REVIEW OF THE GAS ACCESS REGIME

**Submission to the
Productivity Commission**

ON

THE GOLDFIELDS GAS PIPELINE EXPERIENCE - BENEFITS AND COSTS

August 2003

1.0 INTRODUCTION

The Goldfields Gas Pipeline (GGP) extends 1380 kms from gasfields in the north-west of Western Australia to Kalgoorlie. Commissioned in 1996, before the introduction of the National Gas Access Regime (the Gas Regime), it delivers gas to a small number of major mining and processing ventures in the Pilbara, Northern and Eastern Goldfields regions. The gas is used primarily for power generation.

The GGP was constructed pursuant to an Agreement with the State Government, which was ratified by the Goldfields Gas Pipelines Agreement Act 1994 (the State Agreement).

The purpose of this submission is to use the GGP development experience to compare the benefits and costs associated with the State Agreement framework and that of the National Third Access Code for Natural Gas Pipelines Systems (the Gas Code). In the course of this comparison, the submission also endeavours to highlight some of the shortcomings of the Gas Code and the features which are important to the successful development of a new greenfields pipeline.

2.0 DEVELOPMENT HISTORY OF THE GGP

Prior to the development of the GGP, electrical power had been supplied to the Eastern Goldfields by transmission line from the State Energy Commission of Western Australia's (now Western Power) Muja power station. Power for remote operations such as Mt Keith, and Leinster in the Northern Goldfields was supplied by stand-alone company owned diesel power stations. Power to major mining operations in the Pilbara, such as Newman, Tom Price, Paraburdoo and Pannawonica was supplied by a combination of company owned stand-alone diesel powered stations, and transmission lines from coastal power stations.

The State Government had for some time been keen to see the development of a gas line to the Eastern Goldfields, but the State Energy Commission had concluded that such a development was not viable. In April 1993, following some indications of private interest in the project, the State Government called for expressions of interest in the construction of a gas pipeline to Kalgoorlie. 16 formal submissions were received, and a competitive selection process - which took into account factors including proposed third party access arrangements and tariff levels - followed.

The Goldfields Gas Transmission Joint Venture (the Joint Venture), comprising three large resource companies – WMC (63%); Normandy (25%); and BHP (12%) – was selected as the preferred proponent. The primary motivation of these companies was to reduce the costs of electricity generation at their respective operations, but in order to obtain Government support they were prepared to make specific provision for future transmission requirements of third parties. WMC had an additional interest in the development of the East Spar gasfield, of which it was part-owner. Negotiations ensued to translate the terms of the successful Joint Venture proposal into a detailed State Agreement. This was signed in March 1994.

Goldfields Gas Transmission Pty Ltd (GGT) was formed to manage the pipeline on the owners' behalf. Prior to finalising the design and capacity requirements for the pipeline, GGT offered an "open season" for foundation third party pipeline users. This offered a discount of 7.5% on transport tariffs for a period of 5 years. No third party took advantage of this initial incentive.

A Pipeline Licence was granted in January 1995 and gas was first delivered to Newman in June 1996; Mount Keith and Leinster in August 1996; and Kalgoorlie and Kambalda in September 1996.

The GGP introduced natural gas into regions where it had previously not been available. In introducing an alternative and competitive energy source into the markets it could reach, the pipeline displaced approximately 140 MW of electrical generation capacity from the South West Interconnected System (SWIS) as well as almost 300 million litres per annum of diesel fuel previously used in remote power generation.

It was not until after the GGP was commissioned that a number of third party users took up the opportunity to purchase capacity on the pipeline. While third party usage has grown steadily, it currently comprises only a quarter of total contracted capacity.

In late 1998 and early 1999 the three mining companies which developed the GGP - WMC, Normandy and BHP - sold their interests to a group of utility investors and operators. The pipeline is now 88% owned by Southern Cross Pipelines - a joint venture between APT (55%) and CMS (45%) - with Duke Energy owning the remaining 12%. At about the same time WMC and BHP sold their interests in the power generation facilities which had been purpose-built to take GGP gas. WMC also sold its petroleum interests, in particular the East Spar gasfield which had been developed to supply its operations along the GGP.

