# SUBMISSION TO
# OFFICE OF GAS ACCESS REGULATION

**17 December 2002**

**WMC RESOURCES LTD**
191 GREAT EASTERN HIGHWAY
BELMONT WA 6104
TEL: (08) 9479 8457
FAX: (08) 9479 8458

**REF:** CW/KLK/17/3/1

# Contents

# one executive summary

## Purpose

This submission is made by WMC Resources Limited ("**WMC**") in response to the notice issued by the Acting Gas Access Regulator (the "**Regulator**") on 6 November 2002 and entitled "Proposed Access Arrangement for the Goldfields Gas Pipeline ("**Notice**").

WMC make this submission in its roles as:

(a) a party to a gas transmission agreement with Southern Cross Pipelines Australia Pty Ltd ("**SCPA**"), one of the owners of the Goldfields Gas Pipeline ("**Pipeline**"), which provides that a Reference Tariff determined under the *National Third Party Access Code for Natural Gas Pipeline Systems* ("**Code**") may apply to WMC; and

(b) a potential shipper on the Pipeline, in so far as it requires access to additional services from Goldfields Gas Transmission Pty Ltd ("**GGT**"), the manager of the Pipeline, for its Eastern and Northern Goldfields operations.

## Scope

This submission will address and comment on each of those amendments contained in the Regulator's draft decision published on 10 April 2001 ("**Draft Decision**") concerning the access arrangement lodged by GGT, on behalf of SCPA, Southern Cross Pipelines (NPL) Pty Ltd and Duke Energy Power Pty Ltd (collectively, the "**Pipeline Owners**") on 15 December 1999 ("**Proposed Access Arrangement**"), which WMC believes relate to the issues raised in the Notice.

In addition, this submission will explore an alternative approach to setting the Reference Tariff, the results of which WMC believes bear directly on the application of the Epic Court Decision to the Draft Decision.

In particular, this submission will:

(a) comment on the process proposed by the Regulator in the Notice;

(b) comment on those amendments contained in the Draft Decision which WMC believes relate to the setting of the Reference Tariff;

(c) report on an analysis undertaken by WMC regarding the determination of the Reference Tariff under the agreement between the State of Western Australia ("**State**") and the Pipeline Owners as ratified by the *Goldfields Gas Pipeline Agreement Act 1994 (WA)* ("**State Agreement**") which explores, amongst other things, the Pipeline throughput assumptions used by GGT in the Proposed Access Arrangement and by the Regulator in the Draft Decision;

(d) examine the implications of WMC's analysis on the application of the Code to the Pipeline;

(e) examine the relationship between, and the implications of, WMC's analysis in regard to the assessment of the decision by the Full Court of the Supreme

Court of Western Australia in the proceedings brought by Epic Energy (WA) Nominees Pty Ltd ("**Epic**") and another in respect of the Regulator's decision on the proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline ("**Epic Court Decision**");

(f) examine the demand scenario put forward by GGT in its Proposed Access Arrangement; and

(g) examine the proposition that the acquisition price paid for an asset should be considered when determining the Initial Capital Base attaching to the Pipeline.

## Regulatory Process

WMC received a letter from the Regulator's solicitors dated 26 November 2002 ("**Letter**"), which clarified the Notice. WMC now understands that the Regulator's decision will be in two separate parts.

As explained in the Letter, the first part will contain a decision as to the access arrangement that would be approved by the Regulator if the Code applied to the Pipeline. As part of that process, it may be necessary to consider the tariffs applicable under any previous regulatory regime, in this case the regime established under the State Agreement. In this regard, the Letter refers to the objective expressed in clause 8.10(f) of the Code.

Accordingly, the first part of the decision will identify a Reference Tariff which is determined without taking into account whether the Regulator's decision materially adversely affects the legitimate business interests of the pipeline owners within the meaning of clause 21(3) of the State Agreement.

WMC agrees that the Regulator should proceed with the first part of his decision.

The Letter then explains that the second part of the decision is intended to contain the Regulator's decision as to the extent to which the Regulator has jurisdiction or power to make a decision under the Code that applies to the Pipeline.

As stated in the Letter:

> "*Obviously, the Regulator cannot make a binding determination as to the scope of his own jurisdiction or power. However, the Regulator as an administrative decision maker is obliged to reach his own views as to his jurisdiction to implement the Code. Any views expressed by the Regulator as to his jurisdiction are not an attempt to make a quasi judicial determination; see **R v Hickman (1945) 70 CLR 598 at 618**.*
>
> *The decision has been divided into two parts for two reasons. First, whatever the outcome in respect of the contentions of the various parties as to the jurisdiction of the Regulator, the decision will identify the Regulator's conclusion as to the access arrangement that would be approved by the Regulator. Secondly, it may be necessary for the nature of the Regulator's decision under the Code to be known in order to determine whether the application of the Code would materially adversely affect the legitimate business interests of the pipeline owner within the meaning of clause 21(3) of the State Agreement. Therefore, it is application to complete the first part of the decision before embarking upon the second part.*"

The Regulator will recall that in the recent Supreme court action commenced by the Pipeline Owners against the State of Western Australia ("**State**") and the Regulator (the "**GGT Court Proceedings** "), the Pipeline Owners pursued two broad claims, namely for declarations that:

(a) pursuant clause 21(3) of the State Agreement, the provisions of the Code (including those relating to the setting of a Reference Tariff) should have no effect in relation to the Pipeline, on the ground that their application would have a material adverse effect on the legitimate business interests of the Pipeline Owners; and

(b) the Regulator's draft decision was vitiated by errors of law involving misconstruction of clause 21(3) and of the Code.

The first broad claim involves two aspects. Firstly, the Pipeline Owners contended that the very application of the Code to the Pipeline constituted material adverse effect upon them. Secondly, the Pipeline Owners relied upon the financial consequences of the adoption of the proposed Reference Tariff.

It is still not clear from the Notice and the Letter which of the above issues the Regulator intends to consider in the second part of the decision.

WMC's view is that the Regulator cannot make a binding decision in respect of any of these issues.

Clause 21(3) is contained in the State Agreement to which the Regulator is not a party. The provision only operates to the extent that the Pipeline Owners can demonstrate that the uniform laws or subsidiary legislation referred to in clause 21(2) of the State Agreement have or are likely to have a material adverse effect on their legitimate business interests. This raises the question as to whom do the Pipeline Owners have to demonstrate material adverse effect.

WMC submits that the Minister for State Development (the "**Minister**") is the person to whom the Pipeline Owners are required to demonstrate that the operation of the Code has a material adverse effect on their legitimate business interests. Accordingly, it is WMC's view that to embark on the second part of the decision will be a waste of effort on the part of the Regulator which has the potential to cause further delay.

Even the Pipeline Owners contended in the GGT Court Proceedings that it was the Supreme Court, not the Regulator, which had the power to make the determination of whether their legitimate business interests had been materially affected.

Further, under sub-clause 21(3), the Code will apply except "to the extent that" material adverse effect can be demonstrated. Unless and until that effect is so demonstrated, the Regulator clearly has jurisdiction, under the Code, to proceed with the Regulator's determination in relation to the proposed access arrangement and arrive at a final decision. The final decision should identify a "pure" set of Reference Tariffs which have been derived without regard to clause 21(3) of the State Agreement.

The Regulator should not, in WMC's view, anticipate any decision about the application of clause 21(3), regardless of whether the decision is ultimately found to vest in the Minister (as the State and WMC contend) or the Court (as the Pipeline Owners contend).

## Delay

Given that the Regulator delivered its Draft Decision over 18 months ago, WMC takes this opportunity to suggest that it is incumbent upon the Regulator to deliver its final decision as soon as possible. The delay in the delivery of the final Decision is causing WMC considerable prejudice.

## WMC Analysis

WMC has undertaken a comprehensive analysis of the Reference Tariff which should apply to the Pipeline using a methodology based upon the tariff and access regime set out in the State Agreement. Whilst WMC acknowledges that this analysis differs from the manner in which the Regulator has applied the Code in relation to the determination of a Reference Tariff, the method is essentially consistent with the Code.

The WMC analysis is based on the original GGT model used in 1994 at the inception of this Pipeline and uses the following as inputs:

- assumes a 42 year quarterly capacity reservation and throughput profile for the Pipeline;
- allocates this throughput over Pipeline Delivery Points (to calculate distance weightings);
- applies the proposed tariffs to those volumes/deliveries;
- adopts the actual project capital cost and an estimated construction expenditure draw down structure;
- assumes an annual operating cost and "stay in business" capital expenditure program; and
- calculates a 42 year internal rate of return using these forecast cash flows.

The key drivers, as in the Regulator's application of the Code, are the Initial Capital Base, the forecast demand and applicable tariffs which are then used to derive the rate of return. This is consistent with the Regulator's methodology which uses the Initial Capital Base, estimated Weighted Average Cost of Capital (in a similar way to the rate of return) and forecast demand to derive the appropriate tariff.

The major points of difference between the Code and State Agreement methodologies relate to:

(a) the term of the analysis;

(b) the definition of the Initial Capital Base; and

(c) the construction of forecast cash flows and the choice of an appropriate rate of return which should be applied thereto.

Despite these differences, the analysis undertaken by WMC suggests that the Reference Tariff applicable to the Pipeline should be set at a level which is in the order of 30% below the tariff submitted by GGT in its proposed Access Arrangement. Importantly, this conclusion is consistent with the recommendation of the Regulator in its Draft Decision.

