DAMPIER TO BUNBURY NATURAL GAS PIPELINE

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

COURT DECISION ADDITIONAL PAPER CDAP#1: RESPONSE TO ALINTA COURT DECISION SUBMISSION

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1 Executive Summary

1.1 This paper responds to the issues raised in the Alinta Submission of 8 November 2002. There are many comments in it which contain serious errors in relation to the interpretation of the Code, particularly in light of the Court decision. Furthermore, Alinta makes many submissions which are not substantiated by factual information.

1.2 The overall conclusion advanced by Alinta is that the Regulator "can and should maintain the position established in the Draft Decision".

1.3 However, Alinta's conclusion and its associated reasons are made without any new factual material being put forward to support them. Furthermore, the part of the submission which seeks to justify reliance upon a DORC value for the initial Capital Base on the basis that such a value as being the upper limit of economic efficiency lacks any economic justification, let alone is it supported by empirical evidence.

1.4 As the Full Court held that the primary factual reason given by the Regulator for rejecting Epic's proposed reference tariff had no basis on the materials before the Regulator,[1] Alinta's position seems untenable without further evidence.

1.5 Moreover, the legal analysis on which Alinta bases its conclusion is flawed in many significant respects.

1.6 Accordingly, Epic Energy would be extremely concerned were the Regulator to rely upon Alinta's submission in so far as it:

1. fails to lead any evidence in relation to issues from the draft decision that the Court has concluded were determined by the Regulator without basis; or

2. is based on flawed legal analysis.

1.7 This paper responds to the following issues raised by Alinta.

Alinta's Flawed Legal Analysis

1.8 Alinta's legal analysis of the Court decision is fundamentally flawed in 3 key respects:

1.9 First, it seeks to adopt a building block approach to the assessment of an access arrangement. This fails to recognise the conclusion of the Court that the assessment of an access arrangement is a single assessment process that requires a consideration of the factors in section 2.24 of the Code.

1.10 Second, Alinta attempts to marginalise the role of section 2.24 in the decision making process and to give priority to section 8.1. This is incorrect and inconsistent with the Full Court's Decision and furthermore, unsupported by the provisions of the Code. The Court made it adamantly clear that it is section 2.24

[1] Reasons para 211.

that guides the Regulator in his decision making process. In addition, such an approach espoused by Alinta would render the Western Australian Regime to be inconsistent with the Competition Principles Agreement's effectiveness test.

1.11 Third, Alinta also makes submissions in relation to the role of the Regulator in the assessment process. It submits that this role is one where he must endeavour to establish certain elements of the access arrangement. However, such a role demonstrates a fundamental misunderstanding of the Regulator's role in the assessment process – it is not the role to develop his own reference tariff or reference tariff policy. Rather, he should assess the reasonableness of the Service Provider's proposal.

Alinta's statements are unsupported by any factual evidence

1.12 Alinta then submits that the DORC value of the DBNGP is the value of $1,234 million, although, it states, that valuation is at the upper limit of the range of permissible values and it is arguable that it should be reduced below that value (possibly to around $1,000 million). This is sought to be justified as follows:

- Epic Energy contends that the purchase price of $2,407 million reflects a purchase price value, but Alinta claims there are serious questions about whether the purchase price:

  (a) reflects a reasonable commercial judgment; and

  (b) was influenced by considerations such as the prospect of obtaining monopoly profits and an increase in transport volumes which did not materialise.

- A DORC derived value has significant economic advantages.

- Any value in excess of one derived by the DROC methodology will have a negative impact on the economically efficient utilisation of gas resources.

- A DORC derived value can be supported by regulatory precedent.

- A DORC derived value would deter the inefficient construction of a second pipeline parallel to the DBNGP.

- A value derived by the purchase price paid by Epic Energy suffers from the concept of the "winners' curse".

- The use of a purchase price value methodology is inappropriate because equity markets typically value regulated infrastructure assets at a 50% premium above regulatory asset value.

- The establishment of an ICB at or below a DORC valuation would be consistent with international best practice.

- A higher reference tariff will result in gains to Epic Energy at the expense of Alinta.

Serious questions about whether a purchase price can be relied upon

1.13 On this point, Epic Energy has provided substantial information to the Regulator to refute these claims in its court decision submissions. However, it is noted that nothing Alinta claims on this point in its submission is supported by factual evidence. Accordingly such claims suffer from a lack of credibility. Furthermore, Alinta is in a position to provide the additional factual information given its role in the sales process and so its failure to do so must carry significant weight in assessing the credibility of its arguments.

DORC has considerable economic advantages

1.14 Alinta submits that:

(a) the DORC methodology has considerable economic advantages and its use will maintain regulatory consistency; and

(b) the purchase price value methodology suffers from disadvantages associated with the winner's curse and compensating an asset owner for any regulatory premium that forms part of a purchase price.

1.15 In response, Epic Energy submits that the DORC valuation proposed by Alinta is not one that would be set in a competitive market. Furthermore, it has no economic or factual justification.

1.16 A further problem with Alinta's reasoning, is that its expert which it seeks to rely upon for justifying a DORC derived value, does not consider the way in which an optimised replacement cost should be depreciated to yield a value of assets with the same service potential as existing assets, and does not examine the question of why the resulting value is the value that would be established in a competitive market.

1.17 In addition to the fact that the Court rejected the reasons provided by the Regulator for relying on a DORC value to establish the initial capital base, Alinta provides no justification, either factual or based on economic argument, to support the use of a DORC value. Accordingly, there are no grounds for the Regulator to rely on a DORC value to establish an initial capital base.

1.18 Furthermore, there is no justification as to why the particular value arrived at by the Regulator and Alinta is the appropriate DORC derived value. Epic Energy contends that there are significant deficiencies in the Regulator's DORC derived value, not the least of which is the fact that the regulator's optimisation of the pipeline has only been carried out as a high level analysis and as a result, its level of accuracy must be called into question, particularly given the level of accuracy in relation to Epic Energy's DORC derived value.

A value in excess of one derived by the DORC method will have a negative impact on the economically efficient utilisation of gas resources.

1.19 Alinta then submits that if the Regulator determines that the ICB is to be set at a level that exceeds the economically efficient level, this will have a negative impact on the economically efficient utilisation of gas resources. It will adversely affect energy intensive gas users such as minerals processors which compete internationally, in part, on the basis of energy prices. Consideration of the possibility of the construction of an inefficient competing new pipeline, such as a pipeline in the statutory pipeline corridor, suggests that it is appropriate to value the ICB at no more than the DORC valuation.

1.20 Once again, Alinta's submission ignores the very pertinent comments made by the Court on this point and fails to recognise the comments by both the Productivity Commission and the CoAG in relation to incentives for investment.

1.21 Furthermore, it fails to recognise that Alinta will, at least for the next few years, be ensured of price rises higher than those Epic Energy will be entitled to. This is because Alinta's tariff escalation is increased by a full CPI whereas Epic Energy's is limited to only 67% of the change in CPI.

1.22 In a further attempt to justify the use of a DORC value in establishing the ICB, Alinta submits that the Regulator must consider Epic's purchase price for the DBNGP and the matters noted above in relation to the purchase price value methodology. In considering these factors, it claims that it is instructive that section 8.11 states that the initial capital base for an Existing Pipeline normally should not fall outside the range of the DAC and DORC values. In this case, that, Alinta submits, suggests that the range is between $874 million and $1,234 million. It is also notable that the optimised deprival value is $1,528 million and the imputed value is in the range of $1,200 to $1,300 million. Thus, under those methodologies it is clear that the value of the DBNGP would reasonably be somewhere in the range of $1,000 million to $1,300 million. This, of course, is considerably less than the purchase price based ICB of $2,570 million for which Epic contends. This difference of over $1,000 million is extremely significant and certainly material.

1.23 Epic Energy submits that this key submission, upon which the entirety of its analysis in section 4 of Alinta's submission is erected, is directly inconsistent with the reasons of the Full Court. The Court said that applicable factors under section 8.10 must be accorded weight as fundamental elements in the Regulator's decision in establishing the initial Capital Base. In explaining the meaning of giving weight to various factors as fundamental elements in making a decision, the Court expressly said that it is "difficult to conceive that it could have been intended that the Regulator might decide to give no weight at all to one or more of the factors." In other words, if a purchase price methodology applies to establishing an initial Capital Base, the Regulator is not free (as urged by Alinta) to entirely ignore the result of applying this methodology and to choose to apply a DAC or DORC valuation. The Regulator is required to give at least some weight to purchase price methodology.

A DORC value can be supported by regulatory precedent

1.24 Such a claim amounts to a submission that, for the sake of consistency, the Regulator should continue to perpetuate the approach so recently identified by the Productivity Commission and the Council of Australian Governments as having an adverse effect upon future investment in regulated infrastructure.

1.25 Furthermore, this reasoning can not be supported in so far as it seeks to rely upon regulatory precedent of the Eastern States' regulators. Such reasoning is contrary to the very reasoning for Western Australia establishing a state based regulator separate from the Eastern States' regulator. As was outlined in paragraph 4.13 of Epic Energy's submission CDS#3, in bringing in its own legislation (that was to contain differences from that to apply in the Eastern States of Australia), the Government foreshadowed that it would have its own regulator in order to not be linked to the Eastern States' regulator's decisions and to ensure that development in the State was encouraged[2].

An ICB above DORC will deter inefficient construction of a second parallel pipeline to the DBNGP

1.26 This argument may be valid if the DORC valuation proposed by Alinta were appropriately determined. However, as noted above, Alinta proposes a DORC that is not reflective of the valuation that would be established in a competitive market. In consequence, Alinta cannot conclude that its proposed DORC valuation would deter inefficient construction of a second pipeline because its straight line conversion of ORC to DORC is without economic meaning.

1.27 The tariff for zones 9 and 10 under the transitional access regime applicable until the proposed Access Arrangement comes into force[3] is currently $1.019021/GJ. Notwithstanding that this is comparable to the reference tariff of the proposed DBNGP Access Arrangement, there is as yet no serious proposal for the construction of a parallel pipeline. This suggests that the DORC valuation proposed by Alinta is arbitrarily low, and would, if implemented, act as a barrier to efficient entry in the future. The imposition of artificially derived regulated tariffs in a competitive market has been the subject of significant debate in the applications for coverage of the Eastern Gas Pipeline and revocation of coverage of the Moomba to Sydney Pipeline

A value set by reference to the price paid by Epic Energy suffers from the concept of the "Winner's curse"

1.28 The "winner's curse" argument advanced by Alinta is altogether too simplistic. Alinta has failed to make any reference to the fact that the auction process was designed in two stages, which would ameliorate the effects of any "winner's curse". Further, the submissions by Alinta define the "winner's curse" as the situation where a successful bidder in a first-price, sealed bid auction pays too much. In fact, the winner's curse describes a bidder who pays too much due to having incomplete information, not a bidder who pays too much due to taking too optimistic a view of the value of an asset.

[2] Hansard, 16 September 1998 at pages 1475 - 1476
[3] That is, under the *Gas Pipelines Access (Privatized DBNGP System) (Transitional) Regulations 1999*.

