NORTHERN TERRITORY OF AUSTRALIA

Submission to the Australian Competition and Consumer Commission ("ACCC")

Draft Decision - Access Arrangement for the Amadeus Basin to Darwin Gas Pipeline ("the Pipeline")

4 October 2001

Non-confidential version

A. Executive Summary

1. This submission is made by the Government of the Northern Territory in its capacity as:-

   (a) the owner of the Power and Water Authority ("PAWA"); and

   (b) the instigator of the project giving rise to the construction of the Pipeline and the guarantor of NT Gas' obligations to the Pipeline's financiers.

2. In June 1985 PAWA (then NTEC) entered into a long term agreement with NT Gas for the transportation of Amadeus Basin gas through the Pipeline. The haulage charge payable under that long term gas transportation agreement is the best evidence of the ex ante efficient cost of pipeline construction. The circumstances giving rise to the project support this. The project was commenced with a number of parties involved in development of the Pipeline.[1] Over time the number of participants was reduced to the 3 parties who formed NT Gas because of the limited returns available on and perceived large risks of the project. The factual circumstances surrounding the decision to invest in the Pipeline demonstrate the actual risk involved as reasonably assessed by the potential investors. The ACCC's draft decision does not pay adequate regard to the risks which faced those who accepted the risk in the Pipeline at the time of construction.

3. In reaching its draft decision, the ACCC has failed to pay adequate regard to certain matters which are prescribed under the National Third Party Access Code for Natural Gas Pipeline Systems ("the Gas Code") specifically matters prescribed under clauses 2 and 8 of the Gas Code.

4. Under clause 2.24 of the Gas Code, in assessing an Access Arrangement, the ACCC is required to take into account, amongst other things:

   (a) firm and binding contractual obligations with the service provider or other persons (or both) already using the covered pipeline;

   (b) the economically efficient operation of the covered pipeline; and

   (c) the public interest, including the public interest in having competition in markets (whether or not in Australia).

5. Under clause 8.1 of the Gas Code, a reference tariff and reference tariff policy should be designed with the view to achieving the following objectives:

   (a) providing the service provider with the opportunity to earn a stream of revenue that recovers the efficient cost of delivering the reference service over the expected life of the assets used in delivering the service;

   (b) replicating the outcome of a competitive market;

   (c) ensuring the safe and reliable operation of the pipeline;

   (d) not distorting investment decisions in pipeline transportation systems or in upstream and downstream industries;

   (e) efficiency in the level and structure of the reference tariff; and

   (f) providing an incentive to the service provider to reduce costs and to develop the market for reference and other services.

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[1] This is evidenced by Attachment 1 at pages 3-4 and 14.

6. Under clause 8.10, the following factors should be considered by the ACCC in establishing the initial capital base:

(a) the basis on which tariffs have been (or appear to have been) set in the past, the economic depreciation of the covered pipeline, and the historical returns to the service provider from the covered pipeline; and

(b) the reasonable expectations of persons under the regulatory regime that applied to the pipeline prior to the commencement of the Code.

7. There can be no better evidence of the reasonable returns and costs incurred than the haulage charges under the foundation contract arrangements. For the reasons detailed in this submission, the ACCC has failed to pay proper and adequate regard to the terms of this agreement and the circumstances leading to the construction of the Pipeline.

8. It is the Territory Government's submission that, having regard to the matters set out in this submission and the provisions of the Gas Code, the ACCC should set a Reference Tariff no lower than PAWA's average cost of transportation.

B. Background

9. The Pipeline was constructed in 1985 and 1986, and started operating in late 1986. The Pipeline was constructed as part of the implementation of a decision by the Territory Government to utilise the Territory's indigenous gas for the purposes of public electricity supply. The background to this decision is set out below.[2]

10. In 1984, the Territory Government had decided to construct a new coal fired power station at Channel Island to service the electricity requirements of the Darwin area ("the coal project"). The Territory has no coal reserves available, so coal would need to be shipped from interstate in order to develop the coal project.

11. Following representations from the petroleum lease holders of the then underdeveloped Amadeus Basin gas fields (Palm Valley and Mereenie), the Territory Government investigated the feasibility of developing the Amadeus Basin gas fields as the primary fuel for the Territory's electricity needs ("the gas project"). This proposal had the added benefit of enabling the supply of gas generated electricity to the Territory's regional centres such as Tennant Creek and Katherine along the route of the haulage pipeline.

