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Mr A Hinton
Gas Access Regime Inquiry
Productivity Commission
LB2 Collins Street East
Melbourne VIC 8003

Dear Mr Hinton,

Alcoa World Alumina Australia (“Alcoa”) Submission on the Review of the National Third Party Access Regime (“Access Regime”) for Natural Gas Pipelines

Alcoa appreciates the opportunity to provide a submission to this Productivity Commission Review of the Access regime. The purpose of this letter is to give the Review an overview of Alcoa, its role in the energy market and its impact on the Australian economy and then to make some general comments on the impact of the existing Access Regime on Alcoa’s operations in Western Australia. Alcoa intends to make a more detailed submission in due course.

Alcoa fully supports the intent of the Access Regime and its operation in relation to the Dampier to Bunbury Natural Gas Pipeline (DBNGP). However its administration in practice, in conjunction with the outcomes of the pipeline’s privatisation, have produced financial uncertainty around the future capacity, operation and ownership of the DBNGP with flow on effects for expansion of the WA economy.

Alcoa Overview

Alcoa operates bauxite mines at Huntly and Willowdale in the Darling Range south of Perth, which supply Alcoa’s alumina refineries at Kwinana, Pinjarra and Wagerup. These refineries have a combined alumina production capacity of 7.8 million metric tonnes a year. Alumina is exported worldwide from shipping terminals at Kwinana and Bunbury. In Victoria, Alcoa owns the Point Henry smelter and operates the Portland smelter, in which it has a 55% interest. The combined production capacity of these two smelters is 540,000 metric tonnes a year, with most of the aluminium ingot being exported. A coal mine and power station at Anglesea in Victoria provide part of Point Henry’s power requirements.

Alcoa Australian Rolled Products operates rolling mills at Point Henry in Victoria and Yennora in New South Wales. It is the only manufacturer of aluminium rolled products in Australia and in 2002 produced 155,000 tonnes of rolled products including rigid container sheet for beverage cans, aluminium foil and common alloy sheet for building and marine applications.

Alcoa's operations are located in regions outside metropolitan areas. In Western Australia, Alcoa operates in the Peel Region, south of Perth. In Victoria, the principal locations of operation are Geelong and Portland. Alcoa is predominantly a regional employer providing full-time employment for around 8000 skilled people in Western Australia, Victoria and New South Wales.

In 2001, Alcoa's operations in Australia generated total export revenue of \$3.97 billion. Alcoa accounted for:

- 3 per cent of Australia's total export earnings; and
- 7 per cent of exports of minerals and energy resources products.

Alcoa is ranked as Australia's sixth largest mineral and energy exporter with most Alcoa aluminium being exported to Asian markets. This is the fastest growing sector of the world market.

Aluminium consumption is closely linked to world economic growth with a strong correlation between aluminium demand and activity in the construction, transport and packaging industries. Over the past forty years, world consumption has grown at an average annual rate of 5.5 per cent while world production has grown at an average annual rate of 5.2 per cent.

Alcoa's alumina operations significantly benefit Western Australia. Of total alumina revenues (excluding internal sales) of \$2,311 million, \$719 million (31 per cent) is spent on intermediate inputs sourced from Western Australia. This provides a significant demand for goods and services provided by local private and state owned corporations in Western Australia.

Alcoa has been a major contributor to the infrastructure of Western Australia and Victoria since it commenced operations in 1961. Alcoa has made large contributions to the development of regional infrastructure - for facilities that are used principally by Alcoa, for multi-use infrastructure and for community infrastructure. Alcoa has itself contributed directly to the building of infrastructure, or is a major customer that has enabled others to provide it. Examples of Alcoa's contributions to infrastructure include the high voltage power line from Geelong to the Point Henry smelter, a natural gas connection from Allansford to Portland and surrounds, the DBNGP as subsequently outlined as well as port, rail and road infrastructure in both WA and Victoria.

Alcoa is a significant investor in research and development in Australia with an average annual R&D expenditure across Australia of approximately \$20 million per annum. Extensive relationships have been established with research facilities and education facilities external to Alcoa to assist with research into a

variety of issues confronting the business. These issues range from environmental issues (such as residue disposal), alternative processes (such as bright hydrate), to efficiency improvements in operations.

The technical excellence of the Australian R&D group was recognised in 1993 when it was made the primary research group responsible for Alcoa World Alumina's technology development worldwide. This group is based at the Kwinana Refinery and has become the world's largest Bayer process R&D group.

