Central Petroleum

Central Petroleum Limited

13 April 2017

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Chair
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c/o Australian Energy Market Commission
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Dear Dr Vertigan

As invited, Central Petroleum submits its response to the March 2017 Implementation Options Paper ("Options Paper") which should be read in conjunction with its submission dated 18 October 2016 to the Examination. The preliminary views of the Gas Market Reform Group ("GMRG") as outlined in the Options Paper was somewhat disappointing as they seem intent on preserving to some extent the status quo, extending the time before which any meaningful reforms can become effective and erecting new, or at least maintaining, significant barriers to entry for new gas suppliers through excessive pipeline tariffs.

There appears to be little recognition that new gas suppliers will be critical in mitigating the east coast gas shortage as they are economically attracted to supplying the domestic market (as opposed to the export market), particularly if they wish to avoid the need to hedge the currency and commodity risk inherent in supplying the LNG export market and wish to access debt capital markets to finance new development. If the Australian economy must adapt to the LNG Netback Price it will be at a disadvantage if they must also:

1. pay significantly above international comparatives for transport to the citygate;
2. have less flexibility in the transporting of gas due to incumbent shippers hoarding unutilized capacity; and
3. have less risk management tools available, such as futures contracts and flexible storage which are limited to those incumbents that have pipeline capacity or ownership.

The exclusion of Scheme Pipelines from having access to these reforms does not, on its face, appear to be in the national interest as it causes the low-hanging fruit of new supplies, such as North West Queensland and Northern Territory, to be economically penalized.

Having effectively removed the threat of regulation to temper the impulse for monopolistic pricing, by making arbitration costly, time-consuming and uncertain, the Options Paper tends to try to remove any credible threat of arbitration as well. This is despite the Examination stating there was the need for a more credible threat.

Given that the reforms are to be reviewed two years after the implementation, if there is to be any bias in the reform then it should be towards the urgent need for new gas supplies and gas suppliers rather than its present bias of trying to stimulate new but relatively easily obtainable infrastructure funding that would only become necessary if there were to be new gas supplies.

In summary, therefore, our submission seeks to ensure that the reforms cause:

1. The pricing signal to be transmitted to where it is needed—to stimulate an increase in gas supply;
2. New gas exploration and developments, which can take advantage of mature fully amortised pipelines, to occur; and
3. The advent of a deep and liquid spot gas markets and futures trading.

An international standard pipeline regime based on clear concise cost of service pricing principles with a credible threat of arbitration underpinning it is necessary to address these issues.

Yours sincerely

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Submission in response to the

Gas Pipeline Information Disclosure and Arbitration Framework: Implementation Options Paper

13 April 2017

Overview

The 195 page Gas Pipeline Information Disclosure and Arbitration Framework (the "Options Paper") issued last month was issued in the context of:

1. The ACCC Inquiry into the east coast gas market (the "ACCC Inquiry") finding that:
   a. there was an urgent need for "new gas supplies, and new suppliers"[1];
   b. "there is… evidence that a large number of pipeline operators have been engaging in monopoly pricing"[2]; and
   c. this monopoly pricing is not effectively constrained by the threat of regulation[3].
2. The Examination of the current test for regulation of gas pipeline (the "Examination") found that:
   a. "the total return on the pipeline business was double that of the regulated electricity network operator"[4];
   b. "the recommendations seek to reduce the imbalance in negotiating power, constrain the exercise of market power and encourage downward pressure on gas transportation prices"[5]; and
   c. encouraging investment upstream and downstream[6].
3. There is an investment appetite for infrastructure assets as is evidenced by the recent purchases by QIC of the Moomba to Adelaide Pipeline and the Iona Gas Storage Facility.
4. There is an urgent need to create an appetite for investment in gas production as is evidenced by the 69.5% drop in onshore drilling in the year ended 30 June 2016[7].
5. The Prime Minister declaring the nation faces a "national energy security" crisis.
6. The May 2016 AEMC Recommendations were based on submissions given in an environment in which the ACCC was inquiring whether the industrial customers were right that there was a gas shortage looming, a claim disputed by incumbent producers. That is to say, there was not the recognition that there was an urgent need for new gas supplies and suppliers[8] at the time the AEMC conducted their consultation and analysis.
7. In NSW alone, there are 300,000 people directly[9] employed by 500 companies and 33,000 small businesses[10] in which gas is a prime cost[11]. Nationally there are 965,000 such jobs. 49.8% of the gas consumed in NSW was industrial (including fertiliser, brick and glass manufacturing, i.e. food and shelter) and only 26.9% for power generation.

