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**WMC Resources Ltd**

**Response to Productivity Commission's Draft Report on its Review of the  
Gas Access Regime**



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## WMC Resources Ltd

# Response to Productivity Commission's Draft Report on its Review of the Gas Access Regime

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## 1. Executive Summary

WMC Resources Ltd ("**WMC**") welcomes the opportunity to comment on the Draft Report of the Productivity Commission ("**Commission**") on the Review of the Gas Access Regime ("**Draft Report**").

This submission is divided into two principal sections. The first (Part A) contains WMC's submission on the overall intent and application of the Gas Access Regime, while the second (Part B) contains WMC's submissions on some of the specific recommendations made by the Commission in the Draft Report.

The need for an industry specific Gas Access Regime has clearly been made out and whilst there are some modifications which can be made to improve the operation of the regime, the fundamental elements of the regime are sound.

In WMC's submission, the Commission has tended to overstate the negative impacts of the regime. This may be a result of the fact that the Commission has tended to focus on the impact of the Gas Access Regime on investment in pipeline infrastructure in isolation, rather than examining broader questions of investment in industries which depend on the provision of delivered gas. Given that the demand for gas transport services is a derived demand, there is no inherent benefit in investment in pipeline infrastructure. Rather, the investment benefits come from the total investment in pipeline infrastructure and in the mining and industrial projects which depend on gas. When viewed in this context, some of the proposals contained in the Draft Report have the ability to adversely impact investment in this broader sense.

In terms of overall intent and application:

- (a) there has been no case made out that coverage of pipelines should be more difficult to achieve than it currently is under the coverage criteria. The interpretation of the coverage criteria in the decided cases has demonstrated an appropriate balancing of the competing considerations which apply in coverage decisions;

- (b) the Gas Access Regime is intended to focus on the availability of gas transmission services to third parties i.e. it is not and should not be seeking to regulate the terms and conditions which apply to foundation shippers<sup>1</sup>;
- (c) foundation shipper commitments facilitate investments in pipeline infrastructure and it will generally be inappropriate for later third party users of those pipeline services to obtain transmission services on terms and conditions which are more favourable than those that accrue to foundation shippers; and
- (d) to the extent that the regulated tariff is equivalent to the terms and conditions which foundation shippers have negotiated, there is a risk that pipelines will be built only to service the foundation shipper contract volumes.

In Part B of the submission WMC does not seek to comment on each recommendation which has been made but confines its remarks to those recommendations where it has additional information to contribute or views which differ from those reflected in the particular recommendation.

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<sup>1</sup> It being assumed, rightly in WMC's submission, that the terms and conditions of foundation shipper contracts will generally reflect market terms and conditions given the interdependence of the parties at the time of contracting

## PART A - OVERVIEW

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### 2. The Scope and Intent of the Gas Access Regime

#### 2.1 The need for the regime

The focus of the Gas Code is on spare and developable capacity of pipelines. Its focus is therefore rightly on "third parties". This is reflected in the Commission's statement that:

*The potential benefits of regulating pipelines with foundation customers, where these customers had countervailing power in negotiating their contract (such as when pipeline development is contestable), are likely to be lower than the benefits for other pipelines. The market power of service providers with foundation customers is likely to be constrained (chapter 2), so the potential benefits of regulating pipeline access might relate only to future customers using any spare capacity on that pipeline.<sup>2</sup>*

Foundation shipper contracts will generally provide the commercial rationale for pipeline construction. From the pipeline owner's perspective such contracts need to provide sufficient revenue over the life of the contracts to cover most, if not all, of the construction and operational costs, including a return on the investment made. From the shipper's point of view the contracts provide security of supply at a pre-agreed price to enable investment by the shipper in related markets. If a pipeline owner has spare and/or developable capacity above the volumes committed in the foundation contracts, then, absent issues such as vertical linkages, it has an incentive to sell the additional capacity to maximise revenue<sup>3</sup>. Given that most, if not all, of its costs are to be recovered under the foundation shipper contracts and there is a declining average cost curve up to at least the fully compressed capacity of the pipeline, almost all revenue above the incremental costs of the additional usage will fall directly to the bottom line.

If this approach is adopted, it can lead to third parties who compete with foundation shippers in downstream markets obtaining a competitive advantage compared with the foundation shipper in circumstances where it is the contractual commitment of the foundation shipper which has made the pipeline investment possible. At the same time, it needs to be recognised that setting the third party tariff at a high level may distort investment and frustrate competition in upstream and downstream markets. The challenge for the regulatory regime is to find a mechanism for setting third party access tariffs which does not remove the incentive on foundation shippers to commit to long term contractual arrangements, whilst recognising the varying degrees to which foundation shippers may underwrite the risks of a pipeline and

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<sup>2</sup> Draft Report p.82

<sup>3</sup> Given that marginal cost is low, if not close to zero, maximising revenue will be equivalent to maximising profit.

preserving the incentive for pipeline owners to construct pipelines with spare and developable capacity which can be sold at a price which does not distort investment in dependent markets.

In WMC's submission, the Gas Access Regime currently has the mechanisms to ensure that such a balance is set appropriately. There is nothing inherent in the Gas Access Regime that requires reference tariff outcomes to mirror ex-post calculations of foundation tariffs. The development, approval and testing of access arrangements through the review process has taken longer than all participants had expected and would consider desirable. There is, however, now developing a workable body of regulatory principles which are improving overall productivity.

In WMC's submission, the only changes to the Gas Access Regime which are necessary are those needed to ensure that the reference tariff is set to properly reflect third party use rights and not as a mirror of foundation shipper arrangements.

To achieve this several propositions are important:

- (a) there should be no presumption that third party rights should be equivalent to foundation shipper rights;
- (b) setting regulated tariffs at or less than foundation shipper contract levels is likely to reduce the incentives of foundation shippers to enter into such arrangements;
- (c) third party regulated tariffs should be set to both promote downstream and upstream competition and to reflect the costs/risks applicable to any suite of third party access terms; and
- (d) when allocating systems costs and determining third party tariffs, foundation shippers are deemed to be third parties.

## PART B - COMMENT ON SPECIFIC RECOMMENDATIONS

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### 3. Australian Gas Industry

#### 3.1 Draft finding 2.1

*While transmission pipelines have natural monopoly characteristics, the market power of transmission pipeline owners is constrained by a number of factors, particularly:*

- *the availability of substitutes - that is, the presence of a competing pipeline in the end market and/or of alternative fuel and energy sources;*
- *the size and concentration of users and the competitive nature of foundation contracts*
- *the elasticity of demand for the final products, for which natural gas is an input.*

*The extent to which these factors constrain market power differs across pipelines.*

The market power of transmission pipeline owners can be constrained by certain factors. However, the impact of these factors is overstated by the Commission. Further, the Commission attributes little significance to the lack of bargaining power of those pipeline users which are completely dependent on the services of a particular pipeline. The question really is one of the extent to which users have countervailing power and that is not simply a function of size and/or concentration.

The Commission posits that "gas often has other close substitutes in end use, such as coal"<sup>4</sup>. Whilst this is true in some circumstances, in WMC's experience it is not the case in the majority of situations, particularly in the mining sector. In this regard, WMC refers the Commission to the Final Recommendation of the National Competition Council ("NCC") on the application by Goldfields Gas Transmission Pipelines Pty Limited for revocation of coverage of the Goldfields Gas Pipeline and to the report of Frontier Economics which was provided to the NCC on behalf of WMC<sup>5</sup>.

#### 3.2 Draft finding 2.3

*The market conditions facing the gas transmission and distribution sectors have changed significantly since the Gas Access Regime was introduced. In particular, participants in these sectors are increasingly responding to new opportunities that arise in an emerging competitive market. This increased contestability is expected to continue, including through greater connectivity. However, the market is still in transition. In this environment, a gas access regime of sorts is still warranted.*

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<sup>4</sup> Draft Report p.xxiii

<sup>5</sup> A copy of which is Attachment 1 to this submission.

WMC is concerned that this draft finding overstates the extent of competition which now exists in the provision of gas transmission services. In WMC's view, whilst competition is clearly emerging, it is still at a relatively early stage of its development and, in the absence of a legislated assurance of access at tariffs that are subject to regulatory oversight, third parties who rely on transmission services from key pipeline infrastructure to compete in dependent markets do not have certainty as to either the availability of supply in required quantities or the price at, and terms on, which supply will occur.