12. The gas project comprised 3 separate parts:-

(a) gas field - development of the Amadeus Basin gas fields;

(b) pipeline - construction and financing of the Pipeline; and

(c) electricity generation facilities - the construction of gas fired electricity generating plant at Channel Island, Katherine and Tennant Creek.

13. In late 1984, the Territory Government considered the relative merits of the coal and gas projects and the possible structures of any gas project. At the same time, the Amadeus Basin producers undertook further reserves investigations.

14. In deciding on a preferred approach the Territory Government took into account the following factors:-

(a) the gas project would have a significant present value advantage relative to the coal

[2] See also Attachment 1.

project;

(b) private ownership of the Pipeline provided advantages to the Territory;

(c) relative to the coal project, the gas project would allow for lower electricity charges to consumers, or lower operating subsidies from the Commonwealth, over the long term;

(d) of the risks considered, reduced electricity demand had the greatest scope to erode the present value advantage of the gas project over the coal project; and

(e) based upon a "downside analysis" of available Amadeus Basin gas reserves:-

(i) the Territory Government was unlikely to be placed in a materially inferior financial position by proceeding with the natural gas project; however

(ii) the potential benefits of the gas project were to be significant, but depended heavily on the ongoing availability of gas at prices being negotiated at the time.

15. An important part of the Territory Government's decision to proceed with either the gas or the coal project was a consideration of the allocation of gas project costs and benefits. The following factors were relevant to that consideration:

(a) Regardless of any segmentation of ownership which may exist, all components of the gas project (i.e. field, pipeline and electricity generation plant) were important.

(b) It was highly unlikely that the private sector portions of the gas project would be financeable without either:-

(i) the provision of support by the Territory Government to project participants (by way of take or pay obligations, guarantee of debt or otherwise); or

(ii) very strong credit support in the form of corporate guarantees by private participants (which those participants were unable or unwilling to provide).

(c) The suitability to the Territory Government of any distribution of benefits among participants should be measured by the following criteria:-

(i) direct economic benefit to the Northern Territory, compared with the next best option, the coal project;

(ii) provision of enough benefit to other participants to allow financing of the various components and provide sufficient incentive over the project life so as not to jeopardise ongoing operation; and

(iii) provision of enough benefit to private participants to encourage further economic development by the private sector in the Northern Territory.

(d) Private field and pipeline development resulted in an allocation of risk and return between the field operators, PAWA and the Territory, the Pipeline operators and the Commonwealth.

16. An important part of the Territory Government's decision to opt for either the gas or coal project was whether the Commonwealth would agree to transfer the capital and operational assistance grants which it had previously agreed to make available to the Territory for the coal project to the gas project. By letter dated 14 May 1985 from the then Prime Minister to the then Chief

Minister of the Northern Territory, the Commonwealth confirmed that it would transfer the capital expenditure grant, and would provide an operational assistance grant to the Territory Government for the financial years 1985/96 to 1988/89 for the gas project.

17. The letter went on to state that, after 1988/89, it expected the Territory's electricity supply system to be financially autonomous, and therefore that no further operating grants would be made, and that:-

> *"I believe this to be an equitable arrangement given the substantial benefits which the Northern Territory expect to realise from the gas project."*

18. In late 1984, the Territory Government decided to proceed with the gas project, based upon a 3 part model, which comprised:-

(a) private Amadeus Basin gas field development;

(b) private ownership of the transmission pipeline; and

(c) public ownership of the gas fired electricity generation plant.

19. The haulage charge paid by PAWA for the transportation of gas through the Pipeline pursuant to these arrangements can be best described as a postage stamp tariff.

