

01 March 2000

Ref.8.10/PMJ:jw

Mr Robert Pullella
Office of Gas Regulation
Level 6
Governor Stirling Tower
197 St Georges Terrace
PERTH WA 6000

Dear Sir

Proposed Access Arrangement for the DBNGP dated 15 December 1999

Hamersley Iron Pty Ltd is a substantial user of gas in the Pilbara region of Western Australia, and relies upon the Dampier to Bunbury Natural Gas Pipeline (**DBNGP**) to transport its gas requirements to the Hamersley Iron Lateral Pipeline. It uses approximately 9 kms of the DBNGP from the North West Shelf domgas plant to delivery point O11-01.

Hamersley is an initial shipper under the *Gas Transmission Regulations 1994 (WA) (GTRs)*. Its contracted capacity is via a gas transportation contract dated 31 December 1994 between North West Shelf Gas Pty Ltd and the then service provider, SECWA (**existing contract**). The existing contract also caters for the capacity granted to Robe River Iron Associates and the Electricity Corporation as initial shippers.

Hamersley welcomes the opportunity to make the following submission on the proposed Access Arrangement for the DBNGP prepared by Epic Energy (WA) Transmission Pty Ltd (**Epic Energy**). Because of the interrelationship of the parties created by the existing contract, Hamersley has discussed this submission with North West Shelf Gas, Robe River Iron Associates and the Electricity Corporation.

1 Reference Tariff

Hamersley currently pays the tariffs and charges that apply under the GTRs on a pass-through basis. During 1999, Hamersley paid the part-haul equivalent of the full-haul tariff of \$1.09/GJ, resulting in an overall approximate charge of 0.89 cents/GJ.

Under the proposed Access Arrangement, Hamersley will pay the tariffs and charges of a Zone 1a shipper. If the proposed Reference Tariff is approved, Hamersley estimates that its gas transmission costs will increase approximately 14 times from their current level. Effectively, Hamersley's annual gas transportation costs would increase from approximately \$50,000 to \$700,000 (excluding the impact of any penalty charges) under Epic Energy's proposal.

Hamersley considers that such an outcome would be grossly inconsistent with the Government's statements regarding tariff reduction, believing that there is an implied intention for part-haul pricing to remain linked to full-haul pricing. It is also inconsistent with the paper titled "Epic's Vision for WA" delivered to the 1998 Energy in Western Australia Conference.

A breakdown of the charges that comprise the Reference Tariff and their impact on Hamersley is detailed below.

1.1 Gas Receipt Charge

The proposed Gas Receipt Charge is 6.98 cents/GJ. There is no directly equivalent form of charge under the existing contract, but it is somewhat similar in nature to the existing commodity charge, which is currently less than 0.2 cents/GJ for Hamersley.

The information given on these costs in the Access Arrangement Information is not sufficiently detailed to enable close examination of this issue. However, it would appear that contributing factors to the increase are:

- The proposed charge is a fixed charge based on maximum daily quantity (MDQ), and not the actual quantity received as with the current commodity charge, so it has a greater impact on a shipper like Hamersley that does not have a 100% load factor; and
- The proposed charge apportions costs associated with the operation of the entire pipeline - most of which is of no interest or benefit to a Zone 1a shipper.

The proposed Gas Receipt Charge costs represent a grossly disproportionate charge for part-haul shippers compared to a full-haul shipper. To better reflect the cost to Epic Energy of servicing full-haul shippers compared to part-haul shippers, Hamersley submits that the Gas Receipt Charge should be charged as a fixed proportion of the quantity of gas used by recipients, not a fixed cost applicable to all users irrespective of gas use.

The proposed Access Arrangement does not provide sufficient detail of the costs comprising this charge for Hamersley to determine whether the Gas Receipt Charge meets the objectives set out in section 8.1 of the National Third Party Access Code for Natural Gas Pipelines (**Code**). For example, in Tables 2.3 and 4.1 of the Access Arrangement it appears that the Gas Receipt Charge may include the cost of gas used in operations. This cost clearly should be recovered under the compressor fuel charge rates and therefore should not apply to a Zone 1a shipper, which is entirely upstream of any compression units. The components of the Gas Receipt Charge need to be clearly spelt out in the Access Arrangement.

1.2 Pipeline Capacity Charge

The proposed Pipeline Capacity Charge for Zone 1a is a fixed charge of 1.29 cents/GJ. This is approximately 2 times the capacity reservation charge payable under the GTRs for the same capacity. Hamersley submits that such an increase appears unreasonable, and the Access

Agreement information does not provide sufficient information to determine the basis of the proposed increase.

