WMC Resources

Submission on the Proposed Access Arrangement for the Dampier to Bunbury Natural Gas Pipeline

Background

This submission to the Office of Gas Access Regulation (O*ff* GAR) is made by WMC Resources Limited (WMC), in response to the invitation issued by O*ff* GAR on the 22nd December 1999 and the subsequent publication of an Issues Paper in January 2000.

The proposed Access Arrangement has been put forward by Epic Energy (WA) Transmission Pty Ltd (Epic) under the National Access Code for Third Party Access to Natural Gas Pipelines (the Gas Code).

WMC is an end customer of the Dampier to Bunbury gas pipeline (DBNGP) system - being a consumer of natural gas at the Kwinana Nickel Refinery, south of Kwinana Junction.

WMC's view is that the proposed Access Arrangement is seriously deficient when measured against the requirements of the Gas Code; is not in the public interest; and should not be accepted by O*ff* GAR.

Of particular concern is the proposal that the price paid by Epic for the DBNGP system, which was considered by many to be excessive, is being proposed as the Initial Capital Base. WMC is firmly of the view that "acquisition premiums" are not allowable under the Gas Code and that O*ff* GAR should not accept a pipeline valuation that is predicated on throughput assumptions in excess of current levels unless Epic bears the risk associated with this demand not materialising. This is the policy established by O*ff* GAR in the Draft Decision on the Access Arrangements for the Parmelia pipeline system.

WMC's specific comments are submitted generally in the order of items listed in the Issues Paper (with the exception of the first item). If an Item is not mentioned, it is because WMC has no specific comment to make on that matter.

In making this submission, WMC has reviewed the O*ff* GAR draft decision on the Access Undertaking submitted by CMS Energy for the Parmelia Pipeline. In addition, reviews have been conducted of all recent decisions made by the ACCC as the transmission pipelines regulator, ORG and IPART as the State Regulators for gas distribution pipelines in Victoria and NSW respectively, and relevant determinations on electricity transmission and distribution systems from these same organisations.

1. Access Arrangement Information Deficiencies

WMC has noted the First Submission made by AlintaGas dated 11th January, pointing out that the Access Arrangement Information (AAI) is deficient in that it does not specify the Depreciated Actual Cost (DAC) or the Depreciated Optimised Replacement Cost

(DORC) for the DBNGP system. WMC agrees with the AlintaGas submission in this respect. The applicants should be required to provide this information.

In addition, WMC regards it as essential that O*ff*GAR engages competent and independent external consultants to verify the estimates for DORC and DAC, expected capital expenditures and expected operations and maintenance expenditures.

The absence of this information at this stage places those making submissions at a considerable disadvantage - since the levels of DORC and DAC may change substantially the nature of the several of the issues on which comments are made.

The AAI is also deficient in the area of providing the details of Operations and Maintenance costs and cost breakdowns as required by the Gas Code.

Missing information needs to be made available to those making submissions as quickly as possible - preferably to allow supplementary submissions to be made prior to O*ff* GAR publishing a Draft Determination.

2. Reference Services

Epic is offering forward or back haul Firm Service as the Reference Service, together with sponsoring a secondary market in capacity and offering to negotiate Non-Reference services.

WMC has no major objection to this basis for the Access Undertaking, and strongly supports the early development of the secondary market, which should be a feature of all Access Undertakings associated with gas pipelines.

However, 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 traveled, 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 is 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 from Zone 9 to Zone 10. The effect of the proposal as written is that the cost of gas transport to WMC's Kwinana Nickel refinery will be the same as for a user in Bunbury, some 150 km further South. WMC strongly believe that this is an inequitable arrangement.

In addition, the proposed limitation on upstream delivery points (Section 6.3) affords Epic with "absolute discretion" to restrict upstream deliveries. WMC is of the view that this discretionary power is too wide, and needs to be limited to a degree of restriction which can be shown to be the minimum necessary to ensure safe and reliable pipeline operation.

WMC has noted the Second Submission made by AlintaGas dated 21 January, pointing out (Appendix 1) that there is a range of Non-Reference Services which Epic would presumably wish to provide at some extra (as yet unknown) charge. WMC agrees with the AlintaGas submission in this respect. WMC is concerned that this is an attempt to increase the standard tariff by stealth.