Contrary to the position which may exist in eastern Australia, in Western Australia there is little prospect of interconnection significantly changing the competitive dynamics.

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## **4. Impact of the Gas Access Regime on Investment**

### **4.1 Draft Finding 4.3**

*The Gas Access Regime deters and distorts investment, possibly altering the nature and timing of pipeline projects. Pipeline construction might be delayed, for example, or pipelines might be built 'fit for purpose'. Such alterations can delay the emergence of competition in upstream and downstream markets.*

The Productivity Commission found that the Gas Access Regime deters and distorts investment in pipeline projects and, therefore, may delay the emergence of competition in upstream and downstream projects<sup>6</sup>. The Commission reached this view based largely on theory or conceptual considerations<sup>7</sup> rather than fact because of the difficulties which are inherent in determining whether investment decisions have been adversely affected by the Gas Code or by other factors.

WMC has two concerns with the approach which the Commission has adopted. First, it focuses on investment in pipelines, when, given that demand for pipeline services is derived demand, the focus should also be on the broader question of investment in development which depends upon pipeline services or into which pipeline services are an input. Second, it is unsound to reach a conclusion which is not supported by the available evidence. In these circumstances, the most that the Commission properly should do is to note the potential for regulation to distort investment, recommend that detailed studies of the issue be undertaken and seek to review the matter at a later date.

Access to natural gas transmission and distribution pipelines is a key driver of investment in upstream and downstream markets which is essential for economic growth and job creation. In

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<sup>6</sup> Draft Report p.109

<sup>7</sup> Draft Report p.108



the absence of price regulation, investment in upstream and downstream markets may decline. Investment in pipeline infrastructure is not an end in itself. At a conceptual level, the Gas Access Regime is intended to facilitate access to natural gas transmission and distribution pipeline infrastructure which may otherwise exhibit monopoly characteristics so as to ensure that investment overall is efficient.

The challenge for access regulation, therefore, is to strike a balance between ensuring access for business to pipeline infrastructure and providing incentives for investment in pipeline infrastructure (Government's Response to the Productivity Commission's Report on the Review of the National Access Regime, p 2, ("**Government's Response, Part IIIA Report**").

WMC is concerned by the Commission's heavy focus on investment in pipeline projects at the expense of considering the effect of the Gas Access Regime on competition and investment in upstream and downstream markets. To the extent to which users cannot obtain access to transmission services on fair and reasonable terms, then that affects the returns which those users can achieve from and therefore the viability of investment which they would seek to make particularly in the mining industry. For most uses for which WMC requires gas, demand is largely inelastic so that constraints which may be imposed on pipeline owners in other circumstances eg domestic consumption, do not apply. Absent certainty about security and pricing of supply such downstream investment is put at risk.

In response to the Commission's comments on foundation shipper contracts, given the risks which foundation shippers carry, WMC believes it is logical that they would seek to negotiate a 'favoured nation' status in their contracts to ensure they are not disadvantaged by future development of the pipeline. This recognises the fact that pipeline unit costs generally decrease in real terms as throughput increases toward pipeline capacity. Without the 'favoured nation' status, the foundation customer is faced with the possibility that competitors will benefit from a lower tariff despite the competitor taking none of the risk associated with the development of the pipeline.

A pragmatic solution to this scenario is for the foundation shipper and the pipeline owner to agree on terms whereby the shipper pays the original contracted tariff or the regulated tariff, whichever is lower. However, such an arrangement would not deliver the certainty required of foundation shipper cash flows and would act to inhibit investment. WMC believes the Commission's assessment that 'favoured nation' status might result in 'fit for purpose' pipelines to meet foundation loads only is simplistic and does not reflect economic reality. In most circumstances, the actual construction of the pipeline (i.e. the removal of project completion risk) leads to a further increase in demand. A pipeline developer chooses to ignore this additional demand at the cost of a significant revenue windfall. WMC believes that if the 'fit for purpose' scenario occurs it tends to occur as a result of specific cashflow or other

localised imperatives rather than the Gas Access Regime. In many cases after construction of pipeline there is some low cost capability for third party users.

## 4.2 Draft Finding 4.5

*Generally, regulation involving access arrangements with a reference tariff should be considered only where service providers have substantial market power. Where market power is not strong, such as where there is emerging competition in the gas industry, the long run costs of regulatory intervention are likely to outweigh the cost of the market failure that regulation attempts to correct.*

This draft finding begins to raise the underpinnings of monitoring as an alternate form of regulation to be used in place of regulation through access arrangements with reference tariffs ("**price regulation**").

WMC agrees with the Commission that transmission pipelines and distribution networks exhibit natural monopoly characteristics, but that not all have substantial market power. WMC does not dispute that the Gas Access Regime has been administered as a cost of service regime which has tended to operate as a form of price regulation and has been time consuming and costly. Whilst this type of price regulation may not always be the most appropriate method of regulation, care needs to be taken in implementing any alternate regime to ensure that the consequences of a lack of adherence to some more limited method of regulatory oversight has a sufficiently immediate consequence so as to ensure that the pipeline owner faces appropriate incentives.

WMC notes the benefits to be derived from limiting the application of price regulation by, for example, encouraging new entry and investment and the development of competition to provide network services. However, WMC notes that price regulation is sometimes the only form of regulation that will provide competitive outcomes.

Timing is crucial in third party access regulation as delays in obtaining price regulation can lead to missed market opportunities. These opportunities may be lost to the market entirely or may be taken up by parties with vertical interests in dependent markets, thus adversely affecting competitive outcomes and overall efficiency.

In principle, WMC accepts the Commission's views that the application of price regulation could be limited and that in some circumstances the implementation of a monitoring regime as the form of regulation may be more appropriate. However, WMC notes that there are some circumstances, due to the existence of market power amongst service providers, where price regulation is necessary as it is the only form of regulation that will produce efficient/effective market outcomes.

WMC's experience is that service providers can and do use market power to their own advantage even when price regulation is present. While, in conceptual terms, regulation is a poor substitute for competition, in the absence of competition, abuse of market power will occur without regulation. Clearly, the cost of regulation can be significant and must be weighed carefully against the cost of market failure in the absence of regulation. WMC cautions against underestimating the cost of market failure and comparing it with atypical regulation costs incurred during determination of the initial round of regulation decisions.

Prior to 2000, aeronautical charges were subject to price caps and price surveillance. However, following a review of airport regulation, this approach was gradually replaced by price monitoring. Under the previous price cap regime, the airports were required to notify the ACCC prior to increasing aeronautical charges. However, under the new price monitoring system, the ACCC is responsible for reporting on aeronautical prices, yet does not have any role in approving price increases prior to their introduction.

There has been recent experience of a monitoring regime in relation to airports. As the Commission is aware, in February 2004 the Australian Competition and Consumer Commission ("ACCC") delivered its first Airport Price Monitoring Report which reviewed the prices charged by Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports for aeronautical services including the use of runways and terminal facilities. The report showed that in the two years from 2000-2001 and 2002-2003, the average prices airlines pay Australia's major airports for aeronautical services had increased significantly. The average charges for aeronautical services increased at these airports by between 40% and 160% during this time.<sup>8</sup>

The transition to the new price monitoring regime has resulted in a significant increase in the prices payable for aeronautical services. At this stage the reasons for increases of this magnitude are not clear and may reflect appropriate price increases. However, the magnitude of these increases does suggest that any move away from stronger price regulation in favour of less restrictive monitoring regime, needs to be coupled with appropriate and timely sanctions if rent seeking behaviour is observed.

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<sup>8</sup> Further detail regarding the range of price increases and the price increases specific to each major airport can be found in the ACCC's Airport Price Monitoring and Financial Reporting 2002-2003 Report. This report can be obtained from the ACCC's web site at [www.accc.gov.au](http://www.accc.gov.au).

