

Energy Markets Reform Forum

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2 February 2001

Mr Gary Banks
Chairman
The National Access Regime Inquiry
Productivity Commission
PO Box 80
BELCONNEN ACT 2616

Dear Mr Banks

National Access Regime Inquiry

The purpose of this submission is to update the Commission on an important development that has emerged since our initial submission in December 2000 entitled: "The Regulation Game" – Third Party Access To AGL Gas Networks – A Case Study Of Regulatory Gaming. In that submission, we detailed the 'cat and mouse' regulation which characterised the 1999/2000 Gas Distribution Pipelines Access Review process in New South Wales and the improvements to the regulatory regime necessary to deliver effective and informed economic regulation.

It has now emerged that the NSW Independent Pricing And Regulatory Tribunal (IPART) is currently considering an Associate Contract between AGL Gas Networks (AGLGN) and AGL Energy Sales and Marketing Limited (AGL ES&M). AGLGN had not previously sought approval, during the 1999/2000 Access Review, for the Associate Contract as required under Section 7.1 of The National Third Party Access Code for Natural Gas Pipeline Systems (The Gas Code). This appears to be a significant and widespread breach of the Code and our misgivings are that this issue has emerged after the completion of the Access Review and the commencement of the Access Regime.

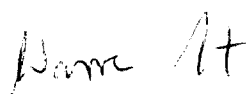
Some information relating to the proposed Associate Contract is contained in the letter from IPART to gas retailers in NSW (copy attached) and include the following:-

- around 68 customer sites are involved
- a majority of contracts received a tariff other than the Reference Tariff
- contracts with end-users ranged from less than 1 year up to 10 years duration
- some end-users were given only 1 week to accept offers
- non-associate retailers were made aware of the network discounts offered only in some cases
- contracts have been written during the 1999/2000 access review.

It appears that the non-compliance with Section 7.1 of the Gas Code could have the effect of substantially lessening, preventing or hindering competition in the NSW market, and in particular, key segments of the NSW Market. Questions arise concerning whether particular customers have been disadvantaged because of reloading of discounts and whether potential retailers have been deterred from the market.

The Energy Markets Reform Forum is concerned that the current and on-going efforts by infrastructure owners to roll back informed regulation would, if successful, disadvantage competition and consumers' interests. The extent of regulatory gaming during Access Reviews can substantially and significantly deter competition and efficient economic outcomes.

Yours sincerely

A handwritten signature in black ink, appearing to read "Warren At".

Warren Martin
Chairman, Energy Markets Reform Forum and
Company Secretary, Tomago Aluminium Ltd.



INDEPENDENT PRICING AND REGULATORY TRIBUNAL
OF NEW SOUTH WALES

Our reference: 00/61

9 January, 2001

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Associate contracts under the National Code

The Tribunal is currently considering an Associate Contract between AGL Gas Networks Limited (AGLGN) and AGL Energy Sales and Marketing Limited (AGL ES&M).

The Tribunal is required to assess proposed Associate Contracts under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). Section 7.1 of the Code requires that:

"A Service Provider must not enter into an Associate Contract without first obtaining the approval of the Relevant Regulator. The Relevant Regulator must not refuse to approve a proposed Associate Contract unless it considers that the contract would have the effect, or would be likely to have the effect, of substantially lessening, preventing or hindering competition in a market."

The proposed Associate Contract aims to redress instances where AGLGN has previously not complied with section 7.1 of the Code. Around 68 customer sites are affected. Specifically, the proposed Associate Contract covers delivery points:

- where terms of the original transport agreement have been varied; or
- which do not meet specific criteria for inclusion under approved contracts.

AGLGN did not originally approach the Tribunal for approval of these contracts. Some of the varied agreements have been in operation since August 1997. The proposed Associate Contract now before the Tribunal would have the effect of:

- terminating the existing above mentioned agreements; and
- immediately following such termination, new arrangements (on the same terms and conditions as those terminated arrangements) taking effect between the parties.

The proposed Associate Contract provides for services at other than Reference Tariffs. Under these circumstances, section 7.3 of the Code requires the Tribunal to conduct such public consultations as it considers appropriate.

As part of this process, the Tribunal requests your comments on the proposed Associate Contract. Following are general details of the proposed contract and offers made to end users:

- the majority of sites covered in the Associate Contract receive a tariff other than the Reference Tariff
- an offer on identical terms to that in the Associate Contract was made to each customer regardless of whether gas was purchased through a supplier, eg the end user may itself act as a supplier
- an offer on identical terms to that in the Associate Contract was made to each customer regardless of which supplier was chosen
- some letters of offer named Wilton as the receipt point into AGLGN's gas distribution network (many of these offers were made at a time when the Eastern Gas Pipeline was not operational)
- contracts entered into by end users ranged from less than 1 year up to 10 years duration
- end users were given between 1 and 12 weeks to accept any offer made. The majority were given 4 weeks within which to make a decision
- in some cases, non associate retailers were made aware of the network discounts offered to end users, and were able to tender for the end user's business.

