme.[117]

176. Western Power submits that the public interest does not extend to include this, which is adequately dealt with by s 2.24(a). Even if s 2.24(e) does extend to include this,

[112] Hilmer Report, para 91 judgment.
[113] Para 133 of the judgment.
[114] Para 91 & 133 of the judgment.
[115] Pages 150-151 of Part B of the Draft Decision.
[116] Para 133 of the judgment
[117] Para 134 of the judgment

Epic was fully aware that the Code was coming when it bought the DBNGP (see Appendix 1), so it cannot be said to have had its rights overborne by a statutory scheme. Any rights Epic has in respect of the DBNGP have always been subject to the statutory scheme and therefore have not been overborne.

177. In any event, were the Regulator to consider Epic's interests under this section, they are more than outweighed by the interests of the other bidders for the DBNGP. Permitting Epic to use the price it paid for the DBNGP as the initial Capital Base would reward Epic's overpayment on purchase and transfer the business risk in the competitive bid process from the purchaser to pipeline users.

178. Such an outcome would be manifestly unjust to other bidders in the public tender who based their bids on a proper commercial assessment of the risk that they would be required to assume, contrary to the public interest.

179. It is also contrary to the public interest for the price paid by Epic for the DBNGP to be used as the initial Capital Base because it transfers the business risk in the competitive bid process from the purchaser to pipeline users in the form of high gas transportation tariffs.

180. It is contrary to the public interest for gas transportation costs to be artificially inflated, because it increases the risk that new power generation plant, acquired by competitive tender under the Public Power Procurement Process, will be coal-fired rather than gas-fired and hence will likely have higher greenhouse gas emissions, because increased gas transportation tariffs will impact on the cost differential between the two technologies.

181. **Deleted under section 7.11 of the Code**.

182. **Deleted under section 7.11 of the Code**.

183. **Deleted under section 7.11 of the Code**.

184. As to the second limb of this factor, competition in markets both upstream and downstream of the DBNGP will be hindered by inefficient transport tariffs.

(d) s. 2.24(f) – Interests of users and prospective users

185. By s 2.24(f), in assessing a proposed Access Arrangement, the Regulator must take into account the interests of Users and Prospective Users.

186. The Court acknowledged that the interests of users and prospective users are likely to be counterpoised to the service provider's legitimate business interests and investment.[118]

187. This is certainly true of the DBNGP. There is a fundamental tension between Epic's "legitimate business interest" in maximising income, and the users' diametrically opposed "interest" (note not limited by a requirement of legitimacy or a business link) in minimising tariffs.

[118] Para 135 of the judgment.

188. Western Power and other users (current and prospective) will be adversely affected by excessively high tariffs.

189. If Western Power absorbs some of these costs, keeping electricity prices unchanged, its own profitability will be reduced. To the extent that it is forced to pass on the costs to its customers by way of increased electricity prices, this will affect its customers' profitability and competitiveness.

190. Although some of these comments seem self-evident, this factor remains one of the section 2.24 factors which must be given weight as fundamental elements.

1.6 Conclusion regarding initial Capital Base

191. Western Power's first post-judgment submission made it clear that the judgment, while clarifying a number of points of interpretation, and while making some general observations on how the Code would apply in certain hypothetical circumstances, did not make binding determinations on how the Code is to be applied to the particular case of the DBNGP.

192. This is emphasised by the judgment's concluding paragraph:

> "It must be remembered, however, that once the basic issues of interpretation are clarified it is for the Regulator, not this Court, to consider and weigh those factors and objectives. It is for the Regulator to assess the relevance and weight of each of these factors and objectives and to exercise the discretions that are committed by the Code to him."[119]

193. Furthermore, as Western Power's first post-judgment submission makes clear, nothing in the judgment requires the Regulator to give primacy or particular weight to Epic's purchase price, or prevents the Regulator in his discretion from reaching the same conclusions as those which he incorrectly thought the Code forced on him, eg:

(a) that a reasonable commercial valuation of the DBNGP in 1998 would have set a purchase price having regard only to future regulated revenues and efficient capital investment; or

(b) that s. 8.1(a) should in this particular case be only forward-looking; or

(c) that Epic's purchase price was uncommercial and unsustainable regardless of whether Epic had purported to make allowance for future capital investment to meet load growth.

This submission has demonstrated that these are entirely appropriate conclusions to draw in this particular case.

