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Mr R Pullella
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Dear Mr Pullella

DRAFT DECISION: PROPOSED DBNGP ACCESS ARRANGEMENT
WESTERN POWER SUBMISSION

Western Power submits the following comments on the Gas Access Regulator's Draft Decision regarding the Dampier to Bunbury Natural Gas Pipeline (DBNGP).

This submission addresses a major element of the Draft Decision that has serious implications for Western Power; the proposed penalty charge regime.

Penalty Charges

Western Power is seriously concerned about the Regulator's Draft Decision in relation to the penalty charges that are currently included in the proposed terms and conditions for the Firm Service reference service in the proposed Access Arrangement. While Western Power appreciates that the Regulator has a difficult task in determining whether to approve of the Penalty Provisions proposed by Epic Energy as part of the Access Arrangement, it has significant difficulties with the Regulator's conclusions in relation to this very important issue.

The **Attachment** sets out in detail the nature of Western Power's concerns and submissions in relation to the penalty charges (referred to in the Attachment as the "**Penalty Provisions**"). In general terms, Western Power views are that:

1. the Penalty Provisions are, both collectively and individually, not reasonable for a range of reasons;

2. that the Regulator should not form the opinion that they are reasonable and should not accept that they satisfy the requirements of Section 3.6 of the Code; and

3. the Regulator should not permit the Penalty Provisions to form part of the terms and conditions for the Firm Service reference service.

There are two significant reasons as to why the Penalty Provisions are not reasonable; viz:

- they represent contractual penalty provisions which, when included in access contracts, the courts, in line with the firmly established law of penalties, are highly unlikely to enforce; and

- they will have a significant financial impact upon users of the DBNGP which use gas to meet peak electricity generation demand.

Western Power estimates that its gas transmission costs are likely increase by approximately $20 million per annum or more than 50 percent above present expenditure levels, should it be required to pay peaking and overrun penalty charges under the Access Arrangement.

In addition, Western Power is of the view that the Penalty Provisions are contrary to a number of the interests inherent in the factors specified in Section 2.24 of the Code. In particular:

1. the introduction of the Penalty Provisions will adversely affect the legitimate interests of Western Power, which will face significant and unsustainable increases in gas transportation costs if, in the future, it is required to transfer to an access contract that incorporates the Penalty Provisions; and

2. it is contrary to the public interest to include Penalty Provisions in the Access Arrangement in that they are 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.

Western Power is of the view that the Regulator cannot reasonably conclude that the Penalty Provisions are reasonable. The very nature of the provisions is such that no reasonable decision-maker would conclude that they are reasonable.

For these reasons, Western Power requests that the Regulator reconsider this issue and specify, in the Final Decision, an amendment or amendments that require Epic Energy to remove the Penalty Provisions from the Access Arrangement. Alternatively, the amendment or amendments should require that Epic Energy change the level of charges imposed by the Penalty Provisions to accurately reflect, or to represent a genuine pre-estimate of, the damage that it will suffer as a result of the particular "breaches" of contract upon which the Penalty Provisions operate.

As a further matter, Western Power expresses concern about the lack of detail provided in relation to the mechanism that is contemplated for the rebating of revenue derived from the Penalty Provisions: Amendment 79. Western Power requests that the Regulator provide a detailed set of principles by which any mechanism is intended to operate.

Other points of importance raised in the Attachment are as follows:

1. The Regulator proposed that an average of the penalty charges from other pipelines should apply across a range of potential service variations in the Western Australia marketplace for gas sales, delivery and use.

   Western Power believes that careful consideration must be given to the technical factors concerning the pipeline operating regime and the customers' off-take regimes in any deliberation of usage surcharges.

2. Since its construction, the DBNGP has serviced users' gas flow variations without the application of penalties for peaking, balancing, and nomination variations. One outcome of the introduction of penalties could be the unnecessary reservation of additional capacity requirements. In Western Power's situation, this capacity would not be used outside peak periods, with the associated fixed costs to be borne by all electricity customers.

3. Application of the penalties proposed by the Regulator would substantially increase Western Power's fuel costs for peaking and mid merit, far outweighing the reduction in the "headline" transportation tariffs. Western Power estimates that peaking and overrun penalties could, on average, add $20 million to it's annual gas transportation costs. Average costs to South West power stations would rise from the present $0.95/GJ to around $1.45/GJ, based on full implementation of the Draft Decision tariffs and penalty charge regime on previously accepted gas offtake patterns.

   As a result, Western Power's peaking electricity customers, largely domestic and commercial users, would be penalised and, with the rebate mechanism proposed by the Regulator, would effectively subsidise industrial base load pipeline customers.

4. Another outcome of the penalty charge regime may be that competitors could force Western Power to operate less base load and more peaking generation plant. Consequently, increased rebates would be provided to those competitors with further subsidisation from Western Power's regulated electricity tariff customers.

Pilbara and Carnarvon Charges

In Submission Numbers 1 and 2 to the Regulator, Western Power raised serious concerns about the Reference Tariff to Zones 1a and 4a as proposed by Epic Energy, and the consequential impacts on electricity generation costs in the Pilbara and at Carnarvon.

