WMC RESOURCES LTD

Submission by WMC Resources Ltd to the Economic Regulation Authority

on the Amended Draft Decision on the Proposed Access Arrangement for the Goldfields Gas Pipeline

24 September 2004

Table of Contents

1. Introduction

1.1 Purpose

This submission is made by WMC Resources Limited (“**WMC**”) in response to the invitation issued by the Economic Regulation Authority (the “**Authority**”) on 29 July 2004 for submissions on the Authority’s Amended Draft Decision on the Proposed Access Arrangement for the Goldfields Gas Pipeline (the “**Amended Draft Decision**”).

WMC is:

- the major customer of the services provided by the Goldfields Gas Pipeline (the “**Pipeline**”) pursuant to a gas transmission agreement with one of the owners of the Pipeline, Southern Cross Pipelines Australia Pty Ltd (“**SCPA**”); and

- a potential shipper on the Pipeline, insofar 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.

WMC has previously made submissions to the Western Australian Office of Gas Access Regulation (the predecessor to the Authority) in relation to the Proposed Access Arrangement for the Pipeline on 9 March 2000, 17 December 2002 and 28 August 2003.

1.2 Scope of Submission

The purpose of this submission is to respond to specific matters raised in the Amended Draft Decision. Broadly, the scope of the submission is limited to comments concerning the following topics:

- the Authority’s determination of the Pipeline’s Initial Capital Base ("ICB");

- the Authority’s determination of a Reference Tariff (having regard to approved proposals under the State Agreement, demand forecasts and the appropriate weighted average cost of capital);

- certain terms and conditions governing shipping contracts (termination, quantity variation charges, a connection charge, surety and security requirements, payment of disputed invoices) and;

- review and expiry of the access arrangement.

2. Initial Capital Base

Establishing the value of the ICB is a central task in the determination of a Reference Tariff for the Pipeline under the Code.

WMC considers that an ICB of $480 million contained in the Draft Decision is above the appropriate range which could be justified by applying the principles required by the Code.

WMC is concerned about the Authority's approach to establishing the value of the ICB for the Pipeline at $480 million, particularly as this value is significantly higher than the range of estimated DORC and DAC values. WMC considers that the Authority should have adopted the approach to assessing the ICB described below. Further, in relation to the Authority's reasoning, WMC is particularly concerned with:

- the Authority's re-definition of the DAC methodology;
- the manner in which the Authority considered the price paid for the Pipeline as a basis for estimating a value for the ICB;
- the fact that the Authority seems to have imputed legitimacy to the tariffs that have actually been charged under the State Agreement tariff regime, and considered the expectations generated by those tariffs, when there was no proper basis or evidence for finding such legitimacy, particularly having regard to the Authority's conclusion that the tariffs did not necessarily comply with the applicable principles under that regime, and that there was evidence that tariffs had been set in excess of a commercial rate of return, especially when this is a matter of substantial dispute between WMC and one of the Pipeline owners;
- the provision by the Authority of, in effect, an additional approximately $50 million, purportedly to reflect GGT's reasonable expectations from the past administration of the *Goldfields Gas Pipelines Agreement Act* 1994 (WA) (the "**State Agreement**"); and
- the absence of a proper basis for considering a value which lies outside the range between DAC and DORC values, in light of s.8.11 of the Code .

2.1 Proper Approach to assessing ICB

The Authority is required to give weight to the matters in s 8.10 of the Code as fundamental elements of the assessment process in determining a pipeline's ICB. The overall purpose of doing so is to attribute a value to the Pipeline, consistent with its actual cost in its present state, and which a Service Provider should be afforded an opportunity to earn and to recover.

Where a factor or consideration must be given weight as a fundamental element of a process, it is not sufficient merely to consider it, but not give it weight. The attribution of weight as a fundamental element necessarily involves the factor or consideration actually influencing the ultimate decision, in a fundamental way.

The DAC and DORC values of the Pipeline (referred to in s.8.10(a) and (b) of the Code) are such fundamental considerations. These values respectively are $407 million and $434 million (although WMC is concerned about the DAC methodology adopted by the ERA: see section 2.2 below). Market value under s.8.10(c), and the purchase price paid for a pipeline under s.8.10(j) of the Code, are also matters for fundamental consideration. In this regard, the implied purchase price (discussed below), and recent market evidence require consideration.

Where, having properly applied the s.8.10 factors, various potential values emerge for consideration, some form of reconciliation between the different values should be attempted. As the analysis in section 2.3 below demonstrates, such a reconciliation is possible (having regard also to s.2.24 and s.8.1 of the Code), so that the provisions of s.8.10 may be harmoniously applied. They indicate that a value for the ICB of $480 million lies above the appropriate range.

For the reasons set out in section 2.4 below, the DAC or DORC value should not be adjusted by reason of s.8.10(f) and the tariffs set for the Pipeline in the past. These past tariffs were subject to the regime under the State Agreement and, as the Authority effectively found, there was evidence that the tariffs were not compliant with the principles established by that regime and substantially exceeded a commercial rate of return. WMC is presently involved in a dispute concerning the level of tariffs which ought to have been properly set under that regime. The Regulator therefore ought not give any weight to the past level of tariffs simply because they in fact applied.