Alcoa's competitive advantage in alumina refining in Australia stems from its relatively secure, long-term, low cost energy supplies (natural gas), low bauxite mining costs, as well as the refining economies of scale. Alcoa's alumina refineries are technologically advanced, are among the largest refineries in the world and are world competitive.

Alcoa's three alumina refineries in Western Australia, at Kwinana, Pinjarra and Wagerup produce 7.8 million tonnes per annum, with some significant brownfield expansion options to increase this output. The alumina refining process is dependent on steam and electricity. Alcoa owns and operates electricity and steam-raising plant at each of its refineries. It transports electricity between refineries and sells surplus electricity into the retail market. The operations currently consume natural gas at a rate of about 240 terajoules a day (TJ/D).

Aluminium smelting is a highly energy intensive process. Electricity accounts for between 30 and 35 per cent of total operating costs and smelters locate where electricity costs are competitive. The relatively high electricity costs and relatively small size of the electricity system of Western Australia has to date been the principal factor preventing the development of an aluminium smelting industry in that State. Energy market reforms and the future availability of low-cost natural gas are the keys to making electricity prices in Western Australia more competitive in the future.

A decision by Alcoa to expand its existing alumina operations and to invest large amounts of capital in new aluminium operations in Australia would be based on a judgement that Australia remains an attractive, competitive location for the production of alumina and aluminium.

Alcoa is constantly reviewing expansion opportunities globally and has recently announced its intention to undertake an efficiency upgrade of its Pinjarra Refinery. This refinery already produces about 3.2 million tonnes of alumina per annum, representing about 7% of the world's alumina refining capacity. The upgrade will increase production capacity by approximately 600,000 tonnes of alumina per annum and will increase export revenue for Australia by up to AUD \$160 million per annum as well as enhance the substantial financial contributions Alcoa already makes to the Australian and Western Australian communities each year.

Alcoa's underwriting of the DBNGP

In February 1983, Alcoa signed a contract with the then State Energy Commission of Western Australia (SECWA) for both gas transportation and gas supply, agreeing to purchase around 50% of the natural gas for a 20-year period. In effect Alcoa became a de-facto equity partner taking 50% of the risk associated with construction, marketing and financing of the pipeline.

Gas is piped 1,500 kilometres from the large offshore reserves of the North West Shelf, and the Alcoa contract currently accounts for around 40% of the gas being piped to the southwest area of the State. The contract replaced a previous mix of energy based on imported fuel oil and local gas supplies from small onshore fields. Without Alcoa's large base load contract for an extended period and capital underwriting, the DBNGP would not have been economic, and Perth's gas supplies would have terminated when the smaller fields in the Dongara area were depleted. Alcoa's underwriting of the DBNGP not only was a key enabler for the development of the domestic gas processing plant for the North West Shelf project in the early 1980's but has also subsequently supported the development of other smaller gas and oil fields with associated gas in the north west of the State.

Alcoa Exempt Gas Transportation Contract

With the implementation of the Gas Corporation Act in 1994, Alcoa's transportation contract was granted "Exempt" status in recognition of the long-term strategic investment made by Alcoa in the early 1980's and to preserve the rights embodied in that contract, then and into the future. This status provided for Alcoa's contract to be exempt from the regulatory process implemented via the Gas Access Regime.

With the disaggregation of SECWA into Western Power and Alinta Gas in 1995, Alcoa's delivered gas contract with SECWA was replaced by a direct purchase agreement with the North-West Shelf Joint Venture for gas supply, and a separate Exempt gas transportation contract with Alinta Gas.

This Exempt Contract is a key strategic asset for Alcoa's refining operations in Western Australia. Whilst specific details of the contract are confidential, in broad terms Alcoa has rights to transport an uninterrupted supply of gas from the northwest of the state and to request expansions of the gas pipeline to meet its energy requirements. In return, Alcoa's exempt contract specifies a tariff that covers the cost of any capital spent (including initial construction) on the pipeline, a profit margin to the operator and the operating expenses pro-rated to usage. Reflecting this, up until mid-2005 this tariff is at a significant premium above that of current Regulated Shippers on this pipeline.

