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Mr Michael Walsh
Director
Network Regulation North Branch
Australian Competition and Consumer Commission
GPO Box 3648
Sydney NSW 2001

By email: dvp2007@accc.gov.au

Dear Mr Walsh

Dawson Valley Pipeline ("DVP") Access Arrangement – Response to Draft Decision

As the owner of one of the largest transmission pipelines in Australia, Dampier Bunbury Pipeline ("DBP") group makes this submission on particular aspects of the ACCC's reasoning in the draft decision for the DVP access arrangement. DBP believes that its experiences in regulatory processes and in expanding the capacity of the Dampier to Bunbury Natural Gas Pipeline ("DBNGP") are relevant to the ACCC's deliberations on the issue of the establishment of the initial Capital Base for the DVP access arrangement.

DBP requests that the ACCC consider this submission notwithstanding it being lodged following completion of the public consultation process.

[deleted – confidential information]

This submission covers the following issues:

1. Methodology for the assessment of the initial Capital Base.

DBP submits that the ACCC's methodology for establishing the initial Capital Base in the DVP draft decision does not correctly reflect the reasoning of the Western Australian Full Court of the Supreme Court in the Epic Energy case[1]. In particular, the ACCC has failed to properly apply the factors in section 2.24 of the Code.

[1] Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor [2002] WASCA 231

The ACCC's approach in the daft decision was to have regard only to the factors in sections 8.10 and 8.1 of the Code in establishing the initial Capital Base.

While the ACCC's draft decision acknowledges that the section 2.24 factors have a role in exercising the discretions contemplated by the last paragraph of section 8.1 of the Code, the ACCC does not undertake this task.

DBP submits that on a correct reading of the Full Court's reasoning, the following is a summary of the correct methodology to be applied:

(a) the Code establishes a single process of assessing a proposed Access Arrangement and deciding whether or not to approve it;
(b) in that process, the Regulator is required by s.2.24 to take the stipulated factors into account and to give them weight as fundamental elements;
(c) the process of assessment includes giving weight as a fundamental element to the s.2.24 factors in the consideration of s.3.1 to 3.20, including the consideration of s.8 as incorporated through ss.3.4 and 3.5;
(d) consideration of ss.3.4 and 3.5 involves an evaluation and exercise of judgment and discretion, taking due account of inter-related matters;
(e) assessing whether a proposed Reference Tariff and Reference Tariff Policy comply with s.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 s.8;
(f) in evaluating the application of ss.3.4 and 3.5 (ie, in considering compliance with the s.8 principles), the factors in s.2.24 are applicable and guide the Regulator in the exercise of the discretions contemplated by the last paragraph of s.8.1.

Therefore, the correct approach to assessing a proposed Access Arrangement and deciding whether it should be approved (including the establishment of the initial Capital Base) may be explained as follows:

(a) there is a single, overall process of assessment, which involves inter-related components or elements – it does not involve a series of individual, final decisions which severally and mechanically produce an outcome;
(b) of necessity, the initial consideration of matters of detail under s.3.1 to 3.20 (including s.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 s.2.24 factors, before final views are formed; and
(c) 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 s.2.24 factors and the weight to be accorded to them as fundamental elements in the particular circumstances of the case.

2. Reliance on draft decision of DBNGP's first access arrangement

it is noted that, in some parts of its reasoning, the ACCC has relied on reasoning of the then WA Independent Gas Pipelines Access Regulator (now replaced by the Economic Regulation Authority) in the draft decision on the access arrangement for the Dampier to Bunbury Natural Gas Pipeline[2].

DBP notes that the Full Court in the Epic Energy case found that the determinations of the WA Regulator in the draft decision in so far as they relate to the Reference Tariffs and the initial

[2] Draft Decision on the Dawson Valley Pipeline access arrangement, May 2007, page 27

Capital Base were affected by errors of law. Accordingly, it would be wrong for the ACCC to continue to rely on reasoning from this decision to support decisions on other access arrangements.

3. Impact of Short Term increases in construction costs for the purposes of valuing the Optimised Replacement Cost

At page 33 of the ACCC's draft decision for the DVP access arrangement, the ACCC states that "[a]s the ORC may be an input into a pipeline's ICB (which can not be revalued at a later date), caution should be exercised in placing too much weight on short term increases in construction costs that may not be sustained over the medium to long term."

At page 34 of the draft decision, the ACCC notes that there have been recent increases in construction costs (largely attributed to increased steel prices and labour). It refers to the Unidel report which concludes that, as a result of recent increases in steel, approvals, labour and specialist sub-contracts, indicate that it is unlikely any pipeline projects for 10 to 15 MPag pipeline systems would now cost less than $40k/in/km and in some cases may exceed $45/in/km.