2.2 Depreciated Actual Cost

At paragraph 102 of the Amended Draft Decision, the Authority refers to the DAC value of the ICB derived by the Regulator and contained in the April 2001 Draft Decision on GGT’s Proposed Access Arrangement for the Pipeline (the “**2001 Draft Decision**”). This DAC value of $435.4 million is a backward-looking accounting construct. It is based upon actual construction costs and book depreciation from the date of the relevant expenditure to the date of valuation. At paragraph 103 of the Amended Draft Decision the Authority concludes that there is a more appropriate methodology for determination of a DAC value than the methodology adopted in the 2001 Draft Decision.

In the Amended Draft Decision the Authority adopts the capital-recovery calculation set out in GGT's submission to the Authority of 17 December 2002 as being a more appropriate methodology for determination of a DAC value. This alternative method:

(a) takes the actual construction cost of the Pipeline;

(b) determines the revenue and costs generated by the Pipeline (including the cost of funds) from the date of the expenditure to the date of valuation;

(c) calculates the net revenue generated to the date of valuation; and

(d) deducts this net revenue from actual cost.

Whilst being backward-looking, this methodology is not an orthodox DAC calculation within the meaning of the Code. Instead, it is a free cash flow (“**FCF**”) method of estimating the value of the ICB of the Pipeline given that:

- the recovery of capital in any time interval is not prescribed but is determined to be the “free cash flow” (ie. revenue not accounted for by costs) generated in that period; and

- the net revenue defined in paragraph (c) above measures the free cash flow generated by the sale of the Pipeline Services as might be calculated in an NPV analysis.

WMC is concerned with the Authority’s classification of this valuation methodology as a DAC method. If this valuation method were properly described as an FCF valuation method, considered pursuant to section 8.10(c) of the Code, it might complement, but not substitute, the Authority’s previous orthodox DAC estimate as a valid valuation method. Importantly, WMC notes that the values derived by either of these methodologies are capable of being audited and verified using actual data. The DAC value is derived from accounting records of actual costs and book depreciation. Similarly, the FCF valuation is based upon accounting records of actual costs and an economic estimate of capital recovery (which is also based upon accounting records).

Whilst value judgments need to be made in assessing a DAC value, and, in relation to a DORC value, providing they are within a reasonable range, as they are here, DAC and DORC values so determined are to be given fundamental weight in light of s.8.10(a) and (b) and s.8.11 of the Code.

2.3 Acquisition Price of the Pipeline

At paragraphs 115 to 118 and 132 of the Amended Draft Decision, the Authority considers, under section 8.10(c) of the Code, a valuation methodology based upon the prices paid in 1998 and 1999 by the current owners of the Pipeline for their respective interests in the Pipeline. In previous submissions, WMC commented on this valuation methodology, cautioning in effect that:

- the price of unregulated assets must be deducted from the purchase price before the valuation is undertaken. This includes the value of laterals included in the purchase; and

- to the extent that the current owners paid a purchase price which reflected the special value of existing contracts relating to the use of Initial Committed Capacity ("ICC") under the State Agreement, that special value ought to be disregarded when estimating the value of the Pipeline for the purposes of regulation.

WMC submits that the Authority failed to make proper adjustments having regard to these points, and says that attributing an implied value of $620 million to the Pipeline, by way of mere extrapolation from prices paid for an interest in the Pipeline without examining the assumptions inherent in the relevant acquisition model, is grossly excessive.

WMC is concerned that the Authority (at paras 117-118) has not undertaken any, or any proper, analysis of the imputed purchase price advanced by GGT, and the factors and assumptions behind it, for the purpose of assessing whether it reflects fair market value, and the extent to which past investments reflected a reasonable price in the sense discussed in **Re Michael; ex parte Epic Energy (WA) Nominees Pty Ltd (2002) 25 WAR 511 at [149], [154]**. WMC is concerned that the Authority has unquestioningly adopted the figure of $620 million proposed by GGT, and has not, for example, attempted to make any (or any proper) adjustments having regard to the points mentioned above. In the very least, the manner in which the Authority has reached a view as to the implied value of the Pipeline, having regard to the price paid for the purchase of an interest in the Pipeline, is opaque. For example, although the Authority mentions the value of laterals as a separate item in para 117, it is not clear whether this value was excluded from consideration in determining whether $620 million is the implied value of the Pipeline to be inferred from purchase price for an interest in the Pipeline. Any adjustments made to take account of the points mentioned above ought to be explicitly stated along with the reasons justifying the need for, and extent of, the adjustment.

Further, and importantly, if a value of the Pipeline is implied simply by reference to the proportionate price paid for the interest of WMC or Normandy in the Pipeline (even allowing deductions for the price of unregulated assets), this will overestimate the value of the Pipeline. The price which Southern Cross Pipelines paid for the interests of WMC and Normandy will reflect various collateral matters such as the commercial benefit of obtaining long term contracts based upon access to ICC (as that term is used in the State Agreement). Collateral benefits are not matters which are properly brought into account for the purposes of valuing the Pipeline for regulatory purposes, on the proper construction and application of the Code, particularly s.8.

