

25 March 2009

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600
via email: economics.sen@aph.gov.au

Inquiry into exposure draft of the legislation to implement the Carbon Pollution Reduction Scheme

Dear Sir/Madam

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to contribute to the Standing Committee on Economics inquiry into the exposure draft of the legislation to implement the Carbon Pollution Reduction Scheme (CPRS).

APIA represents all sectors of the gas transmission industry. The owners and operators of transmission pipelines have a keen interest in the CPRS legislation. APIA members' are concerned that an issue important to their industry has not been addressed, in spite of much "consultation".

The Government has not yet taken action on the critical issue of contractual impediments to carbon cost pass-through. The CPRS imposes major structural change on the Australian economy, and many of APIA's members are parties to long-term contracts that do not make provisions for such a structural change. In the CPRS White Paper, the Government has acknowledged the issue, but declined to address it.

The CPRS places an economic value on carbon emissions, and this value should be reflected in the end price of goods and services so as to provide appropriate price signals to end users. In choosing to not act on the issue of contractual impediments to carbon cost pass-through, the Government is allowing these costs to become stranded in the supply chain, increasing the operating costs of many gas transmission companies, with no compensation for such a critical cost increase.

The failure to ensure that the CPRS enables full carbon cost pass-through is irresponsible and undermines the CPRS itself. The solution is relatively simple: the CPRS should be treated as a tax for the purpose of allocating costs under contractual obligations.

I would be happy to discuss this issue further with the Standing Committee.

Yours sincerely



CHERYL CARTWRIGHT
Chief Executive

Emissions from the Gas Transmission Sector

Australia's transmission pipeline infrastructure comprises approximately 33,000km of transmission pipelines, of which about 25,000km are high-pressure gas transmission pipelines. These high-pressure gas transmission pipelines span the significant distances between Australia's gas fields and its population and industrial centres, supplying the nation with 1158 PJ (petajoules) of natural gas that accounted for 20% of Australia's primary energy consumption in 2006-07. One PJ of natural gas is the energy equivalent of about 43,000 tonnes of black coal or 29 million litres of petrol. Most natural gas in Australia is used for power generation or major manufacturing, with only 5 to 11 per cent used in the home (depending up on the State or Territory).

The transportation of this gas needs energy, primarily through the use of compression to create pressure differentials which drive the gas through the pipelines. The amount of energy used by pipelines in transporting gas varies, depending on distance, operating pressure requirements and other factors.

More than 90% (in some cases above 95%) of a gas transmission pipeline company's total energy use to move its product is the consumption of gas to drive compression. Given that gas transmission pipelines often transport gas more than one thousand kilometres, gas usage for compression results in many pipelines exceeding the CPRS threshold of over 25,000 tonnes of carbon dioxide equivalent annually, thus making gas transmission companies liable for emissions. In the case of Australia's largest gas transmission pipeline, the Dampier to Bunbury Natural Gas Pipeline (DBNGP) in WA, emissions for the next year are expected to exceed 367,000 tonnes. Several other pipelines are expected to exceed the threshold by in excess of 100,000 tonnes.

The remaining energy use mainly comprises maintenance vehicle fuel usage, other travel (such as air travel) and general office usage.

The gas transmission industry, as with other participants in the energy supply sector, closely monitors its energy usage and installation of compression infrastructure is based on efficiency and cost. Hence, the gas transmission market already ensures economic and energy efficiency is maximised.

The only alternative to compression is to 'loop' the pipeline by building additional sections of pipeline running parallel to the existing pipeline, increasing the volume of gas that can be transported. Once installed, a 'looped' pipeline does not require as much compression as a 'compressed' pipeline and, therefore, generates fewer emissions. However, it should be noted that looping is extremely capital intensive and does not necessarily present an economic alternative to acquiring permits in the market being established by the CPRS. It should also be noted that, unlike the coal industry, which must also reduce emissions through capital intensive methods, the gas transmission industry is not eligible for compensation.

As an example, in order to provide the same capacity on the DBNGP by way of looping rather than compression, the DBNGP would need to be looped in excess of 3 additional times. This would involve the construction of around 4,200 kms of 26 inch pipeline at a cost of approximately \$6.3 billion. This would result in the regulated tariff being increased by around 400%.

To acquire the necessary permits to acquit the emissions resulting from the pipelines existing configuration, which include 26 compressor units, the tariff would likely only increase by 25-30%.

The gas transmission market is largely based on long-term transportation contracts (often 10 to 20 years), and the energy use of a pipeline contributes to the total cost of the transmission service being provided by the pipeline company. It is in the interest of a pipeline company to undertake cost and efficiency improvements that will deliver operational savings. But the cost of acquitting emissions arising from the transportation of a product should be reflected in the end price of the product and borne by the end user.

Contractual Impediments to Cost Pass Through

As mentioned above, the gas industry, and the gas transmission industry in particular, is based largely on long-term, bilaterally negotiated contracts.

Many long-term contracts, and some recent contracts, in the gas transmission industry predate the fundamental policy shift reflected in the CPRS. Whilst the wording of these contracts in relation to change of law clauses or pass through of tax changes depends upon the particular contracts, many do not allow for costs associated with carbon constraints to be passed through to customers. These contracts can extend up to 15 or 20 years, which means affected gas transmission companies will bear this cost, with no compensation, for many years to come. While the anticipated cost impact of the CRPS for each transmission company will vary depending on the nature of the pipelines owned (the more heavily compressed pipelines will wear the greatest burden) the cost is substantial and represents a significant portion of total revenue.

