



8 November 2002

Mr Robert Pullella
Office of Gas Access Regulation
GPO Box 8469
Perth Business Centre WA 6849

Dear Mr Pullella

WMC Resources

Submission on the Proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline Effect of the Supreme Court Decision

1 Background

This submission to the Office of Gas Access Regulation ("**OffGAR**") is made by WMC Resources Limited ("**WMC**"), in response to the invitation issued by Off GAR on the 2nd September 2002. The invitation followed the publication on 23 August 2002 of the decision of the Supreme Court of Western Australia concerning the legal action by Epic Energy relating to the Draft Decision on the proposed Access Arrangement for the DBNGP issued on 21 June 2001.

The Court decision was that the regulatory decision making process should proceed in accordance with National Third Party Access Code for Natural Gas Pipeline Systems (the "**Code**"). However, the Court proceeded on the basis that OffGAR would allow all interested parties a reasonable time to prepare and provide additional submissions.

Interested parties were thus invited by OffGAR to prepare and provide written submissions which have regard to the reasons in the Court decision and their effects on matters identified in the Draft Decision as being the reasons for requiring amendments to the proposed Access Arrangement.

WMC is an interested party, being an end customer of the Dampier to Bunbury gas pipeline system ("**DBNGP**") as a consumer of natural gas at the Kwinana Nickel Refinery, south of Kwinana Junction. WMC has made two previous submissions to OffGAR on this matter and welcomes the opportunity to comment on the matters raised in the Supreme Court decision.

2 The Supreme Court Decision

Paraphrasing para 223 of the Supreme Court Decision, WMC understands that the key elements are that:

- The Regulator's determinations of Reference Tariffs and of the initial Capital Base of the DBNGP in the draft decision require reconsideration;

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- The factors in s 2.24(a) to (g) of the Code are relevant to, and are to be given weight as fundamental elements in, the Regulator's assessment of the proposed Access Arrangement, including the issue of whether the Regulator is satisfied that the proposed Access Arrangement contains the elements and satisfies the principles set out in s 3.1 to s 3.20;
- The factors in s 2.24(a) to (g) should guide the Regulator in determining, if necessary, the manner in which the objectives in s 8.1(a) to (f) can best be reconciled or which of them should prevail;
- It is open to the Regulator, pursuant to the objective provided by s 8.1(d), to take into account the actual investment of Epic in the DBNGP when designing a Reference Tariff and a Reference Tariff Policy, including in that context the establishment of the initial Capital Base of the DBNGP;
- The purchase of the DBNGP by Epic on 25 March 1998, the circumstances of that purchase, including the price paid, and any value according to a recognised asset valuation methodology which may be revealed by the price paid in those circumstances, are matters which the Regulator may properly take into account in determining, for the purposes of s 8.11, whether the initial Capital Base for the DBNGP should fall outside the range of values determined under s 10(a) and (b);
- For the purposes of s 8.10 and s 8.11, and in particular s 8.10(c), (d) and (j), it is not the meaning and effect of the Code that only "efficient" capital investment, or that only "regulated revenues", are to be taken into account; nor that the initial Capital Base should represent a value "that is consistent with future regulated revenues and efficient capital investment".

Importantly, the Court failed to support the Epic arguments that some form of "regulatory compact" existed with the State of Western Australia, and that the State "contracted on the basis or the expectation, that the primary Dampier to Perth tariff under the Code would be in the order of \$1/GJ from 1 January 2000".¹ The impact of this purported compact on Epic's regulatory expectations is discussed below.

The court also made it clear that, in relation to the interpretation of the factors in s 2.24, s 8.10 and s 8.11, and the objectives of s 8.1, "once the basic issues of interpretation are clarified, it is for the Regulator, not this Court, to consider and weigh those factors and objectives".²

WMC understands that the effect of the Court decision is that OffGAR is able to continue with the process of making a Final Determination on the Access Arrangement, but it must give detailed consideration to each of the factors and objectives listed in s 2.24, s 8.10 and s 8.11, the objectives of s 8.1 and the circumstances of the purchase of the DBNGP by Epic including the price paid, and any value according to a recognised asset valuation methodology which may be revealed by the price paid in those circumstances.

WMC has compiled these comments in the light of these understandings. If a matter is not mentioned, it is because WMC has no specific comment to make on that matter.

¹ Supreme Court Decision dated 23rd August, para200.

² Supreme Court Decision dated 23rd August, para187.

