GOLDFIELDS GAS PIPELINE
ANALYSIS OF ACQUISITION PRICES PAID FOR GGP INTERESTS

Prepared for

By

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1. EXECUTIVE SUMMARY

The Supreme Court of Western Australia, in the Epic Decision, has stipulated that, when determining the initial capital base (the "ICB") of regulated pipelines, the prices paid for interests in those regulated assets should be given consideration as a fundamental element. The Amended Draft Decision regarding Goldfields Gas Transmission Pty Ltd's Proposed Access Arrangement (the "Amended Draft Decision") gives little attention to the prices paid for interests in the Goldfields Gas Pipeline (the "GGP"). Indeed, the Economic Regulation Authority (the "Authority") appears to uncritically adopt an estimate of ICB in the upper end of the range suggested by available data.

The Authority's consideration of this issue raises three primary concerns. The first of these concerns is the need to differentiate between simple arithmetic estimates of ICB and the actual ICB of the GGP. The Amended Draft Decision adopts uncritically an extreme first order estimate of the ICB of the GGP. It fails to consider how such an estimate translates into the ICB for the GGP for purposes of the National Third Party Access Code for Natural Gas Pipeline Systems (the "Code").

Second, it appears from the Amended Draft Decision that the Authority has not secured, or has been unsuccessful in securing, sufficient information to reach a reasoned view on how prices paid for interests in the GGP might influence any determination of the ICB of the GGP.

Finally, the Amended Draft Decision highlights the need for the Authority to:

- pursue detailed information concerning each of the known transactions involving a transfer of an interest in the GGP;
- require the sellers and the buyers of the respective interests in the GGP to distinguish between the sale/acquisition price of the GGP interest and the sale/acquisition price quoted for the suite of assets involved in the transaction; and
- rigorously review the detail of the transactions, and any adjustments or assumptions applied to the data relating to the acquisition, to derive a valid estimate of the ICB of the GGP in a Code-based framework.

In the absence of the necessary data, the analysis set out below outlines a conceptual framework for exploring the issues relevant to a Code-based evaluation of the prices paid for interests in the GGP. What emerges from this analysis is that the ICB estimate adopted by the Authority is a poor guide to the ICB of the GGP. The analysis goes further to suggest that, even if the acquisition price data suggests an ICB in the order of

$500 million, the actual ICB of the GGP, and the Reference Tariffs produced therefrom, may be consistent with the ICB and Reference Tariffs derived using DAC, DORC and other ICB estimates when all the respective ICB estimates are applied to properly defined costs of funds and other regulatory settings.

2. BACKGROUND

WMC Resources Limited ("WMC") has asked Project Consultancy Services Pty Ltd ("PCS") to review the publicly available information related to sales/purchases of interests in the GGP and to review the issues related to using this information to estimate the ICB of the GGP for the purposes of the Code. Interests in the GGP have changed hands in various transactions between 1998 and 2004 involving Southern Cross Pipelines Australia Pty Limited ("SCP"), Southern Cross Pipelines (NPL) Australia Pty Limited ("SC-NPL"), the Australian Pipeline Trust ("APA"), Duke Energy WA Power Pty Ltd ("DEWAP") and AlintaGas Limited ("AlintaGas").

3. DATA AND METHODOLOGY

Since March 1994, when the Goldfields Gas Pipeline Agreement Act (the "State Agreement") was signed by the initial GGP owners and the State of Western Australia (the "State"), there have been at least six transactions whereby interests in the GGP have changed hands. These transactions include the purchase of:

(a) Wesminco Oil Pty Ltd's ("Wesminco's") interest in the GGP by SCP in the last quarter of 1998;

(b) Normandy Pipelines Pty Ltd's ("NPL's") interest in the GGP by SC-NPL in the first quarter of 1999;

(c) Pilbara Energy Pty Limited's ("PEP's") interest in the GGP by DEWAP in the first quarter of 1999;

(d) Transalta Energy Australia Pty Ltd's ("TransAlta's") interest in SCP and SC-NPL by the Australian Pipeline Trust ("APA") in 2003;

(e) DEWAP's interest in the GGP by AlintaGas in the third quarter of 2004; and

(f) CMS Gas Transmission and Storage Company's ("CMS's") interest in SCP and SC-NPL by APA in the third quarter of 2004.

