NEWMONT AUSTRALIA LIMITED

FURTHER SUBMISSION
TO GAS ACCESS REGULATOR
PURSUANT TO NOTICE DATED 6 NOVEMBER 2002

Submitted 17 December 2002

CONTENTS

In response to the notice of the WA Independent Gas Pipelines Access Regulator (‘**the Regulator**’) dated 6 November 2002 calling for fresh submissions regarding his Draft Decision on the Access Arrangement proposed by the owners of the Goldfields Gas Pipeline (‘**the Draft Decision**’) pursuant to the *National Third Party Access Code for Natural Gas Pipelines Systems* (‘**the Code**’) for that pipeline, Newmont Australia Ltd (‘**Newmont**’) makes the following submissions on its behalf and on behalf of its various subsidiaries that formerly owned a share of the pipeline and who currently use the pipeline for the transport of gas.

Newmont notes that the Regulator has, at this stage, only requested submissions as to the implications of the decision of the WA Full Court in *Re Dr Ken Michael AM; ex part Epic Energy (WA) Nominees Pty Ltd* [2002] WASC 231 (‘***Epic***’) upon the Draft Decision. This submission does not, therefore, purport to address all matters that Newmont may have wished to comment on if the proposed Access Arrangement was being considered de novo but, rather, comments on the extent to which (if at all) the Draft Decision requires revision in the light of *Epic*.

Further, in accordance with the process outlined in the Regulator’s notice of 6 November 2002, this submission does not comment on the question of the impact of cl 21(3) of the *Goldfields Gas Pipeline Agreement* upon the Regulator’s jurisdiction and discretion with respect to the Goldfields Gas Pipeline (‘**the GGP**’). Newmont expects that it will be given an opportunity to be heard as to that question at a later stage in the determination process.

1. <u>SUMMARY</u>

1.1 In general, Newmont submits that there is nothing in *Epic* that should cause the Regulator to alter the conclusions he reached in the Draft Decision.

1.2 With respect to the setting of the **Initial Capital Base** in the Draft Decision, Newmont submits that the Regulator’s adoption of the GGP Owners’ actual cost as the ICB, even thought that cost exceed the DORC valuation, is consistent with the reasoning of the Full Court in *Epic*. Further, it is Newmont’s view that the Regulator’s rejection of the GGP Owners’ suggested use of the unit of production method of depreciation cannot be said to have been the result of a disregard of any of the relevant factors in ss 2.24 or 8.1 of the Code. Newmont accepts, however, that, by virtue of s 8.10(g) of the Code, the GGP Owners are entitled to have any assumption made concerning depreciation for the purposes of the GGPA tariff regime taken account of in the fixing of the ICB for the GGP pursuant to the Code.

1.3 With respect to the setting of the **Rate of Return** in the Draft Decision, Newmont's view is that *Epic* would only require a revision to the Rate of Return fixed in the Draft Decision if the Regulator's consideration of the matter amounted to a unreasonable exercise of the Regulator's discretion in balancing the various factors outlined in ss 2.24, 8.1 and other relevant provisions of the Code.

1.4 In relation to the various matters considered by the Regulator in setting a rate of return in the Draft Decision, Newmont contends that:

(a) the fixing of the market risk premium at 6.0% amounted to a reasonable exercise of the Regulator's discretion with respect to a matter that is the subject of divergent opinions amongst experts in the field;

(b) while the Regulator's fixing of the risk free rate at 5.35% and the inflation rate at 2.14% was not an unreasonable exercise of his discretion as to those matters, the passage of time may warrant a revision of those figures to reflect more closely the contemporary position;

(c) while the Regulator's fixing of the cost of debt at a margin of 1.2% was not unreasonable, it may be appropriate for the Regulator to obtain fresh evidence as to current market practice in relation to the cost of funding for comparable facilities;

(d) the Regulator's adoption of a debt to equity ratio of 60% was a reasonable exercise of the discretion provided to him by s 8.31 of the Code;

(e) the Regulator's use of a proxy beta of 1.33 amounted to a reasonable exercise of his discretion;

(f) the Regulator's use of a 31.4% corporate rate tax rate amounted to a reasonable exercise of his discretion, given the actual reduction in the Australian corporate tax rate from 36% to 30% during the term of the proposed Access Arrangement.

