SUPPLEMENTARY SUBMISSION TO THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION IN SUPPORT OF AN APPLICATION FOR AUTHORISATION

PNG GAS PROJECT

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1. Introduction

The PNG Gas Project Participants (the ***Participants***) refer to the Commission's Issues Paper and the subsequent submissions from third parties in response to the application for authorisation made by the Participants lodged with the Commission on 14 December 2004 (the ***Application***).

Submissions have been made by WMC (Olympic Dam Corporation) Pty Ltd, TXU, Queensland Alumina Limited, Comalco Aluminium Limited, BHP Billiton, Energy Users Association of Australia, Energex and APC (AGL and Petronas). The Participants would like to acknowledge the support that was given to the Project in these third party submissions. The Participants are strongly encouraged by the positive comments made regarding the importance of the Project, and the recognition of the many and substantial public benefits that will arise if the Project is able to proceed.

The Participants would like to clarify and expand upon the following issues that were raised in the submissions:

- the duration of the authorisation;
- the application of the authorisation to future participants; and
- issues relating to the position of the Project in the supply of gas in Queensland.

2. Duration of the authorisation

2.1 Introduction

The Participants submit that there are clear public benefit reasons for the authorisation to extend for a significant period beyond financial close and that the case for this has been established in the Application.

As outlined in the Application, the structural features of the gas industry in eastern Australia continue to act as a barrier to separate marketing. In the case of the Project, the lack of depth and liquidity in the customer base (especially in Queensland) is compounded by the fact that Project gas must compete directly against coal in order to secure customers, indeed some customers need to spend money in order to convert to gas. This is particularly the case in respect of customers in Queensland. The potential pool of customers who are actually existing gas users, rather than conversion customers, is even more limited and shallow.

In addition to the structural difficulties, there are additional and unique risks specific to a greenfields project being undertaken in PNG. These risks give rise to more certainty regarding the quality and volume of gas to be supplied by the Project being required by financiers than for a development wholly within Australia. The Parer Report specifically recognised that the PNG Project was a complex, greenfields project the development of which could be frustrated if joint marketing was not permitted.

2.2 Authorisation is essential for the period beyond financial close

It has been suggested that by the time the Project reaches financial close the Participants will have secured a sufficient volume of gas sales such that they or their financiers will have a high degree of confidence that their required risk adjusted returns will be met. The Participants note that only a very small number of parties have made such a submission. Further, those parties are not themselves considering a decision whether to invest billions of dollars of their shareholders funds into the Project. Rather, they stand to benefit through the lower gas prices modelled by ACIL, if the Participants themselves assume the risks of sanctioning the Project.

For the reasons set out in the Application, any argument that authorisation until financial close is all that is required to enable the Project to proceed is simply untenable. The Participants wish to make a number of comments which further explain the need for authorisation beyond financial close:

- The Participants and the Project's financiers will expect the Participants to be in a position to secure further gas sale contracts past financial close, ensuring that the Project is financially viable over its entire life, and which provide a buffer in terms of the returns required to meet debt repayments.
- There are obviously a variety of events which could lead to less than anticipated returns being obtained from contracts signed up until financial close. For example, a foundation customer becoming insolvent after financial close could have a very substantial negative impact on projected project revenues and cash flows. Projected revenues from contracts secured at the date of financial close are not therefore the only relevant consideration in the analysis of the Project's risk adjusted returns.
- In the absence of the ability to jointly secure additional contracts past financial close, any party undertaking a risk analysis will clearly have concerns regarding the potential for those additional contracts not to be achieved or for an individual Participant not to be a party to, and therefore not to benefit from, such future contracts.
- The Participants must adequately address different types of risk in order to reach financial close on the Project, including constructability, operability, financing and other risks. Therefore, although, for example, there may be sufficient gas sale contracts to reach financial close from a financier's perspective, this is only one of the matters that the Participants must resolve before a project sanction decision can be made. A short-term authorisation will increase the risk that investment returns will not be met in the future and as such the Participants may decide to delay the Project until the threshold volumes have been met, or decide not to go forward with the Project at all.
- Customers taking below expected volumes have an impact on cash flows beyond simply the expected gas revenue in that significant revenue comes from the condensate produced from the gas stream. Again the financiers will require the

ability to obtain larger gas sales volumes in the future to provide greater certainty over these condensate revenues.