The purpose of setting the ICB under the Code is to determine the amount of capital which may be recovered from third party shippers using capacity of the Pipeline under an access arrangement. The proportionate amount of capital which may be recovered from a third party shipper, is not, on the proper construction and application of the Code, to be affected by any component of the purchase price actually paid for the pipeline in order to obtain special benefits available from particular contracts, including contracts not controlled by the previous State regime and on terms not generally available under such regime. Therefore, if a regulatory value of the Pipeline is to be implied by reference to the price paid for an interest in the Pipeline, that value must be based upon the price which would be paid for an interest in the Pipeline to the extent that the Pipeline is (or it is anticipated that it will be) subject to an access arrangement.

WMC has requested Project Consultancy Services to carry out its own analysis, based on publicly available information, as to the value for the Pipeline, having regard to the proper construction and application of the Code, which should be implied by reference to the proportionate price paid to WMC and Normandy for the sale of their interests in the Pipeline. This report is attached to these submissions. The report concludes that excluding the price of unregulated assets and the value of special benefits attached to particular contracts, the value of the Pipeline implied by the purchase price paid for the interests of WMC and Normandy is likely to be near or even below $500 million.

However, the Authority should itself seek detailed information concerning all known transactions involving a transfer of an interest in the Pipeline. There should be a proper assessment of an implied purchase price in light of all relevant information.

While a figure of near or below $500 million is still significantly above a DAC or DORC value, a proportion of this difference may be capable of rational explanation. Firstly, the difference can be attributed to the fact that the $500 million figure remains only an estimate and is not of itself the ICB for the Pipeline. Secondly, when this estimate is properly applied and, for example, attached to an appropriate cost of funds, it is capable of producing Reference Tariffs comparable to those generated using DAC or DORC.

WMC submits that the Authority should take into account (pursuant to s.8.10(k)) that it is against the public interest for GGT to benefit from delays in the application of the Code to the Pipeline. Based upon the Authority's own analysis, as set out in the table at paragraph 182 of the Amended Draft Decision, the delay in the approval of GGT's Proposed Access Arrangement has yielded GGT a windfall in the order of $173 million (being the difference of the DAC value of $434 million as at 31 December 1999 and the DAC value of $261 million as at 30 June 2004). The Authority's upward revision of the value of the ICB for the Pipeline, from the range established by DAC, DORC and FCF methodologies, will increase that windfall to $219 million (being the difference between the Authority's estimated ICB value of $480 million and the DAC value of $261 million as at 30 June 2004 and depicted in the table at paragraph 182 of the Amended Draft Decision).

A second check upon the excessive nature of the derived value of $620 million, which confirms that it does not represent the Pipeline's market value, is the recent transaction announced in August 2004 by the Australian Pipeline Trust ("**APA**"). This implies a value of $493 million for the Pipeline. See the attached PCS report.

The above arguments apply equally under s.8.10(j) of the Code.

2.4 The State Agreement and Reasonable Expectations of the Pipeline Owners and Users

In the Amended Draft Decision, after the Authority considers the estimated values of the ICB derived using the DAC, DORC, FCF and acquisition price methodologies it then considers the implications of:

(a) international best practice of pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries (section 8.10(e) of the Code);

(b) the basis on which tariffs have been (or appear to have been) set in the past, the economic depreciation of the Pipeline, and the historical returns to the service provider from the Pipeline (section 8.10(f) of the Code);

(c) the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code (section 8.10(g) of the Code);

(d) the impact on the economically efficient utilisation of gas resources (section 8.10(h) of the Code);

(e) the comparability of the cost structure of new pipelines that may compete with the Pipeline (for example, a pipeline that may by-pass some or all of the Pipeline) (section 8.10(i) of the Code); and

(f) any other factors the Relevant Regulator considers relevant (section 8.10(k) of the Code).

The Authority concludes that there is no international best practice pipeline valuation methodology which needs to be considered in accordance with s.8.10(e), and largely disregards the implications of those matters identified in paragraphs s 8.10(h), (i) and (k) as having little relevance to the determination of the value of the ICB for the Pipeline. However, in response to various arguments put forward by GGT, the Authority ultimately adds a premium in the order of $50 million to the ICB estimates derived by the DAC, DORC and FCF methodologies to arrive at an ICB value for the Pipeline of $480 million.

The background to the Authority's determination appears to be based on submissions by GGT that:

- GGT's tariffs have been set pursuant to the terms of the State Agreement and that users of the Pipeline ("**Users**") and the owners of the Pipeline could reasonably expect these tariffs to be considered when the Authority determines the value of the ICB for the Pipeline;

- the owners of the Pipeline are entitled under the State Agreement, and under the Code, to recover all construction and operating costs associated with providing gas transmission services to third parties; and

- both Users and the owners of the Pipeline expected that tariffs would be set by GGT, on behalf of the Pipeline owners, as opposed to the Authority.

