Applications for Authorisation

Mereenie Producers – Gasgo Sales Agreement

Date: 7 April 1999

Authorisation Nos:
A90637 – A90645
File No:
CA97/41

Commissioners:
Fels
Asher
Bhojani
Shogren
King

Contents

1. Introduction

On 2 December 1997 the Mereenie Producers ('the applicants') lodged nine applications (A90637 – A90645) ('the applications'), for authorisation with the Australian Competition and Consumer Commission ('the Commission'). The applications relate to the marketing and sale of gas produced by the Mereenie Producers for supply under the 1997 Mereenie Gas Sales Agreement ('the Gasgo Agreement'). The Gasgo Agreement comprises individual gas sales agreements between each of the Mereenie Producers (as sellers) and Gasgo Pty Limited ('Gasgo') negotiated on common terms.[1]

The parties to the Mereenie Joint Venture are:

▪ Magellan Petroleum (NT) Pty Ltd; ▪ United Oil & Gas Co (NT) Pty Ltd;	wholly owned by Magellan Petroleum Australia Ltd ('Magellan')[2]
▪ Canso Resources Pty Ltd; ▪ Moonie Oil Pty Ltd; ▪ Transoil Pty Ltd; ▪ Petromin Pty Ltd; ▪ Farmout Drillers Pty Ltd; and ▪ Santos Exploration Pty Ltd.	ultimate holding company: Santos Ltd ('Santos')

The joint venture interests held by each party are listed in Appendix A. Santos, which operates the Mereenie field on behalf of the Mereenie Joint Venture, ultimately controls 65 per cent of the interests in the Mereenie Joint Venture while Magellan controls 35 per cent.[3] The Mereenie Producers own the gas produced from the Mereenie field as tenants in common in proportion to their respective shares in the joint venture.

Application A90637 was made under sub-section 88(1) of the *Trade Practices Act 1974* ('the Act') for an authorisation to make or give effect to a contract or arrangement, or arrive at an understanding, a provision of which would have the purpose, or would or might have the effect, of substantially lessening competition within the meaning of section 45 of the Act.

The applicants describe the contract, arrangement or understanding relevant to application A90637 as giving effect to the Gasgo Agreement between the Mereenie Producers and Gasgo dated 19 November 1997 and for the joint performance of individual gas sales agreements by the Mereenie Producers with Gasgo as contemplated by the Gasgo Agreement.

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1 Gasgo is the buyer of the majority of gas from the Mereenie Producers. This gas is on-sold to PAWA for the purpose of electricity generation. See Chapter 2 for further detail.

2 Ownership includes 50.7 per cent by Magellan Petroleum Corporation (incorporated in the US) and 18.3 per cent by Santos Ltd.

3 Santos and Magellan, *Mereenie Oil and Gas Field Northern Territory* (undated), p. 1.

Applications A90638 – A90645 are separate applications made by each party to the Mereenie Joint Venture pursuant to sub-section 88(8) of the Act and seek authorisation to engage in conduct that constitutes or may constitute exclusive dealing within the meaning of section 47 of the Act. The applicants describe the conduct as the performance by the applicants of the Gasgo Agreement and the conditions relating to the supply of gas to Gasgo, which may constitute the practice of exclusive dealing.

The applications for authorisation are sought only for conduct relating to the supply of gas by the Mereenie Producers under the Gasgo Agreement and not to any other arrangements entered into by the applicants. The applicants seek authorisation to give effect to the Gasgo Agreement in its entirety, rather than those specific provisions that may be at risk of breaching the Act. Notwithstanding the scope of the applications, the particular provisions of the Gasgo Agreement identified as being at risk of breaching sections 45 and 47 of the Act are those provisions relating to the co-ordinated marketing of gas by the Mereenie Producers to Gasgo and the provisions relating to the term and quantity of gas supplied under that contract.

Applications A90637 and A90638 – A90645 also seek that any authorisation granted by the Commission be expressed to apply to, or in relation to, any successor or assign of a Mereenie Producer that becomes a party to the Gasgo Agreement after the date of this application pursuant to sub-section 88(10) of the Act.

This *Determination* sets out the Commission's analysis and views on the applications. This introduction describes the nature of the applications and the conduct for which authorisation is being sought. The public consultation process undertaken by the Commission is outlined in Chapter 2. The statutory assessment criteria and their application are outlined in Chapter 3. Chapter 4 sets out relevant background information including information concerning the industry structure, production arrangements and supply contracts. Chapter 5 provides an overview of the submissions made by the applicants in support of their application and also a summary of the submissions from interested parties, both in support of and opposed to the applications. The Commission's evaluation of the arguments and scope of the authorisation are set out in Chapter 6. Chapter 7 embodies the Commission's *Determination*. Appendix A contains a list of the joint venture interests held by each party in the Mereenie Joint Venture. Appendix B contains a list of the submissions received by the Commission regarding the applications. Appendix C lists the attendees to the conference held in relation to this matter.

2. Public consultation process

2.1 Issues Paper

The Commission received applications for authorisation in relation to the Gasgo Agreement from the Mereenie Producers on 2 December 1997. Various items included in the submission accompanying the applications were claimed to be confidential by the applicants. Resolution of these confidentiality claims occurred in August 1998.

The Commission released an *Issues Paper* on 12 November 1998 seeking comments from interested parties on the applications and the issues relating to the applications. Eight interested parties provided submissions to the Commission. In addition, the Commission held discussions with some of those interested parties, as well as NT Gas Pty Limited. A list of those parties who have provided written comments on these authorisation applications is located at Appendix B.

2.2 Draft Determination

The Commission issued its *Draft Determination* on these applications on 6 January 1999. Based on the information before it at the time, the Commission proposed that authorisation:

- be granted to give effect to the Gasgo Agreement for the marketing and sale of natural gas by the Mereenie Producers to Gasgo;
- be limited to the current term of the Gasgo Agreement. That is, until the earlier of 1 July 2009 or the completion of delivery of 67.5PJ of natural gas; and
- be extended to the respective successors and assigns of the current Mereenie Producers.

2.3 Conference

Copies of the *Draft Determination* were sent to all interested parties and the Commission invited parties to call a conference regarding the *Draft Determination*. A request for a conference was received from NT Power Group Pty Limited.[4]

The conference was held at the Sydney office of the Commission on 25 January 1999 and was chaired by the Deputy Chairman of the Commission, Mr Allan Asher. The conference was attended by representatives of five groups. A list of attendees can be found at Appendix C.

Discussions at the conference centred on the topics of:

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4 Power Facilities Pty Ltd ('Power Facilities') is the ultimate holding company of NT Power Group.

- the pre-emptive right contained in the Original Gas Purchase Agreement ('Original GPA');
- term of the authorisation;
- long term take-or-pay nature of the Gasgo Agreement; and
- conditions applying to the authorisation.

A record of the conference can be obtained from the Commission's public register.

In addition, parties were provided with an opportunity to make further submissions to the Commission regarding the issues raised at the conference. Submissions were received from the applicants, the NT Government and Power Facilities.

In reaching its decision on the authorisation applications for the purpose of issuing this *Determination* the Commission has considered all information arising from the conference and subsequent submissions.

3. The statutory tests

The applications for authorisation by the Mereenie Producers were made under sub-section 88(1) of the Act (in respect of the giving effect to contracts, provisions of which may be exclusionary provisions or have the effect of substantially lessening competition, within the meaning of section 45 of the Act), and sub-section 88(8) of the Act (in respect of conduct that would or may constitute exclusive dealing).

The Act provides that the Commission shall only grant authorisation if the relevant tests in sub-sections 90(6) or (8) of the Act are satisfied.

Sub-section 90(6) provides that the Commission shall grant authorisation only if it is satisfied in all the circumstances that:

- the proposed conduct would result, or be likely to result, in a benefit to the public; and
- that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result, or be likely to result, from the conduct.

Sub-section 90(8) provides that the Commission shall grant authorisation in relation to an application under sub-section 88(1) (insofar as it concerns an exclusionary provision) or sub-section 88(8) (insofar as it concerns proposed conduct to which sub-section 47(6) or (7) applies) only if it is satisfied in all the circumstances, that the exclusionary provision has resulted, or is likely to result, in such a benefit to the public that the proposed arrangements should be allowed to be made or the proposed conduct be allowed to take place.

Whilst there is some variation in the language between sub-sections 90(6) and (8) the Commission adopts the view expressed by the Trade Practices Tribunal (the predecessor of the Australian Competition Tribunal) that in all material respects the tests are the same.[5]

In deciding whether it should grant authorisation, the Commission must examine the anti-competitive aspects of the arrangements or conduct, the public benefits arising from the arrangements or conduct, and weigh the two to determine which is the greater. The Commission must apply what the Tribunal has referred to as the “future with and without test”. This requires the Commission to compare the “likely shape of the future” with the relevant conduct with the likely future situation without the relevant conduct.

