



Goldfields Gas Transmission Pty Ltd  
ACN 004 273 241

Level 8  
Australia Place  
15-17 William Street  
Perth WA 6000

### **Submission on Supposedly High Tariffs on the Goldfields Gas Pipeline (GGP)**

Goldfields Gas Transmission Pty Ltd (GGT) wishes to address the view being publicised by some parties as part of the current debate over tariff re-determination under the auspices of implementation of the National Code, that;

- (i) the price of delivered gas to the Goldfields region is high relative to other geographical locations, and,
- (ii) that substantially reducing gas transportation tariffs on the GGP will remedy this, improving relative competitiveness and removing a significant barrier to the development of new business in the region and hence will promote economic prosperity for the region and the State.

**GGT submits that this notion is founded on a number of logical fallacies as discussed below.**

- (1) That the price of delivered gas is independent of geographical location or specific pipeline design.

The tariff which a pipeline owner needs to charge in order to generate the revenue commercially required to justify investment in the first place, and then to subsequently stay in business, is a function of;

- (i) the cost of the pipeline (determined by length, required capacity and cost to install and operate), and,
- (ii) the gas volume it will transport (determined by the market it will serve initially, with consideration of future likely prospects for market growth to underpin provision of developable pipeline capacity).

In deriving a tariff equation, effectively; (i) the cost determines the numerator; and (ii) the volume determines the denominator. Making the numerator (ie. the cost) larger or the denominator (ie. the delivered volume) smaller, results in a higher tariff, and vice versa. It should also be noted however that this equation represents the overall average tariff requirement - in reality tariffs will vary depending upon the size and duration of a

contract, recognising the value of commercial certainty in the same way as any other business might.

Considering the cost side of the equation;

- (i) As much as any other capital intensive business, pipelines have their own economies of scale. The smaller the market, the more limited or uncertain its prospects for growth, the further removed from the source of supply it is, the less favourable the economies of scale are going to be.
- (ii) Most (although certainly not all) gas pipelines tend to transport gas from a point of origin to a relatively well defined point of delivery, with little or no offtake before that end point. This simplifies the design of the pipeline and reduces the overall unit-transport cost that can be charged<sup>1</sup>.

Unfortunately, the GGP does not enjoy this characteristic, having substantial offtake points all along its length.

- (iii) The GGP was conceived to supply gas to existing mines located between Mt Newman and Kalgoorlie in order to provide a cheaper fuel source than the diesel then being used. This was a logical step on the part of the mine site owners given that they also owned gas resources on the North West Shelf. In the capacity of custodian of the public interest, the State Government "stepped in" (to greatly understate the complexity of the process) and stipulated the minimum original and developable capacity which the pipeline would have to have. As a result, the GGP can, with some additional expenditure on capacity expansion, accommodate a higher throughput of gas than it might have otherwise been designed for. However, this capability came at an increased capital cost – a price that the mine owners had to pay in order to get the necessary Government approval to proceed with the GGP at all.

Considering the load (or volume of gas transportation) side of the equation;

In the event that demand arises, there are two generic approaches to how tariffs for the use of this expanded capacity could be developed. They are either on a marginal basis (where new Users pay based on the incremental cost of expanding to accommodate them), or on an average cost basis (where all Users see a tariff based on the new increased total cost being shared across the new increased total gas volume being transported)<sup>2</sup>. Whichever approach is adopted, the magnitude of any new tariff will be determined as a function of the new cost base and the new gas transportation volume which eventuates. Until both of these determinants are known, any resulting new tariff can only be estimated.

The current owners of the GGP would be very happy to see and accommodate demand for this additional transportation capacity. In fact GGT recently attempted to precipitate just such an increase in demand for gas transportation to the Goldfields. This was achieved by offering to the

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<sup>1</sup> This is because some portion of the gas volume is only transported part way along the length of the pipeline, and hence a lower volume of gas remains to underscore the investment in pipe required to get to the final destination.