The Regulator has determined Epic's proposed Zone 1a and 4a charges to be anomalies which are inequitable, due to the magnitude of the proposed gas Receipt Charge in the Pilbara and the high asset value ascribed by Epic to the Carnarvon Lateral pipeline.

Significantly, the Regulator now requires Epic to amend the cost allocation underlying the Reference Tariff for shippers in these zones, such that the proposed access charges cost no more than the tariffs payable under the current regulated contracts.

Western Power strongly supports the Regulator in requiring Epic to amend the Zone 1a and Zone 4a charges in accordance with Amendment 63 of the Draft Decision.

In its previous submissions, Western Power expressed concern over the likely impact of Epic's proposed penalty charge regime on electricity generating costs in the Pilbara and Carnarvon. As already stated in this submission, Western Power has significant concerns with the Draft Decision outcomes on penalty surcharges, for all of its power stations.

Yours faithfully

BARRIE BRANDT
MANAGER COMMERCIAL
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ATTACHMENT

PENALTY CHARGE REGIME

1. Introduction

Western Power is seriously concerned about the Regulator's Draft Decision in relation to the "Penalty Provisions"[1] that are currently included in the proposed terms and conditions for the Firm Service reference service in the proposed Access Arrangement. While Western Power appreciates that the Regulator has a difficult task in determining whether to approve of the Penalty Provisions proposed by Epic Energy as part of the Access Arrangement, it has significant difficulties with the Regulator's conclusions in relation to this very important issue.

Based on what is stated in the Draft Decision, it appears that the Regulator is of the opinion that the Penalty Provisions (when amended as specified in the Draft Decision) will be "reasonable" and, therefore, satisfy the requirements of section 3.6 of the Code. Western Power strongly disagrees with that conclusion.

In Western Power's view, the Penalty Provisions are, both collectively and individually, not reasonable because:

1. as contractual penalty clauses, they are inherently unreasonable;

2. they will have a significant and adverse financial impact upon existing users, particularly Western Power;

3. they will lead to increased generation costs and, possibly, increased prices, particularly for domestic and commercial electricity consumers;

4. they will adversely affect the economic viability of using the DBNGP to transport gas to the South West gas market; and

5. they will lead to adverse implications in respect of pipeline security.

The Penalty Provisions are also not reasonable because the level of the penalty charges is based on the flawed methodology set out in the Draft Decision,

As the Penalty Provisions are not reasonable, Western Power submits that the Regulator should not form the opinion that they are reasonable and should not accept that they satisfy the requirements of section 3.6 of the Code. For that reason, Western Power further submits that the Regulator should not permit the Penalty Provisions to form part of the terms and conditions for the Firm Service reference service.

[1] The "Penalty Provisions" are identified in section 2 below. The name "penalty charges" is the name given by the Regulator in the Draft Decision (Part B:276) to the clauses identified below.

In addition, Western Power submits that the Regulator is required to take into account in assessing the Access Arrangement, including the Penalty Provisions, the factors specified in section 2.24 of the Code. In this regard, Western Power draws the Regulator's attention to:

1. paragraph (e), which requires the Regulator to take into account the public interest, including the public interest in having competition in markets; and

2. paragraph (f), which requires the Regulator to take into account the interests of users and prospective users.

Consideration of the factors prescribed in those paragraphs will reveal that it is contrary to the public interest to include Penalty Provisions in the Access Arrangement in that they are likely to lead to increases in electricity prices for small consumers in Western Australia and to motivate Western Power to seriously consider changing fuel and transportation sources. It also reveals that the introduction of the Penalty Provisions will adversely affect the legitimate interests of Western Power, which will face significant and unsustainable increases in gas transportation costs if, in the future, it is required to transfer to an access contract that incorporates the Penalty Provisions. Western Power believes that its gas transmission costs are likely increase by approximately $20 million per annum, or 55 percent, above present costs as a result of proposed peaking and overrun penalty surcharges.

Further, Western Power submits that the Regulator cannot reasonably conclude that the Penalty Provisions are reasonable. The very nature of the provisions is such that no reasonable decision-maker would conclude that they are reasonable.

For these reasons, Western Power requests that the Regulator reconsider this issue and specify, in the Final Decision, an amendment or amendments that require Epic Energy to remove the Penalty Provisions from the Access Arrangement. Alternatively, the amendment or amendments should require that Epic Energy change the level of charges imposed by the Penalty Provisions to accurately reflect, or to represent a genuine pre-estimate of, the damage that it will suffer as a result of the particular breaches of contract upon which the Penalty Provisions operate.

As a further matter, Western Power expresses concern about the lack of detail provided in relation to the mechanism that is contemplated for the rebating of revenue derived from the Penalty Provisions: Amendment 79. Given the vague nature of Amendment 79, it has not been possible for Western Power to meaningfully analyse the potential impact of the rebate mechanism on its business. This places Western Power, a user which has significant exposure to the Penalty Provisions, at a considerable disadvantage. Western Power, therefore, requests that the Regulator provide a detailed set of principles by which the mechanism is intended to operate.

