

Jemena Limited

Northern Gas Pipeline Derogation from Part 23 of NGR

Submission on Rule Proponents' Response to AEMC Draft Determination

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TABLE OF CONTENTS

1.	Introduction	1
2.	NGP tariffs reflect the outcomes of a competitive tender process	2
3.	access principles and interaction with the derogation	4
3.1	How the Access Principles work	4
3.2	Setting and changing of Tariffs	5
3.3	How does it all interact via the derogation?	5
4.	how the derogated was developed.....	6
5.	derogation contributes to the ngo.....	7
6.	Response to unfounded claims made by rule change proponents	8

1. INTRODUCTION

The Australian Energy Market Commission (**AEMC**) received a rule change proposal from Environmental Justice Australia (**EJA**) and the Institute for Energy Economics and Financial Analysis (**IEEFA**) that seeks to revoke the 15 year derogation afforded to the Northern Gas Pipeline (**NGP**) from the operation of Chapter 6A of the National Gas Law (**NGL**). On 15 November 2018, the AEMC commenced a public consultation on the proposal by releasing a consultation paper and the AEMC released its Draft Determination on 21 February 2019. Jemena welcomes the AEMCs' Draft Determination deciding not to make changes to the NGR.

Jemena considers that the AEMC rightly views the access principles agreed to by Jemena as part of the project development agreement (**PDA**) with the Northern Territory Government provide an appropriate level of protection against Jemena's ability to exercise market power when negotiating with prospective users of NGP services.

These access principles, including the provisions that determine maximum charges for use of the NGP, were the outworking of a competitive tender process. The derogation effectively maintains the regulatory arrangements applying at the time Jemena committed to develop the NGP, and for future capacities that formed the basis of that commitment.

In making its draft rule determination, the AEMC cited the access principles agreed to by Jemena as part of the PDA with the Northern Territory government. The AEMC considered these to provide an appropriate level of protection against Jemena's ability to exercise market power when negotiating with prospective users of NGP services. It concluded that:¹

Revoking the derogation is likely to give rise to increased regulatory complexity, increased uncertainty of outcomes and adverse outcomes such as forum shopping by potential users of the NGP.

EJA and IEEFA have filed submissions raising concerns with the AEMC's draft rule determination.² This further submission by Jemena responds to the rule proponents' submissions and subsequent points raised by them at the hearing conducted by the AEMC on 7 May 2019.

There is strong support from the Australian Pipelines and Gas Association to maintain the derogation afforded to the NGP based on the objective of bringing new sources of gas to supply the East Coast market and the regulatory certainty provided by retaining the derogation, which is key to maintaining strong incentives for future investment.

Jemena also refers to the confirmation of the rigorous competitive tender process conducted by the Northern Territory Government, and its submissions to the Draft Determination and statement at the hearing. The remainder of this submission is structured to address concerns raised in the EJA and IEEFA submissions, including in relation to:

- the competitive tender process;
- the effect and purpose of the access principles and the derogation;
- how the derogation was developed;
- why the derogation contributes to the NGL; and
- unsubstantiated or misleading claims by the rule proponents.

¹ AEMC draft rule determination, p i.

² EJA, *Northern Gas Pipeline – derogation from Part 23*, 4 April 2019 ('EJA submission'); and IEEFA, *The Northern Gas Pipeline: Submission on the AEMC's draft rule determination*, 9 April 2019 ('IEEFA submission').

2. NGP TARIFFS REFLECT THE OUTCOMES OF A COMPETITIVE TENDER PROCESS

The NGP was conceived of as a link between the northern and eastern gas markets, (NEGI now known as the NGP) contributing to the development of a national gas grid, a more competitive gas and energy market, and helping to improve security of supply by tapping into the Northern Territory reserves.

It was subsequently developed as a result of a competitive tender conducted by the Northern Territory Government. This process commenced in October 2014 with an industry briefing and concluded on 17 November 2015, when Jemena was selected as the winning tenderer from a final shortlist of four bidders.

Section 2.1 of the Houston Kemp report, submitted with Jemena's submission to the AEMC Consultation Paper on 13 December 2018, outlines the extensive and competitive process deployed by the Northern Territory Government, the competitive tension and number of bidders through various bid stages, including until the very end of the selection process where negotiations continued to be held with Jemena and one other party.