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## 5. Objectives and Objectives Clause (Draft Recommendations 5.2 and 5.3)

*With the implementation of draft recommendation 5.1, the following objectives in the preamble to the existing legislation and the related objectives in the introduction of the Gas Code should be deleted:*

- (a) facilitates the development and operation of a national market for natural gas;*
- (b) prevents abuse of market power;*
- (c) promotes a competitive market for natural gas in which customers may choose suppliers, including producers, retailers and traders;*
- (d) provides for rights of access to natural gas pipelines on conditions that are fair and reasonable for the owners and operators of gas transmission and distribution pipelines and persons wishing to use the services of those pipelines; and*
- (e) provides for the resolution of disputes.*

*The following elements of s.2.24 of the Gas Code should be deleted:*

- (a) the Service Provider's legitimate business interests and investment in the Covered Pipeline;*
- (d) the economically efficient operation of the Covered Pipeline;*
- (e) the public interest, including the public interest in having competition in markets (whether or not in Australia);*
- (f) the interests of Users and Prospective Users; and*
- (g) any other matters that the Relevant Regulator considers are relevant.*

WMC agrees with the Commission's finding that an overarching objectives clause will enhance the effectiveness of the regime.

In particular, WMC considers that the objectives clause will provide sufficient scope to regulators and decision-makers to strike the appropriate balance between the competing interests of pipeliners and gas users in making their decisions.

WMC has considered whether the Commission's recommendation to delete the objectives in the preamble to the existing legislation and the related objectives in the introduction of the Gas Code raises any concerns from an interpretation perspective.

WMC agrees that objectives (d) and (e) are merely characteristics of the regime rather than objectives<sup>9</sup> and so their deletion is of no consequence to the interpretation of the Code. WMC also agrees that objectives (a) to (c) are encapsulated in the recommended overarching recommendation.

WMC disagrees with the Commission's recommendation to delete objectives sub-sections 2.24 (a) and (f). Whilst the regulator must perform a delicate balancing act in taking into account these factors, it is not clear that these factors should be deleted. The Commission states that the interests of the pipeline owner (2.24 (a)) and the interests of users and prospective users (2.24 (f)) are at odds and reasons that there is no good argument to retain them as explicit objectives. However, WMC is not convinced of the Commission's reasoning here.

The Commission seems to be suggesting that current objectives 2.24(a) and (f) are irreconcilable and those matters would feature in the overarching objectives clause. It does not necessarily follow that because 2.24(a) and (f) are irreconcilable they should be deleted. In fact, there are good arguments that they should be retained for that very reason, in that their inclusion requires the regulator to inform himself /herself and have regard to the diversity of interest of pipeline owner and user. In other words, there is not an inherent presumption that one takes precedence over the other.

With reference to sub-sections 2.24(d), 2.24(e) and 2.24(g), WMC agrees with the Commission's recommendation that they be deleted.

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## **6. Coverage Criteria**

In its initial submission, WMC recommended that there be no changes to the coverage criteria. It is WMC's view that the approach taken to interpreting the coverage criteria under the Code is reasonably well settled and does not lead to over-inclusive coverage of pipelines.

However, the Commission has recommended various changes to the coverage including:

- (a) that criterion 1.9(a) be amended so that the relevant test is whether access or increased access "would be likely to have the effect of increasing competition to a substantial degree in at least one market ...";<sup>10</sup>
- (b) that criterion 1.9(c) be deleted from the Code;<sup>11</sup> and

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<sup>9</sup> Draft Report p.148

<sup>10</sup> Draft Recommendation 6.1.

<sup>11</sup> Draft Recommendation 6.3.

- (c) that the coverage criteria in 1.9 should include a new test, "that coverage of the pipeline is likely to improve economic efficiency significantly"<sup>12</sup>.

WMC is concerned by the Commission's recommendations to:

- (a) introduce a subjective test relating to the "substantial" effect of access on competition in at least one other market;<sup>13</sup>
- (b) introduce a subjective test relating to the "material" effect of access on competition in at least one other market;<sup>14</sup>
- (c) prohibit further coverage applications for an arbitrary period after a decision not to cover a pipeline has been made;
- (d) introduce a prescriptive mechanism for different levels of coverage dependent on qualitative factors<sup>15</sup>; and, or
- (e) limit applications for coverage to those who have sought and failed to secure access.<sup>16</sup>

These changes will combine to ensure that participants in upstream and downstream markets are largely unable to pursue third party access rights in a manner and time frame that will allow them to participate in competitive opportunities in the markets in which they do or may compete. The same benefits can be achieved by leaving the coverage criteria unaltered and addressing problems with the application of Gas Access Regime.

It appears that the Commission's objective in proposing these various changes to the coverage framework is to ensure that the responsible Minister only covers a pipeline in circumstances where that coverage is likely to result in significant improvement to economic efficiency. To achieve this, specific changes to the existing criteria are proposed along with the introduction of an explicit consideration of efficiency.

WMC considers that the current form of the coverage criteria is reasonably well settled and it does not consider the case for change is strong. It must not be forgotten that third party access takes place in an imperfect dynamic world and policies that do not address temporal and

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<sup>12</sup> Draft Recommendation 6.4.

<sup>13</sup> Draft Recommendations 6.5 and 6.6.

<sup>14</sup> Draft Recommendation 6.6.

<sup>15</sup> Draft Recommendation 6.6.

<sup>16</sup> Draft Finding 6.9.

dynamic considerations are unlikely to deliver the objectives of the Gas Access Regime. However, to the extent that the Commission recommends amendments to the coverage criteria, those changes should be in line with the Government's response to the changes recommended to Part IIIA of the TPA.

## 6.1 Criterion (a) - Draft Recommendations 6.5 and 6.6

WMC understands that the Commission's objective in recommending changes to criterion (a) is to increase the threshold for coverage and to include a quantifiable measure for the objective of promoting competition. For reasons outlined previously, there is no demonstrated need to increase the threshold for coverage. The analysis by the Australian Competition Tribunal in the *Eastern Gas Pipeline* case demonstrates that the threshold for coverage is set at an appropriate level.

WMC considers that if changes are to be made to criterion (a), then the only changes to be made should be those which have been endorsed by the Government in relation to Part IIIA of the *Trade Practices Act, 1974*. There is no warrant for different criteria to apply in relation to this issue.

In addition, there are significant risks inherent in the introduction of terms such as "substantial". The use of the qualitative term "substantial" (even if such a term is defined under the Code) imports an element of subjectivity on the part of the decision maker, which WMC does not think is appropriate in this context.<sup>17</sup>

Subject to the comments in section 7.2, WMC does not object to there being two possible consequences of coverage: monitoring or price regulation. In considering the form which regulation will take it is inappropriate to use vague terms such as "material" and "substantial". The decision as to what form of regulation should apply in any instance should be left to the discretion of the NCC, which it should exercise having regard to the specific circumstances of the individual case. Guidelines could be used to indicate factors to be taken into account.

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<sup>17</sup> Various interpretations have been given to the word "substantial" in each context in which it appears in the TPA and the exact meaning of the term in each context has not been conclusively determined. For example, it has been noted that the meaning of the term "substantial" can range from considerable or big to "not merely nominal" (*Radio 2UE Sydney Pty Ltd v Stereo FM Pty Ltd* (1989) 62 FLR 437 at 444) or more than trivial or minimal depending on the context. The term can mean real or of substance, "large or weighty", "considerable, solid or big" (*Palser v Grinling* [1948] AC 291 at 317, approved in *Dowling v Dalgety Australia Ltd* (1992) 34 FCR 109). Judicial considerations of this word have concluded that not only is it susceptible to ambiguity, but it is a word "calculated to conceal a lack of precision" (*Tillmans Butcheries Pty Ltd v Australasian Meat Industry Employees Union* (1979) 42 FLR 331).

## **6.2 New criterion, "that coverage of the pipeline is likely to improve economic efficiency significantly"**

WMC is concerned by the introduction of the proposed new criterion (c). Competitive markets produce efficient outcomes and, to that end, this proposed criterion overlaps in a potentially confusing way with the existing criterion (a).

WMC considers that criteria 1.9(a) and (b) currently encapsulate those factors relevant to considerations of economic efficiency.

Criterion (b) requires the decision-maker to determine whether a single pipeline can meet market demand at less cost (after taking into account productive, allocative and dynamic effects) than two or more pipelines.<sup>18</sup> In addition, as competitive markets lead to efficient outcomes, the issue of efficiency is also already an objective of the assessment of criterion (a).