In light of these submissions by GGT, the Authority concludes that:

> "*.... the Authority is of the view that tariffs put in place under the Tariff Setting Principles did not necessarily comply with those principles. There is evidence to suggest that the past approach to the setting of tariffs has resulted in tariffs being established that embody a rate of return to GGT that is substantially in excess of a commercial rate of return. In particular, the agency of the Western Australian State Government with responsibility for administration of the State Agreement (the Department of Industry and Resources, previously the Department of Resources Development) previously commissioned studies of tariffs for the GGP that advised that rates of return embodied in, or implied by, the tariffs have been excessive*." (paragraph 158 of the Amended Draft Decision);

and

> "*It is evident from the analysis of capital recovery undertaken by the Authority that the third-party tariffs established for the GGP have embodied a rate of return that is substantially in excess of the likely cost of capital for the GGP*". (paragraph 178 of the Amended Draft Decision).

Despite these conclusions, the Authority suggests that because excessive returns were allowed to be realised under the State Agreement, there is a matter of public interest which makes it difficult for the Authority to determine an ICB value which "claws back" these excessive returns. In what appears to be an effort to compromise, the Authority ultimately, and arbitrarily, determines an ICB value that is approximately $50 million above the value of the DAC, DORC and FCF estimates.

WMC submits that the Authority has made a number of errors in making a final adjustment of $50 million to its ICB determination.

First, on the issue of capital recovery, GGT's expectation that the owners must recover all operating and construction costs relating to the Pipeline must be construed in the context of the "approved tariff setting principles" and in the Side Letter provided by the State in support of the State Agreement. The relevant references to "costs" in these documents relate unambiguously to the actual costs associated with the development and operation of the Pipeline. Accordingly, these references to costs are clearly founded in, and consistent with, DAC and FCF valuation methodologies. They are not consistent with the other valuation methodologies considered by the Authority.

Secondly, the Authority concludes that the State Agreement tariffs may not have complied with the tariff setting principles (para 158), notes that administration of the State Agreement may have created an expectation of continuing high tariffs (para 178), but then treats the benefits obtained from the high tariffs as having been legitimately – in the sense of lawfully – obtained, so much so that considerations of sovereign risk are then invoked as militating against interfering with the benefits (paras 179, 215, 232-234).

Thirdly, the Authority's view of "sovereign risk" is the risk which arises "in the event that a new regulatory regime was introduced (in this case the Code) and applied to a particular regulated business in such a manner as to take away from the owners of that business the benefits legitimately and lawfully gained under a previous regulatory regime" (para 179). There are several responses to the erroneous reasoning involved in applying this notion here.

- It is difficult to see how any question of sovereign risk can arise when the original investors, who contracted with the State, have borne the risks and then sold to new owners who have acquired a completed pipeline with knowledge of the impending Code.

- The State Agreement imposes on the Pipeline owners a clear legal (contractual) obligation to charge tariffs, to third parties, which are "fair and reasonable and consistent with the tariff setting principles approved by the Minister under" the State Agreement: cl.22(1). As expressed, that distinct contractual obligation is unqualified by any notion of Ministerial satisfaction. The contractual duty is expressed in objective terms. Whether the contractual duty has or has not been performed is a matter of objective assessment. It does not depend upon the attitude of the Minister. If tariffs charged exceed those which conform with cl.22(1), then those tariffs are not lawful under the State Agreement.

- It follows that inaction on the part of the Minister alone cannot conceivably render lawful and legitimate, tariffs which do not objectively conform with cl.22(1). Indeed, it is WMC's understanding that since 20 December 2001 the Minister has not sought to review GGT's tariffs as a consequence of an expectation that the determination of the Authority regarding GGT's Proposed Access Arrangement was imminent.

- Sovereign risk should not arise as a result of unreasonable expectations. For example, if the third party tariffs did not objectively conform with cl.22(1), Ministerial inaction could not generate any reasonable or proper expectation that excessive tariffs would be allowed to continue in the future. At any point in time the Minister may insist upon proper compliance with cl.22(1). Such Ministerial insistence could conceivably correct the tariffs retrospectively. The important point to appreciate is that cl.22(1) of the State Agreement governs the conduct of the pipeline owners at all times. Its lawful application from the outset of a third party contract and its continuing effect must be distinguished from the time when it is sought to be enforced by the Minister.

- The implications of Ministerial inaction, in relation to possible expectations, cannot be assessed without obtaining evidence as to the underlying reasons why there was Ministerial inaction and all of the circumstances (eg, communications between the Minister and the pipeline owners). Ministerial inaction alone, does not infer approval (eg, while not taking action under the State Agreement, the Minister may have been urging tariff review upon the pipeline owners).

- In any event, according to Ministerial Media Statements in 1998 and 1999, reductions in GGT tariffs in both 1998 and 1999 followed negotiations between the Minister and the Pipeline owners. Consequently, WMC submits that it is inappropriate for the Authority to form the view that the State did not act regarding the level of GGT's tariffs.