1.3 Delivery Point Charge

The proposed Delivery Point Charge for Hamersley's delivery point in Zone 1a is \$303.36/day. This is approximately 1.5 cents/GJ, based on Hamersley's contracted capacity of 20 TJ/day. Hamersley submits that this cost is unreasonably high compared to the charges made against other equivalent facilities.

This is a fixed charge which recovers the return and depreciation on metering assets (Table 2.3 of the Access Arrangement Information). There is insufficient information in the Access Arrangement Information to determine how this charge was calculated, particularly whether or not only the assets at MS01 were taken into account or whether this charge results from apportioning total metering asset costs. In any case, the valuations in Table 3.1b are surprising for metering assets that have been in place since 1985.

It is difficult to understand why the charge for the use of the metering assets is more than the charge for using 9 km of the Pipeline.

1.4 Fixed charges

Epic Energy has proposed a Reference Tariff for Zone 1a shippers which is a 100% fixed charge, which is materially different from the capacity reservation charge/commodity charge regime which applies under the GTRs. In 1999, the fixed charge that applied to Hamersley was only 75% of the total charges. This means that Hamersley bears the total risk of its load factor being less than 100%, rather than sharing that risk with Epic Energy as it does under the GTRs. It also means that the effective tariff per GJ is increased significantly as a result of this risk transfer.

In Hamersley's view, the Reference Tariff does not meet the provisions of section 8.1(f) of the Code in that it does not provide an incentive to the Service Provider to reduce costs and to develop the market for the Reference and other Services.

1.5 Recommendations regarding the Reference Tariff

- (a) Under section 8.10(g) of the Code, in determining the Reference Tariff, the Regulator may take into account the reasonable expectations of persons under the regulatory regime in place prior to the commencement of the Code. Accordingly, Hamersley requests that the Regulator take into account Hamersley's reasonable expectations that:
- tariffs would not significantly increase above the current tariffs payable under the GTRs; and
 - Epic Energy's commitment to the State of Western Australia to reduce full-haul tariffs to \$1.00/GJ under the Access Arrangement would apply on a pro rata basis to part-haul shippers.

Hamersley submits that it is not fair or equitable for gas transmission charges to the Pilbara to increase so significantly, particularly when the increased charges appear to be underwriting reduced charges to the South-West of the State. The proposed tariffs

are effectively a “shock” price increase to the Pilbara, and are clearly not conducive to developing a competitive environment for strategic industry development.

- (b) Hamersley submits that it is not fair or equitable for gas transmission charges to be 100% fixed charges which have no regard for actual gas throughput in the Pipeline. Further, it is not fair or equitable for Epic Energy to transfer all of the risk in these circumstances to the shipper in order to place itself in a no-risk situation with respect to this Pipeline capacity.

2 Reference Service

Hamersley submits that the proposed Access Arrangement does not include a Service that is likely to be sought by a significant part of the market or a Reference Tariff for such a Service as required by sections 3.2 and 3.3 of the Code.

The 48 TJ/day being shipped via the existing contract by Hamersley, Robe River Iron Associates and the Electricity Corporation is certainly a significant part of the market in the Pilbara, if not the only existing market. The terms of the Service provided under the existing contract comprise the contract terms and the GTRs. That Service can be extended until 31 December 2006 by the exercise of the option to renew contained in clause 4.2 of the existing contract on or before 30 June 2000.

Hamersley prefers the terms and conditions of its existing Service and believes that the other initial shippers, Robe River Iron Associates and the Electricity Corporation, have a similar view. In Hamersley’s view, the existing Service is a Service that is likely to be sought by a significant part of the market, so Epic Energy should offer that Service and a Reference Tariff for that Service.

Hamersley submits that Epic Energy has not proposed a Service that is likely to be sought by a significant part of the market, since Hamersley is not interested in obtaining the Service for the Pilbara that has been proposed in the Access Arrangement.

If such a Service is not offered, the existing contract will be a non-reference service in relation to the Code until the date that it expires, creating difficulty for both the initial shippers and Epic Energy. The tariff to apply to the non-reference service will be determined as follows:

- (a) The existing contract is an assigned contract for the purposes of the *Dampier to Bunbury Pipeline Act 1997* and was validated by section 17 of that Act. Epic Energy is the assignee from the Gas Corporation under the existing contract.
- (b) Section 96 of the *Gas Pipelines Access (Western Australia) Act 1998* states that the Code does not affect the continuance or operation of the existing contract.
- (c) Section 20 of the *Dampier to Bunbury Pipeline Act 1997* states that Epic Energy must offer to vary the price under the existing contract to not exceed the **statutory price**, which is set out in regulation 35 of the *Dampier to Bunbury Pipeline Regulations 1998*, as amended by the *Gas Pipelines Access (Privatised DBNGP System)(Transitional) Regulations 1999 (Transitional Regulations)*.
- (d) The current tariff under the existing contract, as agreed with Epic Energy, for Hamersley’s part-haul capacity is 9/1399 of the \$1.00 full-haul statutory price, or a

maximum of .643 cents/GJ for both the capacity reservation charge and the commodity charge.

