Dawson Valley Pipeline: Application for coverage under the National Gas Code by Molopo Australia Limited

Supplementary advice

Introduction

On 4 August 2005, the National Competition Council (the Council) forwarded to the Australian Government Minister for Industry, Tourism and Resources, the Hon Ian Macfarlane, its final recommendation in relation to an application by Molopo Australia Limited (Molopo) for coverage of the Dawson Valley Pipeline (DVP). The Minister is the statutory decision-maker in relation to this application.

The Council's recommendation was that the DVP should not be covered under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). The Council was not satisfied that all four of the criteria in s1.9 of the Code are met for the pipeline. In particular, the Council concluded that coverage of the DVP would not satisfy criterion (d)—which requires that access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest.

A significant factor in the Council's conclusion was the presence of another pipeline—the Anglo-Mitsui Pipeline—in sufficiently close proximity to the DVP that it would act as a significant constraint on exercise of market power by the DVP service provider.

On 9 September 2005, shortly after providing its recommendation to the Minister, the Council became aware of an agreement by the owner of the DVP to sell the pipeline to the owners of the Anglo-Mitsui Pipeline. The Council advised the Minister and his officials of this and advised that the Minister should refrain from making a decision in relation to the Council's recommendation. The Council also advised the Minister that he might wish to request that the Council consider this development and report further. (Pursuant to s1.14 of the Code, the Minister may require the Council to provide such information, reports and other assistance as the Minister considers appropriate for the purpose of considering the application.)

On 5 October 2005, the Minister requested that the Council examine the ownership arrangements of the DVP in the context of the Council's recommendation of 4 August 2005 and revise its final recommendation, where appropriate, to reflect this examination.

This supplementary advice sets out the Council's response to the Minister's request. This advice also responds to a request by the Minister dated 7 September 2005 that the Council consider matters raised with him by the Department of Industry, Tourism and Resources and by Molopo.

Background

In its recommendation of 4 August 2005 the Council considered the application for coverage of the DVP against the criteria for coverage set out in the Code. Specifically the Council considered whether:

(a) access (or increased access) to services provided by means of the DVP would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the DVP

(b) it would be uneconomic for anyone to develop another pipeline to provide the services provided by means of the DVP

(c) access (or increased access) to the services provided by means of the DVP can be provided without undue risk to human health or safety

(d) access (or increased access) to the services provided by means of the DVP would not be contrary to the public interest.

The Council's usual format for presenting analysis of the coverage criteria is to begin with criterion (b).

On **criterion (b)** the Council concluded that it would not be economic to develop another pipeline to provide the services of the DVP at current and reasonably foreseeable levels of future demand. Consequently criterion (b) was met.

On **criterion (a)** the Council considered there were two dependent markets of relevance—a downstream Queensland gas sales market and an upstream market for gas production and sales in any fields (including the Mungi gas field) within the vicinity of the DVP. The Council considered whether coverage would promote competition in these markets.

The Council concluded that coverage of the DVP would be unlikely to materially promote competition in the downstream Queensland gas sales market because the operator of the DVP lacked the ability and incentive to vertically leverage its market power to distort competition in the downstream gas sales market.

The Council concluded coverage would be likely to promote competition in the upstream gas production and sales market as a consequence of the ability and incentive of the owner of the DVP to charge monopoly prices for transport services. The Council noted, however, that this upstream market is small with little participation, and considered that coverage would have a limited impact because the market power of the DVP owner was already constrained by the presence of another transmission service—the service provided by the Anglo-Mitsui Pipeline.

On this basis the Council found criterion (a) was met.

On **criterion (c)**, the Council concluded that access (or increased access) can be safely provided to the services of the DVP. The Council therefore found that the DVP satisfied criterion (c).

On **criterion (d)**, the Council considered that, given the small size of the dependent upstream market and the constraint on the pipeline owner's ability to exercise market power (in particular the constraint imposed by the Anglo-Mitsui Pipeline), there was significant likelihood that the costs of regulation would exceed the benefits. The Council was not satisfied that coverage of the DVP would not be contrary to the public interest. The Council therefore found that the DVP did not satisfy criterion (d).

