Epic in Retrospect and Prospect

HENRY ERGAS[1]

1 Introduction

The purpose of this note is to provide a summary of the recent decision of the Supreme Court of Western Australia in *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 ("*Epic*") decision and Offgar's recent final decision on the Dampier to Bunbury gas pipelines, and to draw out some of the key regulatory implications of those decisions.

2 The WA Supreme Court Epic decision

2.1 Facts

The owner (Epic Energy (WA) Nominees Pty Ltd) and operator (Epic Energy (WA) Transmission Pty Ltd) of the DBNGP sought, amongst other things, to set aside the draft decision dated 21 June 2001 of the Independent Gas Pipelines Access Regulator in Western Australia (the Regulator) in respect of proposed access arrangements for use of the DBNGP by third parties.

The key issue related to the draft determination of the reference tariffs that would govern the price charged by Epic for the service of transmitting natural gas for third parties utilising the DBNGP; in particular, the Regulator's proposal to adopt an ICB of approximately $1.234 billion.

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[1] I provided
Expert Evidence on behalf of Alinta Gas in the Epic proceedings, but the views expressed here are entirely my own, as is responsibility for any errors.

The owner of the DBNGP had purchased the pipeline at a price of approximately $2.407 billion in March 1998. Prior to the sale of the DBNGP, the pipeline had been publicly owned by the Gas Corporation of the State of Western Australia pursuant to the Gas Corporation Act 1994 (WA). The sale of the DBNGP was by competitive public tender conducted in accordance with the Dampier to Bunbury Pipeline Act 1997 (WA) (the DBNGP Act), which dealt expressly with the process for the sale and provided for an interim third party access regime for the DBNGP.

The DBNGP Act provided for an interim third party access regime for the DBNGP (that access regime being essentially the same as had applied to the pipeline under the Gas Corporation Act 1994 (WA)). Access contracts which had already been entered into under the latter Act were preserved (the interests of the State being transferred to Epic on the sale). Under the interim regime, the existing access arrangements were taken to be approved Access Arrangements under the National Third Party Access Code for Natural Gas Pipeline Systems (the "Code") until 1 January 2000. Epic was required, however, to submit a proposed Access Arrangement to the Regulator for approval under the Code.

It is the draft decision of the Regulator in respect of Epic's proposed Access Arrangement that is the subject of the *Epic* decision. Briefly, Epic contended that, in proposing to adopt an ICB of approximately $1.234 billion, rather than the price Epic had paid for the DBNGP, the Regulator had misconstrued the Code. The DBNGP Act provides for the existing access arrangements to continue as a transitional access scheme until Epic's proposed Access Arrangement under the Code is approved.

2.2 Court's findings

The *Epic* case involved judicial review of the Regulator's decision – Epic's objective was for the Court to make a finding that the Regulator erred in law by ignoring Epic's investment in the pipeline when making his decision under the Code. In other words, Epic did not seek the Court to assess the merits of the Regulator's decision – the appeal was confined to a question of law as to how the Code should be construed and applied.

In granting relief to Epic, the Court required the Regulator to reconsider his decision and that in effect the price paid by Epic for the pipeline was a matter which the Regulator had to consider in the context of his decision about access charges for the use of the pipeline. However, in making this decision, the Court also emphasised the necessity of the Regulator's discretion under the Code to reconcile conflicting objectives. Accordingly, there remains

considerable uncertainty as to the full implications of the decision – an issue that may well be tested in the future following the Regulator's reconsideration of the matter.

The Court's decision covered a number of issues, including the interrelationships between various provisions of the Code. However, the conclusions with regard to the following issues are most relevant for regulatory purposes:

- Epic's "legitimate business interests and investment" in the DBNGP;
- the nature of the competitive test against which the regulatory process should be assessed;
- what constitutes the "efficient costs" that may be recovered through a stream of revenue;
- the objective of not distorting investment decisions in Pipeline transportation systems or in upstream or downstream industries;
- the relevance of whether the price paid by Epic for the DBNGP represented a sound commercial assessment of the value of the pipeline in the circumstances that prevailed at the time of the purchase and which were then reasonably anticipated.