Specifically, the Tribunal requests your comments in relation to whether the proposed Associate Contracts would have the effect, or would be likely to have the effect, of substantially lessening, preventing or hindering competition in a market.

The Tribunal requests your comments by close of business 25 January 2001.

The attachment to this letter presents background information on the issue of Associate Contracts.

Yours sincerely,



James Cox
Acting Chairman

Associate contracts – background information

What is an associate contract

Section 7.1 of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code) provides that a Service Provider must not enter into an Associate Contract without first obtaining the approval of the Relevant Regulator. The Code defines an Associate Contract as:

- (a) a contract, arrangement or understanding between the Service Provider and an Associate in connection with the provision of a Service; or
- (b) a contract, arrangement or understanding between the Service Provider and any person in connection with the provision of a Service which provides a direct or indirect benefit to an Associate and which is not an arm's length transaction.

An Associate Contract under the Code includes contracts, arrangements and understandings. This is a very broad classification. It includes variations to contracts, as well as those arrangements and understandings which are not in writing or executed as a formal agreement.

Code requirements

Sections 7.1 – 7.6 of the Code specifically deal with the approval of Associate Contracts.

Section 7.1 – “A Service Provider must not enter into an Associate Contract without first obtaining the approval of the Relevant Regulator. **The Relevant Regulator must not refuse to approve a proposed Associate Contract unless it considers that the contract would have the effect, or would be likely to have the effect, of substantially lessening, preventing or hindering competition in a market.**”

In the instance covered by this letter, AGLGN has breached section 7.1 of the Code. It has entered into Associate Contracts without gaining the prior approval of the Tribunal. The Tribunal has separately discussed this matter with AGLGN, with AGLGN implementing a number of changes to ensure that future breaches do not occur.

The issue for the Tribunal now is to consider whether the proposed Associate Contract would have the effect, or would be likely to have the effect, of substantially lessening, preventing or hindering competition in a market.

Section 7.2 – “If an Associate Contract provides for the supply of Services at the Reference Tariff the Relevant Regulator may make a decision under section 7.1 without conducting public consultation.”

Section 7.3 – “In all other cases, the Relevant Regulator must, prior to making a decision under section 7.1, conduct such public consultations as it considers appropriate...”

Section 7.2 gives the Tribunal discretion as to whether to conduct public consultation where supply of Services is at the Reference Tariff. In all other cases, the Tribunal must conduct such public consultations as it considered appropriate before making its decision (section 7.3).

Section 7.4 – “The Relevant Regulator is deemed to have approved an Associate Contract if it does not notify the Service Provider that it does not approve the Contract within:

- (a) 21 days after the day on which the Service Provider’s application to enter into the Associate Contract was received by the Relevant Regulator; or
- (b) if, within that 21 day period, the Relevant Regulator notifies the Service Provider that it requires additional information from the Service Provider to consider the application – the period of 21 days after the day on which the Service Provider’s application to enter into the Associate Contract was received by the Relevant Regulator plus the number of days in the period commencing on the day on which the Relevant Regulator gave notice to the Service Provider and ending on the day on which the Relevant Regulator receives the additional information from the Service Provider.”

Section 7.5 – “If the Relevant Regulator conducts a public consultation in relation to an Associate Contract the references in clause 7.4 to 21 days shall be read as references to 49 days.”

In essence, the Tribunal initially has 21 days in which to make its decision. This period is extended where it requires additional information from the Service Provider (section 7.4). Similarly, the time period is extended where the Tribunal conducts public consultation (section 7.5). A request for additional information under section 7.4 adds to the time extension under section 7.5. That is, where there is public consultation and a request for additional information, the time period allowed for the Tribunal is 49 days *plus* the number of days the Service Provider takes to supply the requested information.

Section 7.6 – “A decision by the Relevant Regulator not to approve an Associate Contract is subject to review by the Relevant Appeals Body under the Gas Pipelines Access Law.”

Substantial lessening of competition

Under section 7.1 of the Code, the Tribunal cannot refuse to approve a proposed Associate Contract unless it considers that the contract would have the effect, or would be likely to have the effect, of **substantially** lessening, preventing or hindering competition in a market.

Notwithstanding the need to define the relevant market (or markets) affected by the Associate Contract, the Tribunal is required to assess whether a *substantial* lessening,

preventing or hindering of competition would be caused through the Associate Contract.

A key reason for being concerned with Associate Contracts is that they have the potential to confer competitive advantage to the entities involved. Obviously, this can have the flow on effect of stifling competition in a market. For example, if AGL's gas retailing arm were to always receive discounted transportation tariffs on AGLGN's distribution system, then we would expect that competition from other non associate retailers would be stifled if they too did not have access to these discounted tariffs.