194. The Court was also at pains to make it clear that it did not expect or require the Regulator's reconsideration to produce a different result. On the contrary it expressly stated that this is a matter for the Regulator.[120]

[119] Para 187 of the judgment
[120] Para 190 of the judgment

195. Western Power has demonstrated above:

(a) that Epic's approach to setting the initial Capital Base in all Epic 's current submissions is fundamentally flawed and inconsistent with the Code;

(b) that the DAC valuation stands unimpeached and must be given weight as a fundamental element;

(c) that the DORC valuation stands unimpeached and must be given weight as a fundamental element;

(d) that there are a number of very serious defects in the case put forward to date by Epic for use of purchase price either as a valuation methodology in its own right or as evidence of market valuation;

(e) that the other factors of s. 8.10 (each of which must be given weight as a fundamental element) tend to support a conclusion that a DORC valuation is the highest appropriate one, ie:

(i) s 8.10(e) – DORC;

(ii) s 8.10(f) – DAC;

(iii) s 8.10(g) – DAC;

(iv) s 8.10(h) – DORC;

(v) s 8.10(i) – DORC;

(f) as to s. 8.11, that there is no credible evidence before the Regulator on which to base a decision to depart from the normal band of DAC and DORC, even if (as is not the case) the s. 8.10 factors produced a number higher than DORC in the first place;

(g) that a valuation no greater than DORC would be most consistent with the objectives in s. 8.1; and

(h) to the extent that the s. 2.24 factors are relevant, and giving each of those factors weight as a fundamental element, the combined effect of the factors in s. 2.24 tends to a conclusion that a valuation no higher than DORC is most appropriate.

196. Therefore, in conclusion, Western Power submits to the Regulator that the changes to the Access Arrangement required by the Draft Decision in relation to initial Capital Base, and hence in relation to tariffs, should remain largely unchanged in the Final Decision.

Part 2 – Matters Other than Capital Base

2.1 Section 20 dispute and T1-equivalent reference service

(a) Introduction

197. Western Power reaffirms the submissions put forward in the joint submission dated 15 August 2001 entitled "Submission to the Gas Access Regulator on the T1-equivalent Reference Service" (**"joint submission"**). The joint submission sets out the background to the s. 20/T1-equivalent Reference Service issue.

198. Section 20 of the *Dampier to Bunbury Pipeline Act 1997*, obliges Epic to offer all pre-sale shippers (other than Alcoa) to move from their GTR[121] tariff to a variable tariff mechanism, under which the contractual tariff is determined from time to time as the tariff (**"statutory price"**) that a person could insist upon paying if the person were, at that time, entering into a contract for the service set out in the shipper's contract.

199. The practical effect of accepting a s. 20 offer is that the firm GTR T1 contract is amended, to replace its existing tariff provisions with a deceptively simple clause which says:

> "The shipper must, on any day, pay the price (**"statutory price"**) that a person could insist upon paying, under the then prevailing statutory access regime, if that person was entering into a contract on that day for a service the same as the service set out in this GTR T1 contract."[122]

200. One aspect of the background to s. 20 of the *Dampier to Bunbury Pipeline Act 1997* deserves emphasis. The sole reason s. 20 was enacted was to give incumbent shippers the opportunity of moving to a new tariff while remaining on their existing contracts. If the intention was purely to move shippers to a tariff under the *Dampier to Bunbury Pipeline Regulations 1998*, section 20 could have avoided the ambiguous references to "statutory price" and instead said that shippers were to be offered to move to a "price determined by the regulations made under this Act". The Act does not say that, because that was not Parliament's intention. At the time the *Dampier to Bunbury Pipeline Act 1997* was enacted it was well-known that that Act was merely creating an interim access regime, pending the arrival of the Code in about 1 January 2000 (this fact is illustrated elsewhere in this submission). Because the precise formulation of the Code was not known at that time, Parliament was forced to use the generic expression "statutory price", but this should not distract the Regulator from recognising that the now-impending move from the *Dampier to Bunbury Pipeline Regulations 1998* to the Access Arrangement **was precisely the move that Parliament intended by s. 20 to make available, in terms of tariffs, to incumbent shippers.** Western Power highlights the significance of this point below.

201. **Deleted under section 7.11 of the Code**.

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[121] "GTR" means *Gas Transmission Regulations 1994*

[122] Section 20 of the *Dampier to Bunbury Pipeline Act 1997* is complex and difficult to interpret and apply, and some areas regarding s. 20 are clearly controversial between Western Power and Epic. However West ern Power does not believe that this proposition as to the contractual effect of s. 20 is open to serious challenge. The controversy comes in the next step, determining what is the "statutory price" from time to time. Western Power would be happy to meet with the Regulator and his legal advisers, to discuss the operation of s. 20.

202. Epic has already told Western Power that in Epic's view if its proposed Access Arrangement were approved the s. 20 mechanism could very well "fail", in the sense that there is no ascertainable statutory price, for the period after the approval date. Epic has foreshadowed that it would argue for this outcome. Epic has expressed the view that if this occurs, the tariff under Western Power's GTR-based contracts should revert to a 1999 tariff of $1.18 /GJ.

203. **Deleted under section 7.11 of the Code**.

204. To give a very crude illustration of the size of this issue: The difference between a headline tariff of $1.18 /GJ and one of $0.85 /GJ (even assuming over-conservatively that all shippers pay the higher Zone 10 tariff), for roughly 250 TJ/d of capacity under GTR contracts (an under-estimate), would equate to very roughly $30m p.a.

