Submission to IPART

2004 Access Arrangement Reviews

AGL Gas Networks

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1 INTRODUCTION

Orica is pleased to provide its views to IPART on the 2004 Access Arrangement Reviews on the AGL Gas Networks' distribution system. Orica Mining Services, via its recent acquisition of the Incitec Kooragang Island Plant, has become one of NSW's largest users of Natural Gas.

The 2004 Access Arrangement Reviews - AGLGN has a significant impact on the cost of production for the Kooragang Island Ammonia Plant, and hence its competitiveness. Ammonia produced by this plant competes against imports, which provide raw material supply to downstream fertiliser and industrial chemical production.

To understand the importance of the Gas Access Regime to the Orica Kooragang Island Plant, a brief description of the plant's relationship with Natural Gas is provided.

Opinions expressed in this submission are those of the Mining Services Division of Orica.

2 ORICA AND THE KOORAGANG ISLAND PLANT

2.1 Orica Group of Companies

Orica is a publicly owned Australian chemical company employing around 8,000 staff across approximately 30 countries and with revenue of $AUD4 billion annually.

Orica's operations are divided into four main business areas - Mining Services, Chemicals, Consumer Products and Agricultural Chemicals.

Mining Services

Orica is the world's leading supplier of commercial explosives and blasting technology, and is placed first or second in key Australian, Asian, European, Latin American and North American markets. Customers are offered a complete range of commercial explosive services, ranging from the supply of bulk and packaged explosives to total blasting services.

Chemicals

Orica is a leading supplier of industrial and specialty chemicals in Australia and New Zealand through its Chemicals business. Key products include chlorine and sodium hypochlorite for water treatment, and adhesives and resins for wood panel boards. The Chemnet trading and distribution business covers Australia, New Zealand, Fiji and Papua New Guinea, providing a broad range of chemicals for use in all industries.

Consumer Products

Orica markets an extensive range of consumer products through such well-known trade names as Acratex, Berger, British Paints, Cabot's, Dulux, Feast Watson, Intergrain, Levene, Polyglaze, Rota Cota, Selleys, Yates and Walpamur.

Agricultural Chemicals

Incitec Pivot is owned 70% by Orica Limited and 30% by minority shareholders. Incitec Pivot Limited is a specialist Australian-owned world-class fertiliser manufacturer and supplier serving primary producers across Eastern and Southern Australia.

Orica places great emphasis on safety and care for the environment. Orica manages all of its activities with concern for people and the environment and endeavours to communicate openly about its operations.

The same commitment extends to quality in our products, systems and services. All Orica employees and facilities are committed to the pursuit of excellence, and operate at the highest standards in the markets in which we operate.

2.2 Kooragang Island Plant

The 100% Orica owned Kooragang Island Plant operates within the Orica Mining Services business. The plant is located North of Newcastle in the Hunter Valley of NSW and employs 130 people. The Kooragang plant was formerly part of Incitec Ltd before being merged into the Orica group of companies.

The Kooragang Island Plant consists of three individual plants manufacturing ammonia, nitric acid and ammonium nitrate to meet the needs of Australia's mining and mineral industries. Each plant is a stand-alone manufacturing unit; the major raw materials for each plant are detailed below:

- Natural Gas for the manufacture of Ammonia.
- Ammonia for the manufacture of Nitric Acid.
- Nitric Acid and Ammonia for the manufacture of Ammonium Nitrate.

2.3 Natural Gas at the Kooragang Island Plant

The Ammonia plant at Kooragang Island consumes some 700,000 cubic metres of Natural Gas per day as a raw material feedstock. Alternatively expressed, the plant consumes approximately 10% of the Natural Gas used in NSW and provided the original justification for natural gas being piped to Newcastle in 1982. Natural Gas accounts for over 85% of the Variable Costs of production of the Kooragang Island Ammonia Plant.

A small proportion of Natural Gas consumed at Kooragang Island is used to fire on-site boilers, however, the vast majority of the Natural Gas is used as feedstock in the manufacturing process to produce ammonia. As ammonia is an internationally traded commodity, the Kooragang Island Ammonia Plant must remain competitive with imported foreign manufactured ammonia to ensure ongoing viability. Other producers who have access to delivered natural gas at prices far less than those currently found on the East Coast of Australia dominate the world ammonia market. In many cases government support for these producers exists through subsidisation by way of capital and tax concessions.

Orica is a Self-Contracting User with a requirement for high-pressure gas at a load factor of over 94%. Orica is one, if not the only End User with unbundled Natural Gas supply and transportation arrangements in NSW and is at the end of the longest supply chain for the transmission and distribution of Natural Gas in NSW. Not surprisingly, transportation costs represent a considerable component of the plant's total gas costs. Apart from the need to be low cost, Natural Gas must also satisfy the requirements of pressure and composition technical specifications and uninterrupted supply.

The Orica Kooragang Island Ammonia Plant and its reliance on Natural Gas is unique to the NSW gas market and gas transportation system. The following factors make Kooragang Island a unique Gas User:

- Self-Contracting User consuming approximately 10% of the gas used in NSW.
- User of gas primarily as a feedstock in the manufacturing process and as an energy source.
- Plant operates 24 hours per day every day of the year with a load factor of over 94%.
- The plant is at the end of the longest Natural Gas supply chain in NSW.
- User of high pressure gas directly from the main trunk.

Orica's existing contracts for the supply of Natural Gas to Kooragang Island is due to expire in late 2005. Orica has signed a new contract for the supply of gas to Wilton until 2011 with an option to extend the contract to 2016. Therefore Orica is committed user for AGLGN transport services on a long-term basis from Sydney to Newcastle.