If Alinta's contention is that Epic Energy was over-optimistic, it should provide the justification for that assertion. However, if Alinta is making the submission that there was a true "winner's curse", it is incumbent upon it to identify specifically what imperfect information it says made Epic Energy fall into the trap of the winner's curse. Epic Energy is aware that a number of Alinta's employees were involved in the information disclosure section of the sales process and would therefore be able to advise the Regulator and Epic Energy of any deficiencies – **if any** exist. Presumably it would be difficult to do this, as the same set of information was available to every bidder in the sales process[4].

1.29 Also, if there was a "winner's curse", this was entirely due to the design of the auction process adopted by the State, which had the objective of maximising sale proceeds as opposed to lowering transmission tariffs. Epic Energy should not be required to bear the burden of any defect in the design of the State's own auction process, which significantly benefited the State. Epic Energy has analysed the "winner's curse" argument in more detail in paras 4.14 – 4.28 of CDS #2.

Use of a purchase price value methodology is inappropriate because equity markets typically value regulated infrastructure assets at a 50% premium above regulatory asset value

1.30 Epic Energy has provided details of regulated assets sold in Australia that have sold at multiples of around 2.0 times their regulatory asset value. However, the DORC valuations used by Australian regulators are without economic meaning. In consequence, the divergence of enterprise value – established through market transaction – from regulated asset value should not be surprising. What is surprising, both in the data provided by Alinta, and in the ratios of sale price to regulated asset value shown by Epic Energy, is the consistency in the divergence between the market-determined value and regulated asset value. Where assets have been acquired, or where shares have been traded, the value placed on a regulated business is consistently higher than the value assigned by the regulatory process. In this context, Epic Energy's situation – purchase price 2.1 times the DORC – is not an aberration resulting from injudicious purchase. It is the norm. In a large number of independent transactions, purchase prices have been about double regulated asset value. The divergences between purchase price and regulated asset value are clearly not the random divergences that would be expected on the assumption of the irrational exuberance of the purchasers of regulated assets. Experienced buyers systematically value assets more highly that regulators using DORC valuations. This may well be a further manifestation of the fact the DORC valuations are without economic meaning.

The establishment of a DOC value is consistent with international best practice

1.31 establishment of an ICB at or below a DORC valuation would be consistent with international best practice. No evidence is provided in support of this assertion. Indeed, international evidence may be difficult to find. North American regulators have generally relied on actual cost valuations of regulated assets. In the United Kingdom, the regulatory asset value of the (former) British Gas transmission system

[4] Epic Energy Submission CDS#3

was established, for the purpose of the first price review after privatisation, by reference to the 1991 market value of shares in the privatised enterprise. A similar approach was adopted for the regulated asset values of the privatised electricity businesses.[5]

A higher reference tariff will result in gains to Epic Energy at the expense of Alinta.

1.32 This is also not correct. This is because Epic Energy's proposal is for tariffs to be escalated by 67% of the change in the CPA whereas Alinta's escalation rate is much higher. It is noted that the Government has approved tariff increases for retail tariffs for AlintaGas of 3.5% in 2001 and 3.00% in 2002. In addition, the Minister for Energy announced on 11 September 2002 an agreement with AlintaGas under which household and small business tariffs (other than residential customers in the South-West Coastal Area which will remain at CPI plus 2%) "will be escalated annually from July 1, 2003 at CPI", again not reflecting the savings that have already been passed onto AlintaGas from the reductions in gas transmission tariffs. AlintaGas has already been the beneficiary of an actual reduction in the tariffs on the DBNGP from 1997 of 27%, but at no stage has that been passed on to AlintaGas' retail customers.

1.33 The fact that the government to date has chosen to allow significant increases in AlintaGas' tariffs (now coupled with ongoing full CPI increases) compared to the limited increase it has allowed for Epic Energy (1.9% - which is well below CPI increases for the period - compared with 6.6% for AlintaGas) when AlintaGas is making significant and increasing profits, is incongruous.

1.34 Furthermore, as is outlined below in the data from the Australian Gas Association, the costs of transmission are a relatively small proportion of the total costs of the delivered price of gas to residential customers.

[5] See The Brattle Group report *Proposed Regulatory Model for the Dampier to Bunbury Natural Gas Pipel*ine, October 1999, pages 14 – 16. Epic Energy filed this report with the Regulator as part of its original Access Arrangement submission on 15 December 1999.

2 Background

2.1 The Western Australian Independent Gas Pipelines Access Regulator ("Regulator") has publicly released a number of submissions made by interested parties in response to the Full Court of Western Australia's judgment on 23 August 2002: *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Ltd*[6] ("Court Decision").

2.2 Most of these submissions were not available to Epic Energy for comment prior to the close of the public consultation period that was opened in accordance with the Regulator's Information Paper of 2 September 2002[7].

2.3 Of these submissions, Epic Energy considers it important to respond, and that the Regulator considers Epic Energy's response, to the following:

Date Submission Released	Stakeholder
03 Feb 2003	Western Power Corporation - *Second Post-Judgment Submission*
03 Feb 2003	Western Power Corporation - *First Post-Judgment Submission*
20 Dec 2002	Alinta Sales Pty Ltd
26 Nov 2002	Wesfarmers CSBP Limited (8 Nov 2002)
22 Nov 2002	Coogee Chemicals Pty Ltd
22 Nov 2002	Nufarm Australia Ltd
15 Nov 2002	Worsley Alumina Pty Ltd
25 Oct 2002	Wesfarmers Ltd

2.4 These submissions make a number of statements which, if the Regulator were to rely upon them as the basis for his final decision, would seriously call into question its validity. In addition, there are other statements which are misleading and therefore need to be corrected or put into their proper context. Accordingly the purpose of this paper is to respond to these aspects of these submissions.

2.5 Epic Energy has already responded to the statements raised in the submissions of Wesfarmers CSBP, Coogee Chemicals, Nufarm Australia, Worsley Alumina and Wesfarmers[8]. This paper responds to the statements made by Alinta Sales Pty Ltd ("Alinta") in its submission.

2.6 Given that the Western Power Corporation submissions have only recently been released by the Regulator, Epic Energy will respond to them in a separate additional paper that will be provided as soon as possible.

2.7 Many of these submissions, including Alinta's, raise the same issues ("common issues"). The common issues can be categorised as follows.

[6] (2002) 25 WAR 511. ("Reasons").
[7] The closing date was 8 November 2002
[8] See Epic Energy Submission CDS#6 – Response to Draft Decision Submissions, dated 31 December 2002.

1. The nature of the regulator's assessment process for the assessment of an access arrangement, including the establishment of the initial Capital Base.

2. The appropriateness of an initial Capital Base established by reference to the depreciated optimised replacement cost methodology.

3. The appropriateness of an initial Capital Base established by reference to the purchase price paid by Epic Energy for the purchase of the DBNGP in March 1998.

4. The expectations and understandings in relation to the tariffs as from 1 January 2000.

These common issues are responded to in section 3 of this paper.

2.8 However, a number of submissions, including Alinta's, raise additional issues ("additional issues"). Epic Energy responds to these additional issues in section 4 of this paper.

2.9 However, before Epic Energy responds to the issues raised in the submissions, there are some general observations in relation to the Alinta submission which need to be made. They are the subject of section 2 of this paper.

3 General Observations

3.1 There are at least four general observations that need to be made in relation to the Alinta submission made in connection with the Court Decision. They are outlined below.

3.2 First, all of the submissions referred to in the table in section 1 of this paper, and Western Power Corporation, were made without having seen Epic Energy's submissions CDS#1 to 6 , in particular submission CDS#2, dated 11 December 2002 ("CDS #2"). Many of the points raised by Alinta, both factual and legal, have been addressed in these further submissions made by Epic Energy. The Regulator has indicated that he will exercise his discretion to take these submissions by Epic into account.[9] Generally, in the present submissions being made in this paper, Epic has only provided further responses where new matters need to be advanced, and otherwise relies on submissions CDS #1 - 6 for the purpose of responding to the issues raised in Alinta's submission. However, in that respect, Epic Energy requests that the Regulator exercise his discretion under section 2.15 of the Code to consider this paper for the purposes of his assessment of the proposed access arrangement.

3.3 The second general observation is the obvious point that Alinta's submission is not made by a neutral party. On this point a number of observations can be made:

(a) Alinta would stand to benefit significantly, in terms of increased profits, from a lower tariff (although Epic Energy disputes Alinta's claim that Alinta would be entitled to the reference tariff under its existing contracts with Epic Energy pursuant to section 20 of the *Dampier to Bunbury Pipeline Act).* Epic Energy raised this point in paragraph 9.30 of its submission CDS#2. The magnitude of the "windfall gain" that would result to Alinta as a result of a lower tariff equivalent to the proposed reference tariffs contained in the draft decision, is stipulated in the affidavit of James Edward Hennessy, dated 28 September 2001 and filed in the Full Court of the Western Australian Supreme Court in connection with the DBNGP Case - a saving of $700,000 per month on average in transmission tariffs, assuming Alinta fully utilises its contracted capacity on the DBNGP.

(b) If recent press reports[10] contain any element of truth and AlintaGas is indeed keen to purchase the DBNGP, it may well be in its interest to have the tariff set at a level where it becomes financially unsustainable for Epic Energy to continue ownership of the DBNGP and hence a forced sale ensues. There would be the added advantage in that case of a lower tariff leading to a lower purchase price.

3.4 While this consideration may not directly affect the merits of the contentions presented by Alinta, it does mean that the result of accepting these arguments should be carefully scrutinised to ensure that they do not simply result in a windfall gain to Alinta and any other user in a similar situation at Epic Energy's expense. If that were to occur, Epic submits that this result would form an additional relevant matter for the

[9] See Letter Regulator to Epic Energy dated 13 January 2003

[10] See *The West Australian*, 19 February 2003, p. 54, "Epic seeks time for pipeline debt" by Michael Wier

purposes of section 2.24(g) of the Code. The Code was designed to prevent abuses of monopoly power by a Service Provider, contrary to the general public's interest. It was not designed to allow a User, which itself has a fixed legislative tariff for charges to its own customers, to obtain a profit for its shareholders at the expense of a Service Provider, particularly when that may force the Service Provider into external administration. In such circumstances, where the User has its own regulated charges, the Code would serve no wider public interest than as a mechanism to unfairly allocate profits between the Service Provider and the User. The same principle would apply in the case of any other User who on-sells gas to end customers as a bundled product (ie the gas purchase, transportation and where relevant, distribution components of the delivered price of gas aggregated by the User and sold to the end customer as a single product), even where the other arm/s of the User's business are not regulated.

3.5 The third observation concerns the many instances in the third party submissions where statements of opinion have been made without any factual information or empirical evidence disclosed to support them.

3.6 Given that the Regulator has indicated that he will publish any information provided to him that is materially adverse to Epic Energy's proposed access arrangement and given nothing of the type has been disclosed to Epic Energy, Epic Energy can only assume that no such factual information or empirical evidence has been provided to him on either a public or a confidential basis. If this assumption is incorrect, Epic Energy requests that the Regulator disclose the information to Epic Energy as a matter or urgency.

3.7 However, if Epic Energy's assumption is correct, Epic Energy would be concerned were the Regulator to rely upon these statements of opinion made by Alinta for the purposes of justifying any conclusion he makes in his final decision. They are, in effect, simply bald statements and moreover, inconsistent with the Court decision. This is an issue which Epic Energy has drawn to the Regulator's attention on several previous occasions[11] but it is important to restate in this paper.

