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The Santos logo is displayed in a bold, blue, serif font.

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

Dear Sir/Madam

Santos' submission to the Senate Standing Committee on Economics on the exposure drafts of the legislation to implement the Carbon Pollution Reduction Scheme

Santos welcomes the opportunity to provide comment on the exposure draft Bills for the Federal Government's Carbon Pollution Reduction Scheme (CPRS). Santos is a major supplier of domestic gas in Eastern Australia and has recently announced plans to move into the gas-fired electricity generation market. Santos supports the need for a carbon impost and strongly endorses the implementation of a well designed, market based mechanism, such as a cap-and-trade system like the CPRS, as the lowest cost path to the achievement of emission reductions.

This submission focuses on two key transitional issues that Santos believes have not been dealt with adequately in the CPRS Bill, namely the:

- removal of impediments to the pass-through of the cost of carbon in long term commercial contracts; and
- Relegation of the determination of the level of assistance to Emission Intensive Trade Exposed (EITE) industries to regulations.

Contractual impediments to carbon cost pass-through

The ability of the cost of carbon to flow through in the price to the end user of a product or service is a fundamental feature of a well designed, market-based, emission reduction scheme such as the CPRS. Section 15.3 of the CPRS White Paper¹ clearly states the significant effects of the cost of carbon not flowing through to the pricing of products and services:

¹ Department of Climate Change White Paper Carbon Pollution Reduction Scheme 2008.

“There are two main effects of constraints on businesses’ ability to pass-through carbon costs:

- *it is likely to be more difficult and expensive for Australia as a whole to meet any particular emissions target if price signals that guide production, investment and consumption decisions to reduce emissions are blocked, and prices do not reflect reasonable carbon costs; and*
- *regulatory or contractual impediments to cost pass-through may increase the impact of the Scheme on particular firms or industries”.*

However, policy position 15.5 in the White Paper states that:

“The legislation will not contain any provisions designed to override contracts to allow for pass-through of carbon costs.”

As a result the legislation drafts have not addressed the case of contractual impediments to carbon cost pass-through.

Santos strongly believes that a statutory pass-through provision, acting for a transitional period, needs to be inserted in the CPRS Bill to reinforce the key design of the CPRS that the costs of the scheme are passed through to the end users. To provide certainty for business on this matter the scope of the statutory pass-through provision should apply specifically to contracts where the:

- issue of carbon cost pass-through was not explicitly and effectively dealt with in the contract
- contract was entered into before 3rd June 2007
- contract is for a supply that has an associated carbon cost and occurs after the commencement of the CPRS; and
- contract is non-reviewable for carbon costs.

In keeping with the overall scheme design, the provision should then provide for a statutory pass-through of the cost of carbon to the recipient of the supply in the contract. Santos submits that the provision should allow for the use of an independent arbitrator if disputes occur between contracting parties as to the quantum of carbon costs to be passed-through.

Santos proposes in Annexure A to this submission a model statutory pass-through provision that addresses the points raised above².

In the White Paper, the government has, for several purposes, settled on 3rd June 2007 as the date from which all commercial entities should be taken to have been aware that there existed bipartisan support for a national cap-and-trade emissions trading scheme.

² Please note that the model statutory pass-through provision operates from the date of Royal Assent, however Santos submits that 3rd June 2007 may also be appropriate.

Therefore, 3rd June 2007 is a reasonable endpoint before which commercial entities should not be taken to have been aware of the likelihood of the introduction of a cap-and-trade emissions trading scheme.

Santos believes the above position is fair and reasonable to all contracting parties. In effect the proposed change simply ensures the clear intent of the CPRS is carried out in cases where the contracting parties have not effectively provided for the treatment of carbon costs in a contract associated with a supply.

However, section 15.3.2 of the White Paper outlines three key reasons why the CPRS Bill is silent on this key issue:

- there is a risk that implementing a statutory override of existing contracts would involve a requirement to provide "just terms" compensation by operation of s51(xxxi) of the Constitution
- the implementation of a transitional provision, similar to that utilised in the case of GST pass-through, is not appropriate as it is not possible to determine with certainty whether and to what extent carbon costs can be passed through. This means that the trigger for the burden shift would be a matter of ambiguity and contention; and
- the supplier would have no incentive to reduce its emissions if it is not liable to surrender permits for those emissions.