2.2.1 "Legitimate business interests and investment"

The Court found that Epic's "legitimate business interests and investment"[2] in the DBNGP (the investment being the full purchase price for the DBNGP of $2.407 billion) ***might*** properly extend to the recovery of that $2.407 billion, at least over the expected life or operation of the DBNGP, together with an appropriate return on investment.

The Court also found that there was no support under the Gas Pipelines Access (Western Australia) Act 1998 (the "Act") or the Code for the view that the recovery of monopoly prices or tariffs – that is, above the level of economically efficient prices – should be seen as being contrary to the "legitimate business interests" of the owner (as opposed to, for example, a

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2 Referred to in section 2.24(a) of the Code.

breach of the Trade Practices Act).[3] In other words, insofar earning such a profit was required to secure a reasonable return on its investment, it was not inconsistent with the pursuit of the pipeline owner's legitimate business interests for it to recover monopoly profit in the circumstances of the case.

2.2.2 Relevant competitive threshold

The Court emphasised that the appropriate competitive benchmark to be applied for regulatory purposes was that of "workable competition" rather than the model of perfect contestability that has historically been adopted by regulatory authorities:[4]

> As such, a workably competitive market will react over time and according to the nature and degree of various forces that are happening within the market. There may well be a degree of tolerance of changing pressures or unusual circumstances before there is a market reaction. The expert evidence and writings tendered in evidence suggest that a workably competitive market may well tolerate a degree of market power, even over a prolonged period. The underlying theory and expectation of economists, however, is that with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency.

As the Court notes, while prices in workably competitive markets may tend towards costs, they can remain above costs for some, potentially lengthy, period of time. This is especially so when one supplier has an efficiency advantage over others (be it in terms of requiring lower resource costs to supply a given grade of service, or of being able to provide a higher grade of service at the same resource cost), in which case it can expect to retain the resulting supra-normal earnings for as long as that efficiency differential persists.

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3 *Epic*, paragraphs 130 – 131.

4 *Epic*, paragraph 128.

2.2.3 "Efficient costs"

The Code provides that access prices should seek to achieve the objective of providing the Service Provider with the opportunity to earn a stream of revenue that recovers the "efficient costs" of delivering the Reference Service over the expected life of the assets used in delivering that Service.[5]

The Court took the view that the word "efficient" was being used in an economic sense, rather than its ordinary English meaning, and to import the concept of economic efficiency to costs in the context of infrastructure regulation. Thus, "efficient costs" was a construct of the relevant economic concept of efficient, together with the ordinary notion of costs. However, the Court found that at the relevant time for the consideration of the case (December 1997) the term "efficient costs" did not have a generally accepted meaning (although the Court also acknowledged that understanding of that phrase has since increased).

The Court's determination on the meaning of efficient costs was that there was some support in economic theory for the view that only forward looking costs should be considered so that the past purchase price could be ignored. However, the Court took the view that the application of "efficient costs" to the circumstances of the DBNGP was a matter for the Regulator.[6]

In summary, the Court's interpretation of "efficient costs" was not entirely clear other than it was a matter for the Regulator and that the assessment was not a precise process. One is left with the impression that the Court did not consider the Code's provisions in relation to efficient costs to be an impediment to Epic earning a stream of revenue over the life of the

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[5] Section 8.1(a).

[6] *Epic*, paragraph 141. The Court went on to find that the construction of the Code was such that there was no cap on prices based upon the recovery of efficient costs as had been argued. The Court noted that section 8.1(a) does not provide that the service provider should recover the efficient cost of delivering the Reference Service; rather, the objective is that the service provider should be provided with the "opportunity" to earn a "stream of revenue" (which is not the defined term "Total Revenue" as used in sections 8.2(a) and 8.4 of the Code) that recovers the efficient costs over the expected life of the assets used.

investment that was consistent with its purchase price assuming that purchase was consistent with the standards of reasonable commercial judgment (an issue which will be considered later). To a large extent, therefore it appears that the Court's primary concern was in relation to the distortion of investment decisions.

