



GOLDFIELDS GAS PIPELINE

ATTACHMENT TO SUPPLEMENTARY SUBMISSION REGARDING AMENDED DRAFT DECISION

Submitted to the
Economic Regulation Authority

23 November 2004

LEGITIMATE BUSINESS INTERESTS AND REASONABLE EXPECTATIONS UNDER THE GOLDFIELDS GAS PIPELINE AGREEMENT ACT 1994 APPROVED ACCESS ARRANGEMENT

1. Introduction

The GGP was developed pursuant to a bidding process initiated by the State in 1993. From a group of 16 bidders the State chose the WMC/Normandy/BHP consortium proposal as the most competitive. This led to the negotiation of the Goldfields Gas Pipeline Agreement Act 1994 (the GGP Agreement), which covered the terms of building, operating, third party access to, and pricing of the GGP. The GGP Agreement was signed on 23 March 1994 and ratified by Parliament on 3 May 1994.

The ERA is obliged to consider the service provider's legitimate business interests and reasonable expectations arising from the GGP Agreement under various provisions of the Code including s.s.2.24(a), 8.1(d) and 8.10(f), (g) and (j). This Confidential Attachment sets out further details of those interests and expectations and seeks to correct certain inaccuracies and misunderstandings contained in the ADD.

2. State Agreements

State Agreements have been the instruments through which economic and regional development have been promoted and sustained in Western Australia for over 50 years. There are more than 60 State Agreements in existence covering a wide range of mineral, petroleum and infrastructure investments. They cover the bulk of mineral and petroleum production in the State and are highly regarded by investors and lending institutions for the long-term investment certainty they provide.

State Agreements typically set out a broad framework for the development of a particular project. Matters of detail are addressed through detailed proposals which proponents are required to submit for the approval of the Minister, after a process of consultation. The proposals clause of each State Agreement provides a list of the specific matters which need to be addressed within the detailed proposals.

Once approved by the Minister, each detailed proposal attains significant status under the particular State Agreement. For example, under clause 10(6) of the GGP Agreement, the failure to obtain approval of proposals ultimately leads to termination of the Agreement. Further, approval of all proposals was a precondition to the grant by the State of a Pipeline Licence and the other land tenure required for the GGP. Once approved, proposals are binding on both the State and the proponents. State Agreements also contain provisions governing the modification of approved proposals, which also require the approval of the Minister.

3. **Clause 9 Proposals**

Clause 9(1) of the GGP Agreement provides that:

...the Joint Venturers shall, within 6 months of the date of agreement on the route for the Pipeline submit to the Minister to the fullest extent reasonably practicable their detailed proposals (including plans where practicable and specifications where reasonably required by the Minister) with respect to the construction and operation of the Pipeline ...

Sub-clauses (a) to (o) list the matters which are required to be addressed within the detailed proposals. As far as the Third Party access regime is concerned, the matters required to be covered by detailed proposals are identified in 9(1)(k) and 9(1)(l) as follows:

9(1)(k) arrangements for access to the Pipeline by Third Parties;

9(1)(l) tariff setting principles to apply to Third Parties other than Initial Customers in respect of the Initial Committed Capacity

During the second half of 1994, the consortium negotiated with the State to define the Tariff Setting Principles (TSP's) required under sub-clause 9(1)(l), which were to govern tariff determination. At the same time, negotiations took place to determine the initial tariffs consistent with those principles. In order to do this it was necessary for the State and the consortium to agree on specific economic parameters for setting tariffs. The initial A1 tariff was determined by the WMC/Normandy/BHP consortium using those parameters and agreed estimates of throughput over the project life.

By agreement with the State, the tariff setting methodology (including agreed parameters), and the A1 tariffs were incorporated in the detailed proposals covering "arrangements for access", submitted to the Minister under sub-clause 9(1)(k) of the GGP Agreement.

In January 1995 the Minister approved the Clause 9 proposals – including TSP's, tariff setting methodology and A1 tariffs. It was only after the Clause 9 proposals had been approved that the consortium made its commitment to proceed with the construction of the GGP.