Whilst WMC is well informed regarding the sale of Wesminco's interest in the GGP to SCP it is not able to place that information on the public record. Indeed, little is publicly known of the abovementioned transactions, except that:

(a) certain terms of the sale of Wesminco's interest to SCP were documented in press releases;

(b) certain terms of the sale of the NPL interest to SC-NPL were documented in press releases;

(c) certain terms of both these transactions are reviewed and disclosed in the Authority's Amended Draft Decision concerning Goldfield Gas Transmission's ("GGT's") Proposed Access Arrangement ("Amended Draft Decision");

(d) the “total transaction cost” of APA’s purchase of TransAlta’s interest in SCP and SC-NPL was $25 million; and

(e) certain terms of the sale of CMS’s interest in SCP and SC-NPL to APA were documented in APA press releases.

The information available regarding transactions (a), (b) and (e) above, and certain estimates that can be made using that data, are summarised in Tables 3-1 and 3-2.

Table 3-1 1998/1999 Sales/Purchases of Interests in the GGP

	Transaction	
	Wesminco Sale to SCP	**NPL sale to SC-NPL**
Assets Bought	Physical GGP Assets WMC GGP Off-take Contract Share in Goldfields Gas Transmission Pty Ltd Other GGP Sales and Input Contracts and operating structures Lateral Assets WMC Lateral Off-take Contract	Physical GGP Assets NPL GGP Off-take Contract Other GGP Sales and Input Contracts and operating structures Lateral Assets NPL Lateral Off-take Contract or equivalent
Interest Bought	62.664%(1) in GGP interests 100%(1) in WMC Lateral interests 100% of shares in GGT	25.493%(1) in GGP interests 100%(1) in NPL Lateral interests
Price Paid $'000,000	$402(1)	$140(1)
Estimated Lateral Value $'000,000	20.2(1)	3.8(1)
Net GGP Acquisition Price $'000,000	381.8	136.2
Net GGP price per % $'000,000	6.1	5.3
Implied Value of GGP $'000,000	609.3	534.3

Notes (1) Source: Press releases and Amended Draft Decision.

Table 3-2 2004 Purchase of SCM Interest in SCP and SC-NPL

	Transaction
	CMS Sale to APA
Assets Bought	45% of SCP and SC-NPL 100% of Parmelia Pipeline 100% of Dongara Processing Plant 100% of Mondarra Storage Facility 100% of small gas retail business
SCP SC-NPL Interest in GGP	88.2%
Interest Bought	45%(1)
Price Paid $'000,000	$206(1)
Estimated Transaction Cost $'000,000	6
SCP SC-NPL Debt $'000,000	250
Additional Debt Accepted by APA $'000,000	112.5
SCP SC-NPL Cash Balance $'000,000	37.4
Effective Price $'000,000	275.3
Estimated Value of Parmelia, Dongara, etc Assets $'000,000	70(2)
GGP Interest Purchase Price $'000,000	205
Estimated Lateral Value $'000,000	24(3)
Price per cent of GGP $'000,000	5.17
Implied Value of GGP $'000,000	493

Notes (1) Source: APA Press releases and presentations.
(2) Based upon Regulator's ICB for Parmelia Pipeline and a provision for other Dongara region assets.
(3) As per table 3-1.

4. RESULTS

The Authority, in its Amended Draft Decision, appears to uncritically adopt an ICB estimate of $620 million (based upon the acquisition price paid for interest in the GGP). However, there is little indication that the Authority has undertaken any critical appraisal of how the numerical data used to produce its figure of $620 million was generated. There is no indication that the Authority has sought to establish the exact nature of the assets acquired in the transactions, summarised in Table 3-1, whether all of those assets are properly included in the ICB valuation for Code purposes or that the value placed on those assets have been properly determined for Code purposes.