Should the public benefits or expected public benefits outweigh the anti-competitive aspects, the Commission may grant authorisation or grant authorisation subject to conditions.

If this is not the case, the Commission may refuse authorisation or alternatively, in refusing authorisation, indicate to the applicant how the proposed contracts, arrangements, understandings or conduct could be amended to change the balance of detriment and public benefit so that authorisation may be granted.

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5 *Re: Media Council of Australia* (No 2) (1987) ATPR 40-774 at 48,418.

4. Background

4.1 Introduction

Natural gas was first discovered in the Northern Territory in the mid 1960s in the Amadeus Basin. Mereenie was the first field to be discovered in 1964 followed by the Palm Valley field in 1965. However, it was not until the 1980s that production of natural gas commenced from either of these fields. Following negotiation and execution of agreements with the Central Land Council in November 1981, production licences were granted for the Mereenie and Palm Valley fields.

Following completion of the Palm Valley to Alice Springs transmission pipeline, transportation and supply of natural gas commenced in 1983 from Palm Valley to the power station in Alice Springs for the purpose of generating electricity. The commitment of the NT Government in 1984 to build gas-fired power stations in Darwin and Katherine led to the construction of the Amadeus Basin to Darwin pipeline, and gas flow commenced in December 1986. Later developments of the pipeline included the construction of the McArthur River lateral pipeline in 1995 and a compressor near Tennant Creek in 1996, which increased the capacity of the pipeline from 44 to 55TJ/day.[6]

The gas-fired power station at Channel Island near Darwin replaced the oil-fired facility at Stokes Hill, Darwin. Originally, a coal-fired power station was designed to replace the oil-fired facility, but gas was preferred on efficiency and environmental grounds.[7]

4.2 Gas production and supply

4.2.1 Amadeus Basin gas supply

The Northern Territory is not interconnected by pipeline with the gas producing basins in the southeast of Australia or in Western Australia. All natural gas supplied in the Northern Territory is sourced from fields located in the Amadeus Basin. Currently the only two gas producing fields in the Amadeus Basin are the Mereenie and Palm Valley fields lying about 250 kms and 150 kms west of Alice Springs respectively.

The applications for authorisation relate only to gas produced from the Mereenie field. The Mereenie Joint Venture produces gas from Petroleum Leases OL4 (West Mereenie Block) and OL5 (East Mereenie Block) which recover hydrocarbons from a common reservoir. Gas produced from the two leases is owned by the participants of the Mereenie Joint Venture as tenants in common. The Palm Valley joint venture produces gas from Petroleum Lease OL3.

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6 'NT Gas – over ten years in business', *The Australian Pipeliner,* January 1998, p. 32.

7 Applicants' submission 2 December 1997, para. 18. NT Government submission 27 November 1998, p. 2.

Although there are two gas producing fields in the Amadeus Basin, the applicants submit that only Mereenie is able to meet the requirements of Gasgo. Palm Valley does not provide an additional competitive supply of gas as reserves are committed to the performance of existing contracts. Also, recent reservoir performance and drilling has resulted in the downgrading of available gas which indicates that Palm Valley cannot reliably deliver high volumes of gas despite almost two years of production utilising field compressors.[8]

In addition to gas, the Mereenie field also produces oil that is pumped to the Brewer Estate terminal 20 kms south of Alice Springs. Some of the gas produced from the Mereenie field is reinjected to maximise oil recovery. The *Petroleum Act 1993* (Northern Territory) requires the producers to undertake production activities in accordance with good industry practice to ensure optimum production of all economically producible hydrocarbons.[9]

Santos and Magellan also jointly hold interests in a retention licence over the Dingo field in the Amadeus Basin, located south of Alice Springs. A condition of the licence is that the licence holder is required to actively seek markets for the gas. To meet this requirement, negotiations are underway for gas from the Dingo field to be supplied to Energy Equity Corporation's power station at the Brewer Estate, south of Alice Springs. The Dingo field is estimated to have reserves of 20-25 PJ.[10]

No other onshore production licences or retention licences are held by the applicants or other parties in the Northern Territory at the current time with the exception of RL1 over Weaber in the northwest corner of the Northern Territory. There are a number of exploration permits covering acreage in the Northern Territory, however, with the exception of the fields referred to above, there are no other viable sources of gas supply currently identified in the Northern Territory.

Applications for licences in respect of land granted under the Commonwealth's *Aboriginal Land Rights (Northern Territory) Act 1976* cannot be dealt with until an agreement with the relevant Land Council has been concluded. Accordingly, permission to construct and operate gas production in the Northern Territory is derived from the petroleum leases and agreements entered into between the producers and the relevant Land Council.

Gas exploration and production in the Amadeus Basin is undertaken in accordance with the respective joint venture arrangements applying to each field. Santos and Magellan control all the interests in the Mereenie Joint Venture, Palm Valley Joint Venture and Dingo retention licence with the exception of the interest held by Kufpec Australia Pty Ltd ('Kufpec') in Palm Valley. Table 4.1 below contains details of ownership, sales, production and estimated remaining reserves of these fields.

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8 NT Government http://www.nt.gov.au/majorprojects/timorsea.shtml.

9 Applicants' submission 2 December 1997, para. 21.

10 Applicants' submission 2 December 1997, para. 57.

Table 4.1: Ownership, reserves and production of Amadeus Basin Fields

	Mereenie	Palm Valley	Dingo
Ownership:			
Santos	65.0%	48.0%	65.7%
Magellan	35.0%	50.8%	34.3%
Kufpec	n/a	1.2%	n/a
Operator	Santos	Magellan	Santos
Gas sales for 1997-98	11 PJ	8 PJ	n/a
Cumulative production to 30/6/98:	94 PJ	110 PJ	n/a
Remaining reserves as at 30/6/98:			
proved	216 PJ	226 PJ	n/a
proved and probable	443 PJ	294 PJ	25 PJ
proved, probable and possible	658 PJ	773 PJ	n/a

Source: ACCC, derived from Magellan 1998 Annual Report and *Beneficial Ownership of Amadeus Basin Fields,* November 1998, submitted by applicants.

4.2.2 Other potential sources of gas supply

Other potential sources of gas supply are from offshore fields in the Timor Sea and from Papua New Guinea ('PNG').

The Timor Sea Consultative Group was convened by the Northern Territory Government and commissioned ACIL Economics and Policy Pty Ltd ('ACIL') to report on the prospects for Timor Sea gas to supply Australian markets. ACIL concluded 'that Timor Sea gas would be very competitive in Darwin, Gove and Mt Isa…'.[11] However, this is in reference to the period 2003-2006. It was also noted that LNG projects are likely to underpin the supply of gas to Darwin and into eastern Australia.[12] The development of projects to supply gas from the Timor Sea to the Northern Territory would require the construction of a pipeline to bring the gas on-shore.

The likelihood of Timor Sea gas being delivered into the Northern Territory would also be dependent on the availability of LNG export markets required to underpin the investment. Since the ACIL report, the Asian market for LNG has shrunk significantly. It has been suggested that in such a climate there is a real likelihood that the proposed

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11 ACIL, *Northern Territory infrastructure development: prospects for Timor Sea gas in the Australian market*, a report to the Timor Sea Consultative Group, February 1998, p. 29.

12 ACIL, *Northern Territory infrastructure development: prospects for Timor Sea gas in the Australian market*, a report to the Timor Sea Consultative Group, February 1998, p. 4.

LNG projects for Western Australia and the Northern Territory will be postponed, leaving Amadeus Basin gas with no other gas competitor for an indeterminate period.[13]

However, more recently the Northern Territory Department of Lands, Planning and Environment has sought comment on draft guidelines for the preparation of an environmental impact statement regarding a proposal by Woodside Energy to establish an LNG facility near Darwin.[14]

In addition to reserves in the Timor Sea there are also sizeable reserves in PNG. Proposals are currently in place for gas to be transported via a pipeline from PNG to Cape York and down the Queensland east coast, linking up with existing eastern state pipelines. It is proposed that gas deliveries to eastern Australia could occur by 2002 via a pipeline capable of transporting 200 PJ/year.[15]

Recent press reports indicate that a lateral pipeline off the PNG to Queensland pipeline to Gove in the Northern Territory is being considered to supply gas to the Nabalco alumina refinery. It is understood that discussions have been taking place between the developers of the proposed PNG to Queensland pipeline on this issue but that no firm proposals are in place at this time.[16]

ACIL observed that the potential for penetration of Timor Sea gas into the Northern Territory, and potentially the eastern states, is likely to depend on whether construction of the PNG to Queensland pipeline proceeds and provides a further source of gas supply into the region.

