

3 March 2000

Our Reference: 2353RD

Dr Ken Michael AM
WA Independent Gas Pipelines Access Regulator
Office of Gas Access Regulation
Level 6
Governor Stirling Tower
197 St Georges Terrace
Perth WA 6000

Attention: Mr Mike Jansen

Dear Dr Michael,

Re: Submission Regarding the Proposed Access Arrangement for the GGTP

North West Shelf Gas Pty Ltd (NWSG) is pleased to make this submission regarding the proposed Access Arrangement (AA) for the Goldfields Gas Transmission Pipeline (GGTP) submitted to you as the Western Australian Independent Gas Pipelines Access Regulator (the Regulator) by Goldfields Gas Transmission Pty Ltd (GGT).

We will restrict our comments to the following material areas.

Capital Base

The Initial Capital Base (ICB) proposed by GGT for the initial access period is A\$452.6 million which is said to represent the initial actual construction costs of the GGTP with subsequent adjustment for depreciation, interest costs during construction and other movements in CPI and exchange rates. This is proposed by GGT as an appropriate way in which to determine the Depreciated Optimised Replacement Cost (DORC) of the pipeline.

We are concerned that the value of DORC proposed may not represent an appropriate value for the DORC and may result in a higher value for the ICB that in turn results in a higher than reasonable tariff for the reference service.

In particular the cost of interest during the construction period of approximately \$26.7 million appears to have been calculated using the Weighted Average Cost of Capital (WACC) proposed of 12.2% real pre tax. If the Regulator determines that a lower rate of return is appropriate then the value of this interest cost during construction will be lower and thus the value of DORC will be lower.

The adjustment of the construction costs for CPI should be compared with more specific and relevant indexes related to the changes in costs of pipeline construction. It may not be valid to assume that present day pipeline construction costs are the same as those in 1995 after adjustment for CPI. Indeed present day construction costs may be lower than in 1995 due to the current lower level of local engineering and construction and project activity and the lower (in real terms) cost of major pipeline inputs such as pipe.

The movement in exchange rates between 1995 and 1999 is also proposed to suggest a significant difference in the cost of imported components and that this higher cost can be used in calculating the DORC. A comparison of actual present day prices for the imported components may show that the full affect of the exchange rate movement is not reflected in present day equipment prices.

In the calculation of the proposed value of DORC, GGT appear to have used a throughput basis (units of production method) to determine the amount of depreciation of the Optimised Replacement Cost to arrive at a value for DORC. Given that the GGTP is now said by GGT to be operating at full capacity it may be more appropriate to have used another depreciation method which would result in a greater amount of depreciation and a lower value of DORC.

We request that the Regulator determine the validity and appropriateness of the adjustments for CPI, exchange rate variations, the cost of interest during the construction period and the depreciation method in calculating a value for DORC from the original GGTP construction costs.

We also request that the Regulator determine (or that the Regulator request GGT to determine) a value for DORC based upon estimates of present day construction costs and exchange rates so that after due allowance for depreciation, this value can be compared with the \$452.6 million proposed.

Depreciation of the Initial Capital Base

It would appear that it is proposed to depreciate the ICB on the basis of pipeline throughput (units of production method). As projected by GGT and shown in Appendix C of the AAI, reduced pipeline throughput is assumed after the expiry of existing contracts and that the pipeline load is only about 8 PJ/a after 2017. This depreciation method has been chosen rather than depreciation of over the actual or economic life of the pipeline and its associated assets which is normally adopted for onshore gas transmission pipelines. The units of production method would appear to result in more rapid depreciation of the ICB and this would appear to be reflected in higher tariffs in the proposed AA.

We request that the Regulator determine whether the proposed depreciation method is appropriate and what the affect of more conventional depreciation methods would have on the tariff for the reference service.

Rate of Return

In calculating the Weighted Average Cost of Capital (WACC) for the GGTP, a beta of 1.4 has been proposed. This is broadly based upon a line of argument that links the risk (and therefore betas) of the mining companies that use the GGTP to that of the pipeline. As far as we are aware this derivation of beta for a onshore gas transmission pipeline is without precedent.