3.0 HILMER – THE BACKDROP TO THE STATE AGREEMENT REGIME

Negotiations between the Joint Venture and the State Government over the terms of the State Agreement took place during the second half of 1993 and early 1994. This was prior to the development of the National Access Regime now embodied in Part IIIA of the Trade Practices Act, and prior to any serious consideration of a specific Gas Regime or Gas Code. Essentially the only guidance provided to the parties negotiating the State Agreement regime at the time, came from the National Competition Policy Review (Hilmer Report) which was published in August 1993.

Discussion of the Hilmer Report is relevant in this context as it served as the principal benchmark for the State Agreement regime, and created expectations as to how a future National Access Regime would evolve.

The Hilmer Report addressed six questions as follows:

1. When should a Legislated Right of Access be Created?

The Hilmer Report argued that industry specific regulation was not required and that:

- access should be essential rather than merely convenient;
- access should be in the public interest having regard to the "…significance of the industry to the national economy…" and to "…the expected impact of effective competition in that industry on national competitiveness…";
- special emphasis was needed to ensure that "…access rights did not undermine the viability of long-term investment decision…";
- obligations to provide access should be made clear before an investment is made;
- "the legitimate interests of the owner of the facility must be protected".

2. Determination of Access Prices

The Hilmer Report was of the view that "…neither the application of general economic theory nor general notions of fairness provide

a clear answer as to the appropriate access fee in all circumstances”. It proposed two alternative approaches to the issue:

- entrust broad discretion to an independent regulator;
- require the relevant Minister to stipulate more specific pricing principles in the context of declaring a right of access.

In the latter case, parties would be free to negotiate access agreements and if agreement could not be reached, there would be recourse to binding arbitration in accordance with the declared principles.

The Hilmer Report clearly favoured the second approach on the basis that:

- policy issues relating to pricing principles “…are more transparent and are made by an elected representative”;
- once principles are in place the parties have a greater degree of certainty;
- this approach is “…less interventionist than regulated outcomes and should facilitate the evolution of more market-orientated solutions”.

3. Other Terms and Conditions

The Hilmer Report expressed the view that relevant terms and conditions would tend to vary between industries and between facilities. It did not exclude the possibility of the owner of a private facility giving priority to its own requirements, and for discrimination between different third-party users.

4. Additional Safeguards to Protect Competition

The Hilmer Report argued that in a newly competitive market some additional safeguards might be required to ensure that an incumbent did not misuse market power to damage emerging competition. It was felt that these concerns could generally be met by “…requirements to provide cost data relevant to the application of the pricing principles to place access agreements on a public

register; and to ensure all parties are subject to the general competition conduct rules…"

The Hilmer Report also argued that "…additional safeguards that intrude into the rights of the owner are even less likely to be appropriate in the case of private facilities, as the costs of pro-competitive policies ought to be borne by the public… since the beneficiaries of the policy are consumers generally".

5. *Remedies*

The Hilmer Report proposed a binding arbitral process for access disputes.

6. *Relationship with Existing Access Regimes*

As far as existing regimes are concerned, the Hilmer Report expressed the view that "…where such a regime provides access on fair and reasonable terms there will usually be no need for declaration…"

The Hilmer Report's concluding comments with respect to the application of a new access regime were that "… such a regime should be applied sparingly, focusing on key sectors of strategic significance to the nation".

The following section of the submission addresses the specific provisions incorporated in the State Agreement. The ideas developed in the Hilmer Report feature extensively in the access regime incorporated in the State Agreement.

4.0 THE STATE AGREEMENT REGIME

The State Agreement is very clear in its objectives which are:

- to promote economic development in the inland Pilbara and Goldfields regions;
- to facilitate the availability of natural gas; to reduce energy prices; and to assure reliability of energy supplies;
- to provide transmission access to parties other than the Joint Venturers on a non-discriminatory basis at fair and reasonable prices;
- for access to natural gas transmission pipelines in WA to be subject to fair and reasonable terms and conditions based on principles of a consistent nature.

The State Agreement distinguishes between the capacity reserved by the Joint Venturers - defined as "Initial Committed Capacity" - and that available to Third Parties. The access regime incorporated within the State Agreement applies only to Third Parties, and to capacity which is not "Initial Committed Capacity".

Detailed proposals – for consideration and approval by the Minister – are called for with respect to the construction and operation of the pipeline, including details of the specific arrangements for access by Third Parties, and tariff setting principles (as per Hilmer) to apply to Third Parties other than the Joint Venturers.