A positive coverage recommendation requires that all four criteria are met. As a consequence of its finding that criterion (d) was not met, the Council recommended that the DVP not be covered under the Code.

On 7 September 2005 Origin Energy announced an agreement for the sale of its interests in the Moura coal seam gas field assets to Anglo Coal (Moura) Ltd and Mitsui Moura Investment Pty Ltd (the Moura joint venture)—the owners of the Anglo-Mitsui Pipeline.

The Moura coal seam gas field assets comprise:

- a 100 per cent interest in Petroleum Lease (PL) 94
- the DVP
- a 50 per cent interest in PL 94 (north sublease)
- Authorities to Prospect (ATP) 564P and ATP 602P.

The effect of the sale is to place the DVP and the Anglo-Mitsui Pipeline under common ownership.

After receiving the Minister's request for further information the Council wrote to Molopo, Origin Energy (which wholly owns Oil Company of Australia (Moura) Transmissions Pty Ltd (OCA), the owner and vendor of the DVP), Anglo Coal (Moura) and Mitsui Moura Investment. The Council asked these parties for information concerning the sale of the DVP and for submissions on why, given the analysis in the Council's 4 August 2005 recommendation to the Minister, the Council should not now advise that the DVP should be covered under the Code. The responses from these parties are noted below.

Views put to the Council

Molopo considered that common ownership of the DVP and the Anglo-Mitsui Pipeline would materially change the environment that Molopo operates within.

Origin Energy advised that it has not yet finalised the Moura coal seam gas field assets sale, though it expects to do so by the end of December 2005. The sale is subject to conditions being met including securing the required ministerial approvals.

Anglo Coal (Moura) on behalf of the Moura joint venture provided the following comments on the likely change in DVP ownership.

- The basis of consideration of whether a pipeline meets the coverage criteria of the Code should be actual ownership rather than potential ownership.

- The Moura joint venture is working toward satisfying the conditions of sale and intends proceeding with settlement.

- Third party access to gas transmission services provided by the Anglo-Mitsui Pipeline has never been denied, and the Moura joint venture intends to continue the same approach for the DVP.

- If the Moura joint venture became the DVP service provider, then the conclusions reached by the Council in relation to promotion of competition in the downstream market remain valid.

- The Council's upstream market definition is too narrow given the interconnected transmission pipeline network and multiple sources of gas, extending beyond fields within the scope of connection of the DVP.

- The Moura joint venture would not have incentives to exercise market power in transmission services to adversely affect competition in the upstream market. Forecast substantial excess capacity on the DVP means that the Moura joint venture would be faced with the commercial imperative of making available transmission services on the DVP.

- The Moura joint venture does not currently, nor does it intend to, purchase gas from other producers from fields within the feasible scope of interconnection with the DVP, and it does not generally have interests in downstream aggregating or retailing of gas in Queensland.

- Countervailing power of another market participant is only one factor to consider in assessing whether coverage would promote competition, and little weight should be attached where the Moura joint venture lacks the incentive to exercise any transmission service market power it may have.

- The benefits of coverage would be minimal, given a small upstream market with little participation, and to the extent that there are any benefits, these would be outweighed by the regulatory costs identified by the Council.

Implications of a change in ownership

The Council considers that the imminent change in ownership requires a reassessment against the criteria for coverage under the Code. While there are other mechanisms in place to deal with changed circumstances post a coverage decision (application for revocation, for example), such mechanisms are usually invoked where there are changes in circumstances that are beyond what is currently foreseeable.

The Council's analysis and conclusions on criteria (b) and (c) are not affected by the change in ownership of the DVP.

The Council's conclusion on criterion (a) with respect to the downstream gas sales market in Queensland is also unchanged.

The change in ownership of the DVP is significant, however, to the Council's analysis and conclusions on criterion (a) as it applies to promotion of competition in the upstream markets for gas production and gas sales, and for its analysis and conclusions on criterion (d).

Criterion (a) / upstream market

The Council remains of the view that criterion (a) is satisfied for the reasons set out in its recommendation of 4 August.