205. **Deleted under section 7.11 of the Code**.

206. **Deleted under section 7.11 of the Code**.

207. Western Power and other shippers have sought the inclusion of a T1-equivalent Reference Service in the Access Arrangement for one primary purpose: to ensure that for those shippers with GTR T1 contracts who have accepted a s. 20 offer, it is possible to determine what the "statutory price" is after the Access Arrangement is approved.

208. As illustrated by the notional clause set out in paragraph 199 above, under s. 20, the "statutory price" (being the new contractual tariff once the s. 20 offer is accepted) is the price that a person could insist upon paying if entering into a contract for "the service concerned"; ie. if entering into a contract for the GTR T1 service set out in the GTR shipper's contract. The process of determining what price a person could hypothetically "insist upon paying" if entering into a contract for a GTR T1 service, will be very greatly facilitated if the Access Arrangement specifies a Reference Tariff for a Reference Service which is equivalent to the GTR T1 service.

209. In contrast, if the Access Arrangement does not specify a Reference Tariff for a Reference Service which is equivalent to the GTR T1 service, the parties may be forced to arbitration or litigation in order to determine (for the purposes of determining the contractual tariff) what price the hypothetical applicant would be able to "insist upon paying" if entering into a contract for a non-reference GTR T1 service.

210. Epic has foreshadowed to Western Power that it will resist such arbitration and will argue that the arbitrator should refuse to determine a tariff, thus causing the s. 20 mechanism to "fail".

211. In this context, Western Power requests the Regulator to re-examine the question of whether Epic should be required to amend the Access Arrangement in order to include a T1-equivalent Reference Service, in light of the Court's affirmation that the s. 2.24 factors apply for the purposes of s. 3 generally, and in this context in particular to the consideration of ss. 3.2(a)(i), 3.2(a)(ii) and 3.3(b). Western Power makes some submissions below regarding the s. 2.24 factors in this context.

(b) s. 2.24(a) in the context of a T1-equivalent Reference Service

212. The judgment makes it clear that not all of a Service Provider's commercial objectives will be "legitimate". Without suggesting that the category was closed, the court noted at anti-competitive conduct or tax evasion could be an "illegitimate" interest.[123]

213. **Deleted under section 7.11 of the Code**.

214. **Deleted under section 7.11 of the Code**.

(c) s. 2.24(b) in the context of a T1-equivalent Reference Service

215. The Regulator, in considering shippers' requests for the Access Arrangement to include a T1-equivalent Reference Service, should have regard to shippers' firm and binding contractual obligations to take-or-pay very substantial amounts of capacity under GTR-based contracts.

216. Those shippers like Western Power who have accepted a s. 20 offer have a firm GTR T1 contract in which the tariff provisions have in effect been replaced by a clause such as the notional one set out in paragraph 199 above.

217. This is a firm, binding contractual commitment to take or pay for large quantities of gas. It will not be made less so by any difficulty the parties may have in determining what price this mechanism produces. Western Power urges the Regulator to consider the impact of the Regulator's decision upon this firm, binding contractual commitment.

218. One risk faced by shippers, if the Regulator refuses to require Epic to include a T1-equivalent Reference Service, is that Epic could be successful in its argument that if the above mechanism fails, the tariff reverts to $1.18. Shippers would thus be faced with a binding long-term take-or-pay contract at a heavily inflated tariff, which incidentally has been forced on them in place of a Code tariff in circumstances where **the principal intention of s. 20 was to enable incumbent shippers to move to the Code tariff**. This illogical and … **[Deleted under section 7.11 of the Code]** …outcome can be very easily avoided by requiring Epic to include a T1-equivalent Reference Service in the Access Arrangement, thus eliminating the uncertainty as to what tariff is payable under contracts which have been amended under s. 20.

219. **Deleted under section 7.11 of the Code**.

(d) s. 2.24(c) in the context of a T1-equivalent Reference Service

220. There is no way in which a requirement that the Access Arrangement be amended to include a T1-equivalent Reference Service could adversely impact the operational and technical requirements necessary for the safe and reliable operation of the DBNGP.

(e) s. 2.24(d) in the context of a T1-equivalent Reference Service

221. If the Access Arrangement does not include a T1-equivalent Reference Service, which would make it a straightforward process to determine what tariff is payable under the

[123] Para 130 of the judgment

amended pricing clause now included in GTR T1 contracts by the acceptance of a s. 20 offer (see paragraph 199 above), the parties to each GTR T1 contract will face a contractual dispute to determine what price is payable.

222. These disputes are likely to be both complex and protracted, and to involve substantial devotion of time and resources by Epic and many shippers. This is not an economically efficient utilisation of resources, compared with the alternative and much simpler and cheaper solution of ensuring that the Access Arrangement includes a Reference Service and a Reference Tariff which make the task of determining the contractual tariff a more straightforward one.

