



**PRODUCTIVITY COMMISSION  
REVIEW OF THE GAS ACCESS REGIME**

**SUBMISSION IN RESPONSE TO ISSUES PAPER**

**PROBLEMS AND SOLUTIONS  
SUBMISSION IPS#1**

**5 SEPTEMBER 2003**

Epic Energy Corporate  
Shared Services Pty Limited  
ABN 76 069 799 588  
Level 7, 239 Adelaide Terrace  
Perth WA 6000  
CONTACT: Anthony Cribb  
TELEPHONE: 9492 3803

## **1. Executive summary**

- 1.1 Australia is at the crossroads in determining the role that gas is to play in the nation's fuel mix. Future economic development will be heavily influenced by the path that is chosen.
- 1.2 For gas to play a greater role, there is a need for new gas fields to be brought into commercial operation in the medium to long term. Potentially commercial new fields are, however, far from existing and likely future gas markets, and new transmission pipelines, and other gas supply infrastructure, will be required to link these markets and fields. In the longer term, this should lead to an integrated national pipeline network.
- 1.3 An integrated pipeline network should afford energy consumers with the opportunity to choose between alternative suppliers of gas. This will be the catalyst to competitively priced gas.
- 1.4 If this integrated pipeline network is to develop, governments must ensure that their policies, including regulation, do not act as disincentives to investment.
- 1.5 Public policy affecting energy markets should be designed and implemented with a view to avoiding disincentives for further investment for at least the following reasons:
  - Governments made explicit policy decisions in the 1990s to privatise energy infrastructure, including gas transmission pipelines, and to rely, in the future, on private sector investment for the further development of that infrastructure.
  - New pipeline infrastructure will be necessary if the expected demand for gas over the next 20 years is to be satisfied.
  - Investment in new transmission pipelines will be needed to ensure that Australia has secure and reliable energy supplies, developed and operated in a way consistent with increasingly onerous environmental obligations.
  - The adverse consequences of inadequate investment are far greater than any short term gains that may be achieved by inappropriately forcing down the prices of gas and gas transmission. This was a clear message from the Productivity Commission's review of the National Access Regime.
  - Investment in pipeline infrastructure will be a key driver of fuel-on-fuel and basin-on-basin competition, leading to a more competitive national energy market.
- 1.6 In developing public policy affecting energy markets, governments should avoid disincentives for investment at two levels:
  - given the scale of investment required, governments should avoid disincentives for both domestic and foreign participation in infrastructure development; and

- investment is required not only in physical facilities, but also in a workforce with the skills necessary to design, construct and operate energy supply systems of increasing technological sophistication; disincentives to further investment in a skilled workforce must also be avoided.
- 1.7 Australian energy markets must satisfy the needs of an economy with a structure fundamentally different from the economies of Europe and North America. In developing public policies affecting energy markets, Australian governments must be aware of the real dangers inherent in using policies from the United Kingdom and the United States as templates. The policy drivers in those countries are very different from those in Australia.
- 1.8 At all costs, Australian policy makers must avoid the mistakes that led to crisis in the California energy market in the late 1990s, and to the recent electricity crisis in the North Eastern United States.
- 1.9 Epic Energy is strongly of the view that public policy, including the current regulatory regime, is stifling investment in pipeline infrastructure in Australia. There are, Epic Energy believes, significant problems with both the framework of the Gas Access Regime, and its application by regulators. The critical deficiencies are as follows:
- Regulators approach the access arrangement approval process of the National Gas Code in a way which has been found to be wrong in law – they adopt a determinative approach rather than a proper assessment process.
  - Regulators focus on the elimination of economic profits even though this is not an objective of the National Gas Code. Their treatment of the process of assessment as a series of separate deliberations, which allows a focus on abuse of monopoly power to dominate, and allows a narrow concern for what they perceive to be lowest cost outcomes, is a significant failure in the approach of the Code. It runs counter to the recent decision of the Western Australian Supreme Court in *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & anor [2002] WASCA 231*.
  - Service providers face uncertainty caused by frequent regulatory reviews in which returns to investors are placed at risk. Regulator concern to ensure zero economic profits in the short term means that Code provisions permitting longer regulatory periods are of little relevance.
  - Inordinate delays in the regulatory approval processes – up to 4 years – are unacceptable to both pipeline service providers and shippers and prospective shippers of pipelines.
  - There is very limited accountability for, and transparency of, regulator actions under the National Gas Code.
  - New facilities investment provisions in the National Gas Code fail to recognise the additional risks inherent in new project development, and fail to provide certainty that costs will be able to be recovered.

- Appeals provisions under the Gas Access Regime are inadequate, both in terms of the limited grounds of review of regulator decisions, and also in terms what it is that can be the subject of review.
  - The National Gas Code fails to adequately cater for greenfields pipeline developments.
  - The National Gas Code fails to give priority to negotiated outcomes.
  - Funding arrangement through which service providers must fund regulatory processes are inappropriate.
  - Processes for changing the National Gas Code are unwieldy and ineffective: the current system is inflexible, cumbersome and fails to give proper weight to the interests of one group of stakeholders – the service providers.
  - A “hands off” approach on the part of some governments is amounting to an abrogation of responsibility for a process for which governments were directly responsible, and in which governments must continue to play a part.
  - Economic regulation is far removed from the safety and technical aspects of operating transmission pipelines.
- 1.10 These deficiencies are giving rise to a number of adverse consequences, the most significant of which is the disincentive to invest. Where investment occurs, it will result in inefficiently sized pipelines and higher tariffs, not only the short term but also the long term.
- 1.11 Even though regulation may have brought about reductions in transmission tariffs, the benefits not have been passed on gas consumers.
- 1.12 In this submission, Epic Energy proposes changes to the Gas Access Regime which should remove the disincentives for investment, while remaining consistent with the principles and objectives of National Competition Policy.
- 1.13 Epic Energy would welcome further discussion on any aspect of this submission with the Commission.
- 1.14 Finally, Epic Energy notes that this review is being conducted at a time soon after completion of a number of other reviews of third party access regimes, and at a time when the Council of Australian Governments is considering further changes to institutional and governance arrangements in the energy sector. These all have a direct impact on the gas pipeline industry. Given the significant work carried out to date, Epic Energy endorses an approach to the Commission’s review of the Gas Access Regime that does not “reinvent the wheel” but which, nevertheless, takes into account the specific circumstances of pipeline owners and operators. The outcomes of the National Access Regime review, and work of the Parer Committee, should be used as platforms upon which the Commission’s current review should be based.

## **2. Epic Energy**

- 2.1 Before making substantive comments, Epic Energy outlines its credentials in the gas pipeline industry.
- 2.2 The Epic Energy group of companies is one of Australia's largest owners and operators of gas transmission pipelines, with more than A\$3.5 billion invested in energy infrastructure. Established in 1994, Epic Energy is building upon a strong and dynamic track record of development and expansion in its role as a major pipeline operator.
- 2.3 As a non vertically integrated gas transmission pipeline owner and operator, Epic Energy offers an objective view of the problems that are facing the pipeline sector of the energy industry, and effective solutions to these problems.
- 2.4 Epic Energy is a proprietary Australian corporation with the following shareholders:
- El Paso Energy Corporation (33.3%);
  - Dominion Resources (33.3%);
  - AMP Henderson Global Investors Limited (formerly AMP Asset Management Australia Limited) (11.1%);
  - Deutsche Asset Management (Australia) Limited (formerly Axiom Funds Management) on behalf of the SAS Trustee Corporation (11.1%); and
  - Hastings Funds Management Limited (through Australian Infrastructure Fund Limited and Utilities of Australia Pty Limited (11.1%).
- 2.5 The company's shareholders contribute Australian and American financial strength and technical resources. El Paso Energy Corporation, with over US\$50 billion in assets, provides energy solutions worldwide through its regulated and non-regulated business units. Dominion Resources, which acquired the original Epic Energy shareholder, Consolidated Natural Gas Company (CNG), operates one of the largest integrated natural gas systems in the United States.
- 2.6 The remaining investors are Australian corporations. AMP Asset Management is Australia's largest investment manager, managing funds of over \$50 billion for Australian clients in all major asset classes. Deutsche Asset Management is one of Australia's largest wholesale fund managers. As an integral part of the asset management division of Deutsche Bank AG, one of the world's strongest independent banks, Deutsche Asset Management is among the few truly global fund managers, and manages over \$270 billion on behalf of clients in 60 countries and in 23 currencies. This figure includes over \$25 billion managed on behalf of Australian domiciled clients. Hastings Funds Management is the leading independent manager of

- infrastructure and alternative assets in Australia, currently managing investments in excess of A\$2 billion.
- 2.7 The investors in Epic Energy have a wealth of experience as owners of regulated infrastructure in Australia and in other jurisdictions throughout the world. Their investments include airports, ports, electricity supply facilities, gas distribution pipelines, and gas transmission pipelines.
- 2.8 Their decision to invest in Epic Energy, and to direct Epic Energy's vision as a pure gas transmission pipeline developer and operator was made on the basis of this experience. This decision was also made at a time when:
- Australian governments had agreed on the key elements of National Competition Policy, had signed the Competition Principles Agreement, and had laid out the roadmap to establishment of the National Access Regime; and
  - Governments had made explicit decisions that the private sector was to fund and own public utility infrastructure such as gas pipelines.
- 2.9 Epic Energy's owners can not therefore be accused therefore of having invested in the Australian gas pipeline industry as "babes in the woods".
- 2.10 Epic Energy currently owns 3,300 km of transmission pipelines in Australia, and operates another 891 km on behalf of other owners. Its own operations serve the energy needs of three states via the following pipelines:
- Dampier to Bunbury Natural Gas Pipeline (DBNGP), Western Australia;
  - Dampier to Port Hedland pipelines (BEP & PEPL), Western Australia;
  - South West Queensland Pipeline (SWQP), Queensland;
  - Moomba to Adelaide Pipeline system (MAPS), South Australia; and
  - Katnook to Mount Gambier and Snuggery Pipeline, South Australia.
- 2.11 Epic Energy's pipelines in Western Australia are the main conduit for the supply of natural gas from a number of fields to markets in the mineral-rich Pilbara region, and in the more populous South West. They are central to the economic development of Western Australia.
- 2.12 Epic Energy's Moomba to Adelaide Pipeline System is currently the only means by which the South Australian gas market has access to gas supplies.
- 2.13 In 1996, Epic Energy built its South West Queensland Pipeline to allow for the introduction of a new gas source into energy markets in South East and Central Queensland. Epic Energy (or Tenneco Energy as it was then known) won a competitive tender process to construct the pipeline which connects the Roma to Brisbane and Queensland Gas Pipelines.



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#### *Problems and Solutions*

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- 2.14 Epic Energy's main pipelines are currently subject to third party access regulation in accordance with the Gas Pipelines Access Law, which includes the National Third Party Access Code for Natural Gas Pipeline Systems ("National Gas Code"). For the purposes of this submission, the Gas Pipelines Access Law will be referred to the Gas Access Regime.
- 2.15 As a result of most of its assets being regulated under the Gas Access Regime, over 90% of Epic Energy's revenue is directly affected by government policy. Government policy therefore plays a critically important role in the viability of Epic Energy's business, and in its future expansion plans.

### **3. The relevance of transmission pipelines to the gas industry in Australia - today and tomorrow**

3.1 The purpose of this section of the submission is:

- to briefly outline the historical development of the gas transmission pipeline industry;
- to outline the forecast growth in gas demand in the medium to long term future; and
- to demonstrate the need for additional pipeline infrastructure.

#### **The role of transmission pipelines in the development of the gas industry - today**

3.2 Australia's natural gas industry has evolved over a relatively short period. The first commercial production of natural gas was in the 1960s. While further exploration and commercial development of the country's abundant reserves were undertaken predominantly by private enterprise, construction of the pipeline systems through which gas was transported to foundation customers was funded mainly by state governments.

3.3 That the states played a significant role in the development of the gas industry should not be surprising:

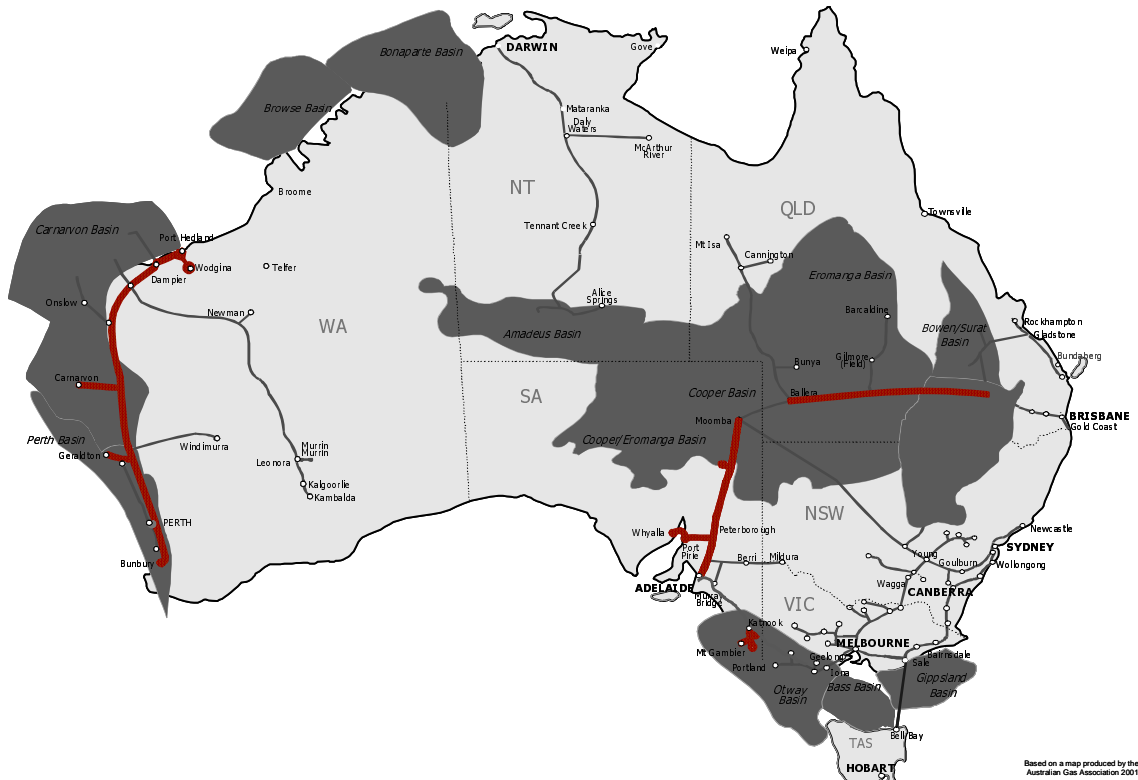
- control of Australia's energy markets was seen as being critical to state economic development programs; and
- transmission pipelines are capital intensive, high risk, and often marginal projects; given the distance between the gas reserves and the markets they supplied, and the relatively small size of these markets, state support was necessary to ensure that pipeline development proceeded state support was necessary to ensure that they proceeded, allowing industry development both upstream and downstream.

3.4 Initially, the states constructed a number of unconnected transmission pipelines, each of which linked a producing area with a single market. More recently, and with increasing private sector involvement, these unconnected pipelines have been interconnected. A national pipeline network has begun to emerge.

3.5 Diagram 3.1 below shows the extent of the transmission pipeline network that presently exists in Australia.



Diagram 3.1

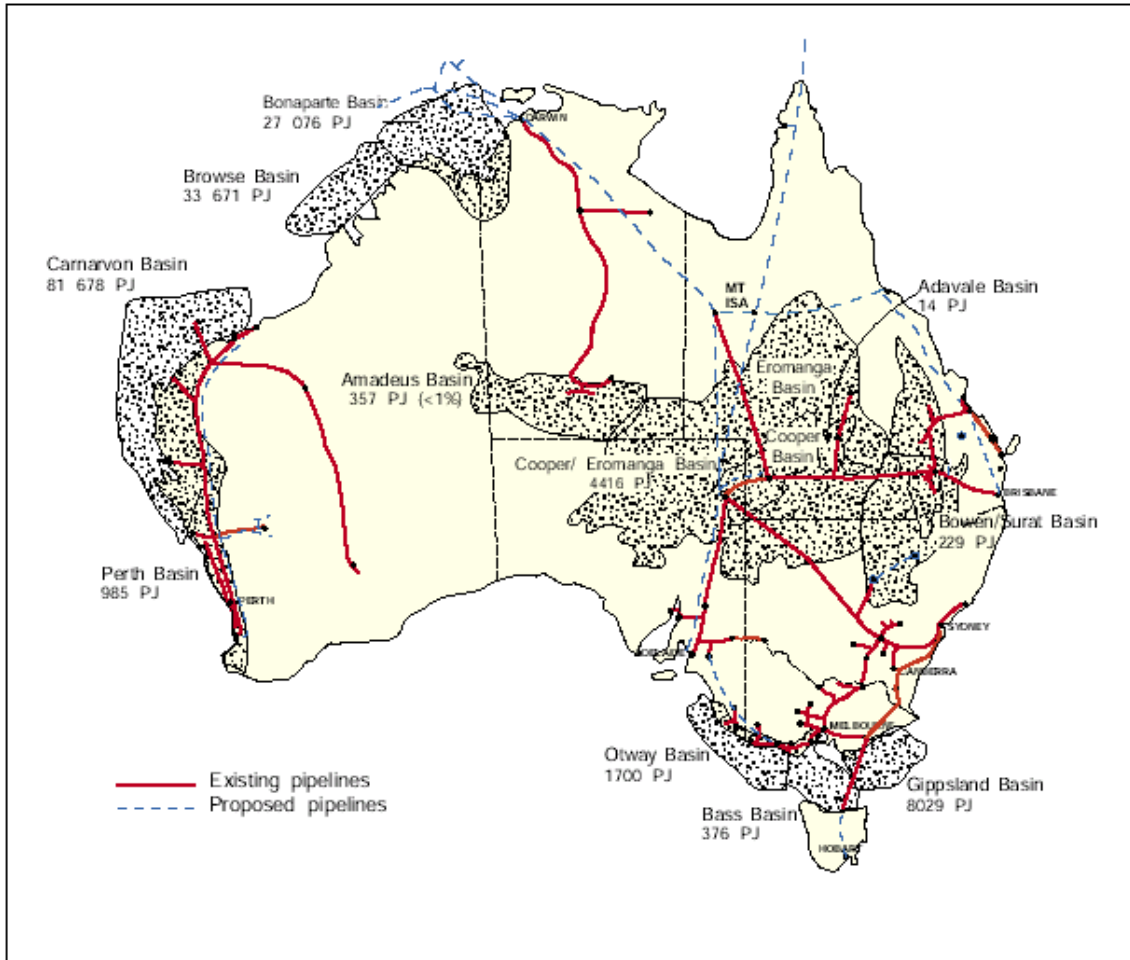


Based on a map produced by the Australian Gas Association 2001

3.6 As stated above, Australia’s gas reserves are abundant but located far from existing and potential markets. Diagram 3.2 shows the location of the principal reserves, and annual production from them.<sup>1</sup>

<sup>1</sup> Dickson, Akmal and Thorpe, 2003 – Australian Energy: Projections to 2019-20, ABARE research report, June 2000

Diagram 3.2



**Figure 1.** Natural gas reserves and transmission pipelines.

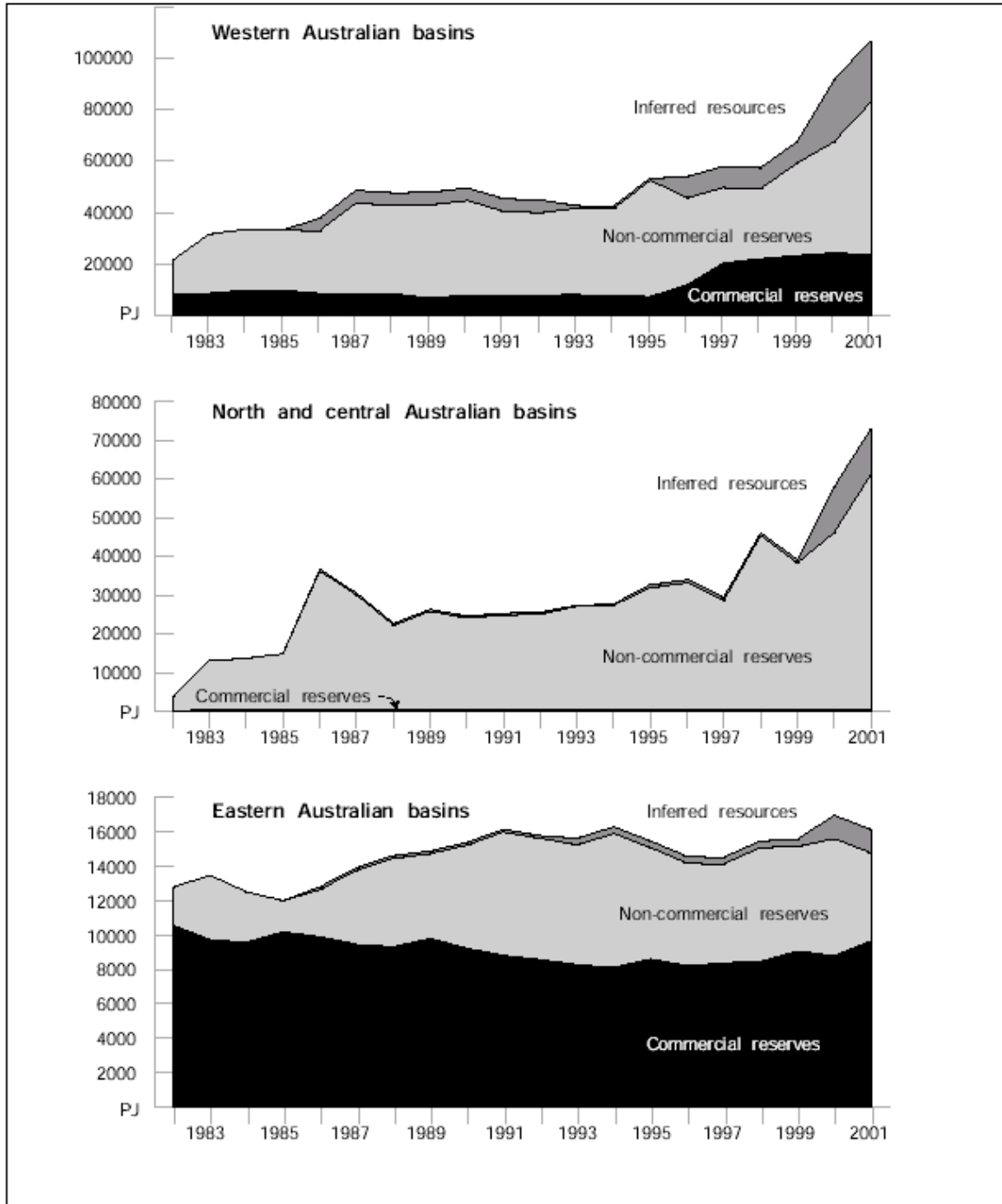
**The role of transmission pipelines in the development of the gas industry – tomorrow**

**The need for additional infrastructure**

- 3.7 The ABARE report from which Diagram 3.2 was sourced also identified substantial potential, undiscovered or unidentified resources of natural gas in various basins within Australia. These total upwards of 37,158 PJ, and most are in the Carnarvon Basin.
- 3.8 The ABARE report concluded that while identified resources have increased four-fold in the last 2 decades, to around 120,000 PJ, this growth has not been uniform across all gas reserves. The report concludes that identified resources in Western and Northern Australia have increased substantially, but known gas reserves in Eastern Australia have remained relatively static, at least since the mid 1990s. This is shown

in Diagram 3.3 below. It is important to note the difference in scale: Western Australian reserves are significantly larger than those in Eastern Australia.