The State Agreement introduced a specific requirement that the capacity of the pipeline should "… be able to be expanded, by using additional compression, by a minimum of 50% of the Initial Committed Capacity". This placed an obligation on the Joint Venture to build a facility considerably larger than their own requirements. In doing so it created a clear incentive for the owners to promote Third Party use, an incentive which was backed-up by a specific obligation to actively promote the pipeline, and to keep the Minister advised of their efforts in this regard.

The State Agreement provides for the term of the Pipeline Licence, and other related land tenure to be 42 years. It also provides assured access to the Dampier to Bunbury Pipeline and to the State's electricity

transmission system (which at the time did not have a third party access regime).

As far as Third Party access is concerned, the Agreement provides for:

- access to capacity (including developable capacity) which is uncontracted or unutilised;

- non-discriminatory fair and reasonable terms and conditions;

- annual reporting to the Minister of all requests by Third Parties, the extent these have been met, and details of any requests not met;

- the Joint Venturers to develop the capacity of the pipeline subject to technical and economic feasibility;

- the Minister to direct the Joint Venturers to submit proposals for expansion of capacity;

- intervention by the Minister if a Third Party has not been able to reach agreement on access after two months. The Minister can require the Joint Venturers to provide details;

- the Minister to determine reasonable terms and conditions – consistent with tariff setting principles – for services to be provided to such a person.

The Agreement provides for the introduction of by-laws covering access, but requires that they have due regard for:

- the Joint Venturers' legitimate business interests;

- the interests of Third Parties;

- operational and technical requirements.

It also acknowledges the possible introduction of "…uniform laws or subsidiary legislation…. for petroleum and gas pipeline operation in Western Australia…", but makes it clear (clause 21(3)) that such laws "… shall not have effect to the extent that the Joint Venturers can demonstrate … material adverse effect…" on their legitimate business interests. The presumption at the time was that any Gas regime would closely follow the

Hilmer report recommendations and would in its final effect be the same as the State Agreement regime.

The State Agreement exempts the Joint Venturers' own activities from the effects of the Gas Regime and the Gas Code, by making it clear that any uniform laws shall not apply to Initial Committed Capacity (except to the extent it is unutilised). Section 97(4) of the Gas Pipelines Access Law makes specific reference to clause 21(3) of the Agreement and provides that "… nothing in that Law or in this section is to be taken to affect the operation of that subclause…".

On the issue of tariffs the State Agreement requires:-

- tariffs for Third Parties to be fair and reasonable and consistent with approved tariff setting principles;

- the Joint Venturers to maintain an indicative tariff schedule and make available to the Minister "… all or any gas transmission contracts entered into with Third Parties" for the purpose of "… making determinations or giving directions…" under the Agreement;

- the maintenance of records as required to demonstrate transmission services are available on a non-discriminatory basis at fair and reasonable prices.

During the latter half of 1994, GGT negotiated with the Minister to define the tariff setting principles required under the Agreement and to determine the initial tariffs for the pipeline consistent with those principles. The tariff setting principles incorporated in detailed proposals approved by the Minister are set out in Attachment 1. Of particular note are the following:-

- tariffs are to be set to provide a commercial rate of return on all project costs, commensurate with the business risk associated with the project;

- Initial Committed Capacity to be ascribed a notional tariff based on third party tariffs;

- the provision for tariffs to be redetermined in certain specified circumstances;

- the provision for voluntary tariff discounts to be offered.

Since the GGP was commissioned in 1996, GGT has introduced a number of voluntary tariff discounts; however there has yet to be a formal tariff redetermination under the State Agreement.

In the negotiations with the Minister agreement was reached on the economic parameters to be used for the setting of tariffs.

Based on these parameters, and using estimates for transportation throughput over the project life, the A1 tariff was determined. This was a three part tariff comprising toll, capacity, and throughput components.

These tariffs were determined on a levelised basis in order to yield tariffs which remained constant in real (ie. inflation adjusted) terms. This whole-of-life methodology reduced tariff levels in the early years of the project with the explicit intention of promoting the use of the pipeline, although a consequence was to defer capital cost recovery to later years of the project life.

In January 1995 the Minister approved the Clause 9 proposals which included the now extant tariff setting principles.

In view of the relatively low cost of increasing the capacity of the GGP through compression, increased throughput can potentially deliver ongoing tariff deductions. This, coupled with some extremely bullish growth forecasts by some sections of the resource industry, resulted in early expectations of substantially lower tariffs. Some shippers and prospective shippers argued that if GGT took the lead with tariff reductions, throughput increases would inevitably follow.