4. **Detailed Proposals**

The detailed proposals submitted by the GGT Joint Venturers on 30 November 1994 comprise three volumes:

Volume 1 - Proposals concerning Clause 9(1) and Clause 16(4);

Volume 2 - Additional Submissions and Advice concerning Clause 8(1), Clause 9(4) and Clause 23

Volume of Attachments - concerning Proposals and Submissions

Volume 1, Part 4 provides a brief summary of the arrangements proposed by the Joint Venturers in respect of:

- Clause 9(1)(d) - Pipeline gas quality specifications;
- Clause 9(1)(k) - arrangements for Third Party access;
- Clause 9(1)(l) - tariff setting principles

Attachment A to the proposals documentation comprises the detailed proposals on third party access arrangements; tariff setting principles; and gas quality specifications. This was originally lodged with the Minister for consideration in July 1994. As far as third party access arrangements are concerned, Attachment A:

- incorporated a review of alternative tariff structures, comparing Cost of Service & Levelised Tariff alternatives;
- proposed a Levelised Tariff structure for the project to ensure the lowest possible up-front tariffs;
- highlighted the higher level of risks associated with the Levelised Tariff approach;
- outlined the information to be included in a standard “Tariff Package”;
- detailed GGT’s tariff calculation methodology and the primary assumptions employed in tariff setting;
- included a derivation of the nominal pre-tax Weighted Average Cost of Capital for the project – 18.81% per annum.

Economic parameters agreed between the consortium and the State – which were appropriate to the circumstances under which the investment in the GGP was undertaken - included:

Debt/Equity Ratio	50/50
Debt amortisation period	[<i>CONFIDENTIAL</i>]
Return on equity	17.5%
Initial capital cost	[<i>CONFIDENTIAL</i>]
Income tax rate	33%
Depreciation	42 years s/line
Interest Rate	[<i>CONFIDENTIAL</i>]
Inflation Rate	4.0%
Pre-tax WACC	18.8%

1997 O&M cost
Imputation credit

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Attachment B to the proposals documentation comprises GGT's Terms and Conditions and Tariff Package which incorporated the original A1 tariffs.

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Clause 22(1) of the GGP Agreement requires that:

Contracts for transmission of natural gas and associated services negotiated by the Joint Venturers with Third Parties must incorporate tariffs that are fair and reasonable and consistent with the tariff setting principles approved by the Minister under this Agreement.

Similarly, clause 20(2) of the GGP agreement requires Third Party access to the GGP to be made available upon non-discriminatory fair and reasonable terms and conditions and, in relation to tariffs, subject to clause 22.

In this context, approval of the detailed proposals incorporating the Tariff Package and Terms and Conditions by the Minister, signified his acceptance that the A1 tariffs were, indeed, fair and reasonable and in accordance with the tariff setting principles.

Since the approval of the detailed proposals on 27 January 1995, there have been no modifications to the detailed proposals approved by the Minister, nor any formal tariff re-determinations under the State Agreement. The original proposals, therefore, remain the approved access arrangements pursuant to the GGP Agreement.

Importantly, the approved access arrangements under the GGP Agreement were also deemed to be an approved Access Arrangement under the Code until 1 January 2000 pursuant to section 97(1) of the *Gas Pipelines Access (Western Australia) Act 1998*.

5. Approved Tariff Setting Principles

The proposals approved by the Minister incorporated tariff setting principles including the following:

- 'tariffs will be set to provide a commercial rate of return on all project capital, including all owners' costs, reasonably incurred in the construction and operation of the pipeline and to recover all reasonable pipeline operating, maintenance and administration costs. The commercial rate of return shall be commensurate with the business risk associated with the project' (TSP 2);
- 'tariffs will be structured to recover the capital cost of the pipeline equitably over time' (TSP 8);

- 'at any time when the tariffs for pipeline services then being applied:
 - do not promote the use of the pipeline; or
 - do not promote the efficient use of reserve capacity; or
 - generate a rate of return which is inconsistent with principle 2 above (except where the owners elect to exercise principle (13),

the tariffs shall be redetermined, and that redetermination shall be applied so as to ensure the principles are satisfied. Such determination shall not, under any circumstances, oblige the owners to adopt a tariff which does not satisfy principle (2).' (TSP 12);
- 'subject to compliance with all the principles (except principles (2) and (12)) the owners, at their sole discretion, may set tariffs or allow tariffs to remain operative, which are equal to or less than those resulting from the application of principle (2) ...' (TSP 13).