Diagram 3.3



3.9 Over the last two decades, Australian demand for natural gas has increased significantly. Furthermore, demand is forecast to increase over the next two

decades. This is clearly shown in demand forecasts produced by ABARE.<sup>2</sup> These are set out in Table 3.4.

Table 3.4

	2000-01	2004-05	2009-10	2014-15	2019-20
	PJ	PJ	PJ	PJ	PJ
New South Wales	141	173	198	211	230
Victoria	236	273	311	349	388
Queensland	78	115	135	152	177
Western Australia	335	406	530	628	749
South Australia	112	117	147	174	193
Tasmania	0	7	15	17	20
Northern Territory	21	31	95	119	131
Total a	923	1,121	1,430	1,651	1,888
Agriculture	0	0	0	0	0
Mining	141	177	273	326	374
Manufacturing	345	410	515	593	687
Electricity generation	247	321	400	458	515
Transport	19	23	28	32	37
Commercial	51	57	63	74	84
Residential	119	132	152	168	190
Other	0	0	0	0	0
Total	923	1,121	1,430	1,651	1,888

a) Totals may appear not to add due to rounding.  
Source: Dickson, Akmal and Thorpe (2003).

3.10 In a recent article in the APPEA Journal, ABARE’s A. Dickson and K. Noble observe:

*"Looking forward over the medium term the consumption of natural gas in Australia is expected to continue to grow strongly, with primary consumption projected to increase by an average 3.8% a year between 2000–01 and 2019–20 (Dickson et al, 2003). Gas consumption in Queensland (4.4% a year) and Western Australia (4.3% a year) are both projected to increase strongly, as is the largest end-use market of Victoria (2.7% a year). The first sales of natural gas to Tasmania also commenced in 2002-03, and are expected to increase to around 20 petajoules a year by 2019–20."<sup>3</sup>*

3.11 One of the key assumptions underpinning these forecasts is a requirement for additional pipeline infrastructure. As noted above, known reserves are located far from existing and potential markets. ABARE commented in its report:

*"Increasingly, however, concerns have been raised about the capacity for supplies to keep pace with growing demand, particularly in eastern Australia. In particular, it has been suggested that unless significant infrastructure investment is undertaken to bring gas supplies from Australia’s north or northwest to the eastern market the balance between supply and demand in eastern Australia will deteriorate quickly as natural gas resources are depleted in the face of strongly growing demand."*

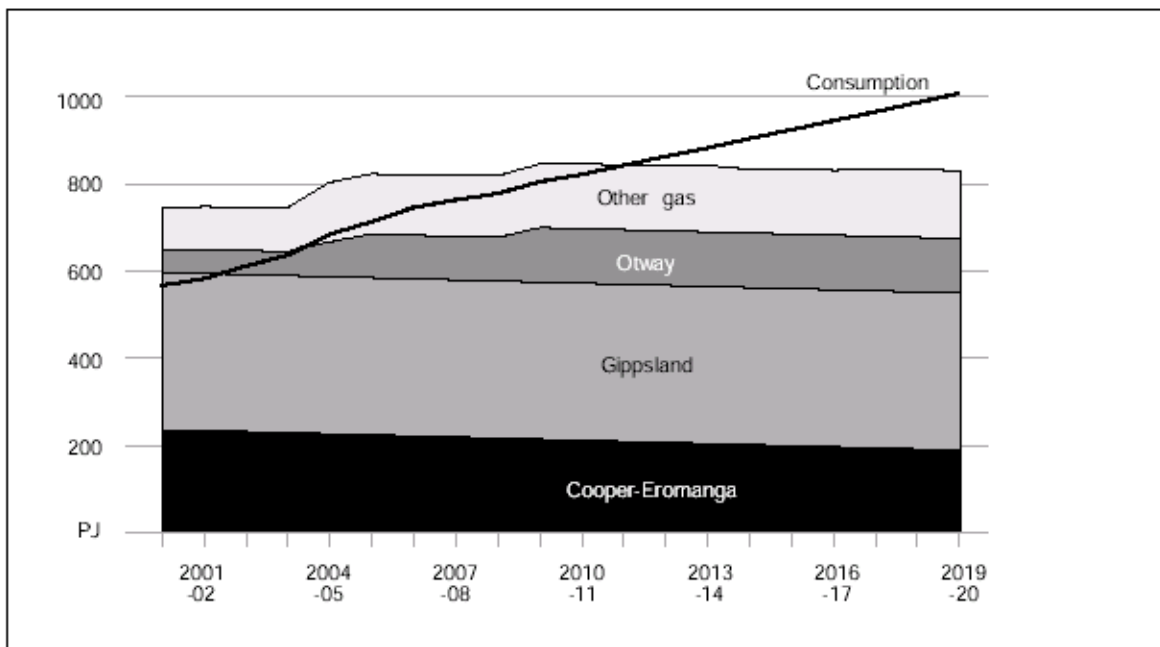
3.12 ABARE has identified a number of options for new gas supplies to replace or augment the reserves from which existing markets are currently supplied. These

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

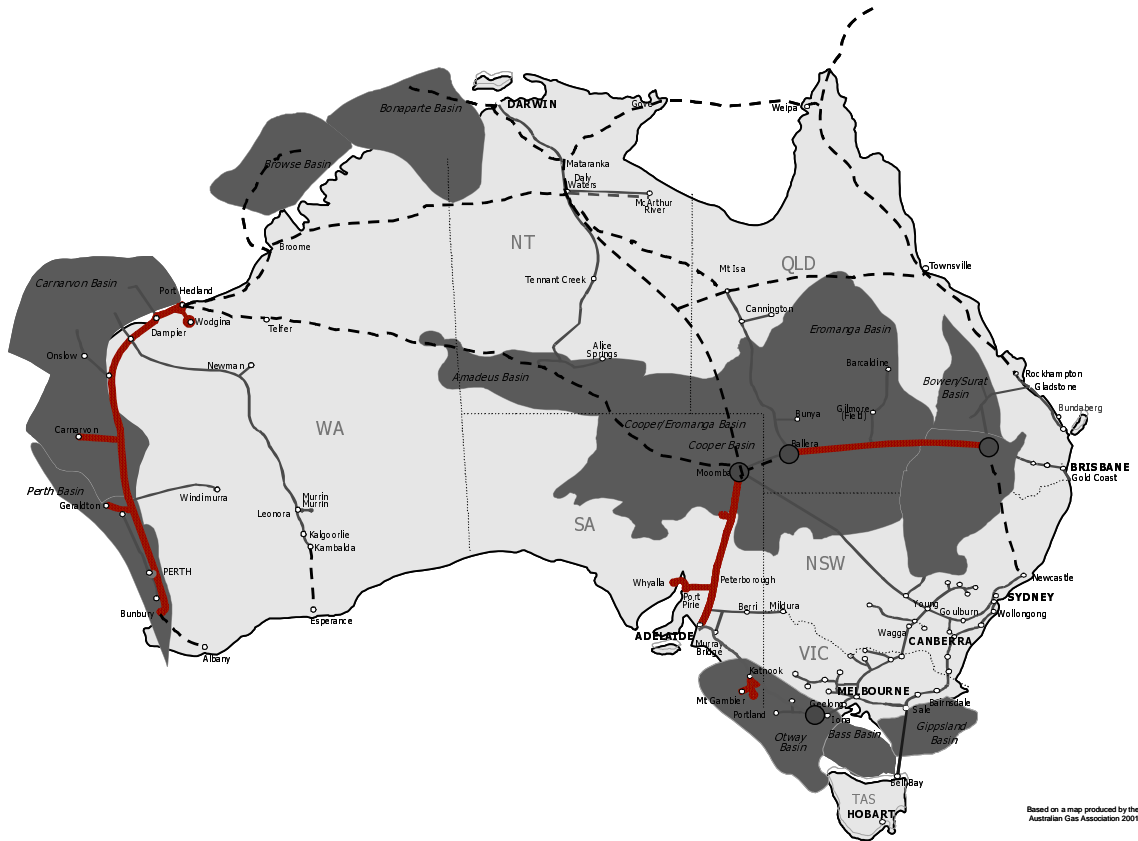
options, Epic Energy believes, will require the building of additional transmission pipelines, initially to supply methane from coal seams in close proximity to the major markets. However, methane reserves will not be sufficient to meet the longer term demand for gas. According to ABARE’s research, from 2012 there will need to be a major supply of gas from Northern or Western Australia. This will require additional pipeline infrastructure. Options for supplying this gas include a Darwin to Moomba pipeline, a PNG pipeline, or a transcontinental pipeline linking the Carnarvon Basin with Moomba. Diagram 3.5 shows that without a new transmission link to gas reserves in Northern or Western Australia, reserves currently supplying markets in Eastern Australia fall short of projected demand by around 20 PJ in 2012-13.

Diagram 3.5



3.13 Epic Energy envisages that, as the demand for gas grows, an integrated transmission pipeline network like that shown in Diagram 3.6 below will evolve:

Diagram 3.6



3.14 The evolution of a national pipeline network will have beneficial outcomes for the Australian economy:

- first, it will provide consumers with the opportunity to choose among energy suppliers, and this opportunity choose will be the prime catalyst for ensuring competitively priced gas;
- second, access to gas across Australia will provide a catalyst for regional development; and
- third, it will enable greater use to be made of a fuel which is cleaner than a number of the alternatives, allowing more onerous domestic and international environmental obligations to be met at lower cost.

3.15 To maximise the benefits, it is critical that advantage is taken of the economies of scale that are available in the construction of transmission pipelines, even if this means that there is substantial spare capacity at the outset.

3.16 This issue will be discussed in more detail later in this submission.

**Transmission Pipelines – a wholesale industry**

3.17 The demand forecasts outlined above show that more than 80% of the gas required will be sought by three categories of shippers<sup>4</sup>:

- Mining – 20%
- Manufacturing - 36%
- Electricity Generation - 27%

3.18 This indicates that shippers on gas transmission pipelines will primarily be sophisticated customers, requiring large amounts of capacity secured by long term contracts. A small number of shippers will take most of the pipeline capacity. In essence, the market for gas transmission will be (and is currently) a wholesale market.

3.19 The expected shipper profile is consistent with Epic Energy’s existing customer base on its transmission pipelines. The existing customer base is shown in Table 3.7.

Table 3.7

<b>Pipeline</b>	<b>No of customers</b>	<b>Customer Industry Category</b>	<b>% of Pipeline Capacity</b>
DBNGP	11	Manufacturing/Minerals Processing	62%
		Retail	11%
		Electricity Generation	27%
		<b>Total</b>	100%
MAPS	4	Manufacturing/Minerals Processing	10%
		Retail	16%
		Electricity Generation	74%
		<b>Total</b>	100%
SWQP	3	Manufacturing/Minerals Processing	95%
		Retail	5%
		Electricity Generation	-
		<b>Total</b>	100%

3.20 Table 3.8 shows the percentage of each pipeline’s capacity that is contracted to the major shippers using the pipeline.

<sup>4</sup> Op. cit., page 3.



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### *Review of Gas Access Regime – Submission IPS#1 Problems and Solutions*

Table 3.8

<b>Pipeline (capacity)</b>	<b>% of Pipeline Capacity Contracted by largest 3 shippers</b>	<b>% of Pipeline Capacity Contracted by largest 4 shippers</b>	<b>% of Pipeline Capacity Contracted by largest 5 shippers</b>
DBNGP (628TJ/Day)	78.00%	84.18%	90.33%
MAPS (418 TJ/Day)	99.76%	N/A	N/A
SWQP (103 TJ/Day)	100.00%	N/A	N/A



#### **4. Public policy reasons for new pipeline infrastructure**

- 4.1 Market growth will not be the only factor contributing to greater gas use in Australia. There are sound public policy reasons for why gas should play a greater role in Australia's fuel mix and why, therefore, there is a need for the further development of transmission pipelines. This section of the submission outlines these reasons.
- 4.2 As was outlined in Epic Energy's submission to the Parer Committee<sup>5</sup>, the following policy objectives should be key platforms in the development of national energy policy:
- promotion of environmental sustainability so as to assist in meeting the nation's environmental obligations;
  - promotion of alternative fuel choices in downstream markets, as a driver of price competition;
  - pursuit of regional development opportunities; and
  - security of energy supply, particularly by way of the development of Australian gas resources.
- 4.3 Environmental obligations are becoming more onerous, not only at a domestic level, but also at an international level. Natural gas is considered to be a cleaner fuel than some of the alternatives now available. Given the significant cost disadvantages and inefficiencies of alternative "clean" fuels, gas should be seen as an important transitional fuel.
- 4.4 Accordingly, investment in gas as an alternative base load energy source, which will require further investment in transmission pipelines, will greatly assist in meeting environmental obligations.
- 4.5 Access to alternative energy sources – not only to alternative supplies of the same fuel, but also to fuels of different types – will allow greater choice in downstream markets. The opportunity to choose among substitutes will be one of the key drivers of price competition.
- 4.6 Relative to the rest of the world, Australia has a small population spread over a vast area. In addition, it has an energy market that, until the mid 1990s, developed predominantly by governments. Having said that, as is also demonstrated earlier in this submission, it has significant untapped energy reserves. However, the location of these reserves is quite far from their main markets. The nature of gas transmission pipelines is such that the gas can be delivered to almost any point along its length if it is appropriately configured. Therefore, by their very nature, pipelines

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<sup>5</sup> Dated 5 June 2002.

- have the opportunity to act as a major benefit for promoting regional development along their routes.
- 4.7 As has been noted by the Northern Territory Government in its submission to the Commonwealth Government seeking to promote the development of Timor Sea gas, the Northern Territory is one of the few remaining regions in Australia that is without gas supplies sufficient to underpin economic development.
- 4.8 ACIL Consulting's work has shown the benefits to regional economies that result from the introduction of an additional gas reserve into the Australian market as a result of creating incentives for further investment.<sup>6</sup>
- 4.9 The Northern Territory Government's submission to the Federal Government in support of the development of the Sunrise Gas field for onshore supply also establishes the benefits to regional Australia from further investment in the development of energy resources.<sup>7</sup> For example, the development of the Timor Sea gas reserves is estimated to generate more than \$100 million pa in flow-on investment opportunities<sup>8</sup>.
- 4.10 Given the significant multiplier effects that projects such as infrastructure projects have on the development of downstream industries and the community in general, it is critical therefore that governments place a high priority on promoting incentives for infrastructure projects that promote development opportunities in regional Australia when formulating energy policy.
- 4.11 The efficient introduction of competitive supplies of alternative fuel sources to regional areas of Australia will introduce direct and immediate benefits to such communities.

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<sup>6</sup> See attachment to AusCID submission filed with the Parer Committee.

<sup>7</sup> Northern Territory Government Submission to Commonwealth Government, dated February 2002, viz pages 14 and 15.

<sup>8</sup> Northern Territory Government submission to the Commonwealth Government – "*Integrated Development of Timor Sea Gas: The National Interest Case*", dated February 2002

## **5. National Competition Policy reforms - the original intent**

- 5.1 The importance of gas to Australia's economy was recognised by the Council of Australian Governments (COAG) in its development of a national competition policy. As part of measures to promote economic development and to stimulate employment growth through the creation of competitive national markets, the governments of the Commonwealth and the States and Territories reached agreement, in November 1997, on a uniform framework for access to natural gas pipeline systems. The agreement, the Natural Gas Pipelines Access Agreement, provided for the implementation of the Gas Access Regime.
- 5.2 The Gas Access Regime is an integral part of the national competition policy reforms.
- 5.3 The basis of Australia's national competition policy was established by the Independent Committee of Inquiry, chaired by Professor Frederick Hilmer, which reported in August 1993 (the Hilmer Committee). As part of its wide ranging review of matters which impacted on the competitiveness of the Australian economy, the Hilmer Committee drew attention to the "essential facilities" problem.<sup>9</sup> In markets critical to the further growth of the national economy – in particular, in markets for energy – competition could not be expected to develop unless competitors had access to certain facilities which could not be economically duplicated. These facilities – essential facilities – had monopoly characteristics, and public policy was required to ensure that this monopoly was not exploited to the detriment of shippers and the economy as a whole.
- 5.4 A new legal regime, under which prospective shippers would be granted rights of access to these essential facilities if the granting of such rights satisfied certain public interest criteria, was proposed by the Hilmer Committee. The Committee was well aware of the fact that many of the facilities for which access rights would be required were publicly owned. Governments, however, were proposing to privatise the enterprises that owned these facilities, and any attenuation of private property rights in the public interest needed to be carefully considered:
- "The Committee is conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. Failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment."<sup>10</sup>*
- 5.5 Any restriction of private property rights in the of granting access to essential facilities to serve the public interest was, in the opinion of the Hilmer Committee, a complex matter which should be one for Government, rather than a court, tribunal or other unelected body. Access rights should only be created by Ministerial declaration under legislation, and a Minister should make a declaration of access to an essential facility only if:

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<sup>9</sup> *National Competition Policy*, Report by the Independent Committee of Inquiry, August 1993, page 240.