[1] Sims, R. (ACCC) 'Observations on the east Australian gas market' Keynote Address presented at the Australian Domestic Gas Outlook Conference, Sydney, March 2016
[2] ACCC Inquiry Page 18
[3] Ibid.
[4] Examination Page 10
[5] Ibid. Page 16
[6] Ibid. Page 17
[7] ABS June Quarter 2016 4812.0
[8] Op. cit. Keynote Address, Rod Sims (ACCC)
[9] NSW Gas Plan Common Questions and Answers
[10] NSW Gas Plan
[11] ACCC Inquiry Page 36

It is in this context that two of the four "outcomes sought" of the Options Paper[12] serves to enhance the investments in pipelines where there is already sufficient appetite to invest, and to place further hurdles to the sorely needed investment downstream required to meet the criteria of satisfying the urgent need for new gas supplies and gas suppliers.

It appears that the premise upon which the Options Paper is founded is that the pipeline owners' claim the source of the "imbalance in negotiating power"[13] is information and lack of transparency, rather than lack of physical choice on pathways to market. The Options Paper suggests the information be designed to enable shippers and offtakers "to make an informed decision about whether they should seek access and, if so, to assess the reasonableness of the price offered by the pipeline operator".[14]

In other words, the decision remains the same, but it is a more informed decision about investing in new gas supplies, becoming a new supplier or investing to maintain the 965,000 jobs presently dependent on gas. If the information shows that the gas price signals are not visible, then gas suppliers and gas customers don't make their investment and let the national interest suffer accordingly. The information pays no regard to the final cost of the gas supplied or the national interest in ensuring competitive mechanisms for adequate supply of appropriately priced gas to industrial consumers. The import of which is to bring the economic ramifications to a head as quickly as possible. Shortening the timeframe for the economic impact on the national economy hardly enhances the ability of the nation to adapt to the resultant economic shock created by a restricted gas supply at rapidly escalating prices.

Notwithstanding the urgent need for new gas supplies and gas suppliers, the Options Paper effectively excludes the Northern Territory from becoming a potential new supply of gas for the east coast market. It also excludes the region surrounding Mt Isa from being such a source. The new regime specifically excludes "Scheme Pipelines", which are pipelines covered by the current regulations (either light or full regulation) even though it is precisely this existing regulation that limits competitive pricing. The Mt Isa to Ballera pipeline ("Carpentaria Gas Pipeline" or "CGP") is covered under light regulation and the Alice Springs to Darwin pipeline (the "Amadeus Gas Pipeline" or "AGP") is covered under full regulation. The Carpentaria Gas Pipeline commenced operations in 1999 (and will be nearly 20 years old when the Northern Gas Pipeline (the "NGP") is commissioned) and the Amadeus Gas Pipeline commenced operations in 1987 (some 30 years ago). It costs 50% more to get gas to Ballera by back haul through the AGP and CGP as fully amortised pipelines compared to the tariff to forward haul transport gas through the new NGP with its at risk new capital investment. The tariff construct presently in place for these Scheme Pipelines ensures that it costs 25% more to transport gas to Moomba—the relevant hub to address the domestic (as opposed to export) gas shortage—than the proposed tariff for the Alice Springs to Moomba pipeline option as quoted to Central during the COAG Energy Council ("COAG") endorsed NEGI (North East Gas Interconnect) tender.