6. Tariff Discounts

Since the approval by the Minister on 27 January 1995 of the detailed proposals under the GGP Agreement, there have been no formal tariff redeterminations under the State Agreement, nor any amendments or additions to the detailed proposals. GGT has, however, made a number of voluntary tariff reductions:

- A2 - equivalent to 85% of A1, introduced in March 1998;
- A3 and A4 – announced in February 1999 (A3 equivalent to 80% of A1 introduced in July 1999; and A4 equivalent to 75% of A1 introduced in January 2000);
- economic development tariff (**EDT**) - introduced in mid 1999;

These tariff reductions were introduced as discounts under the terms of tariff setting principle 13. The A4 discount was withdrawn at the end of 2001, and replaced by the original A1 tariff.

At the time of the offering of the discounts, significant future expansion of the GGP load had been forecast. For example, in GGT's press release dated 24 February 1998 announcing the introduction of the A2 discounted tariffs, it was noted that:

'GGT's ability to offer the discounted tariffs is a reflection of current contracted gas transmission loads filling earlier forecasts and the expectation that further gold, nickel and iron ore mining companies will take advantage of gas power generation in their projects. The discounted tariffs will assist the viability of new projects and provide greater incentive for existing mining operations to convert from their historical use of diesel power generation.'

At the relevant time, the forecasts of imminent load growth were made in the context of publicly announced expansion plans for major projects such as Anaconda's Murrin Murrin operation. Expansion plans were also under active consideration for the Cawse and the Bulong nickel projects.

In summary, it is clear that the offering of voluntary tariff reductions as summarised above did not result in any modification of the approved proposals, nor any redetermination of tariffs under the tariff setting principles. In those circumstances, it cannot be concluded that the joint venturers' legitimate business interests or reasonable expectations under the original approved proposals should be downgraded in any way as a result of the offering of the discounts.

7. Code Requirements

Section 2.24(a) of the Code requires the ERA to take into account “the Service Provider’s legitimate business interests and investment in the Covered Pipeline”. Section 8.10(f) also requires the ERA to take into account “the basis on which Tariffs have been set in the past”, and Section 8.10(g) requires the ERA to consider “the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code”.

It is GGT’s view that the expectations of the joint venturers – and their legitimate business interests - were embodied in the detailed proposals regarding access arrangements, all elements of which were subject to detailed negotiations with the State and approved by the Minister. The joint venturers' expectations based on the approved proposals under the GGP Agreement included the following

- they would be entitled to recover all expenditure incurred in constructing and operating the GGP;
- the A1 tariffs determined as part of the final project approval process were fair and reasonable;
- they would be entitled to charge tariffs which would provide a commercial rate of return on all project capital commensurate with the business risk associated with the project;
- the fundamental parameters underlying the tariff model were acceptable to the State and would continue to apply until expressly revised by way of amended proposals being approved; and
- the principles underlying the 42 year levelised tariff model would continue to apply.

Any decision on the part of the Regulator must therefore take into account these reasonable expectations under the detailed proposals submitted and approved pursuant to the GGP Agreement.

GGT believes that the ERA has made an error in not acknowledging that the tariff setting methodology, ROR and specific tariffs were included in the detailed proposals approved by the Minister under the State Agreement. By confining its consideration to the Tariff Setting Principles – and in attempting to make its own interpretation of the out-workings of these Principles - the ERA has ignored detailed evidence of what the joint venturers and the State specifically agreed in terms of parameter values, ROR etc. This has resulted in a number of erroneous conclusions being reached in its ADD analysis.