- (e) When the Access Arrangement is approved, it is arguable that the statutory price under the Transitional Regulations will expire. However, it is Hamersley's view that the statutory price will continue to apply to GTR contracts until the *Dampier to Bunbury Pipeline Regulations 1998* are repealed. That is because the amendments to regulation 35 under the Transitional Regulations continue to apply after 1999 and the transitional period only applies to the repealed access scheme, not the GTR contracts.
- (f) In order for the provisions of section 96 of the *Gas Pipelines Access (Western Australia) Act 1998* to be effective, it is important that the *Dampier to Bunbury Pipeline Regulations 1998* are not repealed until the date that either:
 - (1) the existing GTR contracts expire; or
 - (2) the prices under the GTR contracts are redetermined. The price redetermination under the existing contract is effective on 1 January 2001.
- (g) If the *Dampier to Bunbury Pipeline Regulations 1998* are repealed prior to the dates set out in paragraph (f) above, then there will be no statutory price applicable to the GTR contracts. The Reference Tariff will not apply to the non-reference service and the provisions of the Code will not apply by virtue of section 96 of the *Gas Pipelines Access (Western Australia) Act 1998*. It is arguable that the tariff until 31 December 2000 would revert to the price redetermined in 1998 in accordance with clause 9.5(c) of the existing contract.
- (h) After 1 January 2001, the tariff would be redetermined by Epic Energy in accordance with clause 9.5 of the existing contract.
- (i) If Hamersley disputes the redetermined tariff, the dispute would be determined by the Western Australian Gas Disputes Arbitrator in accordance with section 90A of the *Gas Corporation Act 1994*, as inserted by Schedule 3 clause 22 of the *Gas Pipelines Access (Western Australia) Act 1998*. The Arbitrator would act as the referee for the purposes of the GTRs to determine the prescribed dispute in regulation 245(b) in accordance with the *Gas Referee Regulations 1995*. As a result, the Arbitrator would not be guided by the Code or the Access Arrangement in making his decision in relation to the new tariff to apply to Hamersley.

In Hamersley's view, it would be easier for all concerned if Epic Energy proposed a Service that would be sought by the initial shippers in the Pilbara, with a Reference Tariff meeting the objectives set out in paragraph 1.5 above. If Hamersley was able to replace the existing contract with that Service, as contemplated by section 96(2)(b) of the *Gas Pipelines Access (Western Australia) Act 1998*, then it would be governed by the terms of the Access Arrangement and the provisions of the repealed legislation set out above would no longer apply.

Accordingly, Hamersley requests the Regulator to require Epic Energy to submit an Access Arrangement which includes a Service that is likely to be sought by a significant part of the Pilbara market, as required by section 3.2 of the Code.

3 Initial Capital Base

Hamersley submits that the proposed Access Agreement has an undue reliance on section 8.10(j) of the Code to justify Epic Energy's purchase price for the DBNGP as being a key determinant of the Initial Capital Base used for the proposed tariff charges.

Epic Energy's initial Capital Base of \$2,449.49 million represents the total amount paid by Epic Energy to acquire the DBNGP in 1998. Epic Energy has primarily relied on section 8.10(j) of the Code to justify this initial Capital Base.

While section 8.10(j) is one factor that can be taken into account, Hamersley submits that section 8.11 of the Code is an overriding determinant for the Initial Capital Base calculation. Section 8.11 states that the initial Capital Base should not normally fall outside of the range of values given by Depreciated Actual Cost (**DAC**) and Depreciated Optimised Replacement Cost (**DORC**) valuations.

The proposed Access Arrangement does not contain DAC or DORC valuations. It appears that the Access Arrangement does not meet the requirements of section 8.11 of the Code. Furthermore, insufficient information has been supplied to provide reasoned argument as to why section 8.11 of the Code should not apply in this case. In Hamersley's view, Epic Energy should be required to provide the DAC and DORC valuations and that the Initial Capital Base be transparently based on these valuations and not the purchase price of the asset.

