Dawson Valley Pipeline – Application for coverage under the national gas code

Issues Paper

April 2005

National Competition Council

1 Background

1.1 On 16 March 2005, the National Competition Council received an application for coverage of the Dawson Valley Pipeline (DVP) under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code).

1.2 The applicant, Molopo Australia Limited, seeks coverage of the entire pipeline (Qld: PPL 26) which extends from Dawson Valley to the Wallumbilla to Gladstone Pipeline. The operator of the pipeline is Oil Company of Australia (OCA).

1.3 The Code has application in Queensland pursuant to the *Gas Pipelines Access (Queensland) Act 1998*. A copy of the Code can be found at http://www.coderegistrar.sa.gov.au.

1.4 The Code previously covered the DVP. However, the Commonwealth Minister for Industry, Science and Resources revoked coverage in 2000 following the Council's recommendation that regulated access to the DVP would not promote competition in another market or confer net public benefits.

1.5 The Code requires the Council to conduct a public consultation process and issue a draft recommendation followed by further public consultation, prior to making its final recommendation to the relevant decision maker, in this case, the Commonwealth Minister for Industry, Tourism and Resources. The Code sets out a timetable for completion of this process. In accordance with section 7.16 to 7.18 of the Code, the Council decided to extend the date on which it will release its draft recommendation to 8 June 2005 and the date for which it will accept public submissions on the application. Notice of the extension of time was published in the 'Australian Financial Review' on Wednesday, 30 March 2005.

2 Coverage criteria

2.1 Under section 1.9 of the Code, the Council must recommend that the pipeline be covered if it is satisfied of all of the following matters.

(a) that access (or increased access) to services provided by means of the pipeline in question 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 pipeline in question

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

(c) *that access (or increased access) to the services provided by means of the pipeline in question can be provided without undue risk to human health or safety*

(d) *that access (or increased access) to the services provided by means of the pipeline in question would not be contrary to the public interest.*

2.2 The Council begins by considering criterion (b) as it focuses on whether the relevant pipeline has natural monopoly characteristics, conferring market power on its owner. It then considers criterion (a) which focuses on constraints on the market power and the impact of access on dependent markets.

3 Submissions

3.1 The Council is seeking submissions from interested parties to assist it in assessing whether the DVP meets the coverage criteria in section 1.9 of the Code. To facilitate the preparation of submissions, the Council has prepared this issues paper.

3.2 Parties interested in making submissions in the current matter may be assisted by the Council's previous work in revocation matters and the Council's publication, *The National Access Regime: A Guide to Part IIIA of the Trade Practices Act 1974*. Copies are available at www.ncc.gov.au or by contacting the Council directly.

3.3 Submissions should be sent to Mr John Feil, Executive Director, National Competition Council, GPO Box 250B, Melbourne VIC 3001, **and** emailed to info@ncc.gov.au. Queries may be directed to Ms Michelle Groves on (03) 9285 7476.

3.4 All submissions will be treated as public documents and made available to interested parties and the public (via the Council's web site); unless a specific and detailed claim as to the confidentiality of particular material due to commercial reasons or similar justification is made to, and accepted by, the Council. Any claim for confidentiality must be discussed with the Council prior to submission of the purportedly confidential material. Submitting parties should be aware that the Council's ability to test information that is subject to confidentiality is likely to be limited, and the

Council may therefore give less weight to such material in its consideration.