8. Specific Errors in the ADD Analysis

In paragraphs 98 and 99, the ERA refers to Appendix B, which sets out a methodological approach and assumptions for calculating capital recovery in a way that represents “the most plausible assessment of historical capital recovery.” Paragraph B11 of this Appendix refers to the proposals lodged with the Minister in November 1994, which it states included the Tariff Setting Principles. The ERA goes on to comment that:

'The then Department of Resources Development was advised of the A1 Tariff and provided with details of the Goldfields Gas Transmission joint venturers' internal rate of return analysis based on these tariffs'.

This is a complete misinterpretation or misunderstanding of the facts. As previously advised the tariff setting methodology, the ROR and the A1 Tariffs were incorporated in the package of proposals considered and approved by the Minister after independent advice. Prior to the approval of the proposals, there were considerable discussions between DRD and the joint venturers regarding the methodology, individual parameters, the ROR and the A1 Tariffs. It is incorrect for the ERA to suggest that the State was simply “advised” of these matters.

In paragraph 141 the ERA comments that GGT was required to submit proposals for approval of the Minister, and that these proposals included tariff setting principles. It goes on to acknowledge in paragraph 145 that:

'.. the Tariff Setting Principles, and the Government's administration of the State Agreement as it relates to the determination of tariffs in accordance with the Tariff Setting Principles, are relevant considerations under Section 8.10(f)'

As indicated above section 8.10(f) requires the ERA to consider “the basis on which Tariffs have been... set in the past”.

The ERA confines its acknowledgement of “relevant considerations” to the tariff setting principles agreed under the State Agreement. GGT reiterates that

a tariff setting methodology, specific economic parameters (including ROR), and the A1 tariffs themselves, were all incorporated within the detailed proposals approved by the Minister. In GGT's view these are all "relevant considerations" which the ERA is required to consider and has failed to do so.

Paragraph 149 makes reference to Appendix D where the ERA has calculated capital recovery under assumptions which it believes reflects the manner in which tariffs have been calculated in the past. In paragraphs D10 and D11 the ERA has in fact considered documents "relating to past determination of tariffs for the GGP, including determinations of rates of return either underlying tariff proposals or expected tariffs actually put in place." This appears to acknowledge that tariffs and rates of return were part of the original proposals. Clearly the State required this detailed analysis and sought external advice for the purpose of supporting the Minister's approval of the tariffs and tariff setting methodology.

In Appendix D paragraph D14, the ERA takes the view that:

'...the expectation of GGT under the State Agreement was for a commercial rate of return (which may vary from time to time), rather than a possible capture of windfall gains (or suffering windfall losses) from a deviation of market parameters and taxation rates from those assumed in the original WACC estimate.'

The understanding with the State was that the owners would have the right and opportunity to earn the agreed rate of return - or at least a return consistent with the agreed parameters - on a continuing basis, but that there could be no guarantees in this respect. Clearly the owners were required at the outset to take the ongoing risks on:

- capital cost;
- project completion delays;
- technical performance;
- regulatory uncertainty;
- inflation;
- interest rates;
- ICC volumes;
- third party volumes;
- taxation changes.

If there had been a significant change in any of these parameters which had impacted negatively on revenues, GGT theoretically could have approached the State for a review of tariffs, but in reality would have had no opportunity to recoup these losses. Equity would appear to demand that the risk of such losses should be able to be balanced by an ROR which reflected all those risks.

In paragraph 153 the ERA advises that it has given "particular attention to the Tariff Setting Principles that applied prior to the commencement of the Code". As indicated above, consideration of the Tariff Setting Principles alone is meaningless without consideration of the approved tariff setting methodology,

economic parameters and tariffs which were specifically approved by the Minister.