(f) s. 2.24(e) in the context of a T1-equivalent Reference Service

223. The joint submission set out the context for s. 20.

224. There can be no doubt that Parliament's intention was to allow the then-incumbent GTR shippers to move from their then-regulated GTR tariffs to a "moving target" tariff, which picked up the prevailing regulated tariff from time to time.

225. Western Power submits that it would be completely adverse to the public interest for Epic Energy's Access Arrangement to be structured in a way that either defeated Parliament's objectives in s. 20, or made it difficult or expensive for those objectives to be achieved.

(g) s. 2.24(f) in the context of a T1-equivalent Reference Service

226. The joint submission makes it abundantly clear that the entire body of non-Alcoa shippers wish the Regulator to address this matter. The joint submission and the arguments above demonstrate very clearly why it is in the interests of these shippers for the Access Arrangement to include a T1-equivalent Reference Service.

(h) Summary regarding T1-equivalent Reference Service

227. The joint submission demonstrates why ss.3.2 and 3.3 of the Code either require, or failing that are completely consistent with, an exercise by the Regulator of his discretion to require the Access Arrangement to be amended to include a T1-equivalent Reference Service.

228. The above discussion demonstrates how almost all of the s. 2.24 factors weigh in favour of such an amendment, and how s. 2.24(a) cannot weigh against that amendment.

229. The Court's finding that each of the factors in s. 2.24 must be given weight as a fundamental element is not limited to matters associated with setting the initial Capital Base.

230. In this context, Western Power urges the Regulator to reverse his decision not to require Epic to include a T1-equivalent Reference Service in the Access Arrangement.

2.2 Penalties

231. Western Power's submission dated 21 September 2001 urged the Regulator to revisit his position on penalties set out in the Draft Decision. Western Power reaffirms its

submissions, and makes the following additional comments in light of the Court's emphasis on the s. 2.24 factors.

232. As to **s. 2.24(a)**, Western Power and other shippers have demonstrated that both Epic's ambit claim of $15 /GJ, and the Regulator's proposed penalty of 350% of the relevant 100% load factor Reference Tariff, would constitute unenforceable penalties if included in a contract. There is no way that Epic's interest in imposing penalties that the courts would render unenforceable for public policy reasons, could be characterised as "legitimate".[124]

233. Western Power notes that the Regulator's proposed 350% penalties in the Draft Decision should not be assessed by comparing them to Epic's unsustainable and unsubstantiated ambit claim of $15 /GJ. Rather they should be assessed on their merits by comparing them to what is reasonable and necessary, consistent with the Code, for the DBNGP.

234. As to **s. 2.24(b)**, the Regulator can very appropriately have regard to the firm and binding contractual commitments of all existing GTR and *DBNGP Access Manual* contracts, none of which have any peaking or balancing charges at all, let alone unlawful penalties. These contracts have operated for almost 7 years without mishap, which brings into serious question the need for any such charges.

235. As to **s. 2.24(c)**, that same almost 7 year operational record in an environment with no peaking or balancing charges at all, suggests that these charges are certainly not necessary to meet the technical and operational requirements for safe and reliable operation of the DBNGP. No-one would suggest that the DBNGP's operation since 1 January 1995 has been anything but safe and reliable despite the total absence of such charges, and Western Power is unaware of any evidence from Epic that something is about to radically change that would now render such charges necessary.

236. Epic apparently considered its ambit $15 /GJ penalties necessary as at 15 December 1999 when it lodged its proposed Access Arrangement, but Western Power is not aware of any safety or reliability issues that have arisen in the intervening 3 years despite Epic's not having access to these penalties.

237. Western Power emphasises the fact that the current regime does not leave Epic powerless to deal with peaking and balancing excursions. Both GTR contracts and the *DBNGP Access Manual* contracts give Epic the power to interrupt or curtail, or refuse gas deliveries to, shippers who violate the peaking and imbalancing limits. In terms of preventing the "harm" caused by peaking and balancing excursions, and provided this power is exercised to the standard of a reasonable and prudent pipeline operator and not arbitrarily, this seems a far more direct control mechanism than the indirect after-the-event application of arbitrary monetary fines. It certainly seems far better aligned to the operational and technical needs of the pipeline.

238. As to **s. 2.24(d)**, permitting Epic to recover arbitrary, unnecessary and excessive penalties from one sector of the shipping community and then potentially distribute them to other shippers as rebates, when there is no operational, technical or commercial rationale for doing so, is not consistent with the principles of economic efficiency.

[124] Para 130 of the judgment

239. Furthermore as Western Power made clear in its 28 September 2001 submission, the penalty regime will adversely affect it as a peaking and mid-merit electricity generator in comparison with other shippers including potential competing base load generators. It is not consistent with the principles of economic efficiency for the DBNGP Access Arrangement to create artificial imbalances in downstream marketplaces that are not necessary or justifiable on technical, operational or commercial grounds.

