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11 November 2002

Moomba to Sydney Pipeline – Proposed Access Arrangement

The Commission is currently reviewing East Australian Pipeline Ltd's (EAPL's) proposed access arrangement for the Moomba to Sydney Pipeline System (MSP). The Commission is now seeking comments on two issues relating to the MSP access arrangement.

Balancing arrangements

Firstly, the Commission is seeking comments from interested parties on amendments to the MSP balancing provisions which have been proposed by EAPL. Details of the proposed amendments and EAPL's explanation are set out in Attachment A to this letter.

Implications of the 'Epic decision'

Secondly, the Commission is seeking comments on the implications for the MSP access arrangement of the Western Australian Supreme Court decision in *Re Michael; Ex parte Epic Energy* in relation to Epic Energy's Dampier to Bunbury Natural Gas Pipeline (the Epic decision).

On 5 November 2002, EAPL made a submission to the Commission on this matter. According to EAPL, in light of the Epic decision, the Commission's Draft Decision on the MSP is fundamentally flawed, particularly in relation to the setting of the initial capital base (ICB). Therefore, EAPL considers that the Commission must undertake a complete reassessment of the ICB and, accordingly, the reference tariffs.

The Commission is now seeking the views of interested parties on EAPL's submission and the implications of the Epic Decision on the MSP access arrangement.

In its latest submission EAPL has proposed a value for the ICB of \$768m. This contrasts with the value originally proposed by EAPL in May 1999 (\$667m), the value proposed by EAPL in its revised access arrangement of April 2002 (\$740m) and the value proposed by the Commission in its Draft Decision of December 2000 (\$502m).

The proposed ICB contained in EAPL's submission, if accepted by the Commission, would have significant ramifications for reference tariffs on the MSP. Tariffs calculated on an ICB

of \$768m, as proposed by EAPL, would be \$0.66/GJ (equivalent to its current published tariff) for the Moomba to Wilton pipeline for the first year of the access arrangement period. The Commission's Draft Decision proposed a tariff for the first year of the access arrangement period of \$0.43/GJ.

In its submission, EAPL states:

... the Commission is required under the Epic Decision to take into account the matters set out in section 2.24 [of the Gas Code]. A consideration of those matters includes the service provider's legitimate business interests and investment in the pipeline. Those legitimate interests and investment indicate an ICB in the range of the value of the reasonable expectations under the prior regulatory regime at \$768m, to the residual economic value of the pipeline at \$1700m. The interests of users can be argued to be taken into account at residual economic value, but might be better served by avoiding price shocks, which would indicate an ICB set at the level of \$768m which would ensure that the price payable by users did not increase. The public interest in encouraging long term investment in gas infrastructure is also best served by recognising the legitimate interest of the service provider in retaining the benefit of the deal negotiated on privatisation of the pipeline.

The Code requires consideration of a number of valuation methodologies, which in the case of the MSP range up to \$1700m. The minimum value which would properly recognise the interests of EAPL as required under the Code while still recognising the interests of Users is the amount which represents the reasonable expectations of EAPL under the prior regulatory regime, being no less than \$768m (pp. 23-24)

Background

On 19 December 2000, the Commission released its Draft Decision in relation to the proposed access arrangement submitted by EAPL in May 1999.

In June 2001, EAPL approached the Commission requesting a postponement of its Final Decision pending the outcome of its application to the National Competition Council (NCC) for the revocation of coverage of part of the MSP. The Commission agreed to EAPL's request and advised EAPL at that time that it would review the arrangement in six months. Following the release of the NCC's Draft Recommendation in December 2001 that coverage of the MSP not be revoked the Commission advised EAPL that it would now proceed with its Final Decision.

EAPL submitted a revised access arrangement on 30 April 2002 and supporting access arrangement information on 20 June 2002. The Commission sought submissions on the revised access arrangement by 12 July 2002.