In WMC's view, it is therefore unnecessary to include a separate economic efficiency test such as that proposed by the Commission.

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## **7. Form of regulation**

### **7.1 The proposal for lighter handed regulation - Draft Recommendation 8.1**

The Draft Report indicates a preference for commercially negotiated outcomes. However, as the Commission notes, "the likelihood of commercial negotiations resulting in the most efficient outcomes possible depends on the market circumstances in which negotiations occur."<sup>19</sup> The Commission identifies four criteria necessary to ensure that there is a realistic prospect of commercial negotiations occurring in the appropriate market environment. Those are:

- (a) separation of pipeline operations from associated businesses in upstream and downstream markets;
- (b) a commitment by service providers that they will enable third parties to access spare capacity;
- (c) a high level of transparency in the behaviour of service providers; and
- (d) a credible threat that the misuse of market power would lead to the imposition of regulation that more directly controls the terms of commercial transactions.

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<sup>18</sup> *Duke Eastern Gas Pipeline Pty Limited* (2001) ATPR 41-82 at 43,059

<sup>19</sup> Draft Report p.261.



Absent these criteria being met, it is likely that any lighter handed approach will fail to deliver conditions conducive to negotiated outcomes but will instead reinforce the market position of the pipeline owner.

It is therefore important that the recommendation to develop a monitoring regime as a lighter handed alternative addresses each of these issues. WMC comments on these issues in the balance of this section.

## **7.2 The threshold for alternate regulatory models**

The Commission has recommended that the NCC should be able to recommend the form of coverage that would apply to a particular pipeline. As discussed above, WMC supports the idea of introducing alternative forms of regulation once the case for coverage has been made out provided that appropriate care is taken in specifying an effective monitoring regime and in determining when monitoring will be applied. WMC does not believe that the approach which the Commission has proposed to address this issue is appropriate.

The Commission's approach identifies two circumstances in which the monitoring regime should apply:

- (a) where access is likely to increase competition to a material, but not a substantial, degree; or
- (b) if access is likely to have the effect of increasing competition to a substantial degree but the monitoring regime would improve economic efficiency to a greater extent than would an access arrangement with reference tariffs.

WMC sees two difficulties arising with this proposal. First, the distinction between material and substantial is not clear. This is particularly so given the range of interpretations which have been attached to the word substantial in the context of the Trade Practices Act.<sup>20</sup>

Secondly, the second element of the proposed test for introducing a monitoring regime focuses on whether a monitoring regime would improve economic efficiency more than an access arrangement. This is required to be considered in the context of a criterion which itself requires that the NCC be satisfied that there is a promotion of competition to a material extent. There could be little dispute that competitive markets will lead to economically efficient outcomes. Accordingly, it is not clear in what sense this notion of economic efficiency is said to be used seemingly in contrast with or superimposed upon a requirement for a promotion of competition.

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<sup>20</sup> Refer footnote 16

WMC would support a change to section 1.9(a) of the Gas Code to ensure that it mirrors the Government's proposed amendment to the equivalent provision in Part IIIA of the TPA. If coverage is recommended, then the NCC should recommend whether monitoring or price regulation is appropriate in the circumstances. This decision should be one left to the NCC with a set of factors which are to be taken into account in determining what should be applied.

Any mandatory stipulation as to the circumstances in which monitoring is to be used risks not permitting particular circumstances being taken into account.

The tests of "a material increase in competition" and "a substantial increase in competition" are too subjective to form the basis of the decision as to whether the monitoring regime should apply. This is the case even if the term "substantial" is defined in the Gas Code.

It may be appropriate to include guidelines for the NCC on the factors relevant to determining which form of regulation is the most appropriate, however WMC does not support a prescriptive approach which contains subjective tests to be applied.

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## **8. Monitoring Regime**

### **8.1 The period of monitoring - Draft Recommendation 6.7**

In reaching its determination that the timeframe for applying the monitoring regime should have a fixed minimum period, the Commission noted that the timeframe should be long enough to encourage commercial negotiations between the service provider and users, but not so long that the threat of price regulation does not moderate service provider behaviour. The Commission has suggested five years as an appropriate period.

There are risks inherent in any fixed period given the need for market participants to respond to market opportunities in a timely fashion. If a fixed minimum period for the application of the monitoring regime is to be used it should not be the Commission's suggested period of five years. WMC considers the proposed five year time span is far too long and suggests that a period of two years is more appropriate.

WMC submits that if the monitoring regime was applied for a minimum five year period service providers could extract very high monopoly prices during the five years of the monitoring regime if they thought either that price regulation would not be implemented at the end of the five year period, or that the prices they could extract during the five years was worth the risk of price regulation. This is particularly pertinent as service providers, who are currently subject to price regulation, would not be any worse off if, after five years of monitoring, they were subject to price regulation again.

The ability of a service provider to extract such prices for a period of five years may be enough incentive to the service provider to exercise its market power. Therefore, a period of five years would not act as an effective constraint on service provider behaviour and a shorter minimum period is required, potentially coupled with other mechanisms to ensure that this period is not simply used as an opportunity to capture rents.

In WMC's submission one way in which this could be addressed, at least in part, is for an access seeker who has been unable to negotiate satisfactory access terms, or the relevant regulator, to lodge a request with the NCC that at the conclusion of the two year period price regulation applies. If the NCC makes such a recommendation, it should then have the power to backdate the operation of the consequent access arrangement to the date on which the relevant user made that complaint. Such a mechanism provides a real incentive for pipeline owners to come to commercially negotiated outcomes whilst at the same time ensuring that the monitoring period is not inappropriately used to extract monopoly rents. Such a mechanism does not, however, provide a solution for a third party who does not succeed in obtaining any access, as there is then no arrangement on which such backdating can operate. This can be a particularly significant issue in circumstances where the pipeline owner has interests in the downstream market and the market opportunity cannot be taken up unless access is resolved in a relatively short time frame. These sorts of considerations emphasise:

- (a) the care which needs to be taken in deciding that monitoring is an appropriate tool in any given case; and
- (b) the fact that absolute rules about when monitoring may apply carry significant risks.

## **8.2 Other aspects of the monitoring regime - Draft Recommendation 8.2**

WMC otherwise agrees that it is appropriate for the monitoring regime to have:

- (a) a third party access policy formulated by the service provider;
- (b) separation of pipeline operations from associated businesses in upstream and downstream markets;
- (c) public disclosure of information by the service provider; and
- (d) scope for the service provider to adopt, at its discretion, additional pro-competitive features, such as a code of conduct.

Further, the Commission should consider a mechanism whereby the regulator can intervene when the service provider appears to be extracting monopoly rents.

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## **9. Forum shopping - Draft recommendation 6.8**

The Commission has proposed that where a service provider potentially covered by the Gas Code lodges a Part IIIA Undertaking, this should trigger an assessment to determine whether the pipeline meets the requirements for coverage under the Gas Code. This recommendation is made to avoid infrastructure services being exposed to "the possibility of double regulation"<sup>21</sup>.

In WMC's submission, as the submission of an access undertaking to the ACCC is a voluntary process by the service provider, there should be no necessary suspension of that undertaking process whilst the coverage criteria are considered. It is also not clear how the Commission anticipates that this will operate with sections 1.20 and 2.3 of the Code. Under section 2.3 of the Code, where a pipeline or proposed pipeline is not covered, a service provider may apply to the relevant regulator for approval of an access arrangement by submitting the proposed access arrangement to the relevant regulator together with the applicable access arrangement information. Under section 1.20, a pipeline or proposed pipeline which is to submit to an access arrangement made under section 2.3 is covered from the date the access arrangement becomes effective until the expiry date, if any, as contemplated under section 3.20.

In WMC's submission, it is important that a service provider has a mechanism by which it can propose access arrangements to apply to services provided by the pipeline. If the Commission intends that the mechanisms provided under section 1.20 and 2.3 of the Code remain, then it would seem that instead of triggering NCC review of the coverage criteria, a more appropriate course would be to require any access undertaking to be assessed in accordance with the access arrangement provisions of the Code.