- Accordingly, the volume of gas sales contracts that the Participants or their financiers may have regarded as acceptable to reach financial close will inevitably be affected by the additional risk that will arise from an inability to jointly market gas to customers post financial close, and therefore greater volumes of contracted sales are likely to be required to mitigate the risk. A necessity to secure greater volumes of firm gas sales contracts before financial close, imposed by a short term authorisation would, at a minimum, delay the Project and could in fact cause the Project to fail.
- The Project moved to the FEED stage well below the level of foundation customer commitments that it had targeted in order to break the Project cycle of delay resulting in lost customers. The Participants will be unable to bring the Project to financial close at the earliest opportunity if post financial close gas sales contracts secured through joint marketing are not within the scope of the authorisation.
- Further, the increased risk profile for the Project arising from a short term authorisation may prevent financial close being reached. As stated in the Application, the Project has experienced great difficulty in retaining customers given their concerns regarding the Project's viability, the need for the Project to match customer requirements given the long lead times before gas will become available to customers. Any additional volume requirements may result in an unanticipated delay in reaching financial close and this in turn, based on past experience, may lead to a further loss of foundation customers as they turn to alternative gas or other energy sources to satisfy their needs. This has the real potential to create a negative cycle for the Project which prevents the Participants ever securing sufficient volumes to justify proceeding to financial close.
- There is also a potential for separate marketing arrangements to result in a misalignment of commercial interests among the Participants leading to disputes over how the gas sale agreements will be administered. The potential for such disputes is likely to add to Project finance risk rather than reduce it.
- Short term authorisation will also lead to financiers requiring all the necessary agreements for administration of separate marketing being put in place prior to financial close adding very significant complexity to the Project development.

2.3 [confidential]

2.4 Recognition by the Australian Competition Tribunal of the public benefits from long term investments

Joint marketing is a crucial factor in determining the viability of the Project and whether it will proceed in the foreseeable future. Therefore, when assessing the public benefit arising from joint marketing, the benefits of the Project generally must be taken into account. The significant upfront capital expenditure required to fund a major new development such as the Project must be secured against the cash flow of the venture over the life of the Project.

The significant period of time for this upfront expenditure to be amortised means that long term authorisation is required for these public benefits to be realised. As the decision of the Australian Competition Tribunal in *Re AGL Cooper Basin Natural Gas Supply Arrangements* confirmed, public benefits can continue to exist in the long term from an arrangement which is "necessary to sustain substantial, long-lived, sunk investments" (see (1997) ATPR 41-593 at 44,216). In the case at hand it is clearly appropriate to have regard to the long term public benefits that will result from the Project and not just those up until financial close.

2.5 [confidential]

2.6 Recognition of the need for long term exemptions by other regulators

Many international regulators and courts have recognised the need to provide companies making very significant, long term investments with an appropriate degree of protection from the operation of regulations or laws the potential application of which is likely to create additional uncertainty or risk. A summary of several key decisions from Europe is set out below.

(i) ***European Night Services & Ors v European Commission*** **(EC)**[1]

This well known case involved a decision of the EC to grant an exemption from the operation of Article 85 of the EEC Treaty (as it then was) (the equivalent of sections 45/47 of the TPA) for a period of 8 years only in relation to an agreement relating to the formation of a joint venture company by 4 railway operators for the provision of overnight passenger rail services through the Channel Tunnel. The parties to the agreement, supported by the United Kingdom, appealed against the EC's decision, including in relation to the term of the exemption.

The European Court of First Instance overturned the EC's decision, and, relevantly, considered the duration of the exemption granted by the EC. The Court of First Instance held that:

> 'the Court considers that the duration of an exemption granted … must be sufficient to enable the beneficiaries to achieve the benefits justifying such exemption, namely, in the present case, the contribution to economic progress and the benefits to consumers provided by the introduction of new high-quality transport services …' and
>
> 'Since, moreover, such progress and benefits cannot be achieved without considerable investment, the length of time required to ensure a proper return on that investment is necessarily an essential factor to be taken into account when determining the duration of an exemption, particularly in a case such as the present, where it is undisputed that the services in

[1] European Night Services & Ors v Commission of the European Communities, Court of First Instance (Second Chamber), 15 September 1998, Joined Cases T-374/94, T-375/94, T-384/94 and T-388/94.

question are completely new, involve major investments and substantial financial risks and require the pooling of know-how by the participating undertakings.'[2]

While it was not necessary for the Court to determine the appropriate period for an exemption, it is clear that the Court considered that the period granted by the EC was inadequate.