3.8 An example of such a statement is the following statement in the Alinta submission on page ii:

"*If the Regulator determines that the ICB is to be set at a level that exceeds economically efficient levels, this will retard the economically efficient utilisation of gas resources".*

3.9 In this particular instance, Epic Energy makes the following points. First, elsewhere in its submission, Alinta submits that the Regulator must, on a proper application of the Code, adopt an ICB derived by reference to the DORC methodology. Second, by adopting this proposition at the same time as making the above statement, Alinta takes the position that an ICB derived by reference to the DORC valuation methodology (and in particular, the DORC value derived by the Regulator) is at the upper limit of economically efficient levels. Not only does Alinta provide no empirical evidence to support this conclusion, it is contrary to the Court's reasons, where it was

[11] See for example DDS#5 – DBNGP Sales Process, filed with the Regulator on 30 November 2001

made clear that the Code is not concerned exclusively with forward looking concepts derived from economic theory. This is expanded upon in sections 4 & 5 of this paper.

3.10 It is important to raise this issue again in this paper, particularly in relation to the establishment of the initial capital base, because not only have unsubstantiated statements of opinion been made that the Regulator should reject the use of a purchase price or market valuation methodology for establishing the initial Capital Base, but they have also been made in connection with various issues such as seeking to justify the use of the DORC valuation methodology as the basis for the establishment of the initial capital base.

3.11 This is of even greater importance given that even Epic Energy's submissions made before and after the Court Decision contain significant and compelling factual evidence supporting Epic Energy's proposed access arrangement and the use of a purchase price or market valuation methodology as the basis for establishing the initial Capital Base for the DBNGP.

3.12 The fourth observation relates to comments made in submissions by Alinta and Western Power Corporation to the effect that because no party made submissions to the Court in relation to certain aspects of the Regulator's reasoning in the draft decision in connection with certain factors, principles or considerations and because the Court did not pass any comment on these aspects of the Regulator's reasoning in the draft decision, the Regulator's reasoning is "unimpeached" and does not involve any error. For example, in Western Power Corporation's submission, this comment is made in relation to the Regulator's consideration of the principle in section 8.10(e).[12]

3.13 Epic Energy would be concerned were the Regulator to adopt the stance that the Court's silence on these matters amounts to an endorsement of the Regulator's reasoning on these issues. Epic Energy would be further concerned were the Regulator to adopt the stance that because Epic Energy (or any other party for that matter) did not make any submissions to the Court on these matters, that Epic Energy should also be taken to endorse the Regulator's reasoning on these matters. This is so for the following reasons:

- First, Epic Energy's application in the DBNGP Legal Challenge was based on limited grounds and then only in relation to a particular aspect of his draft decision. The parties were therefore limited to making submissions to the Court on this aspect of the draft decision.

- Second, the Court itself was equally only concerned with the limited aspects of the draft decision that was the subject of the draft decision. As reflected in the discussion on the final form of the orders, it did not feel the need to stray beyond the subject matter of the application or the specific matters in dispute[13].

- Finally, Epic Energy has already made compelling arguments in the Regulatory approval process as to why the Regulator's reasoning and conclusions in relation to various aspects of his draft decision should be called into question.

[12] Western Power Corporation First Post Judgment Decision, dated 8 November 2002 and published on 3 February 2003, paragraph 14

4 Response to Common Issues

4.1 This section deals the common issues, and where appropriate, cross refers to Epic Energy's CDS Submissions that already deal with the relevant issue.

Common Issue #1 - Regulator's approach to the assessment process

4.2 This issue is dealt with extensively in the submissions by Alinta[14] and Western Power Corporation[15].

4.3 There exists, between Epic Energy and users such as Alinta and Western Power Corporation, a fundamental difference as to the proper approach to the assessment process. This is so in at least 2 respects.

4.4 The first respect relates to the interrelationship between sections 2.24 and 8 of the Code. While Alinta accepts[16] that the Full Court decided that section 2.24 of the National Third Party Access Code for Natural Gas Pipeline Systems ("Code") provides for a single process of assessment,[17] Alinta goes on to impose its own structure as to how the assessment process is to be carried out. Thus, it contends:

> *"Although the process may be a single process (particularly in the context of assessment), it is also clear that, in practical terms, and it has a starting point and end point. In so far as an initial capital base and a reference tariff is concerned, that process involves (among other things) the establishment of the initial capital base and ends with consideration of the reference tariff against the 8.1 objectives."*[18]

4.5 Epic submits that this exposition of the assessment process is incorrect, inconsistent with the Full Court's decision, and unsupported by the provisions of the Code. Epic has outlined the proper approach which it considers should apply, in paragraphs 3.1-3.9 of CDS #2.

4.6 The approach adopted by Epic focuses upon section 2.16 of the Code, which is the provision pursuant to which the Regulator's power to decide whether to approve an access arrangement (in a final decision) arises. The power contained in section 2.16 is to be exercised in accordance with section 2.24 of the Code. As these are the legislative provisions which provide and regulate the power of approval to be exercised by the Regulator, they must ultimately control the Regulator's discretion.

4.7 While the Full Court declined to make a declaration concerning the steps to be followed in the decision-making process, it clearly considered that section 2 of the Code controlled the decision-making process as a whole, consistently with what has just been said. The Full Court said:

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[13] See *Re Michael; ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231(S), para 13- 15
[14] Alinta Submission, section 2
[15] Western Power First post-judgment submission, dated 8 November 2002, publication version 30 January 2003
[16] Alinta Submissions, p 3.
[17] *Re Michael; ex parte Epic Energy (WA) Nominees Pty Ltd* (2002) 25 WAR 511 ("Reasons"), para 58.
[18] Alinta Submissions, p 8.

> *"Given the detailed and complex process of decision-making which the Regulator must follow by virtue of the requirements of s 2 of the Code, of which the draft decision is but the first stage, it appears to us that it would be undesirable in the present case to seek to anticipate the Regulator's consideration of this aspect of his eventual decision-making."* (underlining added)

4.8 As is outlined in section 3 of Epic Energy's submission CDS#2, this issue was discussed at the hearing as to the final orders before the Full Court on 28 November 2002. It is important that the oral submissions at the hearing of counsel for both the Regulator and Epic Energy on this point be read by the Regulator (see pages 671 – 673 of the transcript for the hearing). This is particularly so because Alinta's submission to the Regulator predates the hearing on 28 November 2002. While Epic Energy accepts that Alinta was not bound to do so, the fact that Alinta was the principal contradictor in the proceedings and failed to make any oral submissions to the Court on this point at the hearing should not be ignored by the Regulator when considering this part of Alinta's submission, particularly given the submissions being made by Epic Energy and the Regulator at the hearing on this point starkly contradict the argument made by Alinta in its submission.

4.9 Notwithstanding this, in its most recent submissions, Alinta attempts to marginalise the role of section 2.24 in the decision making process. It does so by two steps, which are apparent from the passage set out in paragraph 3.3 above.

4.10 First, Alinta divides the assessment process into separate stages, so that the fixing of an initial capital base and the design of a reference tariff are discrete steps, albeit in a single process of approving an access arrangement, in which section 2.24 has "very limited potential application".[19] This depends upon characterising the issues presented by sections 3 and 8 of the Code as requiring the exercise of independent decision-making powers. However, that analysis is contrary to the scheme of the Code.

4.11 The Code provides for various interim and final decisions to be made under section 2 as part of a single assessment process. For the purpose of the various decisions to be made in that single process, certain considerations arise by virtue of the principles contained in sections 3.1 to 3.20, which are "picked up" and made relevant to section 2 by section 2.24. The considerations contained in sections 3.4 and 3.5 are further elaborated in section 8, which is to be read as contained in sections 3.4 and 3.5.[20] However, the drafting technique of separately setting out section 8 does not transform the matters in section 8 from principles to be considered by reason of section 2.24, as if contained in sections 3.4 and 3.5, into independent decisions to be made under the Code distinct from the decisions required by section 2.

4.12 Second, Alinta says that establishing an initial capital base and designing a reference tariff ends with consideration of the objectives in section 8.1. Again, that is contrary to the structure of the Code, as explained above and in CDS #2. The end point is the single decision-making power contained in section 2.

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19 Alinta Submissions, p 6.
20 Reasons para 66.

4.13 The flaw in arguing that section 8.1, which is not a provision which itself contains any decision making power, is the end point of establishing an initial capital base and designing a reference tariff, may be illustrated by considering public interest matters. For example, the Regulator might legitimately consider that there is a public interest in ensuring that a service provider remains solvent and is able to maintain the safe and reliable operation of the pipeline . For that reason the Regulator may consider that a tariff and tariff path should apply in a proposed access arrangement that ensures the service provider remains a viable concern..

4.14 This public interest consideration could not be taken into account in designing a reference tariff in accordance with section 8.1. However, the uncertainty and adverse impact on future investment in the State, particularly as a result of a regulatory decision made in relation to an asset that was sold by the State is self-evidently a matter of public interest. Section 2.24 would oblige the Regulator to take such a matter into account pursuant to paragraphs (a) and (b), in finally deciding whether to approve a proposed Access Arrangement. However, on the analysis of Alinta, the Regulator would be obliged to wholly ignore the public interest in this respect, because the Regulator could not take these obligations into account under section 8.1. This illustration demonstrates the difficulties with the Alinta interpretation.

4.15 A further problem with the approach advocated by Alinta is that it fails to distinguish between two different types of question which may arise in relation to the application of section 8 to the facts of a particular case. One type of question is the meaning to be given to the words used in section 8. The other type of question is how the provisions of section 8 are to be applied to a particular case. The approach taken by Alinta effectively merges the two types of question, and says that section 2.24 has almost no relevance at all to section 8. However, at the very least, to the extent that the factors set out in section 2.24 reflect, in more precise context, the general objectives of the Act and Code,[21] they may be relevant to interpretational issues arising in section 8. The Full Court itself recognised this in discussing the proper interpretation of section 8.1(d). Parker J considered that "there is some underlying consistency of objective between s 8.1(d) and provisions such as 2.24(a), and s 8.10(c), (d), (f), (g) and (j)."[22]

4.16 In fact, the point just made, carries further. In the context of the Code, it may be practically impossible to separate factual and interpretational issues, as the two become intertwined based on expert economic evidence. So, in respect of section 8.1(a) and (b), the issue is whether past costs should be taken into account in considering economic efficiency. That is the same issue which arises in respect of s.2.24(d). It would be artificial to say that reference could not be made to the way in which section 2.24(d) should be interpreted, against the background of relevant economic evidence applied to a particular case, in reaching a view about the proper interpretation of section 8.1(a) and (b). Once the proper interpretation of section 8.1(a) and (b) is determined, having regard to the objectives of section 2.24 (d) in the particular case, it would then be possible to apply section 8.1(a) and (b), as construed against the objectives of section 2.24(d), to the facts of the case. The application of section 8.1(a) and (b) would then, inevitably, be consistent with section 2.24(d). However, this would be by reason of using section 2.24(d) to interpret the words of

[21] Reasons para 129.
[22] Reasons para 153.

section 8.1(a) and (b), not by a process of using factors under section 2.24(d) to guide the exercise of any discretion arising under section 8.1(a) and (b).