The analysis conducted by WMC is important in so far as the Epic Court Decision is concerned because it is based on the State Agreement tariff and access regime under which the Pipeline was built and purchased by the Pipeline Owners. As such, the results of the WMC analysis reveal the reasonable expectations, and legitimate business interests, of the Pipeline Owners at the time they purchased their respective interests in the asset.

## Initial Capital Base

WMC submits that although there may be a valid argument for using the acquisition price of an asset in determining the applicable Reference Tariff, this price needs to be adjusted to remove those elements attaching to assets which do not form part of the Pipeline.

In addition, the rate of return constructed by the Regulator in its Draft Decision is inappropriately high if it is applied to an asset acquisition price which has not been adjusted accordingly to take account of the reduced risks inherent in purchasing an existing, operating asset.

WMC submits that whilst use of the acquisition price is not irrelevant, it should only be considered where the Pipeline Owners are prepared to make full disclosure of the breakdown of the acquisition price and acquisition arrangements.

## two background

### State Agreement

On 23 March 1994, the State and certain companies ("**Original Joint Venturers**") entered into the State Agreement, which governed the construction, commissioning, operation and maintenance ofthe Pipeline.

The State Agreement was ratified and its implementation was authorised by section 4 of the *Goldfields Gas Pipeline Agreement Act 1994* which came into operation on 3 May 1994.

Between January 1995 and September 1996, the Pipeline was duly constructed and commissioned by the Original Joint Venturers in accordance with the provisions of the State Agreement.

Under the State Agreement, the Original Joint Venturers reserved certain Pipeline capacity to themselves and their associates which, together with certain other proposed committed capacity, was called "Initial Committed Capacity" (as defined in clause 8 of the State Agreement). The State Agreement also provided for access to the Pipeline to be given to third parties on terms, in effect, to be set or approved by the Minister (clauses 20 and 21).

During 1994, the Original Joint Venturers, by their agent and manager, GGT, established and published a Statement of Tariffs and Charges which set out indicative tariffs for four Firm Services (as defined in the general terms and conditions published by the Original Joint Venturers) for all third parties accessing and utilising the Pipeline, to apply from December 1994 ("**A1 Tariffs**").

| **Particulars of A1 Tariffs** | | | |
|---|---|---|---|
| **Tariff** | **Toll (Dollars/Gigajoule)** | **Capacity Reservation (Dollars/Gigajoule kilometre)** | **Throughput (Dollars/Gigajoule kilometre)** |
| 1-5 year contract | 0.276509 | 0.001914 | 0.000720 |
| 6-10 year contract | 0.251373 | 0.001741 | 0.000653 |
| 11-15 year contract | 0.239946 | 0.001660 | 0.000625 |
| 16-20 year contract | 0.228520 | 0.001581 | 0.000595 |

In the course of 1998 and 1999, the Original Joint Venturers sold their respective interests in the Pipeline and assigned their corresponding interests in the State Agreement to the Pipeline Owners.

Over this period, GGT, on behalf of the Original Joint Venturers and the Pipeline Owners (as the case may be), established and published, under the State Agreement, revised Statements of Tariffs and Charges setting out new indicative tariffs for Firm Service which:

(a) from, in or about March 1998, offered tariffs equivalent to a 15% discount to the A1 Tariffs ("**A2 Tariff**");

(b) from 1 July 1999, offered tariffs equivalent to a discount of approximately 19% from the A1 Tariffs ("**A3 Tariff**"); and

(c) from 1 January 2000, offered tariffs equivalent to a discount of approximately 24% from the A1 Tariffs ("**A4 Tariff**")

The A4 Tariff is set out below:

| **Particulars of A4 Tariff** | | | |
|---|---|---|---|
| **Tariff** | **Toll (Dollars/Gigajoule)** | **Capacity Reservation (Dollars/Gigajoule kilometre)** | **Throughput (Dollars/Gigajoule kilometre)** |
| 1-5 year contract | 0.269392 | 0.001556 | 0.000494 |
| 6-10 year contract | 0.246943 | 0.001427 | 0.000453 |
| 11-15 year contract | 0.235718 | 0.001362 | 0.000433 |
| 16-20 year contract | 0.224494 | 0.001297 | 0.000412 |

By clause 21, the State Agreement foreshadowed, and made provision for, the application of uniform access laws in relation to the Pipeline.

## Gas Transmission Agreement

By a gas transmission agreement dated 29 September 1998 ("**GTA**") and by a variation agreement dated 23 December 1998 between Wesminco Oil Pty Ltd ("**Wesminco**"), WMC and WMC Limited, the parties recorded the terms upon which WMC was entitled to, and would pay Wesminco for, gas transmission through the Pipeline.

By a deed of novation dated 23 December 1998 between Wesminco, WMC, SCPA and WMC Limited, Wesminco's interest in the GTA was assigned to and novated by SCPA contemporaneously with the sale by Wesminco to SCPA of its interest in the Pipeline.

The GTA provides that if, as a result of the application of the Code, there is a tariff published which is lower than the tariff otherwise applicable, WMC obtains the benefit of the lower, regulated tariff.

## Code

In 1998 the Western Australian Parliament enacted the GPA Act which adopted the Code and applied it to the Pipeline. The Code provides, relevantly, for a base service tariff, a "Reference Tariff", to be proposed by the Pipeline Owners and to be approved by the Regulator.

The Proposed Access Arrangement submitted by GGT to the Regulator in December 1999 included Reference Tariffs which correspond to the A4 Tariff. These Reference Tariffs are set out below:

| Particulars of Draft Access Arrangement Tariff | | | |
|---|---|---|---|
| **Tariff** | **Toll (Dollars/Gigajoule)** | **Capacity Reservation (Dollars/Gigajoule kilometre)** | **Throughput (Dollars/Gigajoule kilometre)** |
| 1-5 year contract | 0.269392 | 0.001556 | 0.000494 |
| 6-10 year contract | 0.246943 | 0.001427 | 0.000453 |
| 11-15 year contract | 0.235718 | 0.001362 | 0.000433 |
| 16-20 year contract | 0.224494 | 0.001297 | 0.000412 |

The Reference Tariffs proposed by the Regulator in its Draft Decision, published in April 2001, represents a 30% reduction on the Reference Tariffs proposed by GGT in its Proposed Access Arrangement and are set out below:

| Particulars of Draft Decision Reference Tariff | | | |
|---|---|---|---|
| **Tariff** | **Toll (Dollars/Gigajoule)** | **Capacity Reservation (Dollars/Gigajoule kilometre)** | **Throughput (Dollars/Gigajoule kilometre)** |
| 1-5 year contract | 0.188574 | 0.001089 | 0.000346 |
| 6-10 year contract | 0.172860 | 0.000999 | 0.000317 |
| 11-15 year contract | 0.165003 | 0.000953 | 0.000303 |
| 16-20 year contract | 0.157146 | 0.000908 | 0.000288 |

## GGT Court Proceedings

In December 2001, the Pipeline Owners initiated a Supreme Court action against the Regulator and the State:

(a) claiming that, in light of clause 21(3) of the State Agreement and s. 97(4) of the GPA Act:

  (i) provisions of the Code, including provisions for the determination of a Reference Tariff, have no effect on or application to them as owners of the pipeline; and

  (ii) the Regulator's Draft Decision, and any subsequent final decision, concerning the setting of a Reference Tariff, has no effect on or application to them; and

(b) seeking judicial review of the Draft Decision by alleging that the Regulator's Draft Decision is vitiated by error of law in, amongst other things;

  (i) his misconstruction of the Code;

  (ii) his failure to take into account relevant considerations;

  (iii) his consideration of irrelevant factors; and

  (iv) his reaching of decisions unsupported by evidence.

(the “**GGT Court Proceedings**”).

On 21 November 2002, WMC was admitted to the GGT Court Proceedings as the third defendant.

The Pipeline Owners have now sought leave to discontinue the GGT Court Proceedings.

**Epic Court Decision**

On 23 August 2002 the Supreme Court of Western Australia handed down the Epic Court Decision.

WMC submits that although there are similarities between the proceedings initiated by Epic and the GGT Court Proceedings, there are also major factual and circumstantial differences.

## three comments on GGT's reference tariff and rate of return

The Epic Court Decision is focused upon the application of the Code to the DBNGP and, in particular, upon the application of the Code by the Regulator to determine the DBNGP's Initial Capital Base and Reference Tariff.

Typically, the administrators of the Code have argued that, as far as is reasonably possible, risk should be removed from cash flow forecasts so as to render the cash flow forecasts compatible with the rate of return constructed by regulators as a weighted average cost of capital (**"WACC"**).

The approach of defining a single and unique rate of return and one cash flow to determine a Reference Tariff underpins one central aspect of the concern expressed in the Court Decision in regard to the Regulator's determination. That is to say, the concern that there is only one possible set of regulated cash flow forecasts and one rate of return (and no regulatory discretion) which can be arrived at pursuant to section 8 of the Code.

Instead, WMC submits that there is in fact a range of applicable cash flow forecasts that may be relevant to calculating a Reference Tariff and that regulatory discretion is an integral part of the tariff setting process. The State Agreement tariff and access model does not require the construction of a single or unique cash flow forecast and matching the rate of return. It is an essential part of the State Agreement tariff and access model that the parties must consider the risk inherent in the cash flow forecasts and strike a "commercial rate of return" consistent with the risk encapsulated in the cash flow forecast.

The contrasting methods used by the Regulator in its Draft Decision and by WMC in its analysis accentuate the fact that it is the balance of risk and return which is an essential feature of regulation and not the production of cash flow forecasts consistent with a pre-defined rate of return model.