The Moura joint venture currently operates in several functional levels of the gas market including production, transmission and gas sales. The Council has not been provided with precise information on the scale of Moura joint venture's operations, although the scale of operations appears to be significant for each functional level.

In regard to gas sales, the Moura joint venture has a major long term coal seam methane gas supply and sales agreement with Energex Retail Pty Ltd and Moura Sales Pty Ltd (the later being a company owned by the Moura joint venture), supplying major industrial customers in Gladstone and other regional Queensland markets. The contract volumes were sufficient to establish Moura as one of the largest coal seam gas operations in regional Queensland (Anglo Coal Australia 2003).

The Council considers that the presence of vertical linkages (between production, transmission and gas sales) are likely to provide the Moura joint venture with the ability and incentive to exercise market power in the upstream market in the absence of coverage. The Moura joint venture's ability and incentive will mirror that of the previous owner of the DVP, as outlined in the Council's recommendation of 4 August 2005. When the DVP and the Anglo-Mitsui Pipeline were in different ownership, the availability of gas transmission services on the Anglo-Mitsui Pipeline constrained the extent to which the DVP owner may have been able to exercise market power in the upstream market. That constraint would be removed if the Moura joint venture controls both the DVP and Anglo-Mitsui pipelines.

The upstream market for gas production and gas sales in the vicinity of the DVP would remain relatively similar under the new ownership of the DVP. Several gas producers would remain in this market—Molopo and its joint venture partner and the Moura joint venture—and several prospectors. To the extent that most potential gas producers would need to use the gas transmission services of the DVP, the vertical linkages between the Moura joint venture's transmission services and its gas production and sales provide the Moura joint venture with an incentive and ability to leverage its transmission market power into the upstream market.

The presence of the Anglo-Mitsui Pipeline would no longer provide a cap on the ability of the DVP owner to charge monopoly prices for transmission services on the DVP. The Moura joint venture would have the ability to exercise monopoly pricing up to the cost of building another pipeline to connect to the Queensland Gas Pipeline (complete bypass), rather than only to the point at which building an interconnection pipeline and seeking access to the adjacent Anglo-Mitsui Pipeline is a commercially viable option.

The change in ownership of the DVP therefore strengthens the Council's 4 August 2005 conclusion that criterion (a) is met with respect to the upstream market for gas production and gas sales.

Criterion (d)

The Council considers that, with the change in ownership arrangements, the DVP would satisfy criterion (d).

The sale of the DVP to the Moura joint venture, owner of the Anglo-Mitsui Pipeline, would remove the cap on transmission service market power that currently constrains the owner of the DVP. The new owner of the DVP would have the ability and incentive to raise prices up to the point at which a transmission service user (currently only Molopo and its joint venture partner) would decide to bypass the DVP altogether. This could only be achieved by constructing a new pipeline to connect to the Queensland Gas Pipeline. Based on the estimates of pipeline construction costs in the Council's recommendation (paragraphs 6.11 and 6.12), the cost of a complete bypass pipeline is likely to range from $1.4 to $2.5 million for 20 kilometres of pipeline. This cost is significantly greater than the cost of interconnecting to the transmission services of the Anglo-Mitsui Pipeline ($140 000 to $500 000). This interconnection option is no longer relevant with common ownership of the DVP and the Anglo-Mitsui Pipeline.

As stated in the final recommendation (paragraph 9.11), the Council considers that the direct costs to parties participating in developing an access arrangement are likely to be towards an upper bound estimate of $600 000. The Council noted that the total cost of regulation could be significantly greater than $600 000 when all relevant costs are included, though no party provided such an estimate.

Despite the small size of the dependent upstream market, with the removal of the constraint that the independently owned Anglo-Mitsui Pipeline provided on the owner of the DVP, there is a significant likelihood that the costs of regulation would not exceed the benefits. The Council therefore concludes that, with a change in DVP ownership, the DVP would satisfy criterion (d).

Other issues

In his letter of 7 September 2005 the Minister noted that Molopo had questioned the Council's consideration of criterion (a) in the context of a downstream market encompassing a Queensland gas sales market.