4.3 Gas demand

Total annual demand for gas in the Northern Territory is currently approximately 18 PJ, with Mereenie supplying 9-10 PJ and Palm Valley supplying 8-9 PJ. Of this, approximately 15-16 PJ per annum is delivered to the Darwin area.[17]

Only Gasgo and PAWA purchase gas supplied from the Palm Valley field. Of the gas sold by the Mereenie Joint Venture, approximately 0.1 PJ per annum is sold to NT Gas Distribution Pty Ltd (a subsidiary of NT Gas Pty Ltd ('NT Gas'), the pipeline operator) which sells gas to a small number of industrial customers in Darwin.[18] While Alice Springs has some reticulation of gas,[19] Darwin currently has no domestic reticulation of gas.

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13 Treadgold, T 'Suddenly, an excess of gas threatens big projects', *Business Review Weekly*, 23 November 1998, pp. 41-42.
14 *Northern Territory News*, 1 February 1999.
15 'Issues and opportunities for major gas pipelines to serve south eastern Australia by 2010', *The Australian Pipeliner*, July 1998, pp. 17-20.
16 Askew, K 'PNG pipeline is edging closer to a full market', *Sydney Morning Herald*, 2 December 1998, p. 29.
17 Notes of meeting with applicants 3 November 1998, p. 3.
18 Applicants' letter to Commission 16 December 1998, p. 2.
19 Boral Energy is the retailer in Alice Springs and Centre Gas Pty Ltd the distributor.

The remaining gas supplied by the Mereenie Joint Venture is sold to Gasgo. Gas purchased by Gasgo is ultimately sold to the Power and Water Authority ('PAWA'), a statutory body charged under the *Power and Water Authority Act 1987* (Northern Territory) to supply electricity and evaluate the fuel and energy needs of the Northern Territory for the supply of electricity.[20]

Approximately 99 per cent of gas sold in the Northern Territory is used for the generation of electricity, while approximately 84 per cent of the electricity consumed in the Northern Territory is generated from gas.[21] Most of the gas purchased by Gasgo is used to generate electricity at the PAWA Channel Island power station (which generates approximately 205 MW) and other PAWA power stations at Katherine (approximately 19.5 MW), Alice Springs (approximately 53.3 MW) and Tennant Creek (approximately 15.6 MW). Gas requirements for the Yulara power station (approximately 6.6 MW) are supplied as LNG as the station is not connected to the Amadeus Basin to Darwin pipeline.[22]

In addition, generating plant owned by third parties is supplied with gas from PAWA (via Gasgo). These plant include:

- Pine Creek Power Station (34 MW);
- McArthur River Power Station (15 MW);
- Alice Springs Brewer Power Station (8.7 MW); and
- Cosmo Howley Power Station (7.5 MW).

The applicants previously supplied gas on an interim basis to Pegasus Gold Australia Pty Ltd ('Pegasus') for the generation of electricity at its gold mine at Mt Todd. However, with the closure of the mine in November 1997, supply of gas by the producers to Pegasus ceased. Prior to the Mereenie Joint Venture supplying gas to Pegasus, International Oil Pty Limited (an AGL subsidiary) supplied the mine for a short time.[23]

Discussions have been held in the past for the sale of gas by the Mereenie Joint Venture to Nabalco at Gove, which currently uses imported fuel oil to satisfy the energy requirements (25 PJ/year) of its alumina refinery. However, the Mereenie field has insufficient gas reserves available to replace the present fuel oil usage or underwrite the capital cost of converting the facilities to gas and the construction of a pipeline to Gove.[24]

In the early 1990s, the applicants held discussions with Mount Isa Mines Limited ('MIM') for the supply of gas to MIM's operations at Mt Isa in Queensland. This

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[20] NT Government submission 27 November 1998, p. 2.

[21] Applicants' submission 2 December 1997, para. 90 and NT Government letter to Commission 17 December 1998, p. 5.

[22] NT Government submission to Commission 17 December 1998, p. 5 and AGL letter to Commission 27 January 1999.

[23] Applicants' letter to Commission 6 August 1998, p. 5.

[24] Applicants' letter to Commission 6 August 1998, pp. 5-6.

would have required the construction of a lateral pipeline off the Amadeus Basin to Darwin pipeline to Mt Isa. Discussions ceased when MIM elected to continue with coal for its energy needs. MIM later entered into an arrangement for the supply of gas from the South West Queensland Unit Producers via the pipeline constructed from Ballera to Mt Isa, which was completed in 1998.

4.4 Mereenie gas sales contracts

Gas supplied by the Mereenie Producers under two existing contracts and the proposed Gasgo Agreement is sold ex-plant by the Producers to Gasgo, a subsidiary of PAWA. Gasgo then sells the gas to NT Gas, which on-sells the bundled product (gas and haulage), to PAWA, ultimately for electricity generation.[25]

Authorisation has not previously been sought for the two earlier contracts and is not sought as part of the present applications. The Mereenie Producers state that at the time of negotiating and entering into the two earlier contracts they did not perceive there to be any trade practices risk associated with the contracts. They state that then, as now, the contracts did not in any way result in a substantial lessening of competition in any relevant market.[26]

The Gasgo Agreement builds on the two previous contracts and is a reflection of higher demand growth for gas as a result of increasing electricity usage in the Northern Territory than anticipated when the earlier contracts were entered into. The applicants state that the current operational regime, which is dictated by Gasgo, is that Palm Valley produces at its maximum capacity with the balance of its requirements met by the Mereenie contracts.[27]

Details of the negotiated contracts between the Mereenie Producers and Gasgo are:

- 1985: The original Mereenie Gas Purchase Agreement ('Original GPA'). The term of the agreement is the earlier of 25 years from the date of the initial delivery or until 66 PJ is delivered. It is expected that this contract will cease in 2010;
- 1995: The Mereenie Gas Sales Agreement ('MSA1'). The term of the agreement is approximately 15 years (May 1995 to July 2010) with a contract quantity of 25 PJ. The MSA1 was executed to cover a small incremental increase in demand, but due to accelerated demand, may cease prior to 2002; and
- 1997: The Gasgo Agreement. Executed in November 1997 with an anticipated commencement date of 1 February 1999. The term is for ten years or upon completion of delivery of the contract quantity of 67.5 PJ. However, the term and contract quantities can be extended within certain agreed limits. Details on extending the contract are confidential.

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25 In addition, the Palm Valley Producers have a contract with Gasgo (executed in 1985), as well as a contract with PAWA at Alice Springs (1981). Both contracts are still on-going. Applicants' letter to Commission 6 August 1998, schedule 3, p. 7.

26 Applicants' letter to Commission 6 August 1998, schedule 3, p. 3.

27 Applicants' letter to Commission 6 August 1998, schedule 3, p. 7.

The processing plant and associated facilities are owned jointly by the joint venture parties. The current uninterruptible capacity of the Mereenie processing plant is approximately 16 TJ/day and, on an interruptible basis, a maximum of 36 TJ/day.

Underpinning the Gasgo Agreement is further investment in infrastructure enhancements to the Mereenie processing facilities. This development includes:

- construction of the Western Pipeline project to provide additional deliverability required by the new contract;
- upgrade of the Central Treatment Plant to provide additional uninterruptible supply; and
- additional field development work.

As a result of these enhancements, the uninterruptible capacity of the Mereenie facilities will be increased significantly beyond the present level.[28]

4.4.1 Mereenie Operating Agreement

The operation of the Mereenie Joint Venture is subject to the Mereenie Operating Agreement dated 27 April 1984 ('the Operating Agreement'). The Operating Agreement sets out the terms relating to the appointment of an operator, appraisal of reserves and development and production from the petroleum leases.[29]

Under the terms of the Operating Agreement all gas produced is owned by the joint venture parties as tenants in common in proportion to their respective interests. Although the agreement also allows for each joint venture party to dispose of its entitlements separately, the practice has been for the partners to agree and sell the gas produced on common terms and conditions, including price (that is, co-ordinated marketing of gas).

4.4.2 Pre-emptive rights

In assessing the application for authorisation of the Gasgo Agreement, the Commission's analysis must include consideration of the prevailing competition environment in order to assess the balance of anti-competitive detriment to public benefit resulting from the conduct for which authorisation is sought. During this process, particular attention has been drawn to a specific provision of the Original GPA.

The Original GPA contains a provision that requires the Mereenie Producers, prior to selling gas to third parties, to first offer that gas to Gasgo. Gasgo has a limited time in which it may choose to accept the offer or it may decline or waive its rights with respect to that gas, in which case the Mereenie Producers may then sell that gas to the other party.[30] Notwithstanding that the pre-emptive right resides in a previous contract, it impacts on the ability of gas purchasers other than Gasgo to acquire gas available for sale from the Mereenie Producers.