This Attachment sets out in detail the basis for Western Power's submissions. It is structured as follows:

- section 2 analyses Penalty Provisions, summarises the law in relation to contractual penalties, and establishes that the Penalty Provisions are clearly designed to operate as contractual penalties;

- section 3 sets out why the Penalty Provisions are not reasonable for the purposes of section 3.6 of the Code and why it is not reasonable for the Regulator to come to any other conclusion;

- section 4 explains why the methodology used by the Regulator to set the level of charges imposed by the Penalty Provisions is flawed; and

- section 5 sets out Western Power's concerns in relation to the proposed rebate mechanism for revenue generated by the Penalty Provisions.

2. Analysis of the Penalty Provisions

2.1 The Penalty Provisions and Their Role

In the proposed Access Arrangement, Epic Energy included certain terms and conditions on which it will supply the Firm Service reference service: Annexure B of the proposed Access Arrangement, "Proposed Access Contract Terms and Conditions". The terms and conditions included a number of clauses which impose fees and charges in addition to the fees and charges that will be payable as part of the Reference Tariff for the Firm Service. In the Draft Decision, the Regulator referred to the clauses as "Penalty Clauses": Draft Decision, Part B: 276.

The "Penalty Provisions" include[2]:

1. clause 2.4(c) , which will impose an "Out of Specification Gas Charge" of $15/GJ in certain circumstances ("**Out of Spec Charge**");

2. clause 4.4(c), which will impose a "Nominations Surcharge" of $15/GJ in certain circumstances ("**Nominations Surcharge**");

3. clause 5.2, which may require a shipper to pay for "Overrun" in certain circumstances (calculated as a percentage of other specified prices) ("**Overrun Charge**");

4. clause 5.4, which will impose an "Unavailabilty Charge" of $15/GJ in certain circumstances ("**Unavailability Charge**");

5. clause 6.4, which will impose an "Excess Imbalance Charge" of $15/GJ in certain circumstances ("**Excess Imbalance Charge**"); and

6. clause 7.1(b), which will allow Epic Energy to require the payment of a "Peaking Surcharge" of $15/GJ in certain circumstances ("**Peaking Surcharge**").

[2] The Draft Decision also referred to a prescribed fee for an Access Request as being a Penalty Provision. For the purposes of this submission, that provision is not covered by the term "Penalty Provision".

In the Draft Decision, the Regulator specified 5 amendments that he will require in relation to the Penalty Provisions before he will approve of the Access Arrangement. The most important of the amendments have the effect of requiring that Epic Energy:

1. reduce the maximum rates of the charges imposed by the Penalty Provisions, with the exception of the "Overrun" clause (clause 5.2), to no more than 350 percent of the relevant 100 percent load factor reference tariff: Amendment 74; and

2. amend the terms and conditions for the Firm Service reference service to provide for revenue from the Penalty Provisions to be rebatable as if the activities or events to which the rebates relate were "Rebatable Services" within the meaning of the Code.

If the proposed Access Arrangement is approved, and commences, in line with the amendments proposed in the Draft Decision, it will include the proposed Firm Service reference service and the Penalty Provisions (as amended) will form part of the terms and conditions for that reference service.

Epic Energy will then, undoubtedly, seek to include Penalty Provisions in any access contract under which the Firm Service is to be provided. If a prospective user and Epic Energy cannot then agree on whether the Penalty Provisions should be included in an access contract, the matter will probably be dealt with by the Gas Access Arbitrator ("**Arbitrator**") as an access dispute under section 6 of the Code. The Arbitrator could then make a decision on access by the prospective user to the Firm Service: Section 6.7 of the Code. The decision could be to require Epic Energy to enter into an access contract to provide the Firm Service to the prospective user at a specified "Tariff" and on specified terms and conditions. In general terms, the Arbitrator would be required to not make a decision that is inconsistent with the Access Arrangement: Section 6.18 of the Code. As the DBNGP Access Arrangement would prescribe the "Reference Tariff" and terms and conditions for the Firm Service, the Arbitrator would (provided that certain other conditions are satisfied) normally be expected to require that Epic Energy provide the Firm Service at the Reference Tariff and on the terms and conditions in the approved DBNGP Access Arrangement: Sections 6.18(a) and (e). As such, the Penalty Provisions are likely to be included as terms and conditions of an access contract under which Epic Energy provides a user with the Firm Service.

2.2 Nature of the Penalty Provisions

Western Power and other interested parties have previously made submissions to the Regulator asserting that the Penalty Provisions, if reflected in access contracts, will constitute unenforceable contractual penalties clauses.

Unfortunately, the Draft Decision indicates that the Regulator did not consider those submissions or the out-workings of those submissions.

2.2.1 The Law on Penalty Clauses

It is a firmly established principle of law that courts will usually refuse to enforce penalty clauses because they do not represent a genuine pre-estimate of the loss that a party will suffer as the result of a breach of contract. In contrast, courts will enforce "liquidated damages" clauses on the basis that they do represent a genuine pre-estimate of loss.

The law in relation to the enforcement of penalty clauses can be traced as far back as the 17th Century: Lanyon, E V, (1996) 9 JCCL No 3. Its role and significance in contemporary Australian jurisprudence is founded in the idea that the courts will "not lend their aid to the enforcement in any way of a provision which is oppressive": *AMEV-UDC Finance Ltd v Austin* (1986) [162 CLR 170 at 192 per Mason and Wilson JJ.