<sup>10</sup> *Ibid.*

- access was essential to permit effective competition in a downstream or upstream activity;
- a declaration of access was in the public interest having regard to the significance of the industry in the national economy, and the impact of effective competition in that industry on national competitiveness;
- the legitimate interests of the owner of the facility were protected through the imposition of an access fee and other terms and conditions that were fair and reasonable; and
- the creation of access rights was recommended by an independent and expert body.<sup>11</sup>

- 5.6 The Hilmer Committee proposed that rights of access to an essential facility be created in the public interest only if the legitimate business interests of the facility owner were protected through fair and reasonable access prices, and other appropriate terms and conditions. In the Committee's view, neither economic theory, nor general notions of fairness, could provide clear guidance on access prices.<sup>12</sup> A balancing of interests was required. Facility owners had an interest in receiving a high price for access, including the monopoly rents that were available. Prospective shippers had an interest in paying a low price. Low access prices may contribute to an efficient allocation of resources in the short term, but weakened the facility owners' incentives for innovation, investment and cost reduction. Policy judgements were required as to how best to implement an access pricing regime which permitted flexible response to the specific circumstances of particular industries and facilities, and to changes in industry conditions over time.<sup>13</sup>
- 5.7 One approach was to leave access pricing to an independent regulator, provided with some general guidelines as to the factors to be taken into account in balancing the relevant interests.<sup>14</sup> Another was to require Ministers to stipulate pricing principles in declaring rights of access to particular facilities. Once the principles were established by a Minister, a facility owner and prospective shippers would be free to negotiate access terms and conditions, including price. If agreement could not be reached on the price of access, either party could call for binding arbitration in accordance with the access principles established by the Minister.<sup>15</sup>
- 5.8 The Hilmer Committee favoured the second of these two approaches to access pricing, arguing that policy in respect of pricing would be made by an elected representative, and that once principles were in place the parties would have greater certainty over their rights and obligations. Furthermore, this second approach would

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<sup>11</sup> Ibid, pages 250 – 252.

<sup>12</sup> Ibid, page 253.

<sup>13</sup> Ibid, pages 254 – 255.

<sup>14</sup> Ibid, page 255.

<sup>15</sup> Ibid.

be less interventionist than leaving pricing to an independent regulator, and should facilitate the evolution of more market oriented outcomes over time.<sup>16</sup>

- 5.9 Ministerial declaration of access, with each access declaration specifying principles that would provide for fair and reasonable access prices, and with provision for binding arbitration in the event of the parties' failure to reach agreement, were key elements of the Hilmer Committee's recommendations in respect of the "problem of essential facilities".<sup>17</sup> They were subsequently adopted as principles of competition policy in the *Competition Principles Agreement* signed by the Commonwealth, States and Territories on 11 April 1995.
- 5.10 Under the *Competition Principles Agreement*, the Commonwealth was to put forward legislation to establish a regime of third party access to services provided by significant infrastructure facilities. The Commonwealth regime was not to cover services provided by facilities subject to State or Territory access regimes which conformed to the access principles of the Agreement. Those principles included:
- third party access to services provided by a facility should be on the basis of terms and conditions agreed between the owner of the facility and the prospective shipper seeking access;
  - a right to negotiate, to be exercised in the event of such agreement not being reached, should be established;
  - where the owner of the facility and a prospective shipper cannot agree on terms and conditions for access, they should appoint and fund an independent body to resolve the dispute;
  - the decisions of the dispute resolution body should bind the parties; and
  - in deciding on the terms and conditions for access, the dispute resolution body should take into account:
    - the owner's legitimate business interests and investment in the facility;
    - the costs to the owner of providing access;
    - the economic value to the owner of any additional investment that the owner or prospective shipper has agreed to undertake;
    - the interests of persons with contracts for use of the facility;
    - the firm and binding contractual obligations of the owner or of other persons already using the facility;
    - requirements for safe and reliable operation of the facility;

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<sup>16</sup> Ibid.

<sup>17</sup> Ibid., pages 266 – 267.

- the economically efficient operation of the facility; and
  - the benefit to the public from having competition in markets.
- 5.11 References to the costs of providing access, and to the economically efficient operation of the facility, although reasonable within the broader context of a negotiate-arbitrate approach to establishing access terms and conditions, became the foundations of the more intrusive, regulator-centred, model of the National Gas Code.
- 5.12 Between 1995 and 1998, critical aspects of the Hilmer Committee's recommendations in respect of rights of access to essential facilities were removed as CoAG proceeded with its implementation of National Competition Policy. In December 1996, a letter from the Prime Minister to all Heads of Government sought agreement to, among other things, the regulatory framework to be adopted in the National Gas Code. The Australian Competition and Consumer Commission was to become the single national regulator for gas transmission pipelines. Effectively, the commercially focused negotiate-arbitrate approach to establishing access terms and conditions was to be abandoned. It was to be replaced by an intrusive regulator concerned less with the evolution of market-oriented outcomes, and more with a narrow focus on market power and the elimination of monopoly rents. Commercial negotiation between business entities, supported by the statutory framework necessary to ensure rights of access, and to provide for binding arbitration in the event of access disputes, was to be watered down in favour of control of access by a consumer advocate<sup>18</sup>. The foundations were established for an access regime, implemented through the November 1997 Natural Gas Pipelines Agreement, in which there was limited concern for the balancing of the interests of facility owners and prospective shippers. In the setting of access prices, the national regulator would be guided by its consumer focus, and by a static and simplistic economic theory of monopoly pricing (which it has failed to apply with any rigour).
- 5.13 The Hilmer Committee's approach to regulation – so called "light-handed regulation" – was acceptable to many owners of essential facilities. That it would form a key element of a national access regime for gas pipeline systems was widely accepted within the pipeline industry, and was one of the reasons why the industry supported development of the Gas Access Regime. However, in the development of the Regime, and in its subsequent implementation, the intentions of Hilmer have been subverted and, in place of light-handed regulation, there has been intrusive regulation conducted by regulators who seem driven solely by a concern to eliminate any element of monopoly rent from the profits of businesses they regulate. There is no longer much concern with the difficult issue of balancing the interests of pipeline owners and prospective shippers so as to secure the best long term outcomes for both.

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<sup>18</sup> Although section 2.50 of the National Gas Code seeks to preserve the prominence of negotiated outcomes, as is demonstrated later in this submission, the practical effect of the Code is that there is a reluctance to negotiate outside the regulatory framework.

- 5.14 The adoption of a narrow perspective on access pricing is clear from the submissions of the Western Australian Independent Gas Pipelines Access Regulator in *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & anor* [2002] WASCA 231 (“DBNGP Decision”).<sup>19</sup> That this narrow perspective is inappropriate - even within the context of the National Gas Code as it is currently drafted - is clear from the Western Australian Supreme Court’s decision in the DBNGP Decision.
- 5.15 It is important to understand the context in which these reforms took place. They occurred at the same time the governments were proposing the privatisation of major public utility assets (such as gas pipelines), and were seeking the involvement of the private sector in the financing of the future development of this category of infrastructure.

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<sup>19</sup> Reasons, paragraph 64.

## **6. Problems with the National Gas Code**

6.1 Epic Energy's direct experience with the National Gas Code has revealed problems with both its structure and application. If these are left unattended, they will:

- stifle the efficient development of the transmission network that is required; and
- lead to circumstances where, in the long term, a service provider's ability to properly maintain and secure the safe and reliable operation of its facilities is compromised.

This section of the submission outlines the problems with the National Gas Code and provides examples to assist the Productivity Commission with its understanding of the situation.

6.2 Subsequent sections of the submission then set out the consequences of these problems and possible solutions to ensure the key objectives of the national competition policy reforms, and also the wider policy objectives noted earlier in section 4, can be achieved.

6.3 As a preliminary matter, under the Western Australian implementation of the Gas Access Regime there is a statutory requirement for the State Minister for Energy to carry out a review of the Regime's operation and effectiveness.<sup>20</sup>

6.4 In the course of that review, the Minister is required to consider and have regard to:

- the effectiveness of the operations of the Western Australian Independent Gas Pipelines Access Regulator, the Western Australian Gas Review Board and the Western Australian Gas Disputes Arbitrator; and
- such other matters as appear to the Minister to be relevant to the operation and effectiveness of the *Gas Pipelines Access (Western Australia) Act*.

6.5 Epic Energy is not aware the Minister having commenced this review, and notes that he is required to report to the Western Australian Parliament by no later than 6 November 2003. In the event that this review by the Productivity Commission is considered by the Minister to be the required review, this submission should be considered by the Minister as being relevant to it.

### **The regulators' access arrangement approval process – a determinative approach instead of an assessment process**

6.6 The broad policy objectives to be achieved through the National Gas Code are set out in its introduction:

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<sup>20</sup> See section 88 of the *Gas Pipelines Access (Western Australia) Act 1998*.



*“The objective of this Code is to establish a framework for third party access to gas pipelines that:*

- (a) facilitates the development and operation of a national market for natural gas; and*
- (b) prevents abuse of monopoly power; and*
- (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders; and*
- (d) provides rights of access to natural gas pipelines on conditions that are fair and reasonable for both Service Providers and Users; and*
- (e) provides for resolution of disputes.”*

- 6.7 There are, in these objectives, tensions between facilitating development of a national market and preventing the abuse of monopoly power, between preventing the abuse of monopoly power and providing rights of access that are fair and reasonable to both service providers and shipper, and between promoting a competitive market and preventing the abuse of monopoly power. However, based on Epic Energy’s experience, regulators have, by and large, ignored these tensions, and their implications, particularly for service providers and future investment in pipelines, by focusing almost exclusively on one of the objectives: preventing the abuse of monopoly power.
- 6.8 In the DBNGP Decision, the Supreme Court of Western Australia found this approach (which was adopted by the WA regulator in the DBNGP draft decision) to not only be wrong at law, but also to be a misapplication of a regulator’s statutory function. This is not a problem specific to the Western Australian implementation of the Gas Access Regime: the WA regulator, in his draft decision, slavishly followed the approach of the ACCC and the Victorian regulator in its prior regulatory decisions.
- 6.9 Furthermore, the problems with this approach are exacerbated by the interpretation by regulators of this objective to mean ensuring the removal of any form of monopoly power. They have done so by making access prices the focus of their decisions, and by adopting a static and simplistic economic theory of regulated monopoly pricing which they have applied consistently but without much rigour.
- 6.10 This focus on removing any form of monopoly power appears to be based on the regulator’s consumer protection role, particularly in the case of the main transmission regulator, the ACCC. However, it is important to note that consumer protection is not one of the stated objectives of the Code.
- 6.11 Regulators have been able to maintain this narrow focus on access prices and the removal of monopoly power, to the exclusion of other issues, through the way in which they have approached their role in approving proposed access arrangements, and proposed revisions to access arrangements.

- 6.12 A regulator’s decision to approve an access arrangement submitted in accordance with either section 2.2 or section 2.3 is governed by section 2.24 of the National Gas Code. Section 2.24 provides:

*“The Relevant Regulator may approve a proposed Access Arrangement only if it is satisfied the proposed Access Arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve a proposed Access Arrangement solely for the reason that the proposed Access Arrangement does not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing a proposed Access Arrangement, the Relevant Regulator must take the following into account:*

- (a) the Service Provider’s legitimate business interests and investment in the Covered Pipeline;*
- (b) firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline;*
- (c) the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline;*
- (d) the economically efficient operation of the Covered Pipeline;*
- (e) the public interest, including the public interest in having competition in markets (whether or not in Australia);*
- (f) the interests of Users and Prospective Users;*
- (g) any other matters that the Relevant Regulator considers are relevant.”*

- 6.13 Similarly, in respect of proposed revisions to an access arrangement submitted in accordance with section 2.28 of the National Gas Code, section 2.46 requires:

*“The Relevant Regulator may approve proposed revisions to an Access Arrangement only if it is satisfied the Access Arrangement as revised would contain the elements and satisfy the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve proposed revisions to the Access Arrangement solely for the reason that the Access Arrangement as revised would not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing proposed revisions to the Access Arrangement, the Relevant Regulator:*

- (a) must take into account the factors described in section 2.24; and*
- (b) must take into account the provisions of the Access Arrangement.”*

- 6.14 In either case (that is, under either section 2.24 or section 2.46), the National Gas Code imposes on the regulator a requirement to make an assessment of a proposed access arrangement, or of proposed revisions to an access arrangement, submitted by a service provider, and in making that assessment, the regulator is required to take into account the factors described in section 2.24.

- 6.15 If this were not the case, there would be doubt as to whether the Access Regime (including the National Gas Code) would be consistent with what is required of an effective access regime under Part IIIA of the TPA (the test for which is outlined substantially in paragraph 5.10 of this submission).
- 6.16 As may be seen by examining any of the draft or final decisions they have issued, regulators approach the task of assessment as a series of separate deliberations which severally and mechanically produce an outcome. Typically, the structure of the decision follows the scheme of sections 3.1 to 3.20 of the Code. There is, for example, early in the document setting out the decision, a discussion of the services offered by the service provider. An assessment is made of the services policy against criteria established a priori by the regulator, which may derive from comparison with the services policies which have been advanced by other service providers. In establishing criteria for assessment, the regulator may also draw on issues which have been raised in the public consultation process which must be carried out in accordance with either section 2.10 or section 2.31 of the National Gas Code. Conclusions are then drawn and, if necessary, the regulator specifies the amendments which must be made if the proposed access arrangement, or revision to the access arrangement, is to be approved. The regulator then moves on to the next element of the scheme, and the process is repeated. The outcome is simply a list of amendments which the service provider must make. There has been little or no attempt by the regulators to treat the process of assessment as a coherent whole, and to give consideration to the factors set out in section 2.24.
- 6.17 It is the regulators' treatment of this process of assessment as a series of separate deliberations which severally and mechanically produce an outcome that allows a focus on the removal of any form of monopoly power to dominate the approval process. Taking the view that the National Gas Code permits separate and independent approval of each of the elements of a proposed access arrangement, or of proposed revisions to an access arrangement, the regulators rely on the National Gas Code's requirements for replicating the outcome of a competitive market (section 8.1(a)), for not distorting investment decisions (section 8.1(d)), and for efficiency in the level and structure of the reference tariff (section 8.1(e)), to apply a criterion of zero economic profits in their assessments of reference tariff policies and reference tariffs. Through the way in which they apply the assessment process, the regulators focus narrowly on what they perceive to be lowest cost outcomes. They are little influenced by the legitimate business interests of, or the investments made by, service providers, or by the specific interests of other parties elicited in the course of public consultations. Furthermore, they show little concern for any of the broad policy objectives to be achieved through the National Gas Code, other than prevention of the abuse of monopoly power.
- 6.18 The regulators' treatment of the process of assessment as a series of separate deliberations which allows a focus on abuse of monopoly power to dominate, and allows a narrow concern for what they perceive to be lowest cost outcomes, can be seen in their assessments of rate of return. The extremity of their position has been demonstrated most clearly in the WA regulator's recent Final Decision on Epic Energy's proposed access arrangement for the Dampier to Bunbury Natural Gas Pipeline.

- 6.19 As part of this approval process, Epic Energy established a rate of return for use in determining the reference tariff of its proposed access arrangement using an approach which was similar to, but not the same as, that usually taken by Australian regulators. The reasons for this were set out in a report by international regulatory advisers, The Brattle Group, which formed part of Epic Energy's proposed access arrangement documentation. The WA regulator rejected Epic Energy's approach, which established a rate of return about 50 basis points higher than would have resulted from the application of the approach usually taken. The basis of his rejection was a conclusion that section 8.2(e) of the National Gas Code required a rate of return that was the best estimate of the true cost of capital. This was set out in paragraph 320 of the regulator's Final Decision. To eliminate Epic Energy's proposed approach, and to entrench a single view on a single issue (in this case, rate of return), the Regulator interpreted section 8.2(e) of the Code in a most idiosyncratic way. Section 8.2(e) requires that, where forecasts are used in setting a reference tariff, those forecasts must "represent best estimates arrived at on a reasonable basis". In paragraph 320, the regulator focused only on the term "best estimate", and sought to imply that what was required under the Code was a formal estimation process of the type that might be carried out by a statistician. Footnote 104 of the Final Decision discussed the statistical concept of best estimator. Not only did the Western Australian Regulator take an extremely narrow view of the assessment process required by the National Gas Code; he also used section 8.2(e) of the Code in a way which Epic Energy considered to be grossly misleading.<sup>21</sup>
- 6.20 This example – establishing the rate of return for the Dampier to Bunbury Natural Gas Pipeline – not only illustrates the way in which the regulators have approached the assessment process required under the National Gas Code. It also illustrates why the Code, correctly interpreted, requires another approach to that process. There is no unambiguous method for determining the "true cost of capital". The cost of capital is a complex concept, and its measurement, if it is to be part of a regulatory assessment process, requires the making of assumptions about aspects of the concept itself, and choice among alternative measurement techniques. At best, an estimate must be made by choosing among alternative theoretical frameworks purported to explain the cost of capital, and choosing among the alternative methods available to operationalise and measure the relevant theoretical constructs. Parts of that measurement process – for example, estimation of the asset beta to be used in applying the Capital Asset Pricing Model in the case of a business which does not have traded shares - are no more sophisticated than looking for supposedly similar companies with traded shares and arguing by analogy. As with the other parts of the assessment process, an exercise of judgement is required and, in Epic Energy's view, that exercise of judgement must extend beyond the single issue under consideration to its implications for the proposed access arrangement as a whole. This is what is required by the factors described in section 2.24.

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<sup>21</sup> While Epic Energy accepts that it is not the role of the Commission to reconsider existing or pending access arrangements, it is critical that the Commission be made aware of some of key aspects of the regulatory approval processes relating to these access arrangements so that the arguments Epic Energy is making can be put in their proper context.

- 6.21 That the assessment process was a coherent whole, and not a series of separate deliberations made independently was made clear by the Court in the DBNGP Decision.
- 6.22 The Court held that:
- the Code establishes a single process of assessing a proposed Access Arrangement and deciding whether or not to approve it;<sup>22</sup>
  - in that process, the regulator is required by section 2.24 to take the stipulated factors into account and to give them weight as fundamental elements;<sup>23</sup>
  - the process of assessment includes giving weight as a fundamental element to the section 2.24 factors in the consideration of sections 3.1 to 3.20, including the consideration of section 8 as incorporated through sections 3.4 and 3.5;<sup>24</sup>
  - consideration of sections 3.4 and 3.5 involves an evaluation and exercise of judgment and discretion, taking due account of inter-related matters;<sup>25</sup>
  - assessing whether a proposed Reference Tariff and Reference Tariff Policy comply with section 8 principles does not involve the Regulator undertaking calculations producing fixed results and a fixed “yes” or “no” answer, but involves considering whether the proposed Reference Tariff and Reference Tariff Policy are consistent with the stated “principles” (not prescriptions) – the notion of compliance does not involve a single uniquely correct outcome, but a determination whether the proposal is reasonable within section 8;<sup>26</sup>
  - assessing whether a proposed Reference Tariff and Reference Tariff Policy comply with section 8 principles does not involve the Regulator undertaking calculations producing fixed results and a fixed “yes” or “no” answer, but involves considering whether the proposed Reference Tariff and Reference Tariff Policy are consistent with the stated “principles” (not prescriptions) – the notion of compliance does not involve a single uniquely correct outcome, but a determination whether the proposal is reasonable within section 8;<sup>27</sup>
  - in evaluating the application of sections 3.4 and 3.5 (ie, in considering compliance with the section 8 principles), the factors in section 2.24 are applicable and guide the Regulator in the exercise of the discretions contemplated by the last paragraph of section 8.1.<sup>28</sup>

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<sup>22</sup> DBNGP Decision, reasons para 58.

<sup>23</sup> DBNGP Decision, reasons para 55.

<sup>24</sup> DBNGP Decision, reasons paras 61-69.

<sup>25</sup> DBNGP Decision, reasons paras 57-63.

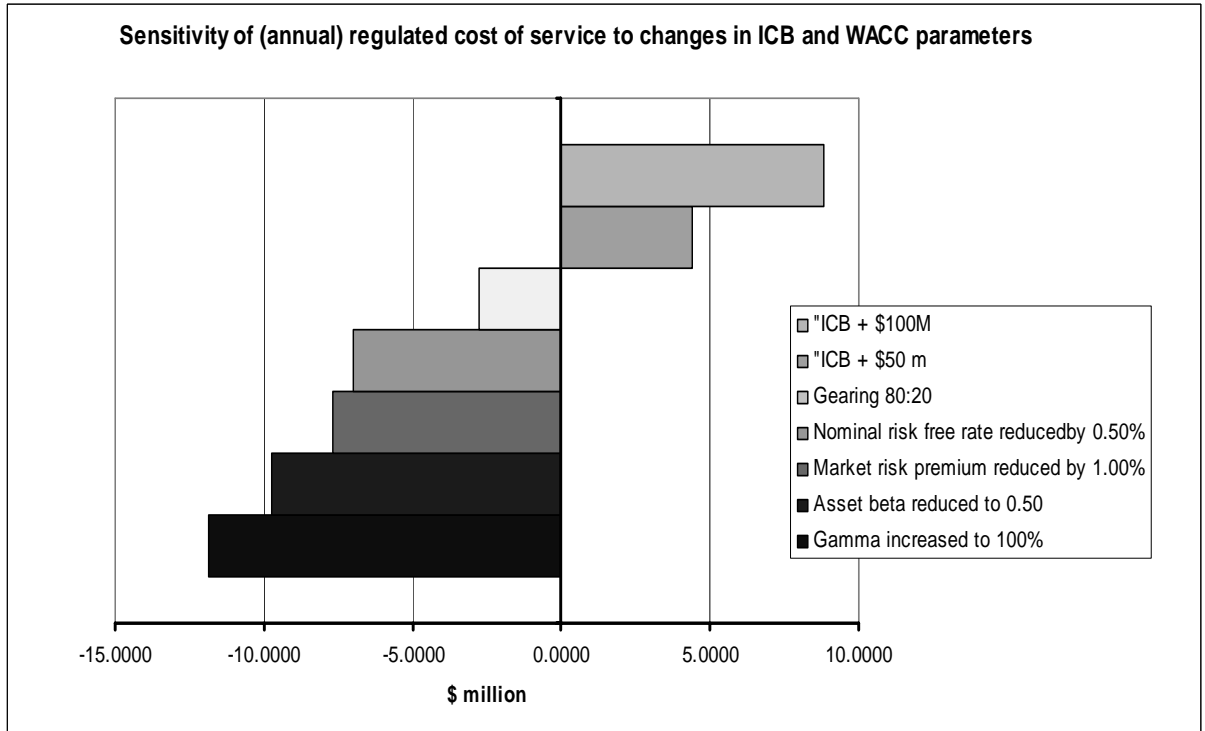
<sup>26</sup> DBNGP Decision, reasons paras 64-68.