1.5 Accordingly, other than to acknowledge that the Regulator might need to obtain fresh data as to the risk free rate, the inflation rate and the cost of debt, Newmont submits that the Rate of Return fixed in the Draft Decision amounted to a reasonable exercise of the Regulator's discretion in balancing all of the objectives referred to in ss 2.24, 8.1 and other relevant provisions of the Code and, hence, that there is nothing in *Epic* that should cause him to amend that Rate of Return.

2. SIGNIFICANCE OF FACTORS IN CODE, S 2.24

2.1 In *Epic*, the Full Court held that the Regulator was required to give the factors referred to in s 2.24 of the Code weight as fundamental elements in assessing a proposed Access Arrangement, particularly in resolving conflicts between the various matters referred to in s 8.1 of the Code.

2.2 The s 2.24 factors are:

(a) the Service Provider's (in this case, the GGP Owners') legitimate business interests and investment in the Covered Pipeline (in this case, the GGP);
(b) firm and binding contractual obligations of the Service Provider;
(c) the operational and technical requirements for the safe and reliable operation of the Covered Pipeline;
(d) the economically efficient operation of the Covered Pipeline;
(e) the public interest, including the public interest in having competition in markets (whether or not in Australia);
(f) the interests of Users and Prospective Users;
(g) any other matters that the Regulator considers are relevant.

2.3 Pursuant to s 8.1, a Reference Tariff should be designed with a view to achieving the following objectives;

(a) providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service (in this case, the service of transporting gas through the GGP) over the expected life of the assets used in delivering that Service;
(b) replicating the outcome of a competitive market;
(c) ensuring the safe and reliable operation of the Pipeline;
(d) not distorting investment decisions in Pipeline transportation system or in upstream or downstream industries;
(e) efficiency in the level and structure of the Reference Tariff; and
(f) providing an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services.

2.4 It is also noteworthy that the Full Court ruled that s 8.1(a) was not paramount and, hence, did not impose a ceiling on the Reference Tariff that may be set and that the efficient cost of delivering the Service must be weighed alongside the other matters referred to in s 8.1 and the factors in s 2.24.

2.5 In the wake of *Epic*, therefore, Newmont accepts that the Regulator must take the legitimate business interests of the GGP Owners into account in setting the Reference Tariff for the GGP, but also submits that those interests must be balanced against other, possibly conflicting, interests, such as the interests of users of the GGP and the interest in the efficient operation of the pipeline.

3. INITIAL CAPITAL BASE

3.1 In *Epic*, the tension between the various interests referred to in 2 was considered extensively in relation to the question of whether the Regulator had taken sufficient account of Epic's legitimate business interests in setting the Initial Capital Base ('**the ICB**'). Epic argued before the Full Court that the Regulator, by not accepting the price paid by Epic for the DBNGP as the ICB, had failed to give sufficient weight to Epic's legitimate interests. The Full Court found that that matter had not been given sufficient attention by the Regulator.

3.2 In the Draft Decision, the Regulator essentially accepted the actual cost of the pipeline to the GGP Owners as the ICB (subject to an argument as to the method of depreciating this cost: see below, 3.4-3.7) even though that amount exceeded the Depreciated Optimial Replacement Cost ('**the DORC**'). In doing so, the Regulator noted in the Draft Decision that 'the inefficiency implications of an ICB in excess of the DORC [are] outweighed by the reasonable interests of [the GGP Owners] in having the design constraints of the [*Goldfields Gas Pipeleine Agreement Act*] recognised in the valuation of the ICB' (Part A, 17, Part B, p 111).

3.3 Newmont submits that there is nothing in *Epic* that suggests that the Regulator should alter those conclusions in the Draft Decision as to the setting of the ICB.