4.17 This simple example demonstrates that it is wrong to erect any absolute barrier between the operation of section 2.24 and section 8, as Alinta attempts. Instead, it illustrates the correctness of the proposition that at each point in the single process of assessment the same matters will have weight, and that there is "an underlying harmony and consistency in the general policy objectives of the Act stated in the preamble, and ss 2.24, 8.1, 8.10 and 8.11 of the Code."[23]

4.18 As a final point to underscore the relevance of s 2.24 in the assessment process, it is important to note that for the Code to be effective and therefore displace the operation of the National Access Regime in Part IIIA of the *Trade Practices Act* 1974, it must satisfy the effectiveness test in clause 6 of the Competition Principles Agreement. That test requires, inter alia, that an industry specific or state based access regime must be consistent with the following principles:

(1) an access user must have a guaranteed right of access through arbitration; and

(2) in making a decision, the arbitrator is required to take into account a set of factors and considerations which are almost identical to the section 2.24 factors[24].

4.19 However, while the Code contains such features[25], the Code is structured so as to minimise the instances when a user should be forced to resort to arbitration and even then, what role an arbitrator has.

4.20 This is because an arbitrator is bound to apply the reference tariff set by a regulator in the event of a dispute in relation to a reference service being referred to an arbitrator and is also generally required not to make a decision that is inconsistent with the Access Arrangement[26].

4.21 In effect, the Code's regulatory approval process involved in assessing and approving an access arrangement for a covered pipeline fetters the discretion of an arbitrator when making a decision.

4.22 If this approach, and therefore if the Code, is to be consistent with the effectiveness test in Part IIIA of the Trade Practices Act, the Regulator, when assessing an access arrangement that includes one or more reference tariffs, must take into account the same set of principles that an arbitrator is required to take into account under clause 6(4)(i) of the Competition Principles Agreement ("CPA") or at least a set of principles that are consistent with the CPA principles. Given that the CPA factors that an arbitrator must take into account are similar to or the same as those contained in section 2.24, if the Regulator were not to have regard to these factors as fundamental elements in his assessment process, one must question to what extent the Code is an effective access regime. If it is not an effective access regime, then it raises the

[23] Reasons para 185.
[24] See in particular clause 6(4)(i) of the Competition Principles Agreement, April 1995
[25] See section 6 of the Code, in particular section 6.15
[26] See section 6.18 of the Code

question whether it actually operates given the existence of Part IIIA of the *Trade Practices Act*.

4.23 The second respect of the assessment process with respect to which there lies a fundamental difference of opinion between Epic Energy and Alinta relates to the task of the Regulator in the assessment process. Alinta argues that it is the Regulator that establishes the various elements of an access arrangement and the sub elements of these elements. For example, on page 11 of Alinta's submission, it states that "the **Regulator must endeavour to establish** the cost of replacing the remaining service potential of the asset, not the cost of replacing the asset itself." (emphasis added)

4.24 In Epic Energy's view, this demonstrates a fundamental misunderstanding of the Regulator's role in the assessment process. As Epic Energy argued in section 3.8 of submission CDS#2 and also at the hearing on 28 November 2002, it is not the role of the Regulator to establish the ICB, nor is it the role of the Regulator to develop his own Reference Tariff or Reference Tariff Policy. The Regulator's counsel accepted this form of analysis in argument on 28 November 2002.[27]

4.25 Rather, the Regulator's task is to determine whether the reference tariff proposed by Epic is acceptable and complies with the principles in section 8. Before the Regulator can reject Epic's proposed reference tariff, he must be positively satisfied that Epic Energy's proposed tariff, including the proposed initial Capital Base, does not comply with the principles in section 8.

Common Issue #2 – Reliance upon the DORC methodology for the establishment of the initial Capital Base

4.26 Epic Energy responds to the following issues in the Alinta submission relating to the reliance on a value derived by reference to the DORC methodology for the purposes of establishing the ICB:

1. what is meant by the DORC methodology;
2. the value that would be derived by applying the DORC methodology; and
3. the appropriateness of relying upon the DORC valuation methodology as the basis for the establishment of the initial Capital Base.

4.27 However, before doing so, the fact that Epic Energy is responding to any of these issues should not be taken to mean that it resiles from its position that the correct outworking of the Code is as reflected in Epic Energy's proposed access arrangement, which seeks to adopt an initial capital base by reference to the price paid by Epic Energy for the purchase of the pipeline in 1998.

4.28 In responding to these issues, Epic Energy has sought to identify the relevant paragraphs of Alinta's submission where they are raised.

4.29 Para 3.3(b), page 11, second paragraph – Alinta takes the view that, based on the interpretation adopted by the Court in the DBNGP Decision, the DORC methodology

[27] Transcript p 699.

is aimed at deriving the cost of replacing the remaining service potential of the asset and **not** the cost of replacing the asset itself. This, Alinta argues, is the value that would arise in a competitive market.

4.30 Para 3.5(b)(iii)(A) – Alinta then notes that "one of the 8.1 objectives is that a reference tariff should be designed with a view to achieving the objective of replicating the outcome of a competitive market." In these circumstances, Alinta contends, "from an economic perspective a DORC valuation provides the best method for determining the value that would arise in a competitive market". Furthermore: "This feature is an important advantage of a DORC valuation methodology and is, Alinta submits, a primary reason as to why regulators of infrastructure have demonstrated a preference for using it".

4.31 In support of its assertion that there are sound economic reasons for using a DORC methodology for valuation, Alinta refers to the testimony and written statement of its expert witness in the legal proceedings, Mr Henry Ergas. In paras 20-42 of his statement, Mr Ergas sets out economic arguments as to why a DORC valuation might be reflective of the asset valuation that would be established in a competitive market. However, Mr Ergas's arguments are essentially conceptual. He does not consider the way in which an optimised replacement cost should be depreciated to yield a value of assets with the same service potential as existing assets, and does not examine the question of why the resulting value is the value that would be established in a competitive market.

4.32 In addition to the above limitations of Mr Ergas' arguments, it should be noted that Alinta did not seek to rely on these paragraphs for the purposes of its evidence. Furthermore, the Court observed that Ergas was not confined to expressing an opinion as to the meaning of the term from the viewpoint of an economist. Accordingly, the Court only allowed these paragraphs on the basis and to the extent that they expressed an expert opinion from the viewpoint as an economist.[28] However, even then, this evidence was not tested given that it was not pressed by Alinta.

4.33 The question of how a replacement cost should be depreciated to yield a value of existing assets reflective of the valuation that would be established in a theoretically competitive market has been considered by Professor Stephen King.[29] In a report prepared for Agility Management, Professor King sets aside his general concerns about the use of replacement costs in regulatory asset valuation, and examines the way in which a DORC valuation should be constructed to be reflective of a competitive – contestable – market valuation. Having established the contestable market benchmark, he concludes that a straight line depreciation adjustment made to convert optimised replacement cost (ORC) to DORC – the depreciation adjustment proposed by the Regulator for a DORC valuation of the DBNGP, and used by all other Australian regulators in their DORC valuations – is without economic meaning:

[28] Reasons, para 109
[29] Stephen P King, *Report on the construction of DORC from ORC*, February 14, 2001. Professor King's report was prepared for Agility Management, and has been submitted to the Regulator by Goldfields Gas Transmission Pty Ltd in support of its proposed Access Arrangement for the Goldfields Gas Pipeline.

". . . it is not consistent with the contestability or new entrant justifications used by the regulators for DORC. In this sense, the use of a straight line adjustment, to convert ORC to DORC is arbitrary and appears to lack any economic justification."

4.34 Alinta submits that the appropriate DORC valuation to be taken as an upper limit for the Initial Capital Base of the DBNGP is $1,234 million. This is the DORC valuation of the Regulator's Draft Decision. It has been calculated by making a straight line depreciation adjustment to an estimated ORC of $1,495 million. In consequence, the DORC valuation proposed by Alinta is arbitrary and lacks economic justification: it is not reflective of the valuation that would be established in a competitive market.

4.35 Furthermore, Alinta's approach tends to the view that concepts of economic theory should be afforded some overarching significance in the establishment of the initial Capital Base, a conclusion that the Court in the DBNGP decision expressly rejected.

4.36 Professor King's approach highlights a significant limitation in the method used by Australian regulators to construct DORC valuations reflective of competitive – contestable – market conditions. His approach would, however, have its own difficulties were it to be applied. Professor King focuses on the use of an ORC valuation to establish the price for service provision that would be charged by an entrant which constructed new facilities. However, the ORC of the new facilities is not the only input needed to establish the entrant's price. In addition, forecasts of future demand for service, of any capital expenditures required to create the facilities needed to satisfy growth in demand, and of future operating and maintenance costs would be required. Those forecasts are likely to be subject to uncertainty. In consequence, the new entrant's price will be uncertain, as will be the net revenue stream from existing assets calculated using that price. Therefore, the present value of the net revenue stream available from existing assets, over the life of those assets, (the DORC valuation to be attributed to the existing assets) will also be uncertain. DORC does not offer any shortcut in, or simplification of, the problem of asset valuation. Construction of a DORC from an ORC necessitates confronting many of the same uncertainties that would have to be confronted in applying any other method which seeks to establish asset value from a future net revenue stream.

4.37 Where the assets which the new entrant must create comprise a pipeline system with a long life, and that pipeline serves an economy with growing mining, minerals processing, industrial and residential sectors, the uncertainties affecting the new entrant's price will be great. Considerable uncertainty will therefore surround the value of existing assets established using the approach of Professor King. This is the reason why, when such assets are sold by a government, they are usually sold by auction rather than by posting a price which the government will accept. The government simply does not know the price which should be posted, and risks selling the assets in question at a price lower than it might otherwise have realised. A sale to informed bidders allows the asset to be sold to the party which, in circumstances of considerable uncertainty, places the highest value on the assets. The risk for the government is that informed bidders will anticipate the "winner's curse", and will bid low. To ensure that the government obtains the maximum value for the assets, consistent with their expected - uncertain - future use, the auction must be designed to reduce the possibility of bidders bidding low. The State of Western Australia constructed such an auction for the purpose of selling the DBNGP. That auction, and

not an economically meaningless calculation of DORC, now provides the best information available on the value of the DBNGP assets.

4.38 Recognising the difficulties bidders would face in attempting to value the DBNGP assets, the Government of Western Australia sought to reduce uncertainty during the sale process, by making public its views on the future gas transportation price: around $1/GJ to Perth. Epic Energy and, to the best of its knowledge, the other bidders, bid on the basis of an expectation that the transportation price would be of this order. The final bids produced a range of asset values. The highest was that made by Epic Energy. It is now entirely appropriate that this bid price, and not an artificial and economically meaningless DORC constructed by subtracting an arbitrary amount of depreciation from ORC, be the basis of the ICB for the Pipeline.