A penalty clause is an agreed damages clause, which is in the nature of a punishment for the non-observance of a contractual term or condition. A penalty is said to be a sum "*in terrorem*" of the defendant, in that its intention is to intimidate the defendant to perform. By its nature, a penalty clause does not express the party's entitlement to recover his or her actual loss (common law damages), but expresses an entitlement to recover an exorbitant sum.

Whether a clause is a penalty clause is tested by circumstances existing at the time the contract was entered into, not at the time of the breach of contract. In undertaking such an examination, the Courts will inquire into whether the objective intention of the parties was that the clause was to be a coercive penalty, or whether the intention was that it was to be a genuine pre-estimate of the value of the loss.

In this respect, the courts will take into account a number of factors. For example, the words of the clause may be considered, but they are not binding as the courts are concerned with matters of substance, rather than form. Other factors include that:

1. a clause will usually be held to be a penalty if the sum stipulated is extravagant, exorbitant or unconscionable in comparison with the greatest loss that could conceivably be proved to have followed from the breach;

2. a clause will usually be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid;

3. there is a presumption (but no more) that a clause is a penalty clause when a single lump sum is made payable by way of compensation on the occurrence of one or more or all of several events, some of which may result in serious damage and others only "trifling damage"; and

4. it is no obstacle to a sum being found to be a genuine pre-estimate that the consequences of the breach makes precise pre-estimation almost an impossibility – in fact, that may be the type of situation in which the parties probably did attempt a genuine pre-estimate.

Finally, it is usually the case that a clause will only be held to be a penalty clause if the penalty is payable on a breach of contract.

2.2.2 The Penalty Provisions are Penalty Clauses

Western Power submits that the Penalty Provisions are clearly unenforceable penalty clauses. In this regard, Western Power makes the following comments:

1. There is a significant amount of publicly available information about the purpose of the Penalty Provisions. That information, in both Epic Energy's submissions to the Regulator and in the Draft Decision, offer support for the proposition that the clauses are not intended to be a genuine pre-estimate of the damage that Epic Energy would suffer as a result of a shipper breaching the terms and conditions of the proposed Firm Service reference service.

   For example, the Draft Decision quotes Epic Energy's Submission 7 as follows:

   "The imposition of surcharges in the situations proposed in the Access Arrangement is directed at correcting behavioural attitudes to ensure all users of the system get the maximum benefit available. It is not an issue of cost recovery. Generally, the matters addressed by such surcharges are to deal with breaches that Epic Energy can only become aware of after they have occurred and is not able to take preventative action. That aspect coupled with the general reluctance of amongst pipeline operators to shut off gas supply to a breaching Shipper, dictates the importance and need for higher amounts to deter unsatisfactory behaviour.": Part B: 280.

   In that passage, Epic Energy is using the language of coercion. Its justification for the surcharges is to intimidate shippers into complying with their contractual obligations for fear of incurring penalties of up to 350% of the Reference Tariff. It expressly disclaims any link between the level of the surcharges and the costs (or damages) that it will suffer as a result of a breach.

2. Further support for the proposition can be found in the Draft Decision. At Part B: 279 to 290, the Regulator repeatedly refers to reasonable penalty levels given common practice in the gas transmission industry. The Regulator does not appear to link the level of "penalties" to estimates of the costs or damages that Epic Energy is likely to incur as the result of a breach of contract. An example can be found at Part B: 282, where the Regulator acknowledges and accepts that the "implied purpose" of the Out of Specification Gas Charge is to "discourage" certain shipper behaviour.

Further examples can be found at Part B: 284 in relation to the Excess Imbalance Charge and at Part B:288 in relation to Peaking Surcharges.

3. A factor that adds even further support to the proposition that the Penalty Provisions are of a penal character is that five of the proposed surcharges will, if the amendments in the Draft Decision are followed through to the Final Decision, be set at 350 percent. It appears that the 350 percent level of surcharge will apply regardless of the nature or severity of the breach. In addition, the Draft Decision seems to indicate that the Regulator calculated the 350 percent value by reference to common industry practice, rather than by attempting to genuinely pre-estimate the loss that Epic Energy would suffer in the event of a breach.

4. It is clear that the Penalty Provisions operate on a breach of contractual obligation. For example, note the language that Epic Energy uses in the passage quoted above where it speaks of "breaches". This is also implicitly recognised in Epic Energy's Submission 7 in which Epic Energy stated:

   "In order to avoid any legal issues the Regulator may consider requiring the Access Arrangement to be modified so that the Shipper is obliged to use best endeavours to not exceed the relevant requirement and that the Shipper has a right to exceed that requirement, but that if it does a surcharge will be payable": at Part B: 280

   By making that submission, it seems that Epic Energy attempts to create a situation where the imposition of a surcharge does not rely on the breach of term of the access contract. In such a case, the surcharge could be taken outside of the law on penalties. Western Power requests that the Regulator not accede to Epic Energy's request on the ground that it appears to be an attempt to by-pass the law on penalties.

3. The Penalty Provisions

Western Power is strongly of the view that the Penalty Provisions are not reasonable for the purposes of Section 3.6 of the Code and that it is not reasonable for the Regulator to come to any other conclusion.