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## **10. Access Arrangements Draft recommendation 7.1**

WMC agrees that it is sensible to align the reference tariff pricing principles under the Code with those suggested by the Commission in its Part IIIA review (which were, on the whole, endorsed by the Government, (Government's Response, Part IIIA Report. p 4-6). In particular, the Government in its Part IIIA review recommended that the proposed Part IIIA pricing principles be introduced into the CPA for the purposes of assessing the effectiveness of access regimes (Draft Report p.210). WMC therefore considers it desirable to ensure that the pricing principles in the Gas Code are consistent with those principles.

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<sup>21</sup> Draft Report p.197.

## **10.1 Pricing Principles - Proposed section 8.1(a) of the Gas Code**

WMC generally supports the pricing principles proposed by the Commission at pages 212 and 214 of the Draft Report. More particularly, WMC:

- (a) strongly supports inclusion of recommended pricing principle (a)(iii) as necessary to ensure cross subsidies cannot be built into regulated tariffs; and
- (b) suggests that the meaning of the term 'long-run cost' in pricing principle (a)(i) be clarified.

In regard to paragraph (b) above, WMC notes that the long run average and total cost curves are defined as the locus of points on a family of short run average cost curves. This family of short run cost curves is defined as the short run cost curves (scale options) which deliver the least cost means of producing at any level of output. By definition, except in those rare instances where adjustments between scales of operation can be achieved instantaneously, a firm is always operating in the short run.

It would appear that the pricing principle should be interpreted to assess optimisation at any point in the life of the relevant asset. Thus, the pricing principle should be clarified to make clear that a service provider is entitled to a tariff which, after optimising to remove stranded assets and operating inefficiencies, reflects the service provider's cost of operating at its currently installed (or planned expanded) scale/capacity.

If it is intended that the focus of recommended pricing principle (a)(i) is 'the efficient long run cost' of a service provider at any point in time, then that should be explicit, otherwise, given the fact that, in the downward sloping range of the long run average cost curve, long run average cost is above the corresponding minimum short run average cost at the relevant scale, the implications of the term 'long run' without further clarification must be considered questionable.

## **10.2 Multi-part tariffs and price discrimination - Proposed section 8.1(b) of the Gas Code**

WMC accepts the proposition that third party access pricing principles should not exclude the possibility of price discrimination and multi part pricing. However, WMC's concurrence with this proposition is predicated upon continuation of the Gas Code's provisions regarding secondary trading in contracted pipeline capacity remaining as they are at present or as they may be amended to increase the rights of pipeline users to trade in contracted capacity.

Further WMC is concerned that some extreme examples of multi part pricing will distort the efficient use, and provision, of pipeline services. For example, two part pricing based upon charging a uniform lump sum payment to all users (irrespective of pipeline usage, in a form

analogous to a poll tax) and a usage charge based upon marginal costs should not be contemplated as valid tariff models under the Gas Code.

### **10.3 'Use it or lose it' contracted pipeline capacity rights**

WMC is party to a number of foundation contracts for pipeline services and at different times it has had, and probably will have in the future, underutilised contracted pipeline capacity. This underutilised capacity arises because of:

- (a) inflexibility in gas transmission contract and tariff structures which do not allow contracted volumes to be accurately tailored to match changing forecast gas needs;
- (b) short and long term forecasting errors; and
- (c) short and long term unforeseen changes in circumstances.

Neither third party management nor its shareholders would countenance a contract for gas supply which artificially increased contract gas transmission rights and costs.

Any proposal to confiscate third party underutilised contracted pipeline capacity rights could seriously jeopardise the viability of projects and operations. The 'use it or lose it' proposal aired by the Commission on page 250 of its draft report represents an attempt to confiscate property rights and could have devastating implications for users. This concern is compounded because of the take or pay nature of typical foundation contracts. It is not clear from the Draft Report how the 'use it or lose it' policy regarding underutilised capacity would interact with foundation contracts.

WMC believes the 'use it or lose it' policy regarding underutilised contracted pipeline capacity will undermine the value of foundation contracts as a means of underwriting pipeline investments.

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## **11. Consistency Draft recommendation 7.3**

The Commission, in Draft Finding 7.3, noted that regulators are currently seeking to have their powers extended so they can obtain information between access arrangement reviews. This extension has the potential to add unnecessarily to service providers' compliance costs.

The Commission noted its concern that State-based powers are being used to obtain information beyond that specified in the Gas Access Regime. The use of these powers has led to inconsistencies in the information requirements placed on service providers by regulators across different jurisdictions. Accordingly, the Commission recommended that the Code be amended to remove this inconsistency.

WMC agrees with the Commission's approach and draft recommendation 7.3. WMC can see no reason why the requirements for establishing and maintaining information should not be uniform across all jurisdictions.

In particular, WMC notes that in all jurisdictions other than Western Australia, any review of the Minister's Decision goes to the Australian Competition Tribunal, whereas in Western Australia reviews go to the Gas Review Board which is comprised from a panel of legal practitioners and experts appointed by the Governor. WMC cannot see any benefit in maintaining this discrepancy in the review processes between the States. The alignment of Western Australia with the other jurisdictions will create consistency of interpretation as reviews will only be conducted by one body. Further, WMC acknowledges the benefits of a review being conducted by the Australian Competition Tribunal as a Federal Court Judge with experience will be involved in the hearing of the review.

Further, WMC notes that although the NCC makes a recommendation to the relevant Minister in relation to applications by pipeline owners in each State for revocation of coverage, the relevant Minister differs according to the State in which the pipeline is situated. Accordingly, should the Minister choose not to endorse the recommendation made by the NCC, there is no consistency in the outcome, with different Ministers adopting potentially quite different approaches. Further, WMC submits that the relevant Minister is not the appropriate decision making authority as such Minister does not have the necessary independence.

WMC suggests that the Code be amended to enable the NCC to be the ultimate decision maker in relation to coverage.

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## **12. Lighter handed regulation**

### **12.1 Is there a need for lighter handed regulation?**

The Commission stated that the changing nature of the gas industry means that the current method of price regulation is becoming outdated in many circumstances. In its draft decision, the Commission stated that emerging competition and the interconnection of networks have led to some 'contestable' and 'imperfectly competitive' markets in which two or more service providers can compete to supply gas.<sup>22</sup>

The NCC has noted that as markets become increasingly competitive, the level of regulatory intervention under the Gas Access Regime may need to become less intrusive<sup>23</sup>. This is

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<sup>22</sup> Draft Report p.257.

<sup>23</sup> Draft Report p.258.

because there are more choices available to gas producers, retailers and users, resulting in fewer pipelines with substantial market power and the ability to restrict competition in gas markets.

Lighter handed regulation puts emphasis on commercial negotiations rather than reference tariffs. The Commission noted the potential advantages of lighter handed regulation, including: lower compliance costs, it is less costly for regulators to implement, there is less scope for regulatory error, it encourages innovation, it enables users to negotiate appropriate terms and conditions, and it provides for de-regulation to be phased in gradually as the market becomes increasingly competitive.

WMC does not dispute that lighter handed regulation has some benefits. However, it is important to note that the potential benefits can be outweighed by the potential for service providers to misuse market power under lighter handed regulation. Generally, service providers will tend to favour lighter handed regulation as it can allow them to exploit any market power they may possess, while users tend to be somewhat reluctant to move to lighter handed regulation due to concerns about unfair or uncompetitive terms, conditions and prices, such as monopoly rents.

The ACCC has been sceptical about the usefulness of price monitoring in the gas industry as parts of the industry continue to possess substantial market power. In such circumstances, price monitoring is not an effective substitute for full price regulation. The ACCC noted, in its submission, that price monitoring does not provide a mechanism for facilitating access on reasonable terms and conditions, or reducing prices in an environment where costs are declining. The ACCC further noted that price monitoring is a resource intensive process that may require the same level of resources as the current regime, especially if a judgement needs to be formed on the reasonableness of the prices imposed.

## **12.2 Consequences of Transgression**

WMC submits that if the monitoring regime was to be implemented it would need to be balanced by a credible threat that any abuse of market power will be identified and appropriate action taken. It is this ability to enforce the regime and penalise service providers for failing to comply with it that WMC believes is particularly problematic.

