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

PNG GAS PROJECT

(A40081)

27 MARCH 2006

1. Introduction

1.1 Purpose of submission

The PNG Gas Project Participants (***Participants***) refer to the 'Response to the ACCC on the Draft Determination of the PNG Gas Project – Application for Authorisation' (***EUAA submission)*** lodged by the Energy Users Association of Australia (***EUAA***) with the Australian Competition and Consumer Commission (***Commission***) on 15 March 2006.

The purpose of this submission is to assist the Commission in its consideration of the propositions raised for discussion by the EUAA, by providing it with the Participants' views on the following issues:

(a) the appropriate term of the authorisation;

(b) the appropriate counterfactual;

(c) the public benefits of the Project;

(d) the shape of the market;

(e) what conduct is being authorised; and

(f) the appropriateness of the proposed ring fencing and confidentiality arrangements.

As a preliminary point, the Participants wish to again state that the EUAA's mandate to make claims on behalf of its members is completely unclear. At the pre-decision conference in Brisbane a major energy user, NRG Flinders, made very positive comments regarding the Project. It therefore cannot be assumed that the EUAA's position is universally accepted. Further, the EUAA's submission is cast in generalities, there is little specific analysis of its claims as relevant to particular members. The extent to which the interests of coal seam methane (***CSM***) producers, who clearly have a vested interest against the Project, have influenced the EUAA submission is also a matter of concern to the Participants.

Additionally, the EUAA submission includes a number of claims about the status of the Project and what the Project does and does not require in order to proceed (including not requiring authorisation beyond financial close). Significantly, the Participants wish to point out that they were not approached by the EUAA to present at a conference attended by the Project's key customers, yet CSM producers were. Nor have the Participants been approached by the EUAA for a briefing about the Project in any other context. Accordingly, the Participants question whether the EUAA has sufficient knowledge of the Project to make the claims that it does.

The Participants believe that they have already properly responded to the issues raised by the EUAA in their previous submissions, in particular, the Participants' submission lodged on 15 March 2006. The Participants rely on those submissions. For the sake of clarity, the Participants make the following additional submissions.

2. The appropriate term of authorisation

2.1 The EUAA submission to align the term of authorisation with a volume level

In section 7 of the EUAA submission, it is proposed that the Commission consider a volume based approach to the setting the term of the authorisation.

The Participants submit that the proposal that the authorisation term be aligned with a certain volume level is completely inappropriate. It appears that this suggestion is based on a simplistic assumption that a decision as significant as Project Sanction will be made by the Participants simply on the basis of a particular volume of gas being the subject of GSAs. Such an assumption is commercially and legally flawed.

A decision to proceed to Project Sanction will be made on the basis of a complex matrix of legal, commercial and risk factors, which will take into account the views of a large number of the providers of both equity and debt to the Project. One of those factors is the volume of gas sales secured by the Participants. However, other critical factors include the relevant contractual provisions in the GSAs, including term, and assessment of the likelihood of the projected revenues under the contract being secured having regard to various risk factors including customer creditworthiness. While the Project accepts that it is generally dealing with large Australian customers, having regard to corporate history in Australia and overseas over the last decade it cannot be contended that the Participants and their financiers are overstating the potential risks of the Project failing to secure contracted cash flows, for example due to events of insolvency or force majeure.

Further, as repeatedly stated by the Project, both financiers and the Participants will also have regard to their ability to secure additional gas sales after financial close. Such forward sales are necessary as a buffer against the risks of a failure to secure cash flows under the foundation GSAs and to meet required rates of return. Project financing will be non-recourse, therefore the security of current and future cash flows is a matter of critical importance. The assumption that the Participants will, or should, simply draw a line in the sand at a particular gas volume without any consideration for sales volumes post that time is completely false and is rejected by the Participants.