The Options Paper appears to be satisfied that the "threat of regulation" is ineffective in addressing the imbalance of negotiating power, but it also strives to ensure the "threat of arbitration" is equally incapable of addressing the imbalance. The Options Paper goes to great lengths to ensure that the arbitration process is costly, time-consuming and with as many impediments (euphemistically called "incentive to negotiate") erected as barriers to arbitration.

Scheme Pipelines (which are being excluded from the binding arbitration framework under the Options Paper) currently have access to an arbitration provision and much is made of the fact that it has never been utilised. Notwithstanding the clearly "excessive returns"[15] of pipeline owners, the current regulatory framework is not utilised because of the barriers to effective use, especially by smaller potential gas suppliers:

[12] Options Paper Executive Summary Page x
[13] Ibid. Page 4
[14] Options Paper Page 24
[15] Examination Page 16

a. rules concerning the economic efficiency are so opaque that the outcome is uncertain or in favour of the pipeline owners; and

b. the “gateways” to arbitration are so strict that it is costly to even get to arbitration.

Central sought legal advice as to whether it was possible to get to arbitration on a Scheme Pipeline from a leading Australian Law Firm and was advised that it was likely to be too costly and difficult for them to be able to recommend commencing arbitration in Central’s circumstances (a copy of this advice is available on a confidential basis). The nett result is that our proved reserves (and likely any uncontracted gas reserves available from the Northern Territory) may remain uneconomic notwithstanding the domestic gas shortage.

The Examination found, “The reforms are not designed to damage the ability of the pipeline industry but rather to limit the excessive returns”[16]. The arbitration mechanisms should aim to minimise “the time costs and uncertainty associated with the regulatory processes”.

The mechanism proposed in the Options Paper ignores the issues of time, cost and uncertainty of their proposed arbitration while giving as its overarching objective to “only have recourse to arbitration mechanism that cannot be resolved by commercial negotiation”. This overarching objective is to ensure that the excessive returns are not limited by:

i. the threat of regulations; nor

ii. the threat of arbitration.

As the ACCC Inquiry noted for scheme pipelines, “The threat of arbitration under the NGL in these cases appears to be having little influence on the behaviour of these pipelines, with some shippers informing the Inquiry that the costs and resources associated with an access dispute, coupled with the uncertainty surrounding how the AER would approach certain issues and the final outcome, discourage shippers from triggering these provisions”[17].

Time is the enemy of the new supplier or the incumbent offtaker who is having difficulty in obtaining gas supplies from 2019 onwards. It is the friend of those who benefit from the existing transportation arrangement, particularly if the pipeline user needs to contract now. If one does need to contract it will be excluded from the benefits of the new pricing principles. It is obviously in the economic interests of the present incumbents for there to be delays in the reform process being implemented and, following that, delays in the negotiation of the transportation services (and possibly causing it to go to arbitration) and delays in advising an outcome from the arbitration.

Whilst these delays will have little impact on pipeline tariffs for LNG exports, it will inhibit new production and accelerate demand destruction amongst domestic manufacturers and industry.

The Option Paper should return to the underlying simple philosophy of the COAG endorsed Examination, including that “It is not appropriate that access to dispute resolution be predicated on whether or not the pipeline is covered”[18].

The most relevant and important point is the clarity of the pricing principles. The clearer the guidelines the less likely arbitration will be called upon because the parties will be able to calculate the likely arbitration outcome and alter their negotiating stances accordingly. Central supports the “cost of service plus a reasonable return” model and this depends “upon how the starting asset values are determined”. Central supports the AER being asked to determine the appropriate starting asset value in advance.

