Normandy Mining Limited

Submission on the Proposed Access Arrangement for the Goldfields Gas Transmission Natural Gas Pipeline

Background

This submission to the Office of Gas Access Regulation (O*ff* GAR) is made by Normandy Mining Limited (Normandy), in response to the invitation issued by O*ff* GAR on the 22nd December 1999 and the subsequent publication of an Issues Paper in January 2000. The proposed Access Arrangement has been put forward by Goldfields Gas Transmission Pty Ltd (GGT) under the National Access Code for Third Party Access to Natural Gas Pipelines (called the Gas Code in this submission).

Normandy is a major customer of the GGT pipeline system - being a shipper of gas under contract to the Goldfields Power Joint Venture's power station at Parkeston (near Kalgoorlie), for ultimate consumption of electricity by Normandy associated companies in the Goldfields region and other customers. Normandy was a 25.493% participant in the original Goldfields Gas Transmission Joint Venture and sold its interest in the pipeline system to the Southern Cross Pipelines consortium in March 1999.

Normandy's view is that the proposed Access Arrangements are deficient when measured against the requirements of the Gas Code; are not in the public interest and therefore should not be accepted by O*ff* GAR.

Access Arrangement Information Deficiencies

The submission made by GGT is deficient in that information on the expected throughput levels of the pipeline, past the end of the Access Undertaking Period, are not supplied. GGT propose to use an net present value (NPV) methodology, similar to that which has applied to the GGT pipeline since its inception. Such a methodology is critically dependent on throughput assumptions for future years. Normandy believes that GGT must have adopted unreasonably pessimistic assumptions for future throughput and thus derived Reference Service Tariffs that are arguably higher than can really be justified.

Commentary on the Level of Risk Associated with the GGT Pipeline

The Access Arrangement Information dwells significantly on the level of risk associated with the GGT pipeline and the influence that this increased level of risk has on the proponents approach to the Access Undertaking. Normandy accepts that the GGT pipeline does have some characteristics which may make it more risky than pipelines feeding settled large urban areas, but Normandy cannot agree with the forcefulness of the arguments raised by the proponents.

Normandy and the original partners gave careful consideration to the levels of risk that they were running in proceeding with the investment in the project. While being aware of the difficulty (or impossibility in some cases) of securing very long term contracts for the use of pipeline capacity, the original developers were prepared to place great weight on the long term development prospects of the extensive mineral provinces through which the pipeline passes. These include the iron ore deposits in the eastern Pilbara and the nickel and gold mineralisation in the northern Goldfields/Mid-West area and around Kalgoorlie.

Both nickel and gold are produced in world scale quantities and at competitive prices in areas serviced by the GGT pipeline. Normandy has an involvement in several major gold mines in this area, some of which have long prospective lives (especially the KCGM operation). There are also proposals to develop other nickel, gold and mineral prospects in the surrounding regions and process the ores in the Kalgoorlie area. The diversity of the mineral base itself provides some degree of security to the GGT pipeline owners.

The overall outlook that has been painted by GGT for the pipeline is, in Normandy's opinion, rather pessimistic. GGT appear to ignore the possibility of expanding the pipeline capacity that is essential to get current and new customers transporting more gas. GGT also fail to recognise the future growth that will arise in gas transport as the benefits of gas, as a low greenhouse gas emitting fuel, are recognised and other fuels such as coal are penalised as high greenhouse gas emitters, in a future emissions trading regime. An example of this is the possibility of gas fired power stations in the Goldfields supplying all the power to the Goldfields market, and eventually into the southwest, as gas displaces coal as a preferred fuel.

Normandy therefore cannot agree with the arguments put forward by GGT that the pipeline is significantly different and greatly more risky than other pipeline projects in Australia. With sensible pricing policies and professional marketing, throughput would be expected to increase in future years and not be constrained by the expiry of the initial set of contracts provided by the founding customers.

Scope of Reference Services

GGT is offering only a forward Firm Service as the proposed Reference Service, and is also offering to negotiate Non-Reference services. However, since the start of the GGT pipeline, other services (Interruptible Service, Parking Service, and Authorised Imbalance Service), have been offered. Normandy believes that they should continue to be offered.