3.5 The extended closing date for public submissions is **Wednesday, 4 May 2005.**

4 Dawson Valley Pipeline

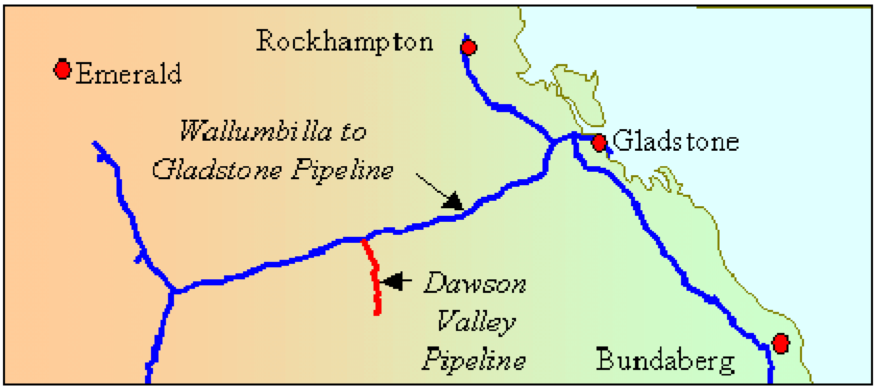
4.1 The Dawson Valley transmission pipeline transports gas 47 km from the Dawson Valley gas fields to the Wallumbilla to Gladstone Pipeline. The pipeline was constructed in 1996 and acquired by Oil Company of Australia (OCA) in 1998 when it purchased all the issued share capital of Conoco Australia Pty Ltd. OCA is a wholly owned subsidiary of Origin Energy.

4.2 The pipeline has a maximum capacity of 20 TJ per day (around 7 PJ per year). The Council understands that the pipeline is currently operating at a significantly lower capacity.

4.3 The major customers of the gas transported in the pipeline are Origin Energy Retail and Energex.

4.4 The applicant has a 25 per cent interest in PL94 through which the pipeline runs. The Council understands that PL94 covers the Moura, Mungi and Dawson Valley fields.

Diagram 1 – Dawson Valley Pipeline



Reason for seeking coverage

4.5 The applicant notes that within PL94, it is producing gas from proven reserves (the Mungi Gas Field). The initial production of gas from this field has been sold to Origin Energy. Following the development of the Mungi Gas Field, the applicant submits that the prospect now exists for sales of gas directly to end users in the Queensland gas market.

4.6 As gas sold to Origin Energy and other parties needs to be delivered through the OCA owned pipeline, the applicant considers that coverage will ensure:

- access is available to the Pipeline on terms and conditions reflecting the provisions of the Code
- ring-fencing of OCA's gas transmission activities from related business activities.

5 Services provided by means of the Pipeline

5.1 The starting point in considering an application for revocation or coverage is to identify the 'Services provided by means of the Pipeline'. This phrase is used in each of the section 1.9 coverage criteria and therefore requires a consistent interpretation.

5.2 Section 10.8 of the Code defines the term 'Service' (for the purposes of section 1 of the Code) to mean a service provided by a 'Pipeline' including without limitation haulage services, the right to interconnect with the Covered Pipeline and services ancillary to the provisions of such services but does not include the production, sale or purchasing of natural gas.

5.3 The relevant definition of 'Pipeline' is that contained in Schedule 1 of the *Gas Pipelines Access (South Australia) Act 1997* (Gas Pipeline Access Law — adopted in Queensland) in which:

'pipeline' means a pipe, or system of pipes, or part of a pipe, or system of pipes, for transporting natural gas, and any tanks, reservoirs, machinery or equipment directly attached to the pipe, or system of pipes, but does not include--

(a) unless paragraph (b) applies, anything upstream of a prescribed exit flange on a pipeline conveying natural gas from a prescribed gas processing plant; or

(b) if a connection point upstream of an exit flange on such a pipeline is prescribed, anything upstream of that point; or

(c) a gathering system operated as part of an upstream producing operation; or

(d) *any tanks, reservoirs, machinery or equipment used to remove or add components to or change natural gas (other than odourisation facilities) such as a gas processing plant; or*

(e) *anything downstream of the connection point to a consumer.*

5.4 Under the definition of 'pipeline' set out above, the pipeline for the purposes of section 1.9 is the system of pipes used for transporting natural gas and any tanks, reservoirs, machinery or equipment directly attached to the pipe making up the system referred to as the relevant Dawson Valley pipeline.

5.5 The principle service provided by the pipeline is the gas haulage service from one point to another serviced by the pipeline. This 'point to point' approach to defining the relevant service was accepted by the Australian Competition Tribunal (the Tribunal) in the Duke EGP decision. In that decision, the Tribunal concluded that the 'service' provided by means of the Eastern Gas Pipeline was a haulage service for the transport of gas between one point on the pipeline and another. (Duke EGP decision, paras 68-69)

5.6 Applying the Tribunal's 'point-to-point' approach, the principal service provided by the DVP is the haulage of natural gas from the Dawson Valley Gas Fields to the Wallumbilla to Gladstone Pipeline and all points in between.