<sup>2</sup> There are of course contractual considerations involving pre-existing rights of access, as well as tariffs, which must also be considered.

market a marginally priced tariff for any new project or new expansion of an existing project which was likely to go ahead within a defined period.<sup>3</sup>

Unfortunately, this initiative failed to capture any additional significant load. The total volume of new business for which interest was expressed was too small to underwrite any significant investment in expansion and the number of enquiries which proceeded to any form of commitment was even smaller. The conclusion which GGT draws is that gas demand in the Goldfields is highly price inelastic in respect to the cost of transporting gas. (This is explored further below).

(2) The relative impact of the transportation component in the delivered cost of gas.

The cost of delivered gas in the Goldfields (as elsewhere in Australia) will vary from customer to customer depending upon the size, duration and nature of the specific contracts into which they enter. Larger corporate businesses will negotiate their own gas supply and transportation contracts, or buy from a Gas Trader whose commission will be included in the delivered cost of the gas.

This variability (as well as commercial confidentiality associated with contracts and the fact that some of these are held by competing companies) makes direct comparison of the tariffs paid by these larger corporate customers within the region and between other regions problematic. However based on publicly available data, GGT has performed its own analysis of the relative contribution of the total cost of gas, and specifically the cost of gas transportation, within the total annual cashflow considerations of a major resource development project serviced by the GGP. For a relatively intensive gas consumer, these figures indicate that the cost of gas transportation represents considerably less than 5% of total operating costs.

At the other end of the customer spectrum, a breakdown of the publicised cost of gas delivered to the average small business or domestic household provides some insight into the relative significance of the cost of gas transportation in the overall price of gas.

According to the new price schedule published by AlintaGas, from 1 July 2001 the price of gas delivered to residential and business customers in Kalgoorlie is 5.86 and 5.22 cents per unit (including GST and the recent 3.5% price rise imposed by AlintaGas). This equates<sup>4</sup> to a delivered cost of gas of \$16.27/GJ for residential customers and \$14.50/GJ for business customers.

As a rough guide, the price of purchasing gas in the North West Shelf area is around \$2.00/GJ. The current cost (under the published "A4" tariffs) to transport this gas the full length of the GGP to Kalgoorlie is somewhat under \$3.00/GJ, depending upon the specific customer's load factor. The balance of the cost of delivering the gas goes to the local distribution and marketing utility. The following table summarises this breakdown.

Breakdown	Residential Customer		Business Customer	
Gas Purchase	\$ 2.00/GJ	12%	\$ 2.00/GJ	14%
Transportation	\$ 3.00/GJ	18%	\$ 3.00/GJ	21%
AlintaGas	\$11.27/GJ	70%	\$ 9.50/GJ	65%
Total	\$16.27/GJ	100%	\$14.50/GJ	100%

<sup>3</sup> Hence the initiative was called an "Economic Development Tariff" (EDT) programme and included a defined period which was a necessary specification in determining correct capacity development and optimum expenditure phasing.

<sup>4</sup> On the basis that one "unit" equates to 1kilowatt hour, or 3.6 MJ.

- (3) That reducing the cost of transporting gas will have any significant effect on the development of new business.

Market evidence, reinforced by the poor response elicited by the recent EDT offered by GGT, indicates that there are no new projects on any scale for which the cost of gas transportation is a critical determinant of viability.

To put the argument in the extreme, even if GGT were able to offer a gas transportation service **for free**, the evidence available to GGT indicates that this in itself would not precipitate one single new business venture proceeding. The only economic effects that would result would be to increase the profits of existing businesses and a possible loss of business for diesel fuel supply companies and diesel delivery drivers.

Obviously offering to transport gas at no cost is not a commercially viable option, however GGT would be most grateful to hear from the proponent of any new business who considers that the viewpoints offered in this section are erroneous. GGT would welcome the opportunity to explore how it might be able to work cooperatively to contribute to the viability of any new undertaking.

It should be noted that GGT is an open access pipeline and as such, actively seeks to promote and attract new business through offering gas transportation services at prices which are commercially defensible and fair and reasonable.

- (4) That the mandating of reductions in tariffs on the GGP will be conducive to development of other business or serve to promote economic prosperity.

Resource development significantly underpins the economy of Western Australia. It is vital to the economic prosperity of the Goldfields region. It is also a field of investment which is exposed to a multitude of technical and commercial uncertainties, and highly exposed to the vagaries of international economic fluctuations. When a project is successful, the Government is generally not slow to appropriate its full share of the proceeds. When it is not, it is the investors who are out of pocket.