(ii) ***Decision of the Ofgem in relation to South Hook LNG Terminal Company Ltd***

In November 2004 Ofgem issued its final decision in relation to the application by South Hook (owned by Qatar Petroleum and ExxonMobil) for an exemption from section 19D of the Gas Act 1986 (UK) which provides a right of third party access to LNG import terminals. South Hook proposed to construct an LNG import facility at Milford Haven in the UK. The facility was to be constructed as part of a proposed multi-billion dollar project involving the supply of LNG from Qatar to the UK.

The South Hook owners submitted that the viability of the entire project depended on the ability to construct an import terminal in the UK at an acceptable level of risk. They applied to Ofgem for a 25 year exemption which would permit the terminal to be used as an own use facility (that is, precluding third party access) since this was the lowest risk and most cost efficient option for the project. The owners advised Ofgem that they required a high degree of comfort from the UK regulatory authorities and the EC that an exemption would be granted in the terms sought in order to justify the investment costs of several billion dollars.

The South Hook owners submitted to Ofgem that:

- the term over which the upstream element of the project was required to produce gas to make an acceptable economic return was at least 25 years;
- firm rights to the capacity of the terminal were essential to allow for repayment of external debt and to provide an acceptable return to the equity investors in the project;
- shortening the period of exemption would introduce uncertainty and risk to the project;
- lenders typically require the period of guaranteed access to the terminal to exceed the length of any loans by several years so that, if project cash flows in the early years fall short of debt service needs, they can recoup losses towards the end of the project life.

In its final decision[3], Ofgem granted an exemption in the terms sought by the South Hook owners including a 25 year period for the exemption. Notwithstanding that

[2] At paragraph 230.

some third parties had submitted that an exemption was only required for a lesser period, Ofgem agreed with the owners that the level of risk attached to the development of the facility meant that the investment to construct the facility would not be made without an exemption for the 25 year period.[4] Ofgem noted that the project would result in the entry of a new supplier into the UK market. The EC, which had a right to veto this decision, permitted the decision to stand.

(iii) Other decisions

In 1995 the EC cleared a long term agreement relating to the UK to Belgium subsea interconnector, and noted that the agreement provided 'restrictions on competition to enable the members of the consortium to enjoy the use of the interconnector for a specified period that allow adequate recompense for the expense of providing a major infrastructure.'[5]

In 2000 the EC did not object to a 25 year exclusive agreement for the rights to use a high-voltage electricity cable that was proposed to be constructed between Norway and Germany, noting the need for 'substantial investments' by the applicants. [6]

Although the decisions outlined above do not relate to exemptions relating to joint marketing, they do involve the consideration of the appropriate period of an exemption from the operation of competition regulation in circumstances where a joint venture type organisation is considering the investment of significant amounts of capital in order to commence supplying a new service. In particular, they demonstrate the recognition by regulators and the courts of the increased level of risk that would be associated with an exemption of a shorter period, and the benefits of granting an exemption for an appropriate duration in order to facilitate such investment.

Further, although all of the decisions above relate to significant investment decisions, only the South Hook investment comes close to the estimated investment of at least US$3.5 billion that the Participants propose to make in the Project. The Participants repeat that this is an investment of a level that is of global significance, and if it proceeds it will certainly rank as one of the largest infrastructure projects ever to have occurred in Australia. The Participants strongly urge the Commission to pay appropriate recognition to the need for the Participants to mitigate the risk of this investment and secure necessary customer commitments through a long term authorisation. The Participants note that, like the South Hook example, the Project is a greenfields investment which will result in a new supplier entering the market. There has been no evidence provided by any of the third parties who have suggested a limited authorisation is appropriate which rebuts the

[3] Application by South Hook LNG Terminal Company Ltd (SHTCL) (owned by Qatar Petroleum and ExxonMobil) under section 19C of the Gas Act 1986 for an exemption from section 19D of the Gas Act 1986 – Ofgem final views, November 2004.