3.4 The principal point of difference between the GGP Owners and the Regulator concerning the calculation of the ICB for the GGP appears to have been in relation to the method of depreciating the pipeline. The GGP Owners argued for a 'unit of production' methodology which would mean that capital was recovered in the earlier years when, it was argued, the majority of revenue is expected to be generated (i.e pursuant to this method, the pipeline's value would be depreciated by 2016). The use of this method was said to be justified on the basis that there was no certainty that the operations of the major GGP customers would continue beyond 2016. The Regulator commented that the unit of production method, while not inconsistent with the Code, ought not be used in this case as there was no reasonable likelihood of a decline in mining and processing in the areas serviced by the GGP after 2016 (Part B, p 159).

3.5 It is noteworthy that s 8.10 of the Code, which lists the factors the Regulator must take account in setting the ICB, requires the Regulator to consider the 'reasonable expectations of persons under the regulatory regime that existed prior to the commencement of the Code' (s 8.10(g)).

3.6 Considering the matter without reference to s 8.10(g), Newmont submits that there is nothing in *Epic* that should cause the Regulator to adopt a worst case prediction of future throughput on the GGP (i.e that there will be *no* mining operations along the route of the pipeline after 2016), particularly in view of the Regulator's acceptance of the price paid by the GGP Owners for the GGP as the ICB (even though that price exceeds the DORC of the pipeline). Newmont notes that the prospectus for the Australian Pipeline Trust (referred to at p 87 in Part B of the Draft Decision) appears as reasonable a projection of the likely demand for the GGP's services as that contained in the proposed Access Arrangement. Accordingly, Newmont's view is that the Regulator's decision as to the appropriate depreciation method amounts to a reasonable exercise of the Regulator's discretion in balancing the factors referred to in ss 2.24, 8.1 and 8.10 (leaving aside sub-paragraph (g)) and, hence, ought not be altered.

3.7 By virtue of s 8.10, however, it is necessary to consider whether the GGPA tariff regime was based on any assumptions as to the longevity of the mining operations serviced by the pipeline. If, for example, that regime was based on an assumption that the mining operations serviced by the GGP would not continue beyond 2016, then the GGP Owners may be entitled to have that assumption reflected in the setting of the ICB pursuant to the Code. Newmont's difficulty in making submissions as to this issue is that it no longer has access to the various submissions made to the Minister by the original owners of the GGP and that there does not appear to be anything in the GGPA Tariff Setting Principles that deals with this matter.

4. RATE OF RETURN: GENERAL

4.1 In *Epic*, the Full Court predominantly focussed on issues relating to the Regulator's setting of the ICB, whereas in the GGP Draft Decision the principal point of dispute between the Regulator and the GGP Owners appears to have been the *Rate of Return*. In the absence of any detailed examination in *Epic* of matters relevant to the setting of a Rate of Return pursuant to the Code, the significance of the Full Court's decision for that issue must be discerned from the general principles outlined therein. In Newmont's view, *Epic* would only require a revision to the Rate of Return fixed in the Draft Decision if the Regulator's conclusion concerning that matter amounted to an unreasonable exercise of the Regulator's discretion in balancing the various factors outlined in ss 2.24 and 8.1 of the Code.

4.2 The Code requires the Regulator to set a Rate of Return that is 'commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service' (8.30). The Code specifies, by way of example, that the 'Rate of Return may be set on the basis of a weighted average of the return applicable to each source of funds' and that the average should 'be calculated by reference to a financing structure that reflects standard industry structures for a going concern and best practice' (both quotes, s 8.31). In Newmont's view, the Regulator's use of the Capital Asset Pricing Model to derive a Weighted Average Cost of Capital was consistent with the requirements of the Code and a reasonable method to adopt to calculate the Rate of Return.

4.3 It is noteworthy that the Code does not expressly require the Regulator, in setting a Rate of Return, to consider the reasonable expectations of the GGP Owners under the GGPA regime. Indeed, Newmont submits that, as the Code does make express reference to such expectations when considering the ICB, there is a reasonable argument that the Code does not require the Regulator to consider such expectations at all when determining the Rate of Return or, at least, that such expectations must be considered to be of subsidiary importance relative to those expressly referred to in ss 2.24 and 8.1 of the Code.