In so far as the Code involves consideration of tariffs recoverable under the State Agreement regime, it needs to be borne steadily in mind that in light of the relevant principles, particularly Tariff Setting Principle 2, no purchaser could have anticipated a return of capitalised monopoly profits. Tariff Setting Principle 2 limits the owners’ return to a commercial rate, which is inconsistent with indirect recovery of monopoly profits as part of the Pipeline’s ICB. As well, any premium paid on the expectation that high tariffs would continue under the State Agreement regime should be left out of account.

These observations which concern the level of return of capital which ought to be permitted are consistent with the operation of other provisions of the Code. In particular, as Tariff Setting Principle 2 ought to have informed what invested capital a reasonable person could expect to recover, this will affect:

- the extent of “efficient costs” in s.8.1(a) and the meaning of “efficiency” in the level of a Reference Tariff which is to be considered by reason of s.8.1(e),;

- the outcome of the competitive market referred to s.8.1(b); and

- what constitutes distortion of investment decisions for the purposes of s.8.1(d).

The expectations of a reasonable person limit what may be described as “efficient” capital costs, and will inform what could be expected in replicating a competitive market, without consequential distortion of related investment decisions.

The meaning of each of these notions, as applied to the present case, will depend upon the extent to which a reasonable person would have an expectation of continuing high tariffs. In this case, having regard to Tariff Setting Principle 2, the largest capital amount which a reasonable person could have expected to recover was an amount representing the DAC or DORC value of the Pipeline, plus some extra amount reflecting the commercial risk of constructing the Pipeline and commencing operations which had been carried out by the original owners.

Further, a reasonable person would not have expected to recover as part of the ICB (or, for that matter, by way of an inflated return upon the ICB) any component of the purchase price which was based upon an expectation of continuing high tariffs. The present situation is different to the one in the Epic Energy case, where there was no equivalent to Tariff Setting Principle 2, and the State conducted a sale of the pipeline on specified bases to achieve specified objectives. Hence, the comments by the Full Court in that case concerning recovery of capitalised monopoly profits under the Code have no relevance here.

Likewise, the owners' legitimate business interests and the public interest in the operation of the Pipeline, which must both be balanced as fundamental considerations in accordance with s.2.24(a) and (e), will be limited to allowing a return of capital to the extent referred to above. Again, this is because of what a reasonable person could have expected having regard to Tariff Setting Principle 2.

2.5 The State Agreement and Authority's Power to Set Tariffs

Finally, it seems that GGT asserts that by some application of the terms of the State Agreement the Authority has no right to set tariffs for the Pipeline. This assertion is flawed.

The State Agreement expressly contemplates the introduction of by-laws and the promulgation of uniform laws or subsidiary legislation governing access to petroleum pipelines in Western Australia and the subsequent superseding of any by-laws by any uniform access laws.

Clause 20(2) of the State Agreement states:

> "*The terms and conditions of Third Party access to the Pipeline (including access by any Initial Customer to capacity which is in excess of that Initial Customer's portion of the Initial Committed Capacity) shall be subject to and in accordance with by-laws from time to time made, altered or repealed as provided in subclause (1) of Clause 21 or other applicable laws or subsidiary legislation referred to in subclause (2) of Clause 21 and…*".

In addition, the Full Court of the Supreme Court in Western Australia in its decision of Re Michael ex parte WMC Resources Ltd [2003] WA SCA288 found that:

> "*Clauses 21(2) and (3) of the State Agreement contemplate the making of a future law or laws of the State*".

It is clear that the Code falls within this construction and, accordingly, that the State Agreement contemplated that uniform access laws such as the Code might address the question of, and even prescribe, GGT's published tariffs. GGT's subtle extension of its right to set tariffs, and its suggestion that the Authority has no such right (despite the terms of clause 20 of the State Agreement), is inappropriate.

Further, the Authority has correctly noted, at paragraph 180, that:

> *"at the time that the current owners of the GGP purchased their respective shares of ownership, the Western Australian Government had committed to implementation of the national access regime for natural gas pipelines through signing on 7 November 1997 of the National Gas Pipelines Access Agreement. While third party access provisions of the Goldfields Gas Pipeline Agreement Act were deemed to comply with the Code to 1 January 2000, there was no derogation under this agreement providing for the exclusion of the GGP from regulation under the Code, and the current owners of the GGP would or should have been aware of this."*

However, not only was the Code contemplated at the time the current owners of the Pipeline acquired their respective interests in the Pipeline, but the national gas access regime had been applied elsewhere in Australia. WMC refers the Authority to Annexure C of its submission to the Western Australian Office of Gas Regulation dated 28 August 2003 which contains a chronology of regulatory precedents in 1997 and 1998.

2.6 Conclusion

In undertaking its consideration of the appropriate ICB, the Authority concludes, in virtually every instance, that the appropriate value of the ICB for the Pipeline falls in the range established by the DAC, DORC and FCF valuation methodologies, being between $407 million and $434 million. However, the Authority goes on to "recognise" that GGT might have expected an ICB value in the order of $495 million on the basis that its excessive rate of return would not be "clawed back" in the regulatory process. The Authority, seemingly in recognition of public interest concerns regarding sovereign risk, and based on what appears to be some form of a compromise in consideration of the excessive rate of return implied by what it describes as "entrenched" tariffs, has determined an ICB value for the Pipeline of $480 million.