It appears that in terms of sanctions and breaches, the Commission has suggested the credible threat is that the misuse of market power by a service provider would trigger use of the gas Code's heavier handed regulation (full price regulation.) Other than the notion of full price regulation as a credible threat on service provider behaviour, the Commission's draft report does not outline exactly what remedial actions might apply to a breach of the monitoring regime. WMC requests further details on these remedial actions is needed, including the exact



nature of the constraint on the abuse of market power by service providers under this lighter handed form of regulation, including in what circumstances action can be taken and the form that action will take.

WMC notes the Commission's proposal regarding the threat of full price regulation in this context. However, WMC believes that price regulation in isolation is not a credible threat and would not act as a disincentive to service providers to abuse market power in the short term. Instead, WMC suggests that pipeline users should be able to make an application to the NCC seeking a pipeline's return to price regulation, provided that such application is not vexatious. The NCC should have discretion to determine that price regulation is backdated to the time at which a pipeline user made an application to the NCC to have the relevant pipeline returned to full price regulation.

The Commission has recommended that where the misuse of market power becomes evident after a period of lighter handed regulation a return to full price regulation would follow. WMC is concerned by this suggested control mechanism as it only puts the service provider in the position it would have been in prior to the implementation of the lighter handed regulatory approach. WMC does not believe this is a sufficient sanction for breaching the proposed new method of regulation.

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## **13. Ring Fencing Arrangements - Draft recommendation 10.1**

WMC supports the Commission's recommendation that section 7.1 of the Gas Code be amended such that a Service Provider is no longer required to seek authorisation from the relevant regulator before entering an associate contract for the supply of services at the reference tariff.



**Goldfields Gas Pipeline Revocation  
Application**  
*Report prepared for Clayton Utz*

**15 May 2003**

## ***Frontier Economics Network***

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## **1. Introduction**

Frontier Economics has been asked for its opinion of the economic analysis presented in the Application by Goldfields Gas Transmission (GGT) for revocation of the coverage by the National Gas Access Code of the Goldfields Gas Pipeline (GGP). We have been asked to direct our attention to the argument presented in Part (G) of the Application, headed “Grounds for Revocation”. In particular, we concentrate on the argument presented under 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”.

This Report is structured in the following way. Section 2 makes explicit certain assumptions on which our analysis of criterion (a) is based. Section 3 characterises the vertical chain of activity of which the GGP is a part. Section 4 discusses the promotion of competition in another market. Section 5 discusses the issue of opportunism. Section 6 presents some conclusions.

## **2. Assumptions**

The National Competition Council sets out its process for considering the criteria in its Issues Paper at page 13. The first two steps in this process are:

- to define the service provided by means of the GGP, delineate the physical assets that comprise it and identify the “provider” of the “service”; and
- to examine whether it is economic to develop another pipeline to provide the service.

Consideration of criterion (a) is only undertaken after these first two steps have been undertaken.

We shall adopt a similar process in this Report – with the exception that we shall not examine criterion (b). So before we attempt to consider criterion (a) we shall make clear what we assume the service to be and what assumptions we are making as to whether it is economic to develop another pipeline to provide the service.

We generally agree with the definition of the service that is adopted in the Issues Paper (at p 16) save that, as the service definition is drafted by the Council in its Issues Paper, it appears not to include points along the route of the GGP. Given the nature of gas transmission services and the ability to take gas at points along the route of the pipeline, it would seem to be appropriate to identify the service as including transmission from Dampier to any point along the route of the GGP.

For the purposes of this Report, we have made some modifications to the Council's definition of service such that the service provided by the GGP is described as a

Gas transmission service from the DBNGP Compressor Station One at Yarraloola to Kalgoorlie and all points in between, via the East Pilbara and North East Goldfields regions of Western Australia.

The second step in the process to be adopted by the Council is consideration of criterion (b): “that it would be uneconomic for anyone to develop another pipeline to provide the services by means of the pipeline.”

Consideration of this criterion would be a fact-intensive enquiry that we are not in a position to undertake. Nevertheless, it seems appropriate to undertake this enquiry prior to any consideration of criterion (a), because consideration of criterion (a) only arises when one has formed a view as to whether the provider of the service is controlling a bottleneck facility. So that

we can proceed to a consideration of criterion (a), this Report will assume that GGT does control a bottleneck facility in a particular sense of that term. That is, we shall assume that it would be uneconomic for anyone to develop another pipeline to provide the service of transporting gas from Yarraloola to Kalgoorlie.

In making this assumption, we mean to say that we assume that it would not be economic for anyone to develop another pipeline that completely by-passed the GGP. The facts before the Council may suggest that it would be economic to develop another pipeline that by-passed part of the GGP and then linked into the GGP in the region of the goldfields. Such an alternative pipeline would still have to deal with the bottleneck of the GGP; and so it would seem that the competition analysis that we present below would still apply.

However, we assume (for the purpose of this Report) that Criterion (b) is satisfied in that it would not be economic for anyone to develop a pipeline that would both:

- completely by-pass the GPP; and
- provide the same services as those which are provided by the GPP.

These assumptions enable us to direct our attention to the competition issues that arise in this application. That is, we can approach the question of criterion (a) in the following manner: on the assumption that the GPP is the only way of transporting gas by pipe into the goldfields and to the points along its route, would access (or increased access) to the service promote competition in at least one market other than the market for the service?

### **3. The vertical chain of activity**

The Application states that:

A gas transmission pipeline is fundamentally and simply one link in a supply chain, a supply chain that in this case ultimately competes with other forms of energy to satisfy the demand of an energy consumption market. (p 20)

The substance of this Report is, essentially, an analysis of this characterisation. However, before we deal with the patterns of competition of gas with other forms of energy, we should state our understanding of the character of the gas supply chain.

According to the Application, the upstream gas production market is dominated by production in the north-west shelf region of the Carnarvon Basin. During 1999/2000, this region accounted for over 98 per cent of the State's gas production (Table 2, p 23). Of this total production, roughly half was exported in the form of LNG and the other half was used within Western Australia.

The GGP transports gas from the north-west shelf to the goldfields. Gas from the Carnarvon Basin is either sold domestically or converted to LNG for export. The vast majority of gas produced from the Carnarvon Basin is converted to LGN for export. This suggests that the ability to convert gas into LNG for export will constrain the domestic price of gas ex producer.

We are informed that the option of converting gas to LNG does not exist for all gas producers. There is a minimum scale required for development of an LNG processing plant such that to become an LNG producer, a gas producer must have a gas field of at least 2 -3 TCF (1 TCF = 1000 PJ) because a single LNG train will consume nearly 100 PJ of gas per annum. Due to the sunk costs involved in converting to LNG, in order to produce LNG, a gas producer must have at least 20 years of supply of gas at 100 PJ per annum (unless it is next door to a LNG project and can sell its gas to an LNG exporter). With the exception of the NWSJV, the other gas fields on the NW shelf (East Spar, Harriet, Tubridgi) are too small to economically convert their gas to LNG and make a profit.

At the time WMC bought from the East Spar Joint Venture, the initial proven reserves of the East Spar field were considered to be approximately 350 PJ (0.35 TCF). As at 31 December 2001, the East Spar field contained 250 PJ. The Harriet field (which is actually a complex comprising 9 fields) is considerably smaller than the East Spar field (215 PJ as at 31 December 2001); and the



Tubridgi field is largely exhausted. The owners of the Tubridgi field had a 10 year contract expiring November 2001 to supply 56 PJ of gas to Alinta. The Griffin field only produces by-product gas.

Nevertheless, the producers of gas for sale within Australia will be constrained by the producers of LNG in the prices they are able to charge. They will be unable to charge more than the export price of LNG plus the cost of conversion. If they did try to charge more than this, it would pay an LNG exporter to divert gas from the production of LNG for export to the sale of gas to domestic customers. We understand that to make the conversion of gas into LNG viable, the export price for LNG must be roughly double that of the local gas price.

The above argument has been confirmed by data that have been made available to us by WMC. These suggest that selling gas to WMC at the prices in the current contract yields much the same revenue for the producers as would be made available to an LNG producer who converts gas into LNG for export. For the purposes of this Report, we shall assume that, over the length of the purchase contracts, the price of gas ex-producer is roughly determined by the value of gas if it were converted into LNG for export.