On 21 June 2001 the Western Australian Office of Gas Access Regulation (OFFGAR) issued its Draft Decision under the National Gas Code for the access arrangement for Epic Energy's Dampier to Bunbury Natural Gas Pipeline (DBNGP). In its Draft Decision, OFFGAR proposed an ICB of approximately \$1.234 billion. This contrasted with Epic's proposed ICB of \$2.407 billion. Epic sought judicial review of this Draft Decision in the WA Supreme Court. Epic's application for review was referred directly to the Court of Appeal.

The Court of Appeal handed down a unanimous decision on 23 August 2002. The Court held that OFFGAR's Draft Decision was affected by errors of law. The Court required Epic to rectify these errors in its final decision.

The Court did not quash OFFGAR's Draft Decision, however, it did expect that OFFGAR would allow Epic Energy and interested parties to make further submissions in light of the Court's ruling.

While the Epic decision relates specifically to OFFGAR's consideration of the DBNGP access arrangement, the decision may have broader implications as it represents the first judicial interpretation of the application of the National Gas Code.

In relation to the ICB, the Court found that 'the Regulator is required by s8.10 [of the Gas Code] to take into account factors (a) to (k) and to give weight to them as fundamental elements in his decision in establishing the initial Capital Base' (para 56). The Court also found that in determining the reference tariffs and reference tariff policy (including the value of the ICB), the regulator should apply the objectives in s. 8.1, and should be guided by the factors contained in s. 2.24 where the s. 8.1 objectives conflict or give discretion to the regulator.

Accordingly, the Commission is now seeking the views of interested parties on the implications for the MSP access arrangement of the Epic Decision and the veracity of EAPL's argument that the Commission's MSP Draft Decision is fundamentally flawed. The covering letter and submission, submitted by Australian Pipeline Trust (APT) on behalf of EAPL, are contained in Attachment B and include legal advice from KPMG Legal.

Key issues raised by EAPL

The key issues on which the Commission is seeking comment are set out in Attachment C. The list of issues is not meant to be exhaustive. Interested parties are encouraged to identify any other relevant issues raised in the EAPL submission that they consider relevant and provide comments for consideration by the Commission.

Copies of the Commission's Draft Decision, EAPL's revised access arrangement, EAPL's submission and other related documents can be downloaded from the Commission's website (<http://www.accc.gov.au> under 'Gas'). The Epic decision can be downloaded from OFFGAR's website (<http://www.offgar.wa.gov.au>)

Lodging a submission

Submissions should be lodged with the Commission by 2 December 2002. They should be in writing and, where possible, be supplied in electronic format compatible with Microsoft Windows XP/Office 2002. Electronic copies of submissions can be emailed to john.bastick@acc.gov.au. They will be made available and placed on public registers held by the Commission and the Code Registrar. Any information considered to be of a confidential nature should be clearly marked as such, and the reasons for seeking confidentiality should be provided. Under the terms of the Code, the Commission must not disclose such information unless it is of the opinion that disclosure would not be unduly harmful to the legitimate business interests of the service provider, a user or a prospective user. Submissions should be addressed to:

Mr Russell Phillips
Acting General Manager
Regulatory Affairs - Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Requests for copies of submissions

The Commission will endeavour to place all non-confidential submissions received on its website (www.accc.gov.au) as soon as possible. Requests for hard copies of submissions lodged by interested parties should be directed to Hema Berry at the Commission (phone 02 6243 1233, fax 02 6243 1199, e-mail hema.berry@acc.gov.au) or to the Code Registrar (phone 08 8226 5786, fax 08 8226 5866). While submissions may be inspected free of charge, a fee may be payable for hard copies.

Inquiries

Any inquiries on this matter should be directed to John Bastick (phone 02 6243 1364) or Suzie Copley (phone 02 6230 9112).

Yours sincerely

Russell Phillips
Acting General Manager
Regulatory Affairs – Gas

Attachment A: Proposed Amendment to the Revised Access Arrangement

Detailed explanation of the issues and revisions to proposed Balancing provisions (Attachment E) in the Revised Access Arrangement

EAPL's approach to gas balancing for the Moomba to Sydney Pipeline (MSP) is to apply a flexible, fair and responsive nominations and balancing regime, which places responsibility on all users, to operate in accordance within predetermined imbalance limits.