<sup>27</sup> DBNGP Decision, reasons paras 64-68.

<sup>28</sup> DBNGP Decision, reasons paras 69, 203.

- 6.23 In these circumstances, the correct approach to assessing a proposed access arrangement, or revisions to a proposed access arrangement, and deciding whether it should be approved, may be explained as follows:
- there is a single, overall process of assessment, which involves inter-related components or elements;
  - of necessity, the initial consideration of matters of detail under sections 3.1 to 3.20 (including section 8) will be to an extent provisional in nature, for the proposal must be assessed overall and in an integrated manner, taking full account of the interaction between factors with proper weight being given to the section 2.24 factors, before final views are formed; and
  - a central feature of the process is an evaluation of the proposed access arrangement, and the supporting case propounded by the service provider, having regard to the section 2.24 factors and the weight to be accorded to them as fundamental elements in the particular circumstances of the case.
- 6.24 The regulators' treatment of the process of assessment of proposed access arrangements, or of proposed revisions to access arrangements is, in Epic Energy's view based on decisions made both before and after the DBNGP Decision, a major problem with the implementation of the National Gas Code. A narrow focus on an economic theoretical ideal – zero economic profits – to be achieved by imposing what are perceived to be the lowest cost outcomes is not consistent with the Court's ruling in the DBNGP Decision on the way in which the assessment process should operate. Nor is it consistent with any reasonable view of business activity. In the normal circumstances of uncertainty, it is difficult enough for those managing a business to ensure that costs are at their lowest possible level consistent with sustainable operation. That regulators, and the consultants they employ, can decide on what is the lowest possible while, at the same time, maintaining that they are disadvantaged by "information asymmetry", is difficult to believe. The consequences of such regulator behaviour are, however, clear. By focusing narrowly, they will put at risk the high levels of service offered by existing pipelines, and deter pipeline owners from making the investments that are necessary to facilitating development of a competitive national market for natural gas and preserving the technical integrity of the existing infrastructure.
- 6.25 This "lowest cost", "building block" approach to the assessment of an access arrangement and in particular to the assessment of reference tariffs can have a significant adverse impact on the revenue that a service provider can earn. In the case of Epic Energy, a focus on reducing the values of each of the elements used in the calculation of the total revenue to the lowest value possible (in the eyes of regulators) will have a significant adverse impact on almost 100% of the company's revenue stream. This is perhaps best evidenced by the Final Decision of the DBNGP Access Arrangement. Diagram 6.1 shows the sensitivity of Epic Energy's revenue stream to changes in the values of some of the critical elements of the total revenue calculation.

Diagram 6.1



- 6.26 The Regulator himself acknowledges the impact of his Final Decision on the DBNGP business at paragraph 237 of that decision where he concluded that a 1% change to the allowed regulatory rate of return has a significant impact on the value of the asset.
- 6.27 Given the significant ramifications to a service provider’s legitimate business interests of such a change, regard must be had to the consequences to the economy of the disincentive to investment that this might give rise to, not to mention the impact on the service provider’s financial viability. As was quoted by the Commission:

*“However, access regulation is not without costs. Paramount among these is the potential for it to deter investment in essential infrastructure. Any such impact on investment is a cause for concern. This is because the costs of failing to invest in essential infrastructure are likely to be larger than the costs of monopoly pricing of the services it provides. Hence it is crucial that access regulation gives proper regard to incentives to invest.”<sup>29</sup>*

<sup>29</sup> Key messages from the Productivity Commission’s position paper on the review of the National Access Regime, March 2001, page xii

**Focus on lowest cost outcomes**

- 6.28 In their assessments of the access arrangements submitted under the National Gas Code to date, regulators have sought to apply a criterion of zero economic profits through a narrow focus on what they perceive to be lowest cost outcomes. In the DBNGP Decision, the Court was critical of such an approach.
- 6.29 The regulators’ narrow lowest cost focus is most clearly seen in the changes regulators have required to the initial capital bases proposed by pipeline service providers, and to the rates of return service providers have proposed. These are the most significant value drivers in the total revenue calculation that is required under the Code.
- 6.30 Table 6.2 shows the reductions regulators have required in the initial capital bases submitted by service providers.

Table 6.2

<b>Service provider/pipeline system</b>	<b>ICB proposed by service provider (\$m)</b>	<b>ICB required by regulator (\$m)</b>	<b>Difference (%)</b>	<b>Regulator</b>	<b>Decision</b>
Transmission Pipelines Australia Victorian transmission system	364	364	0.0	ACCC	Final
AGL Pipelines Central West Pipeline	29	28	- 3.4	ACCC	Final
CMS Gas Transmission Parmelia Pipeline	114	63	- 45.2	WA	Final
East Australian Pipelines Limited Moomba to Sydney Pipeline	667	502	- 24.7	ACCC	Draft
Goldfields Gas Transmission Goldfields Gas Pipeline	453	438	- 3.2	WA	Draft
Epic Energy Moomba to Adelaide Pipeline System	383	353	- 7.8	ACCC	Final
NT Gas Amadeus Basin to Darwin Pipeline	266	229	- 13.9	ACCC	Final
Epic Energy Dampier to Bunbury Natural Gas Pipeline	2,570	1,550	- 31.7	WA	Final

- 6.31 The table below (Table 6.3) shows the adjustment to the return on equity required by regulators. To remove the effects of changes in market interest rates and inflation, this adjustment is expressed in terms of the amount by which the real



return on equity exceeds the real risk free rate assumed for determination of the rate of return. After the two earliest decisions – for the Victorian transmission system, and for the Central West Pipeline – the regulators have consistently reduced the return on equity sought by service providers.

Table 6.3

<b>Service provider/pipeline system</b>	<b>Equity margin proposed by service provider (%)</b>	<b>Equity margin required by regulator (%)</b>	<b>Difference (%)</b>	<b>Regulator</b>	<b>Decision</b>
Transmission Pipelines Australia Victorian transmission system	6.01	6.97	+ 0.96	ACCC	Final
AGL Pipelines Central West Pipeline	5.73	8.75	+ 3.02	ACCC	Final
CMS Gas Transmission Parmelia Pipeline	Not available	7.80		WA	Final
East Australian Pipelines Limited Moomba to Sydney Pipeline	7.00	6.80	- 0.20	ACCC	Draft
Goldfields Gas Transmission Goldfields Gas Pipeline	8.88	7.81	- 1.07	WA	Draft
Epic Energy Moomba to Adelaide Pipeline System	6.93	6.80	- 0.13	ACCC	Final
NT Gas Amadeus Basin to Darwin Pipeline	8.54	6.02	- 2.52	ACCC	Final
Epic Energy Dampier to Bunbury Pipeline	7.30	7.03	- 0.27	WA	Final
GasNet Victorian transmission system	8.20	5.72	- 2.48	ACCC	Final

6.32 In their decisions, the regulators continue to signal further substantial reductions in equity returns (through reductions in the market risk premium, asset betas and the valuation of the imputation credits used in determining the return on equity). The prospect of these changes makes pipeline investment planning exceedingly difficult, especially when the changes will:

- be based on limited academic evidence, with estimates subject to wide margins of error (a fact rarely taken into account by the regulators);
- bear little or no reflection to the approach taken by capital market participants when assessing appropriate returns for investing in infrastructure projects; and
- difficult to dispute under the appeal provisions of the Gas Access Regime.

6.33 Gas transmission pipelines are capital intensive and, as discussed earlier in this submission (see paragraph 6.26), even small changes in the capital base and the rate of return used in reference tariff determination can have a significant impact on revenues and financial performance. By adopting a narrow and theoretical focus, and by not giving any specific and explicit consideration of the legitimate business interests of service providers, as required by section 2.24 of the Code, the regulators have been able to avoid the issue of financial performance and its significance for businesses concerned with financing new investment.

6.34 On this issue, the views of the Australian Financial Review's columnist Pierpont, expressed in a recent commentary on AMP's Diversified Energy and Utility Trusts (DUET), might be noted.<sup>30</sup> Pierpont's style may be whimsical, and his comments directed to gas distribution, but they are directly to the point:

*"Mind you, the returns that any of them get could be upset if the Victorian regulator decides to play one of his little japes on United Energy.*

*Back in 1998, the Victorian government raised \$400 million by floating United Energy as the nation's first privatised electricity distributor.*

*The shareholders had barely received their holding statements when Victoria's Office of the Regulator-General and the Australian Competition and Consumer Commission determined that gas distributors should earn rates of return 31 per cent lower than previously.*

*The market figured that the new rates would apply to electricity, too, so they dumped United Energy's shares to well below issue price. It was Victoria's best practical joke since Joan Kirner.*

*More recently, the ACCC has claimed that the cost of building a gas pipeline has nothing to do with its value after completion and has been arbitrarily writing down the value of pipelines all over Australia. So there would seem no reason to believe that the energy distribution companies in which DUET has invested would be safe from regulatory meddling."*

### **Reset risk – further uncertainty for Investors**

6.35 In addition to the uncertainty that arises from the problems outlined above, real uncertainties are created for investors in the course of regulator assessment of proposed revisions to an access arrangement at the end of each regulatory period. The principal sources of this uncertainty include:

- Service providers are exposed to the risk that parts of their pipeline systems may be treated as being redundant because regulators believe that the capacity they provide is not required during the next regulatory period, and can use the discretion they have under the National Gas Code to impose this belief.

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<sup>30</sup> "Mrs Pierpont asks a Power question", Australian Financial Review, Friday 29 August 2003.

Regulators give no consideration to the fact that businesses operating in (real, not theoretical) competitive markets have spare capacity from time to time.

- Regulators have been unable to appropriately deal with the real prospect of bypass risk at the very time when it matters – ie before the threat of bypass materialises. The perfect example of this is in the case of the MAPS access arrangement process where the regulator was firstly unable to accept that there was a risk that the capacity on the MAPS was to be at risk of bypass during the original regulatory period, and then secondly, to the extent that there may have been some arise in the future, it proposed means which are unlikely to be of assistance to the service provider.
- Regulator imposition, in access arrangements with only a 5 year regulatory period, of mechanisms to trigger early unwinding in the event that some external factor may alter some of the parameters of an access arrangement.

6.36 The above examples manifest a clear failing by regulators to properly reflect the investment horizons of pipelines. No investor will contribute the large sums of capital required for a pipeline unless some assurance can be offered that they will have the opportunity to earn an acceptable return for the life of the investment. If there is a risk that rules will change part-way through the investment horizon, but one cannot say exactly how, this can only act as a deterrent to investors, or it will be reflected in the tariffs which will be based on a worst case scenario.

6.37 One must question why regulatory risk should threaten returns on an investment not only at the commencement of the investment but also at regular instances during its life.

### **Timeliness of Decision Making**

6.38 Another major problem with the National Gas Code is the timeliness of decision making by regulators. Epic Energy has experienced 2 regulatory processes which have taken over 3 years so far and, as at the date of this submission, are yet to be completed. In the case of the MAPS, the matter is currently being determined by the Australian Competition Tribunal. In the case of the DBNGP, the regulator is currently assessing a revised access arrangement submitted by Epic Energy following his final decision issued in May 2003.

6.39 These delays are not isolated events, experienced only by Epic Energy. Table 6.4 shows the delays that have occurred in a number of regulatory approval processes relating to transmission pipelines.

Table 6.4

<b>Pipeline</b>	<b>Duration of regulatory process</b>	<b>Status of regulatory process</b>
DBNGP	3 years 9 months	Final Decision 23 May 2003 with revised access arrangement lodged on 8 August 2003
MAPS	4 years 5 months	Application to Australian Competition Tribunal
Moomba to Sydney Pipeline	4 years 4 months	Draft Decision
Goldfields Gas Pipeline	3 years 9 months	Draft Decision wrong at law

- 6.40 In addition to the above, the ACCC took over two years to assess an access arrangement for the SWQP, in circumstances where the ACCC was not required to assess the tariffs or total revenue.
- 6.41 From Epic Energy’s perspective, and it would hope that it would also have to be said from a shippers’ perspective, these delays are unacceptable. This is particularly the case given that regulation is intended to replicate the outcome of commercial negotiation.
- 6.42 However, were Epic Energy to have to wait over four years to negotiate an outcome for capacity on its pipeline, it would not be able to function as a business.
- 6.43 While there will always be an attempt by some stakeholders to blame the others for the delays, it must be recognised that the system provides only for regulators to control the timetable.
- 6.44 As an example of the delays, **Attachment 1** contains a chronology of the regulatory approval process relating to the DBNGP access arrangement.

**Transparency and accountability of Regulators**

- 6.45 A major concern, arising from Epic Energy’s experience with regulator application of the National Gas Code, is the lack of transparency and accountability of regulators in carrying out their statutory functions. This problem is not confined to just one regulator, nor is it confined to a particular statutory function. It is an endemic problem, made worse by regulator requirements that service providers disclose significant amounts of information as part of regulatory processes. Serious questions must arise about whether due process is being followed by regulators in these processes.
- 6.46 The lack of transparency can be best demonstrated with the following examples:

- The reluctance of the ACCC and the Western Australian Regulator to release the mathematical models which supported the values used in their various decisions, even when most of the information contained in the models was sourced from information provided by the service provider. While the ACCC, in the case of the MAPS regulatory approval process, was prepared initially to allow representatives from Epic Energy to “watch over” the ACCC’s staff as they took them through a version of the model used to support the draft decision, and eventually provided Epic Energy with an electronic version of the final decision model some 3 months after the decision was handed down (and albeit subject to unnecessary confidentiality constraints), the WA regulator has refused to provide Epic Energy with a copy of the model used for the purposes of the DBNGP Final Decision. (The WA regulator did, however, provide Epic Energy with the model used to support his draft decision, which had a tariff outcome significantly different from that of the final decision.)
- In both the MAPS and DBNGP approval processes, the regulators made extensive use of consultants in their deliberative processes. However, in many instances, and particularly in the case of the DBNGP, Epic Energy was refused the opportunity to have access to and to make submissions on information and advice provided by these consultants. There should be a transparent process by which:
  - those who are to provide assistance are identified;
  - their knowledge of matters relevant to the proposed access arrangement is ascertained;
  - they can be excluded because of conflicts of interest or for other proper reasons; and
  - opportunities to object are afforded to the service provider and to third parties.

This has not occurred in the case of the DBNGP and MAPS.

- In the approval process for the MAPS access arrangement, the ACCC failed to disclose until after the regulatory process was complete, detailed reports that it prepared to support the values it relied as part of its deliberations. As a result, Epic Energy was not afforded an opportunity to respond to those reports and, more importantly, given the limited nature of the appeal provisions of the Gas Access Regime, could not respond to them as part of the appeal process.
- The WA regulator’s Final Decision for the DBNGP was reported in a document that was difficult to understand: it lacked much of the reasoning required to support the conclusions reached. The DBNGP Final Decision was a fundamentally different style of decision to the ones previously handed down by Regulators, although in some respects (particularly in relation to its length) that was a positive outcome. Nevertheless, it took Epic Energy over 4 weeks to understand and replicate the Regulator’s reference tariff calculations.

- 6.47 In addition to the lack of transparency, there is a disconcerting lack of accountability in regard to regulators' decisions and actions. The requirement to make regulators accountable for their actions appears to have taken a "back seat" to the pursuit by governments of having independent regulatory agencies.
- 6.48 A clear illustration of this is the use by regulators, and in particular by the WA regulator, of consultants whose work is not available for scrutiny.
- 6.49 The statutory rights, powers and duties that are conferred on the WA regulator under the National Gas Code are conferred on that office by the Gas Pipelines Access (Western Australia) Act 1998. That office is occupied by an individual and therefore, the rights, powers and duties are conferred upon the holder of that office personally. The WA regulator can not therefore abrogate his responsibilities to others in a manner that is not available for effective scrutiny, particularly in the case where the regulator's costs are to be borne by industry.
- 6.50 Generally, there are statutory provisions governing conflict of interest by the decision maker and such provisions should equally apply to staff of a regulator's office who provide assistance to the regulator in relation to a particular task.
- 6.51 In the case of Western Australia, the fact that the regulator does not consider himself ultimately responsible for the costs the consults incur is problematic. While the issue of regulator funding is addressed specifically later in this submission, Epic Energy considers that a "user pays" system which does not have well defined appeal rights, and which does not have transparency and accountability provisions, will only lead to further problems. Epic Energy has direct experience with such a system in the form of the Funding Regulations which are part of the Western Australian implementation of the Gas Access Regime. Epic Energy has been forced to challenge the application of the Funding Regulations and, in a recent decision, the Supreme Court of Western Australia has gone some way to ensuring that appropriate checks are placed on the WA Regulator. **Attachment 2** to this submission provides a summary of this decision.

### **Inadequate new facilities investment provisions**

- 6.52 Problems remain with the New Facilities Investment provisions of the National Gas Code despite the fact that these provisions have only recently been amended by NGPAC.
- 6.53 Under section 8.16 of the Code, New Facilities Investment can only be added to the capital base if one of the following conditions is satisfied:
- the anticipated incremental revenue generated by the new facility exceeds the new facilities investment – section 8.16(a)(ii)(A);
  - the service provider and/or shippers satisfy the relevant regulator that the new facility has system wide benefits that, in the relevant regulator's opinion, justify the approval of a higher reference tariff for all shippers – section 8.16(a)(ii)B; or

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- the new facility is necessary to maintain the safety, integrity or contracted capacity of services” – section 8.16(a)(ii)(C).
- 6.54 There is a further limitation in that even if one of the above conditions exists, a Regulator is required to only allow an amount of the actual New Facilities Investment that does not exceed the amount that would be invested by a prudent Service Provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of providing services.<sup>31</sup>
- 6.55 Section 8.16(b) of the Code states that if the Regulator (under section 8.20 of the Code) agrees to reference tariffs being determined on the basis of forecast New Facilities Investment, the capital base may be increased by the amount of the New Facilities Investment forecast to occur within the new access arrangement period determined in accordance with sections 8.20 and 8.21 and subject to adjustment in accordance with section 8.22.
- 6.56 Section 8.20 states that the reference tariff may be determined on the basis of New Facilities Investment that is forecast to occur within the Access Arrangement Period provided that the New Facilities Investment is reasonably expected to pass the requirements in section 8.16(a) when the New Facilities Investment is forecast to occur.
- 6.57 The main issues associated with the New Facilities Investment provisions of the Code which give rise to uncertainty and which could compromise efficient development or augmentation of pipelines are as follows:
- 6.58 Under section 8.16(a)(ii)(A) the Anticipated Incremental Revenue to be generated by the expansion must exceed the capital cost of the expansion. Given the definition of Anticipated Incremental Revenue and more particularly the definition of Prevailing Tariff under the Code, this section essentially creates a cap that prevents the rolling in of all of the capital costs associated with an expansion. Epic Energy considers it would be more appropriate the costs to be included if there is a reasonable likelihood (based on demand forecasts) that the capacity will be utilised.
- 6.59 Section 8.16(a)(ii)(B) and (C) – it is unlikely given comments such as those made by the ACCC (see section 7 of this submission relating to second class citizens) and in light of recent decisions by regulator that these sections will be satisfied in many circumstances. This is so given that the purpose of a majority of expansions are likely to be to provide additional reference service capacity.
- 6.60 Further, even if any of sections 8.16(a)(ii)(A)-(C) could be satisfied, there is the additional requirement in section 8.16(a)(i) being the ‘prudent service provider’ test. There are two immediately obvious problems with this provision:
- first, if any part of the expanded capacity is not immediately likely, in the eyes of the Regulator, to be contracted, the service provider runs the risk of not being

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<sup>31</sup> Section 8.16(a)(i) of the Code.

able to earn a return on any part of the capital to which that capacity relates; and

- second, it is left to the regulator to determine what would be invested by a prudent service provider acting efficiently, in accordance with accepted good industry practice, and to achieve the lowest sustainable cost of providing services

6.61 Finally there is the issue of timing as a result of sections 8.16(b) and 8.20 whereby Service Providers are provided with no certainty that the costs associated with the New Facilities Investment will be included in the capital base at the time the capital expenditure needs to be incurred.