It would seem that such a derivation of the beta from the betas of the mining companies to that of the GGTP does not take into consideration the fact that the pipeline is proposed to enjoy a fee structure incorporating an 76% fixed reservation fee paid on Shippers' Maximum Daily Quantities (MDQs) under medium to long term contracts. It

would seem that there is a high degree of certainty that the majority of pipeline revenue will be paid whether or not the mining companies use their pipeline capacity or not.

The potential for competition from diesel also does not take into account the medium to long term nature of most gas supply contracts (and therefore gas transportation contracts). Gas supply contracts are often linked to diesel (if applicable as a competing fuel) and often have minimum volume commitments that discourage switching between fuels at short notice.

All of the above mentioned factors suggest that the risk level for the GGTP is overstated in the AAI and that the proposed value of beta for the GGTP is too high. We would suggest a more realistic and accepted beta value of around 0.65 to 0.85 as widely used in other regulatory decisions for onshore gas transmission pipelines in Australia be adopted.

Work undertaken by Professor R.R. Officer and Professor N. Hathaway (Melbourne University) tracking the long term average Market Risk Premium, suggests that the Market Risk Premium is 6%. GGT have used 6.5%.

The cost of debt at 8.95% is much higher than accepted in previous determinations for regulated pipelines. The debt margin of 2.25% is much higher than has been allowed in previous regulated outcomes for onshore gas transmission pipelines. The work of the Office of the Regulator General of Victoria (ORGV) suggested that the cost of debt should be 0.75% to 1.0% higher than the risk free rate. The Commonwealth Bank, Westpac Bank and CSFB confirmed this opinion.

The proposed debt to equity ratio of 50 : 50 differs from other regulatory decisions where a ratio of 60 : 40 has been widely accepted as the optimum gearing ratio for most other regulated onshore gas transmission pipelines in Australia. A lower gearing ratio increases the WACC and GGT have in our view not adequately demonstrated why such a lower gearing ratio should be allowed for the GGT. The debt to equity ratio of the companies that own the GGT may not be relevant as these companies are involved in a range of activities other than ownership of the GGT and their gearing ratios may reflect a range of risks across their respective portfolios.

The value of gamma proposed is 30% rather than the 50% widely used in other regulated outcomes for onshore gas transmission pipelines such as the work of ORGV.

The company taxation rate proposed to be used is 36% rather than the 30% which is most likely to be paid during the majority of the AA period as a result of the Federal Government's proposed changes to the company taxation rate.

It would appear that in arriving at the proposed WACC for the GGTP of 12.2% real pre tax that the input values have been selected at values that would result in a higher final WACC output.

Overall the proposed WACC of 12.2% real pre tax is considerably higher than the 7.0% to 7.75% real pre tax found applicable to other regulated pipelines. We request that the Regulator determine a fair and reasonable WACC value for the GGTP in line with that determined for other regulated onshore gas transmission pipelines.

Load Growth

NWSG believe that the statement in the last paragraph of clause 3.1.3 of the Access Arrangement Information (AAI) wherein the lack of response to GGT's Economic Development Tariff offer is suggested to indicate "that there is little prospect for load growth during the Access Arrangement period" and the statements made in clause 6.2.2 of the AAI along the same lines are not borne out by the facts.

During the Access Arrangement period NWSG believe that there are significant prospects for further load growth in the GGTP catchment area from mooted projects in the iron, nickel and gold industries. Specific examples include the Anaconda Murrin Murrin Phase II (on which we understand design work is proceeding), Murrin Murrin Phase III and Mount Margaret nickel projects, the proposed Mt Weld fertilizer project and a proposed cobalt refinery at Cawse, West Angelas (now a committed iron project) and further conversion of existing diesel fired electrical loads in the gold mining industry. We also understand that the TransAlta power stations in the Goldfields have about 20 MW of spare electrical capacity that they are seeking to sell either locally or on the south west grid. Significant other prospects exist including Western Power's proposed conversion of diesel fired power stations to gas and the water pipeline from Esperance to Kalgoorlie.