[4] At paragraph 2.7.

[5] Press release DN:IP/95/550 of 01/06/1995.

[6] Notice pursuant to Article 19(3) of Council Regulation 18 concerning case COMP/E-3/37.921 (2001/C247/04).

repeated statements and supporting arguments made by the Participants that at a minimum a short term authorisation will delay, if not entirely frustrate, the Project proceeding.

3. Application of the authorisation to future participants

A very small number of third party submissions suggested that authorisation should not be granted to future participants in the Project. At the request of the Commission, the Participants submitted the Application while the Project is still in its formative stages, in order for them to be able to continue to jointly market gas pursuant to an authorisation. As a result, and as noted in the Application, the structure of the Project is very likely to continue to change. In particular, as noted in the Application, if the Project proceeds, there is a strong potential for the State of Papua New Guinea to enter the Project and it has the right to effect its participation through a number of legal entities. Other third parties that have an interest in a licence containing Project reserves, but who are not currently Participants in the Project (such as companies in the Santos group), may also decide to commercialise their interests by entering the Project. The ability for the Participants to fund their participation in the Project may ultimately require different project or commercialisation structures to those that are currently in place, and therefore any restrictions may inhibit the ability of the Project to obtain the necessary cost effective funding.

It is essential that flexibility is granted to the Participants to accommodate changes to the Project in this respect. The Participants have applied for authorisation to extend to future participants in order to avoid the delay, cost and, in particular, the uncertainty and risk involved in making amendments or new applications for authorisation when there is a change in participants.

The Participants do not accept that new participants to the Project are not required in order for the Project to proceed and therefore do not need to jointly market Project Gas. For the reasons set out in detail in the Application, all participants, current and future, will need the ability to jointly market gas in order to find a sufficient customer base to underwrite the Project. Forcing a new participant to separately market could undermine the Project's ability to secure gas contracts, and would also affect the analysis of risks by Project members and their financiers. For example, banks would not welcome a practical impediment to any necessary realisation of their security in the event of borrower default.

Some submissions made reference to confidentiality arrangements that were required by the Commission under the interim authorisation, and suggested that ring fencing arrangements must be imposed on the Participants. The Participants note that those arrangements were developed at a time when Santos was a participant in the Project, and when ExxonMobil had an interest in the Cooper Basin reserves. As this is no longer the case, confidentiality and ring fencing arrangements, such as those under the interim authorisation, need not be imposed. Nevertheless, the Participants are happy to discuss appropriate confidentiality arrangements with the Commission to address any issues that may exist in this respect, particularly in the case where a new participant enters the Project which has a current interest in the eastern Australian gas market.

4. Position in the Queensland market

The Participants accept that if the Project is able to secure sufficient customer support to proceed, it will become a major supplier of gas in Queensland. However, the Participants do not accept that this will somehow provide them with market power or the ability to extract monopoly rents from customers. As outlined in both the Application and the ACIL Tasman report, there will be significant constraints on the Project in the supply of gas in Queensland. In particular, constraints will come from:

- coal seam methane for incremental demand;
- coal for major projects (customers are also keen to maintain diversity of energy sources for security reasons); and
- other current and future gas supply.

These constraints (which have growth potential) will be ongoing and will be coupled with a customer market that, in the opinion of the Participants and based on the previously submitted reports, will remain illiquid and project based.

As outlined in the Application, many of the customers that the Project is targeting to secure sufficient customer commitments to proceed to financial close will need to be converted from other energy forms including low cost coal. Competition from these energy sources will continue to operate on the Project in the future.

The Participants stress that the only way in which the Project could become a major supplier of gas in Queensland (at least in the short term) is if the Project is able to be the most competitive supplier against existing sources of energy. Clearly, in this respect the Project must be price competitive with existing suppliers. Customers will be able to secure the benefit of this competition through long term contracts. In such a situation it cannot be the case that the Project will be able to achieve prices that are above a competitive level. To the contrary, the ACIL Tasman report predicts that there will be significant price falls in gas prices in eastern Australia.

Confidential Annexure 1