3. Terms and Conditions (other than price)

WMC notes that in the case of the O*ff* GAR Draft Decision on the Parmelia Pipeline, O*ff* GAR examined the proposed Terms and Conditions in great detail to eliminate the scope for arbitrary decisions by the proponent and the ensure that the details were acceptable. WMC believes that the same process needs to be followed in this case as well.

We suggest in particular that there is scope for:-

- reducing the scope for the proponent to request additional information in and Access Request;
- specifying the reliability levels associated with "Firm Service";
- eliminating the scope for the proponent to add arbitrary or additional requirements between Access Undertaking approvals.

  In particular, WMC is opposed to the freedom to alter Terms and Conditions sought by Epic in Clause 10.4 of the Access Undertaking submission. Any proposed change to the Terms and Conditions should first be submitted to O*ff* GAR for approval before they can be implemented. It is O*ff* GAR, rather than the proponent, who is best able to judge whether the proposed changes detract or otherwise from the Reference Services.

WMC is particularly concerned with the small tolerance proposed to be allowed for daily imbalances between gas input and output quantities and the unreasonable levels of penalty proposed by the proponents if the allowed tolerances are exceeded. At just 2%, the allowance for imbalance is much less than allowed on other transmission pipelines (where up to 8% is allowed and some accumulation is also possible). The Goldfields Gas Pipeline offers much greater tolerances and a more acceptable and optional penalty regime than is offered by the DBNGP proponents.

In addition, the proposed penalty of $15/GJ for several such matters (Schedule 1 of Annexure B) is quite unreasonable and bears no relationship to any cost or inconvenience suffered by the pipeline owner. Unless the pipeline owner incurs tangible costs in coping with imbalances and other minor deviations from contracted amounts, penalty payments should be minimal and in proportion to the additional cost incurred by the pipeline owner. It is difficult to comprehend the rationale of imposing a cost of 1500% of the total tariff for imbalance penalties. The most obvious conclusion is that it is another attempt to increase the standard tariff by stealth. A similar penalty is proposed for incorrect nominations for daily off takes.

As a general comment, the proposed Terms and Conditions vary considerably from those applying under the present T1 service. The smaller tolerances and greater penalties cited above provide one example of the changes; the use of new zone definitions another.

Because of these changes, WMC believes that the new Reference Service should be materially the same as the existing T1 service. Further, we believe that existing holders of transportation contracts should be given a once only opportunity to make any adjustments to their contracted quantities which they deem necessary to enable them to adjust to the new Terms and Conditions once finalised by OFFGAR.

4. Capacity Management Policy

WMC supports the operation of the DBNGP system as a "contract carriage" pipeline as defined in the Code.

5. Trading Policy

WMC generally supports the development of active secondary markets for the trading of capacity in gas pipeline systems. WMC is aware of very efficient and effective screen-based/internet trading systems in use overseas, for both uncontracted or non-firm capacity, or to allow contracted capacity to be re-traded.

However the proposed Rules for the Secondary Market are lacking necessary detail and confer some privileges on the proponent. For example, it is far from clear as to the priority to be accorded to the holders of contracted capacity seeking to sell on the secondary market as against uncontracted capacity to be sold by Epic. Holders of existing contractual rights should be afforded priority in the sale process as they have entered into binding longer term commitments with large financial obligations.

For example, the price setting mechanism proposed to be used is a most important part of any Secondary Market, and needs to be well defined, understood and approved by O*ff* GAR. To state that the price for Secondary Market Service will be the "prevailing market price" is far too imprecise.

It is important that OFFGAR closely examines the rules for secondary trading and ensures that they are reasonable, as they will create somewhat of a precedent for other pipeline systems in Western Australia and Australia generally.

The proponent should be required to make a revised set of Rules publicly available for review prior to the Access Undertaking being accepted by O*ff* GAR. In addition, any proposed change to the Secondary Market Rules should first be submitted to O*ff* GAR for approval before they are implemented, as it is O*ff* GAR, rather than the proponent, who is best able to judge whether the proposed changes detract or otherwise from the approved Undertaking.

6. Queuing Policy

WMC has no particular objection to the proposed Queuing Policy except to urge O*ff*GAR to ensure that the final rules are very clear as to the priority order of applications being processed, and to ensure that the proponent only has discretion to changing the priority order under clearly stated and reasonable circumstances.