The Authority's ICB estimate is above the upper extreme of the value range suggested by Table 3-1. The transaction summarised in Table 3-2 post-dates the release of the Amended Draft Decision. The adoption by the Authority of an ICB estimate of $620 million demands a review and an explanation of the assumptions inherent in, and the variations between, the acquisition prices derived in Table 3-1 and the variation in the values derived in Table 3-1 and Table 3-2.

It is easy to gloss over the difference between the price paid for the Wesminco and NPL interests in the GGP by simply averaging out the data summarised in Table 3-1. However, averaging out these results discards valuable information which is particularly pertinent to striking an Acquisition Price-Based ("AP-based") ICB estimate for the GGP. Since the physical assets involved in the transaction are identical, understanding the reasons for the divergence in the purchase prices implied in Table 3-1 is absolutely critical. Once the physical assets that are not relevant to the valuation are removed from the data, the variance in implied purchase prices can be largely explained by:

- variations in the "concessions" in the contractual component of the assets sold/acquired (concessions in this case means the benefits and advantages which accrue to SCP as a result of the WMC offtake contract relative to the NPL offtake contract and the benefits and advantages delivered to SCP and SC-NPL in both the WMC and NPL offtake contracts relative to GGT's terms and conditions of third party access) ; and
- premiums paid for non-physical elements in the asset package (eg, control).

An analysis of the divergence in the prices paid also begs the need for additional information regarding the undisclosed transactions noted above.

4.1 The Relevant Assets

For the purposes of the Code, the first step in employing the prices paid for interests in the GGP to produce an ICB estimate is the removal of extraneous/unregulated assets from the portfolio of assets to which the acquisition price applies. In the absence of better information, an attempt is made in Tables 3-1 and 3-2 to make these corrections to the quoted acquisition price data. For the purposes of the discussion below, it is assumed that the corrections made in Tables 3-1 and 3-2 satisfactorily address this matter.

Key to considering any asset acquisition are the future cash flows attaching to that asset. These future cash flows may bear little or no relationship to the replacement cost of the relevant asset and it is the value of the cash flows, and not the replacement cost of the assets, which will determine the value of the asset and its feasible acquisition price. This phenomenon is explained in simple terms below.

Take for example a hypothetical company with one asset, a power station in the western reaches of New South Wales. On its own the power station has no value other than its scrap value (less the cost of transporting that scrap to market) or the value of the relocatable elements of the facility relocated to another location (less the cost of dismantling and reinstating those assets and transporting the moveable elements to a new location). Neither the cost of the asset nor the cost of replacing the asset is a measure of its worth.

If the company signs a contract to sell electricity from the power station, the value of the asset changes. This value, which can be estimated as the present value of the net proceeds of the electricity contract, is not driven by the cost of the assets or the relationship between the company's WACC and the replacement cost of the asset. If the power station is blessed with a skilled workforce, favourable supply and service contracts and operating and business procedures that are soundly based, effectively documented and well administered, its value will reflect the quality of these crucial assets.

Connect the power station to the grid, so that it can off-set transmission system losses, dispose of surplus production, secure a back-up supply service and even hold a comparative advantage in supplying some connected markets, and the value of the asset increases again. But the cost of the assets has not changed and nor has the replacement cost or the company's WACC.

Since each of the transactions described in Table 3-1 relate to the same physical assets, and to the same buyers, the unique element in each transaction is the customised offtake contract for GGP services. In the 1998/1999 sales/purchases it can be surmised that:

- the value of the underlying GGP assets is equal in both transactions; and
- the bulk of the variation in prices paid to Wesminco and NPL is explained by differences in the discounted value of forecast cash flows inherent in the respective offtake contracts for GGP services.

As the actual offtake agreements are not publicly available, it is difficult to place a value on differences in the discounted value of the WMC and NPL offtake agreement cash flows but such differences could readily account for most, if not all, of the $75 million apparent difference in the prices paid to Wesminco and NPL.

More particularly, however, the task of determining the ICB of the GGP for the purpose of the Code demands that the AP-based ICB estimate reflects the terms which are included in third party contracts and not the terms of custom built offtake agreements with WMC and NPL.