2.2.4 Distortion of investment decisions

The Code provides that access charges should be designed with a view to achieving the objective of not distorting investment decisions in pipeline transportation systems or in upstream and downstream industries.[7]

The Court rejected the argument that this objective would be realised by allowing the (forward looking) efficient costs of providing the service to be recovered over time as it would fail to recognise that:

> "a reference tariff which is based only on a cheaper present replacement value, and which has no regard to the actual unrecovered capital investment in the pipeline, may well undermine the viability of the earlier investment decision. If future investment in significant infrastructure, such as a natural gas pipeline, is to be maintained and encouraged, as the public interest requires, regard seems to be required to the need for both existing and potential investors to have confidence that the very substantial long term investment decisions which are required, and which were sound when judged by the commercial circumstances existing at the time of the investment, are not rendered loss-making, or do not result in liquidation, by virtue of future governmental intervention."[8]

The Court recognised that there was general acceptance in economic theory that economic efficiency required that actual past investment decisions be ignored (in part because they may have been based on an expectation of recovering monopoly profits).[9] However, the

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[7] Section 8.1(d).

[8] *Epic*, paragraph 149.

[9] However, it is submitted that the view expressed by the Court on this issue – in order not to have distorted investment decisions, the key issue revolves around whether the sale price

Court recognised that such an approach could be contrary to the public interest in the long term because it would discourage future investment.

The Court took the view that this potential adverse effect was addressed expressly under the Code by not denying the potential relevance of past investment decisions "to reflect a public interest broader than the mere understanding of economic theory, by taking account of wider political and social considerations".

The Court considered that it would be consistent with the objective of not distorting investment decisions if the Regulator, in an appropriate case, were to accept or to take into account the actual investment of the owner in a Covered Pipeline which existed at the time the Act and Code came into force, when establishing the ICB.

According to the Court, "this is not to suggest that reckless, mistaken or highly speculative investment decisions should be accepted for this purpose … it would appear that the outcome under the Code of an investment decision in a pipeline made before the introduction of the Code, even though that decision anticipated some "monopoly" profits, would not be irrelevant to the Regulator's deliberations".[10]

The Court commented that:

> "the reasons of the Regulator in the draft decision reveal that he was well alert to another relevant aspect of the operation of the first limb of section 8.1(d). Future investment decisions in pipelines might well be distorted were it the case that *any* price paid by a service provider to acquire a

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was sufficient to provide its previous owner (ie the Government) with an adequate return on its investment (ie the original cost of construction, having regard to both the riskiness of the investment and the revenue earned during the period the Government owned the pipeline). Any price above this amount would simply have been a transfer between Epic and the Government – a transfer which, if recognised in future pricing outcomes, would only tend to distort investment decisions in favour of the construction of monopoly transmission assets in the future.

10 *Epic*, paragraph 154.

> pipeline, no matter how uncommercial, mistaken or reckless, should automatically be recognised as the initial Capital Base or value of the pipeline for the purposes of the Code. This would encourage the payment of excessive and unrealistic prices to acquire a pipeline in the expectation that the purchase price would be able to be recovered over the life of the pipeline under the Code. It follows that a price paid for a pipeline before the Code applied to it, will need to be carefully evaluated by the Regulator for the purposes of s 8.1(d)."[11]

2.2.5 Setting of initial Capital Base

The Code requires that the ICB should normally fall between depreciated actual cost (DAC) and depreciated optimised replacement cost (DORC) – which would tend to suggest that the DORC valuation is the highest valuation that would be adopted under the Code.[12] However, the Code also provides that a relevant consideration for establishing the ICB is the price paid for any asset recently purchased and the circumstances of that purchase.[13]

The Court concluded that, given the time-lines appropriate to the service life of natural gas pipelines, it was open to the Regulator to regard the purchase of the DBNGP in March 1998 as one which was made "recently". Hence the Court was content that the circumstances of the purchase (occurring as it did before the commencement of the Code) was sufficient to justify departing from the Code's "normal" range of asset values being between DAC and DORC.