Since the GGP was commissioned, tariff discounts have been introduced on three occasions and also an Economic Development Tariff (EDT) was offered in 1999, for new projects commencing no later than December 2003. Unfortunately neither the discounts, nor the EDT tariff, were effective in increasing pipeline throughput. Accordingly the A4 discount, which did not have a specified time limit, was withdrawn in December 2001.

5.0 GGT'S EXPERIENCE WITH THE CODE

Under the Gas Regime introduced in 1999, the GGP was identified as a Covered Pipeline and the owners required to submit a proposed Access Arrangement no later than November 1999. At that time implementation of the Code was still very much in its infancy and there was little indication as to how it would be applied. As indicated previously, it was assumed that its application and effect would be very similar to that of the State Agreement regime. The Joint Venture was ambivalent as to whether access arrangements for the GGP should be administered under the State agreement or the Code.

GGT's proposed Access Arrangement – submitted in December 1999 - was aimed at continued promotion of GGP throughput and was based on:-

- an Initial Capital Base derived from a DORC valuation. This was substantially less than the price which the new owners had paid for the GGP on the basis of the State Agreement.;
- A real pre-tax WACC which was significantly below the level to which the Joint Venture was entitled under the State Agreement - as agreed by the Minister;
- Regulatory life of 40 years, reflecting the 42 year term of the State agreement and the Pipeline Licence, but considerably longer than any of the contracts held by the Joint venture - whether for Initial Committed Capacity, or with Third Parties;
- Approximately constant throughput for the five year period and a load factor of 0.72.
- Reference Tariffs calculated using an NPV "levelised" tariff approach over the five-year term of the Access Arrangement (as opposed to the 42 year term of the State Agreement). These Reference Tariffs were equivalent to the A4 discounted tariffs under the State Agreement.

It took until April 2001 for the Regulator to release his Draft Decision which proposed a total of 49 amendments to GGT's Access Arrangement. In particular the Regulator proposed:-

- An Initial Capital Base below that proposed by GGT ;

- reductions in non-capital costs;

- a real pre-tax WACC dramatically lower than that proposed by GGT, and that which was justified and accepted by the Minister under the State Agreement;

- a weighted average asset life of 65 years;

- a Reference Tariff that would generate a specified level of Total Revenue .

The effect of the Draft Decision, if carried through to a Final Decision, would have been to mandate an across-the-board tariff cut of approximately 30% relative to the A4 tariff discount, which itself was already a 25% reduction in tariffs justified and accepted under the State Agreement.

The Draft Decision effectively ignored the development history of the GGP, and in particular the arrangements which had been negotiated under the State Agreement framework. It proposed tariffs based on a rate of return which might have been relevant to a gas distribution system in a major capital city, but totally inappropriate for such a remote piece of infrastructure with a small number of major mining customers, and competition from other energy sources. It ignored the significant risks associated with the original GGP investment decision, and ongoing uncertainties with respect to throughput and economic life. It also proposed a whole series of intrusive amendments to GGT’s proposed arrangement.

The nature of the Draft Decision demonstrated that "material adverse effect" existed or was likely, and that a Final Decision along the lines of the Draft Decision could be highly prejudicial to GGT's financing arrangements. It was at this point that GGT started to look seriously at its legal options vis-à-vis the Code and the rights afforded under Clause 21(3) of the State agreement for protection of legitimate business interests from any “material adverse effect” of the Gas Code.

Lengthy discussions ensued with the Minister's office and the Office of Gas Access Regulation; however, these did not result in any resolution of GGT's concerns. Consequently in December 2001 - two years after it lodged its proposed Access Arrangement - GGT commenced a legal action in the WA Supreme Court against the Regulator and the State of Western

Australia, seeking a declaration that pursuant to Clause 21(3) of the State Agreement:

- certain sections of the Code; and/or

- the parts of the Regulator's Draft Decision dealing with Reference Tariffs; and/or

- any Final Decision which incorporates the Reference Tariff sections of the Draft Decision.

"…have, will have, or be likely to have…" a material adverse effect on the legitimate business interests of the GGTJV, and accordingly have no effect.

The action further sought a declaration that the Regulator:

- erred in law in misconstruing provisions of the Code and the State Agreement;

- failed to take into account relevant considerations, and took into account irrelevant considerations;

- erred in law by reaching conclusions unsupported by any evidence.