In Western Power's view, the Penalty Provisions are, both collectively and individually, not reasonable because:

1. as contractual penalty clauses, they are inherently unreasonable;

2. they will have a significant and adverse financial impact upon existing users, particularly Western Power;

3. they will lead to increased prices for domestic and commercial electricity consumers;

4. they will adversely affect the economic viability of using the DBNGP to transport gas to the South West gas market; and

5. they will lead to adverse implications in respect of pipeline security.

The Penalty Provisions are also not reasonable because the level of the penalty charges is based on the flawed methodology set out in the Draft Decision, That methodology is inadequate and does not take into account a number of fundamental issues associated with the role of the Penalty Provisions.

3.1 The Penalty Provisions are Inherently Unreasonable

The Penalty Provisions are, due to their very nature, inherently unreasonable. As a consequence, any decision to form an opinion that such a term and condition is reasonable cannot be a reasonable decision. Western Power makes these assertions on the following grounds:

1. As noted above, it is a firmly established principle of law that courts usually refuse to enforce contractual penalty provisions. If the Regulator approves of an Access Arrangement that includes a penalty provision, that penalty provision will become a term and condition of the Reference Service. Ultimately, that penalty will be written into contracts for access to the DBNGP, either as the result of a negotiation which adopts the standard terms and conditions or as the result of an arbitration under section 6 of the Code: see sections 6.7, 6.13 and 6.18. In both cases, it is probable that a prospective user will have little (if any) chance of entering into an access contract which does not contain the penalty provision. In that sense, the Regulator could be seen as making a decision that has a good chance of requiring prospective users to enter into an access contract which contains a penalty provision of the type that the courts usually decline to enforce. Such clauses are fundamentally antithetical to all notions of reasonableness. In addition, is not reasonable for the Regulator, an officer exercising broad discretionary statutory power, to make a decision that cuts across established legal doctrine.

2. If the Regulator approves of a penalty provision in an Access Arrangement and that penalty provision is, for the reasons noted above, incorporated into an access contract, it is likely that the courts will refuse to enforce the penalty provision. It is not reasonable and proper for the Regulator to make a decision to include a penalty provision which the courts, according to established legal doctrine, are likely to refuse to enforce.

3. It is not reasonable for the Regulator, as a holder of significant statutory discretion, to allow himself to be used as an instrument for the application of penalty clauses that the courts would refuse to enforce.

4. It is not reasonable for the Regulator to approve of a provision which is designed to penalise and coerce parties into behaving in certain ways, as opposed to approving of provisions which are designed to ensure that innocent parties to a breach are compensated for their losses.

3.2 The Penalty Provisions will have an Adverse Financial Impact on Users

Western Power submits that:

1. a term and condition that imposes substantial costs upon a user, following a departure by that user from the contractual terms, in addition to the costs payable by virtue of a reference tariff is not a reasonable term and condition;

2. a term and condition that imposes penalties in the order of 350 percent of the reference tariff for a reference service is not a reasonable term and condition; and

3. a term and condition that has a substantial adverse financial impact upon a long established user is not a reasonable term and condition.

The Penalty Provisions are not reasonable because they do all of those things. In particular, they will have a significant and adverse financial impact upon existing users, particularly Western Power. That impact will crystallise when Western Power finds that it is necessary to obtain additional Firm Service capacity on the DBNGP under the proposed Access Arrangement.

In this regard, Western Power believes that the application of the proposed Penalty Provisions would result in a substantial increase in Western Power's fuel costs for peaking and mid merit electricity generation, outweighing the reduction in the "headline" reference tariffs for the Firm Service. Gas transport costs for Western Power in the SWIS, Pilbara, Mid West and Carnarvon electricity networks are conservatively estimated to rise from a total of $37 million per annum at present to $57 million per annum – an increase of $20 million per annum.

3.2.1 The Significance and Nature of Western Power's use of the DBNGP

Western Power understands that Alcoa, the largest shipper on the DBNGP, has separate commercial arrangements for the transport of its gas, and is therefore not likely to become subject to the Access Arrangement. Western Power and AlintaGas, the next largest shippers, and similar to Alcoa in aggregate transport terms, currently have access contracts under the *Gas Transmission Regulations 1994* and are the shippers most likely to be impacted by the proposed penalty regime in the future.

Western Power uses gas for electricity generation, significantly for peaking and mid merit load, although the proportion of mid merit to base load may increase over time, depending on economic comparisons with other fuels. The nature of electricity demand is such that daily and hourly gas flow rates can significantly vary around an average and be, to some extent, unpredictable. To date, Epic Energy has serviced these demand variations without the application of surcharges for peaking, balancing, and other customer load behavioural penalties.

Western Power's gas delivery requirements for each power station reflect the daily generating plant dispatch regime that is designed to meet system load. More than 70 percent of Western Power's gas requirement for electricity generation in the SWIS is presently transported into the proposed Zone 10 under the Access Arrangement for use at Kwinana Power Station and other generating plant.

3.2.2 Financial Impact of Penalties

The Penalty Provisions, even if amended as proposed in the Draft Decision, represent a substantial cost exposure for Western Power. That is the case despite the apparent reduction in the headline value for the reference tariff for the Firm Service.

Western Power estimates that the introduction of the Peaking Surcharge and Overrun Charge penalties alone could potentially add $20 million per annum to its gas transportation cost for the South West Interconnected System (SWIS) electricity network. While Western Power could mitigate these additional charges to some extent by alternative delivery strategies, the net cost impact would still be substantial.