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

Background

6.1 Criterion (b) requires that it be uneconomic for anyone to develop another pipeline to provide the services provided by means of the pipeline. The Tribunal in the Duke EGP decision considered this to mean that:

> *[if] a single pipeline can meet market demand at less cost (after taking into account productive allocative and dynamic effects) than two or more pipelines, it would be 'uneconomic', in terms of criterion (b), to develop another pipeline to provide the same services.* (para 64)

6.2 The Tribunal went on to state:

> *We agree with the submissions of NCC that the 'test is whether for a likely range of reasonably foreseeable demand for the services provided by the means of the pipeline, it would be more efficient, in terms of costs and benefits to the community as a whole, for one pipeline to provide those services rather than more than one'.* (para 137)

6.3 This test was applied by the Tribunal in the Sydney Airport decision in which it reiterated its view that 'uneconomical' should be construed in a social cost benefit sense rather than in terms of private or commercial interests (paras 204-205).

6.4 In considering whether it is uneconomic to 'develop' another pipeline, it is appropriate to have regard to pipelines that have already been developed (Duke EGP, para 57). The term 'develop' is sufficiently broad to encompass modifications or enhancements to existing pipelines.

Issues for consideration

6.5 Applying the Tribunal's test of natural monopoly, the issue under criterion (b) is whether for the likely range of reasonably foreseeable demand for the services provided by the DVP, the pipeline can satisfy that demand at less cost than multiple pipelines. As defined previously, the principal service provided by the DVP is the haulage of natural gas from the gas fields in the Dawson Valley and the Wallumbilla to Gladstone Pipeline as well as all points in between.

6.6 In terms of assessing foreseeable demand, the Council notes that the applicant considers there to be scope for additional production from the Mungi gas field. In particular, the applicant considers that:

> *The independently certified proven and probable (i.e. P50) reserves of the Mungi Gas Field are 25 PJ although it is estimated that the field may contain some 162 PJ of recoverable gas. In addition, other significant prospects exist for discovery* of *gas within the areas surrounding the Mungi Gas Field*. (Molopo Australia 2005, para 6)

6.7 The level of foreseeable demand for the DVP and its existing level of excess capacity will be relevant factors for the Council to consider in determining whether it would be uneconomic to develop another pipeline to provide the service.

6.8 Molopo Australia Limited submits that the cost of new pipeline infrastructure to facilitate delivery of their interest in gas produced from the Mungi and other potential gas fields would be in the order of $2.5 million. This cost is based on the need for at least 20 kms of 88.9 mm diameter pipeline and includes metering and regulation equipment.

6.9 Consistent with the Duke EGP decision, the Council will assess whether other pipelines are able to provide the service. If an existing pipeline (other than DVP) does not presently provide the services provided by the pipeline in question but could economically be modified or expanded to do so, then criterion (b) will not be not met.

6.10 In this regard, the Council's 2000 recommendations with respect to DVP noted that the Peabody-Mitsui Pipeline is located only 20 metres from the DVP, running parallel for 12 kms. As a consequence, it may be that the Peabody-Mitsui Pipeline can provide a competing service for at least a part of the length of the DVP where the two pipelines are located near each other. The Council will also need to consider whether there are other pipelines that may also be able to provide a competing service.

The Council seeks comments on:

- *What is the capacity of, and the reasonably foreseeable demand for, the transportation services provided by the DVP?*

- *Can gas be physically transported along the route of the DVP by other pipelines other than the DVP? What (if any) capacity constraints would prevent this from occurring?*

- *Would it be uneconomic to build another pipeline or modify existing pipelines to compete with the DVP? What would be the cost of building new pipelines or modifying existing ones?*

7 Criterion (a) - that access (or increased access) to services provided by means of the pipeline 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 pipeline

Background

7.1 The purpose of criterion (a) is to limit coverage to circumstances where it is likely to enhance the opportunities and environment for competition in any dependent market(s). Whether competition will be enhanced depends critically on the extent to which the incumbent service provider can, in the absence of coverage, use market power to adversely affect competition in the dependent market(s). If the service provider has market power, as well as the ability and incentive to use that power to adversely affect competition in a dependent market, coverage would be likely to improve the opportunities and environment for competition, offering the prospect of tangible benefits to consumers (including reduced prices and better service provision).