Neither the State Agreement nor the Code gives rise to any legitimate right or expectation on behalf of GGT or the Pipeline owners to earn a rate of return in excess of that which is permitted under the State Agreement or the Tariff Setting Principles approved pursuant to the State Agreement. Accordingly, WMC submits that it is inappropriate for the Authority to adjust the estimated ICB value to $480 million on this basis. Instead, an appropriate ICB value should fall within the range of DAC, DORC and FCF methodologies as determined by the Supreme Court of Western Australia in the Epic Decision and affirmed by the Authority, subject to an upwards adjustment to the extent that there has been a payment which reflects the commercial risk of constructing the pipeline and commencing operations which had been carried out by the original owners. Taking into account that adjustment, the ICB value should certainly be no more than the amount determined by the Authority (ie $480 million)

3. Approved Proposals, Tariffs and Fundamental Elements

GGT submits that various matters relevant to determining the Reference Tariff are the subject of an "approved proposal" (as that term is defined in the State Agreement) or that "*they are fundamental elements of the original arrangement with the State*".

Under the State Agreement, the matters that relate to third party access, and which are the subject of an approved proposal, are "*arrangements for access to the Pipeline by Third Parties*" (clause 9.1(k)), "*the Pipeline and Pipeline sizing"* (clause 9.1(a)), GGT's "*tariff setting principles*" (clause 9.1(l)) and the "*Pipeline gas quality specifications"* (clause 9.1(d)).

The approved proposals to which reference is made by GGT are not in the public domain. In this circumstance, the various matters in the proposals that GGT submits are relevant to determining the Reference Tariff are not available for verification.

However, WMC submits that any "*fundamental element of the original arrangement with the State*" is contained either in the State Agreement, the Side Letter to the State Agreement or in any other document which has been expressly approved by the State pursuant to the State Agreement. The Authority is correct, therefore, to reject any claim by GGT that there are "*fundamental elements of the original agreement with the State*" where such fundamental elements are not set out in the State Agreement or in the Side Letter to the State Agreement or where GGT has not demonstrated that such "*fundamental elements*" have been expressly approved under the terms of the State Agreement.

Further, as a result of the approved proposals, cl.22(3) of the State Agreement requires the joint venturers to establish and maintain an indicative tariff schedule that is "based on" the approved tariff setting principles. The schedule must be provided to the Minister: cl.22(4).

The question whether the indicative tariff schedule is properly "based on" the tariff setting principles, involves the application of objective criteria. That matter may be the subject of dispute and resolution, through the arbitration provision: cl.37. Thus, while there is no express requirement for Ministerial approval, there are objective criteria which can be enforced by Ministerial action at any time if the Minister is not satisfied that the indicative tariff schedule is properly based on the tariff setting principles. As has been explained, Ministerial inaction does not imply satisfaction with the tariffs.

When GGT's A3 Tariff was introduced in 1999, there was a Ministerial Media Statement dated 16 February 1999 by Resources Development and Energy Minister Colin Barnett. The Statement said:

> "*...under the terms of the Goldfields Gas Pipeline Agreement (1994), tariffs on the pipeline were required to be fair and reasonable and consistent with the approved tariff setting principles outlined in the Agreement. He said the State Government had initiated an independent review of the tariff schedule which showed that the benchmark tariff required reduction*".

WMC submits that GGT's withdrawal of the A4 Tariff and the re-introduction of the A1 Tariff in December 2001 was not in compliance with the Tariff Setting Principles. Nothing in those principles allows a Pipeline owner to recover more than a commercial rate of return. That is similar to the position under the Code. Moreover, as compliance with the Tariff Setting Principles is a central requirement of the State Agreement, nothing in any "approved proposal" ought to be interpreted as detracting from this in any way. Therefore, a tariff properly determined under the State Agreement and Tariff Setting Principles should be consistent with the Reference Tariff. At a minimum, WMC consequently submits that the Authority should reconsider its assessment of the value of the ICB for the Pipeline, and the various components in its assessment of GGT's Weighted Average Cost of Capital ("WACC").

4. Demand

In the Amended Draft Decision the Authority evaluates the various Pipeline demand scenarios submitted by GGT. At paragraph 404 the Authority concludes that it "*is prepared to accept the forecasts provided by GGT for the purpose of the Amended Draft Decision*". It is not clear from this conclusion whether the Authority has accepted the GGT demand forecasts described in paragraph 400 of the Amended Draft Decision or the forecasts described in paragraph 402. The data behind both data sets appear to have been provided by GGT for the purpose of the Amended Draft Decision.

WMC submits that the forecasts in paragraph 402 should be preferred by the Authority over the forecasts in paragraph 400 in the Authority's assessment of GGT's Reference Tariffs.