We note that the EJA continues to express concern about the context within which the NGP tender was held and the derogation agreed. In particular, it contends that the Northern Territory Government was:

... at a disadvantage to secure favourable terms in that process

This contention has no bearing on the AEMC's assessment of whether the proposed rule change contributes to the NGO. Further, Jemena considers that the Northern Territory's commercial dealings are not subject to review by the AEMC. Notwithstanding this, a competitive tender is an appropriate mechanism for procuring construction of the pipeline at least cost.

The evidence presented in the Houston Kemp report in relation to the competitiveness of the NGP tender process confirms that the Northern Territory Government was not 'at a disadvantage' in those negotiations, as it was actively negotiating with more than one potential developer until the end of the process.

In addition, there is no basis for the EJA's claim that:

...Jemena is exerting market power of [sic] the NT government whilst consumers will ultimately suffer a loss as a result of high tariffs.

In fact Jemena proactively introduced the concept of a "rolled-in tariff" for relevant expansions/extensions to make its bid even more competitive as part of the tender process.

Further, the EJA also expresses concern that:

the draft determination inappropriately supports evasion by Jemena of regulation under Part 23 of the NGR, because Jemena was not willing to develop the NGP as a covered pipeline. ...the NT government actively sought to have the NGP subject to the National Gas Rules and Jemena refused.

During the tender process, the Northern Territory Government initially sought proposals to develop the NGP as a 'covered pipeline' (which is a pipeline subject to regulation under the NGR). Uncovered pipelines remain subject to other parts of the NGR.

Jemena was unwilling to develop the NGP on the basis that it be a covered pipeline. The regulation of natural gas pipelines in Australia does not compel businesses to undertake investment in new pipelines.

Subsequently, the Northern Territory Government required a set of principles outlining the terms on which access to the NEGI would be provided in lieu of coverage. These access principles are given effect by the PDA between

Jemena and the Northern Territory Government, and place restrictions on the tariffs that Jemena may charge as well as provisions in relation to access requests and dispute resolution via arbitration.

The access principles placed significantly more obligations on Jemena in relation to the NGP than applied at that time to other uncovered pipelines. Given the existence of the access principles, and that they are designed to constrain the use of market power, Jemena considers that the AEMC has correctly concluded that removing the derogation from Part 23 would provide few benefits to consumers and would introduce new complexity to the regulatory framework.

This is not 'evasion of regulation'. Rather, Jemena considers that the AEMC is exercising its power to make a rule that best contributes to the NGP, given market circumstances (in this case, the presence of the access principles).

The IEEFA contends that the AEMC did not undertake adequate investigation of the NGP's prices and costs. It claims that the NGP's tariffs are the most expensive in Australia on a per km basis,³ that the AEMC has not assessed the reasonableness of these tariffs and that under the derogation tariffs could increase with little scrutiny. Additionally, it raises concerns that the AEMC has not closely examined the costs that Jemena incurred to build the NGP. The EJA echoes some of these assertions.

These comments suggest that the tender process for the NGP did not give rise to a competitive outcome. However, there is absolutely no basis for such assertions. The tariff and tariff structure were part of the evaluation criteria employed in the assessment of the tenders. Jemena's low tariffs and charges were cited by the Chief Minister as being compelling aspects of its tender.

Further, a simplistic analysis of cost per km, as put forward by the rule proponents, is misleading and inaccurate. The appropriate tariff for transmission of gas through a pipeline cannot simply be measured on a "per kilometre" basis. In determining a tariff numerous factors are considered including the cost of construction and operating costs which can vary greatly depending on the capacity, size and length of the pipeline, terrain crossed, risks assumed and contractual terms offered. Pipelines are all different, constructed at different times and under different circumstances including physical locations and conditions and accordingly a crude comparison is not appropriate.

