



29 April 2011

Department of Climate Change and Energy Efficiency

Via email: DCCEE-CSMDConsultationsSupportTeam@climatechange.gov.au.

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to provide comments to the Department of Climate Change and Energy Efficiency (the Department) on matters dealing with liability transfers in the natural gas supply chain and cost-pass through of introduced carbon costs.

APIA notes that the discussion paper released by the Department on Point of Liability and Carbon Cost Pass Through does not cover contractual impediments to carbon cost pass through and point of liability in the natural gas supply chain; however, these are critical issues to the gas transmission industry.

Contractual impediments to cost pass through

As noted by the Department in its Discussion Paper on Point of Liability and Carbon Cost Pass Through:

Carbon cost pass through

A carbon price mechanism will impose a cost on carbon pollution that will change the relative prices for goods and services throughout the economy. In general, the additional cost to those producers required to pay a carbon price will be passed through the supply chain and will be reflected in the final price for a product.

However, in some cases, economic, regulatory or contractual barriers might prevent carbon cost pass through initially. Where this occurs, price signals that guide production, investment and consumption decisions to reduce emissions will be blocked or muted and the impact of a carbon price mechanism on particular firms or industries may be increased.

It is policy requirement that costs associated with a carbon price are passed through the supply chain. The gas transmission industry is one industry where there may be significant contractual impediments to the pass through of these costs.

The commercial frameworks of the gas transmission industry are such that the majority of transactions are conducted under long-term bi-lateral contracts. The long-term nature of these contracts means that many were entered into before there was wide-spread acceptance of the need

for a carbon price. These contracts do not have adequate provision to treat a market based carbon price appropriately, with costs passed on to customers of pipelines (shippers) and ultimately to gas users. In some cases, these contracts will run well into the 2020s.

There remain important points of difference between the major political parties' policies on climate change, including the need for a carbon price. Whilst both major parties went to the 2007 election with the explicit intent of introducing a carbon price policy, neither went to the 2010 election with one. Companies cannot be expected to have specific provisions in contracts for policies that do not exist or are not legislated. Although, as noted below, it is standard commercial practice for contracts to allow for new, or increases in, taxes or imposts to be passed through to customers.

It is important to note that contractual impediments to carbon cost pass through impact the gas transmission industry unevenly. The majority of gas transmission pipelines in Australia are unregulated, which means they face competition from other pipelines or energy sources. Therefore, new government policy can shift the competitive balance between these companies because of the timing of a company's contracts and, thus, whether the contracts account for carbon costs.

In 2009 APIA raised with the Department the issue of contractual impediments to cost pass through. APIA's submission of 14 April 2009 is attached.

In that submission, APIA proposed that costs associated with a carbon price be treated as a tax. It is standard practice to have clauses dealing with new taxes in contracts, and this would simply and clearly resolve the matter of cost pass through for the gas transmission industry.

As noted in 2009, the Department had clearly considered the possibility that costs associated with the Carbon Pollution Reduction Scheme (CPRS) may be found to be a tax, as there was a set of supplementary legislation ensuring the costs would be managed under the CPRS legislation rather than tax legislation in the event a court ruled the costs constituted a tax.

Given the acknowledgement by the Prime Minister that her proposal to introduce a fixed price for carbon emissions is effectively a tax and the uncertainty previously acknowledged in the CPRS that it may ultimately be found to be a tax (even without a fixed price), it is appropriate that the proposed carbon price legislation specifically deals with this issue and sets out that a carbon price is a form of taxation. This would resolve contractual impediments to carbon cost pass through.

The acknowledgement by the Prime Minister that the price on carbon would be, effectively, a tax has occurred on several occasions, starting on 24 February 2011, when she announced that there would be an initial fixed cost period of three to five years for a carbon price mechanism. This acknowledgement was recorded in Hansard on 24 February and subsequently during numerous media interviews.

From *Hansard* on 24 February, the Prime Minister:

The carbon pricing mechanism that I have announced today, arising from the discussions of the Multi-Party Climate Change Committee, is a carbon price mechanism that would start on 1 July 2012. It is a scheme that would start with a fixed price for a fixed period, effectively like a tax.

Clearly, this statement supports the case that the Government's carbon price proposal is a form of taxation.