Schedule 1 to this submission shows the valuation methodologies adopted by Regulators elsewhere in Australia. Schedule 1 shows that of the decisions that have been made, governing bodies have shown a clear preference for the Initial Capital Base to be based on, or be no greater than, the DORC valuation.

4 Weight Average Cost of Capital (WACC)

The WACC proposed by Epic Energy is higher than the WACC approved by Regulators elsewhere in Australia. Schedule 1 to this submission shows the WACC determined for other pipelines in Australia.

The reliance on the purchase price of the asset for the Initial Capital Base rather than DAC and DORC valuations, combined with a higher WACC than that approved by regulators elsewhere, has contributed to the unreasonably high tariffs proposed in the Access Arrangement.

5 Access Contract Terms and Conditions

The proposed Access Contract Terms and Conditions are, in some respects, less favourable than the GTRs or they are not commercially reasonable. In particular:

- (a) Clause 4.4(c) imposes a Nomination Surcharge of \$15/GJ - this is likely to have a substantial impact on the overall tariffs payable and represents a penalty which is approximately 2,100 times the capacity reservation charge Hamersley pays under the GTRs. It is approximately 150 times the proposed Reference Tariff that would apply to Hamersley as a Zone 1a shipper. Hamersley submits that the penalty imposed by the Nomination Surcharge is not commercially reasonable.

- (b) The Imbalance Limit of 2% of Shipper's MDQ is far less than the 8% limit imposed under the GTRs and may prove difficult to comply with. Again, the Excess Imbalance Charge of \$15/GJ will greatly increase overall charges, yet imbalances have little or no bearing on the costs incurred by Epic Energy. Hamersley submits that it is a commercially unreasonable penalty.

The intent of the Daily Balancing and associated Imbalance Charges is somewhat unclear. However if daily charging is intended, it must be recognised that this is not possible, given the current method of delivery of commingled gas in the Pilbara and the monthly/3 monthly reconciliation of electricity and gas usage between Hamersley, Robe River Iron Associates and Electricity Corporation.

- (c) Similarly, the other proposed charges set out in Schedule 1 to the Access Contract appear to impose unreasonable penalties on shippers. Charges of this nature should seek to recover the reasonable additional costs incurred by Epic Energy as a result of the unauthorised action, and should not be a means of raising revenue.
- (d) Clause 13.4 is more onerous to shippers than Division 5.5 of the GTRs. The indemnity provided by shippers is unreasonably broad in that it:
- (1) is provided to Epic Energy and all of its contractors;
 - (2) relates to loss or damage anywhere along the route of the Pipeline;
 - (3) does not necessarily require the shipper to be at fault; and
 - (4) holds the shipper liable for loss or damage caused by Epic Energy's breach of contract or statutory duty (although liability is reduced where Epic Energy is negligent) and the wilful misconduct of its employees.

Hamersley submits that shippers will not be able to obtain insurance coverage for this indemnity, as required by clause 23 of the Access Contract, because of the broad nature of the indemnity. It should be narrowed so that the shipper will indemnify Epic Energy for loss or damage caused by the negligent act or omission of the shipper.

- (e) Under clause 15(d), a shipper is not relieved from paying Capacity Charges by the occurrence of an event of Force Majeure, despite not receiving transmission services, even if the Force Majeure is claimed by Epic Energy. Hamersley submits that this is not commercially reasonable as it means that the shipper bears all of the risk of Force Majeure under the Access Contract. In accordance with normal gas industry practice, the shipper should get relief from the payment of Capacity Charges when Epic Energy claims Force Majeure so that there is a proper sharing of this risk between the parties to the Access Contract.

Tariffs should decrease if the Access Contract Terms and Conditions are more onerous than the provisions of the GTRs.

6 Conclusion

In summary, Hamersley requests that the Regulator take the following matters into account when considering Epic Energy's proposed Access Arrangement:

- (a) The substantial increase in tariffs for services to the Pilbara region are unreasonable and inequitable compared to existing GTR tariffs and the proposed tariffs to the South-West of the State. The Pilbara is a major industry development zone, with substantial scope for expansion. Competitive gas prices will underpin the future development of strategic industry.