Normandy supports the early development of a secondary market to trade contracted and uncontracted pipeline capacity. Normandy comments further on this matter under the Trading Policy section of this submission.

Terms and Conditions (other than price)

Normandy notes that in the case of the O*ff* GAR Draft Decision on the Parmelia Pipeline, O*ff* GAR examined the proposed Terms and Conditions in great detail to eliminate the scope for arbitrary decisions by the proponent and the ensure that the details were acceptable. Normandy believes that the same thorough process needs to be followed in this case as well.

Trading Policy

As mentioned, Normandy supports the development of active secondary markets for the trading of capacity in gas pipeline systems. Normandy is aware of very efficient and effective screen-based / internet trading systems in use overseas (for both uncontracted or non-firm capacity) – this could be applied and / or GGT could allow contracted capacity to be re-traded.

GGT has made provision for the "Bare Transfer" of capacity without consent and for other forms of transfer but only with their consent.

In Normandy's view, GGT should be required to provide a full "Secondary Market" service, extending to the provision of an on-line capacity trading system. They also should undertake to make available any spare capacity held by themselves or able to be made available, and to allow unused contracted capacity to be offered on such a system.

Review of the Access Arrangement

Normandy understands that O*ff* GAR can only accept or reject an Access Undertaking and cannot revoke an acceptance once given. Once accepted, the Undertaking prevails for the duration of the Access Undertaking Period (proposed to be for five years).

In these circumstances, it is most important that O*ff* GAR ensures that the initial Access Undertaking includes all of the features required and is capable of being accepted under the Code. It is also essential that the proponent agrees in the Access Undertaking to resubmit all or part of the Undertaking in the event that circumstances change to an extent which questions or undermines the assumptions made when the Undertaking was submitted.

Depending on the final approach adopted in selecting the weighted average cost of capital (WACC) discount rate and its treatment of tax (addressed later in this submission), one such circumstance would be a change in the corporate tax rate - as is being proposed by the Commonwealth Government at present. There may be other specific changes of circumstances which become apparent to O*ff* GAR in the assessment process which should also trigger a review of particular aspects of the Access Undertaking.

Reference Tariffs - Initial Capital Base

Normandy has no great objection to the proposal that the Initial Capital Base should be set and based on the actual construction cost of the pipeline, depreciated appropriately and with justified adjustments. Normandy agrees with the GGT contention that the pipeline was constructed at a cost that was less than the prevailing length-weighted pipeline costs at the time.

However O*ff*GAR will need to carefully check the proposed adjustments once the WACC discount rate and the depreciation policy is settled. Both will have an effect on the Initial Capital Base. In addition, the proposed adjustment for $US/$A exchange rates needs careful review, since it may have been possible to have procured items of equipment from countries other than the USA and hence paid for equipment in other currencies. Finally, the starting Capital Base needs to be depreciated to account for the initial three and one half years of operation of the pipeline. Obtaining the opinion of a competent and experienced outside consultant would be valuable in resolving these matters.

From Normandy's limited experience in the construction costs of gas pipelines[1], it is expected that the Depreciated Optimised Replacement Cost (DORC) valuation on the basis outlined will be a little lower than that proposed by GGT.

Reference Tariffs - Rate of Return

Normandy has carefully examined the latest regulatory decisions in relation to the assumptions used and the calculation of the WACC using the Capital Asset Pricing Model. Normandy has also noted, and generally agrees with, the general approach and the assumptions used by O*ff*GAR in the Draft Decision on the Parmelia pipeline.

Regulatory practice has generally favoured the use of a real pre tax WACC, using the prevailing corporate tax rate and assumptions relating to other parameters which usually lie in a relatively narrow range.

We note that the Australian Competition & Consumer Commission (ACCC) has only very recently updated its set of assumptions in light of the prevailing economic settings in their Final Decision on the TransGrid NSW electricity transmission matter[2] .

The use of assumptions consistent with those of the latest ACCC Decision along with the calculation method used in the recent regulatory decisions and allowing a factor for a slightly higher level of risk (by an adjustment to the ß factor) could lead to values of pre tax real WACC of around 8%. This compares with values in the 7.5-7.75% range emerging from recent gas pipeline decisions. Normandy believes that an appropriate pre tax real WACC for this pipeline is of the order of 8.0-8.5%.