[16] Examination Page 16
[17] ACCC Inquiry Page 101
[18] Examination Recommendation 2 Page 14

If the pricing principles are clear and starting asset values are determined in advance First Offer Arbitration ("FOA") mechanism for the arbitration should be preferred. The FOA mechanism will only need to determine which of the two offers are more closely aligned to the pricing principles.

Central favours selecting a date immediately after which contracts can access the new pricing principles. This should overcome the economic disincentive to introduce new supply until after the New Rules are in place. The nation urgently needs new supplies now to ensure manufacturers can contract beyond 2018.

The central tenet of the Options Paper on pricing principles for derivative and ancillary services appears to be that they remain with the pipeline owner because without that monopoly the service would not exist. This ignores the current reality which is the monopoly position of pipelines is creating market distortion (a clear example of this is pricing for back haul services which fail to recognise that back haul relieves pipeline constraints and reduces operating costs[19]). Central believes there is no reason why windfall profits should accrue to the pipeline owner unabated, particularly when there is a national interest in mitigating the impacts of the domestic gas shortage.

The nation, as a whole, is going to have to accept international pricing ("LNG Netback Pricing") for its gas inputs, but it should not be burdened with pipeline transportation costs that are dramatically higher than international comparatives.

Submission Summary

On 14 December 2016, COAG endorsed the recommendations of the Examination. The Examination concluded that:

"… gas pipelines have natural monopoly characteristics creating a high barrier to entry for prospective competitors. This lack of competitive constraint on most existing pipelines translates into market power".[20]

In order to address this problem, the Examination made the following critical recommendation:

That a framework for binding arbitration, available to all open access pipelines in the event the parties are unable to reach commercial agreement, be introduced into the National Gas Law ("NGL").

There were additional recommendations relating to enhanced disclosure and transparency, maintaining the current pipeline coverage test, and tasking the Gas Market Reform Group ("GMRG") with developing a detailed design. These recommendations appear to support the critical recommendation of binding arbitration in order to address the market power of pipelines in setting tariffs.

Central was very supportive of these recommendations as they appear to set the stage for real economic reform in pipeline tariff pricing which we believe is the only solution to rectify a glaring inefficiency in the domestic gas market.

Based on our review of the Options Paper, however, it appears that the sound conclusions and recommendations that arose initially from ACCC Inquiry and then progressed through the Examination are at risk of being fundamentally sidelined. If this is the case, COAG will have missed a unique opportunity to correct the major roadblock to an efficient domestic gas market. This is clearly not consistent with the National Gas Objective ("NGO") which is to "promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

[19] Options Paper Page 134
[20] Examination Page 9

1 GMRG Overarching Objective

It appears to Central that the GMRG has simply misinterpreted the conclusions and key objective of the Examination. This is immediately evident in their statement of "Overarching Objectives" which reads as follows:

"To facilitate timely and effective commercial negotiations between shippers and the operators of non-scheme pipelines by: reducing the imbalance in bargaining power that shippers can face; and pose a constraint on the exercise of market power by pipeline operators."

By establishing the objective to simply facilitate commercial negotiations, the GMRG is failing to address the real source of market power for pipeline owners which is that they operate as natural monopolies. To be clear, enhanced information disclosure and transparency without effective pricing principles to constrain pipeline tariffs, will do nothing but preserve the "status quo" and maintain the fundamental pricing power currently enjoyed by pipeline owners.

As highlighted in Central's submission to the Examination dated 18 October 2016, the dominant pipeline owner has recently reported a compounded annual shareholder return of over 19% since 2000. This is from what they themselves describe as "low risk" infrastructure assets. The monopolistic pricing power of pipeline owners needs to be urgently addressed so that price signals in the gas market are visible to suppliers and customers. Failure to directly address pipeline tariff pricing will result in an underinvestment in gas exploration and unnecessary demand destruction from customers due to higher gas costs causing a contraction in Australia's manufacturing base and consequent job losses. This is clearly not consistent with the NGO or international "best practice" for gas transmission pipelines.