4.39 This Epic Energy believes, is the correct interpretation to be placed on the conclusions on asset valuation contained in report prepared by the Government's regulatory advisors, Price Waterhouse, on possible future DBNGP tariffs.[30] Price Waterhouse did not reject the use of a valuation based on a market transaction (valuations of this type had been used in the United Kingdom). The consultant concluded only that such a valuation could not be made for the DBNGP because, at the time of its report, "there has been no stand alone market based price for the DBNGP assets".[31]

4.40 In addition to the above concerns about the DORC value being suggested by Alinta and the Regulator (in his Draft Decision) as the appropriate value for the purposes of section 8.1(b), it should also be noted that Epic Energy proposed an alternative basis for its proposed DORC derived value ($1,368.4 million as at 1 January 2000). It optimised the pipeline based on the principal assumptions of a greenfields development and the notional replacement pipeline being constructed in stages, with the same staging of capacity augmentation as occurred in the historical construction of the pipeline although with optimisation of each stage of construction. This was supported by regulatory precedent in the United States Federal Communications Commission.[32]

4.41 Even if one is to accept that the Regulator's DORC valuation methodology does have economic justification in order to determine the DORC value of the DBNGP (which Epic Energy does not), one must question how it can be said that the Regulator's DORC value in the draft decision is the upper limit when valuing the DBNGP under this methodology. By making this claim, Alinta is suggesting that the value arrived at by the Regulator in the draft decision (ie $1,233.7 million as at 31 December 1999) is more accurately determined than the value proposed by Epic Energy.

4.42 It should be noted that the Regulator has relied upon two reports to establish his DORC value. Firstly he commissioned a report from Connell Wagner to identify any "manifest errors, omissions or inadequacies in Epic Energy's methodology or

[30] Price Waterhouse, *Dampier to Bunbury Natural Gas Pipeline Regulatory Report on Revenue Requirement and Future Price Path*, August 1997.
[31] Price Waterhouse Report, p. 26.
[32] Epic Energy Additional Paper 5: Code Compliance, Attachment 4: Initial Capital Base valuation methodologies, p7

assumptions". He then relied upon a report by CMPS&F that was prepared for the purposes of the sale of the pipeline to determine the DORC value.

4.43 However, the following points should be noted about the methodology adopted by the Regulator in deriving his value:

- First, and most importantly, the Regulator acknowledges that both reports he relied upon for the purposes of the Draft Decision were undertaken as "high level [studies]". While he acknowledges the subjectivity and uncertainty in this methodology, he nevertheless concludes the CMPS&F report to be reasonably accurate. However, the CMPS&F report itself indicates a level of accuracy of +/- 15% with the valuation. The same deficiency applies in relation to the Connell Wagner report.

- There is nothing to show that either the CMPS&F or the Connell Wagner report's calculations are any more detailed and accurate than the work undertaken by Epic Energy in determining its DORC value. In this respect, there are no details about what level of probability can be attributed to the accuracy of the values relied upon by either Connell Wagner or CMPS&F. In fact there are aspects of the CMPS&F report which show it is less accurate and detailed than Epic Energy's proposed DORC value.

- In relation to the CMPS&F report, the regulator excluded certain cost items which other regulators have accepted as being included in determining a DORC value for a pipeline. For example, the regulator excluded easement costs and land management related costs. However, these costs have been allowed by the ACCC in at least the access arrangement for the Moomba to Adelaide Pipeline System. It should also be noted that these costs were accepted by users of that pipeline as being appropriate to include in determining the DORC value of a pipeline. A further example is in relation to Epic Energy's financing costs. The Regulator's total revenue calculations have assumed a 60:40 gearing ratio so some level of financing costs will be a necessity. It should be noted that an amount to reflect such costs was allowed by the ACCC in the final approval of the MAPS access arrangement, even during the period of construction.

- Furthermore, the report commissioned by the Regulator from Connell Wagner suffers from the deficiency that the consultants do not have a demonstrated experience in estimating the costs for constructing pipelines whereas Epic Energy's estimates are based on its own experience of designing and constructing pipelines over the last 8 years.

4.44 For at least the above reasons, significant doubt must exist about the level of accuracy of the Regulator's DORC value or for that matter the reasons for not accepting Epic Energy's proposed DORC value.

4.45 In addition to the above submissions as to whether a DORC methodology is the appropriate methodology to use as the basis for establishing the ICB for the DBNGP, this has been dealt with in paras 9.6 – 9.12 of Epic Energy's submission CDS#2. In essence, the Regulator's reasons for adopting a DORC valuation were found by the Court to be invalid. For these and the above reasons, Alinta's principal argument for

using a DORC valuation $1,234 million as an upper limit of the Initial Capital Base for the DBNGP is, therefore, without foundation.

4.46 As well, Alinta has failed to mention the problems created by a DORC valuation based on forward looking cost rules, in the case of a regulated asset purchased for a significant price which becomes a sunk cost. These difficulties are outlined by Epic in CDS #2 at paras 4.92-4.97 and are further elaborated upon in section 5 of this paper under the heading "Additional issue #2". As mentioned in para 4.97 of Epic Energy's submission CDS#2, the Productivity Commission and the Council of Australian Governments' Parer review have recently noted the adverse effects upon investment in regulated infrastructure which flows from the use of forward looking DORC valuations.

4.47 Para 3.5(b)(iii)(B) – The above reasoning from Alinta is one of two main arguments for use of the DORC valuation. In para 3.5(b)(iii)(B) of its submission, Alinta notes that a further advantage of using a DORC valuation is that doing so is generally consistent with the approach taken by other regulators. Such a claim amounts to a submission that, for the sake of consistency, the Regulator should continue to perpetuate the approach so recently identified by the Productivity Commission and the Council of Australian Governments as having an adverse effect upon future investment in regulated infrastructure.

4.48 Furthermore, this reasoning can not be supported in so far as it seeks to rely upon regulatory precedent of the Eastern States' regulators. Such reasoning is contrary to the very reasoning for Western Australia establishing a state based regulator separate from the Eastern States' regulator. As was outlined in paragraph 4.13 of Epic Energy's submission CDS#3, in bringing in its own legislation (that was to contain differences from that to apply in the Eastern States of Australia), the Government foreshadowed that it would have its own regulator in order to not be linked to the Eastern States' regulator's decisions and to ensure that development in the State was encouraged[33].

4.49 Para 3.10, pages 28 – 29 – A further argument which Alinta makes to justify the adoption of a DORC value to establish the ICB is that this would deter the inefficient construction of a second pipeline parallel to the DBNGP. This argument may be valid if the DORC valuation proposed by Alinta were appropriately determined. However, as noted above, Alinta proposes a DORC that is not reflective of the valuation that would be established in a competitive market. In consequence, Alinta cannot conclude that its proposed DORC valuation would deter inefficient construction of a second pipeline because its straight line conversion of ORC to DORC is without economic meaning.

4.50 The tariff for zones 9 and 10 under the transitional access regime applicable until the proposed Access Arrangement comes into force[34] is currently $1.019021/GJ. Notwithstanding that this is comparable to the reference tariff of the proposed DBNGP Access Arrangement, there is as yet no serious proposal for the construction of a parallel pipeline. This suggests that the DORC valuation proposed by Alinta is

[33] Hansard, 16 September 1998 at pages 1475 - 1476

[34] That is, under the *Gas Pipelines Access (Privatized DBNGP System) (Transitional) Regulations 1999*.

arbitrarily low, and would, if implemented, act as a barrier to efficient entry in the future. The imposition of artificially derived regulated tariffs in a competitive market has been the subject of significant debate in the applications for coverage of the Eastern Gas Pipeline and revocation of coverage of the Moomba to Sydney Pipeline.

4.51 Para 3.13(b)(iv), page 34 – Alinta suggests that even if the Regulator has regard to the purchase price methodology, he has a discretion to select whether to establish the initial Capital Base according to the price which would be dictated by DAC, DORC or the purchase price methodology. That follows from the comment in the submissions by Alinta that the Regulator may determine whether or not to establish the initial Capital Base outside the range of DAC and DORC, but "nothing in the Court's decision requires him to do so; it merely makes it clear that he is not precluded from doing so by a perceived intention of the Code that the initial Capital Base be necessarily consistent with the principles of economic efficiency and a competitive market."

4.52 This key submission, upon which the entirety of the following analysis in section 4 of the Alinta submissions is erected, is directly inconsistent with the reasons of the Full Court. The Full Court said that applicable factors under section 8.10 must be accorded weight as fundamental elements in the Regulator's decision in establishing the initial Capital Base.[35] In explaining the meaning of giving weight to various factors as fundamental elements in making a decision (albeit in the context of section 2.24), Parker J expressly said that it is "difficult to conceive that it could have been intended that the Regulator might decide to give no weight at all to one or more of the factors".[36] In other words, if a purchase price methodology applies to establishing an initial Capital Base, by reason of section 8.10(c), the Regulator is not free (as urged by Alinta) to entirely ignore the result of applying this methodology and to choose to apply a DAC or DORC valuation. The Regulator is obliged to give at least some weight to the purchase price methodology.

4.53 Moreover, Alinta's submission misconceives the nature of the Regulator's function. The Regulator's task is to determine whether the reference tariff proposed by Epic Energy is acceptable and complies with the principles in section 8. It is not for the Regulator to develop his own reference tariff, after establishing the initial Capital Base he would prefer, and to ask himself whether Epic Energy's proposed reference tariff matches his own assessment. Before the Regulator can reject Epic Energy's proposed reference tariff, he must be positively satisfied that Epic's proposed tariff, including the proposed initial Capital Base, does not comply with the principles in section 8.

4.54 In any event, as submitted previously, there is no factual basis upon which the Regulator could now choose to apply a DORC valuation after the Full Court's decision. Therefore, the abstract analysis asserted by Alinta, concerning a value between DAC and DORC valuations, is not relevant to the present case.

4.55 Para 3.14, pages 34 - 36 – Alinta summarises its previous submissions, to which Epic Energy has provided responses above. For the reasons already given, Epic Energy contends that each and every one of the points made by Alinta has an appropriate

35 Reasons para 56.
36 Reasons, para 55.

answer, and that Alinta's submissions in justification of establishing an initial Capital Base at a DORC valuation cannot be sustained factually or legally.

Common Issue #3 – Reliance upon Epic Energy's purchase price or the market valuation methodology as the basis for the establishment of the initial capital base.

4.56 Para 3.4(a), pages 11 - 12 - In CDS # 2 Epic Energy has devoted significant effort to elaborating upon the question of what may constitute a legitimate return upon its investment, and whether the price paid was reasonable in the circumstances of the sale process designed and implemented by the State. See paras 4.3 – 4.74 of CDS #2. As to the applicability of the Full Court's general comments,[37] Epic observes that:

(a) there is no suggestion in this case that any transactions involved related entities or false motivations which might affect price. To the contrary, Epic Energy was an arms length commercial purchaser, with the aim of maximising its profitability;

(b) the Full Court made it clear that the recovery of monopoly prices or tariffs, above the level of economically efficient prices, was not illegitimate, at least to the extent that Epic Energy was simply recovering capitalised monopoly profits extracted by the State as part of the purchase price for the sale of the DBNGP.[38]

4.57 Para 3.4(b)(ii), page 13 – The emphasis upon Epic Energy bearing the onus of justifying a purchase price methodology is incorrect and liable to mislead unless it is properly understood. There is no onus of proof in the sense of a proceeding before a judicial tribunal. The question which the Regulator faces is whether, on the material before him, it would be reasonable to take into account and give effect to the purchase price methodology. But this is the same question which applies equally to each and every methodology which the Regulator may consider. The vice in the approach of Alinta is to imply that Epic Energy is requesting something exceptional, and that it must positively demonstrate that this is the proper approach.