Molopo suggested to the Minister that coverage would have the effect of promoting competition in a narrower market—the gas market in the Gladstone area. Molopo considers that it has proximity and cost advantages over the other gas producers supplying this market area.

Molopo suggests that Origin Energy (through its wholly owned company OCA) has incentives to restrict or overprice DVP transmission services because Origin Energy supplies about 60 per cent of gas sold to the Gladstone area. Much of the gas is shipped from further afield and at higher transport cost than Molopo's gas. Molopo considers that coverage of the DVP would ensure fair terms for transmission services, and improve the environment for competition in Gladstone. The Minister sought, for procedural fairness, the Council's consideration of the issues raised and whether they affect the Council's final recommendation.

Molopo raised these matters with the Council in its application, in supplementary information and in its response to the draft recommendation. There are no new issues raised in Molopo's correspondence with the Minister. The Council's view on these matters is essentially reflected in paragraphs 7.18 to 7.24, and 7.45 of the final recommendation. The Council sees little benefit in restating these views.

In his letter of 7 September 2005, the Minister also asked the Council to consider whether the Anglo-Mitsui Pipeline would continue to act as a constraint on the DVP service provider's market power if most of the capacity on the Anglo-Mitsui Pipeline is contracted.

The Council has limited information on the likelihood of the Anglo-Mitsui Pipeline becoming capacity constrained under its current configuration. In its submission of 14 June 2005, Anglo Coal Australia stated that:

> *Preliminary discussions are being held with potential customers…if all those discussions are successful, the Anglo-Mitsui Pipeline on its present configuration may only have 2 TJ per day spare capacity after 2007.*

The Council also notes that the option of using this alternative service has not been pursued by Molopo.

The Council considers that, should the pipelines remain in separate ownership, the Anglo-Mitsui Pipeline would continue to constrain pricing of DVP services regardless of whether its current capacity is fully contracted. It is almost always cheaper to transport additional gas by augmenting pipeline capacity (through compression or looping) rather than by constructing a new pipeline. The option of using Anglo-Mitsui Pipeline transmission services would therefore remain. However, under the scenario that the Anglo-Mitsui Pipeline is almost fully contracted and noting the additional cost of increasing its capacity, the constraint that the Anglo-Mitsui Pipeline places on the DVP service provider's market power would be reduced (by an amount in proportion to this additional cost).

The Council nevertheless considers that augmenting the Anglo-Mitsui Pipeline would be a lower cost option than constructing a new pipeline. The Anglo-Mitsui Pipeline would therefore provide a degree of constraint on the DVP service provider's ability to extract monopoly rents.

The above analysis assumes no sale of DVP assets to the Moura joint venture. In the likely event that the DVP is sold to the Moura joint venture, the Anglo-Mitsui Pipeline would not constrain the DVP service provider's ability to leverage market power, regardless of the extent of available capacity, and the question becomes redundant.

Conclusions

While Origin Energy and the Moura joint venture parties state that the sale of the Moura assets including the DVP is not complete, the available evidence suggests a strong likelihood that the sale will occur. The sale would mean that the DVP and the Anglo-Mitsui Pipeline are in common control.

Should the DVP and the Anglo-Mitsui Pipeline come under common control, a very significant underpinning of the Council's recommendation that the pipeline not be covered is removed.

The Council remains satisfied that criteria (a), (b) and (c) are met. However, its previous conclusion in relation to criterion (d) no longer holds. The Council considers criterion (d) would be met, given common control of the two pipelines.

The Council considers therefore that the DVP meets all the criteria for coverage under the Code. The Council considers that the Minister should set aside the recommendation of 4 August 2005 and determine that the DVP be covered under the Code.

National Competition Council

31 October 2005

Submissions

Molopo Australia Ltd

Origin Energy Ltd

Anglo Coal (Moura) Ltd

Mitsui Moura Investment Pty Ltd

References

Anglo Coal Australia 2003, *Major long term coal seam gas supply and sales agreement*, viewed 18 October 2005, http://www2.recruitmanager.net/anglocoal/publicjobs/index.cfm?cid=3