The markets served by the MSP are no different to markets served by other pipelines in south-east Australia in that there is a significant difference between summer and winter demand. In addition, there is a significant difference in demand on weekdays compared to weekends throughout the year.

There is intra-day and intra-week variability of upstream production and downstream demand, and the MSP, unlike other pipelines in south eastern Australia, is able to provide users a degree of flexibility by utilising available linepack to smooth out these variations. This flexibility is reflected in the Balancing provisions of the Revised Access Arrangement.

Such flexibility has considerable value to users during peak demand periods. During short term unplanned supply interruptions it provides the benefits of limited continuity of supply; however, this must be managed within reasonable limits to ensure the pipeline's operational integrity and safety.

The gas market in the SE corner of Australia is in the early stages of development. Until very recent times producer and shipper behaviour has been related to long term contracts for gas resulting in stable patterns of supply and demand. The Victorian wholesale gas market, operated by Vencorp, has been providing a basis for trading gas since 1998 and the Interconnect between the MSP and Gas Net Systems was completed soon after its implementation. However, it has only been in recent months that significant variations in traded gas prices have occurred, creating an environment in which producers and shippers have responded to prices based short term variations in supply and demand rather than to prices based on long term contracts .

In this new and developing market environment producers, shippers and retailers will seek to optimise their trading positions through utilisation of linepack in pipelines where it is possible. The level of exercise of linepack (drafting and packing) is becoming quite considerable and is having significant impacts on the levels of linepack to the point where the operational effectiveness (or efficiency) is reduced, and ultimately safe operation of the MSP may be threatened.

Consequently EAPL has identified that there is a requirement for new strong economic signals to sufficiently discipline users to balance their receipts and deliveries in both the short term in addition to those which currently deal with the need for long term balancing. EAPL believes the balancing procedures as proposed in the Revised Access Arrangement do not contain sufficient incentives for users to remain in balance, and thus EAPL may face unreasonable risks as a result.

Operational Issues

EAPL's greatest concern is that a significant pipeline imbalance contributed to by some shippers may result in the inability to maintain minimum delivery pressures under contract to all shippers.

In addition excessive imbalances may require EAPL to operate compressors more often and considerably less efficiently than would otherwise be the case. Although MSP users now provide their own compressor fuel for operations, this fuel is allocated pro-rata based on a shippers share of total deliveries, so one shipper's imbalances requiring greater use of compressors could causes all users' fuel costs to rise.

In consideration of the above points, amendments to the Balancing Procedures are proposed below.

ATTACHMENTE: BALANCING

Users will be responsible to control and, if necessary, adjust Nominations and vary receipts and deliveries of gas to ensure that each Day the quantity of gas:

- (a) received into the pipeline by or on behalf of the User, and
- (b) delivered to the User's Delivery Points to or on account of the User

is the same.

CALCULATION OF IMBALANCE

The User's Daily Imbalance equals Input minus Withdrawal minus Change in Quantity of the User's share of Users' Linepack.

Input

The User's Input will be one of three amounts:

- (a) Where there is only one User at the Receipt Point, the metered quantity at the Receipt Point is the User's Input.
- (b) Where there is more than one User at the Receipt Point, the metered quantity must be allocated to each User in accordance with the allocation methodology agreed by all Users or, if the Users fail to agree, then such methodology as EAPL reasonably determines (such as pro-rata based on Nominations).
- (c) Where a User trades a Daily Imbalance with another User, the Input will be adjusted in accordance with the traded amount.

Withdrawal

The User's Withdrawal will be one of two amounts:

- (a) The Withdrawals will be the total quantity of gas measured on the Day at all of the User's Delivery Points.
- (b) Where there is more than one User at a Delivery Point, the metered quantity will be allocated to each User in accordance with the methodology agreed by all Users or, if the Users fail to agree on a methodology, such methodology as EAPL reasonably determines (such as pro-rata based on nominations).

Change in Quantity of Linepack

EAPL will determine for each User a Target Linepack from time to time – that is the share of the Users' Linepack to be provided and maintained by the User.