In summary, WMC's view remains that the proposed Access Arrangement:

- (a) is seriously deficient when measured against the requirements of the Gas Code;
- (b) is not in the public interest; and
- (c) should not be accepted by OffGAR.

3 General Comments on the Draft Determination

Although this submission deals primarily with matters raised by the Supreme Court decision, WMC wishes to record the fact that it found the Draft Decision generally satisfactory.

4 Comments on s 2.24 Factors

WMC's comments on the relevant factors listed in s 2.24 are noted below:

2.24 The Relevant Regulator may approve a proposed Access Arrangement only if it is satisfied the proposed Access Arrangement contains the elements and satisfies the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve a proposed Access Arrangement solely for the reason that the proposed Access Arrangement does not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing a proposed Access Arrangement, the Relevant Regulator must take the following into account:

- (a) the Service Provider's legitimate business interests and investment in the Covered Pipeline;*

The Court decision makes it clear that it is open to OffGAR to take into account the actual price paid for the DBNGP and the circumstances of the purchase. The Court also points out that, while the purchase price needs to be taken into account, "[t]his is not to suggest that reckless, mistaken or highly speculative investment decisions should be accepted"³

The Court also notes that "[f]uture investment decisions in pipelines might well be distorted were it the case that any price paid by the service provider to acquire a pipeline, no matter how uncommercial, mistaken or reckless, should automatically be recognised as the Initial Capital Base or value of the pipeline for the purposes of the Code".⁴

WMC believes that what needs to be considered under this heading is what might be termed the "reasonable business interest" and "reasonable investment" in the pipeline system. To the extent that Epic made an investment decision that could be termed any of "uncommercial, mistaken or reckless" (to use the Court terminology), then the Service Providers' "legitimate business" interests would not extend to accepting that the investment made in the DBNGP was reasonable and prudent and represents an acceptable valuation of the pipeline system for the purposes of the Code.

Indeed, we make the point that in determining the Initial Capital Base, the Regulator should, amongst other considerations, examine the circumstances of the investment of \$2,400 million by Epic and determine the extent to which the investment decision may

³ Supreme Court Decision dated 23rd August, para154.

⁴ Supreme Court Decision dated 23rd August, para 155.

have been “uncommercial, mistaken or reckless”. In addition to the purchase price, the Regulator should take into account a number of factors associated with Epic’s investment decision, such as expected pipeline throughput and government undertakings (if any) regarding tariffs.

We examine the circumstances applicable to the purchase later in this submission, when the factors covered in s 8 are considered.

(b) *the economically efficient operation of the Covered Pipeline;*

The Court decision makes it clear that this factor is not to be confined to just the physical operation of the pipeline but has a broader, economic meaning.⁵

In this case, it is open to OffGAR to interpret this factor as requiring the consideration of the “economically efficient” replacement cost and operations and maintenance expenditure as a factor to be taken into account when exercising judgment. WMC considers that the assessment of the Initial Capital Base and operations and maintenance expenditures set by OffGAR in the Draft Determination, provides this basis if the correct rate of return is applied to that valuation.

(c) *the interests of Users and Prospective Users;*

Obviously, the interest of WMC as a User of the DBNGP would be best served by holding Reference Tariffs as low as practicable, consistent with the requirements of the Code.

The opposing view, being made in public statements by Epic and other pipeline owners — that revenues being allowed by regulators under the Code are insufficient to encourage new investment — must be demonstrated.

(d) *any other matters that the Relevant Regulator considers are relevant.”*

⁵ Supreme Court Decision dated 23rd August, para133.

Section 8 of the Code deals with Reference Tariff Principles. The most material provisions, with WMC comments, are as follows:

"General Principles

8.1 *A Reference Tariff and Reference Tariff Policy should be designed with a view to achieving the following objectives:*

- (a) *providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service;*

The Court finds that the notion of "efficient costs" in this context refers to "a construct of the relevant economic concept of efficient, together with the ordinary notion of costs."⁶

It would seem to WMC that OffGAR has developed the methodology to calculate "efficient costs" in the Draft Determination and should not deviate from those findings in the Final Determination.

- (b) *replicating the outcome of a competitive market;*

The Court finds that the notion of a "competitive market" in this context refers to a "workably competitive" market.

In the situation facing the DBNGP, workable competition can be provided for by the provision of a competing pipeline, and indeed, the Parmelia pipeline provides such competition for the lower portion of the DBNGP.