4.58 Moreover, Alinta suggests that if Epic Energy cannot justify that the purchase price which Epic actually paid represented a sound commercial assessment of the DBNGP, the Regulator may not take into account the purchase price methodology. That view suffers from the defect that it is an "all or nothing" approach. This issue is discussed in para 4.50 above and section 2 of this paper. The proper analysis is that if the Regulator considers that Epic Energy paid more than a sound commercial value, the Regulator may still properly take into account the purchase price methodology to the extent that a purchase price would have represented a sound commercial assessment of the DBNGP (in the circumstances of the prevailing sale process). Thus, Epic Energy has referred to the independent assessment of its bankers as to whether the purchase price was commercially appropriate (CDS #2, para 4.44), and to the bids submitted by other independent bidders (CDS #2, paras 4.45 - 4.48). At the very least, the amount which the banks were prepared to lend to

[37] Reasons para 172.
[38] Reasons para 130.

Epic Energy (plus an appropriate margin of equity based on a loan-value ratio), and the amounts offered by rival bidders, reveal what other independent commercial organisations thought would represent a reasonable purchase price.

4.59 Para 3.4(b)(iii), pages 13 – 16 – In CDS #2, paras 4.4 – 4.74, Epic Energy has provided extensive justification for the commercial soundness of its decision to purchase the DBNGP at the price paid. It has also specifically addressed the comments made by the Court about the commercial soundness of its purchase price and the regulatory compact arguments, at paras 4.52 – 4.68 of CDS #2. The thrust of Epic Energy's submissions about Parker J's comments is that the he was making observations on limited factual material, which has now been supplemented. In fact, this is evident if regard is had to the opening words of the passage quoted in the Alinta Submissions at page 14. Parker J qualified the passage quoted with the words: "Nevertheless, having regard to what is before this Court, the material before the Regulator … " (underlining added).[39]

4.60 Consequently, the conclusions (on pp 15-16 of the Alinta Submissions) which Alinta contends the Regulator must draw, as a matter of fact, cannot be sustained having regard to the further material put before the Regulator in CDS #2 and related submissions.

4.61 Para 3.4(b)(iv), pages 16-17 – In preparing its bid for the DBNGP, Epic Energy established the price it was prepared to pay the State through a careful analysis of the circumstances in which a new owner would expect to operate the Pipeline. These circumstances included the expected demand for gas transmission services, which was derived from, among other things, forecasts of gas demand provided by the Government at the time of sale. (The forecasting process was described in CDS#2, paras 4.39 – 4.45, and the forecasts themselves were included in Epic Energy's Acquisition Model, which was provided to the Regulator with submission CDS#3.) The forecasts showed an increasing demand for gas, particularly for anticipated major minerals and minerals processing and electricity generation projects, which implied an increasing demand for gas transmission services. Accordingly, Epic Energy included in the analysis supporting its determination of the price it was prepared to pay the State, the forecast capital expenditure required to expand the capacity of the DBNGP to meet the increased demand. For the period from acquisition to 2007, that capital expenditure was expected to be $874 million, assuming that demand materialised. This figure is the total of the capital expenditure forecasts for the period 1998-2007 included in the Acquisition Model which has now been provided to the Regulator.

4.62 Para 3.4(b)(v), pages 17-19 – Alinta attempts to raise doubts concerning the commercial reasonableness of the price paid by Epic Energy. Each and every one of the points made by Alinta is specifically answered in paras 4.4 – 4.74 of CDS #2. Further, Epic Energy has provided substantial additional justification in support of the commercial reasonableness of the price it paid for the DBNGP (see in particular Epic Energy's submission CDS#3).

4.63 Para 3.5(b)(iii)(C), page 22 – Alinta also seeks to rely upon the "winner's curse" argument to argue why it is inappropriate to rely on the price paid by Epic Energy.

[39] Reasons para 200.

However, the "winner's curse" argument advanced by Alinta is altogether too simplistic. Alinta has failed to make any reference to the fact that the auction process was designed in two stages, which would ameliorate the effects of any "winner's curse". Further, the submissions by Alinta define the "winner's curse" as the situation where a successful bidder in a first-price, sealed bid auction pays too much. In fact, the winner's curse describes a bidder who pays too much due to having incomplete information, not a bidder who pays too much due to taking too optimistic a view of the value of an asset. If Alinta's contention is that Epic Energy was over-optimistic, it should provide the justification for that assertion. However, if Alinta is making the submission that there was a true "winner's curse", it is incumbent upon it to identify specifically what imperfect information it says made Epic Energy fall into the trap of the winner's curse. Epic Energy is aware that a number of Alinta's employees were involved in the information disclosure section of the sales process and would therefore be able to advise the Regulator and Epic Energy of any deficiencies – **if any** exist. Presumably it would be difficult to do this, as the same set of information was available to every bidder in the sales process[40].

4.64 Also, if there was a "winner's curse", this was entirely due to the design of the auction process adopted by the State, which had the objective of maximising sale proceeds as opposed to lowering transmission tariffs. Epic Energy should not be required to bear the burden of any defect in the design of the State's own auction process, which significantly benefited the State. Epic Energy has analysed the "winner's curse" argument in more detail in paras 4.14 – 4.28 of CDS #2.

4.65 Para 3.5(b)(iii)(D), page 23 - Finally, Alinta's view, expressed in para. 3.5(b)(iii)(D) of its submission, that use of a purchase price value methodology is inappropriate because equity markets typically value regulated infrastructure assets at a 50% premium above regulatory asset value, must be treated carefully. As shown in the following table, regulated assets offered for sale in Australia have typically sold at multiples of around 2.0 times regulatory asset value, where regulatory asset value is either a DORC value, or a value derived from a DORC valuation.

YEAR	ASSETS	PURCHASE PRICE ($m)	REGULATED ASSET VALUE ($m)	SOURCE OF REGULATED ASSET VALUE	RATIO
1997	Victorian electricity transmission system – sold to GPU PowerNet	2,716	1,391	ACCC Draft Decision, 24 September 2002	2.0
1995	Victorian electricity distribution assets – sold to TXU	2,080	828 Adjusted optimised depreciated replacement	*Victorian Electricity Supply Industry Tariff Order*, June 1995	2.5

[40] Epic Energy Submission CDS#3

			cost		
1995	Victorian electricity distribution assets – sold to Powercor	2,150	1,066 Adjusted optimised depreciated replacement cost	*Victorian Electricity Supply Industry Tariff Order*, June 1995	2.0
1995	Victorian electricity distribution assets – sold to Solaris	950	422 Adjusted optimised depreciated replacement cost	*Victorian Electricity Supply Industry Tariff Order*, June 1995	2.3
1995	Victorian electricity distribution assets – sold to CitiPower	1,580	611 Adjusted optimised depreciated replacement cost	*Victorian Electricity Supply Industry Tariff Order*, June 1995	2.6
1995	Victorian electricity distribution assets – sold to United Energy	1,553	879 Adjusted optimised depreciated replacement cost	*Victorian Electricity Supply Industry Tariff Order*, June 1995	1.8
1998	Victorian gas transmission system – sold to GPU GasNet	1,025	364	ACCC Final Decision, 6 October 1998	2.8
March 1998	DBNGP (WA) – sold to Epic Energy	2,407	1,124	Price Waterhouse report (August 1997), page 1	2.1
1998	South Australia gas distribution assets – sold to Envestra	910	617	South Australian Independent Pricing and Access Regulator, Final Decision, 21 December 2001	1.5

1998	Victorian gas distribution assets (Westar) – sold to TXU	1,617	632	Office of the Regulator-General, Victoria, Final Approval, 17 December 1998	2.6
1998	Victorian gas distribution assets (Multinet) – sold to CitiPower	1,970	740	Office of the Regulator-General, Victoria, Final Approval, 17 December 1998	2.7
1998	Victorian gas distribution assets (Stratus) – sold to Envestra	1,200	580	Office of the Regulator-General, Victoria, Final Approval, 17 December 1998	2.1
1999	South Australian electricity transmission assets – ElectraNet SA	938	683	ACCC Draft Decision, 11 September 2002	1.4
1999	South Australian electricity distribution assets – ETSA Utilities	3,500	2,081	*Electricity Pricing Order*, 11 October 1999	1.7
2002	Sydney Airport	6,128	1,422	ACCC Decision, May 2001	4.4

4.66 The ratios listed above are broadly consistent with the data provided by Alinta (although Alinta provides no indication of whether the regulated values from which the ratios in its table on page 23 have been calculated are from DORC valuations). However, as indicated above, the DORC valuations used by Australian regulators are without economic meaning. In consequence, the divergence of enterprise value – established through market transaction – from regulated asset value should not be surprising. What is surprising, both in the data provided by Alinta, and in the ratios of sale price to regulated asset value shown above, is the consistency in the divergence between the market-determined value and regulated asset value. Where assets have been acquired, or where shares have been traded, the value placed on a

regulated business is consistently higher than the value assigned by the regulatory process. In this context, Epic Energy's situation – purchase price 2.1 times the DORC – is not an aberration resulting from injudicious purchase. It is the norm. In a large number of independent transactions, purchase prices have been about double regulated asset value. The divergences between purchase price and regulated asset value are clearly not the random divergences that would be expected on the assumption of the irrational exuberance of the purchasers of regulated assets. Experienced buyers systematically value assets more highly that regulators using DORC valuations. This may well be a further manifestation of the fact the DORC valuations are without economic meaning.

4.67 Para 3.6, page 24 – Epic Energy repeats its previous comments concerning the inapplicability of DORC and the "winner's curse" arguments. Epic Energy also notes Alinta's assertion that establishment of an ICB at or below a DORC valuation would be consistent with international best practice. No evidence is provided in support of this assertion. Indeed, international evidence may be difficult to find. North American regulators have generally relied on actual cost valuations of regulated assets. In the United Kingdom, the regulatory asset value of the (former) British Gas transmission system was established, for the purpose of the first price review after privatisation, by reference to the 1991 market value of shares in the privatised enterprise. A similar approach was adopted for the regulated asset values of the privatised electricity businesses.[41]

4.68 Para 3.7, pages 24 - 25 – In substance, Alinta submits that, having regard to section 8.10(f), the Regulator should consider the tariffs charged by the State prior to privatisation. This is "to obtain an appreciation of the extent to which the value of the DBNGP has already been recovered by its owners".

4.69 In his Draft Decision, the Regulator has advised that he has considered the basis upon which tariffs had been set in the past, and the historical return of capital, but appears not to have given them great weight in his assessment of the ICB. This is entirely appropriate. The link to the past has been explicitly severed by Government policy for the sale of the DBNGP. As a matter of policy, the State has, through the sale process, lowered gas transmission tariffs, and has introduced a new regulatory regime to govern access to gas transmission capacity and future movements in Pipeline tariffs. Past tariffs, and the asset valuations that might have supported them, are now of little relevance. There is no longer value in undertaking further work on past prices as an indicator of "established relationships". Furthermore, the asset valuations on which those past prices were based can be of only very limited relevance in current circumstances. The value of the Pipeline has now been established through its sale. Epic accepts that there are important questions for the Regulator about the value established by the sale process, and about the application of the asset valuation provisions of the Code. Nevertheless, the sale process and the new regulatory regime, and not the arrangements prevailing prior to privatisation, are now critical to establishing the ICB.

[41] See The Brattle Group report *Proposed Regulatory Model for the Dampier to Bunbury Natural Gas Pipel*ine, October 1999, pages 14 – 16. Epic Energy filed this report with the Regulator as part of its original Access Arrangement submission on 15 December 1999.