In paragraph 158 the ERA expresses a view that the:

'... tariffs put in place under the Tariff Setting Principles did not necessarily comply with those principles. There is evidence to suggest that the past approach to the setting of tariffs has resulted in tariffs that embody a rate of return to GGT that is substantially in excess of a commercial rate of return'

It is clear from the early history of the GGP that the tariff methodology, parameters and tariffs resulted from detailed negotiations with the State Government. The Minister approved these arrangements before the consortium agreed to commence construction. At the time there were no other proponents willing or able to develop the GGP on better terms than proposed by the GGTJV. For the ERA to suggest, therefore, that the approved arrangements embodied a rate of return “substantially in excess of a commercial rate of return” is to ignore the commercial realities of the GGP investment.

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In paragraph 162 the ERA expresses the view that:

'... calculation of historical capital recovery with reference to a rate of return that is in excess of the cost of capital for the pipeline business would result in an asset valuation that does not reflect efficient costs of providing the pipeline services.'

GGT is firmly of the view that the State Agreement negotiations provided for a rate of return commensurate with the risks of developing the GGP as a single project – including the risks of constructing surplus capacity, and of accepting an obligation to invest in expansion. This was the context in which the rate of return for the GGP was agreed with the State – following a competitive process – and defines the level of risks which were involved in delivering the services and the expectations of the original and subsequent owners.

In GGT’s view this can be the only legitimate approach to the determination of the “efficient costs” of providing services. The values negotiated with the State, and the competitive context in which they were determined, provide direct evidence of how the risks of the project were perceived at the time – as well as a real world view of the opportunity cost of capital for this investment.

It is important to emphasise that the original developers of the GGP were miners and processors, and not primarily engaged in the pipeline business, having a portfolio of other pipeline investments. They were the only parties which could have developed the GGP at the time, as they were the ones in a position to underwrite the demand for gas. The appropriate ROR for the

investment must, therefore, be their opportunity cost of capital – as agreed with the Minister.

For the ERA to argue in paragraph 164 that the rate of return assumed by GGT “is a substantial over-estimate of the true cost of capital for the GGP business” by between four and nine percentage points over the years 1994-2002 is to ignore reality. If this were indeed the case, then alternative investors would surely have appeared at the time of the competitive process initiated by the State, to construct the GGP on such terms. This was not the case. The State itself was certainly not prepared to invest in the GGP, and none of the other parties which expressed interest at the EOI stage proved to be serious contenders. Efforts by the original joint venturers themselves to find a fourth investor to assume the third party provider role were unsuccessful. Suffice it to say that the GGP would not have been constructed on lesser terms.

In paragraph 178 the ERA does acknowledge that:

'...the manner of administration of the State Agreement by the Western Australian government allowed these tariffs to become entrenched under the Tariff Setting Principles and may have created an expectation that the high rate of return would continue.'

Given that the approved rate of return actually incorporates an accommodation of the risk premium required in order that the original investment were to ever have been undertaken, it is indeed the case that the joint venturers had an expectation that the approved rate of return would continue. The evidence is in the approved proposals which embodied the tariff methodology, the ROR and the resulting tariffs. Notwithstanding the acknowledgement in the State Agreement about the possible introduction of uniform laws, in 1994 there was no reason for the GGTJV to expect that such laws might deliver different outcomes from those negotiated with the State to underpin the investment.

GGT believes that the primary determinants of regulated tariffs established under the Code, that is Rate of Return (ROR) and ICB, should have due regard to the particular history and circumstances surrounding the development of the GGP, and in particular to the bases on which GGP tariffs have been determined under the State Agreement.

This is a requirement of the Code under sections 8.10(f) and (g) in regard to establishing the ICB, however given the significance of the role which it has to play, consideration of the bases for, and context of, the historically derived rate of return is also fundamental to meeting the requirements of the Code in respect of sections 2.24(a) and 8.1(d).

Consequently, consideration of the facts underlying the background to the development of the GGP, along with consideration of the reasons for which it is unique (in the context of the application of the Code), is fundamental to an understanding of the risks involved in delivering the Reference Services provided by the GGP. Consideration of the historical facts are also

fundamental to an understanding of GGT's expectations with respect to ROR, however these appear to have been misinterpreted by the ERA in its ADD.