Santos has made appropriate enquiries on the risk of a statutory override triggering a requirement for the government to provide "just terms" compensation by operation of s51(xxxi) of the Constitution. It is Santos' strong view that such a provision would not effect any acquisition falling within the area of the operation of s51(xxxi). Rather the effect is to determine where a particular new cost burden is to fall in particular prescribed circumstances, a constant feature of new legislation, and in fact a feature of the CPRS Bill.

In the CPRS Bill, the government introduces an administrative mechanism called the "Obligation Transfer Number", which in effect shifts the cost burden for emissions associated with fuel use from the upstream supplier to the downstream buyer, again reinforcing the key design of the CPRS that the costs of the scheme are passed through to the end users.

Further, it is Santos' strong view that in any event s51(xxxi) does not itself provide any enforceable right to compensation for those whose property is acquired, therefore there could be no possible compensation burden on taxpayers. The effect of failing to provide just terms for an acquisition of property is that the relevant legislative provisions are invalid to the extent that they effect such an acquisition and will be severed from the legislation without effecting the remainder.

The situation may be different if the government provided a right to reasonable compensation to any person whose property was acquired within the meaning of s51(xxxi). Indeed the draft CPRS Bill contains such a provision in clause 383. However, Santos submits that it would be possible to redraft clause 383 so that it does not extend to a statutory pass-through provision.

Santos submits that a statutory pass-through provision would be easy to achieve, and could be inserted as a stand alone section in Part 26 of the CPRS Bill with a minor consequential amendment to clause 383.

Secondly, the *National Greenhouse Emissions Reporting Act 2007* (NGER Act) mandates:

- reporting of greenhouse gas emissions, energy consumption and production by large corporations
- public disclosure of corporate level greenhouse gas emissions and energy information; and
- consistent and comparable data available for decision making, in particular, the development of the CPRS.

These emissions reports will be independently audited to achieve a reasonable level of assurance (as per financial audits) and therefore the contracting parties can be confident that emissions, and therefore carbon costs associated with the supply are accurate. Santos submits that the allocation of the ensuing emission costs to the various contracting parties will involve general cost allocation processes used when apportioning other passed through costs.

Thirdly, the supplier responsible will have a significant incentive to reduce its emissions given the provision is transitional. If the product or service is to remain competitive in the longer term the supplier will need to enact abatement opportunities wherever possible. Also, many of the contracts in question have a set price but the product or service volumes are flexible. If the supplier is to encourage the buyer to purchase greater quantities of the product or service it will need to minimise the carbon cost pass-through wherever possible.

Santos submits that there is a further, unintended, contractual impediment to carbon cost pass-through as a result of the drafting of Part 3, Division 6 of the CPRS Bill, which provides for transfer of CPRS liability to another member of a controlling corporation's group. Section 15.3.2 of the White Paper indicated that a "controlling corporation" (which is ordinarily the "liable entity" under the CPRS) would have some flexibility to shift its obligations under the CPRS, with the approval of the CPRS Regulator, to another legal entity within its corporate group where certain criteria are met.

This proposal for pass-through was in response to submissions that without such a mechanism, many carbon cost pass-through provisions would be rendered ineffective, because those contractual provisions will provide for the pass-through of increased costs to which the contracting party itself (and not its controlling corporation) is liable.

Although the CPRS Bill reflects this approach, it has been modified with one significant change. Whereas the White Paper indicated that the power would be a power in the controlling corporation to shift the obligation to a subsidiary, under the CPRS Bill the power will be a power in the subsidiary to assume the obligation from the controlling corporation.

Santos submits that this has a number of significant, unintended consequences to possibly render carbon cost pass-through provisions ineffective:

- the subsidiary may be in breach of contract if it assumes the obligation for the CPRS from the controlling corporation if the contract contains a contractual prohibition against “incurring” or “precipitating” a “change event” (such as the CPRS obligation); and
- the directors of the subsidiary will have a fiduciary duty not to assume the obligation if it is not in the best interests of the subsidiary, notwithstanding if it is in the best interests of the controlling corporation.

Santos submits that the drafting of Part 3, Division 6 of the CPRS Bill should be amended to follow the government’s position in the White Paper, to provide that it is the power of the controlling corporation to shift the CPRS obligation to a subsidiary (with the approval of the CPRS Regulator and where certain criteria are met).

Regulation for the Emission Intensive Trade Exposed Industry Assistance

Santos believes this is a very important issue, not only to the LNG industry but also to most of the large resource industries in Australia. As was stressed in “The Garnaut Climate Change Review: Final Report”, the issue of EITE assistance is critical to future investment decisions in the resource export sector.

