Submission to the National Competition Council on QGCLNG application for 15-year no coverage determination under section 151 of the *National Gas Law*

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Melbourne Office
Suite 1, Level 2
19-23 Prospect Street
Box Hill VICTORIA 3125
Tel: +61 3 9898 3900

Email: euaa@euaa.com.au
Website: www.euaa.com.au

Executive summary

The Applicant is seeking exemption from coverage in order to secure a competitive advantage against its peers in the development of an LNG terminal at Gladstone. On the basis of the Applicant's own assumptions of pipeline capacity and future demand, it is likely that their pipeline will have considerable excess capacity for the foreseeable future. The Applicant has strong incentives not to make this capacity available to its competitors, in order to secure its competitive position for access to CSG from the Surat and Bowen basins.

With substantial excess capacity on the Applicant's pipeline for the foreseeable future, it is very likely that the most economic pipeline access to Gladstone will be on the Applicant's pipeline. Even if this is not the case, the Applicant's pipeline, if not exempt, will be a source of much needed competition to the current monopoly on gas transport to Gladstone, enjoyed by the Queensland Gas Pipeline (QGP).

The Council's exemption criteria, and the National Gas Objective, to which the Council is required to have regard, are intended to protect against exactly the outcomes that are likely to result if exemption is granted to the Applicant.

We submit that the Applicant's arguments that if exemption is not granted, LNG investment will be jeopardised, is not valid. EUAA members unanimously prefer the access arrangements for covered pipelines as providing secure, firm long term gas transport. We can see no reason for the Applicant to doubt that it too will enjoy secure, firm pipeline access on its own pipeline if this pipeline is covered under the National Gas Law.

The EUAA therefore submits that the Applicant's pipeline should not be granted exemption from coverage.

TABLE OF CONTENTS

1 Introduction

1.1 The EUAA's interest in this application for coverage exemption

The EUAA represents around 100 energy users throughout Australia. Our membership is drawn predominantly from large industrial and resource companies. Our Queensland members include most of the major resource and industrial energy users in that State. Gas consumption in industrial and resource sectors accounts for around 85% of Queensland's total domestic demand. Many of these industrial and resource companies compete in international markets, and thus have limited ability to pass-through input price increases to their customers. These members therefore take considerable interest in the competitiveness of Queensland's gas industry.

Over the last few years, since the prospect of Liquefied Natural Gas (LNG) from Coal Seam Gas (CSG) has become more likely, our members have experienced a contraction in the long term contract market. Where there was once a liquid market with several explorer/producers seeking long term contracts to fund their expansion, this market has now effectively ceased. In line with the contraction in long term contract markets, many of our members have experienced price shocks as gas producers have withheld reserves and effectively abandoned the domestic market in order to enhance their competitive position in the international LNG market. These adverse developments have occurred just at the time that the role of gas in the Australian economy is achieving much greater prominence as a low emission replacement for coal.

The Queensland Government has expressed concern about the adverse impact of LNG on the supply of gas to domestic markets. In policy announcements in December 2009 the Government committed to promoting the competitiveness of the Queensland gas market and said it will consider the possible reservation of prospective CSG resources for domestic consumption, if needed. The EUAA supports this approach.

The EUAA is concerned by QGC's application to exempt coverage of its proposed pipeline from the Surat and Bowen gas basins to Gladstone. Third party pipeline access is important in the development of not only a thriving LNG sector, but also a thriving domestic gas sector. For the reasons set out in this submission, we submit that exempting the QGC pipeline from coverage under the National Gas Law, while providing commercial advantage to QGC will result in inefficient over-investment, and detrimental impacts on the competitiveness of Queensland LNG and domestic gas industries. This is contrary the National Gas Objective, to which the NCC is required to have regard in its assessment of QGC's application.

1.2 Structure of this submission

There are two main parts to this submission. In the first part we outline what we believe to be the fundamental reasons why the Applicant is seeking exemption from coverage. This provides a strategic context to the application. We encourage the NCC to explore further the analysis we set out in that section, in understanding the Applicant's various arguments, and their incentives. The second section sets out our submissions to each of the Applicant's exemption arguments. This section starts by paraphrasing the main points of the Applicant's arguments, and then critiques each of the main arguments. A summary follows to provide an overview of the main points of this submission.

