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POWER & WATER AUTHORITY ("PAWA")

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

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

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Non-confidential version

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A. Executive Summary

1. This submission is made by PAWA in its capacity as the foundation customer and major user of the Pipeline.

2. PAWA agrees with and adopts the submission of the Northern Territory Government in full. For the reasons set out in that submission, and briefly summarised at Part C below, the ACCC should not impose a Reference Tariff any lower than PAWA's haulage cost. In this submission the term "haulage cost" means the total cost of transmission divided by the transmission throughput. It therefore reflects the underlying tariff and the load factor of the user.

3. The appropriate starting date for accelerated depreciation of the Pipeline is late 1999 at the earliest, when NT Gas became aware that there was a real risk of a substantial portion of the Pipeline's capacity becoming stranded after the expiry of PAWA's foundation contract in 2011 (see Part D below).

4. The ACCC's proposed amendment A3.2 in relation to the gas specification to be contained in the Access Arrangement should be amended to include the words *", subject to it being consistent with NT Gas' obligations under existing service agreements"* at the end. Otherwise, NT Gas is at risk of being in breach of its agreements with PAWA and other existing users by the delivery of off-specification gas (see Part E below).

5. Paragraph 6.4 of NT Gas' proposed Access Arrangement, dealing with the priority of prospective users in obtaining services, should remain as originally drafted by NT Gas. The ACCC should not impose its proposed amendment A3.5, requiring the deletion of the fourth dot point under paragraph 6.4 of NT Gas' Access Arrangement, as, if it is deleted, it leaves NT Gas open to being in breach of the Access Arrangement, its agreement with a third party, or its obligation to give PAWA first priority. PAWA's right to first priority reflects the fact that PAWA was obliged to underwrite for 100% of the capacity of the Pipeline and the upstream and downstream infrastructure necessary to underwrite the development of the gas and energy market and is a protected contractual right under clause 2.25 of the Gas Code (see Part F below) which both:

   (a) reflects the fact that PAWA underwrote the development of the Pipeline and the gas market in the Territory; and

   (b) has an inbuilt sunset provision at the expiration of the contract in 2011.

6. For the reasons set out in Part G below, it is unnecessary for the Access Arrangement to include any trigger for its review based upon the arrival of Timor Sea gas in Darwin.

7. The deduction by the ACCC of a deferred tax liability from the Initial Capital Base of the Pipeline amounts to the undoing of government policies in place at the time the commercial arrangements leading to the construction of the Pipeline were entered into, designed to promote investment in infrastructure such as the Pipeline (see Part H below).

B. Background

8. PAWA is a statutory authority incorporated under the *Power & Water Authority Act (NT)*. Its functions include the generation, marketing and supply of electricity and the buying, selling and transporting of gas. Gas is the predominant source of energy used by PAWA to generate electricity.

9. As the ACCC is aware, PAWA is the foundation customer for the Pipeline and the current major user of the Pipeline, pursuant to a long term agreement with NT Gas entered into in 1985 and due to expire in 2011. In its role as foundation customer for the Pipeline, PAWA

underwrote the development of the pipeline system, underwrote the development of the Palm Valley and Mereenie gas fields and put in place the infrastructure necessary to consume gas at various locations in the Territory.

10. The background to the construction of the Pipeline is set out in detail in the Territory Government's submission. PAWA agrees with and adopts that submission. Of particular note is the pivotal role played by PAWA and its owner, the Northern Territory Government, in the development of the gas project (as that term is defined in the Northern Territory Government's submission), including the Pipeline, and the consequent greatly enhanced competition in the Territory energy market.

11. This submission is directed to the following issues raised by the ACCC's Draft Decision:-

(a) the ACCC has paid insufficient regard to the matters prescribed under clauses 2 and 8 of the National Third Party Access Code for National Gas Pipeline Systems ("the Gas Code"); taking into account those matters, the ACCC should not impose a Reference Tariff which, when adjusted to match PAWA's load profile, results in a haulage cost below that paid by PAWA for use of the Pipeline;

(b) the appropriate starting date for accelerated depreciation of the Pipeline;

(c) the gas specification;

(d) the queuing policy;

(e) backhaul services, and the proposed trigger; and

(f) deferred tax liability.