However, it is well recognised that vertical integration between firms may yield significant benefits through economies of scale or scope. Hence, a prohibition on all such arrangements and Associate Contracts would be inappropriate. Only those Associate Contracts that would have the effect, or would be likely to have the effect, of substantially lessening, preventing or hindering competition are prohibited.

The meaning of the word 'substantial' has received considerable attention in the context of the *Trade Practices Act 1974* (the Act) and mergers between companies. Section 50 of the Act prohibits acquisitions which would have the effect, or be likely to have the effect, of substantially lessening competition in a substantial market in Australia, in a State or Territory.¹

Considerations under the *Trade Practices Act 1974* give the Tribunal the basis for interpreting the term 'substantially' in the phrase 'substantially lessening, preventing or hindering competition in a market'.

The word substantial can be the subject of differing interpretations in different contexts, and in relation to other sections of the Act. In the past it has been interpreted as meaning 'real or of substance' and sometimes as 'large or weighty'. The Explanatory Memorandum to the Trade Practices Legislation Amendment Bill 1992 clarifies this issue by stating:²

The term 'substantial lessening of competition' is used widely through the Principal Act. It is here intended to mean an effect on competition which is real or of substance, not one which must be large or weighty.

This was further clarified by the Government during the Bill's passage through the Senate:³

¹ A key difference between section 7.1 of the Code and section 50 of the Act is the latter focuses on a 'substantial lessening of competition in a substantial market'. Consideration for Associate Contracts is on a 'substantial lessening of competition in a market'.

² Trade Practices Legislation Amendment Bill 1992: Explanatory Memorandum, para 12, p 4.

³ Hansard, 10 December 1992, p 4776.

Attachment

In signifying its intention that that word as now proposed to be used in s.50 should bear the meaning 'real or of substance', the Government intends that the test should apply to effects on competition which are not merely discernible but which are material in a relative sense in the impact they may have upon effective competition in the market place.

Hence, the threshold in section 7.1 of the Code when referring to a substantial lessening of competition, would appear to be a relative one.

In analysing whether a merger would be likely to have the effect of substantially lessening competition in a substantial market, section 50(3) requires regard to be had to a non exhaustive list of factors. Some of these factors may be relevant to the consideration of the effect of a proposed Associate Contract on competition:

- the height of barriers to entry to the market
- the level of concentration in the market
- the degree of countervailing power in the market
- the likelihood that the Associate Contract would result in the associate being able to significantly and sustainably increase profit margins
- the extent to which substitutes are available in the market, or are likely to be available in the market
- the dynamic characteristics of the market, including growth, innovation and product differentiation
- the nature and extent of vertical integration in the market.

Market definition

Section 7.1 of the Code requires that the assessment of a substantial lessening, preventing or hindering of competition be applied to 'a market'. Properly defining the particular market in question also serves the purpose of focussing the analysis of competitive effects.

The Code does not set out a definition of a market, nor does it establish how the dimensions of a particular market are to be established. Experience under the *Trade Practices Act 1974* may be useful here.

It is generally accepted that a market has four dimensions:

- product
- geographic
- functional
- time.

Applying these concepts to natural gas, the product market may be: the retailing of gas to end customers, the transportation of gas through regional pipelines, ie

competition between regional pipelines, and/or the wholesale market in NSW. These markets can then be defined in terms of their geographic dimension, ie what is the area or areas that the product is supplied to, and consumers can practically turn.

Consideration of the functional market requires identification of the vertical stages of production and/or distribution which comprise the relevant area of competition. A key question for the Tribunal is whether the Service Provider and Associate operate in different functional markets, eg network operator and retailer.

The Australian Competition and Consumer Commission (ACCC) has indicated in its Merger Guidelines that where there are overwhelming efficiencies of vertical integration between two or more stages, it would be inappropriate to define separate functional markets.⁴

The ACCC has indicated that the time dimension of the market refers to the period over which substitution possibilities should be considered. This is in the context of mergers between companies. The ACCC considers substitution possibilities over the longer term (though still in the foreseeable future) that will effectively constrain the exercise of significant market power by the merged firm.⁵

If this approach were adopted, the assessment of the competitive effects of an Associate Contract would be in the context of the 'market' having the opportunity to 'settle/adjust' to the contract.

Submissions to the Tribunal

This attachment has provided background information on Code requirements for Associate Contracts. It is intended that this background information should assist those who choose to make a submission to the Tribunal on a proposed Associate Contract. The Tribunal's obligations under section 7.1 of the Code have been specified, and this has introduced issues that the Tribunal will have to consider in assessing any proposed Associate Contract.

Similarly, the background information has also interpreted particular terms in section 7.1 of the Code. Again, this should assist those who make submissions to the Tribunal as it provides an indication of the Tribunal's obligations.

Submissions to the Tribunal should attempt to address the matters discussed above, plus others that you feel may be relevant.

⁴ Australian Competition and Consumer Commission, *Merger Guidelines*, June 1999, p 38.

⁵ Australian Competition and Consumer Commission, *Merger Guidelines*, June 1999, p 40.