The GMRG's "Overarching Objective" therefore should focus specifically and deliberately on establishing a clear set of pricing principles within a binding arbitration framework in order to constrain tariffs to actual costs and commercial rates of return that resemble a "competitive" market. The threat of arbitration must be considered real, not nugatory, and time consuming.

2 Pricing Principles

The GMRG has indicated Option 2b as their preferred pricing principle for binding arbitration. Option 2b is based on the actual cost of service, however, it is then supplemented by a broad spectrum of "other" pricing principles, many of which are vague and serve to protect the existing market power of pipeline owners. Central supports pricing principles that are fair for all parties consistent with a "competitive" market landscape. The often conflicting list of "other" pricing principles and requiring each individual arbitrator to determine how to carry out the assessment, however, will make the outcome of any arbitration highly uncertain and will ultimately be ineffective in achieving real economic reform of monopolistic pricing power is the genesis of these to "excessive returns".

The pricing principles outlined under Option 3b provide the only real pathway for binding arbitration to be both efficient for the parties involved and effective in actually constraining the monopolistic pricing power of pipeline owners. The pricing principle options, however, fail to adequately highlight the following two pipeline pricing practices that result in pipeline owners achieving clearly excessive returns from these low risk natural monopoly assets:

a. Pipelines are almost always fully underwritten by gas suppliers and/or gas customers through foundation contracts. These foundation contracts ensure that a pipeline investment achieves a commercial rate of return and the investment is recovered within the foundation contract term (typically 15 years). Pipeline owners, however, are currently free to continue this initial tariff regime through the pipeline's economic life of 40–60 years which has the effect of increasing the entry rate of return for the pipeline owner by over 50%. Given the majority of pipelines on the east coast are mature (>15 years old), continuation of the foundation tariff regime in perpetuity allows for excessive risk-adjusted rates of return for pipeline owners to the detriment of an efficient domestic gas market.

b. In addition to the foundation contract revenue, pipeline owners are unconstrained in pricing and generating additional revenue through ancillary services (e.g. backhaul, as available). These ancillary services are currently priced at what the market can bear, with additional revenue providing a windfall to pipeline owners over the asset's life with no material risk or additional investment required.

The above current pricing practices would not be available within a competitive market and are clearly the source of the excessive returns identified in both the ACCC Inquiry and the Examination.

It is therefore imperative that the pricing principles determine in advance the current capital base or residual investment (if any) for each pipeline as a cornerstone in calculating cost-of-service. This must be undertaking up-front for each pipeline by an independent party (i.e. the AER) with the resources and mandate to identify initial and subsequent pipeline capital investment, historical operating profits and appropriate risk-adjusted rates of returns since commissioning of the asset. This is essential for an arbitrator to effectively apply a set of cost-of-service pricing principles and for potential parties considering an arbitration process to have any clarity on potential arbitration outcomes.

If the pricing principles do not have an independent party like the AER determine in advance the current capital base or residual investment for each pipeline as a starting point for cost-of-service pricing, the arbitration framework will fail in achieving the economic reform in the pipeline sector that is critical to advancing the NGO.

3 Scheme Pipeline Exemption

The recommendation of the Examination makes clear that binding arbitration should be "accessible to all open access pipelines". This is consistent with the Examination's conclusion that the existing regulation for covered pipelines is inadequate and that most existing pipelines (including covered pipelines) had market power. Restricting access to the binding arbitration framework to only non-scheme pipelines fails to recognise the lack of economic regulation that exists for covered pipelines. If this weren't the case, changing the coverage test would have clearly been a preferred alternative.

Notably, the Amadeus Gas Pipeline and the Carpentaria Gas Pipeline (both covered pipelines) would not have access to the binding arbitration framework under consideration. These two pipelines form the only pathway for Northern Territory (NT) gas supply to reach the east coast market. Continuation of the existing regulation regime for these pipelines would allow the excessive tariffs currently charged to continue to constrain a potentially major new source of gas supply for the east coast market.