It is also important to emphasise that at the current time the Project has only one firm GSA; the remaining sales are only under conditional Indicative Term Sheets (***ITAs***). An erroneous theme that pervades the EUAA's submission is that the volumes 'secured' by the Project to date under ITAs are guaranteed to result in GSAs which are acceptable to the Participants and that the cash flows under those GSAs are risk free. This assumption stems from the false premise that underpins all of the EUAA's arguments, namely that having regard to the ITAs currently in place and the current position of the Project, it is inevitable that the Project will go ahead. The Participants rejected this assumption at the pre-decision conference, and continue to reject it (see further below).

In addition, the Participants consider that volume levels are too restrictive and onerous a measure by which to judge the appropriate term of authorisation for the following reasons:

(a) a volume limit would:

(i) increase the uncertainty surrounding investment in the Project as the Project's financiers will be unsure as to the cash flows of the Project once the volume limit is reached;

(ii) restrict the Participants from jointly marketing to expand the Project;

(iii) deny the ancillary public benefits that would result from an expansion of the Project;

(iv) restrict the ability of the Participants to act in the event of customer insolvency or a force majeure event occurring; and

(v) not allow the Participants to offset any unexpected additional costs of developing the Project (Project Sanction is still only based on cost estimates); and

(b) while the Participants have signed ITAs which result in a certain volume level, there is no guarantee that this ITA volume level will convert to the same level under GSAs. The flow of volumes (and therefore cash flow) under GSAs is not guaranteed as:

(i) a customer may only take a minimum commitment under its GSA;

(ii) the customer may become insolvent during the term of the GSA; and

(iii) a prolonged force majeure event may occur.

2.2 Why a long term authorisation is required

The key points which the Participants wish to make in this submission are:

(a) that the Project requires long term authorisation because the Participants do not currently believe that separate marketing is possible in the eastern Australian energy market in the long term. As was stated in paragraph 2.2 of the Participants' 15 March 2006 submission, the larger Participants maintain a preference to separately market where market conditions make this possible. However, the view of the Participants at the current time is that separate marketing for a Project of this significance is not possible in the illiquid and shallow eastern Australia energy market and, therefore, a long term authorisation for joint marketing is required for the Project to have the regulatory certainty to proceed; and

(b) the Participants, their financiers, the AGL Petronas Consortium (***APC***) and their financiers are looking at additional sales to mitigate risks and achieve an acceptable rate of return over the life of the Project. These contracts (and therefore the required Project growth) cannot be achieved without a long term authorisation for joint marketing.

The recent progress of the Project is only to be expected given the Project is now 18 months into the FEED stage. However, this progress does not demonstrate that the Project no longer faces the risks which require a long term authorisation. The Project still faces a number of significant risks, including:

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The ability to jointly market in the long term will mitigate and offset some of these risks.

In section 7 of the EUAA submission, reference is made to a recent report by Macquarie Research discussing the areas of Project uncertainty that present the greatest risk to Project sanction and timelines. The Participants submit that the fact the report does not mention the Participant's application for authorisation may have occurred for any number of reasons, including that at the time of the report, the Commission had issued its Draft Determination which proposed to grant long term authorisation to the Participants. In any event, having regard to the nature and focus of these types of analysts' reports it is not at all surprising that it would not comment on this issue.

In any case, the Participants submit that whilst third parties (who are not Participants of the Project) may not regard securing long term authorisation as one of the greatest risks to the Project, those third parties are not planning on investing a combined total of over US$4 billion and are not required to seek financing for a project of this magnitude, nor are they required to sufficiently address the risks involved in such a significant investment. On the other hand, the Participants:

(a) are investing this very substantial sum of money;

(b) are required to seek financing for the Project;

(c) are required to sufficiently address the risks involved in such a significant investment; and

(d) need the ability to offset long-term risks.

As a result, the Participants would regard the failure to secure a long term authorisation as a critical set-back for the Project.

2.3 Authorisation term based on Project financing term

Section 7 of the EUAA submission discusses the appropriateness of the Commission's proposed authorisation term being based on the Project financing term.