Most of the potential exposure for Western Power's gas transportation costs is estimated to come from the proposed penalty regime for Peaking Surcharge (350 percent of the reference tariff for the Firm Service). Overrun Charges are the next most significant penalty charge exposure. The proposed penalties associated with excess linepack imbalance and nomination variations and out of specification gas (each 350 percent of the tariff) also represent potential cost exposures.

The following analysis demonstrates both the zonal impacts of the Reference Tariffs and the proposed Penalty Provisions on a per gigajoule basis for Western Power's gas-fired SWIS power stations, at the existing level of contracted capacity reserved on the DBNGP:

- the average gas transportation charge for these power stations is estimated to increase by 55 percent from $0.95/GJ to $1.45/GJ;

- the average gas transportation charge to Mungarra Power Station in Zone 7 would rise from the current $0.72/GJ to $1.66/GJ, versus the proposed headline tariff of $0.63/GJ;

- the average gas transportation charge to Pinjar Power Station in Zone 9 would rise from the current $0.95/GJ to $1.85/GJ, versus the proposed headline tariff of $0.78/GJ; and

- the average charge to Kwinana Power Station and other delivery sites in Zone 10 would rise from the current $0.95/GJ to $1.33/GJ, versus the proposed headline tariff of $0.845/GJ.

If the proposed Penalty Provisions, as amended by the Draft Decision, were to be implemented, Western Power would, of necessity, need to take action to minimise its exposure to penalty charges, such as reserving additional firm capacity. For example, to potentially mitigate possible overrun penalties, inter alia, if Western Power reserved an additional 40 TJ/d, or 35 percent, of its current contracted firm capacity, the average tariff for the SWIS would increase by around $0.37/GJ to $1.32/GJ. Average delivery costs to power stations would then become:

- Mungarra $1.40/GJ;
- Pinjar $1.70/GJ; and
- Kwinana $1.20/GJ.

The foregoing analysis assumes that Epic Energy has sufficient uncontracted capacity available in the DBNGP at present to provide Western Power with the option of securing all of its additional transportation requirements at the reference tariff for the Firm Service proposed in the Draft Decision.

Should Epic Energy need to develop new capacity, the resultant costs on the DBNGP may be well in excess of the charges that Western Power has estimated, which are based on the reference tariffs set out in the Draft Decision. Western Power notes that Epic Energy has asserted, in page 1 of its document "Epic Energy's Position On The Draft Decision On The DBNGP" (publicly available at the Regulator's Public Forum of 2 August), that new capacity "would need a tariff of at least $1.32/GJ".

While Western Power rejects the accuracy of, and reasoning behind, Epic Energy's assertion on the cost of new capacity,[3] it is useful to consider what the position would be if Epic Energy's assertions were correct. In such a hypothetical case (where new capacity costs about $1.30/GJ), it would be more economic to bear a large proportion of the penalty charges and reserve only a small quantity of new capacity.

The reality of the financial impact of the Penalty Provisions is heightened when one considers that Epic Energy has, since purchasing the DBNGP, continued the established practice of servicing customer load variations without the application of penalties for peaking and balancing.

3.3 The Penalty Provisions will lead to increased Generation Costs and, Potentially, increased Prices for Domestic and Commercial Electricity Consumers

The Penalty Provisions are unreasonable because it is likely that their application by Epic Energy to users, such as Western Power, which uses gas to generate electricity for "peaking loads", will lead to those users having to increase their product prices.

[3] Refer to the joint submission to the Regulator by several regulated shippers (including Western Power) which deals with the price of new capacity and the 'second class citizens' issue raised by Epic Energy.

It is likely that Western Power will need to increase electricity prices to cover the additional costs associated with gas transportation on the DBNGP or associated with changing to other fuel sources, including coal.

Such an outcome could arise if shippers such as Western Power decide that the best way mitigate the impact of the Penalty Provisions is to reserve additional firm capacity. Western Power's peaking loads, currently partly serviced with interruptible capacity would, on average, require the equivalent of an additional 40% of firm capacity above current reservation levels. The additional capacity would not be used outside peak periods, and the associated fixed costs would be borne by all electricity customers in the form of higher electricity prices.

This incremental capacity may, however, only be available from new capacity that would be in service some years after the implementation of the proposed Penalty Provisions.

Thus, if the Regulator decides to approve of the Penalty Provisions, Western Power's peaking electricity customers, which are largely domestic and commercial users, are highly likely to be penalised if Western Power is forced to adopt the new arrangements. In addition, the rebate mechanism proposed by the Regulator would effectively see those domestic and commercial consumers subsidise industrial base load pipeline customers. Alternatively, Western Power and its customers would have to bear the cost of the installation of additional, less efficient and less flexible plant to meet peak demands.

Of further concern to Western Power is the risk that future base load competitor generators with new, more cost efficient plant may force Western Power to become more of a peaking generator, so increasing the amount of rebate to the competitors, and also the level of cross subsidisation from the peaking customers to such competitors.

Accordingly, it can be seen that the unreasonable nature of the Penalty Provisions is likely to lead to complex and serious consequences in the Western Australian electricity market. For that reason, Western Power requests that the Regulator require Epic Energy to remove the Penalty Provisions from the Access Arrangement.