2 Why is the Applicant seeking exemption from coverage ?

On page 9 of their application, the Applicant asserts that "*Denying the exemption will materially increase regulatory risk, jeopardise future investment and create perverse incentives such as deliberate and inefficient undersizing of new greenfields pipelines*". However the evidence they present in the application contradicts each of these assertions:

- On regulatory risk, they conclude (on page 72) that regulations pursuant to coverage will cost $260k - $326k annually. In the context of the Applicant's operations and the industry, this can hardly be described as a significant impost, and we submit that such an assertion cannot be considered to provide any meaningful justification for exemption.
- On inefficient under-sizing, on page 54 the Applicant notes that "*the QCLNG Pipeline is part of an integrated project, the QCLNG Pipeline and other key project components have been optimally designed to meet the specific requirements of the QCLNG Project. Thus, the concept of economies of scale is addressed in the pipeline configuration only in as far as meeting the maximum capacity for the QCLNG Project, not as regards to meeting the market demand, which is characteristic of the way in which a merchant pipeline would be designed.*" In other words the Applicant has not inefficiently under-sized its pipeline.
- On jeopardising future investment, on page 58 the applicant notes *that "large LNG producers are likely to prefer to develop their own transportation capacity and have the size and scale to do so commercially or in joint venture with other LNG proponents" and "as a matter of economic and commercial reality, the requirement to have large increments of gas transportation capacity locked in at the time such projects reach their FID milestone mitigates strongly against the QCLNG Pipeline being a feasible commercial alternative for this category of upstream producer.*" Therefore, how can coverage be asserted as jeopardising future LNG or pipeline investment ?

The Applicant also suggests (on p*age 57)* that small gas producers (those without LNG proposals) are unlikely to use their pipeline because, inter alia, it will be too expensive for them.

In summary, the Applicant's statements show clearly that:

- regulatory risk will result in insignificant cost to them,
- there is no risk of inefficient under-sizing because their pipelines are designed to suit the LNG project;
- future investment in pipelines is not in jeopardy because its essential to ship gas from the CSG fields to the LNG plant on the coast (unlike merchant investment in other pipelines, without pipelines, LNG projects won't proceed);
- there will be no demand for access to their pipeline by others because access will be too expensive for non-LNG participants, and LNG participants will prefer to develop their own capacity.

On the basis of the Application, none of the arguments on which the Applicant relies are sustainable. It is necessary to look more deeply to see why QGC has gone to the great expense of developing this application, , and engaging various industry and economics consultancies to support their application. The answer of course is that exemption from coverage provides them with a competitive advantage relative to other competing LNG developers at Gladstone.

Specifically, as we show in Section 3.2 using QGC's data, their pipeline will have sufficient capacity to transport enough gas for four times as much LNG capacity as they have said that they are currently progressing to Final Investment Decision, and just under three times as much capacity as they have said their LNG terminal will ever possibly have. This spare pipeline capacity arises because by compressing the gas in the pipeline and looping it in sections, it is possible to increase the capacity significantly.

By securing exemption from coverage, the Applicant is able to force competing LNG developers to develop their own pipelines, rather than access spare capacity on their pipelines. This not only forces the Applicant's competitors to incur additional expense and time delays, but also enhances the Applicant's own position in the competition for capital and skills, and their ability to capture LNG demand in global LNG markets. As such, coverage exemption has important commercial value to the Applicant, this will more than compensate for any lost income that they might earn were they to offer that excess capacity to their competitors.