240. As to **s. 2.24(e)**, the public interest is unlikely to be served by a penalty regime which results in very substantial increases in the costs of electricity generation. This would certainly be inconsistent with the ERTF's objectives, discussed above, of achieving lower electricity prices for all consumers.

241. Also regarding the public interest, it is difficult to see how the public interest can be served by permitting Epic to include in its haulage contracts penalty clauses which will be unenforceable at law. Western Power invites the Regulator to consider the fact that the primary reason that Courts refuse to enforce contractual penalties is because they are **contrary to public policy**.[125]

242. As to **s. 2.24(f)**, self-evidently Western Power's interest lies in the retention of the present successful no-charges approach to peaking and balancing, and Western Power as a mid-merit and peaking electricity generator is particularly sensitive to such penalties. However, more generally Western Power submits that the interests of Users generally, which is a factor to which weight must be given as a fundamental element, will be best served by retaining the current very successful model and not adopting the proposed after-the-event fines approach.

243. Also as to **s. 2.24(f)** but relevant to **s. 2.24(e)**, is a consideration of what actually happens between Epic and Western Power on a day to day basis. There is frequent and close mutual co-operation between Epic's and Western Power's respective operational and technical personnel, which averts the need for punitive action by Epic (such as penalty measures and shutting outlet valves). For example Western Power is able to use its multi-fuel flexibility to switch to alternative fuels, and its generation portfolio to move generation to other power stations on the DBNGP. Western Power works with Epic to synchronise generating plant outages with Epic's compressor plant maintenance and major industrial shippers' scheduled maintenance. This can ensure the operational integrity of the DBNGP during peak flow conditions as a result of unplanned electricity demand or outages in other generating plant on the SWIS including IPPs.

244. A particularly striking example occurred as recently as 6 November 2002, in which the DBNGP experienced an unfortunate coincidence of factors (at a time of abnormally high gas load) that required rapid and very substantial cooperation between the Western Power and Epic control rooms. Western Power's cooperation with Epic included moving substantial amounts of generation to Pinjar and Mungarra in order to relieve pressure constraints at Kwinana Junction, and otherwise adapting and adjusting its gas consumption during the day to avert a crisis or curtailments/interruptions for Western Power or other shippers. All this occurred over about 24 very busy hours, in a contractual environment in which Epic has absolutely

[125] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79. Western Power would be happy to provide further authority for this proposition, if the Regulator requires.

no ability to impose peaking or balancing penalties or surcharges on Western Power or any other shipper.

Conclusion regarding penalties

245. Western Power requests the Regulator to reconsider his Draft Decision in relation to penalties, and instead to require amendments to the Access Arrangement which preserve the very successful status quo for the DBNGP in which no peaking and balancing (or other) penalties are payable and peaking and balancing excursions are dealt with by other more technically and operationally justifiable means.

246. Failing this, and regardless of the penalty regimes established for other pipelines, Western Power requests the Regulator to require amendments to the Access Arrangement to create a regime in which the surcharges or other fees for peaking and balancing excursions are truly cost reflective.

247. Western Power notes that the fact that other pipelines have penalty regimes is in no way a guide to the lawfulness of those regimes, and should not be used by the Regulator as such. Western Power is not aware of any of those regimes having been tested in court. The Regulator should seek his own legal advice on the matters addressed by Western Power in relation to whether the Regulator's proposed penalties would be legally enforceable when included in a contract.

248. The penalty regime imposed for the DBNGP is a matter which can very substantially adversely affect Western Power's interests, as has been demonstrated by earlier submissions. If the Regulator receives, and proposes to act in reliance upon, legal advice that the penalty regime proposed in his Draft Decision would be legally enforceable when included in a contract, Western Power requests an opportunity to comment upon that advice.

249. Finally, Western Power notes that to the extent that other pipelines have a penalty regime which has been the subject of approval under the Code, such approval has little value as a precedent because it would have been given without the benefit of the Court's judgment, and hence the penalty regime may not have been tested against a careful application of the s. 2.24 factors, each being given weight as a fundamental element.

Appendix 1 – Epic Energy was fully aware that the Code was coming

1.1 Facts

1. The circumstances of the DBNGP sale were unusual. While the DBNGP was sold shortly before the commencement of the Code, it was sold at a time when it was known that it would be covered by the Code.

2. Well before the date on which it bid for the DBNGP, Epic was aware that tariffs and service policies for the DBNGP would from 1 January 2000 (as it was then thought) be determined under an independent regulatory process in accordance with the Code.

3. It was expressly stated in the sale information memorandum that was provided to Epic and other bidders by the Gas Pipeline Sale Steering Committee well prior to final bids being made that the successful bidder would have to submit its tariffs and service policies to the scrutiny of an independent regulator. The information stated that the State had committed to adopting an Access Code from 1 January 2000, which would contain a fully negotiation-based and independently-regulated access and pricing regime for the DBNGP and would be fully consistent with the then draft National Access Code.