If the GGP were operated as a "market service pipeline", where all contracts are casual in nature and based upon the terms which are offered to third party Users, the prices paid to Wesminco and NPL would have been substantially below those reported in Table 3-1. That conclusion follows from the fact that the market for GGP services, at the time of the sale/purchase, was dominated by two anchor loads. Without contracts with these anchor loads the GGP has little remaining value.

Further, if these anchor loads had contracted on third party terms:

- with GGT, thus diluting SCP's and SC-NPL's share of contract revenues;
- taking short term contracts;

- with a right to transfer their contracted capacity rights (creating the capacity for WMC and NPL to compete in the market with the buyer of the GGP interest);
- being required to provide security, in regard to their contractual undertakings, only when GGT has "genuine concern regarding Shipper's credit worthiness" (GGT tariff setting principle 5); and
- with tariffs that were to be subject to continual regulatory review,

the prices paid for the GGP interests would have been substantially below the prices quoted in Table 3-3.

By contrast, SCP purchased from Wesminco and NPL, along with its interest in the GGP, highly secure "long term" cash flows with "major mining companies including WMC and Normandy" (APA Offer Document 2002)

An offtake contract, by its terms, can ensure that a large portion of the capacity being purchased by the incoming GGP owner generates a secure cash flow which could be "offered" to lending institutions as security for that party's investment. In such a case, the cost of funds realised by a purchaser would be below the WACC calculated by the Authority and would produce an AP-based ICB estimate above the DAC, DORC or FCF estimates.

In effect, when SCP and SC-NPL purchased the GGP, they acquired not simply an interest in the GGP, but an interest in two even more valuable assets, the WMC and NPL offtake agreements for GGP services. In so doing, SCP and SC-NPL ensured that the asset would deliver reliable cash flows and, by quarantining the anchor loads on the GGP and effectively taking them out of the market, insulated themselves against the risk that their asset would be bypassed in the future. Thus, the WMC and NPL offtake contracts enhanced the bankability of all GGP revenue forecasts, thereby reducing SCP's and SC-NPL's cost of funds. Some of the value thus created may have been transferred to Wesminco and NPL (as compensation for their making these concessions) in the form of higher acquisition prices. Clearly, these acquisition prices represent the value of the cash flows offered by WMC and NPL in their respective offtake contracts and they do not necessarily reflect the value of the GGP. These acquisition prices do not, prima facie, represent estimates of the ICB of the GGP for the purposes of the Code.

In light of the above it is entirely reasonable to expect a Code-based, ICB estimate for the GGP, based upon the prices paid for interests in the GGP, to fall below the value implied by the price paid to both Wesminco and NPL in 1998/1999. If the "value" of concessions in the WMC and NPL GGP service offtake agreements (made to improve the bankability of cash flows, relative to the terms of third party agreements) are deducted from the ICB implied by the acquisition prices, a GGP ICB estimate below $500 million is not out of the question.

4.2 Control Premium

The striking feature of Table 3-1 is the significant variation between the implied prices paid to NPL and to Wesminco for their respective interests in the GGP. Whilst the matters discussed in section 4.1 above may explain the bulk of that variation, the other significant difference between the respective transactions is that Wesminco's 62% interest in the GGP carried with it effective control of the asset. It is reasonable, therefore, to expect that at least part of the difference between the transaction reported upon in Table 3-1 may be explained by a premium in the Wesminco transaction for control of the GGP. There is a need to also consider how a control premium in the implied price paid to Wesminco and NPL for an interest in the GGP should be taken into account when producing a Code-based ICB estimate for the GGP.

In terms of the Code, this control premium can be simply represented as resulting from:

- the use of a lower acquisition cost of funds in the acquisition model to reflect the lower risk attaching to an "active", as compared to a "passive", investment in the GGP; and
- crediting the Wesminco forecast cash flows with synergistic revenue gains (attributable to other assets) which the buyer may be confident of delivering if the buyer actively controls the GGP.

Whilst a control premium may be a valid element in an acquisition price, there are serious questions as to how the acquisition cost of funds and, or, forecast revenues, should be treated for the purposes of estimating the ICB for the GGP for the purposes of the Code.