6.62 This combination of risks, coupled with the approach of regulators to date, will mean that Epic Energy will not expand unless these risks can be negated entirely when assessing the commerciality of a new project.

### **Application of National Gas Code to greenfields pipelines**

6.63 The application of the National Gas Code to greenfields pipeline developments remains problematic despite the ACCC's release of its *Draft Greenfields Guideline for Natural Gas Transmission Pipelines* (the Guidelines) in June 2002. The Code still acts only to facilitate a regulatory decision **after** a new pipeline has been constructed. In consequence, potential investors are, at the very least, discouraged from committing the necessary finance, and further development of the gas market is inhibited.

6.64 A new transmission pipeline delivers gas into a market in which there are alternative energy supplies (gas supplied through other pipelines, electricity, coal, and oil-based fuels). To be viable, the new pipeline must be able to deliver gas at a price which is low enough to ensure that a share of the energy market is captured sufficient to generate the revenues necessary to recover the costs of the investment and a return on that investment. The price at which gas can be delivered will be constrained by the prices at which alternative sources of energy can be supplied. Regardless of the price that may be arrived at in a cost-focused regulatory determination, the prices at which alternative sources of energy can be supplied will be established by competition in upstream and downstream markets. Competition in upstream and downstream markets will limit the price at which gas can be delivered from a new pipeline.

6.65 Development of a new transmission pipeline is a major undertaking, exposing those participating in the development to considerable risk. By way of example, Epic Energy's proposal for a Darwin to Moomba Pipeline required the laying of some 930 kilometres of pipe, at a cost exceeding \$1 billion, to supply gas from fields in the Timor Sea into changing energy markets in the Northern Territory, Queensland and South Eastern Australia. The allocation of the risks of an investment of this order to the pipeline owner, to providers of finance, to energy suppliers and pipeline shippers will be critically important in establishing a price for gas transportation. This risk allocation cannot be mandated by the pipeline owner. It must be discovered through a process of negotiation with the other participating parties. This process of negotiation will be iterative because the size of the market for gas transportation



service, and hence the potential revenue stream to the pipeline owner, will depend on the transportation price, and the transportation price will, in turn, depend on the risks, including those associated with market size.

6.66 Negotiations between those participating in the development of a new transmission pipeline are rarely straight-forward:

- negotiations usually proceed separately with individual providers of finance, energy suppliers, suppliers of materials, government agencies, and pipeline shippers; the pipeline owner does not negotiate with a homogeneous cohort of other participating parties;
- different parties within the same class (for example, shippers requiring gas transportation service) usually have different requirements, with different implications for the transportation price;
- negotiations begin from a low base of information about service levels and costs; as they progress, service levels, costs and prices commercially acceptable to the parties are discovered;
- in this process of discovery, shipper requirements for gas transportation service are influenced by the proposals put forward by the pipeline owner and others, and these changed requirements feed back to influence those proposals.

6.67 Shippers using the service provided by a new gas transmission pipeline are typically gas suppliers, industrial or commercial users of large quantities of gas, power generators, and gas retailers. They are commercially sophisticated, and are generally characterised by their possession of:

- the expertise, resources and incentive to model and research the pricing implications of transmission pipeline construction and service options, to assist negotiation with the new pipeline owner;
- a readiness to choose to share the risks and benefits of a new pipeline by voluntarily negotiating prices for long supply arrangements in advance of the new pipeline being constructed, thereby gaining access on competitively favourable terms, to a source of supply than would otherwise be denied to both them and the remainder of the market;
- access to alternative sources of natural gas and energy;
- a good understanding of what may or may not constitute commercially acceptable prices; and
- the opportunity to diversify risk by not offering to contract all of their load requirements with a single pipeline where a new pipeline enters an existing market.

6.68 The pipeline owner, shippers, and the other participants in a new transmission pipeline development are subject to a range of risks which must be taken into

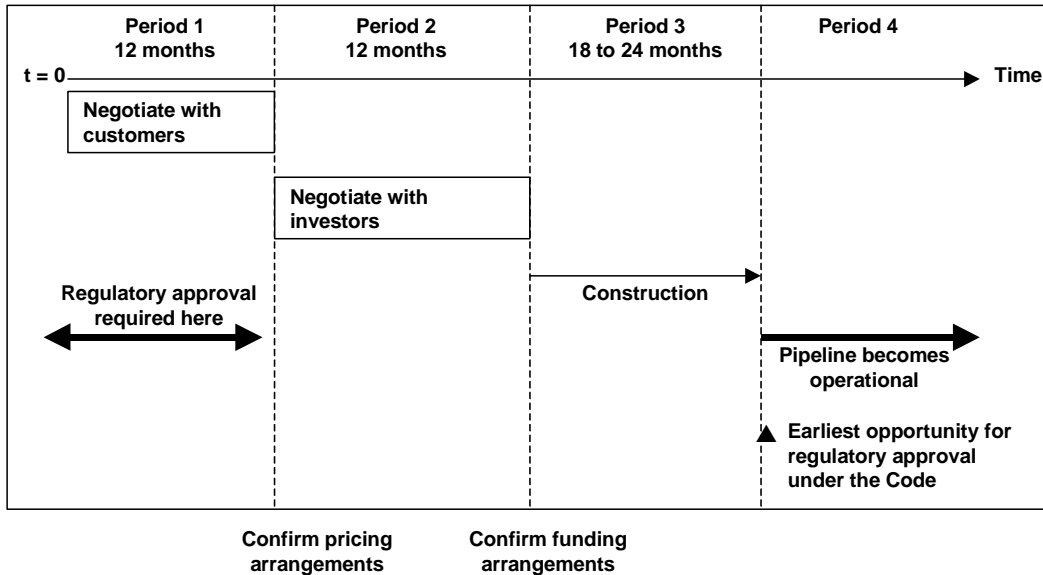
account in establishing project viability, negotiating finance, and agreeing transportation service levels and prices. These risks include:

- cost of construction risk (including foreign exchange risk because compressors, valves, control systems and some line pipe will usually be sourced overseas);
- price risk arising because transportation prices are negotiated on the basis of forecast of costs which may not be realised;
- capacity and volume risk associated with the building of capacity in anticipation of future demand;
- operating risk associated with a technologically complex facility;
- market risk (including the risk of competition from alternative sources of natural gas and energy); and
- regulatory risk arising from the structure of, and changes to, regulation.

6.69 Pipelines are long lived, highly specific assets (they have little or no alternative use). A long term view must, therefore, be taken of these risks, and recognition must be given to the fact that the magnitudes of the risks will change over time. Cost of construction risk will fall away once the new pipeline is commissioned, pricing risk will be managed through the contractual arrangements between the parties; and operating risks will decline as experience is gained with pipeline operation. Capacity and market risks may remain over an extended period and, once regulation is imposed, regulatory risk remains throughout the life of the pipeline because winners and losers are created, and they use political processes to secure further regulatory change.

6.70 The recognition and allocation of these risks is an integral part of negotiations leading to contractual arrangements with foundation customers. These foundation contracts are essential to support the business case for securing finance. Only when the negotiation of the foundation contracts is concluded, will providers of finance have sufficient certainty about the project to commit the finance required to enable pipeline construction to proceed. The sequencing of project activity, and indicative timing, are shown in the following diagram.

Diagram 6.5



- 6.71 As the diagram shows, if regulatory approval is required, it is required within about 12 months of project initiation. This is a critical time in the development process. Release of information for regulatory purposes at this time may serve only to provide others competing for the same opportunity with valuable information about gas suppliers, potential shippers and market costs.
- 6.72 The tariffs that might be obtained through the process of regulation need to be known by both the new pipeline owner and prospective shippers at this time so that they can conclude their negotiation of foundation contracts. However, the earliest opportunity for regulatory approval under the National Gas Code is some two to three years later. This creates major difficulties for new pipeline development.
- 6.73 Sections 8.12 and 8.13 of the National Gas Code set out the way in which the initial capital base of a new pipeline is to be established for the purpose of setting regulated access prices. Both require that the actual cost of the pipeline be known before a reference tariff can be determined. In consequence, regulatory approval of the tariff cannot be obtained prior to the completion of pipeline construction. By this time, the foundation contracts, and project financing, must be in place.
- 6.74 Prospective shippers negotiating the foundation contracts are, as noted above, few in number, commercially sophisticated and have the resources necessary for effective negotiation with the pipeline owner. Their commitment is required to secure project financing and to permit pipeline construction to proceed. Furthermore, they are aware of regulatory requirements, and of the practice of regulators to force down the estimated costs of pipeline businesses in the approval of their tariffs. Prospective shippers negotiating foundation contracts insist on being offered terms at least as good as those which might be offered to any other shipper including a shipper that contracts after regulatory approval is obtained.

- 6.75 This leads to a potential unravelling of the pipeline development process. The foundation contracts no longer implement an agreed allocation of risks and the relative certainty in respect of access pricing which is needed sustain project financing.
- 6.76 Epic Energy does not assert that this unravelling of the process has been the primary reason for any specific new pipeline development proposal not proceeding. The potential for unravelling does, however, make the negotiations that must take place much more difficult, and increases the likelihood that negotiations with at least one of the prospective shippers, or providers of finance, will not be concluded, delaying (if not terminating) the process and adding to total project costs. Both of these outcomes – delay and additional costs – further increase the complexity of the situation of those participating in new pipeline development, and the risks to which they are exposed.
- 6.77 In the case on new pipeline developments, the existence of the National Gas Code, and the way in which it is applied by regulators, in effect interferes with the normal process of commercial negotiation and increases the risk of unsuccessful outcomes which may lead to delays, higher costs, and significant projects not proceeding.

**Lack of priority given to commercially negotiated outcomes**

- 6.78 Epic Energy is concerned that the scheme of the Code, and the way in which it is applied by regulators, diminishes the role for commercially negotiated outcomes in the supply of pipeline capacity. This is contrary to the original intention of the national competition policy reforms.
- 6.79 As part of its proposed access arrangement for the MAPS, Epic Energy proposed a total revenue and reference tariffs which were based on the tariffs that had been included in the contracts customers had negotiated with the previous owner of the pipeline. The regulator – the ACCC – simply used these contract revenues as a “high water” mark , and then proceeded to reduce the total revenue by approximately 12 percent in its final approval of the access arrangement.
- 6.80 That the National Gas Code does not adequately deal with market derived tariffs has been recognised by NGPAC, which discussed this issue in 2002. The matter was, however, deferred for consideration as part of this current review process.

**Funding of the regulators**

- 6.81 In its communiqué released following its 1 August 2003 meeting, the Ministerial Council on Energy recommended new industry-funded institutional arrangements including the office of the regulator. As noted above, under the Western Australian implementation of the Gas Access Regime, there is already an “industry pays” system in place.
- 6.82 This is entirely unsatisfactory from Epic Energy’s perspective given its experience in Western Australia of funding arrangements that are inadequate and inequitable.

- 6.83 The fairest model is one which requires the costs of regulation (and therefore the costs of the regulator) to be borne by the prime beneficiaries of regulation - ie by the shippers and potential shippers of regulated assets. While Epic Energy believes that the costs of regulation should be borne from consolidated revenue, if a cost recovery mechanism is to be implemented it must be accompanied by a guarantee that these costs can be “passed through”. A framework which does not guarantee the “pass through” of regulator costs amounts to a “stealth tax” imposed on regulated businesses.
- 6.84 Other models already exist for ensuring that the beneficiaries of regulation pay for its associated costs via means other than consolidated revenue (e.g. in relation to FRC Market Operation).
- 6.85 Transparency and accountability on the part of the regulator incurring the costs must, however, be a prerequisite for any model that is implemented. The current system in Western Australia provides no incentive for the regulator to properly manage these costs. The recent Western Australian Supreme Court decision (referred to above) has gone some way to ensuring that appropriate checks and balances are put in place by the regulator in that State.

**Appeals Provisions**

- 6.86 It is important for the Productivity Commission to be aware that there has been a significant number of challenges to regulatory decisions in the relatively short time since the Gas Access Regime came into force. It would be wrong for the Commission, or for policy makers, to dismiss these challenges simply as seeking clarification of a new legislative framework, or a gaming of the system by the challengers to “delay the inevitable outcome”.
- 6.87 A list of challenges (and potential challenges), and of the regulatory approval processes that are the subject of challenge (or potential challenge), follows:

<b>Challenge</b>	<b>Challenger</b>	<b>Relevant Regulatory Process</b>
1999 – Australian Competition Tribunal	Duke Energy International	Application for coverage of the EGP
2001 – WA Supreme Court	Epic Energy	Draft Decision for DBNGP access arrangement
2002 – Australian Competition Tribunal	Duke Energy International	ACCC approved access arrangement for QGP
2002 – WA Supreme Court	Goldfields Gas Transmission	Draft Decision for GGP access arrangement
2002 – Australian Competition Tribunal	Epic Energy	ACCC approved access arrangement for MAPS
2002/3 - WA Supreme Court	Western Mining Corporation	Draft Decision for GGP access arrangement
2003 – Australian Competition Tribunal	GasNet	ACCC approved access arrangement for Victorian Transmission System

<b>Challenge</b>	<b>Challenger</b>	<b>Relevant Regulatory Process</b>
2003 – Potential WA Supreme Court challenge	Western Power Corporation	WA Regulator final decision on DBNGP access arrangement
2003 – Potential Gas Review Board	Epic Energy	WA Regulator potential final approval to draft and approve his own access arrangement
2003 – Potential Australian Competition Tribunal	Eastern Australian Pipeline Limited	Potential decision by Minister that MSP should remain covered

- 6.88 The appeal provisions set out in the Gas Access Regime (particularly sections 38 and 39 of Schedule 1 to the Gas Pipelines Access Law of each jurisdiction) have proven deficient.
- 6.89 Sections 38 and 39 of Schedule 1 provide for only a limited merits based review by the Australian Competition Tribunal.<sup>32</sup> The omission of a right of a full merits review is a serious omission and flaw in this area of regulation.
- 6.90 Not only are the limited review rights a significant problem. In addition, the time that elapses, and the process that must be followed, before these limited review rights crystallise further restrict the ability of service providers to question the integrity of the regulatory approval process.
- 6.91 It is somewhat unusual in this day and age for an area of administrative law not to provide for review of a regulator’s decision on the merits. A good example of how this could be done is the well-tested system adopted in Australia’s industrial relations system.
- 6.92 The need for a full merits review is imperative given the impact that regulation has on the viability of pipeline businesses. These businesses have made significant investments in Australia, yet their fate is presided over by economic theoreticians.
- 6.93 Epic Energy is aware of the view that it is open to service providers to use the appeal provisions of sections 38 and 39 of the Gas Pipelines Access Law to frustrate access. This view has little foundation. A service provider cannot frustrate access because an access arrangement (the access arrangement drafted and approved by the regulator) is in effect during the period of the appeal process. Furthermore, while it may be open to a service provider to seek, from a court, a stay of the access arrangement while an appeal is heard, Epic Energy is not aware of any application for a stay having been made.
- 6.94 The problems of partial merits review are compounded in Western Australia. The State created a new body – the Gas Review Board - as the relevant appeals body under the Gas Access Regime. The Gas Review Board appears to be modelled on the Australian Competition Tribunal (being the relevant appeals body for the decisions of the ACCC), in that it is to have 3 members, with the chair being a lawyer

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<sup>32</sup> Except in the case of Western Australian transmission pipelines, where appeal is to the Gas Review Board.

drawn from a panel appointed by the Minister for Energy, and the remaining 2 members being drawn from a second panel providing access to a range of expertise from engineering to economics. While this might work in principle, the reality is that most of the members of the current panels would be unable to participate in a review of any of the pipeline systems within the State's jurisdiction because of conflicts of interest.

- 6.95 A further deficiency in the appeals mechanism in the Western Australian implementation of the Gas Access Regime is that, in the event of an appeal, the Gas Review Board is to be assisted by the State's Office of Gas Access Regulation. The very office that provides technical and administrative support to the WA regulator in the process leading to the decision which is the subject of appeal is assigned the task of supporting the review body! In these circumstances, an objective merits review would seem to be impossible.

### **Unwieldy and ineffective Code change process**

- 6.96 Based on Epic Energy's direct and indirect experience with the process for considering and implementing changes to the National Gas Code, that process has proven to be frustrating, time consuming and ineffective.
- 6.97 Epic Energy's experience has been gained by its being a participant (as one of the Australian Pipeline Industry Association's permitted attendees) in National Gas Pipelines Advisory Committee ('NGPAC') meetings, and through its having sought a specific change to the National Gas Code.
- 6.98 Under the Gas Access Regime, the Code may be amended by agreement between the relevant Ministers of the Commonwealth, the States and the Territories if they have received a report prepared in accordance with section 9.2 of the Code. An amendment to the Code requires the agreement of all relevant Ministers unless it is an amendment that does not change a core provision, does not extend the application of section 38 of the Gas Pipelines Access Law, or does not insert a provision dealing with a matter not previously dealt with in the Code.
- 6.99 Epic Energy considers that the Code change process under the National Gas Code is severely deficient in a number of respects.
- 6.100 The process is extremely time consuming, inflexible and ineffective. This is demonstrated by the fact that in the space of six years, there have been seven amending agreements most of which deal with minor clarifications of the existing regime. NGPAC has been unable to deal with major issues. As noted above, it was unable to deal with market derived tariffs, preferring to leave the matter to this review by the Productivity Commission.
- 6.101 The ineffectiveness of the Code change process is also due to NGPAC's large and diverse membership – representing jurisdictions, pipeliners, shippers and regulators. Given the purported independence of the regulators, making them administrators of policy, not policy makers, Epic Energy questions whether they should be involved in what is effectively a policy making process. There is a clear conflict of interest

between the regulators' role in implementing the Code, and the role they play as a member of NGPAC in relation to amendments to the Code, even though that membership is non-voting in nature. Furthermore, this problem is exacerbated by the fact that at least one of the Secretariat's consultants, the Allen Consulting Group, continues to provide advice to a number of the regulators, thus giving rise to perceptions of conflicts of interest.

- 6.102 The group most affected by Code changes is the pipeline industry. However industry members are not afforded voting rights in relation to the National Gas Code change process itself. Although industry can voice its opinion by way of submissions to NGPAC and through participation in working groups, Epic Energy considers that it should be afforded a more central role in any Code change process to be implemented.
- 6.103 That there are currently no timeframes set out in the Code to be adhered to by NGPAC in relation to the report that must be provided to Ministers, and in relation to the process to be followed, further contributes to the ineffectiveness of the Code change process.
- 6.104 The time taken to effect a Code change is increased by a 'doubling up' of administrative process. Only relevant Ministers are entitled to vote at NGPAC meetings, and to decide on whether to proceed as per the recommendation given in the report by NGPAC. Often jurisdictional delegates attending NGPAC meetings in place of Ministers do not have the authority to make decisions. All they are able to do is relay information back to the relevant Ministers for decisions at a later stage. Given time pressures on Ministers and senior public servants, this may be difficult to avoid. However, the resulting delays in the Code change process could be reduced by including a specific timeframes in the Code for NGPAC reporting to Ministers, and for Ministerial decision making.
- 6.105 Epic Energy draws the Productivity Commission's attention to the fact that it has been provided with a copy of the submission prepared by the NGPAC secretariat for the purposes of this review. The views contained in that submission are not the views of Epic Energy.

### **Ministerial/Government involvement**

- 6.106 Many have expressed concern about the appropriateness of government involvement in regulatory processes, given the independence of the regulators. There is, however, a need for Ministers to remain involved to minimise the risk of the application of Gas Access Regime conflicting with the policy objectives that underpin it – ie the *Competition Principles Agreement* objectives.
- 6.107 The idea of the "independent regulator" has now outlived any usefulness it may have had. Regulator independence was a useful fiction when governments were selling assets. How else might buyers have been persuaded that governments would not later unilaterally break "regulatory contracts", and persuaded to pay high prices for what regulatory risk has made highly risky assets?