The provision of coverage exemption of the proposed pipeline would not only increase the likelihood that other LNG developers will seek to develop their own pipelines instead of efficiently accessing spare capacity on the QGC pipeline, but will also increase the likelihood that other LNG developers will seek coverage exemption of their own pipelines for the same strategic commercial reasons that QGC is seeking coverage exemption

This struggle for private competitive advantage results in a loss of public welfare that is clearly contrary to the National Gas Objective. If an exemption is granted there will be inefficient under-utilisation of pipeline capacity as LNG developers are forced to develop their own pipelines, and spare capacity on each pipeline lies idle. This is also likely to have detrimental consequential effects on the development of the Queensland CSG resource (placing extra cost on LNG developers is a disincentive to development). Compared to the counter-factual of open access, this will in turn result in lower royalties, taxes and employment associated with less development. The

National Gas Objective and the coverage assessment is intended to avoid precisely this outcome.

Gas users in Queensland also have a special interest in the detrimental impact on them that would arise from coverage exemption of this pipeline. Queensland's domestic gas demand, while growing rapidly, is essentially inconsequential compared to the volumes of gas required for LNG production. Supplying domestic gas markets is of little commercial value to the Applicant, and in fairness we suggest that the application for exemption has not intentionally set out to detrimentally impact the competitiveness of domestic gas markets. Domestic demand is simply too small to the Applicant to matter.

However, a loss of competitiveness of domestic markets attributable to coverage exemption (or more precisely in this case, foregone opportunities to make them more competitive) matters a great deal to energy users. As we show in the next section, coverage exemption would forego opportunities to improve the competitiveness of the domestic gas market. This is contrary to the National Gas Objective.

We strongly encourage the Council to carefully consider the real drivers behind the Application, in understanding the private benefits and public detriments arising from such an exemption.

3 Our response to the Applicant's exemption argument

3.1 Summary of their argument

The Applicant has submitted arguments on each of the criteria that the Council uses in its assessment, to put its case that the proposed pipeline satisfies the conditions for exemption from coverage. This section summarises their main arguments, and then critiques these arguments.

3.1.1 They argue that the pipeline is economic to duplicate

Criterion (b) of the Council's assessment tests whether it would be economic for anyone to develop another pipeline. If it is economic, the Council must recommend that exemption be granted.

The Applicant has sought to satisfy this criterion by arguing that over the assessment period, demand is likely to exceed supply and hence a second pipeline will be built.

They have asserted that the assessment period should be 15 years, and have then projected the demand for gas pipeline capacity to Gladstone over this period and compared this to the capacity of their pipeline. From this they have concluded that since future demand will exceed the capacity of their pipeline it will be economic to build another pipeline and hence the criterion is satisfied.

3.1.2 They argue that coverage will not promote competition

Criterion (a) of the Council's assessment tests whether access to the pipeline (by parties other than the applicant) would enhance competition. If the test is failed (i.e. competition is not enhanced) then the pipeline satisfies this condition for exemption from coverage.

The Applicant has sought to show that the test is failed because increased access to the pipeline will not stimulate competition in either upstream gas markets (the CSG resource in the Surat and Bowen basins) or the downstream market (the market for gas liquefaction or consumption in the Gladstone, Rockhampton, Wide Bay areas).

On upstream markets, they concluded that access will not promote competition because:

- Upstream gas producers already have many alternative pipeline options;
- LNG producers will build their own pipelines rather than use the Applicant's; and
- Small gas producers will find cheaper alternatives to accessing the Applicant's pipeline.

On downstream markets, they concluded that gas users in downstream markets will have more economical ways of accessing upstream gas supply than through the Applicant's pipeline, and hence third party access will not enhance downstream competition.

3.1.3 They argue that coverage exemption is not contrary to the public interest

Criterion (d) of the Council's assessment tests whether third party access to the pipeline would be contrary to the public interest. Public interest is defined broadly to include - inter alia - ecologically sustainable development, social welfare, occupational heath, industrial relations, equity, regional development, consumers' interests and competitiveness of Australian businesses. The Council's test is whether access is contrary to the public interest (as opposed to the positive requirement that access is in the public interest).

The Applicant has suggested that this criterion is not relevant because the pipeline satisfied both criteria (a) and (b) discussed earlier, for exemption. Nevertheless the Applicant submitted that the public interest would not be satisfied if exemption was refused. To support this, they argued that incentives to invest in their LNG plant would be diminished, that there would be reduced incentives to invest in other LNG terminals and that additional regulatory costs would arise.

