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Ms Kanwaljit Kaur
Acting General Manager - Gas
Australian Competition and Consumer Commission
PO Box
Dickson ACT
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Dear Ms Kaur

Re: PNG Authorisation for Joint Marketing

Duke Energy International (DEI) provides this submission to the Australian Competition and Consumer Commission (ACCC) in response to the ACCC's letter of 12 September 2000 regarding an application by the proposed producers of PNG gas ("PNG Producers") for an Interim Authorisation of joint marketing for PNG gas ("authorisation application").

It is noted that previous interim authorisations have been granted to a number of the PNG Producers, apart from the relevant Santos group companies ("Santos") and ExxonMobil group companies ("ExxonMobil") who are PNG Producers.

DEI has a number of concerns with respect to:

1. the scope of the authorisation being sought by the PNG Producers;
2. possible anti-competitive impacts of the authorisation; and
3. information asymmetry's stemming from the inclusion of Santos and ExxonMobil in the interim authorisation.

These concerns are detailed below.

1. Scope of Authorisation being sought

There appears to be a degree of inconsistency between the application (form 7) and parts of the submission attached to the application. The inconsistency relates to what the PNG Producers are seeking to have authorised. As detailed in the ACCC's letter, the conduct sought to be authorised is:

> *"All contracts, arrangement or understandings in relation to common terms and conditions (including price) upon which gas to be produced by the Project will be marketed and offered for sale to customers prior to the Financial Close of the Project as identified in the submission of the Applicants which accompanies this application."*

This appears to mean that the applicants, including Santos and ExxonMobil, are seeking the ACCC's authorisation to enable them to jointly agree on contractual terms and conditions for the marketing of PNG gas in Queensland. The application does not appear to seek the ACCC's authorisation to enable them to actually market gas on these terms and conditions in the endeavour to secure 'conditional Gas Sales Agreements ("GSAs")' nor does it allow them to enter into GSAs.

This interpretation is supported by the submission attached to the application:

> *"The Project producers need to be able to discuss price and other terms and conditions for the sale of gas with one another to enable gas to be marketed to potential customers." (p6)*

However, the submission then contradicts itself by noting that:

> *"If interim authorisation is granted, the Applicants, now including ExxonMobil and Santos, will engage in joint marketing of gas to secure conditional GSAs required for the project ...." (p7)*

The scope of the authorisation needs clarification by the ACCC. DEI believes, for a number of reason outlined below, that either interim authorisation for jointly agreeing on terms and conditions or interim authorisation to jointly market gas would have detrimental impacts on the development of the Queensland gas market.

2. Anti-competitive Detriments in the Market

The applicants submit that the project would not result in any anti-competitive detriment in the market, regardless of whether that market is defined as (a) an Eastern Australian energy market or (b) more narrowly as the Queensland gas market. This contention is erroneous for a number of reasons outline below.

An Energy Market

In support of their claim the applicants suggest that:

> *"Gas currently competes with other forms of energy such as coal, oil and electricity." (p7)*

The fact that gas in many instances competes in an energy market is not in dispute. However, the appropriate means for considering the sphere of competitive rivalry created by substitutability is to analyse, at a transactional level, the ability for major customers to substitute gas for other forms of energy. If there are substantial switching costs (or other barriers legislative or otherwise) these customers should be considered captured or dedicated gas market customers and any competitive rivalry stemming from the presence of alternative energy sources should be discounted.

In the Gladstone and Rockhampton markets there are a number of significant customers that currently purchase gas and could potentially be PNG gas cutomers. These customers are technically and commercially dependent upon gas, some of these are highlighted below:

- Orica and AMC operate process equipment which is intolerant of Sulphur. These consumers must remove the sulphur prior to use – there is no commercially viable or practical method to remove Sulphur and its compounds from liquid hydrocarbons (distillate etc). In addition, Orica uses gas to manufacture ammonia which is converted into ammonium nitrate.

- Caustic soda production by Ticor Chemical Company is dependent upon gas in its production processes. Ticor's operations are underpinned by the current reliable economic supply of Natural Gas and the significant local consumption of output by QAL.

- QAL – the principal consumer of energy in Gladstone – has converted from alternative hydrocarbon fuels for the calcining process for reasons of product purity. The absence of high Sulphur levels in Natural Gas results in a high grade of Alumina, thereby eliminating a source of contamination in the subsequent smelting process. It would be technically costly and economically inefficient for QAL to convert to alternative fuel sources.

- In addition, gas from PNG will be largely underwritten by gas fired electricity. The very fact that new gas fired electricity generators are being considered by the Queensland Government is an indication that alternative energy sources such as coal for electricity generation cannot be used by a large segment of the PNG Producers prospective market.