4. Because the sale Information Memorandum was released while the Intergovernmental Agreement was not yet finalised it had to "hedge" as to the precise nature of the code which would apply. But by the time Epic lodged its bid the National Gas Pipelines Access Agreement had been signed. There was no conceivable doubt that the Code would be implemented.

5. The DBNGP was listed in that Agreement as a Covered Pipeline.

6. It is clear that Epic was aware of this from its statement in Schedule 39 (Buyer's Proposed Tariff Rates and Path) to the DBNGP Asset Sale Agreement that:

> *Epic's proposed tariff rates and path have been structured to be in compliance with …the National Access Code.*

7. This has significant implications for the Regulator's assessment under several sub-sections of the Code.

1.2 Implications: Expectations as to tariff

8. The Court found that it had been made clear to Epic at the time that it bid for the DBNGP that a feature of the then anticipated Code was that tariff levels were to be

fixed by an independent regulator. [126] The fixing of tariff levels would then be out of the government's control.[127]

9. The Court found that it should have been evident to Epic that there was uncertainty as to what might be expected under the Code.[128]

10. The Court expressly found that the sale information formed no reasonable basis for expectations regarding tariffs after about 1 January 2000. [129]

11. Also, the basis on which tariffs had been set in the past would consequently be of little or no relevance.

1.3 Implications: No sovereign risk/distortion of investment decisions

12. Principles of fairness and sovereign risk require that incumbent operators who are subjected to new regulatory regimes get some protection from a subsequent shifting of the goalposts. Hence the Code takes into account his torical factors.

13. However Epic was not an incumbent and it should be treated as though it bought the pipeline after the Code had commenced because it knew that the DBGNP was shortly to become a Covered Pipeline.

14. The determination of the initial Capital Bas e and tariffs for the DBNGP by an independent regulator under the Code cannot be seen to be "future governmental intervention" as discussed by the Court in paragraph 149 of the judgment. As shown above, the "governmental intervention" had already occurred by the time Epic bid for the DBNGP.

15. At paragraph 182 of the judgment, in a discussion of s. 8.16(a), the Court makes the general observation that investment decisions made before the Code applies to a pipeline are not made in contemplation of s. 8.16 (o r, by implication, in contemplation of the Code generally). As has been demonstrated above, although this observation is true in many cases, the Court's findings of fact make it abundantly clear that it is not true in the specific instance of Epic's purch ase of the DBNGP. The Court's general discussion of s. 8.16 is not inconsistent with this conclusion in the specific instance of the DBNGP.

1.4 Implications: Capitalising monopoly rents

16. Epic should not have considered there was a prospect that it could make monopoly profits from the ownership and operation of the DBNGP, because as shown above at the time of its purchase of the DBNGP it was aware that the Code would apply to the DBNGP. The Code's objects clearly oppose the recovery of monopoly rents.

[126] Para 197 of the judgment.
[127] Para 197 of the judgment.
[128] Para 198 of the judgment.
[129] Para 198 of the judgment

Appendix 2 – Further comments on purchase price valuation

1.1 Factors potentially relevant to determining whether the purchase price reflects market value

1. The Court listed the following factors as relevant to the exercise under s 8.10(c) of determining whether purchase price reflects the market value of the pipeline.[130]

(a) Whether the price paid accords to the standards of reasonable commercial judgement as to value

2. The Court found that one way Epic sought to show that the price it paid for the DBNGP represented its then market value was by identifying the basis upon which it had calculated the present value of estimated future returns during the anticipated life of the pipeline. However Epic stopped well short of providing its actual calculations to the Regulator and sought instead to satisfy the Regulator by illustrating the nature of the methodology which it had applied. [131]

3. The Court found, without adverse comment, that the Regulator was not satisfied by the case which Epic put forward.[132]

4. The Court ruled that it rests with Epic to justify to the Regulator that the price it paid for the DBNGP represented a sound commercial assessment of the value of the pipeline in the circumstances that prevailed at the time of the purchase and which were then reasonably anticipated.[133]

5. If Epic attempts to do so, it is for the Regulator to re-assess and decide whether this will lead to any different outcome.[134] If Epic makes any further submissions on this point, Western Power will make submissions in response.

6. The Court found that the mere fact that it was a price paid at public tender is not necessarily determinative of any of these issues because Epic may have erred in its assessment of value or had unreasonable expectations.[135] Western Power submits that both of these were the case.

[130] Para 173 of the judgment. Other factors listed by the Court as potentially relevant to the exercise under s 8.10(c), but not relevant in this case, were the extent to which the price paid might have been influenced by considerations such as the prospect of monopoly profits and whether the transaction was between related entities. The Court stated that this list was non-exhaustive, indicating that there may well be other factors that should be taken into account in a given case.
[131] Para 217 of the judgment.
[132] Para 217 of the judgment.
[133] Paras 188 & 189 of the judgment.
[134] Para 190 of the judgment.
[135] Para 189 of the judgment.