In Western Australia, many developments have been facilitated by arrangements with the State Government. There are at least 63 State Agreements, enshrined in law and covering virtually every form of resource project and accounting for more than 70% of mineral production and 60% of all direct employment in mining<sup>5</sup>. This is not to say that all resource development has proceeded under the security of a State Agreement. However these agreements have certainly been instrumental in facilitating the bulk of resource investment in the State, reducing uncertainty and hence lowering the threshold at which the necessary investment funds are made available to developers.

Of course there will always be some investors who are prepared to accept higher levels of risk, but these investors demand higher rates of return, and there will always be fierce competition for these more limited investment funds from more speculative development promoters. Such investment sources cannot be relied upon to underscore the level of regional development that Western Australia demands.

The failure to give proper consideration to the GGP State Agreement by the State Regulator for Gas Pipelines Access under the national code, violates the very investment

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<sup>5</sup> Based on figures published by the Government of Western Australia in "In Agreement, How major developers obtain project security through State Agreement Acts", Department of Resources Development, August 1997.

security which the agreement was intended to provide. The actions of the existing owners, to whom the rights under the State Agreement were duly assigned at the time of purchase, have been entirely consistent with their obligations under that agreement. In contrast, the decision (albeit a draft at this time) issued by the State Regulator represents a denial of the undertakings provided by the Government and purported to afford specific investment securities over the whole of the originally agreed project life.<sup>6</sup>

The ramifications for other existing State Agreements, the credibility of future undertakings and assurances on the part of the State Government, and the medium to long term consequences for resource and infrastructure investment in this state remain to be seen. However, given the preceding appraisal of the lack of economic benefits which this decision brings, and comparing this to the negative consequences for investment certainty and State reputation, it is difficult to see how the Regulator's decision to propose substantial tariff reductions for the GGP can be conducive to either regional development or economic prosperity.

- (5) That any significant reduction of tariffs and hence revenue to GGT is economically sustainable.

The original tariffs for the GGP were determined under State approved tariff setting principles. Included in the methodology were assumptions in regard to project life, pipeline costs, future gas demand forecasts and acceptable rate of return on the investment. Since then, tariffs have been discounted by some 25%.

The GGP Draft Decision, proposes to put a cap on the revenue which the GGP can earn by reducing the tariff which can be charged for its transportation services. This reduction is both substantial and has been set without regard (other than a superficial linkage in respect to setting a revised capital base) to the economic values upon which the investment was undertaken. Moreover, the Decision also proposes that, in the event that an increase in gas demand does materialise, and if GGP revenue were to increase to a value which still falls short of what it is being reduced from<sup>7</sup>, a further tariff reduction would be triggered.

It is obvious that the extent of the reductions from the revenue originally required to justify the construction of the GGP are very substantial. It is also clear that under the Regulator's proposal, this lost revenue could never be recouped, even in the event that significant gas demand in the Goldfields were to materialise. Leaving aside matters of acquisition cost to the current owners, it must be reasonably obvious what the impact of such measures must be on the economic viability of the project.

## Conclusion

As a consequence of the views expressed above, GGT concludes that the tariff reductions being currently proposed in the Draft Decision are not only unwarranted and inequitable, they have been arrived at on a basis that is inappropriate to the specific history, circumstances and intended outcome. In fact it seems likely that the extent and nature of the tariff reductions proposed in the current Draft Decision are more likely to result in a stifled investment and a sustained economic downturn in the resource sector than in any measurable social or economic benefits.

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<sup>6</sup> Unless changed by mutual agreement.

<sup>7</sup> ie. the proposed revenue reduction is 30%, the threshold for the trigger is if revenue reaches a 25% increase from the reduced value.

*10 July 2001*

While the intention of this submission is to address what appear to be fairly widely held misconceptions affecting all interested parties, GGT specifically requests the Regulator to re-evaluate the basis upon which he has previously formed a view in regard to tariffs on the GGP. Furthermore, GGT requests all interested parties to reconsider their own position as to the potential costs and benefits associated with the Regulator's recent Draft Decision.