Sections three and four of this submission:

(a) outline an alternative approach to determining a Reference Tariff;

(b) calculate a GGT Reference Tariff using this alternative approach; and

(c) analyse the risk environment in which GGT operates, paying particular attention to the way the State Agreement tariff and access model impacts on GGT's risk (this impact being analogous to the impact of the GPA Act tariff and access model on GGT risk).

To derive GGT's Reference Tariff, the analysis undertaken by WMC develops a number of cash flow scenarios and draws upon publicly available information to determine a "commercial rate of return" for GGT. The analysis considers which of the forecast cash flows is most compatible with that commercial rate of return and looks at a range of cash flows and rate of return pairs.

Whilst the State Agreement does not guarantee GGT a commercial rate of return it does afford GGT the right to earn a commercial rate of return if market competition will allow tariffs to be charged that are compatible therewith.

The key to rationalising the relationship between tariffs calculated using the State Agreement tariff and access model and Reference Tariffs derived using the Code rests in:

(a) properly defining the range of cash flow forecasts which might be used by the Regulator to set the Reference Tariff;

(b) considering the rates of return which might be consistent with each of those cash flow options; and

(c) understanding the risk faced by the Pipeline Owners, as service providers and, in particular, the impact of the tariff and access regime itself on risk.

It may appear, at first sight, that the guidance given to the Regulator under the State Agreement (that the rate of return be a "commercial rate of return") is imprecise. An examination of the Epic Court Decision may reveal that the guidance given to the Regulator under the Code is no more precise. Indeed, serious consideration of the Epic Court Decision confirms that the tariff and access regime in the Code is very close indeed to the tariff and access regime set out in, and pursuant to, the State Agreement.

The Regulator may consider it necessary to consider the tariffs applicable under the State Agreement in making his determination. WMC's view is that there is a prima facie case that neither the A1 Tariff or the A4 Tariff are consistent with the Pipeline Owner's obligations under the State Agreement. WMC has presented its analysis to the Minister responsible for the State Agreement and has asked him to consider whether the existing tariff and access regime is consistent with the Pipeline Owner's State Agreement obligations.

The WMC analysis presented to the Minister has been utilised in this paper.

## Regulator's Methodology

At page A:15 of the Draft Decision the Regulator sets out a list of the steps which are to be followed to produce a Reference Tariff. These are set out below:

- Estimation of an Initial Capital Base.
- Estimation of Capital Expenditure.
- Estimation of Non-Capital Costs.
- Estimation of an appropriate Rate of Return.
- Specification of a Depreciation Schedule.
- Determination of Total Revenue.
- Determination of a cost/revenue allocation across services.
- Determination of Reference Tariffs.

- Specification of Incentive Mechanisms.

Although the process referred to above does not include the consideration or determination of demand, which is effectively the “denominator” in any Reference Tariff calculations, the Regulator has considered demand for Pipeline Services as part of the Reference Tariff determination model.

Having described the methodology for calculating a Reference Tariff, the Regulator then proceeds to review factual material relating to each step. Importantly, this review draws heavily on the methodology and language of previous draft decisions issued both by the Regulator and his counterparts in other jurisdictions.

The analysis so undertaken by the Regulator has been determined in the Epic Court Decision to contain significant error.

In particular, the Supreme Court has rejected the propositions that:

(a) section 8.1 of the Code is the overriding direction to the Regulator when considering a Reference Tariff (or Reference Tariff Policy); and

(b) there is no range of outcomes and no discretionary element in respect of which the Regulator could apply section 2.24 of the Code.

WMC shares the concerns expressed by the Supreme Court regarding the way in which the Code is being applied. The basis of these concerns is set out below.

## WMC Analysis

WMC has undertaken an analysis of the Reference Tariff using the methodology in the State Agreement and the tariff principles approved in accordance with the State Agreement.

The Regulator should note that the WMC analysis has referred to and followed the methodological steps described by the Regulator, and referred to above.

However, the data set adopted in the WMC analysis contrasts sharply with that adopted by the Regulator. In WMC’s view, GGT’s Proposed Access Arrangement used the methodology and language of draft regulatory decisions in other jurisdictions and inevitably led the Regulator to the same benchmark.

Whilst the methodology employed by WMC to verify the Reference Tariffs stands in sharp contrast with that contained in both the Proposed Access Arrangement and the Draft Decision:

- it satisfies the spirit and the letter of the Code;
- it provides a foundation on which the tariff and access regime set out in the State Agreement and the GPA Act may be reconciled; and
- it addresses a number of key concerns raised by the Supreme Court in the Epic Court Decision.

A comparison of the Regulator’s methodology with WMC’s analysis is set out below.

| Particulars of Analytical Methods | | |
|---|---|---|
| **Matter** | **Regulator's Draft Decision** | **State Agreement Method** |
| Duration of Analysis | 5 year regulatory window, yearly | 42 years, or project life starting in 1994, quarterly |
| Object of Analysis | Calculation of the tariff | Calculation of the rate of return generated by a specified tariff |
| Capital Base | Synthetic estimate as at 1 January 2001 | Actual cost as spent |
| Demand | "Best available estimate" over 5 years | "Best available estimates" over 42 years, WMC uses a range of demand scenarios |
| Stay in Business Capital | "Best available estimate" over 5 years | "Best available estimate" over 42 years |
| Operating Cost | "Best available estimate" over 5 years | "Best available estimate" over 42 years |
| Tariffs | This is solved for in model | The Benchmark Tariff applicable from time to time pursuant to Tariff Principle #12 |
| Tariff Escalation | As per GGT Draft Access Arrangement | As per GGT General Terms and Conditions |
| Rate of Return | Regulator's best estimate of the risk weighted rate of return | This is solved for in model |
| Load Factors | As per GGT Draft Access Arrangement | As per GGT Draft Access Arrangement |

The Regulator talks of specifying a Depreciation Schedule. By this it does not mean depreciation per se, but the profile of the Pipeline Owners' capital recovery over the life of the asset. Whether this schedule matches depreciation (tax, accounting or actual) is a moot point. There is no such schedule in the WMC analysis.

In the WMC analysis, which is based on a project life discounted cash flow model, the Pipeline Owners recover their capital when, and if, there is free cash flow. In other words, the Reference Tariff is set at a level where the present value of the free cash flow generated by the Total Revenue function is sufficient, after the recovery of expenses and the return on capital, to match the present value of capitalised costs. In this analysis there is no imputed or imposed "Depreciation Schedule".

The operating cost and the stay-in-business capital cost forecasts used in the WMC analysis are comparable with those used by the Regulator over the period 2000 to 2004.

However, the capital base used in the WMC analysis diverges from that used by the Regulator in that:

(a) WMC uses the actual capital cost of the pipeline; and

(b) this capital is assumed to be spent in the period 1994 to 1997 (inclusive) as per GGT's estimated construction draw down schedule.

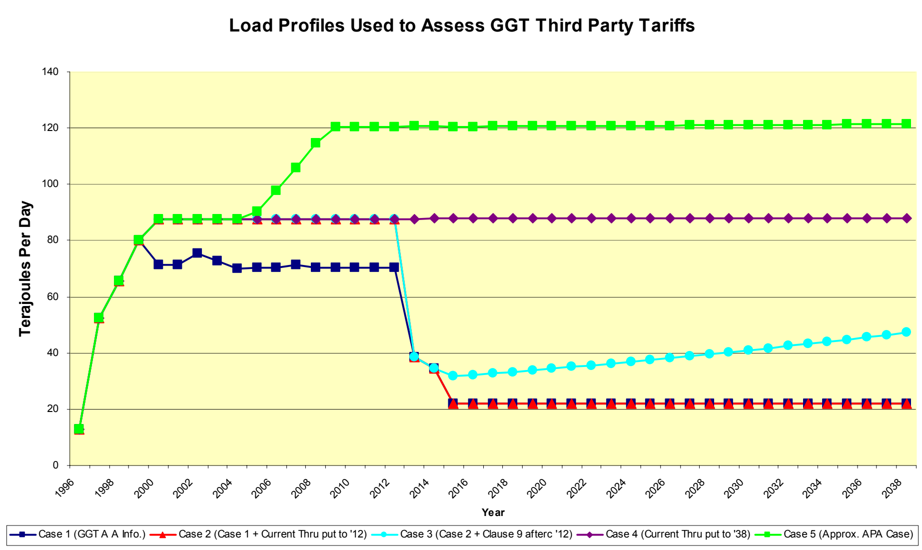
WMC therefore uses a capital base which is higher than that accepted by the Regulator and, in a net present value sense, this difference is amplified because the cost is taken into the analysis as it is spent. WMC's use of a higher capital base draws on the actual capital cost quoted by GGT in its Proposed Access Arrangement and assumes that such figure excludes all interest during construction and similar financial or holding costs. By contrast, the Regulator assumes (by implication) that its Initial Capital Base is spent 1 January 2000.

The WMC analysis produces two fundamental results which need to be explored in the context of the Regulator's Draft Decision. First, the analysis confirms the fundamental importance of the assumed demand for Pipeline services. Second, the analysis explores the project risk exposure at both the time the initial investment was made and as at 1 January 2000.