(b) Whether the transaction involved motivations unrelated to value which might have affected the price paid

7. The Court noted that Epic may have had reason to pay higher than true market value for the DBNGP.[136] This has been proven to be the case in previous submissions[137] that have cited, for example, statements by a person with an ownership interest in Epic conceding that acquisition of the DBNGP was important to Epic for "strategic reasons".[138]

(c) The nature and conditions of the process by which the asset was sold

8. Epic argued that the Regulator should accept the purchase price paid by Epic for the DBNGP as the initial Capital Base under the Code, on several grounds. These grounds are said to arise out of the tender process by which the State sold and Epic purchased the DBNGP.[139]

9. The main ground put forward by Epic for the Regulator accepting the purchase price as representing the DBNGP's fair market value is that Epic offered the State $2.407 billion for the DBNGP, and undertook to incur further capital costs, on the basis of a $1 headline tariff for the primary transmission service to Perth. Epic argued that the material comprising the tender terms and conditions and, in particular, the sale information memorandum had induced in Epic an understanding that under the Code after January 2000, the public interest would be served by a future gas tariff in the order of $1 for the primary transmission service.[140]

10. The Court rejected Epic's argument outright for two reasons.

11. First, it found that the tender process, including the in formation memorandum, falls short of providing an adequate factual foundation for the submission that Epic had been induced to have such an understanding as to the tariff.[141]

12. Second, the Court found that, more fundamentally, it was made clear that a feature of the anticipated Code was that tariff levels were to be fixed by an independent regulator. The fixing of tariff levels would then be out of the government's control.[142] The Court found that it should have been evident to Epic that there was uncertainty as to what might be expected under the Code.[143]

13. The Court rejected Epic's argument that the Regulator had erred in law in failing to accept and act on Epic's submissions in this respect or in failing to give to them the relevance and weight for which Epic contended.[144]

14. Western Power submits that in the circumstances, all of Epic's current submissions on the use of purchase price in setting the initial Capital Base are wholly discredited and

[136] Para 189 of the judgment.
[137] Eg AlintaGas Submission 3.
[138] Australian Infrastructure Fund. See page 108 of Part B of the Draft Decision.
[139] Para 172 of the judgment.
[140] Para 192-195 of the judgment.
[141] Para 196 of the judgment.
[142] Para 197 of the judgment.
[143] Para 198 of the judgment.
[144] Para 200 of the judgment

should not be given any weight by the Regulator. If Epic makes further submissions, Western Power may comment on them.

1.2 Error of law: value of pipeline consistent with future regulated revenues and efficient capital investment

15. The Court found that the Regulator wrongly understood that his function was to establish the value of the DBNGP on the assumption that a feature of the Code was that only "efficient" capital investment should weigh and only "regulated revenues" could be recovered.[145] In wrongly assessing the value of the DBNGP on this basis, the Regulator made an error in law which involved a significant mis-apprehension of his statutory function.[146]

16. It appeared to the Court that the Regulator was allowing an assumed narrow view of the Code to affect the relevance and weight to be attached to factors that the Regulator is required to consider under the Code as part of the process of reaching an outcome.[147]

17. The Court's finding that the Regulator misapprehended the task before him does not establish that the outcome arrived at by the Regulator was wrong. The conclusion that the purchase price paid by Epic was affected by many factors other than a reasonable market value of the assets is well founded on other bases. The Court made no adverse finding against the Regulator regarding this view, [148] and expressly contemplated the possibility that any further submissions by Epic on these matters may not lead the Regulator to reach a different outcome.[149]

18. It remains the case that Epic has failed to substantiate the view that the purchase price paid by Epic for the DBNGP represented its market value.

19. As Western Power's first post-judgment submission demonstrates, although the Regulator erred in thinking that it was a **requirement** of the Code that only "efficient" capital investment should ever weigh and only "regulated revenues" can ever be recovered, it remains open to the Regulator in the particular circumstances of the DBNGP to determine in his discretion that this should be the outcome if Epic, in further submissions, tries to use this argument again. Western Power submits that the circumstances of Epic's acquisition of the DBNGP are such that, in this particular case, the Regulator should determine that only "efficient" capital investment should weigh and only "regulated revenues" should be recovered.

[145] Para 205 of the judgment.
[146] Paras 205 and 207 of the judgment.
[147] Para 206 of the judgment.
[148] Para 217 of the judgment.
[149] Para 190 of the judgment.

1.3 Error of law: allowance for capital expenditure to expand pipeline capacity

20. Epic claims that it determined its purchase price for the DBNGP according to the present value of anticipated net revenue from the future operation of the pipeline.[150]

21. The Court found that the Regulator wrongly concluded that no allowance had been made for the capital expenditure necessary to accommodate the throughput quantities in excess of the current capacity of the pipeline which Epic had relied upon to determine its purchase price,[151] when it had in fact been Epic's express position that it had anticipated and incorporated into its calculations the need to incur capital expenditure to expand the pipeline capacity.[152]

22. Because of his oversight, the Regulator concluded that Epic did not demonstrate that the purchase price was consistent with the present value of anticipated net revenue from the future operation of the pipeline.