3 Orica's Comments on the AGLGN Proposal

3.1 Contract Customers

3.1.1 The development of the contract market with specific emphasis on the Sydney to Newcastle trunk line is of great interest to Orica. Significant increases in MDQ usage on the trunk line would be in the interest of all Newcastle customers to reduce the actual cost per MDQ. AGLGN have not forecasted any gas usage from numerous proposed new Industries and Gas User in Newcastle and the Hunter Valley.

3.1.2 AGLGN has forecasted no significance increases in the Contract Customer base in terms of MDQ or AQC. The general question regarding the inability of AGLGN to attract new significant contract customers must be addressed by IPART. Is the delivered price of gas too high in NSW compared to other states, Table 4.5 Page 13 of AGLGN submission indicates there are no significant increase in MDQ for the contract market in the proposed Access period.

3.2 Term of the Agreement

3.2.1 The existing Access Arrangement has been extended for 6 months-deferring possible saving for AGLGN customers during the extension of the existing Access Arrangement. How will the customers be compensated for the additional costs incurred because the new Access Arrangement could not be put in operation on its original due date?

3.2.2 AGLGN is asking for the term of the Access Arrangement to be changed from 5 to 5.5 years, They have not provide any justifications for this request. To protect the consumers IPART is requested to investigate the attributes of a 4.5 and 5.5 years Access Period.

3.3 Sydney to Newcastle Trunk

3.3.1 Orica supports the revision of the zoning arrangements on the Sydney to Newcastle Trunk. This arrangement should allow for a more competitive pricing of gas into Newcastle because it removes differential pricing from the Wilton and Horsley Park receipt points.

3.3.2 Further clarification is requested for the terms “Coastal” and “Country” used by AGLGN to define regions as used Table 4.9 NSW Distribution System – Contract Segment Forecast page 15.

3.3.3 AGLGN is requested to provide details of the Capital Expenditure proposed for the Wilton to Newcastle Trunk. During the new Access Period a value of 11.5 million has been proposed compared to an actual of 0.7 million for the current Access Period. Where is this additional capital used and is the proposed expenditure prudent?

3.4 Redundant Capital

3.4.1 In the determination of the Regulatory Capital Base AGLGN have made no allowances for Redundant Capital for the whole AGLGN network. In any large organization you would expect some level of Redundant Capital. Orica request IPART to further investigates the Redundant Capital component of the Regulatory Capital base.

3.4.2 In the Newcastle area there has been significant gas users such as BHP (Newcastle Steel Works) and Pasminco at Cockle Creek terminating their operations. What effect does the shutdown of these large gas users have on the Regulatory Capital Base for the Sydney to Newcastle Trunk line? If there is significant over capacity in the Sydney to Newcastle Trunk Line and this additional capacity is not forecast to be used in the proposed access arrangement, can this capacity be classified as Redundant Capital.

3.5 Capex

3.5.1 The capital expenditure on Metering has significantly increased every year in the current Access Arrangement, the increased costs has been carried over into the proposed Access Arrangement. IPART is requested to investigate in the requirements and prudence of the proposed capital expenditure.

3.5.2 AGLGN Net Working Capital shown in Table 5.19 forecast the working capital increasing every year from 2005 to 2010. Why is the forecast working capital growing at a faster rate compared with the forecast growth in Total Revenue?

3.6 Opex

3.6.1 IPART should continue with the target of minimum 3% efficiency saving for every year of the new Access Arrangement. AGLGN have demonstrate this target was achieved in the current Access Arrangement. Additionally productivity saving opportunities must result from the proposed introduction of replacement key IT functionality at a capital cost of $39 million.

3.6.2 AGLGN have proposed an additional operating cost of 4.3 million dollars in 2004/2005 for so called “Market Operations”, these activities are clearly part to the functions of a gas network operator. IPART is requested to oppose the addition of Market Operation costs in the Opex matrix.

3.6.3 AGLGN proposing a significant increase in Total Opex for the new Access Arrangement compared to the current. IPART is requested to investigate in detail if the proposed additional spend is prudent.

3.6.4 Unaccounted for Gas forms a significant percentage of the annual non capital costs, AGLGN have allocation $1.3 million for the Contract Segment. What is AGLGN allocation for UAG in the Sydney to Newcastle Trunk line and is this cost formulated from “activity based costing”? How is Unaccounted for Gas lost in a main high-pressure distribution line?

3.7 Reference Tariffs

3.7.1 The potential dangers of Asymmetric Risk at detailed in 5.6.2.2 has not been demonstrated in the AGLGN Network to date:

“The risk of asset standing or bypass” should be detailed as a Redundant Asset in the Regulatory Capital Base, AGLGN proposed nil Redundant Asset for the proposed Access arrangement.

“This risk of changes to regulatory policy or practice” IPART have demonstrated a consistent policy in to two previous Access Arrangements.

“The nature of regulation which exposes the investor to significant risk that regulatory returns will not be met, with little likelihood that they could be exceeded” this statement is not true for the AGLGN network, the risk is directly associated with the MDQ and ACQ for the network and these figures can be projected with a very high level of accuracy. Additionally the gas network is a monopoly under a regulated tariff structure its income is guarantee due to the captive customer base.

3.7.2 The AGLGN business is a regulated monopoly with a captive customer base with very accurately projected gas usage, the WACC applicable to this business should be toward the lower end of the feasible range as detailed in Table 5.20 – WACC Estimates Based on Final Decision.

3.7.3 The proposed new service Gas Swap Transaction should increase the flexibility of the network. AGLGN has been able to provide a cost for this new service but I don’t believe they have estimated the volumes and included the income in their revenue projections.