The Participants refer the Commission to the submissions made in paragraph 5.2 of the Participants' submission lodged on 15 March 2006 and make the following additional submissions:

(a) it is important that the authorisation term is for at least the Project finance term (as confidentially submitted by the Project's financial advisor) so that the regulatory environment throughout the Project finance term is sufficiently certain for financiers to commit to the Project;

(b) **[*confidential*]**;

(c) the proposed Project financing is structured around the Project's cash flows being directed to the Participants on a consistent basis and according to their proportional interests in the Project. Joint marketing guarantees this consistency and proportionality will be maintained over the term of the financing and avoids the potential for disputes between Participants over the administration of GSA flows, particularly in the circumstances of curtailment of supply;

(d) the Project's financiers are taking gas buyer credit risks. Financiers will take comfort from and have a real interest in an ongoing marketing effort beyond

financial close to secure additional contracts, as providing an additional buffer in their credit assessment of gas buyer credit risk. Financiers would be concerned if the smaller borrowing Participants were to be disadvantaged in these continuing marketing efforts (see following point);

(e) as discussed in 2.6 below, smaller Participants are the most likely to be penalised by an absence of joint marketing. These smaller Participants include MRDC and the State of PNG who will be seeking external Project financing, reinforcing the concerns expressed in (c) and (d) above; and

(f) while the level of interest in financing the Project has increased over the last 12 months, as was stated in paragraph 2.2 above, the Project still faces a number of risks which financiers would wish to see addressed. Having the authorisation term at a minimum match the Project finance term would, amongst other things, remove regulatory uncertainty as an issue and help the Participants address these risks.

2.4 ExxonMobil not seeking project finance

In section 7 of the EUAA submission, it is submitted that as ExxonMobil is not seeking project financing, the term of the authorisation should not be based on the Project financing term.

Regardless of ExxonMobil's position, the Project will not proceed unless the Participants who are seeking external financing obtain this finance. So for the reasons given above, the term of Project financing for these Participants is the appropriate measure for the term of the authorisation.

Additionally, the Project is one of many potential projects that ExxonMobil is participating in globally. These projects compete internally for internal financing by ExxonMobil. The fact that ExxonMobil is not financing the Project from external sources does not mean that ExxonMobil does not have to address and consider the same risks that the Participants seeking external financing do. So whilst the external financiers are generally financing those less experienced parties and gain comfort from those parties jointly marketing with more experienced parties, having a long term authorisation would provide the regulatory certainty that internal financiers also require before investing.

2.5 The marketing activities of AGL and Oil Search

In section 6 of the EUAA submission, it is submitted that as AGL and Oil Search are already separately marketing, authorisation beyond financial close is unnecessary.

The Participants submit that the EUAA has misconceived the nature of the marketing activities undertaken by AGL and Oil Search.

AGL's sale of Project gas to NRG Flinders was not an instance of separate marketing by one of the Participants. AGL purchased Project gas as part of its gas supply portfolio, that is, **as a customer of the Project**. This gas had been jointly marketed to AGL by the Participants pursuant to the interim authorisation. AGL, in its retail capacity, then sold gas to NRG Flinders out of its supply portfolio. This situation is no different to that of any other customer of the Project, who may wish to purchase Project gas into their supply portfolio

for resupply to a third party. The situation is simply not evidence that Participants are separately marketing Project gas.

The Participants also wish to refer to the pre-decision conference, where NRG Flinders submitted to the Commission that the benefits of having the Project in the eastern Australian energy market were evident to NRG Flinders as the presence (and direct competition) of the Project allowed NRG Flinders to obtain a better deal from AGL in purchasing gas.

It is also not the case that Oil Search has been separately marketing Project Gas. Oil Search has been involved in **identifying future sales opportunities** in PNG for Oil Search gas and Project gas if the Project is interested. Potential customers identified by Oil Search are to be approached by ExxonMobil as the Project Operator if the Project decides to pursue the relevant opportunity.

The examples cited by the EUAA are again simply not correct and are not instances of separate sales by the Participants.

2.6 The ability and desire of the smaller Participants to separately market

In section 6 of the EUAA submission, it is submitted that the relatively small size of some of the Participants is of limited relevance as they would effectively be 'shielded by the larger parties involved'.