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28 Applicants' letter to Commission 10 December 1998, p. 3.
29 Applicants' submission 2 December 1997, para. 23.
30 Applicants' letter to Commission, 24 December 1998.

The applicants advise that on every occasion that the Mereenie Producers have offered gas to Gasgo as a result of that requirement, Gasgo has declined the offer or waived its rights in respect of the offer.[31]

4.5 Transmission of gas and third party access

As referred to above, gas purchased by Gasgo from the Mereenie Producers is on-sold to NT Gas, the transmission pipeline operator, for delivery to PAWA. Ownership of the Amadeus Basin to Darwin pipeline is vested in a consortium of banks. The pipeline is leased to NT Gas,[32] as Trustee for the Amadeus Gas Trust. The NT Government guarantees the lease. Under the provisions of the lease agreement, PAWA is required to fund the construction of two compressors. The first compressor was constructed at Warrego, principally to service the contract to supply the Mt Todd gold mine owned by Pegasus (which has since closed). The second compressor has not yet been built.

The Amadeus Basin to Darwin pipeline is deemed to be a covered pipeline in accordance with the National Third Party Access Code for Natural Gas Pipeline Systems ('the Code'). Under the provisions of the Code, the owner (or operator) of the pipeline is required to submit to the Commission, as designated regulator for the transmission and distribution pipelines in the Northern Territory, a proposed access arrangement for third party access to the pipeline. The Commission has granted NT Gas a conditional extension until 21 April 1999 for lodgment of its proposed access arrangement.

The only other major gas transmission pipeline in the Northern Territory is the Palm Valley to Alice Springs pipeline. The pipeline was operated by NT Gas for Holyman Ltd. It has recently been sold to Envestra Ltd ('Envestra').

4.6 Previous Commission decisions

4.6.1 AGL Cooper Basin gas supply arrangements

The Australian Competition Tribunal ('the Tribunal') released its decision on its review of the authorisation of AGL's Cooper Basin natural gas supply arrangements on 14 October 1997.[33] The Commission had granted authorisation to those arrangements in 1986, but revoked the authorisation and substituted a new authorisation in 1996 (A90424) on the basis that a material change in circumstances had occurred and that the anti-competitive detriment subsequently outweighed the public benefit.

The Tribunal in its decision set aside the Commission's determination and decided that the original authorisation should stand. While acknowledging that the public benefits had diminished, the Tribunal concluded that the relevant factor was the total benefits

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31 Applicants' letter to Commission, 24 December 1998.

32 AGL subsidiaries own 96 per cent of NT Gas Pty Limited. Darnor Pty Limited (which is owned by PAWA) and Centrecorp Aboriginal Investment Corporation (which is owned by the Central Land Council) own the remaining four per cent.

33 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593.

derived over the life of the contract. Although critical of some clauses of the arrangements, the Tribunal concluded that they were essential to the implementation of the contract and intrinsic to the achievement of the associated public benefits.

4.6.2 North West Shelf Project

The Commission released its Determination on the North West Shelf Project's Application for Authorisation on 29 July 1998 (A90624).[34] The North West Shelf ('NWS') determination centred on an application to co-ordinate marketing arrangements between the existing and future participants in the joint venture. That is, authorisation for conduct that may breach section 45 of the Act was sought. Gas supply contracts were not covered by the application. The Commission granted authorisation for co-ordinated marketing subject to certain conditions, which included limiting the term of the authorisation to seven years and limiting the authorisation to the named applicants.

In granting authorisation to co-ordinated marketing in that instance, the Commission concluded that many of the market features necessary to support separate marketing (for example, the existence of secondary and spot markets) were not well advanced in Western Australia. The term of the authorisation was limited to seven years in recognition that the market is evolving and may support separate marketing should those market features develop in the future. However, subject to certain conditions, any supply contracts executed within that seven year period would not themselves be confined to a term of seven years.

4.7 Upstream reform

4.7.1 The Australian Competition Tribunal

Although not directly related, the Commission's assessment of this authorisation application is made within the context of the recent Tribunal decision on AGL's Cooper Basin natural gas supply arrangements, in which the Tribunal pointed to the need for competition to develop between producers.

The Tribunal expressed the view that the development of competition between producers is important if the concentration of market power in production and transmission were to be addressed and the pro-competitive Council of Australian Governments ('CoAG') reform directions realised. The Tribunal considered that:

> In the present day market, we observe the play of conflicting forces. On the one hand there are the dramatic changes associated with the implementation of the National Competition Policy: the corporatization and privatization of gas utilities; the removal of State government imposed barriers to interstate trade; the vertical separation of production, transmission and distribution, met in part by ring-fencing arrangements; the implementation of third party access rules to transmission pipelines and to distribution and reticulation networks; and the unquestioned application of the *Trade Practices Act* to the conduct of all business entities within the gas industry.[35]

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[34] ACCC, *Determination – North West Shelf Project*, 29 July 1998.

[35] *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593 at 44,212.

However, the Tribunal identified forces associated with concentration of market power in exploration, production and transmission that conflict with the CoAG reform directions:

> As against this, there are forces that may limit the prospects for effective competition. There is much common ownership of leases for exploration and production in the gas fields. Ordinary commercial sense indicates that ring-fencing arrangements are quite compatible with an awareness of common interests. There are large economies of scale in the development of reserves and the building of pipelines that will restrict the numbers of viable enterprises.[36]

That analysis prompted the Tribunal's comment on the importance of upstream competition developing, as follows:

> While new players can play a useful role in developing financial instruments and participating in secondary markets, the final outcome for consumers of gas will depend to a considerable extent on the extent to which competition develops between producers of gas, for it is they who control the initial supply, though competition downstream would certainly squeeze subsequent costs and margins.[37]

4.7.2 The Upstream Issues Working Group

The Australian and New Zealand Minerals and Energy Council Senior Committee of Officials established the Upstream Issues Working Group ('UIWG') on 5 February 1998. Its objective is to report on issues pertaining to the upstream natural gas industry that have an impact on the growth, diversity and level of competition in downstream natural gas markets. In August 1998, UIWG released a Public Consultation Paper and called for public submissions. At the time of this decision, the UIWG report has not yet been released.

In its submission to the inquiry, the Commission concluded that enhanced competition in gas markets would provide benefits to consumers through greater choice, lower prices and improved services and will also provide flow-on benefits to the Australian economy as a whole. The development of competitive downstream gas markets depends significantly on effective competition upstream among producers of gas. It is therefore desirable that governments make concerted efforts to address upstream competition issues to ensure that reforms to free up downstream gas markets achieve their objectives.

The Commission is aware that the achievement of a more competitive market structure in the upstream gas production sector will be a difficult task, particularly in basins where gas production and use is project-focused and associated with members of the joint venture contracting on common terms with customers for large, long term quantities of gas. Given local market characteristics, Australia is unlikely to match the level of competitive activity in the US and Canada.

However, the prospective development of secondary-market trading in gas and pipeline capacity, the interconnection of pipelines and the development of gas swap opportunities and gas storage will encourage market entry and growth and an environment sustaining greater competition between producers, if complemented by upstream reform initiatives in relation to acreage management, flexibility of delivery

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36 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593 at 44,212.
37 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593 at 44,212.

points, replacement of take-or-pay by more efficient two-part tariffs, and third-party access to gas gathering and processing facilities.[38]

[38] ACCC, *Submission to the Gas Reform Implementation Group on Upstream Issues*, October 1998, p. 11.

5. Submissions

In addition to the applicants' submissions, the Commission received several responses and submissions from interested parties. Discussions were also held with some parties.

The main issues raised in the submissions and the arguments for and against granting the authorisation are examined in this chapter. The key issues raised in the submissions and at the conference were:

- the impact of co-ordinated marketing by the Mereenie Producers on the market;
- whether the long term take-or-pay nature of the Gasgo Agreement would have the potential to foreclose the market to other potential purchasers and sellers;
- the impact of the original Gas Purchase Agreement on the market;
- whether authorisation should extend to the applicants' successors and assigns; and
- the term of the authorisation.

5.1 Competition issues

5.1.1 Market definition

Public benefit and anti-competitive detriment arising from conduct associated with applications for authorisation are assessed in the context of the relevant market. Market definition is crucial to any assessment of competition and whether any lessening of competition is likely to occur. If a market is defined too broadly, market power will be understated as a result of including products or sellers who do not restrain the ability of sellers of particular products from raising their prices above competitive levels. Alternatively, if the market is defined too narrowly, then apparent market power may be overstated because some effective competition might be excluded from the analysis. A market involves four dimensions: product, geographic, functional and time.