## Demand

The WMC analysis considers five demand scenarios.

| Particulars of Demand Cases | | | |
|---|---|---|---|
| | **Q4 1996 to Q4 2001** | **Q1 2002 to Q4 2012** | **Q1 2013 to Q4 2039** |
| Case 1 | Estimated Actual Demand | GGT Access Arrangement Information Loads | GGT Access Arrangement Information Loads |
| Case 2 | Estimated Actual Demand | Estimated Actual based on continuation of, but no growth in, actual Q4 2001 loads | GGT Access Arrangement Information Loads |
| Case 3 | Estimated Actual Demand | Estimated Actual based on continuation of, but no growth in, actual Q4 2001 loads. | GGT 1994 forecast volumes |
| Case 4 | Estimated Actual Demand | Estimated Actual based on continuation of, but no growth in, actual Q4 2001 loads | Estimated Actual based on continuation of, but no growth in, actual Q4 2001 loads |
| Case 5 | Estimated Actual Demand | Estimated Actual adjusted to rise to 120 PJ by 2008/09 to approximate the APT Prospectus | Estimated Actual adjusted to rise to 120 PJ by 2008/09 to approximate the APT Prospectus |



The important difference between Demand Cases 2 to 4 and Demand Case 1 in the period to December 2001 is that Demand Cases 2 to 4 all bring to account the estimated Pipeline utilisation up to 1 January 2002.

The difference between the Demand Cases after 2001 is in the assumed demand from 2004 to 2038. Working from Demand Case 1 to Demand Case 5, each demand scenario assumes an increasingly optimistic demand outlook.

In summary, Demand Case 1 (the GGT proposed demand scenario) assumes that demand on the GGT will never reach the levels currently being achieved and that after 2012/2013 demand will plummet to approximately 25% of current levels. For Western Australia, Demand Case 1 represents a disaster, contemplating a total demise of the mining industry in the east Pilbara and the Northern and Eastern Goldfields.

Of the five demand cases, the most realistic demand scenarios are Demand Case 4 and Demand Case 5. Demand Case 4 represents the continued use of the Pipeline at current levels and Demand Case 5 represents an estimate of the forecast demand for Pipeline services described by the Australian Pipeline Trust ("**APA**"), one of the Pipeline Owners.

The WMC analysis estimates two project IRRs for the Pipeline. The analysis estimates the project IRR of cash flows from 1994 to 2036 (the "40 Year IRR") and the IRR of cash flows from 1994 to 2016 (the "20 Year IRR"), being 20 years of operations from 1997. These IRRs are calculated on the basis that the A4 Tariff applied from 1 January 2003 and continues to escalate, as per the General Terms and Conditions, until 2036.

| **Particulars of 40 Year IRRs Based on A4 Tariff** | | | | | |
|---|---|---|---|---|---|
| **Demand Scenario** | **Case 1 %** | **Case 2 %** | **Case 3 %** | **Case 4 %** | **Case 5 %** |
| Before Tax Nominal IRR | 12.08 | 14.25 | 14.89 | 16.39 | 17.55 |
| Before Tax Real IRR | 9.59 | 11.72 | 12.33 | 13.76 | 14.88 |
| After Tax Nominal IRR | 8.81 | 10.28 | 11.28 | 13.06 | 14.18 |

| **Particulars of 20 Year IRRs Based on A4 Tariff** | | | | | |
|---|---|---|---|---|---|
| **Demand Scenario** | **Case 1 %** | **Case 2 %** | **Case 3 %** | **Case 4 %** | **Case 5 %** |
| Before Tax Nominal IRR | 11.65 | 14.25 | 14.32 | 15.13 | 16.24 |
| Before Tax Real IRR | 9.18 | 11.72 | 11.79 | 12.57 | 13.63 |
| After Tax Nominal IRR | 8.13 | 10.28 | 10.39 | 11.32 | 12.36 |

If the tariff proposed by the Regulator in its Draft Decision applied from 1 January 2003, the real, pre tax rate of return earned by GGT would range between 5.8% and 10.1%.

| Particulars of 20 Year IRRs Based on the Proposed Regulator's Tariff | | | | | |
|---|---|---|---|---|---|
| **Demand Scenario** | **Case 1 %** | **Case 2 %** | **Case 3 %** | **Case 4 %** | **Case 5 %** |
| Before Tax Nominal IRR | 8.20 | 10.51 | 10.61 | 11.62 | 12.71 |
| Before Tax Real IRR | 5.81 | 8.08 | 8.17 | 9.14 | 10.12 |
| After Tax Nominal IRR | 5.46 | 6.98 | 7.13 | 8.27 | 9.23 |

These results emphasise the strong relationship between the return earned by the Pipeline Owners and the risk inherent in the estimated cash flows. The results also emphasise the fundamental difference between, but the underlying consistency of, the Code and the tariff and access model set out in the State Agreement.

# four comments on GGT risk exposure

## Initial Assumptions

Key to the consideration of what constitutes an appropriate Reference Tariff and, by implication, an appropriate rate of return is the understanding and consideration of the balance of risk inherent in the rate of return and the risk inherent in GGT's cash flow forecasts and of the regulatory regime which applies to the Pipeline.

Of particular importance in this regard is the level of risk in the assumed demand for pipeline services, capital costs and operating cost. Given that the A1 Tariff was struck prior to the construction of the Pipeline, and given that key aspects of the State Agreement regarding native title and other matters were resolved at the time the submissions in relation to the AI Tariffs were made to the Minister, the risks associated with access to land and resources were largely reflected in the cost base used to derive the A1 Tariff.

The key project risks faced by GGT at the time of calculating the A1 Tariffs were:

(a) demand risk;

(b) completion risk; and

(c) construction cost overrun risk.

Whilst not wishing to understate the importance of design and technical risks, GGT's exposure to these risks was not considered to be significant in the Pipeline project (other than to the extent that these risks are reflected in cost overrun risk), as the project did not significantly test established technical competencies.

Given the modest role played by non-capital costs in pipeline economics, and the essential correspondence between the operating cost estimates contained in GGT's Access Arrangement Information and those derived for WMC's analysis, the risk attaching to GGT's Pipeline operating cost forecasts would appear to be limited. The real cost risk borne by the Pipeline Owners, relates to those risks associated with completion of construction and construction cost overrun. Indeed, construction costs did increase modestly relative to the 1994 estimates. This blowout in construction costs is reflected in the capital cost employed in WMC's analysis.

## Demand Scenarios

The demand scenario which should be considered by the Regulator to assess GGT's Proposed Access Arrangement can be divided into 3 periods.

The first such period runs from the date of first commercial operation of the Pipeline until today. WMC submits that the assumed demand in any portion of the regulatory reset period overlapping the period from 1994 to 2002 should reflect actual Pipeline utilisation and not an artificial forecast.

There is considerably more room to debate the merits of the alternative demand scenarios that might be used in the remaining periods 2002 to 2012 and 2013 to 2036.

GGT advises, in its Access Arrangement Information, that the Pipeline is heavily contracted in the period 2000 to 2036. The demand scenario options for this period would appear to be to assume Pipeline utilisation at:

(a) contracted levels, as per GGT's Access Arrangement Information until around 2012;

(b) current levels until 2012 and beyond, recognising that current contracts will be replaced extended on expiry;

(c) decreasing levels after 2012, as per GGT's Access Arrangement Information; or

(d) increasing levels, as per the APA prospectus.

Adoption of a demand scenario at the very conservative end of these options would be consistent with a Reference Tariff generating a low rate of return for GGT. It follows that use of a demand scenario which largely assumes away project demand risk warrants the determination of a correspondingly risk adjusted Reference Tariff and rate of return.

A rate of return approximating GGT's weighted average cost of capital, a figure around or even below the level proposed by the Regulator, would be an appropriate rate of return if the principal project risk (demand risk) is assumed away. Conversely, adoption of the APA prospectus demand scenario would justify a rate of return above the proposed regulated rate, reflecting the increased risk in the assumed project revenue profile.

In simple terms, a tariff cannot be set by removing the major risks to revenue (and, in this case, to investment) and then arguing that the "rate of return" applied to those forecasts should continue to reflect the risk which has been removed. If risk is removed by adjusting the revenue functions used in the tariff setting exercise, then the rate of return and the Reference Tariff need to be adjusted accordingly.

## 1994 Demand Outlook

In their 1994 submissions made in compliance with the State Agreement, the Original Joint Venturers furnished an assessment of the market for the services of the Pipeline. At that time, the nickel market was depressed and established hard rock nickel operations in Western Australia were under threat from a number of proposed (but not committed) low cost lateritic nickel developments. More particularly, hard rock nickel miners were exposed to the risk that, if the lateritic processing technologies being developed in Australia were successful, the viability of the world's lateritic nickel resources would be greatly enhanced. The competitive balance in the industry was poised to shift irrevocably.

WMC, taking a 62% interest in the Pipeline, clearly had significant concerns when considering long term take or pay type obligations to procure gas for its then existing nickel operations. The rates of return incorporated in the 1994 submissions reflected both the fact that the pipeline was still to be built and the uncertain future demand given developments in minerals markets.

## Current Demand Outlook

By 2000, the nickel market had proven its resilience and the industry had observed recent developments in the more advanced lateritic nickel projects. Whilst there are still risks to the viability of each of Western Australia's nickel operations, it is becoming increasingly clear that the future of GGT, in so far as the Goldfields' nickel industry is concerned, can be best represented by the extent of Western Australia's nickel resource.

In its submission to the Prosser Inquiry (2002) the Western Australian Department of Mineral and Petroleum Resources ("**DMPR**") estimates the indicated and inferred nickel resources of Western Australia, in 2001, to be 17.9 and 15.0 million tonnes respectively. The inferred contained nickel resource is estimated at 17,300 tonnes, or over 80 years of production at 2001 production levels (182 tones). DMPR notes that it is difficult to estimate the mine life for nickel projects given the nickel market volatility and the rate of technological change in nickel production but that it is clear that the nickel industry in Western Australia will continue in the long term. More particularly, the locations of projects and resources identified by DMPR reveals the very strong spatial association of Western Australia's nickel resources and the route of the Pipeline.