20. It is abundantly clear that the Territory Government's decision to proceed with the gas project over the coal project, and the implementation of that decision was a prudent decision taken at the time based upon the facts available to relevant parties at the time and was in the public interest in that it:-

(a) developed the Territory's indigenous gas reserves;

(b) created a Northern Territory gas market;

(c) led to greatly enhanced competition in the Territory energy market;

(d) resulted in the reduction in and subsequent cessation of electricity subsidies by grant from the Commonwealth to the Territory;

(e) led to royalties and substantial income tax receipts by the Territory and Commonwealth governments respectively, through the involvement of the private sector in the project;

(f) reduced the cost of electricity for Northern Territory consumers;

(g) provided substantial Territory based employment and industry opportunities; and

(h) allowed new projects, such as the McArthur River, Cosmo Howley and Woodcutters mines to be developed.

Absent the long term agreement between NT Gas and PAWA and the Territory Government's support, development of the Pipeline would not have occurred.

C. Submission

21. As at 1985/86, the Northern Territory needed to replace and upgrade its primary generating facilities in Darwin, which resulted in the Territory having an option to replace its source of primary energy for conversion to electricity. Two potential sources were identified: namely coal and gas. The Northern Territory Government evaluated the comparative costs and benefits of each option. That assessment indicated significant benefits arising from the gas option. Those benefits included lower cost structures and therefore reduced Commonwealth subsidies and

lower electricity prices for Northern Territory consumers. Given the state of the energy markets in the Territory in the early 1980s, the construction of the Pipeline, in and of itself, was going to increase competition in the energy market in the Northern Territory.

22. In the circumstances outlined above, it is rational to expect that the tariff for foundation customers, namely PAWA, was a cost reflective price taking into account *ex ante* assessment of the likely risk.

23. Therefore having regard to the history of the development of the Pipeline and, in particular, the Territory Government (and PAWA) having effectively created the Territory gas market, by proceeding with the gas project and providing the required security for the Pipeline and gas fields to be developed, the average cost of transport which PAWA (a statutory authority of the Territory) is obliged to pay under the long term gas transport agreement is the best evidence of cost reflective pricing of the transportation service on an *ex ante* basis. Put another way, the total revenues to be generated by NT Gas over the life of the contract are a reflection of the cost of the Pipeline over the life of the contract.

24. The effect of imposing the Reference Tariff proposed in the ACCC's draft decision is to allow third party users, who have not taken any risk in the project, to have gas transported through the Pipeline at a tariff substantially less than that which the instigator and foundation customer, the Territory Government/PAWA, is obliged to pay. In the face of evidence from the relevant investors that construction would not have occurred without the long term agreement and support and the evidence, accepted by the ACCC, that the contracted volumes represent all available firm capacity, the ACCC's approach to determining cost of service is inappropriate and inconsistent with provisions of the Gas Code in this instance.

25. When the ACCC's proposed reference tariff is adjusted for the purposes of comparison with PAWA's cost of transportation, reflecting PAWA's load factor, PAWA's cost of transportation is higher than the haulage charge payable by a third party user under the access arrangement.

26. Under clause 8.1 of the Gas Code, a reference tariff and reference tariff policy should be designed with the view to achieving the following objectives:

    (a) providing the service provider with the opportunity to earn a stream of revenue that recovers the efficient cost of delivering the reference service over the expected life of the assets used in delivering the service;

    (b) replicating the outcome of a competitive market;

    (c) ensuring the safe and reliable operation of the pipeline;

    (d) not distorting investment decisions in pipeline transportation systems or in upstream and downstream industries;

    (e) efficiency in the level and structure of the reference tariff; and

    (f) providing an incentive to the service provider to reduce costs and to develop the market for reference and other services.

27. The introduction of the proposed reference tariff, which is materially lower than the foundation customer arrangements, operates contrary to the objectives set out in clause 8.1. Specifically, the principles set out in clause 8.1(a) require an ex ante assessment of the stream of revenue to cover efficient costs. It is not appropriate to carry out that assessment on an ex post basis. As is recognised in the ACCC's draft decision, there are real questions about the extent of the utilisation of the Pipeline for forward haulage beyond the term of the long term agreement which ends in 2011. In these circumstances, the starting point for the ACCC's assessment of the recovery of efficient costs should be the price under the foundation contract.

28. In addition, a tariff structure which sets the reference tariff below the foundation customer

contract provides no incentive for similar long term agreements to be entered into by foundation customers and therefore has significant prospect of deterring, or at least delaying investment in required pipelines.