3.4 The Penalty Provisions will Adversely Affect the Economic Viability of using the DBNGP to Transport Gas to the South West Gas Market

The proposed Penalty Provisions will, due to the cost implications noted above, adversely affect the economic viability of using the DBNGP to transport gas to the South West gas market. This will particularly be the case for users such as Western Power which, because of the peaking nature of their demand for gas, are likely to incur significant additional transportation charges.

If Western Power is unable to recover the additional transportation charges through higher electricity charges it will need to consider alternative gas transportation options and the viability of changing fuel sources for this type of power generation. Western Power suggests that terms and conditions that have such an effect are not reasonable and should not be approved by the Regulator.

Western Power believes that further deliberation needs to be given to the factors associated with variations to gas delivery. These matters will have a very significant influence on the economy of using gas in Perth and further south. What was proposed by Epic, which holds to be a world class natural gas pipeline operator, is at very best an ambit opening.

3.5 The Penalty Provisions are Likely to have Adverse Implications for Pipeline Security

Western Power believes that the introduction of the Penalty Provisions is likely to have adverse implications for pipeline security on the DBNGP. For that reason, the Penalty Provisions are not reasonable.

The present operating regime is one in which the DBNGP is kept reasonably full through the co-operative approaches of the pipeline operator, the gas producers, and customers/shippers. This ensures security of supply through maximising linepack. The proposed Penalty Provisions, however, will discourage both Epic Energy and users from maximising the use of linepack, thereby jeopardising some supply security. Furthermore, Epic Energy may decide to maximise revenue because of the potential afforded by the Regulator's penalty regime, which takes away some incentive to operate the pipeline in the best interests of the market, that is, to provide maximum security for shippers.

Western Power is most concerned that the introduction of the proposed penalty charge regime would provide cause for Epic to operate strictly in accordance with the Access Arrangement, and so adversely impact the service delivery and reliability. A term and condition that has the potential to lead to such an outcome is not reasonable.

4. Flawed Methodology

The Penalty Provisions are not reasonable because the level of the penalty charges that they impose is set based on the flawed methodology set out in the Draft Decision. That methodology is inadequate and does not take into account a number of fundamental issues associated with the role of the Penalty Provisions.

4.1 Regulator's Methodology

Given the complexities associated with assessing the Penalty Provisions and inconsistent proposals made by Epic Energy, the Draft Decision appears to have reduced the issue of whether the Regulator should approve of the Penalty Provisions to a simple review of alternatives found in other access regimes. For the reasons noted above, this approach to the assessment of the Penalty Provisions is manifestly inadequate.

A further difficulty with the methodology presented in the Draft Decision is that the Regulator appears to proceed from the assumption that the best way to assess whether a particular Penalty Provision is reasonable is to ascertain whether there are similar penalty clauses in relation to access to services covered by other regulated gas pipelines.

From there, the Regulator appears to proceed from the further assumption that the level of a particular Penalty Provision for the DBNGP should be established by reference to the level of similar penalty clauses on those other pipelines. It is apparent that the analysis in the Draft Decision is based on a tabulation of some form of weighted or aggregated average from elsewhere; although the data presented is incomplete and includes some proposed access regimes which are yet to be reviewed (let alone approved). The Draft Decision appears to conclude from the data tabulated in section 6.2.1.3 that penalty rates tend to average around the 350 percent mark in Australia. On this basis, the Draft Decision proposes that this average from elsewhere should apply across a range of potential service variations in the Western Australia marketplace for gas sales, delivery and use.

Western Power disagrees with the approach taken in the Draft Decision. The assessment of whether it is reasonable to approve of an Access Arrangement that includes penalty clauses should be undertaken on a pipeline specific basis. Technical factors in relation to each pipeline, including engineering and specific operating factors in a marketplace with increasing numbers of shippers, and much more timely shipper load information capabilities, should be carefully considered on a pipeline specific basis. Accordingly, Western Power submits that:

1. Even if it were reasonable and proper to approve of penalty clauses, the fact that the terms and conditions of access to one pipeline include a penalty provision does not mean that it is reasonable to include a penalty in the terms and conditions of access to a second pipeline. While regard might be had to the situation in relation to the first pipeline, the reasonableness of applying a penalty to the second pipeline should be primarily assessed by reference to the facts and circumstances that exist in relation to the second pipeline. It might or might not be appropriate to apply a penalty to the second pipeline. There is some doubt about the soundness of a process of reasoning which simply states that the first pipeline has a penalty provision, so the second pipeline must have one. That is particularly being the case where the penalty provisions exist pursuant to a regulatory approval which has not been tested before the courts.

2. Even if the fact that the terms and conditions of access to other pipelines include penalty provisions is taken to be a measure of the reasonableness of approving a penalty provision in a proposed Access Arrangement, that does not mean that the level or magnitude of the penalty provisions in respect of those other pipelines is reasonable for the pipeline under consideration. The level or magnitude of a penalty on one or more pipelines does not mean that a penalty imposed on a particular pipeline is, therefore, reasonable.