WMC has already found it advantageous to utilise part haul on the DBNGP as far as Mondarra, and to use the Parmelia pipeline to deliver gas to the Kwinana Nickel Refinery.

In a more general context, it is the cost of constructing a new pipeline from Dampier to Bunbury, or part of this route, and the tariffs which might apply to such a pipeline, which can be used to place a measure on this factor.

- (c) *providing an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services.*

WMC simply comments that Epic, having apparently made an investment decision predicated on, amongst other things, much higher pipeline throughput levels, has plenty of incentive under the Reference Tariffs proposed in the Draft Determination, to actively develop the capacity and utilisation of the DBNGP.

If the original investment was decision based on a set of throughput assumptions that have proven to be overly optimistic, other pipeline users should not be penalised for Epic's optimism. Epic could recover their position by developing the market to the volumes which they originally assumed.

To the extent that any of these objectives conflict in their application to a particular Reference Tariff determination, the Relevant Regulator may determine the manner in which they can best be reconciled or which of them should prevail.

⁶

Supreme Court Decision dated 23rd August, para139

"Initial Capital base – Existing Pipelines

8.10 *When a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the following factors should be considered in establishing the initial Capital Base for that Pipeline:*

- (a) the value that would result from taking the actual capital cost of the Covered Pipeline and subtracting the accumulated depreciation for those assets charged to Users (or thought to have been charged to Users) prior to the commencement of the Code;*
- (b) the value that would result from applying the "depreciated optimised replacement cost" methodology in valuing the Covered Pipeline;*
- (c) the value that would result from applying other well recognised asset valuation methodologies in valuing the Covered Pipeline;*
- (d) the advantages and disadvantages of each valuation methodology applied under paragraphs (a), (b) and (c);*
- (e) international best practice of Pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries;*

WMC places special importance on the second limb of this factor due to the very high proportion of the throughput of the DBNGP which is used by industries operating in internationally competitive markets (including WMC). Over 90% of the gas flowing down the DBNGP falls into this category, and the Code obviously requires the Regulator to take the situation facing such industries into account. Due consideration of this issue is essential to ensure the Code is complied with in respect of competition in upstream and downstream markets.

It is not a factor that OffGAR specifically took into account in the Draft Decision, and in the light of the Court decision, WMC trusts that OffGAR will give this aspect specific and detailed consideration in the Final Determination.

The meaning of the term "international best practice of pipelines in comparable situations" also needs discussion. The Court was inclined to the view that OffGAR took this into account only in the limited sense of international best practice in pipeline valuation techniques. WMC is of the view that the Code requires the Regulator to consider international best practice in pipeline construction, capital costs and operation and maintenance costs, in assessing the appropriate Initial Capital Value of the pipeline system.

- (f) the basis on which Tariffs have been (or appear to have been) set in the past, the economic depreciation of the Covered Pipeline, and the historical returns to the Service Provider from the Covered Pipeline;*

WMC notes that the past practice of setting tariffs for the DBNGP provides little comfort nor guidance in the present exercise.

The pipeline was originally developed by SECWA in the days when it was a combined electricity/gas utility, and the allocation of asset valuations and debt between the electricity and gas operations prior to their split in 1995 was essentially a political, not an economic, exercise.

Since pipeline tariffs are dominated by capital servicing costs, to a great extent the cost structure of the DBNGP as inherited by AlintaGas in 1995 can be viewed as being somewhat artificial, as can the tariffs that previously applied.

- (g) *the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code;*
- (h) *the impact on the economically efficient utilisation of gas resources;*
- (i) *the comparability with the cost structure of new Pipelines that may compete with the Pipeline in question (for example, a Pipeline that may by-pass some or all of the Pipeline in question);*

As mentioned above, WMC has already found it more attractive to move gas down the parallel Parmelia pipeline as compared to the lower section of the DBNGP.

In a more general context, it is the cost of constructing a new pipeline from Dampier to Bunbury, or part of this route, and the tariffs which might apply to such a pipeline, which can be used to place a measure on this factor.

From WMC's experience in the construction costs of gas pipelines⁷, it is expected that the construction cost of a new pipeline from Dampier to the Perth area is unlikely to exceed \$1100 -1200 million - well below the \$2449 million paid by Epic for the DBNGP

WMC believes that this is a relevant fact for OffGAR to take into account in the exercise of discretion on the Initial Capital Base, and generally supports the results of the Draft Determination. The Court decision requires the Regulator to give appropriate consideration to any reasonable expectation of Epic regarding what Epic describes as a regulatory compact.