29. The long term agreement between NT Gas and PAWA and the Territory Government's support of the gas project were both essential to the construction of the Pipeline. The Pipeline has had a material impact on the availability of gas supply and therefore the scope for competition in the energy market.

30. The imposition by the ACCC of a Reference Tariff for the Pipeline which is lower than the effective tariff paid by the foundation customer, PAWA, is patently not in the public interest because:-

(a) it undermines commercial arm's length transactions entered into many years ago;

(b) it undermines the ability of government to most efficiently address the needs of the community;

(c) it, with the benefit of hindsight, ignores the commercial risks taken by the parties in 1985, which, of necessity, were built into the commercial arrangements entered into at that time;

(d) it undermines the confidence of participants proposing to undertake greenfields projects;

(e) it has the potential to leave PAWA's assets stranded and lead to the write off of a substantial portion of PAWA's capital; and

(f) it represents intervention by a Commonwealth statutory authority in commercial arrangements where that intervention could not have been contemplated or foreseen at the time those arrangements were entered into and therefore amounts to a form of sovereign risk.

31. It is clear that the Territory Government's decision to proceed with the gas project was taken having regard to legitimate considerations and to the considerable benefits which would accrue to the public as a result.

32. Those benefits were considered to be substantial, and to outweigh the potential risks as known at the time. The major public benefits which have accrued as a result of the Territory's decision are substantial and include:-

(a) lower cost electricity for Territory consumers;

(b) the creation of a Territory gas market;

(c) greatly enhanced competition in the Territory energy market;

(d) the development of the Territory's indigenous gas resources;

(e) the use of those resources to generate electricity for public consumption;

(f) the reduction and then elimination of Commonwealth grants to the Territory for electricity;

(g) maximum private sector involvement in the development of industries required for gas supply and the generation of electricity;

(h) consequent substantial Territory based employment and industry opportunities in all 3 elements of the gas project;

(i) the development of new projects such as the McArthur River, Cosmo Howley and Woodcutters mines; and

(j) the receipt of royalties and substantial income tax by the Territory and Commonwealth governments respectively from the gas project participants and related developments.

33. The benefits the Territory Government expected to flow from the gas project were also articulated in a booklet in relation to the Pipeline published in November 1984 by the Northern Territory Government.[3]

34. The arrangements entered into by the Territory Government and other parties to implement the gas project represented a deal which was cost reflective, appropriately allocating the risks and rewards of the project and minimising the potential for project failure. The Prime Minister's letter of 14 May 1985 also amounts to implicit approval of the gas project.

35. It is the Territory Government's submission that the consequence of the Draft Decision is, with the benefit of hindsight, to deny the risks inherent in the gas project. That is to say, in 1985 the parties were confronted with an opportunity which had identifiable risks and they allocated those risks as between the parties. Having allocated the risks the parties agreed an arms length tariff structure which reflected the risks to the parties. Once the decisions are made to proceed with the investment, ex post events do not change those risks.

36. The ACCC’s draft ruling, by setting third party tariffs below the PAWA effective tariff, is appropriating the value of successful risk taking to third parties. It is an effective refinancing of the project with hindsight, but the parties who took all the project risk do not share in the benefit. If this risk was contemplated in 1985, then the risk/return criteria applied to the decision would have required a higher return up front to accommodate the lower return in later project years.

37. The Draft Decision will clearly distort investment in such projects in the future by requiring that the benefits from risk are crystallised prior to the first regulatory review and the costs of risk deferred. Such an outcome is distorted from the scenario one would find in a workably competitive market and is in conflict with the object and letter of the Gas Code. It cannot have been the intended that the administration of the Gas Code would result in the overturning of commercial arm's length arrangements based upon professional advice.

38. In the Territory Government's submission, the difference arises, not because the arrangements the Territory Government and PAWA entered into in 1985 were uncommercial, but rather because of the prescriptive and mechanistic manner in which the ACCC has chosen to interpret and apply the Gas Code on an ex post basis.

39. Equally, the Territory Government took and implemented its decision to proceed with the gas project having regard to and taking on the then known and foreseeable risks of less than foreseen electricity demand and sufficient gas reserves being available. The Draft Decision passes the commercial risk attaching to third party users of the Pipeline to the Northern Territory Government.