At the same time Epic Energy was pursuing a parallel - although not identical - action against the Regulator in respect of his Draft Decision on the DBNGP. The Epic decision was handed down on 23 August 2002. In summary, the Court found that:

- the Regulator's determinations in respect of Reference Tariffs and the Initial Capital Base were affected by errors of law, and required reconsideration;

- the Regulator failed to give weight to the factors in Section 2.24(a) to (j) of the Code as fundamental elements, including the issue as to whether the proposed Access Arrangement contained the elements and satisfied the principles set out in Sections 3.1 to 3.20;

- the factors in Sections 2.24(a) to (g) should guide the Regulator in determining the manner in which the objections in Section 8.1(a) to (f) can best be reconciled, or which of them should prevail in assessing proposed Reference Tariffs;

- it was open to the Regulator to take into account the actual investment of Epic in the pipeline;

- it is not the meaning and affect of the Code that only “efficient” capital investment, or “regulated revenues” be taken into account, or that the initial Capital Base should represent a value “that is consistent with future regulated revenues and efficient capital investment”;

- the reference in the Code to replicating a “competitive market” should be interpreted to mean a “workably competitive market” and such a market may well tolerate a degree of market power, even over a prolonged period;

- the recovery of monopoly prices does not necessarily constitute an “illegitimate business interest”;

- in relation to Section 8.10(g) of the Code, if the previous regulatory regime was more favourable than the Code, the reasonable expectations of the service provider would be for a more favourable return on the investment in the pipeline.

In November 2002, the Regulator advised that in light of the Epic Decision, he intended to amend his Draft Decision on the proposed Access Arrangement for the GGP, as his earlier draft decision was affected by some of the same errors of law identified by the Supreme Court. He also advised that he intended to take into account jurisdictional issues associated with the interaction between the State Agreement and the Code.

The Regulator outlined a two-stage process, involving as a first stage, application of the Code without consideration of Clause 21(3), and the issue of Part 1 of the amended Draft Decision. GGT would then be invited to make submissions as to the extent of any “material adverse effect” likely to be experienced as a result of the part 1 Draft decision. These would then be taken into consideration in the drafting of Part 2 of the amended Draft Decision. Interested parties would then have the opportunity to make submissions before the Final Decision was prepared.

Throughout the processes which GGT has pursued under the Gas Code - including the related actions in the Supreme Court - some Shippers with "Initial Committed Capacity" - which sits outside the jurisdiction of the

Gas Code or the State Agreement regime - have continued to make use of Gas Code processes in an effort to improve their commercial positions. GGT regards this as an example of the extent to which the current Gas Code permits "gaming" of the system for commercial advantage, and amounts to a clear misuse of processes which have been designed to look after the interests of Third Parties seeking access.

As a result of the Regulator's acknowledgement that his Draft Decision was flawed and needed amending, GGT withdrew its legal action in the Supreme Court.

As of August 2003, the Regulator is still in the process of preparing Part 1 of his amended Draft Decision. In the meantime, in June 2003 WMC initiated a new action in the Supreme Court which challenges the ability of a State Agreement provision (ie clause 21(3)) to modify the effect of subsequent State legislation (eg the Gas Pipelines Access Law). It also seeks to prevent the Regulator from proceeding to consider the effect of clause 21(3) of the State Agreement on his Draft Decision. This action is due to be heard in early October 2003.

In March 2003, in an effort to resolve the jurisdictional tension between the State Agreement regime and the Gas Regime, GGT submitted an application to the NCC for revocation of coverage of the GGP.

GGT has come from its early ambivalence towards the Gas Regime, to a position of strong opposition to it and its tortuous processes. The key question is whether the fault lies with the specific provisions of the Gas Code, or the manner in which it has been implemented. From GGT's viewpoint there is clear evidence of collaboration by Regulators throughout Australia to produce a consensus view on regulatory issues. While this might be expected, the group appears to have taken as their mandate the lowering of tariffs and associated rates of return for existing infrastructure investments throughout Australia, rather than the promotion of investment in new or expanded facilities.

The experience of the Epic Supreme Court action bears out the fact that in their pursuit of lower tariffs, Regulators have wrongly interpreted the Gas Code and have not taken advantage of discretions which are available to them. History suggests that without clear and explicit guidance, Regulators will continue to see their role as protecting the interests of Shippers and that the Gas Code will continue to be interpreted from this perspective.