This issue could not reasonably have been anticipated at the time many of these contracts were executed. While officials at the Department of Climate Change suggest that contracts entered into in the last 5 years should have included carbon provisions, this demonstrates a lack of appreciation of the reality of commercial negotiations. In such negotiations, inclusion of provisions for laws that might or might not have been announced or developed, is fraught. Prior to the election of the current Government in 2007, there was no commitment to a carbon price in Government policies. Commercial negotiations do not always consider allowances for a mere possibility.

APIA is aware of at least one circumstance where a company did attempt to taken proactive action to provide for such a contingency in contracts entered into in recent times. In this circumstance, the contract contains provisions for a carbon tax, which the CPRS is not. As a result, there is confusion for both parties as to the contractual obligations for CPRS costs. The situation that has occurred in this example demonstrates the futility of companies trying to make provisions for laws that are not yet passed.

Interestingly, the CPRS White Paper cites a similar example where parties to a contract are not certain who is liable for the costs associated with the CRPS as a reason to not act on this issue.

The CPRS White Paper, with the Government's final position on its emissions trading scheme, was published on 15 December 2008. In the White Paper, it is suggested that many parties would be expected to simply renegotiate contracts in order to allow for appropriate pass through of carbon costs (CPRS White Paper p15-14). Such a comment demonstrates a lack of understanding of commercial realities. It is highly unlikely that any party to a contract would willingly renegotiate to accept additional costs. In fact, it would not be in the shareholders interests to do so. Clearly, entities that are party to long term contracts, such as participants in the gas transmission industry, are seriously disadvantaged by this issue.

The Government has also suggested that if renegotiation of contracts does not occur, a supplier unable to pass through carbon costs would leave the market and be replaced by a new supplier who would be able to enter a new contract that would reflect the legislative requirements of the CPRS (CPRS White Paper p15-14,15-15). This view is not particularly helpful to the owners of capital intensive, long-term infrastructure such as gas transmission pipelines. **Such comments imply that it is acceptable for Government policy to put companies out of business simply because their existing contracts do not reflect new economic policies,** even if they are not major polluters.

The Government's policy position (15.5 of the CPRS White Paper) on this issue is to take no action, noting that some submissions suggested that existing contracts would allocate carbon costs "appropriately". Clearly, the parties that would benefit from such contracts, that is, not face increased costs, would be happy for the legislation to remain silent on this issue.

By choosing to not act on the issue of contractual impediments to carbon cost pass through, the Government is putting forward the unreasonable view that industry should, when preparing contracts, make provisions for laws not yet conceived.

Conclusion

The gas transmission industry transports natural gas to Australian industries, electricity generators and households in an efficient, safe and cheap manner, generally consuming around 1% of the gas it transports in doing so. Without efficient and effective transportation of natural gas, Australia's major energy needs would be met by other energy forms, notably coal. This outcome is unlikely to reduce Australia's carbon intensity.

Australia's gas transmission industry produces a relatively small amount of emissions in the process of providing the Australia economy with a low cost and low emission fuel that accounts for around 20% of primary energy usage.

In implementing the CPRS, the Government is imposing major structural change on the economy, with the intention of reducing the carbon intensity of the economy in the most economically efficient manner. The CPRS purports to ensure the cost of carbon emissions associated with products and services is given an economic value, and in doing so providing a signal to end users which will modify behaviour and ultimately reduce emissions.

Every element of the supply chain should pass carbon costs through in order to ensure the full (CPRS created) economic value of carbon emissions is represented in the price paid by end users. Any carbon costs that remain in the supply chain and not passed on should be viewed as a failure of the CPRS system.

The costs of the emissions arising from the transportation of a fuel should be considered a component of the emissions arising from the use of a fuel and be passed on in full to the end users of a fuel.

The Ministerial Council on Energy (MCE) has put forward a view that end users of energy should bear the price of the CPRS. To ensure this occurs, the MCE will put a proposal to the Council of Australian Governments that it amend the 2006 Australian Energy Market Agreement to specify that, where retail prices are regulated, energy cost increases associated with the CPRS shall be passed through to end-use customers (MCE Communiqué 6 February 2009). However, this does not ensure that all the costs associated with the CPRS in the full energy supply chain, that is, transmission companies, will reach end users.

In the CPRS White Paper, the Government has acknowledged the CPRS creates an issue of contractual impediments to carbon cost pass-through, but has chosen not to address the issue, thus ignoring a design failure of the policy.

In its submission to the CPRS Green Paper, APIA raised the issue of contractual impediments to carbon cost through:

“Cost pass through of new government charges must be addressed in legislation and regulations associated with the CPRS to avoid negative impact on some gas transmission pipelines owners. Pass through issues arise for both regulated and unregulated pipelines.

Such a measure would also need to ensure that regulators are required under the National Gas Rules to allow any CPRS related costs as being prudently incurred for the purposes of achieving the lowest sustainable cost of delivering pipeline services in any future pricing determination.

The most effective means of addressing this issue is to legislate to authorise affected providers who entered contracts prior to 2008 to pass through the costs attributable to the CPRS, or in the event that these costs cannot be passed through, provide for compensation for affected parties for the duration of the relevant contracts.”

APIA submits to the Senate Standing Committee on Economics that the Government should, at a minimum, provide specific legislation in the CPRS that allows for costs associated with acquiring permits to be treated as a tax for the purpose of allocating costs under contractual obligations.