7. Extensions/Expansion Policy

WMC has no particular objection to the proposed Extensions/Expansion policy proposed by Epic.

8. Review of the Access Arrangement

WMC understands that O*ff* GAR can only accept or reject an Access Undertaking and cannot revoke an acceptance once given. Once accepted, the Undertaking prevails for the duration of the Access Undertaking Period (proposed to be 1st January 2005).

In these circumstances, it is most important that O*ff* GAR ensures that the initial Access Undertaking includes all of the features required and is capable of being accepted under the Code. It is also essential that the proponent agrees in the Access Undertaking to resubmit all or part of the Undertaking in the event that circumstances change to an extent which questions or undermines the assumptions made when the Undertaking was submitted.

Depending on the final approach adopted in selecting the WACC value and its treatment of tax (addressed later in this submission), one such circumstance would be a change in the corporate tax rate - as is being proposed by the Commonwealth Government at present. There may be other specific changes of circumstances which become apparent to O*ff* GAR in the assessment process which should also trigger a review of particular aspects of the Access Undertaking.

9. Reference Tariffs - Initial Capital Base

WMC has a very strong objection to the proposal that the Initial Capital Base should be set equal to the cost of acquisition plus expenses.

The Gas Code sets out the range of values to be considered in setting an Initial Capital Base (in 8.10). WMC seeks to draw O*ff*GAR's attention to sub-Clauses (e), (g) and (i) which state:-

"(e) international best practice of Pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries;

(g) the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code;

(i) the comparability with the cost structure of new Pipelines that may compete with the Pipeline in question (for example, a Pipeline which may bypass some or all of the Pipeline in question)."

These sub-clauses are especially important in relation to the DBNGP due to the very high proportion of its throughput which is used by industries operating in internationally competitive markets (including WMC and our associated company, Alcoa of Australia[1]). They are also important in that it can be argued that the DBNGP system suffered cost over-runs in construction which took its cost structure well above "international best practice of Pipelines in comparable situations".

There is a real prospect that the DBNGP could be bypassed by a newer, lower cost pipeline in the foreseeable future and in any event, from Mondarra south, the pipeline is already paralleled by the Parmelia pipeline and care needs to be paid by O*ff* GAR to the relative transportation tariffs applying over this portion of the DBNGP system.

In particular, the Code does not provide for the regulated recovery of imprudent levels of expenditure on gas pipelines.

In relation to a pipeline which has recently been purchased, sub-clause (j) states:

"(j) the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase."

In this case, the "circumstances of the purchase" are particularly relevant. Many believe that Epic paid a price which was far in excess of reasonable value in purchasing the DBNGP from the Government. The circumstances which led to their decision on price were at least, unusual.

In particular, the Code provides no reason which would allow Epic to recover any acquisition premium which they may have elected to pay above a reasonable valuation of the asset.

Clause 8.11 of the Gas Code states that "the initial Capital Base.... normally should not fall outside the range of values determined under paragraphs (a) and (b) of section 8.10". Paragraph (a) describes the calculation of DAC and paragraph (b) that of DORC.

Given these provisions of the Code, WMC believes that the Initial Capital Base for the pipeline should be set at a level no greater than the DORC valuation of a modern equivalent pipeline system of the same capacity as the existing DBNGP system.

1 WMC holds a 40% share of Alcoa World-wide Alumina & Chemicals and has a vital interest in both the Nickel and Alumina industries fed with gas from the D-B system.

Furthermore, this valuation should be independently assessed by competent and experienced outside consultants to O*ff* GAR.

From WMC's experience in the construction costs of gas pipelines[2] , it is expected that the DORC valuation on this basis is unlikely to exceed $1100-1200 million - well below the $2449 million sought by the proponent.

In the Draft Decision on the Parmelia pipeline, O*ff* GAR state that they would not accept

"... a pipeline valuation that is predicated on throughput assumptions in excess of current levels unless [the pipeline owner] bears the risk associated with this demand not materialising." -

WMC believes that O*ff* GAR should maintain this policy and refuse to accept an Initial Capital Base which is predicated on future throughput assumptions and/or which reflects an acquisition premium.

10. Reference Tariffs - Rate of Return

WMC has examined the latest regulatory decisions in relation to the assumptions used and the calculation of the Weighted Average Capital Cost (WACC) using the Capital Asset Pricing Model.