The change in Quantity of the User's share of Users' Linepack equals User's Target Linepack for the Day minus the User's actual Linepack at the end of the previous Day¹.

Consequence of Imbalance

Where an Imbalance exists, there are the following consequences:

Operational

- 1 If an Imbalance is likely to jeopardise the ability of EAPL to comply with the requirements of any Transportation Agreement or to operate the pipeline properly, EAPL may require the User to correct the Imbalance as soon as possible.
- 2 If the User fails to correct or to take reasonable action to correct the Imbalance within four Hours of receipt of the notice, EAPL may without liability to the User, reduce the quantities of gas received, transported and delivered to or on behalf of the User or purchase a quantity of gas to correct the User's Imbalance, to and only to the extent necessary to enable EAPL to comply with those requirements or to operate the pipeline in a safe and efficient manner.

Obligation to rectify

In addition to the above consequences:

For Users with an aggregate Receipt Point MDQ greater than or equal to 50TJ the User's Imbalance Limit will be equal to +/- 10% of the User's aggregate Receipt Point MDQ. For Users with an aggregate Receipt Point MDQ less than 50TJ the User's Imbalance Limit will be equal to +/- 5TJ.

- 1 If on any Day the User's Imbalance exceeds the User's Imbalance Limit the User must adjust its receipts and deliveries to reduce the Imbalance to within the Imbalance Limit by the end of the following Day.
- 2 Where a Imbalance is not reduced to within the Imbalance Limit by the end of the following Day:
 - (a) EAPL may apply a Short Term Imbalance Charge equal to \$0.50 for each GJ in excess of the Imbalance Limit for that Day and each Day thereafter until the Imbalance is reduced to within the Imbalance Limit; and,
 - (b) if the User's Imbalance is in excess of the Imbalance Limit for four consecutive Days, EAPL may purchase gas to correct a User's negative Imbalance, and the User will be liable for a charge equal to 150% of the actual purchase price of the gas.

¹ This means that on Day(t), the Imbalance is: $\text{Input}(t) - \text{Withdrawals}(t) - (\text{Target}(t) - \text{Actual}(t-1))$. The actual value of $(\text{Target}(t) - \text{Actual}(t-1))$ - ie. a positive value or negative value as the case may be - is applied to the formula.

- 3 From time to time EAPL, may
 - (a) reduce the Short Term Imbalance Charge, and/or
 - (b) increase the Imbalance Limit

and will notify all Users in writing of any such changes and the period for which they apply.

For any User;

- 4 If a Imbalance exists on the last Day of a Month (M1), the User must endeavour to reverse the Imbalance during the subsequent Month (M2) by making adjustments in receipts and/or deliveries. If on any Day during M2 the User reverses the Imbalance, then the Imbalance for M1 will be deemed to be corrected (ie. a positive Imbalance at the end of M1 will be corrected by a negative Imbalance on any Day during M2 and vice versa).
- 5 If a User fails to correct the Imbalance during M2, EAPL may adjust the User's receipts and deliveries over the next Month (M3) to correct that Imbalance.
- 6 Where on the last Day of M3 an Imbalance remains, EAPL may:
 - (a) charge the User a Long Term Imbalance Charge calculated by multiplying the Imbalance existing on the last Day of M3 by the Imbalance Rate; and/or
 - (b) in the case of a negative Imbalance, correct the Imbalance by purchasing gas at the Receipt Point and charging the User 150% of the amount paid by EAPL for that gas (which will be treated as gas supplied by the User at the Receipt Point). EAPL will notify the User promptly after it corrects an Imbalance in this manner.

Procedures Relating to Trading of Imbalance Quantities

The User may during M2² trade gas with other Users so as to reduce or eliminate any Cumulative Imbalance they would otherwise have, provided that:

- 1 the gas traded relates to the same Month for both parties; and
- 2 neither User subject to, and as a result of, a trade may exceed the Imbalance Limit for that User; and
- 3 the parties to the trade must both advise EAPL of the identity of the buyer and seller, the period to which the trade relates, and the quantity traded no later than the last Day of M2.

² The requirement that the trade occur in M2 relates only to the User having a continuing Imbalance from M1 which it wishes to reduce or eliminate by trading.