Similarly, the AEMC concluded in its draft rule determination that it was satisfied as to the competitive nature of the tender process underpinning the construction of the NGP. It states further states that:

Accordingly, it is reasonable to conclude that the current tariff and non-tariff terms and conditions of access for the NGP under the access principles that were negotiated as part of the competitive tender process are unlikely to reflect an exercise of market power by Jemena

It is clear that the AEMC has conducted sufficient enquiries to establish that tariffs are at or close to competitive levels. Further, in its east coast gas inquiry, the ACCC also stated that it regards the rate of return earned by Jemena under the NGP tender as a competitive benchmark against which to assess other pipeline owners:

The differences between the returns depicted in this chart, the return on equity estimated by the AER and the return adopted in the winning bid for the NGP are substantial and are consistent with the significant degree of market power that existing pipeline operators can use when negotiating the prices to access incremental projects.

Our view, and consistent with the Draft Determination, is that prices determined under the discipline of a competitive process should be presumed to be cost reflective unless shown otherwise. Finally, it is also simply not the case that under the tariffs can increase with little scrutiny. This is covered next in Section 3.

³ This claim is inaccurate. For example, APA's Eastern Goldfields and Telfer gas pipelines both charge higher tariffs for haulage over shorter distances. See APA's website, <https://www.apa.com.au/our-services/gas-transmission/current-tariffs-and-terms/current-tariffs-and-terms/>, accessed 26 April 2019.

3. ACCESS PRINCIPLES AND INTERACTION WITH THE DEROGATION

3.1 HOW THE ACCESS PRINCIPLES WORK

The AEMC will be aware the access principles cover access requests, tariffs and dispute resolution via arbitration. Specifically:

- the access principles provide an obligation on Jemena to negotiate in good faith and to supply firm forward haulage and as-available haulage services in line with transparent and orderly procedures;
- the access principles set maximum tariffs for firm forward haul and firm nitrogen removal services, which are based on the outcomes of the competitive tender for the NGP and escalate at CPI each year;
- under the rolled-in-tariff provisions in the access principles, prices are initially set at the level established under the competitive tender, and then may change in line with efficient costs where expansions other than Large Expansions (as defined in the access principles) are made, which ensures that pipeline users share in any economies of scale;
- the access principles also require Jemena to connect the NGP to lateral pipelines at charges reflecting reasonable costs, where it is technically feasible to do so; and
- the access principles contain a dispute resolution mechanism culminating in binding arbitration by an independent party in accordance with external guidelines if the parties are unable to agree.

Relevantly, under the PDA the penalty for non-compliance with the terms of the access principles can extend to coverage being imposed on the NGP. Under the PDA, Jemena does not have the ability to unilaterally change the NGP access principles.

- The rule change proponents claim that for tariffs to be changed under the access principles merely notification to the Northern Territory Government is required. This is a selective reading of the pricing framework that is not consistent with Jemena's understanding of how the access principles will operate.
- The access principles must be read in the context of clauses 23 to 26, the formulation for firm tariffs set out in Annexure 1 and the requirements of the PDA. Specifically:
 - Jemena cannot set tariffs at levels higher than the maximum tariffs set out in Annexure 1 of the access principles.
 - Although Jemena can change tariffs following the commissioning of an expansion or extension, the formulation in Annexure 1 means that firm tariffs charged to existing shippers cannot increase as a result of such changes.
 - It is also clear in this context that the requirement for Jemena to notify the Northern Territory Government of changes in tariffs relates only to tariff changes that are otherwise permitted by the access principles.

3.2 SETTING AND CHANGING OF TARIFFS

The access principles establish maximum tariffs with a CPI escalation. Jemena is unable to charge above this for firm forward haulage and nitrogen removal for services covered by the access principles. Firm forward haulage tariffs are set at \$1.40 per GJ in 2015 dollar terms and escalated at CPI.⁴

The access principles also establish that extensions and expansions of the pipeline (that are not “Large Expansions” as defined in the access principles) with incremental costs that are lower than existing charges will bring down those charges.

IEEFA cites a concern that, even if the Northern Territory Government had secured a competitive price in the NGP tender process, other customers may not enjoy the benefit of that price.⁵ This concern cannot eventuate as the access principles that were agreed under the competitive process set the maximum tariffs, and subsequent shippers cannot be charged above these tariffs, and may be charged below these tariffs (under the rolled-in tariff principles).