- 6.108 Although Epic Energy is reluctant to see further government involvement, it cannot be avoided. No scheme of regulation can anticipate and provide, in advance, solutions for all of the issues that will subsequently arise. Some of those issues – for example, issues concerning coverage, and issues about the effectiveness of the access regime – will require the intervention of policy makers.
- 6.109 The situation Epic Energy currently faces with its South West Queensland Pipeline illustrates this issue. The Queensland Government implemented the Gas Access Regime by enacting legislation – the *Queensland Gas Pipelines Access Act* - with a number of derogations from the Code in relation to certain pipelines, including the SWQP. COAG had made specific provision for these derogations at the time the *Natural Gas Pipelines Access Agreement* was signed in November 1997. In fact, they were Queensland's "price of entry" to the Agreement, which had as its objective the fulfilment of the *Competition Principles Agreement* objectives. Under Part IIIA of the *Trade Practices Act 1974*, the Queensland implementation of the Gas Access Regime must be certified as an effective regime, and the National Competition Council (NCC) is the relevant regulator for this purpose. The NCC has recommended that the Queensland regime should not be certified as being effective, would therefore pull the whole regime apart. That will have the effect of destroying the economic foundations on which Epic Energy (then Tenneco Energy) constructed the SWQP. Ministerial intervention is essential to ensure that this does not happen.
- 6.110 A further example of the importance of government involvement is in the DBNGP regulatory approval process. In that case, the Government of Western Australia has persistently advised that it would be inappropriate for it to become involved in the regulatory process on the basis that to do so would undermine the independence of the Regulator and, furthermore, that its intervention would be illegal. A critical issue for Epic Energy in the case of the DBNGP is the importance of public interest objectives being pursued by the Government at the time it sold the Pipeline to Epic Energy. Only the Government is in a position to apprise the regulator of the importance of those objectives.

**Can economic regulation adequately deal with safety and technical integrity of pipeline**

- 6.111 It must be a primary objective of the National Gas Code that it be structured so as to not act as a disincentive for investment in:
- the long term preservation of and the maximisation of the life of gas transmission pipelines; and
  - a sufficiently skilled workforce to assist not only in the design and construction of the infrastructure but also its continued operation and enhancement.
- 6.112 The National Gas Code requires the regulator, when assessing an access arrangement, to give consideration to (as a fundamental element in the regulator's assessment process) the operational and technical requirements necessary for the safe and reliable operation of the covered pipeline (see section 2.24(c)).

- 6.113 As the Court noted in the DBNGP Decision, expenditure necessary for the safe and reliable operation of a pipeline would need to be taken into account whether or not it would have been made in a competitive market or according to theories of economic efficiency.<sup>33</sup>
- 6.114 Epic Energy has long contended that it should be permitted to earn an appropriate return on its investment so as to enable it to make provision for the safe and reliable operation of the DBNGP, including properly maintaining it. In fact, the ability of Epic Energy to show a proven track record in maintaining and operating pipelines was one consideration leading to the acceptance of its bid for the purchase of the DBNGP. The ongoing maintenance which is required for the DBNGP is a significant annual sum. While Epic Energy will make every endeavour to ensure that the safe and reliable operation of the DBNGP is never compromised, the importance of being able to carry out ongoing and preventative maintenance of such an asset should not be underestimated.
- 6.115 Epic Energy contends that the current application of the National Gas Code is failing to achieve this objective.
- 6.116 First, if service providers are financially constrained by arbitrarily low reference tariffs, this will lead to them not only being unable to carry out necessary pipeline maintenance. It will also lead to them being unable to undertake the research and development, and systems implementation, required to optimise the lives of existing assets. This will, in turn, have the flow-on effect of reducing the reliability, and the capacities, of existing pipeline assets, and potentially reducing asset lives. These effects are often slow to emerge and difficult to discern, but they can have significant consequences. A pertinent example is the English railway system, where the railway tracks were transferred to the private sector in the 1990s. The owners of the tracks allowed them - or were forced to allow them - to degenerate without proper maintenance. This resulted in a number of major accidents. A more recent example is the massive power system failure in the North Eastern United States in August 2003. In both cases, the failure of regulation to provide the right financial incentives to invest in the long term safety and reliability of the system has been identified as a factor contributing to system failure.
- 6.117 Second, the adoption of five year regulatory periods (as a maximum) for existing pipelines means that regulators often do not consider the long term requirements of operating a pipeline. Regulator focus is on the lowest cost outcomes in the short run.
- 6.118 Third, the approach to incentive regulation under the National Gas Code and the fixing of the Total Revenue means that that Service Providers are forced to improve their returns through seeking to achieve lower operating costs in a regulatory period. This could lead to service providers compromising on the capital and operating expenditure required for the long term operation of the pipeline. This would be a perverse outcome of the application of the National Gas Code.

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<sup>33</sup> Reasons para 132.

6.119 Finally, while the development of a domestic skills set is a long term objective, in the short to medium term, this can be achieved with the use of appropriately skilled and experienced personnel from other jurisdictions. Many companies that have sought to invest in Australia over recent years have sought to utilise their existing employees who already possess such skills sets. Epic Energy, for example, has had ready access to El Paso personnel with expertise in areas it lacks, such as offshore pipelines. That expertise has been provided on a knowledge exchange basis as opposed to simply providing the resources. Epic Energy has also found that its own expertise and experience has been sought by El Paso on a similar exchange basis. It would be against the national interest if these companies were deterred from investing and providing such support, particularly given the short to medium term requirements in this respect.

## 7. The consequences of the problems

- 7.1 There are a number of adverse consequences not only for service providers but, more importantly, for the wider economy, as a result of the problems with the Gas Access Regime that have been outlined in the previous section of this submission. This section discusses these adverse consequences.

### **Disincentive to Investment**

- 7.2 The National Gas Code, and its application by regulators, are giving rise to unacceptable levels of regulatory risk, and to sovereign risk for investors. These risks are adversely affecting the investment decisions of current industry participants. If the problem is not addressed, the future investments in pipeline infrastructure needed to satisfy a growing demand for gas will not be made.
- 7.3 Epic Energy understands that a number of its owners will make (or have made) submissions to the Commission, providing it with examples of how the Gas Access Regime is affecting the way in which they approach pipeline investment decisions.
- 7.4 Epic Energy's owners made their initial investments in Australian pipeline systems – their investments in the SWQP and the MAPS – at a time when the *Competition Principles Agreement* had been signed, but the Gas Access Regime had not been developed in any detail.
- 7.5 Given the state of the regulatory framework, and the fact that Australian governments had recently made policy decisions to privatise pipelines, and to have the private sector finance future pipeline development, those governments need to provide some policy direction on the pricing of gas transmission in order that investors would have the opportunity to recover their investments, and would have the incentive to make further investments in pipeline infrastructure. This requirement to provide investors with a degree of certainty was critically important for those privatisations of pipeline assets (probably all) in which the prime objective of the government was to maximise the price it received.
- 7.6 In Queensland, where new pipeline development was required, the Government attempted to provide investors with a degree certainty by approving access principles for the major pipelines, and by later carrying those principles over into the Gas Access Regime by way of derogations.
- 7.7 In 1997, Epic Energy's owners began their participation in the privatisation process which would lead to their purchase of the DBNGP from the State of Western Australia. By this time, development of the Gas Access Regime was well advanced (although it would be another twelve months before it was implemented by the Western Australian Government). Nevertheless, the State Government also attempted to provide some certainty, and incentives for future investment, through its announcements on future prices and in communications with bidders for the Pipeline. As Colin Barnett, Minister for Energy at the time, subsequently explained, it was the role of the regulator to regulate, not to become a price or policy maker –

that was the province of the Government. It was the province of the Government, because only the Government could reflect a range and a balance of economic and social objectives.<sup>34</sup>

- 7.8 With the coming into effect of the Gas Access Regime, and the regulators' approach to application of the National Gas Code, Epic Energy's owners' views on investment in pipeline systems have fundamentally changed.. This change in the owners' views reflects their experience. In the case of the DBNGP, they had been led to believe that regulation would be light-handed, allowing them to earn a reasonable rate of return, and to commit to further substantial investment in the pipeline system to meet the expected future needs of mining and minerals processing in Western Australia. Implementation of the Gas Access Regime has, however, resulted in intrusive regulation, and regulator adoption of the lowest cost outcome approach discussed earlier in this submission, to the point where their investment has been rendered worthless.
- 7.9 In Queensland, they find that the NCC and ACCC are now attempting to unwind the basis on which the original pipeline investment was made – a basis which was agreed to by the Queensland Government, and by COAG in its acceptance of the Queensland derogations from the National Gas Code – because it is not consistent with the regulator's lowest cost outcome approach to application of the Code. The regulators are, in effect, seeking to overturn the decisions of elected governments in pursuit of their own view of what constitutes the public interest.
- 7.10 From Epic Energy's owners' perspective, implementation of the Gas Access Regime has resulted in greatly increased uncertainty as to the returns on, and to the return of, their investments in pipeline systems. This uncertainty is not only evident in relation to the initial returns regulators have allowed, but also in relation to future returns as a result of the impact of regulatory resets on future returns (as discussed earlier in this submission).
- 7.11 This increased uncertainty has manifested itself in the owners' decision making. In general, they are not prepared to invest in any new pipeline, or in any expansion of an existing system, where there is a real risk of the capacity being subject to regulatory control. The flow on consequence of this in terms of the capital costs and tariffs is explained in further detail below.
- 7.12 Moreover, some of Epic Energy's owners have decided not to make further investments in regulated pipeline systems. This should not be seen as simply the rhetoric of investors – a consistent message has been sent by industry and some observers since at least mid 1998 (since the ACCC's decision on the Victorian Principal Transmission System).
- 7.13 El Paso Corporation, one of the major shareholders in Epic Energy, publicly announced in December 2001 that it had not committed any of its approximately (US) \$4.7 billion of total capital available for 2001 to Australia because of risks

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<sup>34</sup> See Amended Access Arrangement Information for DBNGP dated 8 August 2003 at page 28.

associated with the current regulatory environment. It made the following comments:

*“Australia offers significant opportunities in terms of gas reserves and market growth, but current regulatory decisions have put Australia in a high risk category. As international investors we are deeply concerned that our Australian interests could be seriously jeopardised if regulatory decisions such as the DBNGP draft decision are made final. An investor cannot commit risk capital when a regulator can change the rules after the investment has been made.....Our international investment decisions are based on analysis of the competitive environment, market liquidity and optionality, currency risk, political and regulatory risk. Given the current negative regulatory climate in Australia which has been highlighted by the regulatory case in Western Australia, the decision was made not to target these funds towards Australia in 2001.”*

- 7.14 Another of Epic Energy’s shareholders, Deutsche Asset Management, in a submission to the Western Australian Independent Gas Pipelines Access Regulator made the following comments:

*“Until regulators adopt a realistic “whole of asset life” approach reflecting the investment and return requirements of different parties discussed above, infrastructure investment in this country will suffer and decline. Deutsche Asset Management has made only one investment in a significantly regulated asset (i.e. 50% or more of revenue from regulated sources) since the acquisition of the DBNGP in 1998. In that case, the relevant regulator had determined that sufficient competition existed and adopted a largely “hands off” approach.”*

- 7.15 To the extent that they may be prepared to further invest in pipelines, Epic Energy’s investors now require that commercial safeguards (for example, foundation contracts for most or all of the capacity in a pipeline system) are in place before funds are committed. This was evident in Epic Energy’s planning for the proposed Darwin to Moomba Pipeline.
- 7.16 In addition, Epic Energy’s investors have sought to factor regulatory risk into their required rates of return – a factor which was not required in the late 1990s. Epic Energy is prepared to discuss this with the Commission on a confidential basis.
- 7.17 Regulators “model” owners as passive investors facing a given distribution of returns available from the capital market, and then use the Capital Asset Pricing model to estimate the rates of returns they expect. Epic Energy understands that Deutsche will be making a submission to the Commission which argues that this is an inappropriate characterisation of those investing in major infrastructure assets such as gas pipeline systems. In applying the National Gas Code, the regulators assume “mums and dads” investors - passive portfolio investors who accept going rates of return, and for whom the CAPM might provide an adequate measure of expected return. This is not the case for the principal investors in major infrastructure assets.
- 7.18 In the case of Epic Energy’s overseas investors, Australia has been identified as a riskier place to invest since 1998 primarily as a result of the regulatory regime and its

application. Epic Energy is prepared to discuss this with the Commission on a confidential basis.

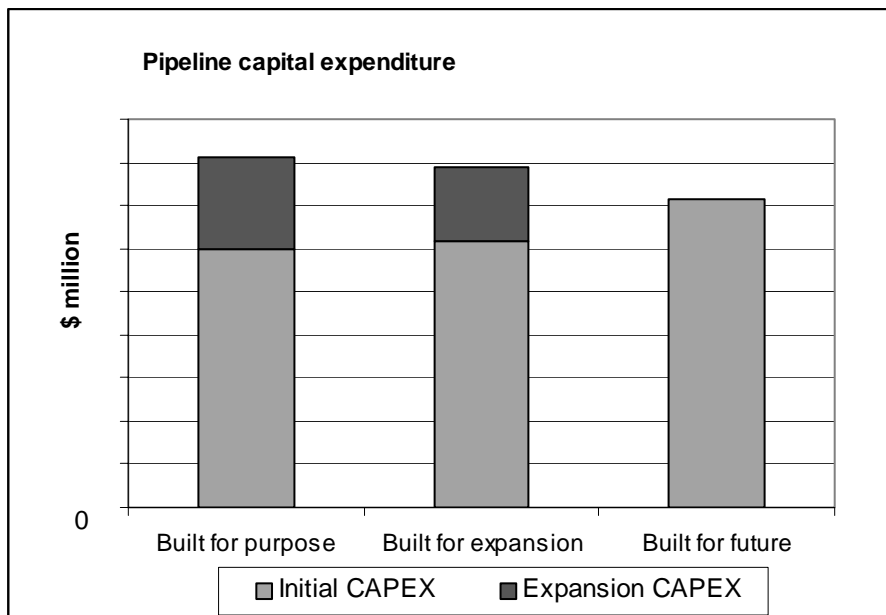
**Inefficient pipeline sizing leads to shippers paying higher tariffs**

7.19 As mentioned above, one of the consequences of the way in which the National Gas Code, and its application by regulators, interferes with the normal process of commercial negotiation is that proposals for new pipelines are now developed on the assumption that construction will provide only the capacity that is needed to meet owner obligations under foundation contracts – ie they will be “built for purpose”. There will be no construction of spare capacity which could precipitate a coverage application, coverage and subsequent regulation, leading to the unravelling of the initial risk allocation, pricing and project financing. Scale economies, available at the time of initial design and construction, will not be exploited.

7.20 The following diagram shows the relativity of capital costs when a major transmission pipeline, for which detailed planning has been carried out by Epic Energy, is:

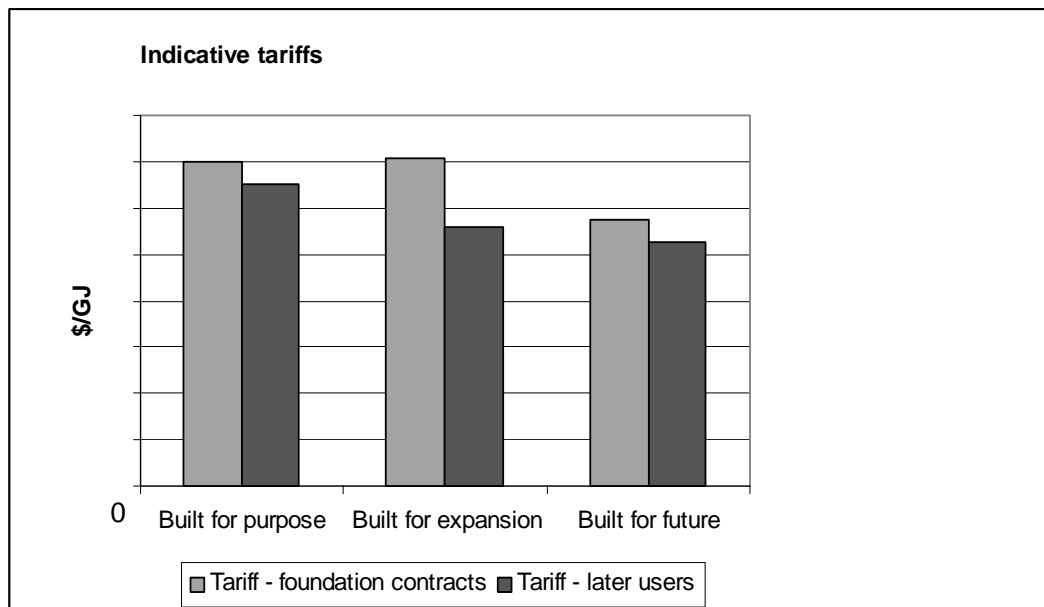
- built for purpose;
- built with a small amount of spare capacity (built for expansion); and
- built to accommodate significant growth in the market for gas transportation service (built for future).

Diagram 7.1A



- 7.21 When the pipeline is initially built for purpose, and must later be expanded by around 55% of its initial design capacity, further investment amounting to about 35% of the initial construction cost is required.
- 7.22 If the initial design includes a small amount of spare capacity (around 3% of initial design capacity), and the pipeline must later be expanded to increase its capacity by about 50% of initial design capacity, further investment amounting to about 32% of the initial construction cost of the built for purpose pipeline is required.
- 7.23 Finally, if the initial design includes sufficient spare capacity to accommodate expansion of the same magnitude as in the preceding cases (55% of the initial design capacity of the built for purpose pipeline), the construction cost is only about 20% more than the initial construction cost of the built for purpose pipeline.
- 7.24 Clearly, with the relatively lower construction cost of the “built for future” pipeline, tariffs, in the longer term, will be lower than those which are likely to prevail if the pipeline is built for purpose or built with only a small amount of spare capacity. Indicative tariffs are shown in the diagram below.

Diagram 7.1B



- 7.25 In Australia’s developing gas market, the National Gas Code, and the way in which it is being applied by regulators, are leading to a situation of inefficient pipeline sizing.

**Second Class Citizen argument**

- 7.26 A further example of the inefficiencies that arise from the regulator’s application of the National Gas Code exists in the case of the DBNGP. In that instance, Epic Energy bought the pipeline on the basis that it would commit to expanding the pipeline over



a 10 year period at a cost of \$874 million but that the tariff would be a levelised tariff over that period and beyond. The effect of this was that all customers (both existing and future) would pay the same tariff irrespective of how much the cost of the incremental capacity would be. In the final decision for the DBNGP access arrangement, the Regulator has prevented that from occurring by setting the initial tariffs so low as to make it unviable for Epic Energy to persist with its levelised tariff path approach. Therefore future capacity (even if it is ever funded by a service provider) will be more expensive than existing capacity.

- 7.27 Under the Code, the Service Provider is required to expand capacity only to the extent that the party seeking access is prepared to fund the investment in capacity expansion, and as stated by Epic Energy previously in its submissions to the WA regulator:

*"the Service Provider has an unfettered discretion under the Code on the issue of whether it should invest further in a covered pipeline. Sections 3.16 of the Code provides that the Service Provider can not be compelled to provide in its extensions/expansions policy that it will fund New Facilities, unless it agrees. Furthermore, section 6.22 of the Code also states that a Service Provider can not be compelled by an arbitrator in an access dispute, to fund any part of the expansion of the pipeline."*

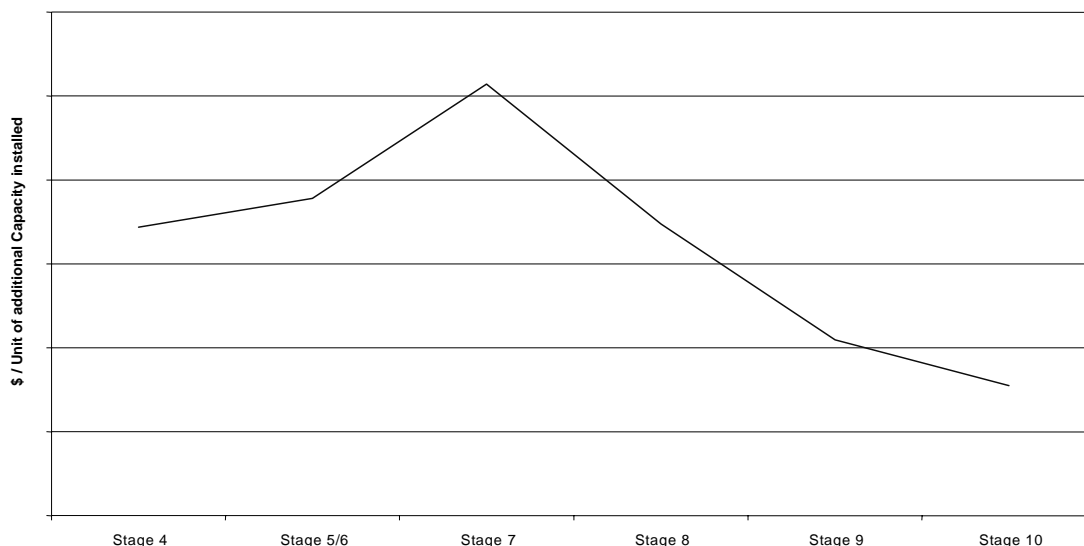
- 7.28 The Code therefore exposes future shippers to the requirement to directly fund that portion of capacity expansion that is required to meet their individual needs. This leads to the following undesirable outcomes:

- the need to apply the shipper's own funds up front and at the shipper's own cost of capital, which may be higher (and for upstream developers it is likely to be considerably higher) than the cost of funds available to pipeline infrastructure investors; and
- a shipper will be unable to justify any investment in capacity beyond that necessary to meet its own needs and so the economies of scale that might have otherwise been available to the pipeline operator will not be captured.