DMPR also reviews the prospects for the Western Australian gold sector in its submission to the Prosser Inquiry. DMPR concludes that, in the absence of new gold projects, the Western Australian gold industry will decline from 2001 to 2020. Importantly, however, the DMPR forecasts that the Golden Mile operation (the principal gold industry user of Pipeline services) and several other operations in the vicinity of Kalgoorlie will continue to operate at current output levels to 2020. Given the continuation of the Golden Mile operation, and recognising that:

(a) gold exploration has shifted in recent years to brownfields exploration, focussed upon extending the life of existing mining operations; and

(b) the gold sector has historically been characterised by a high turnover of small, short lived projects,

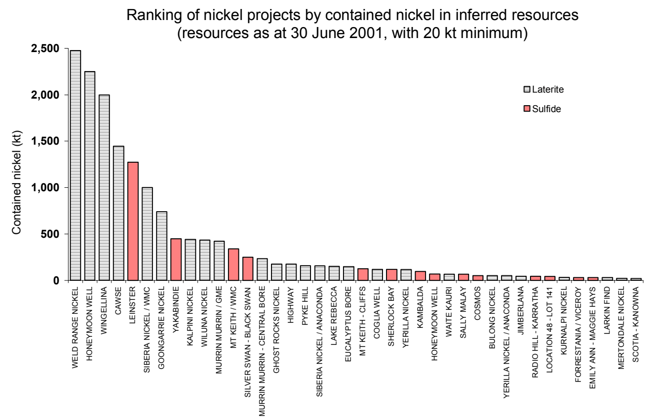
it is unlikely that gold sector demand for GGT services will collapse after 2012.

Similarly, BHP Billiton ("**BHPB**") has recently commenced development of the iron ore body near Newman known as Mining Area C ("**MAC**") and Robe River Iron Associates ("**RRIA**") has completed the first stage of the West Angelas mine which is located approximately 100 kilometres west of Newman. These developments are indicative of the strong growth in east Pilbara economic activity. Several other iron ore projects in the east Pilbara, notably Hope Downs, are also being promoted for development. In addition, existing Pilbara iron ore production infrastructure has been subject to major recent development with a view to meeting the needs of very long term market opportunities. RRIA sees the West Angelas project production rising to 20 million tonnes per annum by 2007 and BHPB has indicated that:

(a) the development of MAC marks BHPB's determination to maintain its share of the global seaborne market for iron ore; and

(b) global seaborne iron ore demand is projected to grow by 122 million tonnes over the next 15 years, of which about 86 million tonnes is forecast to come from Asia.

**Particulars of DMPR Nickel Resource Estimates**




Taking these developments, and the outlook for economic activity along the route of the Pipeline, into consideration it is difficult to understand how the prospects for the long term use of Pipeline services after 2012 could be expected to collapse. However, this is exactly what is suggested by GGT in the demand scenario painted in its Access Arrangement Information (Demand Case 1).

Even though the market for Pipeline services is unlikely to collapse after 2012, WMC submits that it would be erroneous to overstate the importance of trends in demand for Pipeline services after 2012. WMC's estimate of GGT's 20 Year IRR's and the Pipeline Reference Tariff considers GGT cash flow forecasts only until 2016. It is not difficult, in light of the evidence referred to above, to contemplate the continuance of GGT's forecast 2012 revenue levels out as far as 2016.

With the first commercial operation of the Pipeline assumed to be 1 January 1997, demand trends after 31 December 2016 have little impact on the estimated GGT IRRs or Reference Tariff. For the purpose of WMC's calculated 20 Year IRRs, it is necessary to be satisfied that demand for Pipeline services will remain strong only until 31 December 2016. To argue that demand for Pipeline services will collapse in the period 2013 to 2016 is to contradict the substantial body of evidence that is available.

The impact of long term demand growth for the Pipeline, if any, is most likely to be to trigger capital expenditure in the period before 2016. In the Reference Tariff and IRR analysis conducted by WMC, this capital expenditure would be brought to account as a cost but the revenue corresponding to that cost will largely be earned after 2016. That is to say, in a high demand growth environment, WMC's estimated 20 Year IRR's may understate actual GGT actual understate returns and the Reference Tariffs.

Rather than accept the GGT demand scenario, it would be far more realistic to adopt the demand scenario contained in the APA prospectus since this scenario has been put forward by one of the Pipeline Owners in compliance with the laws and regulations applicable to prospectuses and, accordingly, verified by APA and certified by an independent consultant (Demand Case 5).

If it is deemed necessary to adopt a more conservative demand scenario to strike GGT's Reference Tariff, it would be difficult, given the outlook for development in the east Pilbara and Eastern and Northern Goldfields, to adopt a demand which is below current utilisation levels (Demand Case 4).

In WMC's view, the focus should be on Demand Case 4 and Demand Case 5.

## The Tariff and Access Regime

To understand the risk faced by GGT it is necessary to understand the tariff and access regime enshrined in the State Agreement and the Tariff Setting Principles authorised pursuant to the State Agreement.

Under the State Agreement, GGT sets future tariffs by forecasting cash flows ahead to 2036 and looking back at actual cash flow outcomes. Under the State Agreement, GGT is obliged to set tariffs that generate not more than a commercial rate of return to the Pipeline Owners. In assessing performance under GGT's tariff and access regime it is essential to ensure that the cash flow data, the assumptions employed and the threshold established as a commercial rate of return are logically consistent.

For example, when the Pipeline Owners submitted the A1 Tariff for approval under the State Agreement in 1994 they were, prima facie, exposed to the risks identified above namely, the substantial risks of project completion, construction cost overruns, design and technical risk, other execution risks and demand risk. Despite the fact that many project cost and land access risks had been addressed and priced into the A1 Tariff, the completion and cost over run risks wore not insubstantial.

However, the true risk faced by GGT in 1994 was not a simple exposure to adverse outcomes in regard to these risks, but the risk that tariffs would initially be set too low to allow GGT to pass on actual cost outcomes to shippers. The A1 Tariff was therefore set by the Original Joint Venturers and accepted by Government at a level that reflected the risks to the Original Joint Venturers at that point in time. By pricing these project development risks into the A1 Tariff, a significant portion of the project development risk was passed on to shippers.

To balance this generous approach to setting the A1 Tariff, Tariff Setting Principles 2 and 12 provide a mechanism by, and benchmark against, which GGT is to monitor and adjust its tariffs. In its 1995 Tariff Package, GGT assured then current and potential shippers that, in regard to its tariffs and tariff setting method, that the *"Minister will monitor compliance by the Owners with their obligations under the GGP Act"*.

The manner in which this was to be addressed was set out in GGT's 1995 Tariff Package Explanatory Note – Tariff Setting Method and is reflected in Tariff Principle 12 and in each of GGT's subsequent discounts on the A1 Tariff.

The first obvious implication of the State Agreement tariff and access regime is that GGT should recalculate its tariffs following the completion of construction and any other major event affecting revenues and costs. These reviews should take account of the actual cost of project construction and the actual sale of pipeline services at the review date.

However, the movement from forecast to actual data to reset tariffs requires that the change in the risk inherent in the cash flows is reflected in the rate of return applied to those cash flows. That is to say, GGT must test its tariffs by re-evaluating its cost and revenue forecasts and rate of return whenever its cost and/or revenue forecasts or performance change significantly. The first such review was contemplated when the Pipeline completion and other construction related risks had been removed.

To adjust the cost and revenue forecasts in the tariff setting model so as to reflect the outworking of construction risk without also adjusting the benchmark rate of return, which is to apply thereto, would be entirely inappropriate. The State Agreement access and tariff regime clearly envisages a dynamic application of the discounted cash flow model. This is achieved by updating data sets as actual outcomes become known and by updating forecasts as new forecasts become available. Thus, the exposure to unforeseen outcomes, and the corresponding risk, borne by the Pipeline Owners is minimised under the State Agreement.

Each time GGT reviews its rate of return and tariffs the crucial question becomes determining the appropriate rate of return which should be used to judge and reset tariffs. The rate of return used to set the A1 Tariff needed to reflect the project development risk faced by GGT at the time, being the risk that the project might not reach completion or the risk of a significant blow out in construction cost. More particularly, the risk faced by GGT was limited to the risk that these increased costs could not be recovered under contracts signed prior to the first tariff reset or from the revenue generated from additional sales.

The rate of return reflected in the A1 Tariff needed to provide sufficient "head room" to allow GGT to recover project cost blow outs under the contracts signed prior to the first tariff reset. By so doing, the A1 Tariff passed a substantial portion of the development risk of the Pipeline to those shippers contracting for GGT services prior to the first tariff reset. This transfer of risk was also an effective transfer of project risk from the Original Joint Venturers "as investors" to the Original Joint Venturers "as shippers" because the Tariff Setting Principles make it clear that, when setting the published tariffs, GGT ascribes the published tariff to the Original Joint Venturers'/Owners' (as the case may be) use of the Pipeline.

The transfer of risk enshrined in the A1 Tariff was acceptable to the State because of GGT's obligations under the State Agreement and the Tariff Setting Principles to reset tariffs so that its rate of return would not exceed a risk weighted commercial rate of return. This protection was confirmed in the Explanatory Note to GGT's 1995 Tariff Package.