In determining the regulatory demand forecasts the Authority should use as a base the actual historical throughput. From this base, WMC submits that forecasts should be made using sound economic data and User based forecasts. WMC submits that GGT's apparent attempt not to make forecasts beyond current contracts should be dismissed as unrealistic. There is no indication in the Amended Draft Decision that the GGT forecasts for throughput are based on sound economic data. It is submitted that in the current economic climate forecast throughput until 2009 will at least match the actual historical throughput for 2004. This is evidenced by the public offer document for units in the Australian Pipeline Trust which says, in no uncertain terns, that "the Goldfields Gas Pipeline currently has long term contracts in place with major mining companies including WMC and Normandy. … ACIL considers the risk that these contracts will not be renewed is low. The long term contracts are all based upon supplying energy to projects whose economic lives can be reasonably expected to extend beyond the term of current contracts."

5. WACC Calculation and Other Assumptions

WMC considers the analysis undertaken by the Authority and reported at paragraphs 235 to 399 and 405 to 425 of the Amended Draft Decision, to be reflective of current best practice methodology. WMC notes that the Authority has been generous to GGT in adopting the proposed 42 year asset life and the proposed depreciation model. Provided that the assumed asset life is monitored in future access arrangement determinations, WMC does not propose that these determinations be revisited.

WMC is concerned, however, that the Authority should revisit its estimates of ICB values so as to ensure that the asset life assumptions used to derive these estimates are consistent with its adoption of the 42 year asset life and the depreciation model. By way of example, WMC submits the Authority's DAC value of the ICB estimate may need to be reconsidered as a result of the reduction of the effective life of the Pipeline to 42 years.

Further, one of the methodological difficulties with the Authority's approach to WACC is the assumption that it is for the Authority to determine a uniquely correct outcome. On the contrary, on the proper construction of the Code, there is a range of complying outcomes and the Regulator's true task is to consider whether what the Service Provider has submitted falls within the range.

6. General Terms and Conditions

WMC commends the rigour of the assessment undertaken by the Authority and reported in the Amended Draft Decision at paragraphs 426 to 675. WMC wishes to comment only on a small number of matters addressed in these paragraphs.

6.1 Termination

At paragraph 449, the Authority proposes to amend clause 3.2 of GGT’s general terms to preclude the unilateral termination of a services agreement by GGT. Any such amendment must not, however, preclude the User in such an agreement from terminating the agreement when the installation of enhancements and/or additions to the Pipeline are delayed. If this right is eroded the User may be precluded from obtaining a proper remedy to any fuel supply problem caused by a delay to expand the GGP and the User may be locked into a failed contract until GGT agrees to a termination.

6.2 Quantity Variation Charges

At paragraphs 468 to 500 of the Amended Draft Decision the Authority discusses the matter of GGT's proposed Quantity Variation Charges. WMC is concerned that GGT proposes to penalise Users for exceeding their MDQ, MHQ and/or for failing to equate nominations and actual gas injections/withdrawals, where such actions have no consequence for GGT or for any other User. MHQ is a critical consideration when designing pipeline receipt and delivery facilities and for setting limits on GGT’s liability when gas delivery capacity (above MHQ) is not available. Further, WMC is not aware of any history in Australia of pipeline users manipulating gas receipts and deliveries (by systematically exceeding MDQ) and pipeline line pack to the disadvantage of other users or the pipeline owners. WMC submits that generally the act of a User exceeding MDQ and MHQ has no immediate consequence for GGT or for other Users.

Similarly, WMC is concerned that under GGT's proposed terms Users who fail to match their daily gas nominations with their daily gas injections into, and withdrawal from, the Pipeline would be subject to an excessive penalty. Typically, nominations are made at least 18 hours in advance of a “Gas Day” and Users have only limited rights under GGT’s general terms to adjust their nominations and/or their actual pipeline injections and withdrawals to reflect daily weather and plant operating conditions. Where an adjustment to a duly derived forecast is made for valid reasons by a User and the adjustment does not compromise the Pipeline or other Users, the User should not be subject to a penalty at the unqualified discretion of GGT.

WMC supports the Authority’s proposal to limit GGT’s right to penalise a User for exceeding MDQ, MHQ or for variation between actual and nominated Pipeline utilisation.

6.3 Connection Charge

WMC submits that any Connection Charge must be a transparent fee for services actually provided by GGT. A Connection Charge should not be an arbitrarily determined entry price which might, in itself, be used to discourage connection to, and use of, the Pipeline. The Access

Arrangement Information should explicitly state that the Connection Charge is simply to allow recovery of the actual costs of connection.

6.4 Surety/Security

In regard to the matters of surety and security discussed at paragraphs 541 to 545, WMC shares the concern of the Authority regarding the lack of transparency in the determination of need for, and the quantum of, any bond or deposit that a User is required to lodge with GGT. Under the Tariff Setting Principles applicable pursuant to the State Agreement, GGT could only expect to seek credit support from Users in those instances where GGT has "*a genuine concern regarding Users credit worthiness*" (approved Tariff Setting Principle 5).

WMC submits that the matter of bonds and requirements to provide credit support proposed by GGT gives rise to a risk of discouraging access to Pipeline services. The Authority should ensure that GGT is constrained and transparent in its demands for surety and security from Users.