40. The Reference Tariff proposed by the ACCC also has the effect of undermining the ability of government to efficiently address the needs of the community. In late 1984, the Territory required upgraded electricity generation facilities. The Territory Government was faced with 2 options, and it took the option open to it which offered the best outcome at the time, which maximised the public benefit, and which most appropriately addressed the needs of the community.

41. The imposition of the Reference Tariff proposed by the ACCC sends a message that, had the

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[3] See Attachment 1 at pages 4 - 7.

Territory Government been faced with its decision now, under the current regulatory regime, it may have been forced to take up the coal project in order to mitigate an unacceptable level of sovereign risk.

42. It is also worth noting that, if in 1984, the diesel excise rebate had been available to PAWA (as it is to mining companies generating electricity), the Northern Territory Government would probably have chosen a third option, liquid firing of its electricity generation facilities. Similarly, had the ACCC's draft decision been foreseen in 1984, the balance is likely to have swung in favour of the coal project over the gas project. Commonwealth government policies in place from time to time have had the effect of distorting the market and consequently altering the decision making environment of project participants. In the circumstances, the profile of the risk which arises from the ACCC's Draft Decision is far in excess of that which was contemplated and decisions of this nature and kind will significantly alter the way in which projects of this kind are evaluated by the Territory Government and others. A pipeline would not have been sustainable had the tariff proposed by the ACCC been contemplated in 1984 to be the likely level of imposed tariff.

43. The Draft Decision outcome is patently not in the public interest. As stated above, the Territory Government's decision to proceed with the gas project has resulted in substantial public benefits, the bulk of which would not have been realised had the Territory Government decided to generate the Territory's electricity with any other fuel. By implementing that decision, the Territory Government greatly enhanced the Territory's energy market. In determining an appropriate access arrangement, and an appropriate Reference Tariff to be imposed, the ACCC must take those matters into account including replicating competitive market outcomes and the public interest.

44. It is the Territory Government's submission that the ACCC's proposed Reference Tariff will also have the effect of discouraging future investment in essential infrastructure. The ACCC's final decision, and the Reference Tariff imposed under it, must ensure that the risks built into commercial arrangements at the time they were committed to are not discounted with the benefit of hindsight, and that sufficient and appropriate incentives are maintained for future investment in infrastructure. The imposition of a Reference Tariff which has insufficient regard for the Territory Government's role in creating the relevant market, and effectively penalises the Territory Government for doing so, must have the effect of discouraging future investment in infrastructure. It also encourages risk averse decision marking by potential project participants, reducing the scope for the use of relevant infrastructure by third parties and therefore for competition to develop.

45. As is stated by the Australian Pipeline Industry Association in its submission to the Productivity Commission:-[4]

> *"The current regulatory regime (e.g. gas and electricity codes) has focused on establishing the minimum prices for access to existing infrastructure, not on whether appropriate incentives are in place for future infrastructure development.*
>
> *Future infrastructure investment brings the benefits of infrastructure services to a larger number of citizens (particularly regional Australia), enhances competition between substitutes (e.g. gas pipelines , increase inter-fuel competition) and enhances competition in upstream and downstream markets."*

46. The ACCC's proposed Reference Tariff, if implemented, will have the effect of discouraging future infrastructure investment, regardless of whether the Pipeline is fully utilised or not.

47. Having regard to the structure of the haulage charge PAWA pays to NT Gas for the use of the

[4] APIA response to the Issues Paper released by the Productivity Commission in relation to the review of Part IIIA of the TPA and Chapter 6 of the CPA, 22 December 2000, at page 4.

Pipeline, the diminishing quantity of gas which will be hauled for PAWA through the Pipeline will incur a corresponding increased haulage charge. The cost of generation of electricity in the Territory using Amadeus Basin gas will increase.

48. As part of the NCC's certification of the Territory's electricity third party access regime, the Territory Government has recently implemented zero electricity contestability levels to take effect from 2005, subject to a public benefit review to be carried out in 2002. If the ACCC imposes a Reference Tariff for pipeline services which is lower than PAWA's average cost of transportation, the public interest will most certainly have to have regard to the effect that zero contestability levels will have on PAWA's ability to compete in markets and therefore the potential for stranding of PAWA's generation assets.