4.3 2004 Transactions

Of the two 2004 sale/purchase transactions involving interests in the GGP, APA has disclosed sufficient information to suggest a first approximation, ICB estimate for the GGP falling below $500 million. In the circumstances, it is unlikely that this transaction entails a premium for control of the GGP because APA already had a controlling interest in SCP which in turn controls the GGP.

However, it is SCP and SC-NPL, and not GGT (or all owners of the GGP) which have the benefit of the WMC and NPL offtake contracts for GGP services. It follows, therefore, that the comments in section 4.1 above, relating to the value of contractual concessions in the WMC and NPL GGP offtake contracts, apply equally to the valuation derived in Table 3-2. In this light, the value derived in Table 3-2 must be interpreted as the upper boundary to the AP-based ICB estimate for the GGP based upon the APA/SCM 2004 transaction.

An analysis of the APA purchase of TransAlta's interest in SCP and SC-NPL also suggests, assuming the debt and cash position of SCP and SC_NPL is similar to that summarised in Table 3-2, a first approximation, ICB estimate of around $485 million.

Given the changes in financial markets and the regulatory experience between the 1998/1999 and the 2004 transactions reported upon in Tables 3-1 and 3-2, the indicated ICB values should be seen to be broadly consistent. All of the data suggest an ICB below $500 million.

4.4 Undisclosed Transactions

One striking feature of GGT's disclosure regarding the prices paid for interests in the GGP is that GGT avoids any disclosure regarding the sale of PEP's interest in the GGP DEWAP. GGT purports to adopt this position because the DEWAP transaction involved a basket of assets which included the interest in the GGP. However, as noted in sections 3 and 4 above, the SCP and SC-NPL transactions both included a suite of assets which incorporated the physical GGP interest.

The task of valuing Wesminco and NPL offtake contract concessions and control premiums may be significantly enhanced if the implied value placed on the GGP by the DEWAP transaction is disclosed. Significant insights would also be derived by greater disclosure of the basis on which APA acquired TransAlta's interest in SCP and SC-NPL and disclosure of the terms on which DEWAP acquired its interest in the GGP and on which AlintaGas subsequently acquired DEWAP's interest in the GGP.

The Authority should be urged, in the strongest terms, to:

- pursue detailed information concerning each of the known transactions involving a transfer of an interest in the GGP;
- require the sellers and the buyers of the respective interests in the GGP to distinguish between the sale/acquisition price of the GGP interest and the sale/acquisition price quoted for the suite of assets involved in the transaction; and
- rigorously review the detail of the transactions and the adjustments and assumptions used to derive a value for the GGP in a Code-based framework.

5. USING AN ACQUISITION PRICE-BASED ICB

It is one thing to generate an ICB estimate for the GGP but another thing to employ that ICB in the context of the Code. In particular, it is necessary to adjust the way an AP-based ICB estimate is used to reflect:

- the fact that an acquisition price can only be derived from the acquisition model cash flow forecasts and cost of funds; and
- the "depreciation" or capital recovery profile used in the acquisition model.

That is to say, it would be entirely inappropriate to adopt an AP-based ICB estimate and to apply to that ICB a cost of funds and depreciation profile derived using a DAC, DORC or Free Cash Flow (the "FCF" method of estimating ICB is described by the Authority, in the Amended Draft Decision, as the DAC method) valuation methodology.

5.1 Cost of Funds

If an ICB for the GGP is to be based on the prices paid for interests in the GGP, then the only cost of funds that can be rationally applied to that ICB is an acquisition cost of funds. This acquisition cost of funds can be found in the acquisition models which underpin the prices paid for the various GGP interests.

It is to be expected that the acquisition cost of funds will involve a higher gearing than the gearing used to produce WACCs derived by the Authority. Since the focus on prices paid for interests in the GGP is essentially reversing the acquisition process (that is to say, starting with the ICB and producing a Reference Tariff and forecast cash flow) the only cost of funds relevant to this process is the acquisition cost of funds.