The primary development risk exposures of GGT, therefore, related to:

(a) the risk that the project would not reach completion; and

(b) unforeseen blow outs in construction costs which could not be recovered under contracts entered into prior to completion of construction.

WMC submits that the true business risk faced by GGT is that Tariff Principle 12 and transportation contracts will operate to limit the recovery of any unforeseen deterioration in costs and revenues from existing customers (to the extent that the cost blow out justifies a tariff above the tariff written into each shipper's contract) and will limit the recovery of these unforeseen revenue and cost movements to future customers and future (including renewed) contracts.

GGT is therefore exposed because, at any time under its existing contracts, the tariffs charged to some customers may not be able to be adjusted upward (in whole or in part) to reflect unforeseen adverse movements in costs and revenue. Of course, as existing contracts expire, the tariffs therein will be reset to reflect the consequences of unforeseen adverse movements in costs and demand and under existing contracts Tariff Principle 12 allows for some, in some cases significant, upward revision of tariffs. Managing or mitigating this risk was an inherent part of setting the A1 Tariff.

Provided that the A1 Tariff was set at a level that reflected the prevailing project risks in 1994, the ongoing risks (post construction) faced by GGT relate primarily to:

(a) its failure to foresee adverse movements in costs and demand;

(b) contract inflexibility which delays and/or limits the recovery of unforeseen adverse cost and revenue movements under existing contracts (this inflexibility may result in a loss of revenue to GGT, not simply a deferral); and

(c) the risk that a cheaper source of energy is found for the West Pilbara and Northern and Eastern Goldfields relative to the delivered price of gas required for GGT to earn a commercial rate of return.

However, these risks are reduced by the temporal structure of the State Agreement access and tariff model. In particular, the State Agreement does not provide a time period between tariff resets but simply places the onus on the Pipeline Owners to earn no more than a commercial rate of return at any time. If things are going well, this mechanism requires GGT to regularly review its returns and tariffs.

However, in the event of an unforeseen adverse movement in costs or revenues, GGT can reset its tariffs immediately and ensure that uneconomic terms are not built into any new contracts. It can also, within limits and to the maximum extent possible, increase tariffs charged under existing contracts. This flexibility is a key risk mitigation tool available to GGT under the State Agreement and the Tariff Setting Principles.

Under the State Agreement, it is acknowledged and expected that GGT's risk exposure will change over time. As the Pipeline approaches the end of its 42 year project life (assuming the Pipeline is taken out of service at that time although there is no reason to believe this will be the case), GGT's capacity to recover unforeseen adverse movements in revenues and costs will be constrained because there will be fewer "future sales" (i.e. sales under new contracts) from which to recover these losses. Thus, early in the life of the Pipeline (including the present), GGT's risk exposure is reduced simply because of its capacity to recover losses under a larger portfolio of future contracts.

The mechanisms contained in the State Agreement and the Tariff Setting Principles for mitigating GGT's exposure to unforeseen adverse changes contribute substantially to ensuring that the overall risk borne by GGT in regard to the Pipeline is relatively low.

Whilst there are differences between the State Agreement and Code tariff and access models, the fact that the State Agreement has applied to the Pipeline from 1994 to the present, and will continue to apply, in some form, to the Pipeline means that the risk mitigation tools built into the State Agreement have had the desired effect through the important period of project delivery. The real contrast between the tariff and access models of the State Agreement and the Code is that:

(a) the Initial Capital Base under the State Agreement is defined as the actual cost as spent;

(b) the analysis period under the State Agreement covers the life of the project from 1994 to2036; and

(c) the applicable rate of return under the State Agreement is a commercial rate of return.

The setting of the Initial Capital Base and the determination of the rate of return applicable to that Initial Capital Base under the State Agreement and under the Code are consistent. The argument focuses more on the appropriateness of the values adopted by the Regulator for these parameters rather than on whether the Code has changed the underlying risk borne by the Pipeline Owners. The term of the regulatory interval (up to 5 years) and the periodicity of Reference Tariff resets represent the more substantial contrasts between the Code tariff and access model and that contained in the State Agreement.

## Proposed Access Arrangement – Section 3

Section 3 of GGT's Proposed Access Arrangement repeatedly raises a number of issues which GGT purports establish the uniqueness of the Pipeline and go substantially to the consideration of the Initial Capital Base and Reference Tariff. Whilst these issues are stated and revisited (repeatedly) in the course of section 3.2, 3.3 and 4 little or no evidence is given to substantiate the claim of "significant difference".

According to the Access Arrangement Information, the significance of these matters for the GGT Pipeline is not that they impact the absolute level of risk faced by GGT, but that the risk faced by GGT is relatively high compared to the risk faced by other regulated pipelines.

The claims made by GGT in this section 3 of its Proposed Access Arrangement include the following:

(a) **Foundation Load**

Referring to "foundation load", GGT says that it "has taken a conservative approach regarding tariff determination for the purpose of this [Proposed] Access Arrangement and has included all pipeline throughput in the tariff setting calculation".

The treatment of the Pipeline Owners' contract rights to use Pipeline capacity is important for a number of reasons.

First, there is the assertion that GGT is acting conservatively by including the Pipeline Owner's Pipeline capacity reservations in its tariff setting calculation. However, this treatment is explicitly required under State Agreement and the Tariff Setting Principles and is also the simplest means of complying with sections 3.21 to 3.36 of the Code. By deeming the Pipeline Owner's reserved capacity to be third party pipeline use, GGT ensures that an appropriate share of cost is allocated to the Pipeline Owners (as shippers), with the minimum disclosure of information. To do otherwise would require disclosure of the arrangements of the Pipeline Owners so as to ensure compliance with the Code.

In the Proposed Access Arrangement, whilst the Pipeline Owners' capacity reservations are declared for the purpose of the tariff setting, it would appear that they are not included when statements are made such as "one third of the Goldfields Gas Pipeline's Transport Contract will expire within five years" or "the Goldfields Gas Pipeline does not hold any contracts whose remaining life are in excess of twenty years". It would appear that these statements should be read to exclude the Pipeline Owners' capacity reservations. That is to say, it may be correct to assert that 33% of those marginal pipeline capacity sales made by GGT are short term and will expire in five years (from December 1999), but the vast majority of the Pipeline's capacity is contracted for more than five years and some capacity, that portion allocated to the Pipeline Owners, is contracted to 2036 and beyond.

Further, in regard to pipeline capacity reservations and contracted capacity, the Department of Resources Development has advised the Regulator that the Pipeline Owners have reserved 98 TJ per day of pipeline capacity as Initial Committed Capacity (Draft Decision Part B: page 20). Since GGT estimates the capacity of the Pipeline, as currently configured, to be 88TJ per day to 95 TJ per day, suggestions that there are insufficient contracts for use of the Pipeline capacity appear to be incorrect.

Finally, in regard to Initial Committed Capacity and the duration of third party contracts, it must be emphasised that GGT's Reference Tariff and Reference Services incorporate a premium for short term contracts. Having duly priced these short term contracts, WMC submits that there is no basis whatsoever for GGT to argue that its short term contract structure should further influence the calculation of the Reference Tariff.

(b) **Voluntary reductions**

GGT asserts that it has made repeated and "voluntary" reductions in its third party access tariff.

WMC submits that GGT's assertion that it has voluntarily reduced tariffs since 1995 is incorrect.

The Pipeline Owners have an obligation not to breach the State Agreement and the Tariff Setting Principles. The State Agreement relies, in the first instance, on the self-regulation of tariffs by GGT. Regulatory intervention only occurs when there is suspicion or evidence of breach. The "voluntary" reductions in the GGT tariff since 1995 represent reductions in the tariff so as to ensure the Pipeline Owners complied with their State Agreement obligations.

It should also be noted in this regard that, on 20 December 2001, GGT withdrew all "voluntary" reductions in the tariff and reinstalled the tariff at the 1995 level (the A1 Tariffs), suitably adjusted for inflation.

(c) **Government Approval**

GGT asserts that past and present GGT tariffs have received government approval.

WMC submits that GGT's assertion that any tariff issued by GGT has received Ministerial approval is incorrect.

There is no mechanism in the State Agreement for such approval. Instead, it is the Tariff Setting Principles that are approved by the Minister. It is may be correct to say that, the Minister has not sought arbitration of the tariff published by GGT, a failure to thus challenge the tariffs does not equate to Ministerial approval.

(d) **Commercial Risk**

GGT makes claims that the Original Joint Venturers were required to build surplus pipeline capacity, thus increasing commercial risk.

The Pipeline Owners' obligation to build surplus pipeline capacity does not appear to be particularly onerous when the Initial Committed Capacity exceeds the minimum capacity specified in the State Agreement. In the circumstances, it is difficult to see how this obligation increases project risk.

(e) **Promotion of Use of Pipeline**

GGT asserts that its tariffs have been designed to be lower in the early years of the project and, hence, promote use of the pipeline.

It was true that the GGT tariffs were lowered in the "early project years" by the levelised design of the tariff, but this has not been the case since 20 December 2001.

(f) **State's Objectives**

GGT asserts that the State's objectives for Pilbara and Goldfields development would not have been realised without the GGT commitment of capital to the construction of the pipeline.

An analysis of energy costs (and GGT's impact thereupon) and development commitments since 1994 makes it very difficult to accept the proposition that the GGT Pipeline is responsible for delivering the State's "development objectives" in the Pilbara and Goldfields regions.