23. The Court found that this factual finding made by the Regulator was not open to the Regulator on the materials before him, and consequently he made an error of law.[153]

24. The Court's finding that it was not open to the Regulator to find that Epic had not made an allowance for capital expenditure for expansion does not mean that the ultimate outcome arrived at by the Regulator was wrong. The conclusion that Epic had failed to substantiate the view that the price it paid for the DBNGP represented its market value[154] is well founded on other bases. The Court made no adverse finding against the Regulator regarding this view,[155] and expressly contemplated the possibility that any further submissions by Epic on these matters may not lead the Regulator to reach a different outcome.[156]

25. It remains the case that Epic has failed to substantiate the view that the purchase price paid by Epic for the DBNGP represented its market value.

1.4 Deferred recovery account

26. Epic tried to use a capital base for the DBNGP calculated for each year by adding two components: the physical asset account balance (the written down value of the physical assets that form the pipeline) and the deferred recovery account balance.[157]

27. The use of a deferred recovery account for a fully-committed mature pipeline is a peculiar device designed by Epic to accommodate the fact that its proposed Capital Base is unsustainably high.

[150] Epic's Additional Paper 5
[151] Page 137 of Part B of the Draft Decision.
[152] Para 210 of the judgment.
[153] Para 211 of the judgment.
[154] Page 137 of Part B of the Draft Decision.
[155] Para 217 of the judgment.
[156] Para 190 of the judgment.
[157] Epic Energy APAAI page 37.

28. Previous submissions on the Proposed Access Arrangement argued that the deferred recovery account model for the Capital Base was inconsistent with the Code and should be abandoned.[158] Western Power reiterates this view.

29. The Regulator concluded in the Draft Decision that, for the DBNGP at present, there was no reasonable justification for economic depreciation and deferred recovery of capital costs so as to accommodate a higher value of the initial Capital Base.[159]

30. The Court agreed, commenting that:

> *..it is fair to say that the manner in which Epic sought to demonstrate that it paid market value for the DBNGP has shown itself, in the course of these proceedings, and in the Regulator's draft decision, to be well capable of being misunderstood in more than one material respect, namely the financial provision for future expansion of the capacity of the pipeline, and the period over which it proposed it should recover its capital investment. That will be for Epic to seek to remedy, if it is so minded.*[160]

31. In light of the rejection by the Regulator of the deferred recovery account device for the DBNGP, and in deference to the Courts comments, Western Power presently makes no further submission on the deferred recovery account.[161]

32. If Epic does make any further submissions on this point, Western Power will make submissions in response.

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[158] Wester Power's submission dated 22 February 2000.
[159] Page 218 of Part B of the Draft Decision.
[160] Para 189 of the judgment.
[161] Western Power has previously made submissions on the deferred recovery account device in its submission dated 22 February 2000

Appendix 3– Valuation methodologies using purchase price/market value

1. It is not clear from Epic's Access Arrangement Information, or the Draft Decision, or the judgment, precisely how purchase price relates to the s. 8.10(c) factor of "other recognised valuation methodologies".

2. Epic's (now discredited) approach in the Access Arrangement Information and generally prior to the judgment was simply that purchase price should be the initial Capital Base, due to the "regulatory compact" and to an argument that s. 8.10(j) should be applied and all other elements of s. 8.10 should be disregarded.[162] There was no attempt by Epic to analyse purchase price in the context of s. 8.10(c) and (d).

3. The Regulator, in contrast, analysed purchase price in the Draft Decision under s. 8.10(c) as though there were a recognised valuation methodology named "Purchase Price Valuation". The Draft Decision does not discuss the relationship between purchase price and market value, except for one brief comment.[163]

4. The judgment, in further contrast, said that Epic was trying to advance purchase price as evidence of market value, and the judgment clearly considers that the relevant valuation methodology is the one of market valuation. It is possible that by the time of the litigation, this was indeed how Epic was characterising its argument.[164] Western Power does not know because it was not involved in the litigation. It is certain that the Court's analysis of Epic's approach differs from the approach taken by Epic in its Access Arrangement Information and related submissions.

5. These differences in approach are more than mere semantics. Disregarding Epic's original approach of ignoring most of s. 8.10 and arguing on a holistic basis that purchase price should be the initial Capital Base, which the judgment has shown to be incorrect, Western Power has set out in this submission responses to two conceptually quite different arguments:

   (a) the view that purchase price is itself a valuation methodology, which seems to be the Draft Decision's approach; and

   (b) the view that the valuation methodology is "market value", of which an indicator is purchase price, which the judgment suggests is (now?) Epic's approach.

[162] Epic's APAAI pages 31-32
[163] Page 145 of Part B of the Draft Decision
[164] A view which is supported by the Court's reference to Epic's "submission" in para 195 of the judgment