- 7.29 This is what Epic Energy has commonly termed the "second class citizens" argument.

- 7.30 Pipeline capacity expansion does not automatically imply an increase in tariffs. The marginal costs of some expansions are lower than the average cost of capacity. Those expansions result in a lowering of tariffs determined on an average cost basis. However, not all expansions have this desirable outcome. When a pipeline is fully compressed, additional capacity must be obtained by looping (duplicating sections of the line). Initial looping typically has marginal costs which exceed the average cost of capacity and, when undertaken, increases tariffs that have been determined on an average cost basis. This point is illustrated in Diagram 7.2 - the references to "stages" are various stages of expansion. The underlying assumptions contain confidential information. However, Epic Energy would be prepared to discuss this concept with the Commission on a confidential basis.

Diagram 7.2



- 7.31 Transmission pipelines such as the DBNGP and the MAPS are close to being fully compressed, and therefore their next expansions will require looping.
- 7.32 The issues of the higher marginal cost of capacity, and whether the tariffs to be paid by prospective shippers seeking the additional capacity should be the same as the tariffs currently paid by shippers of the same service, are of immediate relevance.
- 7.33 To deal with this issue, Epic Energy’s proposed access arrangement was designed to ensure that:
- any additional capacity expansions would not result in an increase in the reference tariffs to all shippers; and
  - the same tariff would be payable by all shippers of the same service, irrespective of whether the shipper was using the original capacity or the incremental capacity.
- 7.34 Epic Energy submitted to the WA regulator<sup>35</sup> that under the proposed access arrangement, the tariff and tariff path (and by implication, the proposed Initial Capital Base) reflect the expectation arising from the sale of the DBNGP that substantial new investment will be required to more than double the Pipeline capacity over the next 10 years.

<sup>35</sup> Section 3.24 and 3.32 of Epic Energy submission to the Regulator “Additional Paper 5: Code Compliance”, dated 25 October 2000.

- 7.35 The tariff path was therefore smoothed over an extended period to reflect that the expansions will be made without increases in the tariff at the time the expansions are built (where the cost of the expansion would have ordinarily caused tariffs to increase due to the higher marginal cost of the additional capacity). It is true that where the pendulum swings the other way and the incremental expansion cost is lower, the tariff does not drop, but the whole tariff path structure took that into account in order to provide a smoothed path. The tariff and tariff path proposed by Epic Energy in its proposed access arrangement therefore already takes into consideration the fact that the marginal cost of some expansions (eg looping) is greater than the cost of other expansions (eg reconfiguration). Hence Epic Energy would, for the initial expansion stages, have taken some pain while in the later stages, it would have made some gain. That in itself, given the stage in the incremental expansion cost curve the DBNGP is in, provides an incentive for Epic Energy to expand the pipeline and to gain new customers.
- 7.36 However, the Regulator's final decision no longer allows for this to occur because the allowable tariff is too low. By adopting the approach to the setting of tariffs used by regulators in the Eastern States who are dealing with mature pipelines facing the prospect of little expansion (ie by setting the value of the initial capital base by reference to the current configuration of the pipeline), the Regulator requires expansions, and therefore tariffs that need to be levied for that expanded capacity, to be assessed on a case by case basis. As mentioned above, the next expansion to the capacity of the DBNGP will require looping and the marginal cost of that incremental capacity will be greater than the cost of the capacity of the pipeline as it is currently configured.
- 7.37 The consequence of an access arrangement which incorporates the amendments in the Final decision will be that Epic Energy's second class citizens' claim will become a reality.
- 7.38 The Code is required to encourage the further development of the pipeline networks and to promote competition in downstream and upstream markets. However, the Code cannot compel a Service Provider to fund further expansions of a pipeline especially where it is not economically feasible to do so. The ranges of the parameters that the regulator has allowed for the total revenue calculations to date do not make it economically feasible to fund an expansion. Furthermore, the Code does not allow for a rolled in tariff where the cost of any incremental capacity is higher than the cost of existing capacity. Pipelines such as the DBNGP are almost fully contracted and therefore additional capacity will be required for any future growth in demand. However, the cost of that next capacity tranche will be at a greater marginal cost than the cost of the existing capacity. Therefore, unless the tariff path is structured from the commencement to accommodate future expansions (as is the case for Epic Energy's proposed access arrangement) a differential tariff structure will have to be implemented. One must consider how such an outcome will satisfy the requirements of section 2.24 of the Code.

**Fettering of right to negotiate**

- 7.39 A pipeliner's right to negotiate is fettered by the National Gas Code. The provisions require reference services and reference tariffs to be determined by a regulator before any actual negotiations between the service provider and prospective shippers may have even commenced. The regulator therefore becomes a defacto arbitrator of the terms of access, without there having been any negotiation but also with such "arbitration" conducted in quite a unique manner.
- 7.40 This problem is further exacerbated by the fact that the very tariffs are set by reference to a theoretical cost of service assessment designed to replicate a theoretically competitive environment with lowest cost outcomes. A further example of the fettering of the right to negotiate arises in relation to the role of the arbitrator who is bound to impose the terms and conditions (including tariffs) set by a regulator in relation to a reference service in situations where the service provider and shipper can not agree on the tariff<sup>36</sup>.
- 7.41 While the National Gas Code specifies that nothing in it limits the Services a Service Provider can agree to provide to a shipper or prospective shipper and the terms and conditions that can be agreed for that service<sup>37</sup>, given the "binding" nature of reference services, shippers will become less reluctant to negotiate, thus fettering a pipeliner's right to negotiate.
- 7.42 Epic Energy has experienced first hand the effect of the National Gas Code acting as a surrogate for effective commercial negotiations in its negotiations with shippers and prospective shippers on the MAPS for capacity beyond 2005. Due to confidentiality constraints, Epic Energy is unable to elaborate further without the agreement of all the shippers involved in negotiations, suffice it to say that the shippers' negotiations are being unreasonably influenced by the actions of the regulator and the possibility of a regulator drafted access arrangement rather than negotiate terms and conditions of access. Epic Energy is also experiencing similar reservations regarding negotiations by shippers in respect of the DBNGP.
- 7.43 This has an immediate impact on the ability for a service provider to be innovative in the development of new market service offerings.

**No pass on of price reductions to customers**

- 7.44 It is also important to note that despite the significant reductions in transmission tariffs since the inception of the National Gas Code, there have been no comparable reductions in the delivered price of gas to customers in that time. The report by the Commission 'Trends in Australian Infrastructure Prices 1990-91 to 2000-01' dated May 2002, confirms this. It sets out the real gas prices in most Australian capital cities over the study period and shows the changes in prices during that period for

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<sup>36</sup> See section 6.13 of the National Gas Code.

<sup>37</sup> See section 2.50 of National Gas Code.

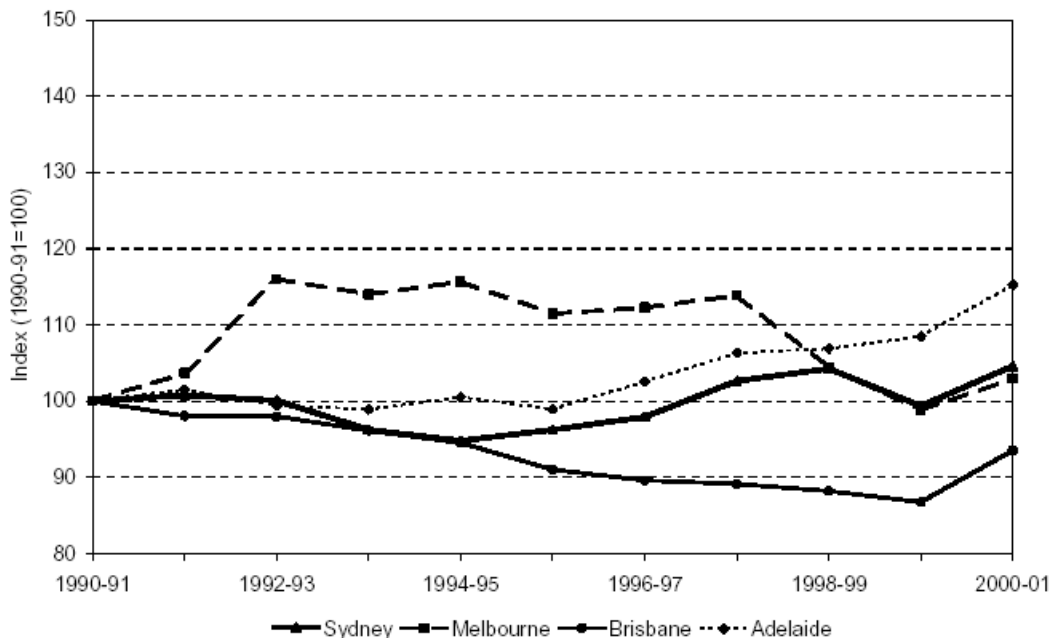
various customer classes. The key conclusions to be drawn from this study are as follows:

- Despite the relevance of the cost of transmission to the total cost of gas to end customers, the overall price of gas has not reduced significantly and in areas where the application of the National Gas Code has significantly reduced transmission prices, gas prices have increased.
- Any reductions that have occurred were not as a result of regulation, rather as a result of commitments given by service providers when assets were privatised.
- Most of the reductions in the transmission prices have not been passed onto end customers.

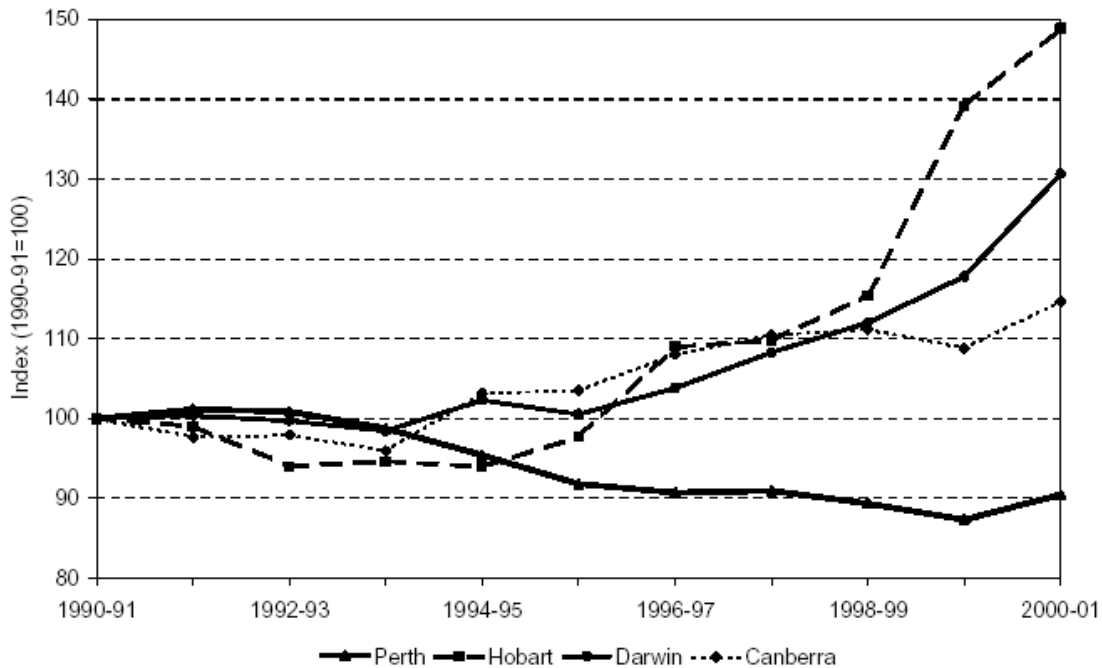
7.45 In metropolitan households, real gas prices for households increased in most Australian capital cities over the study period (see the graph below). In Adelaide and Canberra, they increased by 15 per cent. Real prices increased by 5% in Sydney and 3% in Melbourne. Metropolitan prices in Perth and Brisbane decreased in real terms, falling by 10 and 7% respectively. Although the critical period of analysis for this review should be from 1998 (when the Code took effect) onwards.

Graph 7.3

Real gas price trends — metropolitan households  
1990-91 to 2000-01<sup>38</sup>

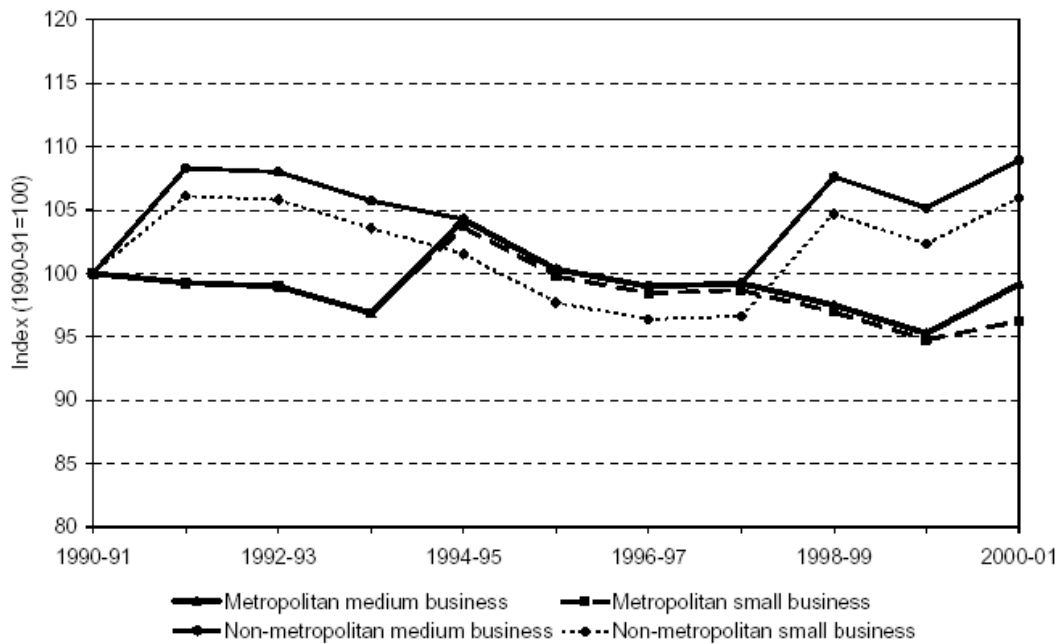


<sup>38</sup> From the report by the Productivity Commission 'Trends in Australian Infrastructure Prices 1990-91 to 2000-01' dated May 2002.



7.46 In the case of business customers in Western Australia, the point is more evident with the price trends as follows:

Graph 7.4<sup>39</sup>  
Real gas price trends — business, AlintaGas (WA)  
1990-91 to 2000-01



<sup>39</sup> From the report by the Productivity Commission 'Trends in Australian Infrastructure Prices 1990-91 to 2000-01' dated May 2002

- 7.47 The information set out above demonstrates that while there has been a significant reductions in transmission tariffs over time, they have not been passed on to end users. Further, the reductions in transmission tariffs do not appear to be as a result of regulation but rather as a result of privatisations.
- 7.48 Using the DBNGP as an example, prior to 1995, there was no third party access regime to the DBNGP, although a small number of shippers had succeeded in negotiating transportation service agreements with the then owner, the State of Western Australia under the guise of the State Energy Commission of Western Australia.
- 7.49 The biggest reductions in transmission tariffs occurred from 1 January 1998 through the time that Epic Energy has owned the DBNGP. During this time tariffs were not established under the National Gas Code. At the high point of 31 December 1997, the tariff for T1 (firm) full haul service was \$1.27/GJ. From 1 January 2000, the tariff (prescribed by legislative framework that preceded the Code) was \$1.00/GJ for T1 full haul.
- 7.50 The tariffs (reservation plus commodity charge, at 100% load factor) for full haul firm (Tranche 1) service applying since 1995 were as follows:

Table 7.5

<b>From</b>	<b>Reservation charge</b>	<b>Commodity charge</b>	<b>Total tariff</b>
1 January 1995	\$1.030000/GJ	\$0.220000/GJ	\$1.250000/GJ
1 January 1996	\$1.030000/GJ	\$0.227374/GJ	\$1.257374/GJ
1 January 1997	\$1.030000/GJ	\$0.233633/GJ	\$1.263633/GJ
1 January 1998	\$0.917457/GJ	\$0.271971/GJ	\$1.189428/GJ
1 January 1999	\$0.822743/GJ	\$0.271971/GJ	\$1.094714/GJ
1 January 2000	\$0.728029/GJ	\$0.271971/GJ	\$1.000000/GJ

- 7.51 Despite the transmission tariff coming down from a high of \$1.27/GJ in 1997 (it is not possible to determine what the tariff was prior to 1995 as the Government only sold delivered gas and the transmission tariff was not broken out) there has been no flow on to tariff customers of Western Power or AlintaGas. As Western Power announced on 28 June 2001<sup>40</sup> its last residential price increase “was only” 3.75% in July 1997 and the last business tariff increase was in July 1992. They failed to mention that there had not been a decrease of either tariffs during that period. Two days later AlintaGas announced that it was increasing all its tariffs by 3.5% with effect from 1 July 2001<sup>41</sup>. Again it should be noted that AlintaGas has not over the

<sup>40</sup> See p.21 of The West Australian, Thursday 28 June 2001, advertisement under the heading “Electricity prices will not go up.”

<sup>41</sup> See p.43 of The West Australian, Saturday 30 June 2001, advertisement under the heading of “New AlintaGas Prices (inclusive of GST) Effective 1 July 2001”.

period from 1995 reduced tariffs. In fact as should be appreciated, sitting behind this announcement is a guaranteed escalation path of CPI + 2%. Hence it has been shown that these utilities do not pass on the benefits of the transmission tariff reductions to their tariff customers and at least in the case of AlintaGas, their tariffs will increase.

**Costs of regulation: drain on resources/the paper burden**

7.52 Epic Energy has been forced to devote significant resources and time to managing its regulatory risk with no benefit to its business. The “expenditure” can be categorised as follows:

- the time spent preparing substantial volumes of submissions to regulators;
- the costs in engaging consultants; and
- the devotion of management time on regulatory matters which would otherwise have been spent on developing its business.

7.53 These costs have been spent simply to protect the company’s legitimate business interests and proprietary rights.

7.54 In relation to the DBNGP regulatory process alone, there have been over 100 formal submissions made to the regulator by Epic Energy to date. This does not take into account the significant amount of correspondence entered into with the regulator.

7.55 If regulators were to have their way, this paper burden would become more onerous, as regulators are proposing that service providers be required to maintain regulatory accounts. It is noted that both the ACCC and the QCA are proposing to impose the collection of such information. Given that operating costs comprise such a relatively small proportion of the overall costs of transmission pipelines, Epic Energy questions what benefits are to be achieved from such a course of action.

7.56 In relation to the direct costs incurred in engaging consultants, in the case of the DBNGP process alone, these costs total almost \$2.5 million for a process that has lasted almost 4 years. In addition to this, Epic Energy has had to pay the regulator’s costs –which currently total \$2.5 million (although this does not include the \$800,000 that the regulator incurred in participating in the legal challenge of the DBNGP draft decision).

7.57 In relation to the time spent by management on regulatory matters, the cost of this “lost time” is not immediately quantifiable although the consequences of a lost development opportunity would be significant.



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**Costs of regulation: direct costs**

7.58 It is noted that the Ministerial Council on Energy, at its meeting on 1 August 2003 made the following announcement<sup>42</sup>:

*"To streamline and improve the quality of economic regulation across energy markets, lower the cost and complexity of regulation facing investors, enhance regulatory certainty and lower barriers to competition, the MCE recommends:*

- *Two new statutory commissions be established on 1 July 2004, funded by an industry levy:*
  - *Australian Energy Market Commission (AEMC), with responsibility for rule-making and market development;*
  - *Australian Energy Regulator (AER), with responsibility for market regulation.*
- *The new commissions initially be responsible for electricity wholesale and transmission in the connected (NEM) jurisdictions, extended in 2005 to include gas transmission for all other than WA (in accordance with the CoAG Natural Gas Pipeline Access Agreement of 1997). Provision to be made for WA and NT to join for electricity, and WA for gas under the AER, by agreement."*

7.59 There are a number of aspects relating to this announcement that will only give rise to further additional costs having to be incurred by service providers. As such, Epic Energy can not understand, at least in so far as the gas pipeline industry is concerned, how this proposal will "streamline and improve the quality of economic regulation across energy markets, lower the cost and complexity of regulation facing investors, enhance regulatory certainty and lower barriers to competition".

