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Dr Michael Vertigan
Independent Chair
Gas Market Reform Group
COAG Energy Council Secretariat
GPO Box 787
Canberra ACT 2601

Dear Dr Vertigan

Examination of the Current Test for the Regulation of Gas Pipelines Consultation Paper

Santos welcomes the opportunity to comment on the Examination of the Current Test for the Regulation of Gas Pipelines Consultation Paper. The eastern Australian transmission pipeline network has grown rapidly to meet the needs of the domestic and international markets for gas, although it has done so relatively unchecked. It is therefore appropriate that this consultation openly discuss the recommendations of the ACCC inquiry with regard to transmission pipelines.

Santos was surprised with some of the evidence highlighted in the ACCC report, including that a pipeline operator of a major arterial calculated that it was earning 70% more revenue than if it was regulated. If this is in fact true, then this can't be good for the broader gas market and changes are required to ensure pipeline owners have a greater incentive to negotiate with shippers to achieve outcomes that are more aligned to a competitive market.

Pipeline tariffs are a significant proportion of the delivered price for our customers. Santos estimates that transmission pipeline tariffs typically represent approximately 20% of the delivered price to large customers, and in some cases a higher percentage. With new gas resources vital to meet the east coasts future demand situated further afield, this proportion will continue to grow unless there is a change. Utilising existing infrastructure to promote greater economic efficiency is essential.

This submission responds to specific areas Santos believes are important to consider when assessing the pipeline regulatory framework.

Natural monopolies

Pipelines are an essential link to connect upstream producers to their downstream customers, they are also a natural monopoly. Where natural monopolies exist, the regulatory goal is to improve the incentives on owners so that their behaviour is more closely aligned with that which would occur in a competitive market.

The ACCC inquiry found that the majority of existing transmission pipelines:

“have market power and their ability and incentive to exercise that power is not being effectively constrained”

The ACCC also concluded pipeline owners were engaging in monopoly pricing, which has in turn given rise to a wealth transfer to pipeline owners from either upstream producers or downstream customers. This has effectively given pipeline owners a greater share of the pie without taking any additional risk, resulting in a less economically efficient outcome.

Although natural gas projects are inherently risky in terms of the large capital outlays required and the long lead times, investing in new or expanded gas supply remains commercially feasible. There are numerous market participants like Santos who accept and manage these risks and invest in new gas projects, provided that it is economically viable and the relevant regulatory framework is appropriate and sufficiently certain.

In comparison, with a few exceptions (for example Jemena’s Northern Gas Pipeline), pipeline owners do not share the production risk that upstream and downstream users do, despite taking a sizable portion of the available margin. This is an area that Santos believes a more mature market, consistent with the COAG Vision, would reward those who take the risks, ensuring that they have the opportunity to share in more of the rewards. Changes to the current test appear to be required to enable this to occur.

Threat of regulation

It is important to note that the proposed changes to the current regulatory test will not necessarily result in an increase in the number of major transmission pipelines regulated. The goal of any change is to improve the incentives on pipeline owners to behave like there is competition. With a more balanced negotiating position shippers may still feel that a bi-lateral contract still more closely meets the total needs of the organisation.

Santos does not believe that full regulation of all the pipeline network is necessarily in the best interests of all market participants, nor should be the measure of success of any proposed changes.

The current, mostly bi-directional interconnected pipeline network has been evolved rapidly due to the ability for pipeline companies and shippers to directly negotiate and support changes to the pipeline network. It is questionable if the changes would have occurred at the same speed if all the transmission pipelines were fully regulated.

What Santos does contend is that there needs to be a more equitable balance in the negotiation positions of both parties. Pricing negotiations can be difficult for a shipper as there is often no plausible alternative to provide the gas to market. Without the real threat of regulation there is not an effective incentive for a pipeline owner, or course of action for shippers to ensure that they are not engaged in monopoly pricing.

Facilitating additional supply

As the ACCC report highlighted, there are sufficient gas reserves to meet demand for both export and domestic demand until 2025, the challenge is how to bring this supply to market and find new reserves to meet demand post 2025. Reducing costs on the pipeline network would facilitate this.

There is significant resource in conventional gas in the Amadeus Basin in the Northern Territory as well as the prospective resource in the McArthur Basin. If these Northern Territory resources are to help fill the void in the east coast market, then the ability to more effectively negotiate with pipeline owners on all aspects of pipeline services (forward haul, backhaul, compression, etc.) is essential to enable this gas to get to market providing the greatest economically efficient outcomes as possible.

Access to reasonably priced transmission pipeline services for existing infrastructure will be key to increasing the supply to the east coast market.

Greenfield pipeline exemption

Santos' experience in Greenfield pipeline discussions has been positive. The competitive tension to tender for the right to secure pipeline rights elicits competitive market results. Santos has been involved recently in the Northern Gas Pipeline and Narrabri Gas Pipeline Greenfield pipelines and have been very impressed with the level of engagement and commitment that pipeline organisations have presented.

The original reasons that the Greenfield exemptions were recommended in the 2002 Parer review are still relevant today. The recommendations highlighted the concerns raised by the pipeline industry on the effect that regulation (or the prospect of regulation) can have on investment in greenfield pipelines.

Greenfield pipelines are usually the result of strong customer demand and are underwritten by one or a more of shippers for a long term contract. The business case for a greenfield pipeline requires a level of pricing certainty that the exemption provides.

It is this positive experience has resulted in Santos' recommendation that the 15 year exemption, or other such measure should be retained to ensure pipeline industry continues to be able to invest in new projects without the threat of regulation.

Closing comments

Santos believes that the pipeline industry has helped transform the current eastern Australian wholesale gas system, helping to deliver on a functioning interconnected market. However we also believe that there is merit in carefully considering the regulatory alternatives to ensure that any monopoly pricing is removed. The threat of regulation is the best way to ensure that bi-lateral negotiations between shippers and pipeline owners has the potential to create this outcome. If not shippers have the option to apply for full regulation if required.

Santos supports access arrangements that result in a fair return for the level of risk taken by the pipeline owner, a monopoly infrastructure provider. This will ensure a fair outcome for pipeline owners, shippers and consumers alike as well as giving the best chance of bringing forward higher cost gas in existing fields or new finds from prospective gas fields from further afield.

Santos looks forward to engaging with you further during the course of this review and ongoing with the Gas Market Reform Group's agenda.

Should you have any questions in relation to this submission, please contact Matt Sherwell at matt.sherwell@santos.com or on (08) 8116 5824.

Yours sincerely

John Anderson

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