(g) **Pipeline Tender Process**

GGT claims that the Goldfields Gas Pipeline tender process and the setting of the initial Benchmark Tariff for the Pipeline "followed the process" for competitive tendering set out in the Code.

The competitive tender process set out in the Code is reasonably precise in that:

(a) the invitation to tender should not specify the pipeline configuration/capacity;

(b) the criteria for selection of the successful tenderer is clearly set out; and

(c) the tender outcome should deliver tariff and access arrangements consistent with the selection criteria and the Code.

Whilst it may be ascertained that the selection of GGT to build the Goldfields Gas Pipeline complied with these requirements, it is worth noting that:

(a) the invitation to tender did specify the pipeline size and it thus breached the Code principles;

(b) access to the various submissions and analysis of tenders would be essential to substantiate such a claim; and

(c) the drafting of the Code (and, in particular, sections 3.21 to 3.36) did not commence until well after the GGT Pipeline arrangements were put in place.

(h) **Fuel Switching**

GGT claims that fuel switching by users of the Pipeline is readily available and relatively inexpensive. GGT asserts that diesel can be substituted for natural gas along the Pipeline and that installing a dual fuel capability on existing gas fired plant is inexpensive.

There are two difficulties with this assertion.

First, the cost of installing dual fuel capacity on most plant is not inexpensive and often carries with it a loss of plant efficiency. Accordingly, it is inappropriate to classify such investment as inexpensive. Most plant that is currently tied to the Pipeline is tied by contract and unable to engage in fuel switching. It is consistent with this very limited ability to fuel switch that most of the facilities using the Pipeline are not dual fuel facilities and, accordingly, lack fuel switching capabilities. If fuel switching was possible, however, it would not be enough for plants to have a dual fuel capability. It would also be necessary to have in place the infrastructure required to deliver large and continuous volumes of these alternative fuels.

Fuel switching is not, as GGT would have the Regulator believe, a simple and inexpensive matter.

(i) **Competition**

GGT asserts that the Pipeline faces intense competition from:

- diesel; and
- the Mid West Pipeline.

Whilst the Pipeline may face some competition from diesel and the Mid West Pipeline, this competitive threat is minimal when compared to the competitive threat faced by other pipelines. Gas consumers in major urban areas typically have a greater capacity to fuel switch than shippers contracted with GGT. (Note that GGT contracts with end users of gas whereas many end users in major centres/markets have short term supply contracts with local energy retailers. End users of gas with short term contracts are much more capable of fuel switching than are GGT's Users).

Further, coal seam methane and local gas (e.g. Surat Basin, Bowen Basin, Sydney Basin, Perth Basin, etc) represent major threats to gas pipelines in New South Wales, Queensland and Western Australia, the East Coast Pipeline and the SEA Gas Pipeline provide real (not potential) competition to the Moomba to Adelaide and Moomba to Sydney gas pipelines and the Amadeus Basin to Darwin, Carpentaria, South West Queensland and Queensland Pipelines all face competitive bypass from Timor Sea and/or, PNG gas.

It is true that more shippers on the Pipeline are entitled to the Diesel Excise Rebate than may be the case for users of some other pipeline systems, but even a cursory review of the facts will reveal that the competitive threat to the

Pipeline is, on balance, lower than that faced by many other gas transmission pipelines in Australia.

(j) **Viability of Pipeline**

GGT claims that:

- viability of the Pipeline is "almost solely dependent" upon mining activity which is "volatile", "dependent on both the mining industry in Australia and the cost structures of competing mines elsewhere in the world", "high cost" and, by implication, subject to the "depletion of mineral reserves";
- viability of the mining industry would be undermined by (unspecified) taxation changes; and
- life of the Pipeline is less than that of other pipelines because of its reliance on the mineral industry, intense competition and its short term contract arrangements.

It is true that GGT is heavily dependent upon the mining industry. However, the submissions of the State to the Prosser inquiry (discussed above) and the reality that WMC is a low cost nickel producer (placed in the lowest quartile of operating costs), indicate that GGT's claims regarding depleting reserves, high mining costs and the short life of its market are un-substantiated.

Whilst WMC acknowledges that the Pipeline is exposed to some commercial risk, it is readily apparent that:

(a) the level of that risk is not clarified by the material in the Proposed Access Arrangement;

(b) the level of that risk is not demonstrably higher for the Pipeline than it is for other pipelines and, whilst the Proposed Access Arrangement makes certain claims, it offers no concrete evidence to support these claims; and

(c) any previous commitment by GGT to promote use of the GGT Pipeline was clearly abandoned on 20 December 2001.

# five price paid by the owners for the pipeline and the supreme court decision

## Proposed Access Arrangement – Section 4.1.2

In section 4.1.2 of its Proposed Access Arrangement, GGT states that the "acquisition price" of the GGT Pipeline was $624 million.

GGT bases this assertion on the fact that WMC sold its interest in the GGT Pipeline for $402 million and Normandy Pipelines Pty Ltd ("**Normandy**") sold its interest for $147 million. GGT ignores the price paid to Pilbara Energy Pty Ltd ("**Pilbara Energy**") for its share of the Pipeline because Pilbara Energy sold a bundle of assets. The figure of $624 million is, therefore, based on a weighted average of the price paid to WMC and Normandy.

However, the acquisition by SCPA of WMC's interest in the Pipeline includes the acquisition of significant assets which do not form part of the Pipeline and which are subject to separate tariff arrangements. Clearly, to estimate the acquisition price of the regulated assets the Regulator should:

(a) deduct the value of unregulated assets from the $402 million paid to WMC and recalculate the weighted average; or,

(b) simply use the price paid to Normandy to derive the acquisition cost of the Pipeline.

Properly calculated, the maximum acquisition price that should be placed on the Pipeline would appear to be less than $580 million. It is clear that there has been insufficient disclosure by GGT in light of this significant overstatement of the acquisition price of the Pipeline.

Accordingly, WMC submits that if the Regulator is to consider the price paid for the Pipeline by the Pipeline Owners, it must remove from the acquisition price:

(a) the value of all assets which form part of the purchase and which do not form part of the Pipeline;

(b) all premiums paid for control of the assets and the joint venture in the acquisition of WMC's interest and the combined WMC and Normandy interests; and

(c) any undue risks borne by the Pipeline Owners.

In the circumstances, it is difficult to believe that the sale price would be significantly above $580 million.

## Epic Court Decision

The Epic Court Decision focuses on what Epic described initially as a "Regulatory Compact" and upon those aspects of the Code which would require the Regulator to give fundamental consideration to:

(a) the price paid by Epic for the Dampier to Bunbury Natural Gas Pipeline ("**DBNGP**") and the circumstances of that purchase;

(b) Epic's reasonable expectations concerning the Reference Tariff which was to be determined by the Regulator; and

(c) Epic's legitimate business interests.

In regard to these matters, the circumstances of Epic's purchase of the DBNGP from the State contrasts markedly to the circumstances under which the Pipeline Owners acquired the Pipeline from the Original Joint Venturers. In particular:

(a) there can be no suggestion that the Original Joint Venturers had the capacity to influence the legislated regulatory model or that they were capable of entering a "Regulatory Compact" with the Pipeline Owners;

(b) the tariff and access regime set out in the State Agreement was fully operational at the time of the sale, approved Tariff Setting Principles and the Tariff Package were in place and at least one tariff reset had been given effect;

(c) the Pipeline Owners could not have reasonably expected that the regulated tariff would be higher than the tariff which could, from time to time, be justified under the State Agreement and the Tariff Setting Principles;

(d) the Pipeline Owners' legitimate business interests could not be based on a Reference Tariff above that which might, from time to time, be justified under the State Agreement and the Tariff Setting Principles; and

(e) the Pipeline Owners might legitimately have expected that any material adverse divergence of the Reference Tariff from the regulated tariff justified under the State Agreement and the Tariff Setting Principles would not apply to the Pipeline.

## Consistent Use of Cash Flow Models and Revenue Expectations

Given the arrangements set out in the State Agreement and the Tariff Setting Principles, which were known to the Pipeline Owners at the time, there is no basis upon which the Pipeline Owners could conceive or argue that the Reference Tariff determined pursuant to the Code would be based upon the price paid to the Original Joint Venturers to acquire the assets.

However, there is something of a "chicken and egg" problem when it comes to using the acquisition price of an asset as a basis for setting regulated tariffs. Specifically, the purchase price paid by the Pipeline Owners for their respective interests in the Pipeline represents the Pipeline Owners' valuation of the net contract and regulated cash flows generated by the business/asset. To then argue that the price derived using this assumed revenue stream should be used to determine the Reference Tariff (and thus a new revenue stream) is circular.

The real issues, therefore, are whether:

(a) the cash flow profiles used by the buyer to set the acquisition price of an asset are reasonable, legitimate and/or consistent with reasonable cost, demand and tariff expectation; and

(b) these cost and revenue expectations are consistent with the applicable regulatory regime.

Going one step further, it is important to recognise that the determination of an asset's acquisition price is a fundamentally different exercise from establishing an asset base and tariff for the purpose of regulation. In essence, in striking the acquisition price of an asset, the prospective buyer will estimate:

(a) contract and non-contract capacity sales ("contract" and "non-contract" in this case means contracted or not contracted at the time the acquisition price is determined);

(b) the treatment of forecast contract revenues for regulatory purposes;

(c) expected revenues from non-contracted pipeline capacity (in this case regulated revenue tempered, where necessary, by market conditions);

(d) ongoing stay-in-business capital expenditure and operating costs; and

(e) ongoing capital needed to satisfy expected growth in contracted and non-contracted sales and revenues.