In this regard, the Court recognised that the sale at market value may well involve the capitalisation of monopoly returns and that in such circumstances the recognition of such an investment by a purchaser had "social, political and public interest dimensions" particularly as the sale occurred before the Code applied.

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[11] *Epic*, paragraph 155.

[12] Section 8.11.

[13] Section 8.10(j).

The Court therefore concluded:

> 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. The interests of such a service provider may well be in tension with other considerations, but it is not apparent that their exclusion is intended by the Act and the Code. … In some cases, at least, to exclude such interests would infringe seriously on established and legitimate rights, interests and expectations.[14]

Hence a material consideration in the process was the reasonableness of the price paid by Epic to which we now turn.

2.2.6 Reasonableness of price paid by Epic

On the basis of the Court's findings discussed above, a relevant consideration became whether the price paid by Epic for the DBNGP represented a sound commercial assessment of the value of the pipeline in the circumstances that prevailed at the time of the purchase and which were then reasonably anticipated, or reflected the reasonable expectations of Epic under the regulatory regime that applied to the DBNGP prior to the commencement of the Code.

The conclusions reached by the Court of greatest relevance for regulatory purposes were that:

- the mere fact that it was a price paid at public tender was not necessarily determinative, as Epic may have erred in its assessment of value, had unreasonable expectations or had reason to pay higher than true market value; and

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[14] *Epic*, paragraphs 178 and 179.

- it was not for the Court to attempt to evaluate or decide whether the price paid represented market value for the DBNGP; rather, that was a matter for Epic to justify to the Regulator.

2.3 Commentary

The *Epic* decision, as the first decision by a court pertaining to the interpretation of the Code, is clearly an important decision of itself and in guiding future decisions under the Code by regulators, arbitrators and courts.

The Court appears to have been struggling between conflicting forces. On the one hand, the Code clearly emphasizes efficient costs, which seems to point to the relevance of forward-looking considerations. On the other, the Court gave substantial weight to the legitimate commercial interests of a service provider, to the promotion of investment more generally, and to the relevance of workable, rather than perfect, competition as the appropriate benchmark. These seem to point towards a notion of maintaining intact the financial capital investors have devoted to the enterprise, so long as that investment was prudent in the circumstances of the time.

The Court seemingly resolved this tension through its finding that economic theory and analysis, whilst important in several respects, was not determinative of the relevant issues considered in the case. Rather, these should be considered in conjunction with the relevant social, political and public interest circumstances. This clearly opens the way for a very broad range of arguments to be made on the issues that need to be assessed under the Code, and potentially other regulatory processes, including what constitutes the legitimate commercial interests of a service provider, as well as in the determination of the methodology for determining the initial Capital Base.

Having thus opened out the range of relevant considerations, the Court ultimately referred the matter back to the Regulator for re-decision.

Instead of thus broadening the range of relevant considerations – which effectively **increases** the discretion vested in the Regulator – the Court could have taken a more economic perspective. More specifically, it is not correct that the economic approach to costing treats

prior decisions as irrelevant – rather, as has been emphasized by James Buchanan, a Nobel Laureate in economics, past choice is irrelevant to current valuation "excepting insofar as the experience may modify choice alternatives in the future."[15] In other words, as future expectations are framed by the contrast between current outcomes and past expectations, yesterday's decisions (and the expectations on which they are based) cannot be ignored in considering the effects of the decisions being made today. It seems to be this concept, which goes to the credibility of commitments and hence the encouragement of investment, that the Court was seeking to articulate.[16]

This concept leads to an emphasis on *ex ante* financial capital maintenance – that is, that investors should have a reasonable expectation of recouping the costs involved in the prudent provision of assets. So long as this condition is met for outlays efficiently incurred, then investment will be appropriately encouraged.

Focussing on this test would have helped the Court avoid a confusion into which it may have stumbled when it argued that the promotion of efficient investment involves ensuring that investors can expect to recoup the amount they expended to acquire assets (see 2.2.4 above). While there are circumstances in which this may be the case, the proposition fails to distinguish between costs and transfers.[17] Promoting efficient investment requires that a reasonable expectation that the costs incurred so as to efficiently provide assets will be

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15 James Buchanan (1969) Cost and Choice: An Inquiry in Economic Theory, Markham: Chicago, at page 48.