7.2 In assessing whether criterion (a) is satisfied, the Council must:

(a) define the relevant market(s) in which competition may be promoted and verify that this market or these markets are separate from the market for the service to which access is sought

(b) determine whether access (or increased access) facilitated by coverage would promote a more competitive environment in the additional market(s), which requires assessing:

(i) whether the incumbent has the ability and incentive to exercise market power to adversely affect competition in the dependent market(s)

(ii) whether the structure of the dependent market(s) is such that coverage would, by constraining the exercise of market power by the service provider to adversely affect competition in the dependent market(s), promote competition.

Issues for consideration

Defining the relevant market

7.3 The first step in the application of criterion (a) is to define the market(s) in which competition may be promoted as a result of coverage. Such market(s) (referred to as the dependent market(s)) must be separate from the market for the services provided by the pipeline that is the subject of the application. Typically, the dependent market(s) will be either upstream or downstream from the market for the services provided by the pipeline which (if criterion (b) is satisfied) represents the bottleneck that coverage seeks to unlock.

7.4 The High Court has accepted the following definition of 'market' (*Queensland Wire Industries Pty Ltd* v *The Broken Hill Proprietary Ltd and Another* (1989) 167 CLR 177):

> *A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them (if there is no close competition there is of course a monopolistic market). Within the bounds of a market there is substitution — substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive. ... Whether such substitution is feasible or likely depends [on a number of factors] ... [I]n determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to `give less and charge more' would there be, to put the matter colloquially, much of a reaction?* (Re Queensland Co-operative Milling Association Ltd (1976) 25 FLR 169 at 190).

7.5 Molopo Australia submits that the relevant dependent market is the Queensland gas market. Potential issues for the Council to consider include:

- whether the relevant market is the natural gas sales market or the broader energy sales market

- whether there are a number of functional levels within which sales of natural gas occur (e.g. wholesale, retail)
- the geographic extent of this market
- which aspects of the Queensland gas market can be defined as dependent markets
- whether there are other dependant markets.

Would access promote competition?

7.6 The Council must determine whether access (or increased access) facilitated by declaration would promote a more competitive environment in a dependent market. This requires an assessment of:

(a) whether OCA has the ability and incentive to exercise market power to adversely affect competition in a dependent market

(b) whether the structure of the dependent market is such that coverage would, by constraining the exercise of market power by OCA to adversely affect competition in the dependent market, promote competition.

Market Power

7.7 It is only where the service provider has both the ability and incentive to use its presumed monopoly power to adversely affect competition in the dependent market(s) that coverage will be likely to improve the conditions for competition in the market(s). In essence, there are three means by which the service provider may seek to use its presumed monopoly power to adversely affect competition in a dependent market or markets:

(a) the service provider may charge monopoly prices for the provision of the service

(b) the service provider may engage in explicit or implicit price collusion

(c) a vertically integrated service provider may engage in strategic behaviour designed to leverage its presumed monopoly power into the dependent market.

7.8 The Council seeks views on these market power issues. The Council notes that OCA is a subsidiary of the Origin Energy group that operates in both transmission and retail markets. The Council will need to consider whether these vertical linkages provide OCA with an ability and incentive to exercise market power in the absence of coverage, and the effect of such an exercise on dependent markets.

7.9 To the extent that Origin Energy sells gas in the Queensland gas market, it appears to have an incentive to exercise any market power in this market to maximise returns. Where declaration enables the applicant to sell directly to end users, OCA's market power in the dependent markets may be constrained. This would be in contrast to the current arrangement where gas is sold to Origin Energy who then onsells the gas to end users.