If the acquisition cost of funds has been adjusted by the purchaser to reflect the value of controlling the GGP, the adoption of the acquisition cost of funds should, at least partially, correct for any control premium included in the purchase price.

5.2 Capital Recovery

One concern with reconciling the methodology adopted in applying the Code and with the use of ICB estimates based upon the prices paid for interests in the GGP, is that:

- the Authority takes a regulatory window approach to capital recovery and imposes an artificial capital recovery ("depreciation") profile to generate Reference Tariffs; and
- the discounted cash flow model used to establish acquisition prices is a long term model where the "free cash flow" (and not an imposed depreciation schedule), inherent in the forecast cash flows, determines when capital is recovered.

That is to say, the capital recovery model reflected in an acquisition price is a forward looking version of the FCF model for estimating ICB adopted by the Authority in its Amended Draft Decision. There is no simple formula which can be applied to foreshadow the capital recovery in any 5 year regulatory window implied in an acquisition price. Again, the adoption of an ICB based upon the prices paid for interests in the GGP requires access to the capital recovery schedule inherent in the buyer's acquisition model.

5.3 Errors and Omissions

The purpose of this report is to comment on the prices paid for interests in the GGP and to explore the implications of these transactions for the Code, the ICB of the GGP and for GGT's Reference Tariffs. This task is difficult because of the very limited disclosure relating to these transactions.

It is reasonable to expect that the revelation of detailed information regarding these transactions will raise unforeseen issues when considered in light of the Code. In particular, the Supreme Court of Western Australia has made it clear that it believes that the errors of fact and judgement reflected in acquisition prices should not find expression in ICB estimates for the relevant assets. These and other issues may need to be addressed as more information becomes available on how acquisition prices have been derived.

Not least among such considerations will be the reasonableness of forecast Reference Tariffs adopted in acquisition model cash flow forecasts. These assumed future tariffs will need to be considered in light of the reasonable expectations of the various buyers of interests in the GGP. It is interesting to note, for example, that GGT's current claim for a Reference Tariff reflecting its current A1 Tariff settings would seem to suggest an acquisition price for the GGP, based on any reasonable GGP demand forecast, in excess of any acquisition price quoted to date.

Indeed, based upon prices apparently paid for interests in the GGP, it is reasonable to question whether the acquisition models built by buyers contemplated tariffs at the level suggested in GGT's December 1999 proposed Access Arrangement. That is to say, GGT's A4 Tariffs. The Authority should seek to establish the third party tariffs used by buyers of interests in the GGP to set their respective acquisition prices.

5.4 Conclusions

Again, the adoption of an ICB based upon the prices paid for interests in the GGP demands access to, and use of, the acquisition models used to derive those acquisition prices. Without access to this data, it is impossible for the Authority to:

- form any reasonable view on how prices paid for interests in the GGP might be used to derive an ICB consistent with the Code.; or
- develop a methodology for using an ICB, based on acquisition prices, which is both internally consistent and consistent with the Code.

The Supreme Court of Western Australia has required that the prices paid for interests in the GGP be properly assessed. It is equally important that ICB estimates derived using the prices paid for interests in the GGP are used in a manner that is internally consistent and consistent with the Code. There is a strong argument that the Authority should consider parallel Reference Tariff analyses, one based on the information in the acquisition model developed by buyers of GGP interests and another (or others) based on DAC, DORC or FCF. Such parallel analyses would go a long way to providing the range of ICB and Reference Tariff estimates contemplated by the Supreme Court of Western Australia.

6. THE ACQUISITION PRICE ICB

Based upon the limited disclosure of information regarding the sale/purchase of interests in the GGP, it seems reasonable to expect the AP-based ICB of the GGP will fall below $500 million. There is nothing to suggest that an AP-based ICB estimate will produce Reference Tariffs which diverge significantly from those derived using the DAC, DORC or FCF ICB estimates derived by the Authority. It must be emphasised, however, that the cost of funds, capital recovery model, etc applied to any AP-based ICB, should be adjusted to reflect the settings consistent with the acquisition models used to determine the acquisition prices.