In Hamersley's view:

- The tariffs should not significantly increase above the current tariffs payable under the GTRs.
 - The reduction in tariffs to \$1.00/GJ to the South-West of the State under the Access Arrangement should apply on a pro rata basis to shippers in the Pilbara.
 - The tariffs should not be structured on the basis of a 100% fixed charge for use of the Pipeline.
- (b) Epic Energy should be required to offer a Service at a Reference Tariff that is likely to be sought by a significant part of the market, as required by sections 3.2 and 3.3 of the Code.
- (c) The proposed Access Arrangement has insufficient information to allow for a full examination of the tariffs proposed by Epic Energy. In particular, the Access Arrangement Information does not contain DAC or DORC valuations, nor reasoned arguments as to why the Access Arrangement is not required to meet section 8.11 of the National Third Party Access Code for Natural Gas Pipelines.
- (d) The proposed WACC is higher than regulated outcomes elsewhere in Australia.
- (e) In some respects, the Access Contract Terms and Conditions are more onerous than the provisions of the GTRs or they are commercially unreasonable.

If you wish to discuss this submission further, please telephone Peter Jensen on 9143 5603.

Yours faithfully
HAMERSLEY IRON PTY LIMITED

G S NEIL
General Manager Services

Schedule 1

Summary of Regulators' decisions re: pipelines

| Pipeline | Party | WACC | Initial Capital Base (ICB) |
|---|--------------------------------------|--|---|
| Central West Pipeline (CWP) | AGL Pipelines (NSW) Pty Ltd | The pre tax real WACC should be 7.5% to accurately reflect current financial market settings | As the CWP was only just commissioned, the ACCC accepted AGL's proposed valuation based on optimised construction cost , adjusted to allow for the 1 year period between construction and establishment of the ICB. |
| Parmelia Pipeline | CMS Gas Transmission of Australia | The Regulator's draft ruling provides for a WACC of 8.3% (based on a range of 7.6% to 9.5%, reflecting market practice and reverse transformation methodologies). | <p>The Regulator considered that a DORC valuation methodology was not appropriate. Rather it considered that an Optimised Deprival Value methodology was appropriate.</p> <p>However, a DORC value still comprises the maximum value that may be ascribed to an ICB by an Optimised Deprival Value methodology.</p> |
| Victorian Gas Transmission Arrangements | Energy Projects Division of Treasury | The ACCC focused primarily on the nominal return on equity and post nominal WACC, which produced a real pre tax WACC of 7.75% . | <p>The ACCC found that DORC represents the upper limit to the value of the ICB, with the Depreciated Actual (or historical) cost (DAC) being the lower limit. Other factors should also be considered, including the legitimate interest of the owner and the public interest, including economic efficiency and the interests of users.</p> <p>The ACCC was of the opinion an alternative value, even if it was thought to be appropriate, would be required under the Victorian Access Code to be reduced to the DORC valuation.</p> <p>The ACCC accepted that it could have regard to a price paid for a pipeline in a recent sale (and that the Service Provider's legitimate expectations at the time of sale be respected). However, the ACCC must have regard to the circumstances of the sale and is under no compulsion to accept the sale price of an asset as the regulatory asset base.</p> |
| Albury Gas Distribution System | Albury Gas Company | The Independent Pricing and Regulatory Tribunal considered a pre tax real rate of return of 7.75% | <p>The Tribunal concluded that economic analysis provides guidance on a range of feasible asset values, while the lower bound is set by scrap value, the upper bound is set by the cost of bypass by an external firm. Also, there is no significant economic argument which requires the ICB to be founded on a DORC valuation for sunk assets.</p> <p>The decision was to accept a value close to the DORC valuation as an ICB.</p> |
| Wagga Wagga Gas | Great Southern Energy | The Tribunal believes a return of 7.75% is the appropriate real pre-tax | A DORC valuation was used. |

| Pipeline | Party | WACC | Initial Capital Base (ICB) |
|--------------------------|-------------------------------------|--|--|
| Distribution Network | Gas Networks Pty Ltd (GSN) | WACC. | |
| Moomba to Adelaide | Epic Energy South Australia Pty Ltd | <p>Epic has submitted that a WACC of 7.75% (as was found to be appropriate in the Victorian decision) as the absolute low, and that a far greater WACC would be appropriate. The proposed pre tax WACC is 9% to 10% with a mid-point range at 9.5%.</p> <p>No decision has been made yet.</p> | <p>Epic submitted that the correct valuation of the asset should be on the basis of what it would cost for a competitor to fully replace the asset - or its Optimised Replacement Cost (ORC).</p> <p>DORC was thought to be \$358.4 million, Replacement value \$643 million, and ORC \$572 million.</p> <p>No decision has been made yet.</p> |
| Tubridgi Pipeline System | Tubridgi parties | <p>The Tubridgi parties submit that the real, pre tax WACC is a range of 8.01% to 9.38% with a mid point estimate of 8.75%.</p> <p>No decision has been made yet.</p> | <p>A DORC valuation has been prepared by the Tubridgi parties.</p> <p>No decision has been made yet</p> |