   In this respect, Epic Energy noted that penalty regimes exist in Access Arrangements elsewhere, but that different market and pipeline operating and design parameters may apply to those regimes. At point 2.6 in its Submission 6, Epic cautioned against comparing imbalance tolerances across gas transmission pipelines; "*…Differences in facilities, differences in utilisation, and differences in shipper load patterns all contribute to differences in tolerance to shipper imbalances…*".

   In addition, Western Power understands that the Regulator has been advised that "penalty incentive mechanisms" are required in contracts by the service provider for technical reasons, although no technical based proposals are evident and, to the best of Western Power's knowledge, Epic Energy has not provided any evidence to support its assertions. However, Western Power notes that there is an established commercial practice under which penalties are not charged by Epic Energy and have not been charged by any previous owner and operator of the DBNGP. Even if incentive mechanisms are required to assist in achieving the optimum operation of the DBNGP (which is not accepted by Western Power), the mechanisms must be based upon the "cost/benefit" of the behaviour that is being "penalised", rather than upon the inconvenience that is caused (if any) to the operator or other users by that behaviour. Further, the fact that successive DBNGP operators have operated under a third party access regime for nearly 7 years without the imposition of such penalties strongly suggests that such evidence may not be available.

4.2 Fundamental Issues Concerning the Role of the Penalty Provisions

The Draft Decision does address some fundamental issues concerning the operation of the Penalty Provisions. Some examples may help to demonstrate the considerations required to address these matters in the specific context of the DBNGP's asset characteristics and the market requirements for a least cost/risk outcome.

4.2.1 Nominations Surcharge - Example

Consider the Nominations Surcharge for over or under nominations by 10 percent, amended from Epic Energy's proposed $15/GJ to 350 percent of the reference tariff by the Regulator in the Draft Decision. As an example, suppose that Western Power's average gas delivery is about 100 TJ/d. Demand for electricity and the variations in plant performance result in fuel use variations often more than 10 percent (and a 30 percent variation has occurred many times over the years).

If demand was less than 90 TJ on the day when 100 TJ was planned, then one outworking would be that Western Power could be required to pay $2.96/GJ at Kwinana Power Station, or a total of around $30,000 for the surplus gas in the pipeline for each day of imbalance.

Western Power would be better off by getting rid of the 10 TJ somehow. With gas costing around $1.70/GJ the total lost value would only be $17,000. This example raises questions as to why Epic Energy would accept the gas into the pipeline if it was too full and was also facing some costs associated with oversupply.

Further, the outworking of the Penalty Provisions should reflect differences between various linepack conditions. Clearly the cost of having too much gas delivered into the pipeline, as suggested above, is different from the case in which too much gas is used on a day. Unfortunately, the regulatory review process appears to not have been provided with the substance needed to consider these outworkings. The Draft Decision reflects this.

4.2.2 Overrun Surcharge – Example

Consider the proposition that Epic Energy will charge a premium for an overrun of gas delivery using capacity that would otherwise be unused. Consider the context of a shipper using a quantity of gas greater than was expected; say Perth household gas customers experienced a cold snap. This example raises the question of why a premium needs to be charged for using a service that provided additional revenue as a result of more gas being used.

The gas sellers made a sale that may have otherwise gone to an alternative fuel and the pipeline service provider gained revenue from the utilisation of capacity that otherwise would have not occurred. Indeed all parties benefited from marginal capacity that was available, because of the operating practices which ensured supply security. And, in common sense, this only has a marginal cost. It seems that a premium is only charged for such a service in the environment of an inappropriately regulated monopoly.

5. Penalty Revenue Rebate Mechanism

Amendment 79 in the Draft Decision (Part B:290) requires that Epic Energy amend the terms and conditions for the Firm Service to provide for revenue from the Penalty Provisions to be rebatable as if the activities or events to which the rebates relate were "Rebatable Services" within the meaning of the Code. The Amendment states that the mechanism for the rebate should provide for the rebate of a minimum of 95 percent of revenue raised from the Penalty Provisions to users of the Firm Service, without any provision for a threshold revenue to be achieved prior to a rebate being paid.

As previously indicated in this submission, Western Power has serious concerns regarding the potential for inequities to arise from the rebate scheme, particularly the cross-subsidisation of industrial customers and competing base load generators by peaking customers. Furthermore, there is no apparent basis put forward to justify the proportion (5 percent) of rebateable penalty revenue to be retained by Epic, and how this relates to the likely costs of implementing such a scheme.

The Draft Decision is silent on the nature of the rebate mechanism, and the Regulator is requested to provide a detailed proposal of the scheme, for consideration by Epic Energy and all shippers. Western Power expresses concern about the lack of detail provided in relation to the rebate mechanism that is contemplated for the rebating of revenue derived from the Penalty Provision. Given the vague nature of Amendment 79, it has not been possible for Western Power to meaningfully analyse the potential impact of the rebate mechanism on its business. This places Western Power, a user which has significant exposure to the Penalty Provisions, at a considerable disadvantage.

6. Regulator Must Reconsider Penalty Charge Regime

Western Power requests the Regulator to give further consideration to conditions relating to Reference Service variations, to ensure that the outcomes of the Access Arrangement equitably reflect the characteristics of the market served by the DBNGP, taking into account the economic impact on shippers, and the consequential impacts for the Western Australian economy.