According to the Application, miners purchase gas and transport it to the goldfields primarily to power electricity generators. Indeed, 90 to 95 per cent of GGP delivered gas is used in this way (p 24). This process will involve two extra categories of costs. In the first place, dedicated lateral pipelines may need to be built and maintained in order to transport the gas from the GGP to the generator. Secondly, the mining company will need to incur costs of building and operating the generator.

Consideration of the vertical production chain that has been outlined in the preceding paragraphs suggests that a miner will bear four principal categories of costs; and the sum of these costs must be compared with the cost of power generated by diesel or the cost of electricity that is delivered via the SWIS before it makes a decision as to its principal source of power. The four categories of costs are:

- The cost of the gas from the producers;
- The cost of transportation via the GGP;
- The cost of building and maintaining any dedicated lateral pipeline; and
- The cost of building and operating the electricity generator that converts the gas into electricity

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According to the Application, the original parties to the GGT were WMC, Normandy and BHP (p 6). They built the pipeline because they calculated that (summing across each of their mines) the generation of electricity by means of gas would be cheaper (taking into account all the costs mentioned above) than would the generation of power from diesel and the purchasing of electricity from the SWIS. According to the Application, these expectations were realised:

Since then, the dominant existing downstream customer on the GGP has stated that the energy costs of its Western Australian operations in 2001 were 5% below 1995 energy costs in nominal terms, which it equated to a 20% reduction in real terms. This was quoted as amounting to savings of more than \$25 million p.a., while also avoiding exposure to diesel price shocks<sup>1</sup>.

Table One below provides a stylised numerical example of the type of calculations that the original joint venture partners may have undertaken. All costs are expressed per MWh of electricity that would be generated at the end of the process. For example, the cost of the GGP is worked out by taking the A1 tariff that GGT is currently charging parties seeking a transmission service and then this price is converted into a price per MWh of electricity by assuming a rate of conversion of gas into electricity of 10,000 kJ per kWh and then making allowance for the transportation services that would be needed for that quantity of gas. The numbers are not meant to be particularly precise: for example, the price of the lateral transportation will clearly vary depending on the location of the mine. Rather the numbers will be used to illustrate certain points about competition and market power.

**Table One**

**Numerical Example of Calculations of Cost of Electricity per MWh**

Category of Cost	\$/MWh of generated electricity (A1)
Gas purchased from producer	20
Transportation via the GGP	45

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<sup>1</sup> Presentation: WMC's Involvement in the Goldfields Gas Pipeline, John Harvey, Manager Energy Supply, WMC Resources, 12 March 2002 (Application p.48). The 20 per cent reduction in real terms appears to be based upon the A4 tariff.

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Dedicated Lateral Pipeline	5
Conversion of Gas into Electricity	40
Total	110

According to the Application, the cost of electricity generated from gas from the north-west shelf was significantly (15 or 30 per cent) below the price of electricity that was previously generated from diesel or was taken from the SWIS. For purposes of illustration, suppose the cost was 20 per cent below the price of the best alternative source of power – which would make that price approximately \$137.50/MWh compared with an all-in cost of electricity from gas of \$110 in our example.

The result of the introduction of the GGP was a massive shifting of demand from Western Power. According to the Application, “Western Power has some substantial spare transmission capacity to Kalgoorlie, possibly as much as 140 MW, which was bypassed when the GGP originally entered the market.” (p 35)

According to the Application, this substantial excess capacity (along with the possibility of diesel fuel) represents a direct competitive force confronting GGT:

Upon completion, the GGP displaced a substantial volume (but not all) of the electricity which had formerly been supplied by high voltage transmission line to Kalgoorlie from Western Power generation capacity linked to the SWIS. This capacity, along with the presence of diesel fuel for power generation (and other uses) continues to exist as a direct competitive force. As a consequence, the GGP does not enjoy unconstrained monopoly power within the markets that it serves. (p 62)

This passage from the Application contrasts competition with monopoly power as is now standard in the economic analysis of antitrust. This contrast also appears in Australian trade practices jurisprudence:

Or again, as is often said in U.S. antitrust cases, the antithesis of competition is undue market power, in the sense of the power to raise price and exclude entry. That power may or may not be exercised. Rather, where there is significant market power the firm (or group of firms acting in concert) is sufficiently free from market pressures to “administer” its own production and selling policies at its discretion. Firms may be public spirited in their motivation; but if their business conduct is not subject to severe market constraints this is not competition. In such a case there is substituted

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the values, incentives and penalties of management for the values, incentives and penalties of the market place.<sup>2</sup>

Of course, market power and competition are matters of degree. This can readily be illustrated by means of our simple numerical example. If we suppose that \$110 is the all-inclusive unit cost of producing electricity by means of gas, we may refer to that as the price that would prevail if this electricity were produced in a highly competitive market. (Any price greater than 110 would yield monopoly profit.) We may then enquire what competitive pressure is placed on GGT by the possibility that there are alternative means by which electricity may be supplied to a large mine.

Upon first examination of our simple example, it may appear that GGT has significant market power. The three categories of cost other than transport via the GGP are beyond the control of GGT. But if other sources of power were to maintain their prices at \$137.50, then GGT could increase its price by 50 per cent (from 45 to 67.5) which would increase the cost of electricity from 110 to 132.50: and the cost of obtaining electricity by means of gas would still be below that of alternative sources of electricity. This reasoning may be too simple for two principal reasons.

In the first place, once the GGP was operating, alternative suppliers would be unlikely to stick to a price of 137.50. As the Application points out, Western Power has substantial excess capacity to transmit electricity into Kalgoorlie – as a result of the successful opening of the GGP. Western Power may well use this excess capacity (which has zero opportunity cost) to lower its prices in response to competition from the GGP.

The second complication is that the costs that were relevant to the calculations of the miners prior to the construction of the GGP are not the same costs that are relevant to any decision they might make today between alternative sources of power and use of the GGP. In particular, their commitment to the purchase of gas from the north-west shelf enticed them to invest in dedicated lateral pipelines and generation capacity; and a significant part of this investment cost is now sunk. That is, it could not be recovered if the relevant mine were to revert to purchasing electricity from alternative sources.

If we were to suppose that all of the cost of the lateral pipeline and half of the cost of converting the gas into electricity in Table One is now sunk, that would imply that 25 dollars of cost that were relevant to the decision to build the GGP are no longer relevant to the decision of a mine as to whether it

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<sup>2</sup> *Re QCMA and Defiance holding* (1976) ATPR 40-012 at 17,246.

continues to generate electricity from gas or whether it switches to alternative sources of power. That is, if alternative sources of supply were to maintain their (pre 1996) price of 137.50, GGT could more than double its price for use of the GGP (from 45 to 90 in the example) without forcing its large customers to switch back to generating power from diesel or to purchasing electricity from Western Power.

We re-state the proposition that the numbers we have used in this exposition are meant merely to illustrate certain propositions. These propositions are:

- The GGP was built because it offered significant cost savings compared with pre-existing sources of power: diesel and the SWIS;
- Because it is a significantly-lower cost source of power than the alternatives, GGT has significant market power; and
- There is a real danger that GGT could use this market power to increase the price of transportation and thereby decrease competitive pressure on diesel and on the electricity supplied by Western Power.

## **4. Promotion of competition in another market**

Criterion (a) is 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.

The Application appears not to be committed to a particular definition of the downstream market or markets that may be affected by the unfettered exercise of market power by GGT. One reason for this is that GGT appears to wish to argue that access or increased access will not promote competition in a downstream market no matter what downstream markets are considered.

It seems appropriate to concentrate the analysis on two of the regions that are identified in the Application. In both the southern geographical end of the GGP (in the vicinity of Kalgoorlie) and in the region north of Kalgoorlie, the GGP supplies gas that is used as an input to compete with other possible means of generating electricity. We understand that Western Power supplies electricity by means of the SWIS to the Kalgoorlie region but that competition for transport by the GGP in the region north of Kalgoorlie is overwhelmingly from power generated by means of diesel. Because patterns of competition in these two geographical regions are so distinct, it would seem appropriate to think of these as two separate markets. Within each of these two geographical areas it appears that much the same factors determine patterns of competition, so there is nothing to gain by analysing competitive forces within sub-sets of these geographical areas. In sum, it is appropriate to treat the two regions as two separate geographical markets.