12. Each of these issues is addressed in turn at Parts C to H below.

13. Part I contains a very brief response to some of the issues raised in NT Power Generation Pty Ltd's ("NT Power") Submission dated 2 August 2001.

C. Level of Reference Tariff - Code Clauses 2 & 8

14. PAWA adopts and relies upon the Northern Territory Government's submission. In summary, PAWA's position is that:-

(a) without the support of the Northern Territory Government and PAWA, the Pipeline would never have been constructed;

(b) the construction of the Pipeline has resulted in considerable public benefits (which are identified in the Northern Territory Government's submission);

(c) in particular, the construction of the Pipeline led to the creation of a Northern Territory gas market and, after many years where PAWA carried the burden of low levels of utilisation and high costs, a substantially cheaper energy source;

(d) in reaching its draft decision, the ACCC has failed to pay adequate regard to the matters prescribed under clauses 2 and 8 of the Gas Code;

(e) the haulage cost payable under PAWA's long term gas transportation agreement with NT Gas is the best evidence of the ex ante cost of pipeline construction; the circumstances giving rise to the project support this;

(f) the ACCC's proposed Reference Tariff will have the effect, if implemented, of discouraging future investment in essential infrastructure; and

(g) having regard to the matters set out in the Territory Government's submission and the provisions of the Gas Code, the ACCC should set a Reference Tariff at a level which, when applied to PAWA and adjusted for PAWA's load factor, would result in a haulage cost for PAWA no lower than PAWA's actual haulage cost.

D. Accelerated Depreciation

15. PAWA agrees that, having regard to the risk which has now become apparent that the Pipeline will become largely stranded when the PAWA contracts terminate in 2011, it is appropriate that the depreciation for the Pipeline be accelerated for the period to July 2011.

16. However, for the reasons set out below, it is PAWA's submission that the earliest appropriate time to start the accelerated depreciation is late 1999, the time when NT Gas knew or ought reasonably have become aware that the risk of stranding of a substantial portion of the Pipeline's capacity had crystallised.

17. In its Access Arrangement Information, NT Gas proposed "double kinked" accelerated depreciation of the Pipeline as follows:-

(a) straight line depreciation from the Initial Capital Base in 1986 to June 1999;

(b) accelerated straight line depreciation from June 1999 to July 2011, with the depreciated value as at July 2011 equalling the estimated "commercial" value of the Pipeline at that time, $61.84 million; and

(c) straight line depreciation from July 2011 to the end of the economic life of the Pipeline in 2066.

18. In its Draft Decision, the ACCC accepted that it was appropriate for the depreciation of the Pipeline to be accelerated to a depreciated value of $61.84 million at July 2011, however, determined that the accelerated depreciation of the Pipeline out to 2011 should commence from the date the Pipeline was first commissioned, rather than July 1999, the date proposed by NT Gas.

19. The ACCC relied upon a number of factors in deciding to accelerate the depreciation of the Pipeline from the date of first commissioning. These factors are summarised below:-

(a) the residual value of $61.84 million as at 2011 was established prior to the Pipeline being commissioned;

(b) the existence of the residual value of $61.84 million prior to 1999 leads the ACCC to believe that the earning potential of the Pipeline was expected to be significantly reduced by 2011;

(c) the diminished supply capacity of the Palm Valley field and the consequent uncertainty regarding the availability of future reserves has been known for a number of years; and

(d) NT Gas should therefore have recognised and catered for the likelihood of stranding earlier and structured its tariffs accordingly.

20. That NT Gas did not consider there was a real risk of stranding when the arrangements leading to the construction of the Pipeline were entered into in June 1985 is also supported by the construction agreement for the Pipeline required that the Pipeline have a design life of 30 - 50 years.

21. As PAWA stated in its joint submission with the Northern Territory Government dated 17 November 1999, PAWA considers that the Palm Valley field has a poor prognosis and it is likely that, if the Amadeus Basin fields were to supply the balance of PAWA's requirements

for gas, the fields' remaining presently proven reserves would be unlikely to meet market demand by about 2015.