WMC has also noted, and generally agrees with, the approach and assumptions used by O*ff* GAR in the Draft Decision on the Parmelia pipeline.

Regulatory practice has generally favoured the use of a real pre tax WACC, using the prevailing corporate tax rate and assumptions relating to other parameters which usually lie in a relatively narrow range.

We note that the ACCC has only very recently updated its set of assumptions in the light of the prevailing economic settings in their Final Decision on the TransGrid NSW electricity transmission matter[3]. Without repeating all of the arguments supporting the various assumptions, WMC is of the opinion that the following set of assumptions are appropriate for calculating a WACC value for the DBNGP system.

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

3 Published in January 2000.

Assumptions	
Market Premium	6.00%
Risk Free Rate	6.81%
Debt Premium	1.00%
Inflation Rate	3.00%
Cost of Debt	7.81%
% equity	40.00%
Debt Beta	0.34
Asset Beta	0.6
Equity Beta	1.00
Effective Tax Rate	30.00%
Imputation Factor	50.00%
Calculated Parameters	
Risk premium	6.00%
Nominal Equity Return after tax	12.80%
Real Equity Return after tax	9.51%
Nominal Equity return before tax	15.05%
WACC - Nominal pre tax	10.71%
WACC - Nominal after tax	7.50%
Market Practice conversion	
WACC - Real pre tax	7.48%
WACC - Real after tax	4.36%
Alternative practice conversion	
WACC - Real pre tax	6.23%
WACC - Real after tax	4.36%

Comments on particular assumptions are:-

- given the size and stature of Epic, and the evidence of the cost of loans raised in the energy industry (as documented by the ACCC, ORG and IPART), a debt premium of 100 basis points is considered appropriate in this case;

- the beta values lie in the mid range of those adopted in recent regulatory decisions and is also considered appropriate in this case;

- since the change in Corporate Tax Rate from 36% to 30% seems now to be assured, the new rate has been assumed. The alternative is to set the WACC using the existing Corporate Tax Rate but to review the WACC when the reduced rate comes into effect;

- the risk free rate seems to have declined a little since the ACCC made their last determination, and O*ff* GAR will need to be careful in selecting an appropriate rate for the 5 year Regulatory Period.

These assumptions and the calculation method used in the recent regulatory decisions lead to values of pre tax real WACC of 6.23-7.48% depending on the conversion method from nominal after tax to real pre tax. Recent decisions have selected values towards the higher end of this range.

WMC has noted that the ACCC has expressed concern over the range of values obtained from the two conversion methods and the treatment of tax in general. They have stated a preference for the use of a nominal after tax WACC obtained directly from the CAPM, with compensation for tax liabilities (net of imputation credits) determined on the basis of cash flow assessments.

In the Final Decision on TransGrid, the ACCC states that the new approach is roughly equivalent to the old approach (although more complex to calculate), stating that the effective pre tax real WACC increased from 7.25% to 7.35% in that case.

In principle, WMC has no objection to this approach. However, since the publication of the TransGrid Determination, there has been some considerable doubt expressed regarding the accuracy of the ACCC's calculation methodology (and concern as to the lack of transparency and complexity in the approach). These matters have been raised with the ACCC and are yet to be resolved.

WMC believes that the pre tax real WACC approach remains appropriate for this assessment process unless and until the ACCC can satisfy other regulatory agencies and interested parties that they have an acceptable alternative way of assessing the overall revenue requirement.

This discussion leads WMC to believe that an appropriate pre tax real WACC for use in the determination of the annual revenue requirement of the DBNGP system is of the order of 7.5%.

11. Reference Tariffs - New Capital Expenditure

WMC has no particular comment to make on this issue, except to repeat earlier comments that the Initial Capital Base (both DORC and DAC basis), future capital expenditures and future operations and maintenance expenditures should be carefully reviewed in detail by competent independent and expert consultants and allowed only to the extent that they are at efficient (best practice) expenditure levels and matched to the reasonably expected levels of throughput during the Access Period.

12. Reference Tariffs - Operations and Maintenance Costs

Again, WMC has no particular comment to make on this issue, except to repeat earlier comments that the Initial Capital Base (both DORC and DAC basis), future capital expenditures and future operations and maintenance expenditures should be reviewed in detail by competent independent and expert consultants and allowed only to the extent that they are at efficient (best practice) expenditure levels and matched to the reasonably expected levels of throughput during the Access Period.