In 1998 the DBNGP was sold to Epic Energy for around \$2.4 billion as part of the then State Government's privatisation process. This purchase price resulted in a substantial windfall gain to Western Australia. As part of this transaction the Western Australian government assigned Alcoa's Exempt gas transportation contract to Epic Energy. Alcoa thus saw the pipeline asset transfer from a

secure asset with only sovereign risk exposure to a privately owned asset with highly leveraged non-recourse financing.

Third Party Access

As outlined above, Alcoa has played a unique role in the development of the DBNGP and has undertaken significant risk and financial obligations to ensure the viability of the domestic gas industry and related pipeline. In recognition of this contribution, Alcoa's contract has been granted exempt status under the Regulated regime. Notwithstanding Alcoa's status as a de facto equity owner, Alcoa supports the need for equitable access to large infrastructure assets. Alcoa believes that all parties, regardless of their size, should be able to utilise these infrastructure assets at a competitive price that is open and transparent. Alcoa is familiar with the principles of third party access and has been involved in these processes in the areas of rail, electricity transmission and gas transportation. The conditions of third party access should allow viable, competitive businesses to grow and prosper. Alcoa is also cognisant of the potential exercise of monopoly power if these strategic assets are not adequately regulated.

Summary

In Western Australia two significant changes have occurred in the commercial operating environment of the DBNGP, with implications for Alcoa and the economy of Western Australia. The first change was the privatisation of the DBNGP under favourable terms to the State Government. The second significant change was the application of the third party access code to the pipeline. This process commenced not long after the pipeline was sold and is the subject of an on-going dispute between the Gas Access Regulator and Epic Energy.

It is not Alcoa's intention to comment in detail on either process. However, Alcoa does feel it is necessary to comment on the impact that the interaction of both of these processes have had on Alcoa, other resource industries and the economy of the State.

First, the Alcoa Exempt Contract was meant to be just that – exempt from the regulatory and third party access processes – and was a simple recognition of the risks taken by Alcoa in the underwriting of the original capital cost and subsequent expansions of the pipeline since the early 1980's.

The outcome of privatisation of the DBNGP, together with uncertainties on the administration of the access regime (specifically relating to the determination of the capital base and the regulated rate of return), has had unintended consequences for Alcoa and the state. There has been a wide amount of public debate on how Epic Energy has been impacted by this regulatory process. Epic's situation has been exacerbated by the post-Enron energy market conditions and a more difficult global economic environment. The publicly documented financial pressure Epic is experiencing has limited their ability to fund expansions or anything more than essential maintenance on the pipeline.

The third party access code has been implemented via the Gas Access Regulator on the DBNGP. The process commenced in 1998 and Epic Energy is still disputing the Regulator's Final Decision with resolution not expected until some time in 2004. The regulatory process was intended to equitably balance the interests of Epic Energy as the service provider with the interests of the users of the pipeline.

Epic Energy has thus found itself limited in its capacity to continue as owner, operator and to expand the DBNGP in order to meet expectations of major users. The situation that has developed has produced uncertainty for major users with flow on implications for economic development in WA.

Alcoa, along with other major users, has a strong interest in the continued quality of gas transmission services for the DBNGP and the expansion of the DBNGP in a timely manner to ensure that development in WA is not compromised.

In addition, Alcoa is looking to maintain the confidence to invest in plant and equipment for large-scale and long-term production.

Alcoa's expansion in WA rests on its ability to produce alumina at an internationally competitive price. The availability of long-term, secure, internationally competitive gas supplies is an important element in any feasibility studies and planning activities.

Recommendations

Alcoa believes a number of improvements could be made to the Gas Access Regime to help reduce uncertainty and promote economic growth.

These include:

- Reducing the time taken to implement a regulatory framework for gas access in WA. Lengthy delays in decision-making have added to the uncertainty experienced by users and the owner of the DBNGP.
- The lack of guidance on interpretation in the Code has resulted in parties seeking legal interpretation. A large amount of time has been spent seeking clarity regarding the interpretation of the Code in areas such as the tariff pricing mechanism. This has further slowed the regulatory process as these issues have been progressed through the courts.
- The Code does not have a process to deal with past capital contributions. It is well accepted that large organisations such as Alcoa have made significant capital contributions or have underwritten capital costs via tariff mechanisms for infrastructure in their areas of operation. A process for equitably handling and recognising these contributions needs to be covered in the Code.

Yours faithfully,

Lesley Jefferies

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Alcoa World Alumina Australia**