22. PAWA's view is strengthened by the likely availability of Timor Sea gas as a substitute source of supply by about 2005. Having regard to the economic criteria inbuilt in the industry accepted definition of "proven reserves", the availability of a lower priced gas supply in Darwin is likely to reduce the level of proven reserves in the Amadeus Basin fields even further. However, as PAWA stated in its submission of 17 November 1999, the Amadeus Basin fields are likely to be able to produce reasonable quantities of competitively priced gas for the Alice Springs market for some years to come.

23. Accordingly, while PAWA may have had concerns with, and pursued evidence concerning, the reserves and deliverability situation of the Palm Valley field from as early as 1996 or 1997, the publicly listed operator of the field, Magellan Petroleum, did not consider it necessary to advise the stock exchange under the listing rules until January 2000 of the reserves situation[1]. The likely problems with Amadeus Basin gas reserves and deliverability are therefore unlikely to have become evident to NT Gas until about late 1999 at the earliest when:-

    (a) NT Gas had available to it a copy of the non-confidential version of PAWA and the Northern Territory Government's submission dated 17 November 1999; and

    (b) shortly thereafter, Magellan notified the stock exchange of the remaining level of Palm Valley reserves.

24. Furthermore, the conclusion that NT Gas ought to have recognised and catered for the diminished supply capacity of the Palm Valley field, and therefore the possible stranding of a substantial portion of the Pipeline after 2011, is inconsistent with the fact that, up until the mid 1990's, the Amadeus gas field producers had extensive negotiations with a number of potential gas buyers, including Gove, Century Mine, the state of South Australia and Mount Isa Mines (at Mt Isa) for the sale of significant quantities of Amadeus Basin gas under long term supply contracts which the Producers, at that time, apparently believed were uncommitted to other customers.

25. In any event, the failure of the Palm Valley field is not a sufficient condition to trigger the need to accelerate depreciation of the Pipeline, as a number of alternative supply options entail the continued use of the Pipeline.

26. Indeed, the parties always contemplated that the Pipeline would flow gas from north to south at some stage in its life. However, it was not contemplated or expected that this flow would be so large as to necessitate a major new pipeline, such as that proposed by Epic Energy and thereby strand a substantial portion of the Pipeline. This is evident from statements made at the time by the then Northern Territory Chief Minister and Minister for Mines & Energy, Ian Tuxworth, who, in a statement to the Northern Territory Legislative Assembly in June 1984, said the pipeline may be the first step towards a national pipeline grid, that the early development of the offshore gas field might be possible with gas being pumped south, and that *"the prospect of a north-south gas pipeline is an exciting one for the Territory".*[2]

27. Later in 1984, Tuxworth stated at the Australian Pipeline Industry Association Conference:-

> *"I believe we need a rational and co-ordinated Australian gas policy that allows us to set up a gas distribution network which will take us far into the future, well beyond the blinkered 7 to 10 years' life that most project financiers see. We want to ensure that the line is sufficiently large to cover all potential markets - that is*

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[1] See Attachment 1.

[2] "Ministerial Statement: Oil & Gas Reserves", NT Assembly Debates, 7 June 1984 at page 471, Attachment 2.

Darwin, Gove and the other settlements along the way. In the longer term we need also to cover the possibility of gas coming ashore from the Tern and Petrel fields in the Bonaparte Gulf and being sent down the pipeline to Sydney and Adelaide markets. This development will mark the beginning of a local petro-chemical industry in the Northern Territory the potential of which, I am convinced, no one has yet fully appreciated".[3]

28. It was not until it became clear that all of:

    (a) the Amadeus Basin gas reserves were declining and were likely to produce declining deliverability;

    (b) Timor Sea gas would be delivered to Darwin; and

    (c) the scale of development of the Timor Sea gas fields would strand a substantial portion of the Pipeline,

    that stranding became an issue at all. This did not arise as a real likelihood until late 1999 at the earliest.

29. The above facts support late 1999 as being the earliest time at which it ought to have become apparent to NT Gas that there was a real risk that a substantial proportion of the Pipeline's capacity could become stranded after the expiry of PAWA's gas transportation agreement in 2011.