The rule change proponents have misunderstood how the access principles set out maximum pipeline tariffs for firm forward haulage and firm nitrogen removal, subject to escalation for CPI. As a result, firm tariffs to shippers cannot exceed these published rates, and Jemena is not unilaterally able to change these tariffs.

3.3 HOW DOES IT ALL INTERACT VIA THE DEROGATION?

It is also important to consider how the derogation applies to the NGP. The derogation is for 15 years following commissioning (being 3 Jan 2019) and only applies to the

“Northern Gas Pipeline between Tennant Creek in the Northern Territory and Mount Isa in Queensland the subject of Pipeline Licence 34 granted under the Energy Pipelines Act 1981 of the Northern Territory and Pipeline Licence 2015 granted under the Petroleum and Gas (Production and Safety) Act 2004 of Queensland, including any extension to, or expansion of the capacity of, that pipeline that is subject to the access principles”

The access principles apply to the NGP and any expansions or extensions that do not result in:

- the capacity of the NGP exceeding 300 TJ/Day; or
- an extension of the NGP beyond KP0 or KP622; or
- the construction of a lateral pipeline which ties into the NGP .

Such Large Expansions (as defined in Annexure 1 of the access principles) are not subject to the access principles. Accordingly, the derogation does not apply to Large Expansions and Part 23 does apply unless a further derogation is granted.

As a consequence, the assertions by EJA in its April submission that the derogation could apply to part of the capacity of a completely new pipeline, creating opportunities for Jemena to engage in forum-shopping, are incorrect as the scope of the derogation is limited.

⁴ NGP pricing principles, annexure 1.

⁵ IEEFA submission, p 3.

4. HOW THE DEROGATED WAS DEVELOPED

Jemena explained in its December 2018 submission to the AEMC that the derogation was developed after the competitive tender and ensures a continuation of the regulatory terms and conditions under which Jemena successfully tendered for the development of the NGP. Importantly, and only after the completion of the tender process managed by the Northern Territory Government, that concluded in November 2015, a number of events occurred of significance to the regulation of gas pipelines.

These events began with the completion of the ACCC's East Coast Gas Inquiry report in 2016, and culminated in new rules being made on 1 August 2017 to implement a scheme for binding arbitration and information disclosure as Part 23 of the NGR.

The commencement of Part 23 of the NGR represented a material change to the regulation of gas pipelines, and in particular 'uncovered pipelines'. It subjected many uncovered pipelines to a significant degree of regulatory oversight.

In light of this material change to the regulatory framework, the derogation for the NGP was developed by the Northern Territory Government in consultation with the Gas Market Reform Group (**GMRG**).

The derogation was therefore developed as part of the 2017 package of changes to the regulation of gas pipelines. The GMRG was of the view that the access principles agreed as part of the competitive tender process for the NGP addressed many of the same concerns as Part 23 was intended to address.

5. DEROGATION CONTRIBUTES TO THE NGO

The overarching outcome of the NGP will be to supply more gas to the east coast and increase competition. As explained in Section 2 of the HoustonKemp report, the NEGI was conceived by the Northern Territory Government as a link between the northern and eastern gas markets, contributing to the development of a national gas grid, a more competitive gas market, and helping to improve security of supply. It was made possible due to surplus gas that was available to the government-owned Power and Water Corporation .

As a result, Jemena considers that the assessment by the AEMC correctly takes into account expected outcomes for the users and investors in the NGP and expected outcomes for efficient investment in, and efficient operation and use of, natural gas services.

We believe that the draft determination correctly considers the credibility of regulation, given that only 5 months have elapsed since the derogation commenced. Further, Jemena does not agree with the EJA's concern about the AEMC's finding that the application of Part 23 to the NGP would give rise to greater regulatory complexity. This concern misunderstands the basis for and the substance of the AEMC's decision. The AEMC does not apply the NGR, it makes the NGR. The NGR applies to the NGP and provide a derogation from Part 23 which reflects the existence of the access principles agreed between Jemena and the Northern Territory Government. The AEMC rightly concluded that:⁶

The Commission considers that the combination of a competitive tender process setting key tariff and non-tariff terms and conditions of access to the NGP with the contractual obligations placed on Jemena through the project development agreement limit the ability of Jemena to exercise significant market power during the initial years of the NGP's life.

