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GAS PIPELINE INFORMATION AND ARBITRATION FRAMEWORK INITIAL NATIONAL GAS RULES

Central Petroleum is generally supportive of the initial National Gas Rules as proposed but believes there is little chance that the proposed drafting for the initial National Gas Rules will achieve the critical pipeline reform which the nation urgently needs.

Central believes there is an unparalleled opportunity for the nation to implement real pipeline reform arising out of the now widely recognised gas supply crisis for energy and manufacturing. This reform would not only benefit domestic gas suppliers and customers but spur a new international service industry if the economic forces, unleashed by this advent of the LNG export industry, can be harnessed by the right pipeline policy settings. Central predicts that within the next 5–10 years the LNG export market will become predominately spot. The price makers for this spot market will be the Gladstone LNG exporters and the US cargoes out of the Gulf of Mexico as both will be able to take advantage of the arbitrage in price between their respective domestic markets and the export alternative. Presently, the Australian domestic market is unresponsive to market signals due to unjustifiably high pipeline transportation costs throughout the domestic market (as confirmed by the recent IEA report) and the capacity constraints in the pipeline system due to unused capacity being contracted but not used (also known as capacity hoarding), which the IEA postulates as being caused by the lack of competition.

Whilst the market will become more “spot” oriented, there still remains an economic imperative for both energy users and new suppliers to have longer term pricing certainty. In an open and competitive market this term price certainty is made possible through the futures market, the participants of which see volatility as their bread and butter, thus providing the needed counterparty against gas price volatility to both the producer and industrial user.

Central believes the market design planning should be fashioned to accommodate this predicted market outcome.

If the appropriate market design is in place, an Australian city would become the natural ‘market-maker’ for this Asian gas trading hub as:

1. it is in a more appropriate time zone than Houston – the other contender; and
2. understanding the pricing arbitrage will require a deep knowledge of the Australian domestic demand profile. With a third of that demand currently being in the electricity sector, its spark spread could become a decisive factor.

The most important contribution to the pricing disadvantage Australian domestic gas suppliers and gas consumers face is the mismatch between the actual residual asset value for existing mature pipelines, which are typically fully repaid over 15 years (consistent with the existing greenfield exemption period) and asset value for pipeline regulation, which is derived through accounting depreciation that is spread over extremely long life assets. Attachment 1 illustrates the impact of this mismatch, which essentially provides the pipeline owner with an asset value almost three times that of a fair market value. This is driven by pipeline owners whom are able to charge customers as if they are rebuilding the entire east coast pipeline network every 15 years without having to actually spend that capital expenditure.

By not specifically recognising this critical flaw in the current pipeline pricing regulations and leaving this flaw unaddressed, the threat of arbitration is rendered nugatory. This threat of arbitration must be seen as credible for the market design to work. This matter of principle and the need for predictability requires that arbitration should not be left to case-by-case arbitration where the obvious outcome is to continue to incorrectly define asset values based on depreciation rather than actual residual values that take into account pipeline capital expenditure, profits and reasonable market rates of return. The details of the implementation of this principle can be left to arbitration augmented by the AER, which is probably best placed to conduct a thorough analysis to determine an appropriate starting asset value for each pipeline.

Central has had the advantage of reading the Energy Users Association of Australia's submission and in all respects supports that submission, including the critical observations on overinflated pipeline asset values currently used to justify excessive reference tariff rates for pipelines.

Yours faithfully



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Managing Director & Chief Executive Officer

Attachment 1 – Impact of Excessive Tariff Rates