The ACCC then concludes that it is "unlikely that these cost levels will be maintained in the medium term. For these reasons given above, the ACCC considers it not appropriate to base the ICB on a valuation that reflects the recent cost increases."

Instead, the ACCC gives preference to an ORC valuation that is more consistent with average construction cost unit rates over the last couple of decades (excluding the last few years) - $30,000/in/km.

DBP responds to the above reasoning as follows:

(1) The unit rates of construction outlined above may not be reasonable unit rates.
(2) The stated short term cost increases are not "short term" increases.
(3) Even if they were short term increases, it is reasonable to take into account short term increases in determining construction rates.

(1) Appropriate construction unit rates

Since late 2004, DBP has committed almost $1 billion to expanding the capacity of the DBNGP – via two expansion stages. This includes the construction of in excess of 790km of 26 inch pipe. DBP is also presently considering a further expansion of the capacity of the DBNGP, **[deleted – confidential information]**. More details of the nature of these projects are outlined below.

As a result of this experience, DBP has gathered significant market information relating to the cost of construction of pipeline projects.

While it is acknowledged that DBP has not recently constructed any pipeline projects for 10 to 15 MPag pipeline systems, part of its analysis required gathering cost information for various diameter pipelines.

This analysis demonstrates that adopting a unit cost per inch per kilometre for the purposes of comparing pipeline construction costs is an overly simplistic methodology and potentially fails to recognise that the costs for individual pipeline construction projects are affected differently by a number of factors including:

- the cost of steel (which has been at increased levels for some years)
- the size of the project
- the location of the project (urban/rural/pastoral)

- the nature of approvals required
- the pipe length
- pipeline diameter
- the number of camps that are required to be established
- the number and location of alternative pipe manufacturers and coating plants
- the approach of regulators (from a technical and safety perspective)
- exchange rates

It is important therefore that these factors are taken into account when arriving at a value for the replacement cost of a pipeline. It is not apparent that the ACCC's analysis takes these factors into account. Although it is noted that, in the supplementary Unidel report[3], Unidel cautions the ACCC that comparing projects on this basis is inherently unreliable and should be considered as a guide only.

(2) Recent increases in construction costs are more likely not short term increases

DBP notes that Unidel identifies the cost increases are related to steel, labour, equipment and specialist supplies. It then attributes the recent increases in construction costs to:

- high demand on labour
- high demand on equipment from the resource sector;
- key specialist supplies' costs (particularly camp costs);
- steel cost increases due potentially to demand in China

As outlined above, by 2010, DBP expects to have invested more than **[deleted – confidential information]** in pipeline projects. A summary of the capacity, configuration and cost involved in each stage of expansion is summarised in the table below.

Stage	Configuration	Cost
Stage 4 (125TJ/day)	• 8 10MW compressors • 217km of 26inch looping	$433m
Stage 5A (about 100TJ/day)	• 573km of 26 inch looping	$560m
Stage 5A2 **[deleted – confidential information]**	• **[deleted – confidential information]**	**[deleted – confidential information]**

While DBP has experienced first hand the increase in costs since the early 2000s, the market intelligence from DBP's expansion activities suggests that the costs are not likely to reduce to their early 2000 levels, if at all during at least the medium term. This is particularly the case with respect to the cost of steel and labour.

Accordingly, DBP submits that there is more likelihood than not that the recent increases are not short term cost increases.

(3) Short term cost increases are appropriate to take into account

Even if these increases are considered to be short term increases, DBP submits that the ACCC's stated reasons for not taking them into account for the purposes of valuing the ORC of a pipeline are flawed.

The stated reasons are as follows:

[3] Unidel, DVP: supplement to the access arrangement review, 9 May 2007, p4

(a) in a competitive market, assets would not be constructed or replaced if their cost generated prices that would be considerably higher than the prices that users would be willing to pay; and

(b) if the high construction costs are expected to be temporary, pipeline developers may defer construction in the expectation that costs will return to more sustainable levels.

DBP submits that this ignores the reality in which new pipelines, and expansions of existing pipelines, are constructed. In effect, new pipelines compete with suppliers of alternative energy sources. This is becoming more certain with the fact that gas is being used increasingly for electricity generation purposes.

Proponents of new pipelines and expansions of pipelines therefore have a short window of opportunity in which to secure each new customer. Otherwise they run the risk of the customer being lost to a competitor.

As a final matter, please note that the fact that DBP has only commented on some parts of the ACCC's draft decision should not be taken to mean that DBP agrees with the other parts of the draft decision.

If you have any questions in relation to the above, please contact me on 08 9223 4304.

Yours sincerely

Anthony Cribb
General Manager Legal & Regulatory
Company Secretary