- Environment considerations for large energy users such as QAL also drive dependency on gas as the most efficient form of energy. Reliance on Natural Gas by Gladstone and Rockhamption industries provides a least cost approach to reducing emissions.

Many major customers (Ticor, QAL, Orica etc) appear to have high degrees of asset specificity, that is they are reliant on gas for production processes. In this respect, the market cannot be considered an energy market but a gas market.

A Queensland Gas Market

The application states that:

> *"Even if the ACCC adopts a narrower view of the market, the grant of an interim authorisation will not result in any anti-competitive detriment." (p8)*

The applicants' reasoning for this is that:

> *"Neither ExxonMobil nor Santos supply gas in Queensland in sufficient quantities to be considered a competitor of the project." (p8)*

Queensland's gas requirements (including those requirements for the aforementioned companies) are served predominantly by reserves from the Queensland part of the Cooper Basin. The main producers of these reserves are the joint venturers called the South West Queensland Producers.

The South West Queensland Producers are compromised predominantly of various Santos and ExxonMobil companies. Based on available information [*Queensland Department of Mines and Energy*], the interests of the Santos companies and the ExxonMobil companies, are approximately 60% and 20% respectively of the South West Queensland Producers joint venture.

[The following paragraph is confidential and DEI requests, in accordance with section 89(5) of the TradePractices Act, that it be excluded from the public register should this submission be included on the public register]

Paragraph Deleted

In addition, Santos has significant interests in the other major basins in Queensland from which gas is currently supplied, ie the Bowen and Surat Basins, through joint ventures within those basins and partial ownership of companies such as Oil Company of Australia (OCA).

Santos' and ExxonMobil's substantial interests in the Cooper, Surat and Bowen Basins (the main gas producing areas in Queensland) indicates the extent to which Queensland gas users are dependent upon the commercial incentives facing the Santos and ExxonMobil companies.

Other Competitive Detriments

Another anti competitive detriment that will more than likely arise as a result of Santos and ExxonMobil's inclusion in any authorisation is the adverse impact it will have on the development of other potential sources of gas from within Queensland, such as coal seam methane ("CSM") gas.

Currently there is an increasing level of production of CSM gas in Queensland. CSM is competitively placed in the market. However, the PNG project and PNG gas is likely to receive significant artificial government assistance, which immediately places PNG gas at an advantage over gas such as CSM gas. Should the PNG Producers, including Santos and ExxonMobil, also be allowed to jointly market their gas, it would pose an additional threat to the further development of CSM Gas and ensure that Santos and ExxonMobil's dominance of the Queensland gas market remains.

Reduction in Competitive Rivalry

As highlighted above the South West Queensland Producers (ie Cooper Basin gas) are currently the main source of gas for Queensland users. Consequently, the South West Queensland Producers will be the main source of competitive rivalry for PNG gas. Any reduction in the sphere of rivalry between these producers and basins, resulting from overlapping membership of joint marketing arrangements, has the potential to reduce competition to the detriment of:

(a) traders and marketers;
(b) gas users in general and more specifically users that have high degrees of asset specificity and large switching costs (as discussed above);
(c) producers of other potential sources of gas in Queensland; and
(d) social welfare.

The PNG project, which is expected to bring gas to Townsville, Rockhampton, Gladstone and eventually Brisbane, would place the two basins Cooper and PNG in direct competition. On this basis the applicants' statement that supply of gas by Santos and ExxonMobil in Queensland is insufficient to be recognised as a competitor should be in doubt.

Competitive Incentives

Competition is a process of rivalry between suppliers at the margin. Provided producers in the Cooper and PNG basins have appropriate incentives, they will actively compete against each other in the supply of gas, especially to major centres such as Rockhampton, Gladstone and Brisbane which are currently served by existing pipeline infrastructure. In this respect it is essential, for market development, that the ACCC recognise the importance of market structure and resulting risk and incentives in driving socially optimal and value creating outcomes. The inclusion of Santos and ExxonMobil in both the Cooper Basin marketing venture and the PNG marketing venture is not an appropriate market structure.

Gas for Electricity Production

The applicants' submission also makes the claim that:

> *"...as Project gas will primarily be consumed in electricity generation, it will compete initially mainly with coal and not with Queensland gas. On this basis, market conditions are such that any increases in the participants share of the any energy market as a result of PNG gas sales would not have a substantial effect on competition." (p8)*

Depending on the location of new gas fired electricity competition in the provision of gas for electricity generation could exist. To the extent that transmission pipeline infrastructure does not currently extend beyond Rockhampton the development of gas fired generation in Northern Queensland could in the short term only be supplied by PNG gas (if the project proceeds). However, in the longer term, dynamic efficiency and dynamic incentives may result in the development of further pipelines being constructed. The ACCC should not discount the economic and social importance of market dynamics in enhancing social welfare and should therefore seek to understand the possible implications on dynamic efficiency from the interim authorisation with or without the inclusion of Santos and/or ExxonMobil.