- (j) *the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase; and*

The Court decision makes it necessary for OffGAR and persons making submissions to pay more attention to the manner of purchase of the pipeline by Epic, and importantly, to the "circumstances of that purchase".

As mentioned above, OffGAR gave the example of assessing whether any part of the investment made by Epic should be considered "uncommercial, mistaken or reckless".

Using the purchase price paid by Epic, current levels of throughput and Epic's expectations relating the WACC values, WMC originally estimated that the year 2000 tariff (100% load factor) past Kwinana Junction (the zone which includes WMC's Kwinana Nickel Refinery) would be **\$1.62/GJ** with a starting annual revenue of some \$304 million. This figure is also calculated by Epic on page 11 of their original submission.

Epic originally proposed to cap the Reference Tariff at this point (Zone 10) to **\$1.08/GJ** - and to escalate the tariff at 67% of the CPI over the five year period, with an accumulation of the unrecovered costs to be carried forward and recovered later in the pipeline life.

7

WMC was the largest Joint Venturer in the Goldfields Gas Pipeline system and managed the design, construction and early operation of that pipeline.

A similar calculation shows that, including the \$875 million promised by Epic to “double the throughput” of the pipeline and assuming that the throughput did indeed double, a tariff of \$1/GJ would be sufficient to provide Epic with a return equal to its expected WACC and full recovery of the initial investment.

Likewise, setting the tariff at \$1/GJ and achieving the same return assuming the current levels of throughput, would only justify a purchase price of around \$1500-1600 million.

The purchase price paid by Epic represents the interplay of the value of the physical assets it acquired, the commercial arrangements surrounding those assets, the value of existing contracts where that value diverges from the Reference Tariff, any cost savings and demand growth it considered reasonable, and the actual gearing in the acquisition. To properly consider the acquisition price, the Regulator must first remove from that price the differential value between the regulated asset base and Reference Tariff and the actual circumstances which underpin the acquisition. In essence, this is what the Court has directed the Regulator to do.

While Epic would have conducted much more sophisticated economic studies than these to come to their decision on purchase price, these simple and easy to replicate calculations, make a strong case that Epic made the assumption that gas throughput down the DBNGP would indeed double in the reasonably near future, and that this assumption, together with Epic’s transaction cost of funds and the tariff which would result from the application of the Code provisions (obviously assumed to be \$1/GJ at Kwinana), led them to offer the figure of \$2400 million.

The assumption of a doubling of throughput is given credibility by the fact that Kingstream Steel, expecting to consume some 65PJ/year, was threatening at the time to build their own pipeline from Dampier to at least the Geraldton area. The Kingstream throughput must have comprised a considerable portion of Epic’s assumption of a doubling of throughput along the DBNGP, and it clearly could not be firmly counted upon.

It would be appropriate for OffGAR to examine these events as being relevant to the “circumstances of that purchase”.

As indicated earlier, WMC believes that the Regulator should examine all of the circumstances surrounding the investment of \$2,400 million by Epic.

6 Distance-dependent Tariffs

There is one further matter which WMC would like to raise again with OffGAR for consideration in the Final Determination.

We repeat that the use of discrete zones along the pipeline length introduces distortions into the pricing for particular customers, and while the proponents charges are generally related to the distance travelled, there are distortions at the upper end of the pipeline and around the Kwinana area. The allocation of zones affects WMC at Kwinana, since the Kwinana Nickel Refinery is located just past Kwinana Junction, placing it in Zone 10 rather than Zone 9 (as defined in the present pricing arrangement) - increasing the transportation cost by some 8% for a very small distance.

WMC remains of the view that the tariffs along the whole pipeline should be directly related to distance - as is being proposed for the Goldfields Gas Pipeline and used on that pipeline since its commissioning. This is the fairest way to allocate charges and will avoid the anomaly faced by the Kwinana Nickel Refinery due to the sudden step change in tariff.

7 Conclusions

WMC is an end customer of the DBNGP - being a consumer of natural gas at the Kwinana Nickel Refinery, south of Kwinana Junction and is therefore concerned with the outcome of the access undertaking consideration.

WMC's view remains that the proposed Access Arrangement:

- (a) is seriously deficient when measured against the requirements of the Gas Code;
- (b) is not in the public interest; and
- (c) should not be accepted by OffGAR

Please contact the undersigned on telephone 9479 8387 should you require further information.

Yours sincerely
WMC Resources Ltd



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