'Market' is defined in section 4E of the Act as:

> … a market in Australia and, when used in relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first mentioned goods or services.

The applicants state that their applications for authorisation:

> … do not rely on a specific definition as to the relevant market and are equally applicable in the context of:
>
> - a market for the supply of natural gas in the Northern Territory; and
> - a broader energy market.[39]

The Commission raised a number of questions in its *Issues Paper* addressing the matter of market definition. Interested parties were invited to identify what they considered to be the relevant product and geographic markets in both the short and long term. In

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[39] Applicants' submission 2 December 1997, para. 10.

addition, interested parties were asked whether their business used gas, whether alternative fuels have been considered for use, and the cost of switching from one energy source to another.

The focus of submissions by interested parties was on product and, to a lesser extent, the geographic aspects of defining a market. However, the majority of submissions did not address the specific elements necessary in defining a market and instead provided more general views on market definition. Interested parties provided the Commission with limited information on price constraints, the cost of switching fuels or other aspects that impact on the choice of fuel in support of their comments on market definition.

In its submission the NT Government indicated its support for a wide product market, stating that:

> … a narrow product market definition and the consequent narrow examination of the competitive impact of the Gasgo agreement will fail to adequately recognise the support that the agreement provides to competition in a wider energy market and other markets in the Territory.[40]

Furthermore, the NT Government submits that the immaturity of gas production and distribution in the Northern Territory and the integral link between natural gas and electricity supports the argument that the relevant product market is energy.[41]

Notwithstanding this conclusion, the NT Government further adds that there are no alternative fuels that could be used to generate electricity without significant detriment to the public, including environmental impact. Even for those power stations that have the capability of burning gas and liquid fuels, the cost of alternative fuels, in the order of three times the price of gas, would prohibit switching from gas. Safety considerations associated with the transport and use of liquid fuels are also cited as public concerns. Furthermore, as some of the power stations, such as Pine Creek, are single fuel facilities, conversion to an alternative fuel would add significant cost, which would have to be passed onto consumers who already incur electricity costs significantly higher than the Australian average.[42]

Power Facilities Pty Limited (‘Power Facilities’) also states that it considers that the relevant product market is energy but adds, without explanation, that in the short term there is little practical difference between identifying the market as energy or gas. It considers that the geographic market encompasses those parts of the Northern Territory where gas or electricity is consumed.[43]

The applicants state that gas is used as an input fuel for electricity generation in the Northern Territory. Other energy sources used in this manner include distillate, fuel oil, butane, jet fuel and LPG. The applicants state that all gas powered generating equipment is capable of using liquid fuel.[44] However, as noted above, the NT Government has stated that not all power stations have duel fuel capabilities.[45] Power

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40 NT Government submission 27 November 1998, p. 3.
41 NT Government submission 27 November 1998, p. 4.
42 NT Government submission 27 November 1998, pp. 4-5.
43 Power Facilities submission 4 December 1998, p. 4.
44 Applicants’ submission 2 December 1997, para. 90.
45 NT Government submission 27 November 1998, p. 5

generation in remote areas, including aboriginal settlements, continues to be carried out with liquid fuels, as gas is not presently available at such locations. In addition, the Nabalco alumina refinery at Gove uses approximately 25 PJ of liquid fuel per year.[46]

The process of market definition can be viewed as establishing that area of product, functional and geographic space within which a hypothetical current and future profit maximising monopolist could impose a small but significant and non-transitory increase in price (SSNIP). If consumers could switch their demand to close substitutes, it will not be profit maximising for a firm to impose a SSNIP and the relevant market needs to be expanded to include these sources of substitute products. If a product or supplier does not place any effective constraint on the price that a firm/supplier could charge for its product, the two products or suppliers will not be considered to be in the same market.

Based on the prices provided by the applicants for natural gas (ex-plant and delivered) and for other fuels such as butane, light fuel and diesel, the price of these other fuels is well in excess of the price of gas.[47] These prices suggest that the price of gas could increase substantially before users would convert to liquid fuel. That is, liquid fuels appear to provide very limited pricing constraint on the price of natural gas.

In reviewing the revocation of the authorisation relating to the AGL Cooper Basin supply arrangements, the Tribunal determined that the relevant market in that instance was natural gas but included other fuels, particularly electricity, at the margin. The Tribunal stated:

> The first [product market] is natural gas, extending at the margin to encompass, at times, alternative and complementary energy sources, principally electricity. When we refer to the 'natural gas market', it should be understood in this extended sense. Then there are two further product markets, the services of transmission and reticulation.[48]

In the context of environmental issues and substitutability between sources of energy, the Tribunal stated:

> Statements from several industrial users as to the logic of their continuing choice among alternative fuels, and from environmental authorities as to their attitudes and practices in the regulation of industrial emissions and wastes, satisfy the Tribunal that (unless the supply of natural gas somehow becomes unreliable or the costs of gas use relative to alternative fuels become highly disadvantageous) natural gas will be increasingly entrenched in the market as the industrial fuel of choice in NSW.[49]

5.1.2 Competition for supply of natural gas in Northern Territory

As noted earlier in Chapter 2 of this *Determination*, there are currently only two gas producing fields in the Northern Territory. In addition, the applicants consider that only the Mereenie field is able to meet the additional gas requirements of Gasgo that form the basis of the Gasgo Agreement.

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46 Notes of meeting with applicants 3 November 1998, p. 4.
47 Notes of meeting with applicants 3 November 1998, p. 6.
48 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593 at 44,210.
49 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593 at 44,197.

However, the applicants do not consider that the arrangements under the Gasgo Agreement will significantly foreclose the market to potential buyers or sellers.[50]

In addition, the applicants state:

> The anti-competitive effect of the Gasgo Agreement is negligible having regard to the Contract Quantity and Annual Contract Quantity in the context of:
>
> - total identified natural gas reserves available for further exploitation and production by the Mereenie Producers; and
> - gas supplied by the Palm Valley and Mereenie Producers under other sales contracts.[51]
>
> Thus, the terms and conditions of the Gasgo Agreement do not inhibit either upstream or downstream competition for natural gas in the Northern Territory.[52]

Notwithstanding these arguments, the applicants also state that ‘the prospects of such competition are negligible’.[53]

The Australian Pipeline Industry Association (‘APIA’) suggests that effective competition in the gas industry will occur only when new suppliers (for example, suppliers from the Timor Sea) emerge that are able to supply Gasgo. Until then, the absence of any restrictive supply clauses in the Gasgo Agreement has little practical effect.[54]

The Northern Territory Chamber of Commerce and Industry (‘NTCCI’) considers that the Gasgo Agreement is anti-competitive and may preclude its members from purchasing gas in the future. As noted by the NT Government, no supporting evidence for this view was provided. [55]

5.1.3 Co-ordinated marketing

The Mereenie Producers own the gas produced from the Mereenie field as tenants in common according to their respective shares in the joint venture. The applicants have stated that joint production, as adopted by the Mereenie Producers, commonly gives rise to co-ordinated marketing. Several factors have been identified by the applicants, in addition to joint production, that they claim lead to co-ordinated marketing of gas. They are:[56]

- Separate production is problematic. The applicants refer to arrangements known as ‘borrow and loan’ to address these problems, but state that the Mereenie Operating Agreement does not provide for such arrangements. In addition, the applicants claim that borrow and loan arrangements are not suitable for the Australian gas industry because of ‘reserves risk’ and ‘facilities risk’.

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50 Applicants’ submission 2 December 1997, para. 59.
51 Applicants’ submission 2 December 1997, para. 98.
52 Applicants’ submission 2 December 1997, para. 100. The NT Government supports this view. NT Government submission 27 November 1998, p. 4.
53 Applicants’ submission 2 December 1997, para. 103.
54 APIA submission 27 November 1998.
55 NTCCI submission 11 December 1998, p. 1. NT Government letter to Commission 17 December 1998, p. 2.
56 Applicants’ submission 2 December 1997, paras. 24-45.

- Storage difficulties. As gas cannot be readily stored it must be delivered to customers via pipelines in a continuous stream.
- Production and sales contracts are inter-related. According to the applicants, the inability to effectively store gas results in a direct link between production and sales. Generally, production does not occur until demand for gas has been established and contracted.
- Common purchasers. The applicants state that the factors that result in joint production often result in the sale of gas to common purchasers. In addition, the delivery of gas can only be at one rate and according to one specification.
- Common terms. According to the applicants, as a result of joint producers selling gas to common purchasers via a single pipeline, there is little scope for each producer to sell on different terms other than price.
- Common price. The applicants state that commercial reality dictates that if producers sell under common terms and conditions, neither the buyer nor any seller would be likely to accept differential pricing.
- Central Land Council (CLC). The applicants state that the arrangements made with the CLC are predicated on the basis that the Mereenie Producers adopt joint production and sale of petroleum.