However, the proposed CPRS Bill leaves the crucial details of the EITE assistance to future regulations. Santos would like to stress the importance of significant and robust engagement with major stakeholders in the development of the EITE regulations.

An open, informed and robust debate around the exact form of the EITE assistance is essential. Given the proposed CPRS Bill is silent on the form and timetable of the regulation development process, Santos strongly believes the government should publish a detailed, realistic timeline for the process that outlines a collaborative approach including workshops and publication of discussion papers for comment prior to drafting the regulations.

Santos suggests that a similar process to that used in the formulation of regulations to support the NGER Act be employed to develop the EITE regulations. Santos regards this as a proven process that has delivered a widely acknowledged balanced set of regulations. However, an essential part of this process was allowing enough time for constructive engagement of industry participants. Santos is particularly concerned that the government is being driven primarily by a deadline as opposed to an objective of good scheme design.

The Carbon Pollution Reduction Scheme

Santos believes a well designed, market based mechanism, such as a cap-and-trade scheme as opposed to a carbon taxation system, is the lowest cost path to the achievement of emission reductions.

However, unless the scheme is allowed to operate correctly by allowing the pass-through of the cost of carbon to the end user, the advantages of the market based scheme will be compromised and end users will not change their choice in products or services towards those with lower emissions, such as natural gas.

This is a common requirement of any emission reduction scheme that imposes a cost on carbon, regardless of whether it is market or a carbon tax based. There has been discussion that a carbon tax may provide further certainty around the price of carbon, albeit at the cost of a lack of certainty around emission reductions. However, because of the unknown emission reduction outcomes due to a specific level of carbon tax, it is almost certain that the carbon tax will need to be adjusted over time, particularly over the 20 to 30 year life of most electricity generation assets.

This means there will not be any significant certainty in the cost of carbon over the investment decision horizon, thereby negating the supposed benefit of a carbon tax.

It is important to realise that when making large investment decisions, such as the construction of a new power station, there are many uncertainties in the future cost of various key inputs such as fuel costs (e.g. the price of gas or water). There is also often significant uncertainty in the revenue earned on outputs due to fluctuations in the wholesale electricity price. The investment decisions are by necessity long term and industries have developed numerous tools and skill-sets to manage these uncertainties.

As a result Santos does not believe that a carbon tax would provide any greater certainty to industry over a well designed cap-and-trade system.

Moving to a lower carbon economy and natural gas

In moving to a lower carbon economy, natural gas presents the following benefits for Australia in terms of supporting practical solutions aimed at delivering clean, reliable and affordable energy, a key desired outcome of the CPRS:

- it is a clean energy source, with gas-fired power generation emitting between 40 to 70% less greenhouse gases than coal-fired power generation³
- gas-fired power generation can reliably and affordably deliver today 80% of the carbon emission reductions than retro-fitting an existing coal-fired power station with carbon capture and storage will deliver (at some unknown future time at some unknown future cost)

³ IPCC 3rd Assessment Report, Working Group III, 2001

- it has a far lower water intensity, using a fraction of the water per Mwh as an existing coal-fired power station
- gas-fired power generation has a small environmental footprint (15 hectares for 1,000MW) and hence low community visibility and infrastructure requirements
- gas-fired power generation is an immediately available and reliable energy source, capable of producing peaking, intermediate and base load power generation
- the flexibility in gas-fired power generation is a perfect partner for intermittent renewable energy sources in ensuring smooth supply-side dynamics in, and the integrity of, the electricity sector
- Australia's natural gas reserves are abundant (measurable in hundreds of years supply) and in close proximity to the major gas demand nodes; and
- it is affordable, with gas-fired power generation competitive against both brown and black coal-fired power generation under a modest carbon price.

Furthermore, the Australian natural gas industry, especially in eastern Australia, is experiencing strong employment growth, particularly around the coal seam gas sector.

Further significant growth can be expected as very large investments in proposed LNG projects and gas-fired power generation move forward.

In its 2007 "Climate Solutions - Vision for 2050" Report, the World Wildlife Foundation (WWF) identified replacing "high-carbon coal with low-carbon natural gas" as having significant short and medium term potential in avoiding locking in higher emissions from coal, and buying time for the deployment of zero-emission technologies.

Yours sincerely

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