3. Santos and ExxonMobil's involvement in the Interim Authorisation

In addition to the anti-competitive detriments noted above DEI has a number of other concerns with the inclusion of Santos and ExxonMobil as applicants in the application currently before the ACCC.

(1) It is noted that in December 1999 the ACCC refused to include Santos in an authorisation granted to other PNG Producers on terms similar to the one being sought in the current application. The ACCC's reasoning was that it was important to maintain "the separation between Santos and the PNG Gas Project....if significant competition in the supply of gas in Queensland is to continue to develop." DEI submits that the market circumstances which existed in December 1999, still exist today and as such, the reason for refusing to extend the authorisation to Santos should still prevail. A similar argument exists for refusing to include ExxonMobil in any authorisation.

(2) The ability to participate in the Joint Marketing Arrangements is likely to have both or at least one of the following impacts which will give rise to anti-competitive detriments identified above:

- First, provide these producers with the ability to influence the terms of trade (or contractual terms and conditions including price) for PNG gas. This may have the effect of distorting the market in favour of one basin over the other. This distortion is likely to arise from Santos' and ExxonMobil's involvement in both the Cooper and PNG Basins.
- Second, knowledge of competitors contractual terms and conditions may provide producers with market information which can be used to influence market positions and marketing strategies. Santos and ExxonMobil would be able to use the information obtained through membership of the PNG joint marketing venture to adjust their market strategies in their other Queensland ventures.

Competition involves a process of price and quality discovery whereby various market participants compete to offer goods and services that satisfy the price and quality requirements (or demand) of consumers. In a competitive market, information on competitor strategy is valuable and is generally well guarded by companies seeking to gain a competitive advantage. Accordingly, the inclusion of Santos and ExxonMobil in the PNG Joint Marketing Arrangement, where they will have available critical market information on product which should compete with their other Queensland gas interests, would distort the market incentives and risks that drive socially beneficial outcomes. Additionally, this information asymmetry would be inimical to the interests of other gas industry participants.

DEI believes that approval of the interim authorisation in its current form would be inconsistent with the objectives of competition and gas market reform in Australia.

4. Other Issues

Final Authorisation

Should Santos and/or ExxonMobil be included in the interim authorisation it would be improbable that the final authorisation could rectify the serious information asymmetry implications. These information asymmetries may constitute a serious market failure.

Regardless of whether final authorisation is granted, Santos and/or ExxonMobil would have been privy to all commercial negotiations that occurred in formulating the PNG gas sales agreements. In addition, past experience with Joint Venture Marketing Authorisations (eg Cooper Basin Joint Marketing) indicates that once authorisation has been provided it is difficult to roll-back.

Public Benefits

The applicants have suggested that while the ACCC is not required to address the issues of public benefit and detriment when considering an application for interim authorisation:

> *"...an analysis of public benefit may still be relevant to the consideration of such an application..." (p9)*

It is noted that the Australian Competition Tribunal has consistently stated that its ultimate concern in cases involving an application for interim authorisation "must always be the benefit of the public, so that any possible benefit or detriment to the public must be given full weight."[1]

When considering the public benefits of including Santos and/or ExxonMobil in any authorisation the ACCC must weigh these benefits against the social costs from restricting competition. In this regard the ACCC might be guided, as indicated by the NCC, by the ideal that *"...the guiding principle is that competition, in general, will promote community welfare by increasing national income through encouraging improvements in efficiency. (p2)"* It may be contended that the joint authorisation through reducing competition is designed to overwhelmingly deliver benefits to the joint venture interests at the expense of the public benefit.

Upstream Reform

For some time regulatory agencies in Australia have been attempting to bring about upstream reform in the gas industry. One of the major hurdles facing regulators has been the presence of joint marketing ventures in various basins. The collary of this is that the ACCC now has an opportunity to ensure a market structure is instituted that would foster effective basin-on-basin competition. By allowing Santos and ExxonMobil to be included in the PNG joint marketing venture the ACCC would stymie the emergence of upstream competition for the various reasons given in this submission. DEI suggests that separate marketing is one of the elements needed to ensure effective upstream competition.

DEI requests that the ACCC give serious consideration to the issues raised above. DEI believes that the authorisation application including Santos and ExxonMobil in PNG Joint Marketing should be rejected on the grounds that it will distort market development and jeopardise competition in Queensland.

Yours sincerely

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[1] Re Queensland Timber Board (1975) ATPR 40-005