Attachment B: EAPL's submission

(see separate documents – covering letter from APT, EAPL's submission 5 November 2002, and legal advice from KPMG)

Attachment C: Key issues raised by EAPL concerning the Epic Decision

EAPL's reasonable expectations, legitimate business interests and investment in the MSP

EAPL states that the Commission did not adequately take into account EAPL's reasonable expectations under the regulatory regime that applied prior to the commencement of the Code (s. 8.10 (g) of the Code). In its submission, EAPL states:

The reasonable expectations of EAPL under the prior regulatory regime formed part of the agreement negotiated between EAPL and the Commonwealth Government in privatizing the MSP. The circumstances of the purchase of the MSP (set out in section 3.5) included the establishment of a regulatory regime specific to the MSP, which underpinned the reasonable expectations of EAPL at no less than \$768m (p. 11).

EAPL further submits that its reasonable expectations are represented by a value of the ICB between \$768-\$972m (\$972m being EAPL's value for depreciated optimised replacement cost (DORC)) (p. 11).

EAPL also states that the Commission did not adequately take into account EAPL's legitimate business interests.

EAPL states:

In the case of the MSP, the investment decision was made on the basis of the regulatory regime established under the MSP Act, and any ICB which did not reflect the deal which was reached between the Government and EAPL at that time, including the reasonable expectations under that regime, would distort the basis on which that investment had been made (p. 20).

It is submitted that, in the context of the controversial privatisation of the MSP which included the establishment of a regulatory framework, the legitimate business interests of EAPL in the MSP are represented at the very least by its reasonable expectations under that regime – that is, no less than \$768m. That figure represents the value to EAPL of the deal, which included both the purchase price and the establishment of a regulatory regime specific to the MSP (p. 21).

Indeed, to establish an ICB at any lesser valuation is to retrospectively confiscate the benefit to EAPL of the deal attained in the privatisation process, a confiscation directly in contrast to the view held by the Court in the Epic Decision (p. 21).

Are you aware of any factors that support EAPL's statements that its reasonable expectations (s. 8.10(g) of the Code) and legitimate interests (s. 2.24(a)) are represented by a value for the ICB of at least \$768m ?

Given this knowledge, what weight should be given to EAPL's statement that its reasonable expectations and legitimate business interests are represented by a value for the ICB of \$768m?

Residual economic value

EAPL has calculated the residual economic value of the MSP at \$1700m (which updates the \$1291m calculated by the Commission in its Draft Decision based on a commercial rate of return). EAPL states:

... EAPL submits that the residual economic value of \$1700m should be taken into account in determining the ICB (p. 12)

EAPL also states that its legitimate business interests ‘may also be properly viewed as the recovery of the residual economic value of \$1700m.’ (p. 21)

What weight should be given to EAPL’s statement that its legitimate business interests may also be properly viewed as the recovery of the residual economic value of \$1700m?

NPV DORC

EAPL has proposed a DORC value of \$972m in accordance with the net present value methodology (NPV DORC) advocated by Agility on behalf of EAPL. EAPL states:

Based on the economic principles expounded by the Commission for the calculation of DORC, now strongly supported in the Epic Decision, it is the submission of Agility and the conclusion of King that the NPV DORC is the only correct definition of DORC (p. 14).

EAPL further states:

It is submitted that the expert evidence supports the contention that the NPV DORC is the proper definition of DORC within the established economic meaning of the term. The NPV DORC value is \$972m (p. 15).

Do you support the approach for constructing DORC (s. 8.10(b) of the Code) from ORC advocated by Agility as the most appropriate methodology for determining the value of DORC? Has the Epic decision changed your views?

APT purchase of the MSP

EAPL states:

... EAPL submits that the value determined by the price paid by APT for the shares in EAPL of [REDACTED] should be taken into account in determining the ICB (p. 16).³

What weight should be given to the price paid by APT (s. 8.10(c) of the Code) for the MSP at the time of the float in June 2000 in setting the value of the ICB?

