FINANCIAL REVIEW
16 June 2017

Central Petroleum a litmus for gas reform

Santos chief executive Kevin Gallagher continues to say we have a price problem rather than a supply issue.
Katherine Griffiths

by **Matthew Stevens**

The fate of Macquarie Group takeover target Central Petroleum has become an increasing complex bellwether of the national progress towards a solution for our on-again, off-again national gas crisis.

Late on Wednesday, Central emerged from self-imposed suspension on the ASX after working out whether it needed to change its recommendation of Macquarie's $87 million offer for the Northern Territory gas producer.

That reassessment was made necessary by the surprisingly tepid final draft recommendations on gas pipeline regulation offered last week by the Gas Market Reform Group and by the equally surprising reach of the gas export controls that have been delivered to Federal Resources Minister Matt Canavan.

To digress momentarily, given his capacity to force gas marked for export back into the domestic market place and that he effectively commands how $5 billion of taxpayers' cash might be spent on northern infrastructure, there is a fair argument that Canavan presently sits as the most powerful resources spokesman in recent Australian history.

Now, back to little Central and the instructive collection of dilemmas that have been triggered by the still evolving shifts in the commercial and political realities of making a living in the Australian gas business.

The North-West Shelf partners used to advertise their gas as the loneliest in the world. But Central, for its sins, owns some of the most isolated gas on the Australian mainland. The gassiness of Central's exploration country that stretches across the southern flank of the Northern Territory has long been recognised. But the gas has remained unconnected to markets because, frankly, no one has ever needed it enough to pay the price needed to get it out of the ground and move it to a market.

But all of that changed when the east coast gas demand suddenly quadrupled with the arrival of three liquid natural gas projects on Gladstone's Curtis Island.

Whether Australia has or hasn't been left short of gas by these export gateways remains the subject of debate.

Market rationality has not prevailed

While Santos chief executive Kevin Gallagher continues to say we have a price problem rather than a supply issue, the simple fact that Australian industrial and residential gas consumers have been left paying more for their gas than some of our export customers would seem a fair indictor of shortage, at least in the immediate term.

The gas market dynamics outlined by Gallagher in a speech on Thursday are as informative of the opportunity that should have been within Central's reach as a public company as they are of the reasons why the business might better thrive in private equity.

There is not a whole lot controversial in the Gallagher proposition.

The export machines were built to introduce regional gas pricing so that development of Australia's next generation of gas supply might be profitably sustained. Whatever else happened in the wake of the $80 billion investment in LNG east coast export projects, Australians would pay more for their gas.

In normal circumstances, this new era of pricing should have inspired a supply response that would see our comparatively slight domestic demand requirements easily met.

But these are not normal times and market rationality has not prevailed.

Instead governments in NSW, Victoria and the Northern Territory have jumped at environmentalists shadows and forced moratoria or outright bans on conventional drilling and the hydraulic fracturing that sits essential to extraction of our next generation of gas supplies.

At the same time, the gas producers claim that the pipeline operators, all of whom effectively run individual monopolies, have been allowed to extract excessive economic rents from their investments.

"Access to reasonably priced pipeline services will therefore be key to increasing the supply and efficiency to the east coast gas market," Gallagher noted on Thursday. "The recent ACCC inquiry into east coast gas found that the majority of Australia's gas transmission pipelines operate under a monopoly pricing regime. The cost of transporting gas on the east coast, even short distances, is excessive and is a significant component of high priced gas.

"Unbelievably, it costs more to transport gas from Bass Strait to Queensland than to ship gas to China. We need to open up our pipeline networks to allow the flexibility for gas to flow where it is most needed. The current pipeline access regime is not providing effective access to the number of unregulated pipelines.

"In this regard, Santos supports the recommendation to look at market power as a criteria for regulating pipelines," he said.

New regulations fall short of expectations

Which bring us back to the reason why Central went into the suspension that was lifted on Wednesday with the release of a second supplementary statement that maintains the junior's endorsement of Macquarie's take-out.

To cut a long and complicated story short, the new gas pipeline regulations recommended to Australia's energy ministers fall short of expectations built on the quality of the findings of Michael Vertigan's review of the east coast network. Vertigan's reforms are aimed at forcing new transparency on the pipeline operators and at developing a new framework for settling access and pricing disputes.

While everyone seems pretty pleased with the initiatives aimed at illuminating capacity management and pricing, the gas producers have been left underwhelmed by the core mechanic of the new arbitration regime.

The original building block of pricing access to monopoly infrastructure is putting a value on the asset in question. But there are many ways of doing that.

Usually the owner of the asset will push for replacement value or, at the very least, original capital cost. Users, on the other hand, will promote the depreciated value as being a more reasonable starting point.

Pipeline users like Central go even further than that. Central argues that by the time pipeline access becomes a matter for commercial contest, the owner's original investment has been more than fully recovered so the starting asset valuation should be much lower.

The problem with the draft recommendations that are likely to set the rules of industry engagement from sometime after the August COAG meeting is that the panel has ducked this core issue. It has offered no guidance at all on the principles that would shape arbitrations. Effectively, each arbitrator will be left to make a decision on the valuation methodology.

The real world effect of that opening uncertainty will be that no one will gamble on arbitration. And that leaves pipeline customers little better off than that are right now. It is worth noting, I think, that regulated pipelines in Australia are already subject to an arbitration procedure. But its uncertainties mean that it has never been used.

This disappointing status quo is unlikely to be disturbed by the new regime, according to the independent expert advising Central on its response to Macquarie's increasingly welcome offer.

"The relevant point for our purposes," Ernst & Young Transaction Advisory reported on Wednesday, "is to clarify that whilst the new framework may ultimately result in lower tariffs in certain instances [either through commercial negotiation with better information and the threat of arbitration, or through arbitration itself], any reduction in tariffs is unlikely to be to the extent advocated by Central."

Setback could work to Central's advantage

As we have noted, Central's problem is the tyranny of distance between its gas and east coast market.

The Central numbers run like this. At a $US60 a barrel oil price, the net back gas price would be something like $8.72 a gigajoule. Central puts its future pipeline costs at $5.20/GJ. That leaves Central with an ex-field (pre-shipment) revenue of $3.52/GJ.

Those that follow Central reckon its gas to be relatively expensive to get out of the ground. It is accepted wisdom that it needs an ex-field price of better than $4/GJ to get itself in the game. Central's view is that that threshold is not achievable without lower pipelines charges and it was banking on the GMRG to make that happen. But it has been disappointed.

Mind you the timing of this setback could very well work to Team Central's advantage. The optimism that sits as motivation to all junior explorers seems to run with excessive exuberance in some corners of Central's broad community of retail owners. Central's endorsement of Macquarie's offer has been challenged by two shareholder groups. And as recently as a week ago, concerns were growing that rejection of the scheme takeover was a real possibility.

Resistance of the Macquarie reality is built on three foundations. Central has more gas than anyone imagines, the gas shortage is worse than has been anticipated and that regulation will remove the pipeline bottlenecks.

But EY assesses that at least two of those hopes have been dashed with the government giving itself the power to redirect gas to domestic markets and bureaucrats refusing to give visible teeth to arbitrators of pipeline access disputes.

In other words, a bid that was fair and reasonable has become very, very fair and reasonable.