The Participants are unclear as to the precise meaning of this statement, but wish to submit that an authorisation for joint marketing is likely to lead to an increase in competition in the eastern Australian energy market. It is only through the ability to jointly market their gas entitlement that the smaller Participants in the Project will in fact enter the market and, therefore, increase the number of firms in the market. The Participants submit that an increase in the number of firms in the market is likely to result in increased competition in the market in the long term. As stated at the pre-decision conference, Merlin and MRDC (and the State of PNG when they become a Participant) are not capable of separately marketing in the eastern Australian gas market and will, therefore, not be able to successfully enter this market without an authorisation as proposed by the ACCC in the draft determination.

Accordingly, authorisation until financial close would not see the smaller Participants being shielded, but would in fact result in their being exposed to the risk of being unsuccessful in gas sales beyond that point, with corresponding implications for their financing arrangements and willingness to proceed with an investment in the Project. As stated at the pre-decision conference, both Merlin and MRDC would not be able to reach financial close without a long term authorisation for joint marketing.

The Participants also rely on their previous submissions to the Commission concerning the willingness of customers to only negotiate and contract with firms of a certain size, financial capability and experience in the eastern Australian gas market. Additionally, the Participants seek to rely on their previous submissions in relation to the countervailing power of customers in the eastern Australian gas market. Without the ability to jointly market in the long term, the smaller Participants will have little to no bargaining power in negotiations with larger customers.

Also in section 6 of the EUAA submission, it is claimed that Merlin and MRDC 'do not wish' to separately market because they do not have the resources to do so and that this is not a sufficient reason for the Commission to grant a long term authorisation.

The Participants submit that this statement by the EUAA is misleading, and highlights the lack of real understanding or attention that the EUAA has to the operation of the entire Project and all of its participants due to the EUAA's narrow focus on the larger Participants. It is not the case that Merlin and MRDC 'do not wish' to separately market; Merlin and MRDC are **unable** to separately market. The position of Merlin and MRDC is that they will not be able to reach financial close without the ability to jointly market. The Participants have never submitted that this is the only reason why a long term authorisation should be granted, but it is certainly one reason.

2.7 The relevance of APC Pipeline financing to Project financing

In section 7 of the EUAA submission, it is submitted that the financing requirements of the APC Pipeline do not relate to the term of the authorisation as the APC Pipeline financing requirements are unrelated to the Project financing requirements.

The Participants strongly disagree with this submission and submit that the financing of the Project and the financing of the APC Pipeline are closely related because certainty of financing for both the Project and the APC Pipeline is required before the Project can proceed. It is self evident that there is no purpose proceeding to Project Sanction if the pipeline to transport the gas to Australia is delayed or does not eventuate.

Further, despite the financing term for the APC Pipeline being significantly shorter than that for the Project, the Participants understand that the APC Pipeline financing will be sized having regard to the Project's 20 year contract terms and hence APC's financiers will have an equal if not greater interest in ensuring the marketing arrangements provide for regulatory certainty.

3. The appropriate counterfactual

3.1 Future with and without test

In section 10 of the EUAA submission, the appropriateness of the counterfactual assessed by the Commission in its Draft Determination is questioned.

The Participants submit that Commission's assessment of the counterfactual was entirely appropriate as the future with and without test is clearly satisfied because:

(a) in the future with a long term authorisation in place, there will be significant public benefits and no anti-competitive detriment; and

(b) in the future without a long term authorisation in place, the public benefits will be foregone and a critically important opportunity to facilitate a major infrastructure development and investment in Papua New Guinea and rural and regional Australia will have been denied.

4. The public benefits of the Project

4.1 Prices under joint and separate marketing

In section 3 of the EUAA submission, the need for joint marketing beyond financial close is questioned as it is submitted that joint marketing prices will be no different to separate marketing prices. This issue involves the public benefits of the Project.