There is a further emerging issue in regard to cost pass through: that of economic regulators' ability to influence the extent to which carbon costs can be passed through. There have been indications that economic regulators of infrastructure will decide an efficient level of carbon costs an infrastructure owner will be allowed to pass through to its customers¹. Such a declaration is a disturbing development and is not unique to gas transmission pipelines. It has implications for many sectors of regulated infrastructure. If the carbon price is legislated to be a tax or impost, it is not appropriate for economic regulators to then make judgements about efficient costs associated with such legislation. There already exists an opportunity for vigorous debate regarding efficient costs. This occurs during economic regulatory determinations, and it would not be appropriate for companies to engage in further debate regarding efficient carbon costs as this would significantly add to the complexity of regulatory determinations and the costs of determinations.

Exclusion of gas transmission pipelines from the point of liability mechanism.

In the absence of a legislative acknowledgement that a carbon price (whether it be fixed or market based) is effectively a tax, it is appropriate that the Government take steps to ensure that costs are passed through the supply chain.

On 18 April the Department convened the Natural Gas Technical Working Group to:

consider ways to apply points of liability within the natural gas supply chain under a carbon price mechanism to minimise complexity and associated compliance costs.

APIA proposes that gas transmission pipelines should be removed as a point of liability within the natural gas supply chain because:

- It is appropriate and the intent of a carbon price mechanism that carbon costs incurred in a supply chain are reflected in the final price of a product. As highlighted above, there are contractual impediments to this occurring in the natural gas supply chain due to the long-term nature of contracts.
- Gas transmission pipeline owners do not purchase the gas that is transported along transmission pipelines. Rather, pipeline owners provide capacity in the pipeline to allow gas to be delivered to a shipper's outlet point. However, custody and title to the gas generally passes to the pipeline owner while the gas is in the pipeline, reflecting the fact that the pipeline owner cannot deliver to a shipper the same molecules of gas that are supplied by a shipper to the pipeline owner at the inlet to a pipeline. To the extent that any regime would require the pipeline owner to assume liability for the gas while it is in its title and possession, a gas transmission pipeline would have to supply an OTN and track liability from multiple shippers, increasing the complexity of OTN transactions for pipelines and increasing compliance costs which will also be passed through to shippers.
- Greenhouse gases are emitted in order to operate transmission pipelines so as to transport gas for shippers. The majority of emissions from the operation of transmission pipelines arise from the running of compressors, which in most instances are powered from gas (commonly known as system use gas). In most instances, the shippers are responsible for the provision of the system use gas which is allocated on a pro-rata basis among shippers

¹ The Australian Energy Regulator's draft decision on the Amadeus Gas Basin Pipeline access arrangement proposal, dated 21 April 2011 -
The Western Australian Economic Regulation Authority draft decision on the DBNGP access arrangement proposal, dated 14 March 2011.

using contractually agreed formulas. A pipeline's emissions, both fugitive and combustion, could be allocated on a similar basis as part of the same transaction.

- To the extent that a pipeline owner is responsible for the provision of all or some of the system use gas, the same formula could be used.
- Shippers on gas transmission pipelines are nearly all large entities that have their own carbon obligations. It is cheaper for shippers to acquire their own permits for their share of a pipeline's emissions than to have a pipeline operator acquire the permits and pass permit and associated admin costs through to the shipper. Indeed, in contract negotiations undertaken since the balance of probability has shifted toward a carbon price, many shippers have insisted on arrangements whereby they can supply permits to a pipeline for their share of a pipeline's emissions liability in lieu of increased transmission charges in the event a carbon price is introduced.
- Emissions on a pipeline are primarily influenced by shipper demand. As shipper demand changes, compressor operation must be modified, influencing combustion emissions and fugitive emissions. Compressors do have operational profiles that can influence emissions, but a pipeline operator is not free to run a compressor at optimal efficiency (in terms of greenhouse gas emissions) as it does not have control over shipper demand. Shippers update gas requirements continuously, influencing compressor operational requirements. Whilst on the surface it appears that a pipeline operator has the greatest control over a pipeline's emissions, it is actually shipper demand that drives the emissions intensity of a pipeline. If shippers have direct responsibility for emissions resulting from a pipeline, they have greater incentive to more carefully forecast gas requirements and take into account the impact of changing nominations on compressor emissions.

As mentioned above, such changes would only be required if the legislation enabling a carbon price does not acknowledge the imposition of a carbon price is effectively a tax.

The gas transmission industry is keen to engage with the Department to resolve these and any other implementation issues. If you would like to discuss these issues further, please contact me or APIA's policy adviser, Steve Davies, on (02) 6273 0577 or sdavies@apia.asn.au.

Yours sincerely

A handwritten signature in black ink, appearing to be 'CD', written over a horizontal line.

CHERYL CARTWRIGHT
Chief Executive