49. In the Territory's submission, the ACCC must have regard to the fact that the Territory electricity consumers and Territory taxpayers will bear the cost of the stranding of PAWA's assets.

50. The Gas Code provides considerable scope for the ACCC to have regard to the public interest considerations discussed in this submission when considering whether to approve an access arrangement, and in setting an appropriate Reference Tariff. The relevant sections of the Gas Code are already set out above.

51. The structure of the arrangements which lead to the construction of the Pipeline and the circumstances which led to a significant reduction in the number of participants remaining in the consortium at construction phase reflect the very real difficulties which arise in assessing the risks involved in infrastructure projects. There is no dispute that without the support of the Territory Government the Pipeline would not have been constructed. PAWA's payment obligations were based on a cost recovery model.[5] It is often difficult to find as clear an instance of contemporaneous transactions. In the present case, such a contemporaneous arms length transaction exists. That should, at the very least, provide the starting point for an assessment of the appropriate tariff. If that is to be departed from in setting the tariff, specific evidence and reasons should be provided as to why it is not appropriate. In the present case, it is not apparent that the ACCC has paid any proper regard to the haulage charges set under the long term agreement.

52. If the Draft Determination holds, it undermines the incentives on gas users to enter into foundation shipper arrangements. Why would a gas user do so if there is a material risk that the regulated tariff, post construction, will be less than the haulage charge under the foundation shipper arrangements? If it did so, it would be potentially disadvantaging its commercial position compared with that of its competitors. The effect of such a decision making environment is that it makes investment decisions significantly more high risk because it undermines the capacity of a foundation shipper to accept additional risk in the arrangements, resulting in a reduction in value over time of accepting such a risk. The minimum effect of such an environment will be to delay the investment but, in the opinion of the Territory Government, it more likely that investment will simply not occur. That leads overall to a less rather than a more competitive environment for all concerned and does not operate to promote efficient investment in or the efficient use of infrastructure.

[5] See Attachment 2.

Attachment 1 - Pipeline Booklet, Northern Territory Government, November 1984

Attachment 2 - Convergence of Cost of Service Charges and the PAWA payment structure

In a typical project there may be no direct connection between the haulage charge applicable to a foundation shipper, and the haulage charge applicable to a third party. The payments made by foundation shippers are determined by the financing needs of the project developer, the need to satisfy debt cover and other financial criteria and a sympathetic sharing of risk and return. By contrast the payments made by third party shippers are driven by the investment/return criteria (and to a limited extent but not uniquely by the cost of funds) of the project developer.

In such circumstances an access charge designed for a Foundation Shipper (even when based on a cost recovery methodology) could be expected to vary from a cost of service based tariff model.

If, however, we accept that PAWA's payments for use of the Pipeline are designed to recover NT Gas' funding and operating costs and accept further the ACCC's decision to align the depreciated asset value of the Pipeline in 2011 with the residual value then the PAWA charges and the cost of service tariff converge. In this regard the arrangements between NT Gas and PAWA regarding the Pipeline as at 2001 are probably unique.

That is to say, the commercial arrangements applying to the Pipeline establish a clear and unambiguous relationship between the charges paid by PAWA and the level at which the Reference Tariff should be set. Specifically, the Reference Tariff should exceed the implied PAWA tariff by an amount:

1. equal to the difference between the cost of equity and the cost of debt multiplied by the regulated equity funding proportion and multiplied further by the capital base of the project; and

2. a further margin to reflect the fact that the acceleration in regulatory depreciation of the asset could not have commenced until the end of 1999 at the earliest, and, whereas this "depreciation schedule" was reflected in the PAWA foundation shipper haulage charges, its capture from third parties was delayed until 2000.

Given that the cost of funds applicable to third party tariffs and PAWA charges have been aligned by aligning the 2011 residual value and the regulated asset value in 2011 then the primary difference between the third party and the PAWA charges should be the return required to equity risk. In the case of the Pipeline the equity risk was largely (but not exclusively) borne by the Territory Government and that is reflected in the PAWA charge structure. There is no doubt, however, that that risk was borne and that the project is entitled to earn a return in regard to that risk. The allocation of that return and the allocation of risk were specifically addressed by the parties in the 1985 agreements.

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