7.10 The Council seeks views as to the effect on dependent markets of any exercise of market power by OCA.

The Council seeks comments on:

- *Has Molopo Australia appropriately defined the relevant dependent markets? Is it separate from the market for the services provided by the Dawson Valley Pipeline?*

- *Are there any other dependent markets in which competition may be promoted as a result of access through coverage?*

- *To what extent do the vertical linkages within the Origin Energy group create an ability and incentive for OCA engage in monopoly pricing or otherwise exercise market power in dependant markets?. To what extent (if any) do other gas pipelines constrain this exercise of market power?*

8 Criterion (c) - that access (or increased access) to the services provided by means of the pipeline can be provided without undue risk to human health or safety

Background and issues for consideration

8.1 The rationale for criterion (c) is that a pipeline should not be covered where access or increased access to the service provided by the pipeline may pose a legitimate risk to human health or safety.

8.2 In its submission, Molopo Australia submits that access can be provided safely as the DVP currently delivers gas from the Mungi Gas Field to Origin Energy.

8.3 The Council notes that some pipelines and ancillary facilities require a degree of spare capacity to provide appropriate safety margins. Pipeline access may need to be governed by conduct codes, operational guidelines and relevant safety regulations. For a pipeline to be covered, access must be possible without compromising system and operational integrity and safe operability.

8.4 Criterion (c) may be satisfied where it is possible to address any safety concerns raised by access to the service through the terms and conditions on which access is provided.

The Council seeks comments on:

- *Whether access to the DVP will pose a risk to human health or safety.*
- *Where risks arise, can these risks be addressed through terms and conditions of access?*

9 Criterion (d) - that access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest

Background

9.1 The Tribunal in the Duke EGP decision considered that:

> *criterion (d) does not impose an additional positive requirement which can be used to call into question the results obtained by the application of pars (a), (b) and (c). Criterion (d) accepts the results derived from the application of the other criteria, but enquires whether there are any other matters which lead to the conclusion that coverage would be contrary to the public interest. (para 145)*

9.2 One matter of public interest is whether any benefits of coverage, such as cheaper prices and more efficient use of resources, are outweighed by regulatory or compliance costs. Other matters of public interest include environment considerations, regional development, and equity. Public interest matters might also include impending access regimes or arrangements, national developments and the desirability for consistency across access regimes, relevant historical matters and privacy.

Issues for consideration

9.3 In its application, Molopo Australia notes that OCA, in its 2000 application for revocation, estimated that the costs associated with the development of access arrangements to be in the order of \$100 000 to \$150 000. Molopo Australia considers that these costs would be outweighed by the potential benefits that can flow from increased competition. For example, they note that a gas price improvement of just \$0.10/GJ would deliver a benefit of \$1.6m p.a. even with the benefit limited to 162 PJ (the estimated quantity of gas recoverable from the Mungi Gas Field) of gas over a 10 year period.

9.4 In addition to the actual costs of regulation, the Council notes that regulation can result in behavioural changes that can impact on dynamic efficiencies.

9.5 The Council seeks views on the relative costs and benefits of continued coverage and on any other public interest issues that may arise with continued coverage.

The Council seeks comments on:

- *What are the costs and benefits of continued coverage?*
- *What other matters may be of relevance in determining whether continued coverage would be contrary to the public interest?*

References

Molopo Australia 2005, *Re: Coverage of the Dawson Valley Pipeline*, Correspondence.

National Competition Council 2000, *Queensland Gas Transmission Pipelines – Applications to revoke coverage of three natural gas transmission pipelines under the Queensland Gas Access Regime*, Issues Paper, September.

National Competition Council 2000, *Draft recommendations, Queensland Gas Transmission Pipelines – Applications for revocation of certain gas transmission pipelines in Queensland from coverage under the Queensland Gas Access Regime*, October.

National Competition Council 2000, *Queensland Gas Pipelines, Applications to revoke coverage of certain transmission pipelines under the Queensland Gas Access Regime, Recommendations*, November.

Oil Company of Australia 2000, *Application for revocation of pipeline coverage under the National Third Party Access Code for Natural Gas Pipelines – PPL3: Kincora to Wallumbilla Pipeline and PPL26: Dawson Valley Pipeline*, 18 August.

Duke Eastern Gas Pipelines Pty Ltd (2001) ATPR 41-821

NCC (National Competition Council) 2002, *The National Access Regime: A Guide to Part IIIA of the Trade Practices Act 1974*, December.

Queensland Wire Industries Pty Ltd v *The Broken Hill Proprietary Ltd and Another* (1989) 167 CLR 177