30. Therefore, in conclusion, it is PAWA's submission that:-

    (a) having regard to declining Amadeus Basin gas reserves and the likelihood of Timor Sea reserves effectively replacing Amadeus Basin reserves, the depreciation of the Pipeline should be accelerated up to 2011;

    (b) NT Gas is unlikely to have become aware of the substantial risk of stranding until about late 1999 at the earliest, when it became apparent that Amadeus Basin gas reserves were declining and that there was a real risk that the development of Timor Sea gas reserves would involve the delivery of gas to Darwin (effectively displacing Amadeus Basin gas) and a scale of development which precluded the use of the Pipeline for Timor Sea gas export south; and

    (c) accordingly, an appropriate time to start accelerated depreciation is the end of 1999 at the earliest.

E. Gas Specification

31. In line with the ACCC's final decision in relation to the Central West Pipeline access arrangement[4], the ACCC's proposed Amendment A3.2 to NT Gas' access arrangement should be amended to insert the words *", subject to it being consistent with NT Gas' obligations under existing service agreements"* at the end. Otherwise, NT Gas is at risk of being in breach of either its Access Arrangement or its agreements with PAWA and other existing users by the delivery of off-specification gas.

32. This amendment is consistent with the words in the opening paragraph of Schedule 3 to NT Gas' proposed Access Arrangement.

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[3] Quoted, NT News, 24 October 1984, Attachment 3.

[4] Dated 30 June 2000, at page 111.

F. Queuing Policy

33. The deletion required by the ACCC of the fourth dot point of paragraph 6.4 of NT Gas' Access Arrangement[5] gives rise to inconsistencies between NT Gas' obligations under the Access Arrangement and PAWA's rights under its long term gas transportation agreement with NT Gas entered into in 1985.

34. Accordingly, paragraph 6.4 of NT Gas' proposed Access Arrangement should remain as originally drafted and the ACCC should not require proposed amendment A3.5.

G. Backhaul Services and Trigger

35. Backhaul is the provision of gas transportation services against a pipeline's dominant flow.

36. If Timor Sea gas comes onshore to Darwin there are a number of possible outcomes for the Pipeline. The two most likely are discussed below.

37. The more likely outcome is that the Pipeline is not used to transport Timor Sea gas to southern markets, either because the gas is used in Darwin, or because the scale of development requires a pipeline of greater capacity to be constructed for the purpose. Epic Energy has proposed such a pipeline. In either case, the only use of the Pipeline will be for the small scale backhaul of gas to regional centres such as Katherine and Tennant Creek. To formulate a backhaul tariff for the Pipeline for this scenario on the information to hand would be a nonsense, and does not pass the test set out in paragraph 3.2.6 of the ACCC's Draft Decision.

38. The alternative development scenario is that the Pipeline is integrated into a new pipeline system which is to be constructed to transport Timor Sea gas to southern markets. If this occurs, the Pipeline effectively becomes part of another pipeline system. There will be no "backhaul" as such of Timor Sea gas as the dominant flow will be south. Therefore, the appropriate place to deal with the services to be made available in respect of that integrated pipeline system is in the Access Arrangement for the integrated pipeline.

39. In PAWA's submission, there is therefore no need for the inclusion of a trigger mechanism in the Access Arrangement based upon the arrival of Timor Sea gas, as the arrival of Timor Sea gas will have one of two likely effects on the Pipeline:-

(a) stranding of a substantial portion of the Pipeline’s capacity after 2011; or

(b) the integration of the Pipeline into a pipeline system for the carriage of Timor Sea gas to southern markets, in which case the new integrated system will be the subject of a new Access Arrangement.

H. Deferred tax Liability

40. In its Draft Decision, the ACCC adjusted the Initial Capital Base for the Pipeline downwards by $12.9 million as at 1 July 1999, representing the ACCC's calculation of the accumulated deferred tax liability for the Pipeline as at that date, due to accelerated depreciation of the Pipeline. For the reasons stated below, the ACCC should not make that adjustment.