6.5 Payment of Disputed Invoices

WMC has first hand experience with the payment model proposed by GGT whereby disputed invoices must be paid in full, subject to subsequent resolution of the dispute. WMC's experience suggests that this payment model is open to abuse and places Users at great disadvantage in the event a User disputes an invoiced amount. WMC urges the Authority in the strongest possible terms to amend this proposed arrangement so that any disputed sums are retained by Users until the dispute is resolved and then, if they are found to be wholly or partially payable, paid with interest.

7. Review and Expiry of the Access Arrangement

At paragraphs 676 to 691 of the Amended Draft Decision the Authority considers the issues of the review and expiry of the Proposed Access Arrangement. The Authority considers "Revisions Commencement Dates" of 1 January 2006 and 1 January 2010 and, in effect, seeks submissions regarding the appropriate Revisions Commencement Date. WMC is strongly of the view that the Revisions Commencement Date should be 1 July 2007. In WMC's submission, given that it is already September 2004 and the Proposed Access Arrangement has yet to be approved, a Revisions Commencement Date of 1 January 2006 would not provide a reasonable period for the operation of any approved Access Arrangement before the Revision process were to commence. This, in WMC's submission, is inefficient and unnecessary. On the other hand, WMC considers that delaying the Revisions Commencement Date to the alternate proposal of 1 January 2010 could result in inaccuracy due to the potential lack of precision of forecasts of costs, contracted capacity and throughput. In the circumstances, WMC supports the proposal to which reference is made at paragraph 682 of the Amended Draft Decision for an Access Arrangement Period extending to June 2007.

8. Appendix B and Appendix D

Appendix B and Appendix D summarise analyses undertaken by the Authority in deriving estimated values of the ICB for the Pipeline reported at paragraph 150 of the Amended Draft

Decision. WMC notes and concurs generally with these analyses. However, WMC makes a number of observations regarding the analyses.

At paragraph D10 of Appendix D the Authority poses a series of questions, namely whether:

- GGT and the Government intended that tariffs established at the commencement of the Pipeline project would persist indefinitely or be reviewed periodically;
- the WACC assumed for the purpose of the Pipeline's initial tariff determination was to be re-determined from time to time; and
- the Government actually had the power to require that GGT's tariffs be reset to incorporate a WACC that reflects a market cost of capital and changes to the market cost of capital.

WMC addresses the last of these queries in section 2.6 above.

In considering the question of whether the parties to the State Agreement expected that GGT's tariffs would be reviewed periodically, it is helpful to turn to GGT's approved Tariff Setting Principles and to its Explanatory Note entitled "Tariff Setting Method". Approved Tariff Setting Principle 12 clearly requires that the tariffs be re-determined under certain circumstances. The Explanatory Note concludes by alerting Users to the fact that GGT's tariff path will be periodically realigned with the approved Tariff Setting Principles and assuring Users that the Minister will monitor GGT's compliance as follows:

> "*In the long term the tariff will be modified in accordance with tariff setting Principle (12). The built-in escalation of the tariff by CPI will thus be modified in accordance with changes made pursuant to Principle (12)*"

and

> *"The Minister will monitor compliance by the Owners with their obligations under the GGP Act".*

At paragraphs D13 and D14 of Appendix D the Authority considers the scope for changes in capital markets to impact on GGT's realised returns and to give rise to windfall gains and losses. WMC is concerned with the narrow interpretation adopted by the Authority. There is nothing in the State Agreement, the Explanatory Note or the approved Tariff Setting Principles to suggest that this analysis should be limited to consideration of the volatility of capital market variables. WMC submits that the analysis undertaken by the Authority should also include scope for changes in project costs and revenue assumptions to vary from forecast.

Great care must be exercised in arriving at, and in applying, the conclusions set out in Appendix B to ensure that an appropriate rate of return is applied to the appropriate cost assumptions. This is complicated when the object of the analysis is to produce a vector of capital recoveries and, ultimately, a single residual value for 31 December 1999.

In concluding that the appropriate WACC for the period from 1994 to 31 December 1997 is the rate of return assumed by GGT, it is of fundamental importance to consider the cost assumptions to which this WACC is to be applied. If the WACC accepted by the Authority changes over time it is necessary to consider the changed cost and revenue assumptions to which those WACC values are to be applied (and not just changes in the capital market variables).

WMC is not privy to the data provided to the Authority that is considered in Appendix D. WMC would suggest that the data is largely historical by nature and of little contemporary relevance beyond the Authority's deliberations.

In relation to the analysis in Appendix B and Appendix D, WMC is concerned that the application of the rates of return reported in paragraph D12 to ex post cost data will result in an overestimation of the residual value of the pipeline as at 31 December 1999.

Further, it is not appropriate to assume a WACC based on GGT's expectation in its financial model that it would receive the A1 tariff after December 2001. There could be no reasonable expectation that the A1 tariff would continue to apply in that period, given the previous tariffs and the circumstances leading up to the withdrawal of the A4 tariff, discussed in section 2.5 above.

In conclusion, WMC submits that in order for there to be a proper analysis of the Amended Draft Decision, in particular an analysis of the Authority's considerations in Appendix B and Appendix D, the data utilised by the Authority for the purposes of it considerations in those appendices should be made available to the public.