16 See again *Epic*, paragraph 149.

17 In economic terms, cost is the amount society foregoes when it chooses one option rather than another – or more precisely, it is the value in the most highly alternative use of the resources that must be withdrawn from other purposes as a result of choosing that option. For example, when the West Australian Government built the pipeline at issue, it thereby consumed resources that could not be used for other purposes. In contrast, transfers are amounts that are reallocated between economic agents without altering the total consumption available to society as a whole. Thus, the amount that was paid to the Government for the pipeline in excess of the value of the resources providing the pipeline entailed was a transfer.

provided; it is does not require coverage of any transfers over and above those costs. To the extent to which the payment Epic made for the pipeline involved transfers, whether or not those transfers would be forthcoming would not affect the decision to build the pipeline, so long as the costs building the pipeline entailed would still be covered.

In short, the Court sought to deal with the conflict between a forward-looking approach to costing and the need to protect the legitimate expectations of investors by widening the scope of matters relevant to the Code. It could have resolved the tension more readily by reference to the importance of expectational financial capital maintenance in securing the commitment of investment resources. This would have tended to limit, rather than further increasing, the discretion and uncertainty regulation involves.

3 Offgar's final decision

On 23 May 2003 Offgar issued its final decision on DBNGP. The key aspect of this decision is a revision in the regulated asset base applying in December 1999 to $1.55 billion rather than the $1.234 billion originally proposed in the draft decision. This revised asset value still represents a significant discount on the $2.407 billion paid by Epic for the pipeline.

The regulator estimated that adoption of an initial capital base of $1.55 billion as of 31 December 1999 produced a net present value of total revenue (with a discount rate equal to real pre-tax rate of return of 7.4%) of $768.53 million as of 31 December 1999[18], and that the average tariffs that would result from this revenue stream would be approximately $0.95/GJ as at 1 January 2000 and $1.01/GJ as at 1 January 2003.

The regulator's approach to addressing the concept of workable competition involved giving consideration to the purchase price paid by Epic Energy "with a view to ensuring that the determination of the Capital Base ... will not so prejudice the interests of Epic Energy that others will be reluctant to invest in a pipeline".[19]

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[18] Note that this is equivalent to $946.66 million (non discounted) and is based on an asset value of $1.55 billion (i.e. including stage 3A enhancement).

[19] Para 137.

In assessing the initial capital base against section 2.24 of the Code,[20] the regulator reaffirmed its view that the price that Epic Energy paid for the Pipeline was not based upon a sound commercial assessment, and as a result it placed less weight on the consequences of this for the financial viability of Epic Energy against the interests of users and the public interest in having competition in markets and in a supply of competitively priced gas.

However, the regulator did accept that statements by Government at the time of the sale created expectations for users as to the tariff that would apply in the future. In paragraph 492 the regulator notes:

> As I have indicated in relation to my consideration of the Sale Process, however, I am satisfied on the basis of Epic Energy's uncontradicted evidence of statements by representatives of the Government could have led a reasonable person making a bid for the pipeline to attach some weight to the prospect of a headline full- haul transmission tariff of $1.00 per GJ as an approved regulated tariff under the Code as of 1 January 2000.

However, the regulator questioned whether such policy statements provided any expectation for subsequent periods. In paragraph 495 the regulator notes:

> Notwithstanding the above, I am not convinced on the basis of the evidence before me with respect to Epic Energy's purchase price for the DBNGP that the value of Epic Energy's bid for the DBNGP was affected by any representations or statements by the Government as to the tariffs that may apply under the Code subsequent to 1 January 2000.

In addition, the regulator concluded that Epic did not undertake a prudent or objective assessment of a future independent regulator's likely position on the rate of return based on information available at the time. As a consequence the regulator concluded that Users should not have to bear the cost of the failure to identify this risk.[21]

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[20] And in particular, section 2.24(a), which requires the regulator to take the service providers legitimate business interest and investment into the covered pipeline into account.

[21] Para 500.