Reference Tariffs - New Capital Expenditure and Operations and Maintenance Costs

Normandy has no particular comment to make on these issues, except to state that the Initial Capital Base (both DORC and Depreciated Actual Cost basis), future capital expenditures and future operations and maintenance expenditures should be reviewed in detail by competent independent and expert consultants. They should only be allowed to

1 Normandy was a 25.493% Joint Venturer in the Goldfields Gas Pipeline system.

2 Published in January 2000.

the extent that they are at efficient (best practice) expenditure levels and matched to the reasonably expected levels of throughput during the Access Period.

Reference Tariffs - Economic Depreciation

GGT has proposed depreciation on a “units of production” method and for a pipeline economic life of 40 years. However GGT also state that their view is that the physical life of the pipeline is as long as 70 years. The assumption of 40 year remaining life is predicated on the expiry of the second 21 year period of the State Agreement, less two years of operation since 1996.

Normandy cannot agree with either of these assumptions. Prevailing regulatory practice in Australia, plus custom and practice as well as simplicity and ease of understanding, all point towards the use of straight line depreciation based on realistic asset lives. The use of a “units of production” depreciation methodology heavily biases depreciation to the early years of operation, especially if based on the throughput profile in Appendix C.

In addition, the 42 year period provided for in the State Agreement is no limitation as provision is made for the owners to apply for a continuation of the pipeline licence for a longer period. There can be no valid grounds for assuming that this extension would not be applied for and granted at the time. In addition, the pipeline has been operating for three and one half years, not two years.

Normandy supports the use of straight-line depreciation applied to baskets of assets assigned realistic physical asset lives.

Reference Tariffs - Total Revenue Determination

Normandy has already commented on the lack of detailed information on future throughput estimates, which makes it very difficult to understand and replicate GGT’s calculations of the Reference Tariff in Section 7.5.3.10 of the Access Arrangement Information. However, for Normandy to broadly replicate the results of the Discounted Cash Flow analysis in Section 7.5.3.10, it requires assumptions that the pipeline throughput decreases very dramatically in future years.

These calculations appear to assume dramatic decreases in future throughput, and rely upon a “residual value” at the end of the access undertaking period, calculated with reference to the starting asset value rather than on future cash flows. The residual value of $352 million is much less than the value assuming operation of the pipeline as a going concern. For example, $80 million per year net cash flow (typical of the 5 year period) at a 12% discount rate over the next 30 years suggests a "residual" of some $640 million.

Normandy is of the view that the Reference Tariff calculation should be made on the assumption that the future pipeline throughput should at least remain at the levels predicted for the first five years i.e. with an annual average throughput of around 72 TJ/day. Even this assumption could be regarded as being on the conservative side.

GGT’s calculation of a Reference Tariff gives a figure of $3.48/GJ (based on year 2000 revenue divided by the pipeline input flows). GGT are not proposing to use this level, but instead are offering to remain with the tariff currently on offer for the year 2000, which is equivalent to $2.50/GJ on this basis.

However, if Normandy changes the assumptions relating to Initial Capital Base, WACC and depreciation to those recommended in this submission and assumes a constant pipeline throughput for the remaining life, then the estimated Reference Tariff reduces to around $1.95/GJ - almost 23% below the level being offered by GGT at the present time.

These indicative calculations show the extreme sensitivity of the Reference Tariff calculation to the future throughput assumptions. They also illustrate that the Reference Tariffs for the pipeline, based on reasonable assumptions consistent with recent regulatory decisions, could be as much as 23% lower than those offered by GGT and over 44% lower than the Reference Tariff calculated by GGT.

Normandy therefore believes that Reference Tariffs of the order of $1.95/GJ (based on average revenue in year 1 divided by pipeline input flow and escalated by CPI) should be the result of the application of the Gas Code provisions to this Access Undertaking.

Conclusions

Normandy is a major customer of the GGT pipeline system - being a shipper of gas under contract to the Goldfields Power Joint Venture’s power station at Parkeston (near Kalgoorlie) for ultimate electricity consumption by Normandy’s associated companies in the Goldfields region and other customers.

Normandy’s view is that the proposed Access Arrangements are deficient when measured against the requirements of the Gas Code and are not in the public interest and therefore should not be accepted by O*ff*GAR.

>>>><<<<