The proposed charge for compressor fuel needs to be linked with a published, understandable and reasonable gas price.

We would however, make the comment that operations and maintenance costs on the DBNGP, by some comparisons, appear to be high, and a detailed justification is needed. We believe the charges should be linked to the drivers of actual costs; in such a way as to provide an incentive to reduce costs and that all stakeholders share in the benefit of reduced costs.

13. Reference Tariffs - Economic Depreciation

Epic has proposed depreciation on an annuity method. They also propose to bring to account in the economic depreciation, depreciation of the "deferred recovery account" - which can be positive or negative. This account is in effect holds the cumulative losses caused by the premium paid in the purchase price which we have already argued should not be allowed.

WMC is strongly opposed to this approach.

Prevailing regulatory practice in Australia, plus custom and practice as well as simplicity and ease of understanding, all point towards the use of straight line depreciation based on realistic asset lives.

WMC supports the use of straight line depreciation and opposes the recovery of the "deferred recovery account".

14. Reference Tariffs - Incentive Mechanisms

Epic proposes to escalate the Reference Tariff by 67% of the CPI (Perth-based) and also to rebate some revenue obtained above certain set levels. No justification is provided for the choice of this escalation rate.

WMC is opposed to the inclusion of a generalised escalation based on a CPI-type of indicator or a fraction of it. We do not see there is a natural link between Australian CPI and the cost of providing pipeline services. In fact WMC operates in an environment where, over the long term the price of our commodities decline in real terms. Therefore, we would support one of the following schemes:

- No automatic tariff increases. All increases to be approved through O*ff*GAR,
- Tariffs are fixed for 5 years based on projected best practice cost improvements and cost input changes, or
- Revenue path determined by O*ff* GAR as part of the acceptance process.

The Gas Code obliges O*ff* GAR to take into consideration "the impact on the international competitiveness of energy consuming industries" - none of whom have the luxury of the sales prices for their products increasing at a stable and predictable rate based on some generalised index.

15. Reference Tariffs - Total Revenue Determination

On the basis of the Epic assumptions regarding Initial Capital Base and WACC, with conventional straight line depreciation, WMC 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 submission.

Epic are however proposing to cap the Reference Tariff at this point (Zone 10) to **$1.08/GJ** - which is higher than the rate that presently applies by some 8%- and to escalate the tariff at 67% of the CPI over the five year period.

However, the shortfall in annual revenue would be accumulated as a "deferred recovery account" and recovered by way of the "economic depreciation" provisions in future Access Undertaking Periods. WMC has already stated its objection to the recovery of any "acquisition premium" by this or any other means.

On the basis of the assumptions set out above and recommended as appropriate by WMC, the year 2000 tariff (100% load factor) past Kwinana Junction (the zone which includes WMC's Kwinana Nickel Refinery) would be of the order of **$0.75/GJ** with a starting annual revenue of some $146 million.

O*ff* GAR needs to settle on some of the major assumptions (asset valuations, WACC, depreciation policy) first before the general level of pipeline tariff can be ascertained. WMC believes that O*ff* GAR then needs to check on the relative tariffs from Mondarra south resulting arising the DBNGP access arrangements compared to those already established for the Parmelia pipeline.

WMC believes that Reference Tariffs of this order of magnitude for a full distance haul to Kwinana should be the result of the application of the Gas Code provisions to this Access Undertaking, with lesser figures applicable to part haul distances.

16. Comparison of Final Tariffs

As a final step, O*ff* GAR needs to require the proponents to develop a precise calculation of the effects of the pricing provisions of the access undertaking for one or more typical customers, compared to the pricing provisions currently applying to the pipeline.

WMC believes that the effect of the access undertaking as currently proposed would increase its present transportation tariff to Kwinana Nickel Refinery by a substantial amount due to factors such as the proposed zone structure, exorbitant and unjustifiable imbalance and nomination penalty charges and the unknown changes to the secondary market.

WMC would be pleased to work with O*ff* GAR to conduct such a detailed comparison using the Nickel Refinery as a model customer, when the final proposals become available.

Conclusions

- WMC is an end customer of the Dampier to Bunbury gas pipeline system - 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 is that the proposed Access Arrangement in its present form is seriously deficient when measured against the requirements of the Gas Code; is not in the public interest and should not be accepted by O*ff* GAR.**