This gas demand upside may be reflected in part by the higher (than DORC) price paid by the new owners of the GGTP for the pipeline. The tariff offered in the AA is one of the most expensive onshore gas pipeline transmission tariffs in Australia. Load growth in the past has also been inhibited due to only one producer of gas having access to the GGT. The key factor in facilitating future load growth on the GGT is a competitive and realistic gas transportation tariff.

The Goldfields load growth that is likely to occur during the initial AA period may be able to be captured by GGT by offering lower (than the AA reference tariff) negotiated tariffs with customers for new loads. If this were the case then the GGT owners would receive revenues above those assumed in the proposed AAI and this would lead to an effective rate of return higher than that approved by the Regulator. This situation would represent a potentially significant extra return to the GGTP owners.

A far more equitable approach would be for a reasonable forecast of GGT load growth to be determined by the Regulator and have the reference tariff set accordingly. If GGT were able to grow the pipeline load at a faster rate or to a larger value than forecast then the pipeline owners would see a reward for their effort.

In clause 6.2.2 of the AAI it is stated that "During the period of the Access Arrangement, several transport contracts are scheduled to terminate. It has been assumed that these contracts will not be renewed." This in part appears to account for the gradual decrease in projected volumes over the course of the AA period. We request that the Regulator satisfy himself that the projected reduction in existing GGTP load will decrease as suggested.

We request the Regulator to make a reasonable assessment of the likely quantity and timing of load growth and to make due allowance for this when calculating the reference tariff. If a realistic reference tariff for the GGTP is not forthcoming then this may necessitate the development of the proposed Mid West pipeline from Geraldton to Mount

Margaret. The development of such a new pipeline may not be the most efficient outcome or the most economic use of existing pipeline infrastructure.

Tariff Levels

The tariffs calculated by GGT using the 12.2% WACC, the proposed ICB of A\$452.6 million and projected throughput are said in the AAI to have resulted in tariffs about 22% higher than those currently charged. NWSG believe that the use of more appropriate values for WACC, ICB and projected throughput may result in tariffs considerably lower than those proposed. We request that the Regulator determine what these lower tariffs might be.

Tariff Structure

The tariff structure proposed for the GGTP AA is one of:

- a toll on a \$/GJ basis (ie a flagfall charge);
- a reservation fee (a fixed portion paid on a Shipper's MDQ) on a \$/GJ.km basis; and
- a throughput charge (a variable or commodity charge portion) on a \$/GJ.km basis.

The AAI does not appear to provide any rationale for the toll, or for the relative split of the fixed and variable portions of the tariff. We request that the Regulator determine the basis for and reasonableness of the proposed tariff structure. In particular the proportions of fixed and variable charges might be reasonably expected to reflect the actual fixed and variable costs of the pipeline.

Benchmarking

The Code requires that a pipeline owner include relevant benchmark comparisons of relevant performance indicators for the pipeline proposed to be covered by the AA and other onshore gas transmission pipelines. GGT's treatment of this area is very limited and we would request the Regulator to publish (or for the Regulator to request GGT to publish) sufficient relevant benchmark performance indicator comparisons so that a reasonable view of the competitiveness or otherwise of the proposed tariffs may be formed by interested parties.

Efficiency Incentive

The proposed AA tariff structure does not appear to have any efficiency incentive mechanism as required by the national Gas Pipelines Access Code (the Code). GGTP tariffs are proposed to be indexed at 100% of CPI. We request the Regulator to consider whether this is appropriate and whether a CPI – X mechanism as used in many other regulated pipelines might be more suitable. It is our view that an appropriate efficiency incentive mechanism should be applied to all charges in the GGTP AA currently proposed to be subject to 100% CPI adjustment.

One detail that needs to be corrected is the value of the base CPI. The base CPI value proposed is 120.2 however the all capitals weighted average CPI for the September quarter of 1999 was 123.4. This is the value, we believe, that should be adopted for the base CPI value for tariff adjustment purposes as the September quarter of 1999 is the 't-2' quarter with respect to the tariffs proposed to be valid as of 1 January 2000 (at which time the March quarter of 2000 is quarter 't').