It should be noted that 18 months after the announcement of the NGP, the only gas contracted into the east coast is the foundation contract which, even then, is sold in the Mt Isa area (rather than the east coast demand centres). This is notwithstanding the significant uncontracted conventional on-shore and off-shore gas reserves that are currently available for sale from NT gas suppliers, including Central, PWC and ENI. It is clear to us that sterilisation of existing NT gas supplies into the east coast (not to mention reduced gas exploration) will continue if scheme pipelines like the AGP and the CGP do not have access to an effective binding arbitration framework that effectively constrains tariffs to actual costs and commercial rates of return that resemble a "competitive" market.

We also note that Section 8–12 of the National Gas Rules may be subject to review in the near future. Whilst this in theory could address the market power of pipeline owners by establishing proper pricing principles within the existing regulatory framework, we understand that the timing and instruction for this review will not likely deliver effective economic reform and therefore suggest that scheme pipelines (or at a minimum lightly regulated pipelines like CGP) be granted access to the arbitration framework (or at a minimum the pricing principles) along with non-scheme pipelines.

4 Concurrent Policy Reviews

Central is aware of several concurrent pipeline policy reviews currently underway. Notably, the AEMC Pipeline Framework Review, amendments to the National Gas Law and an upcoming review of parts 8–12 of the National Gas Rules.

These concurrent policy reviews, whilst generally trying to advance the NGO, were initiated before (and therefore did not have the benefit of) the ACCC Inquiry and the Examination, both of which had unprecedented access to market information. As a result, the concurrent policy reviews do not identify, or seek to specifically address, the market power of pipeline owners in setting tariffs which was highlighted as a problem within both the ACCC Inquiry and the Examination. Central urges COAG, the AEMC and the GMRG to reconsider the concurrent policy activities currently underway to ensure that they are consistent with (and supportive to) the key objectives and economic reform proposed by the Examination.

5 Arbitration Mechanism

The GMRG's preliminary view is for the Conventional Arbitration (Option 3) mechanism. On the basis that the pricing principles are structured effectively (see item 2), Central believes Option 4 (FOA) would allow for more constructive commercial negotiations and ultimately rely on an arbitration process less frequently. This is important for smaller gas shippers, like Central, who may not have the same resources or financial capacity as pipeline owners and therefore have less appetite rely on arbitration. As noted on page 101 of the ACCC Inquiry, "The threat of arbitration under the NGL in these cases appears to be having little influence on the behaviour of these pipelines, with some shippers informing the Inquiry that the costs and resources associated with an access dispute, coupled with the uncertainty surrounding how the AER would approach certain issues and the final outcome, discourage shippers from triggering these provisions". FOAs used in the oil and gas sector where an exiting party must offer to sell its interest first at "market price" to the remaining joint ventures yield an effective mechanism for resolving disputes on market price.

Under no circumstances should an arbitration result force a shipper into an uneconomic contract, either through the arbitration resulting in a tariff that is greater than that sought by the shipper or as a result of a change in market or customer demand during the arbitration process.

6 Enhanced Information Disclosure and Transparency

Central is generally supportive of the GMRG's preliminary views for enhanced information disclosure and transparency. It is, however, important to highlight that whilst these specific initiatives may be supportive, they do nothing to actually fix the fundamental problem of monopolistic pricing by pipelines. It is critical that the pricing principles for arbitration (see Section 2) be developed correctly first, with arbitration processes and procedures (such as information disclosure and transparency) then being developed in support.

Questions

Without knowledge of the pricing principles and whether they are underpinned by a credible threat of arbitration, it is impossible to determine to what extent and detail information needs to be disclosed.

Central does not wish to see scheme and non-scheme pipelines subject to different economic pricing principles. There is some case to be made for exemptions for dedicated single user pipelines.