As the major gas user, the NT Government supports co-ordinated marketing of gas by the Mereenie Producers and states that:

> The Government parties have no objection to dealing with the producers on a co-ordinated basis and see no present advantage coming to them from separate marketing which in fact is likely to increase costs and further complicate arrangements for the securing of appropriate gas supplies to the Territory for the purposes of producing electricity.[57]

The NT Government suggests that there are a number of efficiencies to be gained by producers undertaking co-ordinated marketing including a reliable supply of gas for the buyer and reduced transaction costs in negotiating for supply. In addition, the NT Government submits that if the Commission considered separate marketing was unsupportable for the NWS in Western Australia then it would not be feasible in the Northern Territory.[58]

Although APIA recognises that there may be benefits in joint production and exploration of gas, it considers that:

> … joint marketing could be seen as a means of mitigating normal business risk at the price of limiting competition and potential benefits to consumers.[59]

While acknowledging the historical significance of co-ordinated marketing, APIA questions whether co-ordinated marketing is appropriate in the anticipated new competitive environment of the gas industry. In addition, APIA disagrees with the applicants that co-ordinated marketing will continue in Australia for the foreseeable future. APIA suggests that once the decision to implement co-ordinated marketing is

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57 NT Government submission 27 November 1998, p. 4.
58 NT Government submission 27 November 1998, pp. 5-6.
59 APIA submission 27 November 1998.

made there is no incentive to seek out alternative arrangements that would assist the development of separate marketing.[60]

Envestra also does not support co-ordinated marketing. It argues that by the conclusion of the first contract period between producers and buyers the initial costs of establishing a field should have been recovered. Envestra states that there is 'no reason why competition between producers within a joint venture should not commence at that point'.[61] In response, the NT Government has submitted that issues raised by Envestra may be relevant for the sale of a service such as gas haulage but are not relevant for the sale of a commodity. In addition, the NT Government states that to deliver gas the Mereenie producers will incur additional capital costs.[62]

5.1.4 Long term take-or-pay contract

The Gasgo Agreement has a term of ten years until 2009 (or until the contracted quantity of 67.5 PJ is met).[63] The applicants state that although the terms of gas contracts in Australia have been up to 30 years they have tended to range between ten to 20 years. The applicants submit that:

> The geological and geographical factors existing in Australia and the resultant pipeline configurations may well cause Governments and the majority of users in Australia to continue to prefer the long term contract option. Currently, the vast majority of contracts which exist or are being written are based around long term take or pay provisions. This is particularly the case where parties are contracting for their base load or a substantial part of their requirement, such as in the Gasgo Agreement. These contracts typically underpin major capital investments or required security of supply for utility type operations, such as PAWA.[64]

However, the applicants also note that 'market developments may see shorter term contracts become more of a feature of the gas industry'.[65]

The applicants submit that long term take-or-pay contracts allow an allocation of risk between the parties. An obligation on the part of producers to maintain reserves and capacity for a specified annual contract quantity is a burden on the producers but provides a benefit to the buyer.[66] The nature of long term contracts requires investment by producers to enable them to meet the contract requirements. However, long term contracts also provide the support required to finance the required investment.[67]

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60 APIA submission 27 November 1998. Pegasus is of a similar view. Pegasus submission 10 December 1998, p. 2.
61 Envestra submission 7 December 1998, p. 2.
62 NT Government letter to Commission, 17 December 1998, pp. 1-2.
63 The Gasgo Agreement contains provisions for, firstly, the term to be extended for a specified period in the event that some gas is still banked at the end of the initial term of ten years, and, secondly, annual contract quantities to be increased by a specified percentage under certain circumstances. The preceding agreements were for terms of 25 and 15 years.
64 Applicants' submission 2 December 1997, para. 48.
65 Applicants' submission 2 December 1997, para. 53.
66 Applicants' submission 2 December 1997, para. 50.
67 Applicants' submission 2 December 1997, para. 51.

The applicants identify that take-or-pay provisions are not only found in gas supply contracts in Australia. Other instances include the fixed and variable charges relating to gas transportation, the supply of electricity and the supply of water.[68]

Furthermore, the applicants state that a two-part tariff structure is essentially the same as a take-or-pay structure. That is, a customer pays for reservation of capacity plus a balance payable on delivery. The applicants suggest that a take-or-pay contract has the benefit of allowing for the banking of gas and the right to take this gas in the future whereas a two part tariff structure does not provide this facility.[69]

The NT Government also considers that while the nature of the Gasgo Agreement may theoretically result in anti-competitive effects, the particular circumstances of the Northern Territory justify the Gasgo Agreement as being pro-competitive.[70]

Envestra and Power Facilities have questioned the need for the Mereenie Producers and Gasgo to enter into a third long term contract containing take-or-pay provisions. Although Power Facilities considers that the length of the contract, ten years, in itself is not objectionable, it states that it must be examined in conjunction with other factors such as take-or-pay provisions and the existence of the pre-emptive right in the Original GPA. Power Facilities states that the Gasgo Agreement ties the applicants and Gasgo to a significant volume of gas for a long period and this will restrict or delay the emergence of both alternative suppliers and purchasers and consequently a 'market competitive price'.[71]

In response, the applicants suggest that the assertion that the Gasgo Agreement would restrict or delay a new entrant is without foundation. The applicants note that it is open for gas users to enter into supply contracts directly with the Mereenie Producers and that in the near future that course of action will be assisted by an access arrangement covering the Amadeus Basin to Darwin pipeline.[72]

Envestra suggests that the initial capital outlays should be recovered during the first contract, thus reducing the need for long term take-or-pay contracts thereafter.[73]

In response to this, the applicants have stated that:

- initial investment costs incurred have not been recovered;
- the Gasgo Agreement requires additional investment; and
- if a customer seeks a long term contract then a producer seeks certainty in a take-or-pay provision for that volume of gas.[74]

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68 Applicants' submission 2 December 1997, para. 49.

69 Notes of meeting with applicants 3 November 1998, pp. 5-6. Pegasus also considers that two-part tariffs are not intrinsically superior to take-or-pay provisions. Pegasus submission 10 December 1998, p. 2. See also NT Government letter to Commission 17 December 1998, p. 3.

70 NT Government submission 27 November 1998, p. 6.

71 Power Facilities *Outline of Points for Further Consideration,* submitted to the pre-determination conference, 25 January 1999, pp. 1-2.

72 Applicants' letter to Commission 1 February 1999, p. 1.

73 Envestra submission 7 December 1998, p. 2 and Power Facilities submission 8 December 1998, p. 5.

74 Applicants' letter to Commission 15 December 1998, p. 1.

The NT Government has responded to Envestra's submission by stating that:

> Take or pay provisions in earlier contracts secured earlier capital investment. The take or pay provision in the subject of the application will secure the capital investment needed for delivery of the contracted quantities of gas.[75]

5.1.5 Impact of the Original Gas Purchase Agreement

Two issues have been raised in relation to the Original GPA: a pre-emptive right held by Gasgo and priority rights in the supply of gas. Pegasus submits that these two factors 'only serve to shelter PAWA from effective competition and frustrate and delay the development of competition'.[76]

Pre-emptive rights

Power Facilities has submitted that in negotiating for the supply of gas the Mereenie Producers have advised Power Facilities that their offer to supply is subject to the pre-emptive right held by Gasgo. That is, before a quantity of gas can be sold or offered for sale to a third party, the Mereenie Producers are obliged to offer that tranche of gas under the same negotiated terms and conditions to Gasgo. If Gasgo does not waive its right and takes up the offer, the third party and the Mereenie Producers would then need to commence negotiations for another tranche of gas.