Access to the GPP is important to the competitiveness of both markets because electricity produced by means of gas is the least-cost method of providing electricity to both regions. Two propositions follow from this observation. In the first place (as was explained in section 3 above) the difference in costs gives GGT a great deal of market power to increase prices above competitive levels. Indeed, it may well be argued that the existence of price controls is the chief factor that prevents the exercise of market power. This proposition is contingent upon the assumption that was made explicit in section 2 above: that the GGP is a bottleneck; and that, as a result, GGT does not face competitors who can bypass the GGP and transport north-west gas into the region with a cost of transport comparable to that of GGT.

The second proposition that follows is that the charging of competitive-type prices for the use of the GGP is an important pre-condition for maintaining

competitive pressure on alternative suppliers of electricity – both Western Power in the Kalgoorlie region and the stand-alone generation of electricity from diesel fuel in the region north of Kalgoorlie.

This argument has not explicitly defined the product dimension of these downstream markets. One way of defining them would be to say they are the markets of electricity. This is probably satisfactory; but it is a bit rough for two reasons.

The first reason is that electricity is not the only form in which energy is used on the mine sites. For example, we understand that the heat from the exhaust of gas turbines is used to dry ore in certain locations, to power turbines and to process gas.

The second reason is that, in the region north of Kalgoorlie, constraints on the pricing of use of the GGP will act as a constraint on a set of markets – each of which supplies inputs that are needed to produce electricity from diesel. As with the generation of electricity from gas, so the generation of electricity from diesel will involve a range of sources of costs. As with electricity from gas, some of these categories of costs will have more flexibility in setting prices (that is, more market power) than will others. To the extent that they have some flexibility, the markets in which they compete will be affected by price constraints and access to the GGP.

The Application makes much of the fact that some recent mining projects have elected to use diesel rather than gas. This fact is perfectly consistent with the characterisation of the market power of GGT and the effects that exercise of this market power may have in downstream markets. Consider Table 3 in the Application and the text in the region of that Table. These mining projects have made a choice to use diesel rather than gas.

One can readily guess at the type of the reasoning that must have preceded this choice. Before making a decision, the projects would have looked at the present value of one stream of costs and compared that with the present value of the alternative stream. The key factors that would have influenced the decision would have been:

- The terms quoted by GGT, when price makes allowance for such factors as long-term security of supply;
- The prices quoted by suppliers of diesel;
- The distance of the mine from the GGP (influencing the cost of the lateral transportation); and

- The expected life of the mine (over which the cost of the lateral line could be depreciated).

The less-favourable the terms quoted by GGT, the lower the delivered prices of diesel, the further the mine is from the GGP and the lower the expected life of the mine, the more likely would it be that the project would opt for diesel over gas. This helps to explain how increased access to the GGP might affect competition in the market north of Kalgoorlie.

As the Application states, there are many mines that find it much cheaper to generate power from gas that is transported along the GGP than by means of diesel. Some of these will continue to use gas even if GGT were substantially to increase prices – because of their location close to the GGP, having incurred sunk costs, being large mines, and so on.. But there are other mines that have to make decisions that are more marginal. To the extent that GGT raises its prices for transporting gas, there will be less pressure on the suppliers of inputs that are needed to produce electricity from diesel. For certain projects (depending on the above characteristics) the exercise of market power by GGT will tip them over to the use of diesel or the purchase of electricity from the SWIS.

This is perfectly in accord with standard principles of monopoly pricing that are taught to every undergraduate student of economics. All students are taught that a monopolist will so raise its price above competitive levels that customers will be lost to competing products and the monopolist will be on the inelastic section of its demand curve. That is, the loss of some customers at the margin is not relevant to deciding the degree of market power of any business. To make such an inference is generally referred to as the ‘cellophane fallacy’. Rather, one must examine the underlying structure of the market and the ability of the monopolist to raise prices above competitive levels.

Similar reasoning can be applied to the prices that GGT might charge to transmit gas to Kalgoorlie. The higher those prices, the less will be the competitive pressure on the pricing of electricity from the SWIS. The price that Western Power must meet in selling electricity to a mine in Kalgoorlie will depend on particular circumstances. Nevertheless, a rough indication of the principles involved can be illustrated by means of the example that was utilised in section 3 above. Consider a mine that has fully-allocated costs of generating power from gas of \$110/MWh. Assume, as we did in section 3, that \$25 of these costs are sunk and are, therefore, irrelevant to the purchasing decisions of the relevant mine. The outcome would be that the mine would only source electricity from Western Power if the delivered price were \$85/MWh.



It might be considered that this is below the fully-allocated costs of Western Power generating power and delivering it to Kalgoorlie. However, that would be to ignore the fact that much of Western Power's costs are also sunk. Indeed, the Application makes much of Western Power's excess capacity in delivering to the region. The implication of these sunk costs is that Western Power may well be able to match (or even better) a delivered price of electricity into a mine at Kalgoorlie of \$85/MWh. We are informed by WMC that this reasoning is also consistent with their recent experience.

This Report has followed the facts proposed in the Application. However it has interpreted those facts in a very different way. In particular, we do not follow the Application in drawing the implication that these alternative means of generating electricity put significant competitive pressure on GGT. Rather, our characterisation is that GGT may well have substantial market power; and, if this market power is exercised by raising prices for the services provided by the GGP to monopoly levels, alternative suppliers of electricity to both regions will be relieved of competitive pressure. As is suggested by elementary economics, the exercise of market power by charging prices above competitive levels will lead to the shifting of potential customers to other sources of supply.

The characterisation presented in this Report is, to a large extent, contingent upon the stylised numerical example that was presented in section 3. In particular, the characterisation of market power is contingent upon the opening of the GGP substantially reducing costs of electricity to certain large mines. This fact, more than any other, is evidence that GGT is in a position to exercise market power that could significantly reduce competitive pressure on substitute sources of electricity in the region.

## **5. Opportunism**

The argument presented in this Report might be summarised as follows:

- GGT has significant market power because it controls a bottleneck through which any low-cost supplier of electricity to the goldfields regions must pass;
- GGT may use this market power to raise prices above competitive levels and thereby lessen competitive pressure on higher-cost suppliers of electricity;
- The price-control provisions of the Code might be used to prevent such a lessening of competitive pressure in the market for electricity in the various regions ie north of Kalgoorlie along the route of the GGP and in the Kalgoorlie vicinity.

If this argument is persuasive, it helps explain the role of various businesses in putting submissions to the regulator and to the NCC in these revocation proceedings.

According to the Application, the three original joint-venture partners in GGT still account for some 75 percent of the use of the pipeline. These three original partners sold their interests in late 1998 and early 1999, shortly after the pipeline became subject to the price control provision of the Gas Code. That is, the three original joint-venture partners sold their interests (and the current owners purchased their interests) on the understanding that the provisions of the Code would constrain the exercise of market power by the new owners.

The current attempt by the new owners might well be interpreted as an attempt on their part to be relieved of this constraint. The usual argument that control of access prices might reduce incentives to invest by truncating the distribution of prospective returns that might otherwise accrue to investors is thus of little relevance in this particular case.

The current owners purchased the asset from the original joint-venture partners on the understanding that the services provided by the asset would be subject to the price-control provisions of the code. To try to avoid these provisions appears to be an example of ex post opportunism of a kind that is familiar to students of industrial economics.

## **6. Conclusions**

On the assumption that the GGP is a natural monopoly, the services provided by the GGP are an essential bottleneck through which any low-cost process to supply electricity to the goldfields region must pass. This gives GGT significant power to raise prices above competitive levels. Coverage of the GGP makes access to the GGP available at prices that are controlled according to the provisions of the Gas Code. If the GGP were not subject to the Code, access would not be available to this extent.

If coverage were to be revoked, GGT would be free to take advantage of its market power to raise prices of access to the GGP. This would significantly lessen competitive pressure on alternative means of supplying electricity to the goldfields region. So (on the assumption that criterion (b) is made out) it appears that criterion (a) is also made out: that access (or increased access) to the services provided by the GGP would promote competition in the electricity market in the goldfields region.