6.0 WHAT HAS BEEN THE EFFECT OF THE CODE – BENEFITS AND COSTS

It is now almost 5 years since the Gas Regime and the Gas Code was introduced in Western Australia, and more than 3½ years since GGT submitted its proposed Access Arrangement. There appears to be no end in sight to the lengthy and complex process of achieving an approved Access Arrangement which acknowledges the position of the Joint Venturers under the State Agreement.

Costs

The costs of the Gas Code process have been substantial for all GGP stakeholders – whether owners or shippers. These costs include:-

- the costs of supporting the Regulator and OffGAR for four years without any visible result as far as the gas transmission sector in Western Australia is concerned;
- the costs of GGT's legal action against the State Government and the regulator in the Supreme Court which was withdrawn last year;
- the costs involved in a recent and ongoing legal action brought by WMC against the Regulator and the State Government;
- the increased overhead costs to all parties from having to continually monitor, digest, interpret and engage in debates relating to regulatory policy issues;
- the effects on investment and business planning of ongoing uncertainty as to jurisdiction and final access arrangements, mitigated only by continued reliance on the security of the State Agreement;
- the distraction of senior management with regulatory issues rather than building new business.

Benefits

As far as GGT is concerned the Gas Regime and the Gas Code have brought absolutely no benefits, to the owners or to GGT as manager.

Further, no benefits are foreseen if and when an Access Arrangement is finally approved and the Gas Code starts to apply.

As far as existing or future Third Party Shippers are concerned the Gas Code has also brought nothing in the way of benefits. Whether or not shippers can eventually claim some gains in terms of reduced tariffs will depend very much on the final outcome of the Gas Code process. However, given the rulings of the Supreme Court in the Epic case, and the protection provided by Clause 21(3) of the State Agreement, it is questionable whether any lower tariffs will result than could have been anticipated under the State Agreement.

To the extent that lower gas tariffs for Third Parties are the end result of the Gas Code process for the GGP, GGT believes that this was not the intended purpose of the Gas regime, and will come at the cost of investor confidence and the level of investment in new pipelines or expansions of existing pipelines in Australia.

7.0 WHAT HAS BEEN THE EFFECT OF THE STATE AGREEMENT – BENEFITS AND COSTS

From the time that the Western Australian Government first sought expressions of interest for the construction of a pipeline to the Eastern Goldfields, to the time the GGP was commissioned, was a period of little more than 3 years. It is interesting to note that this is less time than has been spent in debate and disputation over the proposed Access Arrangement required under the Code.

The real test of the effectiveness of the Code is to ask the question as to whether, if the Code had been in place in 1993, it could have delivered equivalent benefits at lower cost than the State Agreement framework. In the view of GGT, there is no possibility that the GGP could have been developed under the Gas Code. This view has also been expressed in Parliament by the State Government Minister under whom the State Agreement was developed.

Costs

From the standpoint of GGT and its owners the State Agreement regime has been extremely low cost. It has not required a dedicated regulatory apparatus and, therefore, no levies on GGT or its shippers. Until the advent of the Gas Code provided a gaming opportunity for some to improve their existing commercial arrangements, there have been no disputes with the State over the access arrangements, and therefore no legal costs associated with the Third Party access framework.

Shippers could argue that tariffs under the State Agreement might have been higher than under the Code, but the State Agreement approach has been responsible for Third Parties being able to take advantage of the same economies of scale available to the Foundation developers. Further the history of the GGP shows considerable evidence of tariff discounting and other promotional efforts to increase throughput - with the objective of reducing tariffs further - via an Economic Development Tariff.

Unlike equivalent pipelines operating under the Code, at no stage have existing or prospective shippers been constrained in terms of available capacity by the Joint Venturers' lack of preparedness to invest in the expansion of pipeline capacity. This contrasts with the Gas Code position where there is no obligation on a Service Provider to invest in new capacity, and front-end investment in surplus capacity is discouraged. The Joint Venturers' recent decision to commit to an $11 million

compressor station at Paraburdoo - notwithstanding the ongoing Gas Code debate - is a reflection of the benefits brought by the State Agreement framework, and GGT's continued faith in the security it provides

Benefits

The decision to invest in the GGP - of itself more than $450 million - was directly responsible for stimulating substantially greater investment in the development of related power stations by WMC, Normandy and BHP, and by WMC and its associates in the East Spar gasfield.