4.4 Newmont's analysis suggests that the inputs to the WACC calculation that have the greatest effect on the rate of return reached are the risk free rate, the debt to equity ratio, the proxy beta and the market portfolio premium, with the changes to the first of those inputs having the most significant impact on the WACC. The equity beta is the only one of these factors that is likely to change according to the view taken as to the peculiar risks of the GGP. Nevertheless, the question of whether the Rate of Return struck in the Draft Decision amounts to reasonable exercise of the Regulator's discretion in balancing the factors referred to in ss 2.24 and 8.1 of the Code is considered below by reference to each of the inputs to the WACC calculation.

5. MARKET RISK PREMIUM

5.1 The GGP Owners argued before the Regulator for a market risk premium of 6.5%. The Regulator in his Draft Decision adopted a premium of 6.0%, following consideration of how the premium had been set in other Australian regulatory decisions regarding gas pipelines (Part B, p 124).

5.2 The difference of view as to this point has little to do with the GGP but, rather, with the question of what is the appropriate risk premium to be paid for holding an average market portfolio compared to a riskless asset, such as a long-term Government bond. The Regulator, adopting the ACCC's reasoning on this point, concluded that the 'equity premium has fallen as investors' perceptions of risks are changing' (Part B, p 123).

5.3 Newmont submits that there in nothing in *Epic* that ought cause the Regulator to change his view as to this issue. The Regulator's decision amounts to a well reasoned discretionary judgment as to a matter of divergent opinion amongst relevant theorists that appropriately balances the various interests referred to in ss 2.24 and 8.1 of the Code.

6. RISK FREE RATE AND INFLATION RATE

6.1 In the Draft Decision, the Regulator's calculations involved the use of a Commonwealth 10-year bond rate (or nominal risk free rate) of 5.35% (being the average for the 20 day period to 28 February 2001). This was lower than the rate used by the GGP Owners of 6.7%, which was the rate prevailing immediately after the Reserve Bank's decision on rates on 3 November 1999. For the inflation rate, the Regulator used a figure of 2.14%, being the 20 day moving average of the difference between nominal and real indexed bonds (calculated for the same 20 day period as for the bond rate). The GGP Owners had used an inflation rate of 2.5%, being the official inflation forecast. The ultimate effect of the choice of these variables was that the Regulator's real risk free rate was 3.14%, as opposed to the GGP Owner's figure of 4.1% (Part B, p 126).

6.2 Newmont would accept that there may be a need for some revision of these figures on the basis that the Draft Decision has employed average figures over a very short period that may now be outdated, although it is Newmont's view if the bond rate and inflation rate prevailing now were used, the result would, all other things being equal, most likely be a reduction in the Rate of Return.

7. COST OF DEBT

7.1 In the Draft Decision, the Regulator referred to previous regulatory decisions regarding gas pipelines and empirical evidence as to utilties' cost of debt in the market and ascribed a debt margin of 1.2%, lower than the GGP Owners' suggestion of 2.25%. Adding this to the nominal risk free rate (i.e 5.35%: see 6.1 above), the Regulator fixed the cost of debt at 6.55%. The GGP Owners had suggested 8.95% (i.e risk free rate of 6.7% plus a margin of 2.25%) (part B, pp 129-130).

7.2 The cost of debt is a matter that is capable of being quantified (to a significant extent at least) by reference to existing market conditions, rather than to economic theory. Newmont would accept that it may be appropriate for the Regulator to obtain fresh evidence as to current market practice in relation to funding for comparable facilities to ascertain whether the figure used for cost of debt is so far out of step with that practice as to be an unreasonable balancing of the factors referred to in s 2.24 of the Code.

8. DEBT TO EQUITY RATIO

8.1 In the Draft Decision, the Regulator noted that the practice amongst UK and Australian regulators was to 'adopt a debt to equity ratio based on a financing structure relevant to a standard and efficient entity for the particular industry' (Part B, p 130) and that the 'weighted average return on funds should be 'calculated by reference to a financing structure that reflects standard industry structures' (Part B, p 131). In doing so, the Regulator was simply applying the requirements of the Code that mandates reference to 'standard industry structures for a going concern and best practice' (Code, s 8.31) For that purpose, the Regulator, by reference to Standard & Poors figures for transmission and distribution companies, concluded that 60% was the appropriate gearing level for the rate of return calculation (Part B, p 132). The GGP Owners had suggested 50%.