3.2 Critique of their argument that the pipeline is economic to duplicate

We think the Applicant's argument that the pipeline would be economic to duplicate is internally inconsistent, and that their conclusion does not hold when this internal inconsistency is rectified.

In particular, their projection of the demand for pipeline capacity to Gladstone is around 1800 TJ/day or 5000 PJ per year. The most significant assumption in their calculation of future pipeline demand is that LNG capacity at Gladstone will be 28 mtpa in 15 years' time. They then argue that although their pipeline can be augmented to this level of capacity, it would be uneconomic to do so, and hence to meet future demand it would be economic to build another pipeline.

There is a great deal of uncertainty on future LNG demand. There is very substantial literature in trade journals, the financial press, analyst reports and consultancy studies on the extreme uncertainty of the level of future LNG development. This extreme uncertainty exists even for developments in the short term (next few years) let alone projections 15 years into the future, as the Applicant has done. The Applicant agrees that future supply and demand is uncertain, but has drawn on one scenario (of many) by consultants MMA for their assumption.

There is also a high degree of uncertainty on pipeline costs: until detailed engineering studies have been done, it would be impossible to conclude with any certainty on the relative cost of one pipeline against another. Potential pipeline developments are nowhere near the stage at which reliable information would be available to provide reliable costing. As such, we submit that there is a very high degree of uncertainty on the proposition that it will be economic to duplicate their pipeline in 15 years.

However, more significant than these flaws, and as mentioned at the start of this subsection their analysis is internally inconsistent. The calculation that their pipeline could not economically meet future pipeline demand to Gladstone over the next 15 years relies critically on the assumption that all 28 mtpa of future LNG gas is carried *on their pipeline*. However, at many points in their application (for example on pages 43, 54, 55, 58, 63) they set out their firm view that competing LNG developers will be developing their own pipelines, not seeking to use the Applicant's pipeline. This seems quite plausible considering the stated intentions of the Asia Pacific LNG project (Origin/Conocco-Phillips), the Curtis Island LNG Project (Santos-Petronas) and the Southern Cross pipeline (Arrow-Golar), is to build their own pipelines. Since these LNG developers plan to develop their own pipelines rather than using the Applicant's, more than twice the capacity needed to support their own planned LNG trains will be available *on the Applicant's pipeline*. This is before capacity expansion attributable to looping has been counted – a common means through which pipeline capacity is supplemented. In fact, if the Council accepts the coverage exemption, and in view of the plausible conclusion that other LNG developers will build their own pipelines, then it is almost certain that there will be significant excess capacity on the Applicant's pipeline. This excess will be more than 30 times the current pipeline capacity to Gladstone. This evidence suggests that it is impossible to sustain the argument that it would be economic to duplicate the pipeline for the foreseeable future. As such there can be no doubt that criterion (b) is not satisfied.

3.3 Critique of their argument that access will not promote competition

We disagree with the Applicant's arguments that their pipeline will not promote competition in upstream or downstream markets. This subsection examines each in turn.

Upstream market
Dealing first with their argument that larger upstream producers (in particular those involved in LNG production) are likely to require their own dedicated gas transmission pipelines, we noted above that this is contrary to their assumption in modelling capacity on their pipeline i.e. that other LNG producers would firstly reserve capacity on QGC's pipeline before developing their own. Our view on this is that this is likely to be a self-fulfilling prophecy: if the Council grants coverage exemption then other LNG developers will have little alternative than to develop their own pipelines. On the other hand if coverage is not granted, then there would seem to be good reason for LNG developers in Gladstone to consider availing themselves of the lowest cost pipeline access, particularly if the opportunity to gain strategic commercial advantage through the ownership and control of uncovered pipelines is not available to them.