In reaching its final asset base of $1.55 billion the regulator "back-solved" a value of the initial capital base that would be consistent with a full-haul tariff of $1.00/GJ for the T1 service at 1 January 2000. In doing so it assumed the benchmark tariff would be inflated by two-thirds of the value of CPI increase in subsequent years, producing a notional revenue value of $936 million for the Access Arrangement Period in dollar values of 31 December 1999.[22] The regulator equated this with an equivalent asset base of $1.525 billion by back-solving using the WACC and straight-line depreciation and by making assumptions in relation to cost allocation. An additional amount was included for "Stage 3A enhancement" to bring the total to $1.55 billion.

3.1 Assessment of the decision

The asset value produced appears to have been chosen to permit Epic to meet its debt covenant purposes with the banks. It is understood that the banks' rule of thumb is that it is willing to lend up to 1.2 times the regulatory asset base, which with an asset base of $1.55 billion produces a value of $1.86 billion – compared with $1.85 billion owed by Epic.

At a process level the decision is notable by virtue of it being written in one long document without clearly defined sections and with paragraphs numbered. This suggests the regulator's lawyers drafted the decision document and that the regulator is anticipating a further appeal to this decision.

At this stage it is not certain what the response of Epic will be. Epic's public statements with respect to the final decision make it clear that they have been unable to replicate the regulator's analysis and results and that their initial analysis (based on the available information on the values of key parameters used by the regulator) suggests a 1 January 2003 tariff of $0.8921/GJ compared to Epic's proposed tariff of $1.0619/GJ - a result which is some 22% lower than that sought.

Epic have been given 6 weeks to respond to the regulator's final decision, giving them until the 4th of July to respond - a not inappropriate date given Epic's 60% US ownership structure!

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[22] Note this is not discounted – hence the discrepancy with the figures on page 10 - and is derived from the asset value excluding the stage 3A enhancement (i.e., $1.525 billion).

4 Conclusions

In Epic, both the Regulator and the Court have struggled to reconcile a range of conflicting objectives. On the one hand, both have emphasized the importance of preserving incentives for efficient investment to occur; on the other, both have seen the Code as providing constraints on prices that incorporate substantial monopoly rents.

The Court's decision is important given the emphasis it rightly places on the legitimate interests of facility owners. However, it seeks to import these interests as essentially going to wider, non-economic, considerations, rather than as being in fact core to a proper economic analysis of access charging. At the same time, the Court recognises the very wide discretion the Code grants the Regulator – a discretion which, it notes, could allow the Regulator to set charges which did not even recover efficient costs.

The Regulator's approach, though highly detailed in its calculations, is very weak on setting out economic concepts that can and should guide access charging. There will be a perception that the Regulator set the charges in its final decision with a view to not forcing Epic to breach it debt covenants. This may seem like an invitation to moral hazard – to pay too much, knowing that a determined campaign will place great pressure on regulatory decision-making. Alternatively, it may seem like redefining down the limits to which regulators can go in reducing access charges – implicitly saying that whatever its substantive merits (or lack of merits) a charge is acceptable so long as it does not drive the regulated firm into bankruptcy. The lack of any fully articulated economic reasoning in the Regulator's final decision thus leaves the fundamental questions unanswered.

Ultimately, the main conclusion to emerge from these proceedings is that the Code is desperately in need of reform. It sets goals that are confused at best, inconsistent at worst. It grants regulators vast discretion, while nonetheless imposing mind-numbing, highly detailed, requirements on the precise form (but not substantive outcome) of the regulatory process. And it frees that discretion from effective review by the Courts, which are limited to matters of law, and hence cannot set out clear guidance of the kind the Australian Trade Practices Tribunal (now the Australian Competition Tribunal) has so effectively given in respect of the Trade Practices Act.

The Productivity Commission, in its review of Part IIIA of the Trade Practices Act, has set out some important elements that could be used for reforming the Code and the other components of the national third party access regime. Unfortunately, nothing has been done to bring this reform process forward. Until that happens, decisions such as those at issue

here will remain controversial and more importantly, a source of unneeded uncertainty, making our infrastructure investment less efficient than it could and should be.