Common Issue #4 – Expectations and Understandings as to the tariff beyond 1 January 2000

4.70 Para 3.8, pages 26 - 27 – Epic Energy has argued that its reasonable expectations were that a tariff of $1/GJ to Perth would apply after 1 January 2000. See paras 4.61 - 4.68 of CDS #2. This is further supported by the expectations of not only other bidders in the process but also users and prospective users at the time of the sale of the pipeline.[42]

4.71 Para 3.9, pages 27 - 28 – The submissions of Alinta assume that Epic Energy is arguing for a tariff which "overvalues" the DBNGP by reference to "economically efficient levels". However, Epic Energy contends that its proposed reference tariff is based on an initial Capital Base which is consistent with the terms of the Code, and a proper understanding of economic efficiency which takes into account historic costs. The "overvaluation" to which Alinta refers is apparently measured against a forward looking DORC valuation. Epic has already argued in this paper that a DORC valuation is without economic justification but even if there is some economic merit to it, it tends to the view that replicating economic theory is an overarching requirement of the Code, a view that was expressly rejected by the Court in the DBNGP decision.

4.72 Further, the submissions made by Alinta assume that if there is a higher reference tariff, this will inevitably be passed on to consumers. This is not apparently correct, as there are regulations capping the price which may be charged to Alinta's residential and small business customers. See para 9.30 of CDS #2.

4.73 In addition, Alinta's submissions also assume that a higher reference tariff will result in gains to Epic Energy at the expense of Alinta. This is also not correct. This is because Epic Energy's proposal is for tariffs to be escalated by 67% of the change in the CPA whereas Alinta's escalation rate is much higher. It is noted that the Government has approved tariff increases for retail tariffs for AlintaGas of 3.5% in 2001 and 3.00% in 2002. In addition, the Minister for Energy announced on 11 September 2002 an agreement with AlintaGas under which household and small business tariffs (other than residential customers in the South-West Coastal Area which will remain at CPI plus 2%) "will be escalated annually from July 1, 2003 at CPI", again not reflecting the savings that have already been passed onto AlintaGas from the reductions in gas transmission tariffs. AlintaGas has already been the beneficiary of an actual reduction in the tariffs on the DBNGP from 1997 of 27%, but at no stage has that been passed on to AlintaGas' retail customers.

4.74 The fact that the government to date has chosen to allow significant increases in AlintaGas' tariffs (now coupled with ongoing full CPI increases) compared to the limited increase it has allowed for Epic Energy (1.9% - which is well below CPI increases for the period - compared with 6.6% for AlintaGas) when AlintaGas is making significant and increasing profits, is incongruous.

4.75 Furthermore, as is outlined below in the data from the Australian Gas Association, the costs of transmission are a relatively small proportion of the total costs of the delivered price of gas to residential customers.

[42] This is outlined in Epic Energy submission CDS3, dated 15 December 2002

TABLE 1: Delivered Gas Cost Break Up[43] as at 1999 in $ terms

Cost Component	NSW Approx $ per GJ	VIC Approx $ per GJ	SA Approx $ per GJ	WA Approx $ per GJ
Ex-plant Price 1999	$2.40	$2.38	$2.40	$1.90
Haulage Price 1999	***$0.80***	***$0.40***	***$0.60***	***$1.00***
Distribution	$11.07	$6.03	$11.96	$12.47
Gas Price 1998 (factored by 4% to 1999 value)	$14.27	$8.61	$14.96	$15.37

TABLE 2: Delivered Gas Cost Break Up[44] as at 1999 in % terms

Cost Component	NSW Approx % per GJ	VIC Approx % per GJ	SA Approx % per GJ	WA Approx % per GJ
Ex-plant Price 1999	16.9%	27.6%	16.0%	12.4%
Haulage Price 1999	***5.6%***	***4.6%***	***4.0%***	***6.5%***
Distribution	77.5%	67.8%	80.0%	81.1%
Gas Price 1998 (factored by 4% to 1999 value)	100%	100%	100%	100%

TABLE 3: Delivered Gas Cost Analysis[45]

Average Delivered Cost Components	NSW	VIC	SA	WA
Residential Consumption per customer	38GJ	60GJ	24GJ	18GJ[46]
Residential Gas cost per customer per year	$542.32	$516.60	$359.04	$276.66
Residential transmission cost per customer per year	$30.40	$24.00	$14.40	$18.00
Residential	$0.58/week	$0.46/week	$0.28/week	$0.36/week

43 Source – AGA Gas Statistics 2001 (tables 4.2 & 4.3)

44 Source – AGA Gas Statistics 2001 (tables 4.2 & 4.3)

45 Source – AGA Gas Statistics 2001 (table 3.2)

46 Residential gas demand inferred at 18GJ from AGA Gas Statistics dated 1995 & 1997. This report conservatively assumes there has been no increase in residential gas demand for WA

transmission cost per customer				

4.76 The same reasoning also applies when dealing with the impact of a further reduction on tariffs. As stated above and in the general observations section of this paper, there is no guarantee that any further reductions in tariffs (real or otherwise) will be passed on to end customers and as such, no certainty that lower tariffs will operate to promote competition in downstream markets.

4.77 As well, Alinta assumes, without offering any verification, that any adjustment in the price of gas will cause gas to be less competitive compared to other fuels. This does not follow, depending upon the availability of other fuel sources and also the relative price of these other fuels. Alinta asserts, by way of conjecture, that there would be "an adverse effect on the wider economy", without any foundation being advanced for this suggestion. In fact the opposite could be said to be true as is demonstrated in the tables above in paragraph 4.76.

5 Response to Additional Issues

5.1 This section deals with the additional issues raised in the Alinta submission (with the paragraph reference noted), and where appropriate, cross refers to Epic Energy's CDS Submissions that already deal with the relevant issue.

Additional Issue #1 – DAC valuation methodology

5.2 Para 3.2(b), page 10 – While Epic Energy has not directly commented on the impact of the Court's decision on the relevance or appropriateness of using a DAC methodology to establish the initial capital base of the DBNGP, Epic Energy's arguments in CDS#2 has equal relevance in relation to demonstrating the inappropriateness of relying on an initial capital base by reference to the DAC methodology.

5.3 Furthermore, it is noted that in the draft decision, the Regulator differs from Epic Energy in relation to both:

1. what is meant by the DAC methodology, or "actual capital cost" in section 8.10(a) of the Code; and

2. the value that would be derived by applying a DAC methodology[47].

5.4 In the draft decision, the Regulator rejected Epic Energy's view as to what is meant by the "DAC methodology" on two principal grounds[48]:

- First, the use of the term in section 8 of the Code is consistent with the cost of construction of relevant assets as opposed to the cost of purchase.

- Second, an alternative interpretation may be inconsistent with the objectives for a reference tariff as set out in section 8.1. In particular, it would be inconsistent to adopt a different interpretation because the objectives include providing a return on the assets comprising the covered pipeline as opposed to providing the service provider with a return on its investment generally. Furthermore, adopting a different interpretation would ensure that the objectives in 8.1(a) and (d) would not be achieved as it could result in more than the efficient costs of providing the reference services being recovered.

5.5 As is clear in the court decision, such an approach to interpretation reflects a fundamental misapprehension of not only the section 8.1 principles but also the Regulator's statutory function. This has been dealt with in detail in Epic Energy's submission CDS#2 and elsewhere in this paper and Epic Energy does not intend to reiterate the point here.

5.6 For the above reasons, it is unreasonable for the Regulator to have rejected Epic Energy's proposed valuation of the DBNGP for the purposes of section 8.10(a) of the Code.

[47] Epic Energy Additional Paper 5 – attachment 4 – initial capital base valuation methodologies
[48] Draft Decision, page B123 and 124

5.7 In addition to the above, even if Epic Energy's understanding of the Court decision, in so far as it relates to the interpretation of the section 8.1 objectives and section 8.10(a), is wrong, Epic Energy questions whether the value arrived at by the Regulator in the draft decision for the DAC value ($874.0 million as at 31 December 1999) is correct. This is so for the following reasons:

- The Regulator himself acknowledges that his proposed valuation is approximate as it is based on general assumptions which he has not sought to substantiate and does not include amounts of capital recovery for certain laterals and metering facilities[49].

- there is a limited amount of accurate information available to properly determine the actual historical cost of construction of the pipeline.

5.8 If however, the Regulator has obtained further information in relation to the meaning of section 8.1(a) and the value arrived at for the purposes of section 8.1(a) over and above that which was disclosed in his draft decision, Epic Energy would still question its validity without affording Epic Energy an opportunity to review the information and provide any comments beforehand.

Additional Issue #2 – meaning of the section 8.1 objectives

5.9 Section 4 of Alinta's submission deals with the meaning of the section 8.1 objectives and how Alinta submits, they should be applied for the purposes of establishing the Reference Tariff and Reference Tariff policy for the DBNGP. While much of this has been dealt with in section 3 of this paper, Epic Energy responds to the following issues:

5.10 Para 4.2(b), page 38 – Alinta takes the view that the meaning of the term "efficient costs" is a matter for the Regulator. This implies some element of discretionary choice, between whether to adopt forward looking cost rules or historic cost rules. However, that is not a correct understanding of the Regulator's task. The task for the Regulator is to determine, according to the evidence presented to him or obtained by him (and disclosed to interested parties), whether the correct approach to interpreting the concept of "efficient costs" is to give effect to historic costs. A failure by the Regulator to act according to the evidence, by reason of some discretionary choice, would amount to reviewable error.

5.11 The proper view of economic theory is that it should take into account historic costs in determining what are "efficient costs" in relation to regulated infrastructure requiring large initial capital investment, so as to prevent future investment in such infrastructure from being discouraged with adverse consequences. This view is developed in paras 4.92 – 4.98 of CDS #2.

5.12 Para 4.3(b), pages 40 - 41- Epic repeats its submissions concerning DORC, set out at paras 9.6 – 9.12 of CDS #2 and the points it has made above in section 3 of this paper in relation to para 3.4(a) and (b) of the Alinta Submission.

[49] Draft Decision, page B128

5.13 In particular, Epic notes again that a DORC valuation determined in the way intended by Alinta is not reflective of the valuation that would be established in a competitive market. In these circumstances, it is not the case that, "as a matter of economic theory and practice, a DORC valuation reflects the manner in which asset values will be determined in a workably competitive market, provided there is sufficient demand". Furthermore, it cannot be asserted – as Alinta asserts – that "a price based on a DORC value will provide a good proxy for the price which would have been realised had the supplier faced workable competition". With a DORC valuation determined by making a straight line depreciation adjustment to ORC, Alinta cannot conclude that "the appropriate valuation for an initial capital base, where what is sought is the replication of a competitive market, is a DORC valuation". For the reasons established by Professor King, such a valuation does not relate "directly to the value a prudent purchaser would place upon a pipeline in a competitive market".

5.14 Para 4.5(a)(ii), page 43 – The Full Court did not categorically hold that, "[as] a matter of economic theory, where a significant infrastructure asset (such as a pipeline) becomes subject to regulation it may be necessary for the asset owner to 'vacate the market' in order to achieve economic efficiency." Rather, this was simply one view which was put to the Court as a matter of expert evidence, which the Court summarised as part of its discussion of the interpretation of section 8.1(d).