41. At the time the decision was taken by project participants to proceed with the gas project (as that term is defined in the Territory Government's submission), the Commonwealth Government had in place clear policies solely designed to promote investment in infrastructure such as the Pipeline. These policies were instrumental in the Territory Government's decision to support the Pipeline, and indeed resulted in the construction of the Pipeline being able to be

[5] See Proposed Amendment A3.5 at page 116.

financed.

42. That the ACCC is able to effect measures which retrospectively negate the policies of the government of the day and penalise investors in infrastructure, over 16 years after the commercial arrangements for the construction of the Pipeline were entered into, is untenable, and is effectively an unacceptable form of sovereign risk.

43. The Draft Decision asserts that:-

> *"NT Gas will be fully compensated in regulated revenues for expenditure to meet those liabilities as they become due. In other words, the adjustment ensures that the service provider is not compensated twice for its tax liabilities"*[6]

44. The logic of this argument is unclear. If PAWA payments to NT Gas are calculated after taking the deferred tax amount into account, and the Reference Tariff is equal to or below the implied PAWA tariff, then how can the ACCC assert that these costs can be recovered by NT Gas? It is PAWA's submission that the Reference Tariff should be significantly above the implied PAWA tariff and, if the ACCC's assertion is to be validated, then the margin by which the Reference Tariff should exceed the implied PAWA tariff would need to be increased further by the amount necessary to recover the deferred tax charge.

I. Response to NT Power Submission

45. PAWA has considered NT Power's submission dated 2 August 2001 and takes this opportunity to respond to some of the statements made in that submission below.

46. There are many statements made in NT Power's submission which are unsubstantiated and in PAWA's view are unlikely to be capable of substantiation. In these circumstances, the ACCC should be extremely cautious in accepting any statements from NT Power's submission which are not verified by some reliable supporting material which is before the ACCC.

47. In addition, there are a number of statements made in the submission which are irrelevant to the issues to be considered by the ACCC. PAWA sees little point in responding to such statements.

Capacity of the Pipeline

48. PAWA repeats paragraphs 12 - 15 of its joint submission with the Northern Territory Government dated 17 November 1999 in relation to the available capacity of the Pipeline. Nothing has occurred since that submission was prepared which changes PAWA's view.

Amadeus Basin Reserves

49. NT Power asserts in its submission that:-

(a) a credible time estimate for exhaustion of Amadeus Basin gas reserves is 2025, assuming these fields are used to meet NT demands;

(b) this date for exhaustion of reserves:-

> *"may be significantly extended depending on gas production technology advances that could result in the economical recovery of very large matrix gas resources of the Palm Valley field presently listed as possible recoverable reserves"*;

[6] Draft Decision page xiii.

and

(c) the Territory Government's and PAWA's statements in their submission dated 17 November 1999 in relation to remaining Amadeus Basin gas reserves are misleading.

50. PAWA repeats the statements made in that submission in relation to Amadeus Basin reserves. Events since that submission was prepared provide further support for PAWA's pessimistic view.

51. In summary, both the Palm Valley and the Mereenie fields are in the production decline phase of their economic lives. While the Mereenie field has a better prognosis than the Palm Valley field it is most unlikely, given current and foreseen commercial parameters, that the Amadeus Basin will be able to meet the needs of the market (even the current market) beyond 2015.

52. There is no credible evidence before the ACCC to support the assertions made by NT Power. In view of the disclosures made by Magellan to the ASX, it is PAWA's submission that the position put by NT Power is untenable. If the ACCC were minded to accept NT Power's assertions, or in any way remained in doubt as to the likely future economically deliverable reserves, this is a matter which could be addressed by information directly from the field operators as to the likelihood is of gas being available for sale under future contracts at prices similar to those payable under existing contracts. If there was uncertainty in the ACCC's view, it would be unsafe to proceed without seeking such information.

Extension of PAWA/NT Gas Agreement for use of the Pipeline

53. NT Power assert that there is "every likelihood" that PAWA's agreement with NT Gas will be extended to 2025. PAWA absolutely rejects this assertion.

Attachment 1 - Magellan Media Release

Attachment 2 - Ministerial Statement, 7 June 1984

Attachment 3 - NT News article, 24 October 1984

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