7.60 First, for transmission pipelines, the proposals actually serve to add a further layer of regulatory oversight with the proposed creation of the AEMC. In all jurisdictions other than Victoria, there is no "system planner", which is essentially what the AEMC's role appears to be. Given that state governments made a conscious decision in the 1990s to divest themselves of responsibility for owning and developing the gas pipeline infrastructure of the nation, and in doing so achieved significant benefits to the general public through the significant prices received for the sale of these assets, the proposal to implement a system planner can only be seen as a means of gaining control without taking on the financial responsibility. When the gas industry has already made its point about intrusive, inefficient and costly regulatory processes, this proposal will only serve as a further potential disincentive for future investment in pipeline infrastructure.

7.61 Second, the MCE claims that the proposals will "*lower the cost and complexity of regulation facing investors*".

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<sup>42</sup> Ministerial Council on Energy communiqué, Sydney, 1 August 2003.

- 7.62 A similar claim was made by the Western Australian government with its proposed multi industry regulator, the Economic Regulation Authority - one of the key justifications by WA Treasury for creating this multi industry regulator is that it will generate significant cost savings with the convergence of a number of separate regulatory bodies.
- 7.63 However, the legitimacy of such claims must seriously be called into question for the following reasons:
- at no stage, as far as Epic Energy is aware, has any cost/benefit analysis been carried out by governments to seek to prove this claim; and
  - furthermore, in one of the few democratic jurisdictions where a multi industry regulator has been established and operating for a measurable period – the United Kingdom’s Ofgem - an independent review of the efficiency of that regulator recommends against the establishment of such regulatory bodies for the very reason that they do not encourage cost savings.<sup>43</sup>
- 7.64 The third issue relates to the proposal that the costs of these regulatory bodies will be “funded by an industry levy”.
- 7.65 It must not be forgotten that the states and territories have already received significant funding from the Commonwealth to offset the costs they were to incur in the establishment of frameworks for the implementation of competition policy reforms in the gas industry – including the establishment of the institutions and processes relating to the implementation of the Gas Access Regime. It seems totally inconsistent that industry will soon be required to pay for these costs, particularly when there is general acknowledgement of the importance of energy to the general community.
- 7.66 Even if one were to ignore the past payments that, it would appear, have not been used by state governments for their intended purposes, Epic Energy sees that there are major potential problems with a regulatory regime where the functions of various institutions are funded by an industry levy. Epic Energy has direct experience with such a regime – the Western Australian version of the Gas Access Regime. This regime enables the WA regulator to recover his costs through a framework whereby service providers are required to pay for the performance and exercise of certain functions and powers of the various institutions (his charges are called standing and service charges). As mentioned earlier in this submission, while Epic Energy has recently been successful in its attempts to clarify the regulatory functions with respect to which service providers are required to fund, the regime that is in place has several adverse consequences which, if is used by the MCE as the template for all jurisdictions to adopt, will be fundamentally inconsistent with the objective of “*lower[ing] the cost and complexity of regulation facing investors*”.

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<sup>43</sup> WS Atkins Management Consultants, External Efficiency Review of Utility Regulators, Final Report, February 2001, page xii.

- 7.67 This is so for the following reasons.
- 7.68 First, regulators would be encouraged to use consultants to assist them in regulatory processes without any stakeholder having the ability to either challenge their engagement or be privy to the work. In the case of the WA regulator's assessment of the DBNGP access arrangement, this has given rise to over \$1.3 million in consultancy fees, from lawyers to economists to engineers. While the WA Supreme Court has gone some way to ensure that most of these costs will not be able to be passed on, the fact remains that regulators will continue to engage these consultants without appropriate checks and balances.
- 7.69 The disregard for costs incurred by regulators is not limited to the case of consultancy costs – it also potentially extends to the internal costs of regulators. In the case of the WA regulator, the costs of his office and that of the other institutions that have been established under the Gas Access Regime have increased significantly since they were first created in 1999. This is demonstrated by the table in **Attachment 3** which outlines the costs that have been imposed by service providers of WA covered pipelines through standing charges since the establishment of the funding regulations under the WA Gas Access Regime. These costs are additional to the direct costs of the regulator in undertaking assessments of access arrangements under the National Gas Code (which are recovered by way of service charges). In the case of Epic Energy, these costs now total over \$1,500,000.

## 8. The solution – light handed regulation

- 8.1 Epic Energy proposes the following solutions to the problems outlined in the previous sections of this submission. These solutions, Epic Energy believes, will:
- maintain consistency with the objectives of National Competition Policy; and
  - ensure that the policy settings of governments foster an environment that will give the best chance of achieving the objectives referred to in section 4.

### Proposed Third Party Access Frameworks

- 8.2 Epic Energy's proposal does not amount to a wholesale change to the existing Gas Access Regime. Epic Energy is of the view that much of the existing framework for third party access should be retained, but there should be a reassessment of the relative importance of the components of the regime. Following is Epic Energy's view of the access regime that should be implemented to reflect the policy objectives referred to earlier in this submission and to ensure that there are no disincentives to the further investment that is required.
- 8.3 Epic Energy notes that, in developing its thinking about the future of the Gas Access Regime, it has been working closely with the Australian Pipeline Industry Association. Epic Energy understands that the APIA's submission will be lodged shortly. Epic Energy's proposals in relation to a future access regime may be regarded as supplementing proposals put forward by the APIA.
- 8.4 **Attachment 4** provides a flow chart setting out Epic Energy's proposal.
- 8.5 The key features of Epic Energy's proposal are as follows. There should be no regulatory oversight in situations where the capacity being sold is new and tariffs are a product of market based negotiations, not only for new pipelines but also for the expansion of existing pipelines.
- 8.6 **Retention of a two part legislated access regime** – In the case of existing capacity, a two part legislated access regime must be maintained. However, while the National Gas Code and the National Access Regime both are two part access regimes, they are starkly different in their substance.
- 8.7 **Part One – Retention of a Declaration/Coverage test** - This entails the retention of a threshold "declaration/coverage" test consistent with the principles embodied in clause 6 of the Competition Principles Agreement, and as reflected in Part IIIA of the TPA.
- 8.8 To afford certainty to all pipeline service providers, and to existing and prospective shippers, all pipelines that are currently covered under the National Gas Code, should be assessed against the declaration/coverage test.

- 8.9 Those pipelines which are determined not to be declared/covered or stated not to be declared/covered would be so at the commencement of the new regime. This should properly reflect the historical context in which these pipelines were developed.
- 8.10 New pipelines would not be declared/covered. This is consistent with the Australian Competition Tribunal's ruling in the Eastern Gas Pipeline case that a regulatory regime should only be imposed if there is a *substantial* likelihood that it will promote access and competition.
- 8.11 This would mean that all new pipelines, all augmentations of existing pipelines (including extensions and expansions of existing pipelines), and existing pipelines where there has been no actual or constructive denial of the right of access (ie a demonstrated market failure) would not be required by law to submit to the legislated access regime.
- 8.12 The final decision on declaration/coverage must be made by a Minister, to ensure that any decision that is made is consistent with the policy objectives of the Competition Principles Agreement. An independent body such as the Productivity Commission should provide a recommendation to the Minister, but the Minister must be required to apply the test "de novo" and therefore the recommendation would not be binding on the Minister.
- 8.13 All declared pipelines are to be listed and are to remain declared/covered for a stated period. This will create additional certainty for all stakeholders.
- 8.14 Undeclared/uncovered pipelines will remain undeclared/uncovered for a stated period. In the case of new pipelines, this period must be consistent with the duration of the foundation contracts entered into for the construction of the pipeline.
- 8.15 **Part Two – Negotiate/Arbitrate access model** – a negotiate/arbitrate model along the lines of that in Part IIIA of the TPA should apply to gas transmission pipelines. This is consistent with the principles in clause 6 of the CPA and affords shippers a legislated and guaranteed right to access to a pipeline. It reflects the wholesale nature of the transmission pipeline industry.
- 8.16 The access regime should make it clear that negotiation is the first method of seeking access to gas pipelines.
- 8.17 In the event that a party can not successfully negotiate access within a reasonable period, that party should have a legislated right to refer the dispute to an arbitral body.
- 8.18 The arbitrator - The arbitrator should be a body structured along lines similar to the Australian Competition Tribunal. Epic Energy considers that having such a body would assist in a balanced approach being taken by the arbitrator.
- 8.19 Fundamental to perceptions of independence of the arbitrator, and to its ability to take a balanced approach, are the backgrounds and calibre of the persons appointed to it.

- 8.20 On that basis, the arbitrator should have at least the following features:
- at least three members actively involved in any arbitration at all time;
  - Those members must be able to be drawn from a panel that is sufficiently numerous to ensure that the panel members have a variety of disciplines but not so numerous that the quality of members is compromised.
  - Some of the members should be employed on a full time basis while others need only to be employed on a part time basis. At any time the body must be comprised of both part time and full time panellists.
  - Each member must have relevant industry experience (apart from regulatory or government experience) – say at least 10 years experience.
  - All panel members should be appointed for a specified tenure. To minimise the ability for politicising the appointments of panel members, it is also recommended that their appointments be staggered and the tenure of each member be for differing periods.
  - The panel to hear any issue must comprise of members with a balance of interests from service providers and shippers/prospective shippers.
  - Members of the panel should also have experience in a cross section of disciplines. Relevant disciplines include law, engineering, economics, finance and safety.
- 8.21 Any supporting administrative office that may be required must be part of the arbitral body itself, and not a separate entity as is the case in Western Australia with the Office of Gas Access Regulation. Epic Energy’s experience with the Office of Gas Access Regulation has shown that this separation of functions and powers has lead to a more protracted and inefficient decision making process, with the potential for communication breakdown between the final decision maker (the regulator) and staff. This must be avoided: members should be directly involved in all aspects of the arbitral process. Further direct support or previous connections with government departments has led to perceptions of a regulator’s lack of independence from government.
- 8.22 **The arbitration process** – in assessing any dispute in relation to a declared/covered pipeline, the arbitrator should be bound to assess the proposal that has given rise to the dispute against the factors and principles in clause 6(4)(i) of the CPA and, if relevant, other factors and principles so long as they are consistent with the clause 6(4)(i) principles. An example of such other factors exists in Part 8 of the *Petroleum Act (QLD) 1923*.
- 8.23 The arbitrator may have regard to the following additional factors:
- other contracts entered into for similar services; and

- any access principles that the service provider has developed and published, although it would be acknowledged that these are not automatically deemed to be an outworking of the clause 6(4)(i) principles.
- 8.24 The decision of the arbitrator will be binding on the parties to the dispute, subject to the review rights described below.
- 8.25 **Review of arbitrator’s decision** – if there is an arbitral body styled along the lines of the Australian Competition Tribunal, then there is only a need for judicial review of its decisions.
- 8.26 **Additional Legislative Requirements for Declared Pipelines – Shipper Protection Provisions** – in addition to the negotiate/arbitrate framework, the access regime should incorporate the following additional features to afford shippers greater protection to secure access and to minimise the potential for unnecessary arbitrations:
- The establishment of a register to contain details of:
    - all contracts entered into by the service provider of the declared/covered pipeline; and
    - any notices of an intention by a service provider to enter into an associate contract.

The register will be maintained by an independent body. While any notices relating to associate contracts will be publicly available, the remainder of the register will be confidential and only accessible by the arbitrator and the body making the decision on declaration/coverage for the purposes of determining the dispute or declaration application, as the case may be.

- The requirement to disclose information (such as information relating to system capacity, indicative tariffs, investigations to expand or extend the pipeline) that will form the basis of parties’ negotiations.
- The requirement to adhere to certain minimum behavioural standards. These would include the following:
  - The development and publication of access principles which must contain, as a minimum such policies as a tariff and service policy, queuing policy, extensions/expansions policy, minimum terms and conditions and a capacity management policy. There would be no requirement to have these principles approved as the arbitrator is not bound to apply them in the event of a dispute.
  - Ring fencing requirements similar to those in section 4 of the National Gas Code, at least in so far as they ensure confidentiality of information is not compromised.

- As an alternative to proceeding with an application for declaration/coverage, a service provider should also be afforded the right to elect whether to lodge an access undertaking similar to the procedure allowed under Part IIIA of the TPA. The undertaking would be assessed against the relevant CPA principles and would be binding upon an arbitrator in the event of a dispute. This would afford greater certainty to both shippers and the service provider.
- 8.27 **Approval of Associate Contracts** - All associate contracts in relation to both declared and non declared pipelines must be disclosed to an independent body (the arbitral body) for approval in accordance with the following principles:
- This obligation would only apply in relation to those non declared pipelines where the service provider has been required to prepare access principles.
  - All foundation associate contracts must be approved and measured against the clause 6(4)(i) CPA principles and any other foundation contracts.
- 8.28 **Retention of Parts 4, 4A and 5 of the TPA** – the retention of these provisions is essential as these are the appropriate customer protection and penal provisions in the event of anti-competitive conduct by a service provider.
- 8.29 **Voluntary Code of Conduct for Non Declared Pipelines** – In addition to the above minimum behavioural requirements that will apply to declared/covered pipelines, non declared pipelines commit to an industry “code of conduct” that ensures a high level of transparency and imposes minimum behavioural requirements on pipeline service providers.
- 8.30 Epic Energy notes that the APIA will outline the proposed code in more detail in its submission to the Commission. However, Epic Energy’s proposed Code of Conduct would contain the following features:
- A commitment to ring fencing requirements not dissimilar to those that apply to declared/covered pipelines.
  - A commitment for pipelines to be operated on an open access basis. This would involve responding in a timely manner to customers’ needs, publicising key information relating to the pipeline such as available capacity and services.
  - The public disclosure of voluntary access principles which detail such policies as indicative tariffs for benchmark services, minimum terms and conditions of access, queuing policy, extensions/expansions policy. While a pipeline could voluntarily disclose these principles, under the Code of Conduct, this obligation would only arise in the event that a prospective shipper has requested access to the pipeline. This ensures that any purpose built pipeline such as a lateral, is not required to incur unnecessary costs.
  - In the event that someone does request access to a non declared pipeline, the request is placed in the register referred to above.



- A commitment to lodge access principles to the register set up under the legislated access regime.
- A commitment to arbitration in the event that a dispute arises between the service provider and a prospective shipper. In such an arbitration, the access principles will act as the benchmark and foundation contracts will be irrelevant to the arbitrator's considerations.

8.31 **Funding** – given the benefits that are to accrue to the community, it is only appropriate that the costs of administering the regime are sourced from consolidated revenue.



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**Attachment 1**  
**Chronology of DBNGP Regulatory Approval Process**

DATE	EVENT
15/12/1999	Epic Energy lodges access arrangement and access arrangement information documentation
17/12/1999 to 17/3/2000	First public consultation period
	Deliberations by Regulator on confidentiality of certain submissions
20/4/2000 to 12/5/2000	Second public consultation period
	Regulator's deliberations
13/6/2000	Regulator grants 2 month extension of time to the 6 month approval period to allow it to complete the regulatory approval process
28/7/2000	Revised access arrangement information document lodged
11/8/2000	Regulator grants consecutive further 2 month extensions of time to allow him to complete the regulatory approval process
13/10/2000	
15/12/2000	
14/2/2001	
12/4/2001	
15/6/2001	
21/6/2001	
1/8/2001	Epic Energy notifies regulator of intention to commence legal action to challenge validity of draft decision
18/8/2001	Epic Energy commences legal action in WA Full Court
15/8/2001	Regulator grants further 2 month extension of time to allow him to complete the regulatory approval process



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<b>DATE</b>	<b>EVENT</b>
28/9/2001	Closure of public consultation period
15/10/2001	Regulator grants further 2 month extension of time to allow him to complete the regulatory approval process
21/11/2001 to 28/11/2001	Hearing of legal action in WA Full Court
14/12/2001	Regulator grants consecutive further 2 month extensions of time to allow him to complete the regulatory approval process
15/8/2002	
23/8/2002	Court Decision – Declarations proposed
5/9/2002	Regulator issues Information Paper seeking further submissions
14/10/2002 14/12/2002	Regulator grants consecutive further 2 month extensions of time to allow him to complete the regulatory approval process
14/12/2002	Further submissions lodged with regulator in response to court decision
14/12/2002 to 4/5/2003	Regulator's deliberations
4/5/2003	Regulator issues aspects of final decision to Epic Energy for comment
16/5/2003	Epic Energy provides submission to Regulator in response to final decision exerts
23/5/2003	Final Decision - to lodge revised AA by 4 July 2003
1/7/2003	Regulator grants an extension to lodge a revised access arrangement until 8 August 2003
8/8/2003	Revised Access Arrangement lodged by regulator
	Deliberations by Regulator

**Attachment 2**

**Summary of Regulator Funding Case**

The WA Regulator had attempted to require Epic Energy to pay, by way of service charges purportedly issued pursuant to the Gas Pipelines Access (Western Australia) (Funding) Regulations 2000, all of his costs incurred in his capacity as Regulator that were related (directly or otherwise) to his assessment of the access arrangement for the DBNGP. Epic Energy had persistently refused to pay at least his costs related to his participation in any challenges that stemmed from this assessment process. The budget for these costs is approximately \$800,000. Given that the Funding Regulations did not provide a mechanism to challenge or otherwise question the service charges but rather allowed the regulator to commence debt recovery proceedings for any amount unpaid, Epic Energy commenced an application in the WA Supreme Court seeking declarations concerning the proper interpretation of the Regulations.

On 18 August 2003, the Supreme Court of Western Australia delivered its judgement in relation to this challenge.

While a copy of the decision is publicly available, the key points from the decision are as follows:

- The Court declared that the Regulator could **not** recover by way of the Funding Regulations, the costs incurred in his participation in judicial review proceedings - either as a service charge or a standing charge. This includes the costs incurred in the proceedings and the draft decision legal challenge. The primary reason for this is that the Court had ultimate power to determine who bears the burden of such costs and the Regulator can not use the Funding Regulations as a means of sheeting home his costs to someone else via a statutory mechanism. In both court actions, the Court ruled that the Regulator should bear his own costs.
- The Court also declared that the Regulator may only impose service charges that pass on **reasonable** costs of a type which it was **reasonably** necessary or convenient for the Regulator to incur. This is probably the most significant aspect of the decision from a national perspective, particularly given that the Ministerial Council of Energy announced recently that it intends to implement a user pays system to fund regulatory agencies.
- This will require the regulator to not only be more circumspect about what costs he can pass on to pipeline owners but also what information he provides to justify these costs. Up until now, the Regulator has refused to provide that justification. This should require the regulator to be more transparent and accountable in relation to costs he seeks to pass on.

It is important to note that the Court did conclude that the Epic Energy did not succeed on its argument that the Funding Regulations were invalid as a whole or its other arguments requiring that standing charges only be imposed where the Regulator performed a function in respect of the relevant service provider during the relevant quarter. The court did also not accept the argument that the Funding Regulations did not permit full cost recovery by the Regulator, but there was also no finding that there was an intention to achieve full



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recovery of costs. Nonetheless, any costs that a regulator does seek to pass on can only be reasonably incurred by the Regulator.



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**Attachment 3**

**Table of standing charges imposed by WA Regulator 2000 - 2002**

Standing Charges							
Year	Pipeline and Relevant % share of Total Cost						
	18.12	3.31	5.35	20.31	3.91	49.00	100.00
	GGT	Kambalda	Parmelia	AGN	Origin	Epic	Total
<b>2000</b>							
1st Qtr	31,327	5,722	9,249	35,113	6,760	84,714	172,885
2nd Qtr	38,351	7,006	11,323	42,986	8,276	103,709	211,650
3rd Qtr	43,584	7,962	12,868	48,852	9,405	117,861	240,532
4th Qtr	43,028	7,860	12,704	48,228	9,285	116,355	237,459
	<b>156,290</b>	<b>28,550</b>	<b>46,145</b>	<b>175,179</b>	<b>33,725</b>	<b>422,638</b>	<b>862,526</b>
<b>2001</b>	-	-	-	-	-	-	
1st Qtr	41,864	7,647	12,360	46,923	9,033	113,207	231,035
2nd Qtr	49,333	9,012	14,566	55,296	10,645	133,407	272,259
3rd Qtr	50,770	9,274	14,990	56,906	10,955	137,292	280,187
4th Qtr	48,300	8,823	14,261	54,137	10,422	130,612	266,555
	<b>190,267</b>	<b>34,756</b>	<b>56,177</b>	<b>213,262</b>	<b>41,056</b>	<b>514,518</b>	<b>1,050,036</b>
<b>2002</b>	-	-	-	-	-	-	
1st Qtr	52,668	9,621	15,550	59,033	11,365	142,424	290,661
2nd Qtr	57,097	10,430	-	63,998	12,321	154,401	315,105
3rd Qtr	53,194	9,717	-	59,623	11,478	143,847	293,566
4th Qtr	56,387	9,892	-	63,295	11,706	149,801	305,598
	<b>219,346</b>	<b>39,660</b>	<b>15,550</b>	<b>245,949</b>	<b>46,870</b>	<b>590,474</b>	<b>1,204,930</b>



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**Proposed Negotiate Arbitrate flowchart**

See attached

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### Attachment 4