Power Facilities states that Gasgo's pre-emptive right has anti-competitive effects, both in its existence and exercise. Those effects are:

- the pre-emptive right forces third parties to disclose to Gasgo the terms and conditions of any agreement negotiated for the supply of gas from the Mereenie Producers (existence); and
- it enables Gasgo to frustrate potential competition in the electricity market by taking up any gas negotiated by third parties to generate electricity by exercising its pre-emptive right (exercise).[77]

The applicants cite the number of occasions in the past on which Gasgo has waived its pre-emptive right as evidence that third parties are able to secure gas supplies. However, Power Facilities argues that this is not necessarily an indication of future behaviour as it is only recently that a competitor to PAWA for the sale of electricity in the Northern Territory has emerged. Power Facilities states that it has entered into a number of contracts to supply electricity at prices 20 per cent less than PAWA. While Power Facilities states that Gasgo has not agreed to waive its pre-emptive right in favour of Power Facilities, the applicants state that negotiations with Power Facilities have not advanced enough for representations to be made to Gasgo at this stage.[78]

In response to the submissions made by interested parties concerning the pre-emptive right contained in the Original GPA, the applicants state that there is no pre-emptive

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75 NT Government letter to Commission 17 December 1998, p. 4.
76 Pegasus submission 10 December 1998, p. 3.
77 Power Facilities submission 8 December 1998, pp. 2-3. The NT Government rejects this suggestion. NT Government letter to Commission 17 December 1998, p. 3.
78 Applicants' submission 1 February 1999, p. 2, and Power Facilities submission, 1 February 1999, p. 2 and *Outline of Points for Further Consideration,* submitted to the pre-determination conference, 25 January 1999, p. 3.

right in favour of Gasgo in the Gasgo Agreement and, as such, the issue of pre-emptive rights is irrelevant for the purposes of the Commission in making its determination in respect of these applications for authorisation of the Gasgo Agreement.[79]

The Northern Territory Government states that Gasgo would not use its pre-emptive right to hinder the entry of a competitor to PAWA as this 'would be in breach of the Trade Practices Act.' Moreover, the Northern Territory Government states that it has a duty to its shareholders to minimise costs and would only exercise its pre-emptive right in the case of a major event and electricity supplies were threatened, and it was in the public interest and not anti-competitive.[80]

Power Facilities states that the take-or-pay provisions compound the anti-competitive effect of the pre-emptive right. According to Power Facilities, the Gasgo Agreement, in conjunction with the pre-emptive right, potentially restricts the entry of a competitor to PAWA as Gasgo could exercise its pre-emptive right and bank any excess gas for the future.

Power Facilities states that in these circumstances a competitor of PAWA would not obtain an uninterruptible supply of gas, even though the overall demand for gas does not increase – as the competitor's gas would merely displace part of Gasgo's demand. Power Facilities refers to this as 'reserving' of gas for Gasgo and it is facilitated by the take-or-pay provisions, including the banking of gas, contained in the Gasgo Agreement.[81]

Priority rights

Pegasus states that Gasgo has a priority right to gas flows on a day to day basis (as distinct from the reserves themselves) from the Mereenie Producers. This ensures that the gas purchased for the purpose of electricity generation is given priority over any other purchases. Pegasus adds that Northern Territory legislation dealing with emergency energy needs would be the most appropriate method to deal with setting priorities.[82]

Power Facilities also states that priority in the supply of gas is given to Gasgo over other customers on the basis that the gas supplied to Gasgo is essential for electricity supply. This leaves other gas customers open to interruptible supply or high costs to obtain firm supply. Power Facilities adds that 'the priority given to Gasgo correctly identifies electricity as an essential product, but incorrectly assumed that all electricity generators would be supplied by Gasgo'.[83]

The applicants state that it is 'incorrect to suggest that if the Gasgo agreement proceeds, that this will somehow reserve all field and plant capacity to Gasgo'.[84] The applicants

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79 Applicants' letter to Commission 14 December 1998, p. 1.
80 NT Government submission 17 December 1998, p. 3 and Record of conference, 25 January 1999, p. 5.
81 Power Facilities *Outline of Points for Further Consideration,* submitted to the pre-determination conference, 25 January 1999, p. 3.
82 Pegasus submission 10 December 1998, p. 3.
83 Power Facilities submission 8 December 1998, p. 3.
84 Applicants' submission 1 February 1999, p. 2.

state that it is a matter for individual negotiation whether uninterruptible or interruptible supply is provided and whether associated investment in plant and field development is required. Furthermore, the applicants have advised the Commission that no priority rights are attached to the supply contracts to Gasgo over the sale of gas to other customers. All firm contracts for uninterruptible supply are treated on an equal basis.[85]

5.1.6 Conditions applying to the authorisation

Power Facilities proposes that, if the Commission grants authorisation, it should be subject to the following conditions:

- that the applicants secure from Gasgo waiver of its pre-emptive right, at least for the same class of third parties; that is, those seeking to compete in the electricity market; and

- the applicants supply gas to purchasers of gas in excess of 1 PJ per annum 'at a price which reflects the prices paid by large users of gas' and that the ACCC be the arbiter of any disputes.[86]

With respect to the first condition, the applicants state that it is inappropriate to place a condition on the applicants which they could not perform, as it is not within their power to secure from Gasgo waiver of its pre-emptive right. Regarding the second condition, the applicants are of the opinion that, apart from being outside the powers of the Commission, it is too prescriptive and fails to take into account that determination of prices is a matter for commercial negotiation.[87] The NT Government also states that the proposed conditions are *ultra vires* the powers of the Commission.[88]

5.2 Public benefits

The applicants claim that the conduct to which these applications for authorisation relate creates numerous public benefits and no detriment. They have identified economic and social benefits of a general nature that emerge from the conduct for which they seek authorisation. These benefits have been outlined as:[89]

- enhanced security of gas supply;
- the provision of gas to PAWA at a competitive price which in turn improves the competitiveness of PAWA customers;
- facilitation of smaller commercial ventures;
- facilitation of the development of secondary industry;
- improved prospects of serving currently unserved customers; and

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85 Notes of meeting with applicants, 18 December 1998.
86 Power Facilities *Outline of Points for Further Consideration,* submitted at the pre-determination conference on 25 January 1999, p. 8 and *Record of Conference,* 25 January 1999, p. 7.
87 Applicants' submission 1 February 1999, p. 4.
88 NT Government submission 1 February 1999, p. 5.
89 Applicants' submission 2 December 1997, para. 66.

- increased employment with expansion of the plant at Mereenie. During construction additional employment will average 15-20 people. Operation of the plant will require a very small increment in field personnel.[90]

According to the applicants the Gasgo Agreement will build on earlier gas supply agreements and thus allow a continuation of the significant public benefits they have generated over the preceding years.[91] The applicants state that past investments are a relevant consideration for the current authorisations under assessment and include past investments made by the Mereenie Producers and others such as power stations and the Amadeus Basin to Darwin pipeline.[92]

In addition to the broad benefits noted above, the applicants have identified benefits arising from the long term take-or-pay nature of the Gasgo Agreement. These are: [93]

- Major expansion of the Mereenie facilities. As a result of the Gasgo Agreement, the Mereenie Producers plan to commit to increase the uninterruptible capacity of the facilities by 2½ times their present capacity. The expansion will allow firm supply of the applicants' maximum obligations.
- Recovery of production costs. The applicants state that the long term nature of the contract assists in recovery of costs, particularly drilling costs. Thus, the investments made are prevented from becoming stranded and cash flow is maintained.
- Security of supply. The Gasgo Agreement provides Gasgo with security of supply, which in turn allows the NT Government to meet its obligations in regard to electricity supply. The applicants suggest that this security is important in a market that is relatively immature and has limited potential suppliers. The contract also provides security in light of the reported decline in Palm Valley production.
- Planning and co-ordination of production. The applicants argue that the inclusion of a take-or-pay provision in the agreement allows them to plan exploration, drilling and production over the life of the contract to maximise efficiency.
- Low gas prices. According to the applicants, the length of the agreement allows the recovery of costs and investments over a long period. This gives PAWA a long term stable price for the fuel needed in power generation. According to the applicants, gas is priced significantly lower than alternative fuels. If the term of the contract were considerably less then costs would need to be recovered over a shorter period, increasing the price of gas.
- Flow on benefits. The applicants suggest that the relatively low price of gas and secure supply generated from the Gasgo Agreement will improve the cost competitiveness of PAWA customers, facilitate the development of small commercial ventures, encourage the supply of energy to remote areas and facilitate the development of secondary industry.

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90 Applicants' letter to Commission 6 August 1998, schedule 4, p. 6.
91 Applicants' submission 2 December 1997, para. 75.
92 Applicants' letter to Commission 10 December 1998, p. 2.
93 Applicants' submission 2 December 1997, paras. 76-94.

In summary, the applicants claim that 'the long term take-or-pay nature of the contract is intrinsic to the creation of this public benefit'.[94]

The applicants state that public detriment would result from the Commission not granting authorisation, as uncertainty would arise in relation to the arrangements and the enforceability of the Gasgo Agreement.[95] In particular:

> A determination by the Commission not to grant the authorisation would be detrimental to the public, particularly Northern Territory electricity consumers, in that it would give rise to destabilising concerns about the enforceability and validity of the agreement and its performance on the part of both Gasgo and the Mereenie Producers and consequently the ability of PAWA to meet the requirements of its current and potentially expanded customer base to guarantee security of supply.[96]

The NT Government also considers that the Gasgo Agreement provides essential public benefits, in particular in meeting the Northern Territory's electricity needs. In addition:

> The NT Government would have a substantial financial exposure if authorisation was not granted and it was not able to secure long term supply of the type contemplated by the agreement.[97]
>
> … the public benefits derived from the Gasgo Agreement are not only substantial, they are total. To refuse the authorisation sought would itself constitute a total detriment to the public.[98]

Power Facilities agrees with the applicants that securing a gas supply for electricity generation has the benefit of reducing energy costs. This in turn creates benefits such as improved cost competitiveness and efficiency of energy users. Power Facilities also agrees that the Gasgo Agreement prevents the stranding of assets.