8.2 Newmont submits that the Regulator's approach to this issue amounted to a reasonable exercise of his discretion under the Code that cannot be said to have overlooked any of the ss 2.24 or 8.1 factors and, accordingly there is nothing in *Epic* that should cause the Regulator to change his view on this point.

9. PROXY BETA

9.1 In the Draft Decision, the Regulator noted that '[w]here entities are not traded, it is common to derive a 'proxy beta' which is based on the estimated betas for other firms that are considered to face similar levels of risk' (Part B, 132). The Regulator also noted the need to remove the level of gearing as a factor in calculating the proxy delta, which is done by 'converting an estimated equity beta into the equity beta that would result if the asset were wholly equity financed … [with the] resultant beta … known as an asset beta' which 'can be re-levered into the equity beta consistent with the desired level of gearing and used in the CAPM to estimate the required equity return' (both quotes, op cit). Further, the Regulator proceeded from the assumption that 'in a competitive capital market, an investor would not be able to receive compensation for bearing diversifiable risk' (Part B, p 133). Hence, the 'beta of a particular asset (as used in the CAPM) is a measure of its level of systematic risk, relative to other assets … [or] the relative sensitivity of an individual asset to economy-wide factors' (Part B, p 133). The GGP Owners calculated the proxy beta for the

GGP (of 1.4) by reference to the weighted average beta of customers using the GGP and to calculations of the proxy beta by Macquarie Bank.

9.2 In their submissions to the Regulator, the GGP Owners argued that the GGP was unique due to it servicing the mining industry in specific geographical areas that were remote from major population centres and, hence, contended that the beta of the GGP's customers was a relevant yardstick for the GGP proxy beta. The Regulator rejected this contention, instead using the beta of other infrastructure and utility operators as his benchmark, although he did recognise that the GGP 'may face a higher systematic risk than some of the other pipelines operating in Australia' (Part B, p 136). The Regulator concluded that 'a reasonable range for the asset beta of an Australian gas transmission business is 0.45 to 0.65' (Part B, p 142) and that, given the risks faced by the GGP, an appropriate proxy asset beta for the GGP was 0.65. Assuming gearing of 60% and a debt beta of 0.2, the appropriate equity beta for the GGP was 1.33 (rather than 1.4, as proposed by the GGP Owners) (Part B, p 142). Using all of these variables, the Regulator concluded that the Access Arrangement should adopt a pre-tax real rate of return of 7.95% (Part B, p 154). The variables used by the Regulator in this calculation, and those used by the GGP Owners, are listed in Part B, p 153 (Table 23). The GGP Owners had proposed a rate of 12.2% (Part B, p 118).

9.3 Newmont submits that the Regulator's conclusion as to the proxy beta amounted to a reasonable exercise of his discretion in balancing the factors referred to in ss 2.24 and 8.1 of the Code and, hence, there is nothing in *Epic* that should cause him to reach a different conclusion as to this matter. In Newmont's view, the Regulator has taken account of the legitimate business interests of the GGP Owners in arriving at a proxy beta at the high end of those applied to other Australian gas transmission utilities but also given weight to the interests of users of the GGP and the interest in efficient operation of the pipeline in concluding that adoption of the beta of the GGP's customers was not appropriate.

10. <u>CORPORATE TAX RATE</u>

10.1 In the Draft Decision, the Regulator adopted the forward transformation methodology and, having acknowledged that corporate tax rates changed (from

36% to 30%) during the period of the proposed Access Arrangement, adopted an average tax rate of 31.4% in the WACC calculation (Part B, 144). The GGP Owners argued before the Regulator for a 36% corporate tax rate.

10.2 Newmont's view is that it would be unreasonable to adopt a 36% corporate tax rate in the face of a known reduction in the rate during the period of the proposes Access Arrangement. In the circumstances, Newmont submits that use of a 31.4% rate amounted to a reasonable exercise of the Regulator's discretion in balancing the factors referred to in ss 2.24 and 8.1 of the Code and, hence, that there is nothing in *Epic* that should cause him to reach a different conclusion as to this matter.