Once these cash flow forecasts are in place, the acquisition price will diverge from any regulated asset value used to set regulated tariffs to the extent that:

(a) the assets being purchased include assets which are not subject to regulation (for example, the lateral pipelines);

(b) the regulated revenue forecasts exceed, or fall short of, expected revenues;

(c) the buyer attributes a value to the assets other than the value measured in the forecast cash flows (control premiums etc);

(d) the buyer expects to appropriate the value of operating and capital cost savings rather than pass them on to users of the asset; and

(e) increased gearing of the acquisition finance is possible (reflecting the lower risk of acquisition as opposed to project development) relative to corporate gearing and the regulated rate of return.

The fact that the Pipeline carries significantly more debt than the level contemplated in the Regulator's WACC is suggested by GGT's Alternate General Terms and Conditions clause 16.5(b) which is characteristic of a highly geared project finance arrangement. Without this higher gearing the acquisition prices would not be achieved.

In reference to the above considerations, it is:

(a) publicly known that some of the Pipeline Owners purchased assets and facilities (as part of the acquired assets) which do not form part of the regulated Pipeline assets (for example, SCPA purchased lateral pipelines from WMC as part of WMC's sale of gas assets);

(b) reasonable to expect that at least some of the acquired assets carried a “control premium” which should not be brought to account for regulatory purposes; and

(c) reasonable to expect that the cost of funds underlying the acquisition price would be substantially lower than the WACC as constructed by the Regulator (reflecting the higher gearing in acquisition financing).

## Use of Purchase Price

It is not unreasonable to consider the use of the purchase price of an asset when establishing the Initial Capital Base and Reference Tariffs for regulatory purposes, but it is essential in so doing that:

(a) the fundamentally different nature of the “acquisition” transaction is recognised;

(b) the regulated rate of return constructed in the Draft Decision is recognised as excessive;

(c) only the price paid for regulated assets is taken into account;

(d) any value derived from the assets which is not reflected in its net revenue stream, which increases the acquisition price (eg, control of key joint venture owned assets), must be deducted from the purchase price; and

(e) any undue market or project risk built into the asset’s purchase price is borne by the buyer of the asset and not, through the regulated tariff, passed on to users of the asset.

Whilst using the acquisition price of a business/asset as a basis for regulation should not be precluded its use requires:

(a) for the reasons set out in Part 4 above, the regulated rate of return to be set at a level significantly below the WACC constructed by the Regulator in its Draft Decision;

(b) the acquisition price to be adjusted to remove those parts of the acquisition price paid for assets which are not regulated assets;

(c) any undue risks that are built into the acquisition price to be quarantined and borne by the buyer; and

(d) the buyer to make full disclosure of the forecast revenues, costs, returns and funding arrangements for the assets.

In the Epic Court Decision the Supreme Court systematically reviews clauses 2.24 and 8.1 of the Code and comments on the application of each of the clauses to Regulator’s draft decision in relation to the DBNGP. The fact that there is significant overlap between clause 2.24 and clause 8.1 of Code should not be surprising given that clause 8.1 relates peculiarly to consideration of the Reference Tariff and clause 2.24 relates to consideration of the whole of the Access Arrangement, including the Reference Tariff. Thus, rather than reviewing clauses 2.24 and 8.1 separately in this submission it is useful to identify any such overlap and to then address the clauses concurrently.

Paragraphs #129 to #156 of the Epic Court Decision summarise the Supreme Court’s view on the application clauses 2.24 and 8.1 of the Code to the DBNGP.

Clause 2.24(a) is judged by the Supreme Court to require the Regulator to recognise that Epic's legitimate business interests justify consideration of the price it paid for the DBNGP when determining the Initial Capital Base of the DBNGP and, further, that Epic's "investment in the Covered Pipeline" is measured by the purchase price. This interpretation flows through to clause 8.1.

WMC accepts that the acquisition price of the regulated asset should be considered when determining the Initial Capital Base of the regulated asset.

WMC submits, however, that an Initial Capital Base derived from the acquisition price can only be employed in conjunction with an appropriately defined rate of return. Care needs to be taken also that the Regulator, when setting the Initial Capital Base, avoids circularity and, if relying upon the acquisition price, focuses on the underlying cost and revenue functions giving rise to that price. The Supreme Court notes that forecast cash flows may include monopoly returns confirming that the regulatory process starts with the cash flows and develops the Initial Capital Base and Reference Tariffs rather than starting with the Initial Capital Base and working down to calculate the Reference Tariff.

The first step in this regulatory process is the determination of the cash flow functions that a buyer of a regulated asset might reasonably expect in the circumstances of the purchase.

WMC submits that:

- the Proposed Access Arrangement significantly overstates the Pipeline Owners' acquisition cost of the Pipeline;
- there are elements in the acquisition price (risk based forecasts and price premiums) which should not be passed on to shippers in the Reference Tariff;
- the cash flows used by the Pipeline Owners to calculate their acquisition price could not have been more favourable than those that would have applied had the State Agreement continued to apply to the Pipeline;
- if the acquisition price is to be used when setting GGT's Initial Capital Base, the cost of funds built into the acquisition financing should be used to set the Reference Tariff; and
- the Reference Tariff derived by WMC reasonably addresses the issues raised by the Supreme Court.

In addition, clause 2.24(b) requires that firm and binding contracts be considered in evaluating an Access Arrangement. The provisions of clause 2.24(b) of the Code are not replicated in clause 8.1 and the question of firm contracts was not addressed in the Epic Court Decision. To the extent that the Regulator proposes to consider the acquisition price of an asset when setting the Initial Capital Base and Reference Tariff, it is imperative that the Regulator determines the quantum by which the acquisition value and the regulated value of firm and binding contracts diverge. That is to say, where the value of firm contract sales diverge from the regulatory value attached to those sales, this value differential will be reflected in the acquisition price and must be quarantined for regulatory purposes.

To consider the acquisition price of an asset when setting the Initial Capital Base and Reference Tariff the Regulator must develop a methodology to estimate and isolate that portion of the acquisition price by which the value of firm contract sales diverges from the regulatory value of those sales.

In summary the Reference Tariff calculated by WMC:

(a) recognises the legitimate business interests of GGT;

(b) is not demonstrably lower than the Reference Tariff which could be expected if the Regulator used the acquisition price paid by the Pipeline Owners for the Pipeline and adjusted that price and the applicable rate of return appropriately;

(c) provides a methodology for considering relevant firm contractual obligations;

(d) accommodates the safe and reliable operation of the Pipeline;

(e) affords GGT the opportunity to recover its long run average, or its efficient, cost;

(f) because it is determined as the average cost of the service derived from a long term discounted cash flow model, replicates a workably competitive outcome; and

(g) will not distort use of Pipeline services or investment; and accepting GGT's tariff structure, is efficient in both level and structure.

# six delay

Earlier this year WMC made application to be joined as a third defendant to the GGT Court Proceedings. This application was refused by Justice Heenan by his judgment delivered 12 June 2002. WMC appealed this judgment and on 21 November 2002, the Full Court allowed WMC's appeal, thereby admitting WMC to the proceedings.

As is apparent from Justice Heenan's judgment, the Regulator's decision as to the appropriate Reference Tariff to apply to the Pipeline will have a flow on effect in respect of the GTA. As stated by Justice Heenan at page 24 of his judgment:

> "*WMC Resources Limited is, therefore, in a situation where the price for the commodity which it is receiving under the Gas Transmission Agreement is set, by express contractual terms in the GTA, which incorporate by reference a tariff determination made by the Regulator under contractual and statutory terms which apply to other parties. No one disputes that proposition. The economic consequences for WMC Resources Limited, if the cheaper tariffs proposed by the Regulator's Draft Decision which is under challenge, do apply, are very great.*"

Until such time as the Regulator's decision is made final, WMC will continue (albeit under protest) to pay the higher Reference Tariff to SCPA. The longer the Regulator delays in making his decision final, the greater this disputed sum will become.

In WMC's view there can be no doubt that prejudice to WMC is a relevant consideration to the taken into account by the Regulator in determining when and how to proceed with the completion of review of the Access Arrangement.

# seven conclusion

In conclusion, WMC requires that:

(a) the Regulator does not anticipate any decision about the application of clause 21(3) of the State Agreement, regardless of whether the decision is ultimately found to vest in the Minister (as the State and WMC contend) or the Court (as the Pipeline Owners contend); and

(b) the Regulator, in his final decision, identifies a "pure" set of Reference Tariffs which have been derived without regard to clause 21(3) of the State Agreement.

WMC submits further that:

(a) GGT's Proposed Access Arrangement significantly overstates the Pipeline Owners' acquisition cost of the Pipeline;

(b) the demand scenario put forward by GGT in its Proposed Access Arrangement is unrealistic;

(c) the risk profile used by GGT in its Proposed Access Arrangement is not appropriate;

(d) there are elements in the acquisition price (risk based forecasts and price premiums) which should not be passed on to shippers in the Reference Tariff;

(e) the cash flows used by the Pipeline Owners to calculate their acquisition price could not have been more favourable than those that would have applied had the State Agreement continued to apply to the Pipeline;

(f) if the acquisition price is to be used when setting GGT's Initial Capital Base, the cost of funds built into the acquisition financing should be used to set the Reference Tariff; and

(g) the Reference Tariff derived by WMC reasonably addresses the issues raised by the Supreme Court and arrives at a Reference Tariff approximate to that handed down by the Regulator in the Draft Decision,

and submits that the Regulator consider these issues as part of the tariff setting process.