Other Charges

For new Shippers, charges are proposed for establishment of an account and for connection. An annual account management charge is also proposed. The charges for these services should reflect the actual cost to GGT of providing the service involved and should not be so high so as to act a potential barrier to entry. We request that the Regulator ensure that 'double-dipping' is not occurring by also determining whether the annual account management fee is not already compensated for in the toll fee or other portions of the pipeline tariff.

A range of penalty charges are proposed for:

- imbalances (at \$2.50/GJ);
- daily overruns (at 3.5 times total pipeline tariff);
- hourly overruns (at 3.5 times total pipeline tariff); and
- variances from nomination (at 2 times total pipeline tariff).

These penalty charges are very considerable and do not appear to reflect the actual cost to GGT of accommodating these variations. We are concerned that they may represent an attempt by GGT to make substantial extra revenue from the unavoidable variations in daily or hourly operations of producers or customers. The very high overrun charges would appear to drive a Shipper to book more capacity (and have a higher MDQ on which the reservation charge is paid) than really needed. This might be quite inefficient if it results in less capacity being available to others or leads to premature or unnecessary expansion of the GGTP's capacity. Moreover there should be some check in place to ensure that GGT do not contract more MDQ in aggregate than the pipeline could deliver.

We request that the Regulator require GGT to demonstrate that the proposed penalty tariffs are fair and equitable and that they reflect the actual, or likely actual, costs incurred by GGT due to such variations in pipeline throughput.

If the proposed structure and amount of penalty charges proposed were accepted, GGT should be required to forecast and provide information to the Regulator to demonstrate the revenue affect of the penalty charges based on historical pipeline performance. This revenue should then be taken into account when determining the tariff for the reference service.

In addition, GGT has proposed that it be able to modify these penalty charges at any time upon giving written notice to Shippers. This would allow GGT to unilaterally increase the penalty charge factors, resulting in consequent extra revenue for the GGTP owners from penalty charges. We request that any such change to the penalty charges should be subject to the prior agreement of the Regulator.

With respect to accumulated imbalances GGT are proposed to be able to charge a Shipper twice the Used Gas price for settling a Shipper's accumulated imbalance if GGT buys gas to remedy the imbalance or to credit the Shipper with half the Used Gas price if GGT has to sell gas to remedy the imbalance. These markups (or markdowns as the case may be) are excessively punitive and do not appear to reflect GGT's costs in remedying the imbalance.

The Used Gas charges are proposed to be passed on to Shippers at cost. There is no incentive for GGT to ensure that the cost of Used Gas is as low as reasonably practical. The cost of Used Gas should be subject to a reasonable cap with respect to price.

There should also be an incentive for GGT to minimise the quantity of Used Gas to ensure that gas is not wasted or inefficiently used. A reasonable cap set at a small percentage of pipeline throughput (which might be based on the lower of historical GGTP Used Gas performance to date or on industry norms) should be established to ensure efficient performance.

Taxes

We request that the Regulator satisfy himself that the Tax and Goods and Services Tax (GST) clauses in the AA Conditions are in accordance with the applicable law.

Inlet Point

Only one Inlet Point is proposed for the GGTP in the AA. The proposed point is the existing inlet from the East Spar and Harriet Joint Venture operations on Varanus Island operated by Apache Energy. We would request that the Regulator ensure that provision is made in the GGTP AA for an alternative Inlet Point(s) from a possible future connection to the GGTP from the Dampier to Bunbury Natural Gas Pipeline (DBNGP). Such a new Inlet Point would allow physical access to the GGTP (and therefore Eastern Pilbara and Goldfields customers) by the other four gas producers in the north west (including the North West Shelf Joint Venture as well as backhaul from producers further south). Equitable access to the GGTP and these customers by all gas producers is required to allow circumstances in which true competition between gas producers might occur.

Conclusion

The proposed GGTP AA has a significant number of areas that we request that the Regulator address in the assessment of the AA documents. There appears to be considerable scope for reduction of tariffs below those proposed by GGT. Lower gas transportation tariffs and effective gas producer on gas producer competition would seem to be key to growing the demand for gas in the Eastern Pilbara and Goldfields.

If you require any further information regarding our submission please contact Mr Rod Duke, Marketing and Engineering Manager at NWSG on 08 9348 4670.

Yours faithfully,

AKOS GYARMATY
General Manager