Second, the applicants argue that their pipeline will not be an attractive commercial option for small producers due to their location, tie-in costs faced by smaller producer, and that lower transportation costs will be available from other pipelines. The Applicant refers to a report by consultants RLMS to support their arguments on this. We reject their arguments on the basis that there is simply too much uncertainty to reach any unequivocal conclusion. There are many ways in which the supply-side of the industry may change. For example small producers may aggregate production (or merge) thus eliminating or diminishing tie-in cost, or geographic barriers. Large LNG producers may be very keen to transport "ramp-up" gas to domestic gas users or other LNG plant in Gladstone. It may well be economic for these producers – being well-located within the 200km header of the Applicant's pipeline, to access that pipeline.

In addition, the assumption that the Queensland Gas Pipeline (QGP) will always be less expensive than the Applicant's pipeline seems baseless. QGP may be close to full capacity the moment the Origin energy expansion is complete (and the Yarwun alumina refinery co-generation facility and plant expansion is fully commissioned). In this case it seems implausible to argue that access to QGP (which would require capital expansion) would be more expensive than access to the Applicant's pipeline which, as demonstrated in Section 3.2, will have very considerable spare capacity for the foreseeable future.

Downstream market
The Applicant submits that gas users in the Gladstone, Rockhampton and Wide Bay areas will find that the QGP will be the predominant method of transporting gas from the Surat and Bowen Basins. We have two comments in response. Firstly it is simply impossible, for the reasons described above, to take a categorical view on this. Secondly, even if the costs of QGP proved favourable relative to the Applicant's pipeline (or subsequent pipelines), the QGP is an uncovered pipeline and access prices may rise well above costs, if the pipeline operator is able to exercise market power.

Currently QGP is the only pipeline into Gladstone. This considerably enhances QGP's ability to achieve prices above cost. It is a new entrant, or a plausible threat of new entry that provides competitive pressure on QGP to reduce prices. If that new entrant is exempt from coverage, this eliminates the competitive pressure on QGP. For this reason, even if we accepted - for the sake of argument - that QGP will be more competitive than the Applicant's pipeline, this does not diminish the fact that if the Applicant's pipeline is exempt from coverage, a great opportunity to improve competition in pipeline services to Gladstone will be foregone. This has obvious ramifications for gas users in Gladstone/Rockhampton/Wide Bay, but also more generally (through potential backhaul from Gladstone) for gas users through-out Queensland. Such outcomes are obviously what Criterion (a) is intended to prevent and for this reason we strongly suggest that coverage exemption not be recommended.

3.4 Critique of their argument that coverage is not contrary to the public interest

The Applicant's argument that coverage is not contrary to the public interest is based on their arguments in relation to criteria (a) and (b) discussed above. Since we don't agree with these arguments, we certainly do not agree that they support the conclusion that coverage is not contrary to the public interest.

As noted in 3.1.3, the Applicant also suggested that without their pipeline, no part of the QCLNG project could proceed. As a result they suggested that there would be public disbenefits attributable to the cancellation of their project, and weaker incentives to invest in LNG and supporting pipelines elsewhere. They also referred to the additional costs of regulation estimated at between $260k and $326k per year.

There is little reason to doubt that there would be private commercial and public disbenefits if LNG projects were abandoned because it became impossible to ship gas to Gladstone. But this is an altogether different matter to the assertion that the Applicant's specific pipeline has to be built in order to proceed with LNG developments in Gladstone (including theirs). Surely the important thing is that LNG producers at Gladstone have firm, certain access to pipeline capacity between the CSG resources in central Queensland, and the LNG terminals at Gladstone ? Why should it specifically matter that it is the Applicant's pipeline instead of other pipelines that provides such firm, certain access ?

Furthermore, we suggest that there is no basis to the argument that the Applicant's pipeline (or any other pipeline) needs to be exempt from coverage in order for LNG developers to have such certainty of pipeline access. The regulatory framework for covered pipelines makes provision for firm pipeline access. Our members unanimously prefer the regulated pipelines – rather than uncovered pipelines - as providing certain, firm pipeline capacity at reasonable prices. Why should this be any different for LNG producers in Queensland ? We suggest it should clearly not, and point to the private commercial benefits to the Applicant that an uncovered pipeline would deliver - as described in Section 2 - as the real reason that the Applicant is seeking exemption. For these reasons we reject the Applicant's argument that coverage exemption will not be contrary to the public interest.