By comparison, the outcome of any arbitration process under the Part 23 access regime is fundamentally uncertain and, in the context of the NGP being only one third contracted for the long term at this stage, the tariff could be much higher under a Part 23 arbitrated outcome. Additionally, under Part 23 rules, the benefits of economies of scale created by expansions as provided by the rolled in tariff principle need not be passed on to shippers with existing contracts. There are also no grounds to form an expectation that the Part 23 access regime would on its own give rise to expected outcomes that better contribute to the NGO than the NGP access principles.

The rule change proposal for revocation of the NGP derogation would give rise to material additional regulatory complexity During the term of the derogation, Jemena is bound by the NGP access principles which set out mandated requirements in relation to the provision of access, determination of prices, publication of information and access to arbitration. None of these requirements would fall away if the derogation was revoked. It follows that there would be overlapping regulatory requirements for gas transportation services on the NGP that would give rise to unnecessary complexity relating to resolving potentially conflicting requirements.

- We maintain that there are a number of special circumstances impacting the NGP which are addressed in our responses to the other questions raised by the AEMC.
- The NGP is a new pipeline connecting a new source of natural gas to east coast markets.
- The current contracting arrangements have the effect of the NGP being exposed to much greater risk than most newly constructed pipelines (see Section 2.2 of the Houston Kemp report submitted on 13 December 2018).
- the NGP was developed under a highly competitive tender process run by the Northern Territory Government;
- the derogation provided Jemena the ability to continue to develop and operate this pipeline on the terms that were agreed under Northern Territory Government's tender process.

⁶ AEMC draft rule determination, p 31.

6. RESPONSE TO UNFOUNDED CLAIMS MADE BY RULE CHANGE PROPONENTS

The rule change proponents make a number of unreferenced, incorrect or misleading claims about the development of the NGP and the obligations imposed on Jemena by the access principles. This section responds to some of these claims with facts that demonstrate their inaccuracy.

Jemena submits that, given the significant number of untrue allegations that the rule change proposal is founded on, the AEMC should exercise great caution in accepting any claim of fact made by its proponents.

Tax audit

In its 2017 financial report, SGSP (Australia) Assets Pty Ltd (Jemena's parent company) noted that:⁷

The Australian Taxation Office is currently conducting a transfer pricing audit in relation to the Company's convertible instruments. No liability has been recognised.

IEEFA expresses concern that the tax audit could lead to higher prices for consumers, because if Jemena were to face a higher tax bill or penalties due to the findings of the audit, then it could seek to recover them:

... via the derogation to the National Gas Laws that is in the process of being granted to them by the AEMC as per the draft determination.

We understand that it is the role of the Australian Taxation Office, and not the AEMC, to administer tax law and in doing so determine if there are any tax issues.

The ATO is currently on-going and we merely note that based on information from the Corporate Tax Association, there are hundreds of large corporates currently under audit or review by the ATO in relation to transfer pricing.

Funding

EJA draws unsubstantiated links between the tax audit and refinancing (convertible notes) and claims that:

... Jemena is subject to a transfer pricing audit regarding \$800 million of convertible notes. Those notes were part of a company restructure that was announced less than a week after the creation of the Jemena Northern Gas Pipeline Pty Ltd. The convertible notes are in exactly the same amount as the proposed cost of the Northern Gas Pipeline and the duration of the notes to 2050 is almost exactly the same as the expected operational life of the pipeline (30 years). There is no reason to believe the convertible notes are not related to the NGP.

We note that the link between the tax audit, refinancing of debt by Jemena and the investment costs of the NGP appears to be nothing more than speculation by the rule proponents. No evidence has been provided to draw such a conclusion.

Jemena notes that the convertibles notes issuance was part of capital structure refinancing and unrelated to the cost of the NGP project.

⁷ SGSP (Australia) Assets Pty Ltd, *Financial report for the year ending 31 December 2017*, 23 March 2018, p 17. The comment is also repeated at page 18 of the 2018 financial report.