As was stated in paragraph 2.2 of the Participants' 15 March 2006 submission, the Participants submit that the EUAA's submission in this regard is misconceived for a number of reasons. The Participants rely on their submissions in paragraph 2.2 of their 15 March 2006 submission, but wish to emphasise once more that if the Project does not proceed then public benefits of the Project will be lost. Accordingly, the Participants submit that the issue of what prices the Project will charge under a separate marketing arrangement is not relevant to the Commission's assessment of the public benefits of the Project.

Further, the Participants wish to emphasise that they have **never** stated that achieving higher gas prices was their purpose for seeking authorisation. Authorisation has been sought in order to provide the Participants the ability, as a group, to approach the market and obtain sufficient certainty and security to proceed with the Project. It has not been sought to price gouge and extract monopoly rents from potential customers. The fierce and ongoing competition that the Project has faced from other gas suppliers, coal seam methane suppliers and other energy forms such as coal, clearly indicates that such profiteering could not occur.

The reference by the Participants to the fact that prices would be no higher than if there was separate marketing is simply a comment which demonstrates that there is not likely to be any public detriment (in the form of higher prices) from the authorised conduct, since absent joint marketing (assuming such a hypothetical could even occur) prices would be no different. The EUAA seeks to import into this statement a purpose which the Participants have never claimed as an objective of seeking authorisation and which could not occur in any event.

The Participants also wish to refer once again to the modelling of ACIL Tasman which demonstrates that the introduction of the Project into the eastern Australian gas market will result in lower gas prices.

5. The shape of the market

5.1 The experience of Energex

In section 8 of its submission, reference is made to the experience of Energex in its attempts to secure gas supply for its Townsville power station.

The Participants submit that this submission is misleading as it suggests that the Participants should be included in the group of 'joint marketing gas sellers' who Energex has experienced difficulty in negotiating with.

As a preliminary point, the Participants state that they regard their confidentiality obligations with their customers very seriously and so make the following confidential submission.

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6. What conduct is being authorised?

6.1 Associated liquids

The Participants refer to section 7 of the EUAA Submission, in particular to the value split figures of 85% oil and 15% gas quoted from a research note on Oil Search and AGL.

The Participants do not agree with the EUAA's submission that liquids returns in the early years of the Project are likely to be large compared to the gas returns.

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The Participants submit that they will be supplying gas to customers along the length of the pipeline system. The Project's customers will be buying gas for different purposes and so the Participants intend to satisfy their customers' needs by supplying gas in accordance with the relevant Australian gas and pipeline specifications in the GSAs. It is for this reason that the Participants sought authorisation of 'Project gas'. In this regard, the Participants seek to rely on paragraph 4.2 of their 15 March 2006 submission. The Participants have never sought authorisation for other Project liquids such as condensate.

7. The appropriateness of the proposed ring fencing and confidentiality arrangements

7.1 Board consideration of competing contracts

The Participants submit that an inevitable consequence of any ring fencing and confidentiality arrangement is that there may be occasions when the Board of the relevant company will consider competing contracts. If the Board did not give due consideration to both contracts then it could be argued that the Board did not fulfil its duty to act bona fide for the benefit of the company as a whole. This would involve a consideration of whether the Board acted in the best interests of joint ventures that the company is a part of.

However, in such a situation, the Board must also act ethically and in compliance with the ring fencing and confidentiality arrangements. Those arrangements require separate marketing personnel to engage in separate marketing conduct and to make decisions and recommendations on GSAs based on the strict separation that is required between them.

The Participants submit that the Board's duty to act ethically and in compliance with the ring fencing and confidentiality arrangements is strongly reinforced by cl 4.3 of the Commission's proposed Project ring fencing and confidentiality arrangements. This clause requires:

(a) the Board of Directors of each Participant to consider each compliance statement; and

(b) the Chief Executive Officer and a director to sign the compliance statement.

Accordingly, the Participants submit that any conduct by the Board that was not in compliance with these requirements would mean that the company's conduct falls outside the scope of the authorisation in any event.

Regardless, the Board will make decisions as to whether to accept or reject negotiated agreements. The rejection of an agreement does not mean any terms of the winning agreement are disclosed down the other side of the firewall.