5.15 Furthermore, the Court did not need to resolve how to interpret section 8.1(d) according to expert evidence, and whether to accept the view just mentioned in preference to the growing awareness in economic theory and practice that, in the long term, a failure to take account of past investment costs would lead to adverse implications for future investment in regulated infrastructure assets.[50] The Court determined the proper construction of section 8.1(d) as a matter of legal interpretation. The Court said:

> *"The extent to which this growing concern has been or will come to be accommodated into economic theory and practice is one issue. In my view, however, s 8.1(d) has dealt with the issue expressly, and has done so by not denying the potential relevance of past investment decisions to the design of a reference tariff or a reference tariff policy."*[51]

5.16 Para 4.5(b)(ii), pages 44 – 45 - Epic Energy repeats the submissions it has made above in relation to paras 3.4(a) and (b) of the Alinta Submission.

5.17 Para 4.5(b)(iii) and (iv), pages 46 – 48 - In these paragraphs, AlintaGas considers the issue of the influence of past investment on future pipeline investment decisions, and extends its arguments to the question of whether investment decisions in upstream and downstream markets might be distorted by a reference tariff determined from an initial capital base not derived from a DORC valuation.

5.18 In para. 4.5(b)(iii), AlintaGas notes that the Court recognised a considerable body of economic theory which suggests that past investment decisions are sunk, and generally will not influence future investment decisions. Certainly, a considerable body of theory contends that sunk costs are of no economic significance. However,

50 Reasons para 151.
51 Reasons para 152.

that view has been substantially modified as economists have developed the tools to examine behaviour, not in static market settings in which large numbers of small businesses take market price as given, but in multi-period (dynamic) settings in which contracting and commitment are critical to economically efficient outcomes. The importance of commitment in regulated industries in which business investment results in substantial sunk costs has been examined at length by Levy, Spiller and others. In their introduction to Regulations, Institutions, and Commitment, Levy and Spiller argue that without commitment, long-term investment will not take place.[52] If regulatory institutions allow a regulator considerable discretion and, in consequence, do not require the regulator's commitment to providing a return on sunk investment, or to ensuring that a business is able to recover a past investment, future investment will not take place. Other contributors to Regulations, Institutions, and Commitment provide empirical support for this fundamental proposition.

5.19 The "Problem of Commitment" has also been considered by Newbery, who argues:

"The political demands for access and "fair" or nonexploitative prices means that investors must expect that after they have sunk their capital, they will be limited in the prices they can charge and subject to possibly onerous obligations to supply, to guarantee security, stability, and safety. If these investors are to be induced to invest, they need the reassurance that future prices will be set at a sufficiently remunerative level to justify the investment. Once the capital has been sunk, the risk is that the balance of advantage will shift toward those arguing for lower and possibly unremunerative prices."[53]

5.20 Newbery continues:

"*If public utilities are to be successfully financed, then regulation must credibly satisfy the demands of both consumers and investors. If consumers are unhappy, they cannot "exit" or choose an alternative supplier but must use their "voice" through the political process to secure their demands, to use Hirschman's (1970) illuminating terminology. If investors are fearful for the security of future returns, they will not finance the needed investment*."[54]

5.21 AlintaGas may acknowledge a "growing awareness" of this need for regulators to balance the interests of owners who have made investments against the advantages of lower prices for consumers in the short term. There is, however, more than a "growing awareness" of these issues on the part of economists concerned with regulation. In a dynamic setting, when investment involves substantial sunk costs, and consumers have access to the political process, regulation becomes a much more complex process. In these circumstances, reliance on a simple – theoretical – competitive market benchmark is overly simplistic.

5.22 In these circumstances, designing a reference tariff in accordance with the objectives of section 8.1 of the Code becomes a much less precise undertaking. Indeed, the objectives of section 8.1 may well conflict, and the requirement that the regulator

[52] B Levy and P Spiller (eds) (1996), *Regulation, Institutions, and Commitment: Comparative Studies of Telecommunications*, Cambridge University Press.
[53] D Newbery (2000), *Privatization, Restructuring, and Regulation of Network Utilities*, MIT Press, pages 28-29.
[54] Ibid, page 29.

determine the manner in which they can best be reconciled, or which of them should prevail, assumes great importance. In consequence, the role of section 2.24 in guiding the regulator also assumes much greater importance than would be the case if simple – theoretical – competitive market benchmark could be relied upon.

5.23 Whether investment decisions in pipelines, or investment decisions in the wider economy, will be distorted will not be a matter capable of resolution by reference to a theoretical ideal. It will be a matter for considered judgement given the particular context within which the reference tariff is being set. Mechanical application of a DORC value for past investment, as advocated by AlintaGas, especially if that value is determined in a way which has no economic meaning, is unlikely to assist in achieving any of the 8.1 objectives.

5.24 AlintaGas proposes, in para 4.5(b)(iv), that investment decisions in both upstream and downstream markets will be distorted if a reference tariff is established using an initial capital base that incorporates the value associated with any monopoly rent. Epic does not disagree with this proposition. Furthermore, Epic agrees with AlintaGas that the impact of a proposed reference tariff on investment decisions in upstream and downstream markets must be carefully assessed. Indeed, Epic presumes the Gas Pipeline Sale Steering Committee (GPSSC) considered the impact of tariffs on investment prior to the Minister for Energy publicly announcing that the Government sought from the Pipeline sale process a tariff of about $1.00/GJ for gas transportation to Perth, and subsequently examined the question of whether bids the State received for the DBNGP implied tariffs which incorporated monopoly rents. Epic's reason for holding this belief is that securing tariffs at appropriate levels was one of the principal objectives of the sale process. As the Chairman of the GPSSC stated in his report to Parliament on conclusion of the sale:

"*The objectives for the DBNGP privatisation could not be developed without careful consideration of the national reform agenda in general and in particular the objectives for the structure of the State's gas transmission industry. Industry objectives which were considered to be consistent with the principal aims of energy reform in Western Australia included:*

- *security of supply;*
- *the facilitation of open access to gas transmission infrastructure to encourage competition in gas supply and retailing;*
- *ensuring that gas transmission providers do not extract monopoly rents particularly from small customers;*
- *promoting efficient investment in infrastructure by the private sector through transparent and commercial regulation;*

- *reducing the potential for conflicts of interest between political, social and commercial imperatives through the separation of gas transmission from AlintaGas' other business."*[55]

5.25 Epic does not, however, agree with AlintaGas that the valuation methodology that is least likely to distort such investment decisions is the DORC methodology. Alinta's assertion as to the appropriateness of the DORC methodology, given the economically meaningless construction of the DORC value accepted by AlintaGas, is unsupportable. Furthermore, section 8.1(d) of the Code does not, as AlintaGas suggests, guide the Regulator toward the use of a DORC valuation.

5.26 Para 4.5(b)(v), page 48 – Alinta suggests that it is possible to derive guidance from section 8.1(d) to the effect that "from an economic perspective, this suggests that it is appropriate to use a value that does not include a component of monopoly rent … ". However, it is difficult to see how that guidance can be deduced from section 8.1(d) when the Full Court expressly said:

> *"However, by virtue of s 8.1(d), it would appear that the outcome under the Code of an investment decision in a pipeline made before the introduction of the Code, even though that decision anticipated some 'monopoly' profits, would not be irrelevant to the Regulator's deliberations, under s 8, including the establishment of the initial Capital Base."*[56] *(underlining added)*

5.27 Further, while Epic Energy accepts that it would distort investment decisions to establish an initial Capital Base having regard to unsound, uncommercial or reckless components of the actual purchase price, Epic Energy contends that the price it actually paid was reasonable. See CDS #2, paras 4.6 – 4.75 and Submission CDS#3.

5.28 Para 4.8, pages 49 – 50 – The principal errors identified above in paras 3.45 and 3.46 of this paper mean that the analysis contained in para 4.8 of the Alinta Submissions is flawed. In particular, it is not for the Regulator to prefer a DORC value for establishing the initial Capital Base if Epic's initial Capital Base also complies with the principles in section 8. Moreover, for the reasons already mentioned, a DORC value is not appropriate in this case.

Additional Issue#3 – the section 2.24 factors

5.29 The analysis adopted in section 5 of the Alinta submissions relies upon a number of themes to which responses have been provided above. In particular, this section suggests or assumes that:

- the factors set out in section 2.24 only have a limited role in establishing a reference tariff, if and when there is a conflict between factors in section 8.1;
- economic efficiency requires a DORC valuation, and that an initial Capital Base greater than this valuation results in "over-valuation" of the DBNGP;

[55] Gas Pipeline Sale Steering Committee, *Report on the Sale of the Dampier to Bunbury Natural Gas Pipeline*, May 1998, pp 5 – 6.
[56] Reasons para 154.

- Epic Energy's actual purchase price was commercially unsound and based on a miscalculation of the appropriate price for the DBNGP;

- there is a serious prospect of a second competing pipeline, in parallel to the DBNGP, being constructed;

- it is for the Regulator to determine an appropriate reference tariff, rather to assess Epic Energy's proposed reference tariff;

- the Regulator has a discretion to wholly ignore an initial Capital Base based on actual purchase price in preference for a DORC methodology, even if the purchase price methodology is one suitable valuation method;

- Epic Energy does not intend to provide further answers in respect of these themes, which have already been dealt with adequately above and in Epic Energy's court decision submissions, in particular CDS#2 & 3.

5.30 Para 5.6(b)(ii)(C), page 60 – The public interest served by Epic Energy's proposed reference tariff, in the context of satisfying the aims of s.38 of the Act, is addressed in paras 4.102 – 4.103 of CDS #2.

5.31 Para 5.6(b)(ii)(D), pages 60 – 61 – It is the nadir of arid legalism to suggest that a test of public interest cannot take into account the manner in which the proceeds from the sale of a public asset have been applied. Such an approach cannot find any place in interpreting the Code, which is evidently a document concerned with substance and not form. In any event, the fact that the State has received the proceeds of the sale, and had the capacity to benefit the public is, at the very least, a highly relevant circumstance material to assessing the public interest, whether or not the sale proceeds have actually been spent for the public's benefit.

5.32 Para 5.9, pages 64 – 65 – Contrary to the analysis offered by Alinta, Epic Energy contends that the reasoning set out in section 4 of CDS #2 compellingly demonstrates that the factors in 2.24 of the Code, as applied to the present case, support Epic's proposed reference tariff. In making this submission, Epic Energy reiterates its general observation in section 2 of this paper that the arguments which it has set out in CDS #2 are supported by detailed factual references and associated material provided in the related submissions, whereas Alinta's submissions tend more towards general assertion not based on specific evidence.

6 Conclusion

6.1 The overall conclusion advanced by Alinta is that the Regulator "can and should maintain the position established in the Draft Decision". However, that submission is made without any new factual material being put forward to support the submission. As the Full Court held that the primary factual reason given by the Regulator for rejecting Epic's proposed reference tariff had no basis on the materials before the Regulator,[57] Alinta's position seems untenable without further evidence. Moreover, for the reasons set out above, the legal analysis on which Alinta bases its conclusion is flawed in many significant respects.

6.2 Accordingly, Epic Energy would be extremely concerned were the Regulator to rely upon Alinta's submission in so far as it:

- fails to lead any evidence in relation to issues from the draft decision that the Court has concluded were determined by the Regulator without basis; or
- is based on flawed legal analysis.

[57] Reasons para 211.