Setting a value outside the DAC/DORC range

The Code provides that the value of the ICB should **normally** fall between the values of depreciated actual cost (DAC) and DORC (s. 8.11). Hence there is scope for a value of the ICB outside this range if circumstances warrant it.

In the Epic decision, the Court said:

In my view, s 8.11 is to be accepted for what it says, rather than seeking by implication to read much more into it. The expert evidence indicates that when the nature of the DAC and DORC valuation

³ The actual price paid is confidential.

methodologies is understood, it can be accepted that, normally, the value of an existing pipeline would fall within that range of values. In a case, however, where there has been an acquisition of a pipeline on the open market before the commencement of the Code, that circumstance may take the application of s 8.10 outside of what is normal within the meaning of s 8.11, because a sale at market value may well involve the capitalisation of some monopoly returns. These will have been paid to the original owner by the new purchaser. While economic theory would turn its face against such a market value, a sale in these circumstances introduces, as an additional factor, the legitimate investment and business interests of the new purchaser which, at the time of the commencement of the Code, is the service provider. Economic theory aside, this investment has social, political and public interest dimensions and it is not a surprising circumstance that the Act and the Code should seek to accommodate them (para 178).

At least in cases where an investment in a pipeline before the Code applied is made in the course of an arm's-length commercial transaction, and is based on a sound commercial assessment of the value of the pipeline in the circumstances then prevailing and anticipated, it is not apparent from the terms of the Act and the Code that the intention is, automatically and necessarily, to preclude consideration of the investment, or the interests of the service provider in recovering it together with a reasonable return, or the reasonable expectations under the preceding regulatory regime of such a service provider ... (para 179).

EAPL states:

... the reasonable expectations of EAPL under the regulatory regime created by the Government in the context of a controversial privatisation process, and the residual economic value of the pipeline purchased in those conditions, are ample justification for the determination of an ICB which departs from the “normal” maximum of DORC in section 8.11 (p. 18).

Do circumstances warrant a value outside the DAC/DORC range (s. 8.11 of the Code) in the case of the MSP?

Firm and binding contractual obligations

EAPL states:

It is a legitimate business interest of existing contracted users that the ICB does not result in tariffs falling below the tariff payable under the existing contractual obligations, since the contracted users having taken risk and contracted to support the pipeline could be disadvantaged in competition with new users at lower prices (p. 21)

Is it a legitimate business interest of existing contracted users (s. 2.24(f) of the Code) that reference tariffs should not be set at a lower rate than tariffs under existing contracts?

Public interest

EAPL states:

The public interest includes the interest in encouraging and securing long term investment in pipelines in Australia, so that competition in markets can eventuate. Such interest is reasonably served by setting an ICB and resultant tariff which recognises the basis on which the investment decision was made prior to the Code, rather than placing greater emphasis on the interest in lower prices (p. 22).

The Court in the Epic Decision noted that the “expert evidence, including the supportive expert writings, suggested a growing awareness of the long term disadvantages of striking the balance with too great an emphasis on the interest of consumers in securing lower prices, and without due regard to the interest of the service provider in recovering both higher prices and its investment.” (p. 22).

It is submitted that the public interest is served by an ICB of \$768m (p. 22).

What effect would setting the value of the ICB at \$768m have on the public interest (s. 2.24 of the Code), and on long term investment in the pipeline industry (s. 8.1(d))? Likewise, what effect would setting the value of the ICB at a value higher/lower than \$768m have?

Interest of users and prospective users

EAPL states that if the value of the ICB is set at the residual economic value of \$1700m, users are no worse off (in the sense that at this value users would still be paying only once for the pipeline). EAPL states, however:

Users might legitimately argue that the price shock which would be inherent in such an ICB would not adequately take into account their interests. However, an ICB set at the value of the reasonable expectation under the prior regulatory regime, being \$768m, does not involve such price shocks, since the tariff at commencement of the Access Arrangement would not alter from existing tariffs. Accordingly, it is submitted that an ICB of \$768m properly takes into account the interests of users (p. 22).

Are the interests of users and prospective users (s. 2.24(f) of the Code) represented by a value for the ICB of \$768m?