Through its contribution to substantial savings in electricity costs it was also an indirect but major contributor to significant expansion activity in the nickel, gold and iron ore industries.

The acknowledgement by the State Government of the need for a financial return commensurate with the high risks associated with the GGP - notwithstanding additional upstream and/or downstream advantages enjoyed by the original owners - was an essential element in enabling its construction. The disparity between returns proposed by the Regulator under the Code framework and that accepted by the State for the GGP is clear evidence that the pipeline would not have been developed at all under the Code.

Critical differences between the State Agreement and Code approaches in this respect is that the former:-

- looks at specific project circumstances and risks (and does not as with the Code differentiate between diversifiable and non-diversifiable risks);

- takes a whole-of-life view of the project and its associated risks (as distinct from a forward looking view emphasised in some of the Code provisions) and provides a binding commitment to the Owners on tariff setting principles and rates of return;

- recognized a levelised tariff approach which delivered front-end benefits to Third Party shippers;

- does not attempt to impose a utility return which might be appropriate for a risk free distribution system in a capital city.

Apart from the essential contribution the State Agreement made to the decision to develop the GGP, other specific benefits of the State Agreement regime are as follows:-

- the Joint Venture accepted an obligation to construct 50% surplus capacity to meet the future needs of Third Parties. This allowed Third Parties to piggy-back on the investment of the original developers and participate in significant scale economies.

  If the Code had applied at the time – because of its attitude towards speculative or premature investment – the GGP would almost certainly have been constructed with a capacity just sufficient to serve the needs of the owner/developers.

- the construction of surplus capacity of itself imposed a powerful incentive on the Joint Venturers to promote the further use of the pipeline.

- the Joint Venturers accepted an obligation to expand the pipeline as required to meet Third Party needs and has continued to invest in additional compression facilities. The State for its part acknowledged the level of risks which were associated with these commitments. By contrast, under the Code there is no obligation on pipeline owners to invest in new capacity – leading to capacity constraints in major trunk-lines such as the DBNGP.

8.0 CONCLUSIONS

With the benefit of extensive experience with the Gas Regime and the State Agreement, GGT is strongly of the view that:

- The State Agreement regime reflects the principles and particularly the light-handed approach recommended by the Hilmer Report;

- The State Agreement enabled the GGP to be developed in a very short time-frame, resulting in significant upstream and/or downstream benefits, through the promotion of direct investment and the reduction in energy costs to the Pilbara, Northern and Eastern Goldfields regions;

- The GGP would not have been developed under the Gas Code. The essential features not available to a greenfields pipeline under the Gas Code :

  - whole-of-life approach and commitment covering risk; rate-of-return; and tariff setting;
  - adequate reflection of project risk in the "commercial rate of return" provided for;
  - levelised approach to tariffs;
  - distinction between capacity for foundation users and Third Parties.

- The Gas Code has been extremely costly, time consuming and distracting. In its five years of operation in Western Australia it has not delivered any benefit to stakeholders - whether Service Providers or Shippers;

- The Gas Code processes have provided gaming opportunities for those who do not qualify as Third Parties or prospective Third Parties to try and improve their commercial positions under existing contracts;

- Regulators have taken as their mandate, the reduction of rates-of-return and tariffs, to the detriment of facilitating investment in new and expanded pipeline capacity.

Attachment 1

Tariff Setting Principles

<table>
<tr><td colspan="2">The principles which govern tariff setting on the Pipeline (the “Principles”) are as follows:</td></tr>
<tr><td>1.</td><td>Tariffs will be structured to promote the use of the Pipeline</td></tr>
<tr><td>2.</td><td>Tariffs will be set to provide a commercial rate of return on all project capital, including all Owners’ costs, reasonably incurred in the construction and operation of the Pipeline and to recover all reasonable Pipeline operating, maintenance and administration costs. The commercial rate of return shall be commensurate with the business risk associated with the project.

For the purpose of this Principle, the Owners will be ascribed a notional tariff based on third party tariffs for their utilization of Pipeline capacity reserved to the Owners pursuant to clause 8(1) of the GGP Agreement.</td></tr>
<tr><td>3.</td><td>Users may be categorized into a User group on the basis of the nature of the service or the duration of the service they are seeking. Users cannot be categorized into a User group on the basis of their credit worthiness or on the basis of the volume of their capacity purchase.</td></tr>
<tr><td>4.</td><td>Tariffs will not discriminate between Users in a common User group.</td></tr>
<tr><td>5.</td><td>Credit support may be requested of a User, before a service contract is accepted, in the event of a genuine concern regarding User’s credit worthiness.</td></tr>
<tr><td>6.</td><td>A minimum account or similar charge may be made to recover the Owner’s reasonable costs in regard to connection of a User to the Pipeline and contract administration.</td></tr>
<tr><td>7.</td><td>Tariffs will have a capacity reservation component, and a throughput component, and will be structured to promote the utilization of reserved capacity.</td></tr>
<tr><td>8.</td><td>Tariffs will be structured to recover the capital cost of the Pipeline equitably over time.</td></tr>
<tr><td>9.</td><td>Tariff differences between User groups will reflect the character of the service to be provided (particularly in terms of the distance of carriage, term of the contract and whether the contract is for interruptible or firm capacity) and the time at which service contracts are entered into.</td></tr>
<tr><td>10.</td><td>All Firm Transportation Service tariffs will be set by reference to the Benchmark Tariff.</td></tr>
<tr><td>11.</td><td>Contracts should not set tariff caps in excess of 20 years from the execution thereof.</td></tr>
<tr><td>12</td><td>At any time when the tariffs for Pipeline services then being applied:

do not promote the use of the Pipeline; or

do not promote the efficient use of reserved capacity; or

generate a rate of return to the Owners which is inconsistent with Principle (2) above, except where the Owners elect to exercise Principle (13).

the tariffs shall be redetermined, and that redetermination shall be applied so as to ensure the Principles are satisfied. Such redetermination shall not, under any circumstances, oblige the Owners to adopt a tariff which does not satisfy Principle (2).

I. Where a tariff redetermination results in a change being made to the Firm Transportation Service tariff, the new tariff shall apply, without any derogation of any existing contractual right, as far as is possible uniformly across all new and existing Firm Transportation Service contracts, and for each existing contract.</td></tr>
</table>

	(a) if the resulting Firm Transportation Service tariff is less than the Contract Tariff (being those charges specified in the Firm Transportation Service Order Form submitted by the User and accepted by the Owners), then the new Firm Transportation Service tariff shall apply. (b) if the resulting Firm Transportation Service tariff exceeds the Contract Tariff, then the Contract Tariff shall apply. II. Where a tariff redetermination results in a discount being offered on the Firm Transportation Service tariff, the discount charge shall apply, as far as is permitted by existing contracts and these Principles, and for each new and existing Firm Transportation Service contract: (a) if the resulting discounted charge is less than the Contract Tariff then the discounted charge shall apply irrespective of whether it represents an increase or a decrease over any discounted charge for the service applicable immediately prior to the redetermination. (b) if the discounted charge exceeds the Contract Tariff then the Contract Tariff shall apply. Tariffs for services other than the Firm Transportation Service shall be reviewed at the time of any Firm Transportation Service tariff redetermination so as to ensure they continue to comply with the Principles.
13.	Subject to compliance with all the Principles (except Principle (2) and (12)), the Owners, at their sole discretion, may set tariffs, or allow tariffs to remain operative, which are equal to or less than those resulting from the application of Principle (2) and such tariffs shall be applied in a manner consistent with provisions I and II of Principle (12).

The following definitions apply to the above Principles.

"Firm Transportation Services" means an agreement between a User and the Owners to reserve Pipeline capacity on an uninterruptible basis.

"Benchmark Tariff" means the tariff applicable to a Firm Transportation Service Contract for the longest contract term not exceeding 20 years offered by the Owners to Third Parties in the Alternate General Terms and Conditions.

"Pipeline" means the Pipeline as defined in the Goldfields Gas Pipeline Agreement Act 1994.

"User" means a person contracting with the Owners to reserve capacity in the Pipeline for the purpose of transporting gas.

"Owners" means the Goldfields Gas Transmission Joint Venturers consisting of Southern Cross Pipelines Australia Pty Limited (ACN 084 521 997), Southern Cross Pipelines (NPL), Australia Pty Ltd (ACN 085 991 948) and Duke Energy WA Power Pty Ltd (ACN 058 070 689).

Terms used in these Principles have the same meaning as they have in the respective service agreements and the Alternate General Terms and Conditions.