However, Power Facilities states that those public benefits would still be realised (and indeed enhanced through greater competition and lower electricity prices) in the absence of the Gasgo Agreement and, therefore, the Commission should ignore those benefits in its assessment of the public benefits versus detriments of the Gasgo Agreement itself. Power Facilities argues that several factors, such as an increasing demand for gas and the lack of competition, suggest that the capital works would still proceed and a less restrictive agreement would be negotiated between the parties if the Commission did not grant authorisation to the Gasgo Agreement.[99]

The applicants dispute this argument and state:

> The simple facts are that the Applicants would not undertake the capital and field work, as is currently proposed, in the absence of the Gasgo Agreement or an agreement involving equivalent terms.[100]

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94 Applicants' submission 2 December 1997, para. 65.
95 Applicants' submission 2 December 1997, paras. 7-8.
96 Applicants' submission 2 December 1997, para. 97.
97 NT Government submission 27 November 1998, p. 1.
98 NT Government submission 27 November 1998, p. 6.
99 Power Facilities *Outline of Points for Further Consideration,* submitted at the pre-determination conference on 25 January 1999, pp. 5-7.
100 Applicants' submission 1 February 1999, p. 3.

5.3 Scope of the authorisation

5.3.1 Successors to the Gasgo Agreement

The NT Government states that it would be concerned if authorisation was extended to new parties to the Mereenie Joint Venture. It refers to the flexibility provided by recent changes to the authorisation provisions of the Act through the *Gas Pipelines Access Act 1998* (Commonwealth) which allows for minor variations to an authorisation. However, the NT Government notes that variations to the participants of the Mereenie Joint Venture would require Ministerial approval under the *Petroleum Act 1984* (Northern Territory).[101]

In response, the applicants submit:

> Unless any authorisation granted pursuant to the applications is expressed to extend to successors and assigns of the present parties to the agreement, it may be necessary for further authorisation applications to be made in respect of the agreement, involving both the Applicants and the Commission in unnecessary time, effort and expense (notwithstanding the recent amendments to the Act to provide for minor variations to authorisations…[102]

5.3.2 Term of the authorisation

APIA has stated in its submission that if authorisation is granted for the Gasgo Agreement the Commission should place a time limit on the period of authorisation.[103]

The issue of the Commission specifying a time period in an authorisation has also been raised with the applicants who state that the authorisation should not be subject to any time limit and that any authorisation should be coextensive with the term of the Gasgo Agreement.[104]

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101 NT Government submission 27 November 1998, p. 7.
102 Applicants' letter to Commission, 10 December 1998, p. 1.
103 APIA submission 27 November 1998.
104 Applicants' letter to Commission 2 December 1998, p. 2.

6. Commission's evaluation

6.1 Introduction

The Commission's evaluation of the applications is made in accordance with the statutory tests as set out in Chapter 3 of this *Determination*. The competition effects and public benefits of the Gasgo Agreement, the subject of the applications for authorisation, are assessed below.

Power Facilities states that it is a function of the Commission to assess whether the public benefits that the applicants claim emanate from the Gasgo Agreement would still be achieved in the absence of the Gasgo Agreement. Moreover, Power Facilities states that it is the role of the Commission to impose conditions that adequately address any identifiable detriments.[105]

The Northern Territory Government, Gasgo and the applicants dispute Power Facilities' arguments and state that the role of the Commission is to assess the future with or without the Gasgo Agreement itself. They state that the Commission should only impose conditions in the event that the anti-competitive detriments outweigh the public benefits and the conditions are necessary to redress the imbalance.[106]

In its decision on the AGL's Cooper Basin gas supply arrangements, the Tribunal stated 'to the extent that detriment is present the question would arise as to whether a less restrictive contract would deliver the same or sufficient benefit'.[107] In this *Determination,* the Commission has adopted a similar approach in its analysis of the Gasgo Agreement and has examined, as part of the general weighing process, whether a less restrictive contract would deliver the same public benefits.

The applicants are applying for authorisation of the Gasgo Agreement in its entirety, rather than specific provisions, and in its assessment the Commission has examined the net public benefit of the whole agreement. The interrelationship of the various provisions makes it necessary to do so, as the public benefits of the agreement may flow from the anti-competitive provisions. The Tribunal stated in its review of the AGL Cooper Basin gas supply arrangements:

> …although the Tribunal accepts that certain provisions of the Letter of Agreement are anti-competitive in their effect we have concluded that in some instances the provisions were so essential to the original conclusion and implementation of the Letter of Agreement, as to be intrinsic also to the achievement of the benefit that arises from its existence and implementation. This consideration warns against assessment of particular clauses in isolation from each other. It is important that

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105 Power Facilities, *Outline of Points for Further Consideration,* submitted to the pre-determination conference, 25 January 1999, p. 1 & pp. 5-7.
106 NT Government submission 1 February 1999, pp. 4-5.
107 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593, at 44,213.

benefit or detriment is determined by considering the Letter of Agreement as a whole. It is the sum of the parts, some of which in their effect are anti-competitive; but others have positive benefit.[108]

6.2 Public detriment

6.2.1 Market definition

As outlined in submissions, gas currently supplied in the Northern Territory is used almost exclusively in the generation of electricity. Alternative fuel options for electricity generation in the Northern Territory are identified in the submissions as the fuels referred to in section 5.1.1. In the industrial and commercial segments, gas use appears limited and competes with liquid fuels and electricity. Domestic gas use occurs only in Alice Springs where gas is available to consumers via the distribution network. It is understood that, given the climate in the Northern Territory, air-conditioning units (which presently can only be operated using electricity) represent a significant proportion of the commercial and domestic energy usage.

The present energy usage in the Northern Territory suggests that submarkets may be defined within a potentially broader energy market. The degree that alternative fuels compete with gas varies according to user groups. For example, fuel substitution possibilities for the generation of electricity indicate that gas is the first choice on price, environmental and other grounds while liquid fuels provide a less viable alternative. No other substitutes were identified in the submissions. Electricity, by virtue of being an end-product of gas, provides no pricing constraint on gas supplied for the generation of electricity.

Conversely, for commercial and domestic uses and some industrial uses, there is potentially more scope for substitution over time between electricity, gas and liquid fuels.

Accordingly, the Commission considers that while overall the relevant market in relation to the present authorisations is natural gas with fringe competition from alternative energy sources over time, submarkets such as the supply of electricity generation display characteristics which suggest that the trend to an energy market in these areas is limited.

The natural gas pipeline system in the Northern Territory is currently not connected to any other gas pipeline system on mainland Australia, nor is it connected to any offshore supplies of gas. While connections to gas supplies outside of the Northern Territory have been foreshadowed, notably to Timor Sea and/or PNG gas, the timing of such connections is problematic. Accordingly, the Commission concludes that the geographical market is the Northern Territory.

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[108] *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593, at 44,220. The Tribunal's comments were made in relation to an existing contract with a relatively short term to run, as distinct from the Gasgo Agreement which is a new contract.

6.2.2 Co-ordinated marketing

The alternative to co-ordinated marketing is separate marketing, by which the partners to a joint venture negotiate individually with gas users and potential users. The Commission believes that separate marketing of gas by joint venture producers, wherever feasible, will be more competitive than co-ordinated marketing and likely to provide a wider variety of supply options that would better meet market demands.

While there were comments expressed by some interested parties questioning the justification of continued co-ordinated marketing at the production level in the anticipated new competitive environment, the applicants state that substantial public benefit will arise from the facilitation of the Gasgo Agreement, by means of co-ordinated marketing, in terms of security of gas supply, lower gas prices and related flow-on effects.

The applicants have stated that the Joint Operating Agreement and the Gasgo Agreement do not prevent or hinder the separate marketing of gas.

The key issue in the context of this and other similar authorisation applications, however, is not necessarily whether separate marketing is *superior* to joint marketing, but rather whether separate marketing is *feasible* in the particular market.

Gas markets where separate marketing by joint venture producers is the norm, such as in the USA and UK, operate as commodity markets with much of the gas produced and brought to market for sale. The physical production and delivery of gas is separated from the contractual sales, with a variety of trading, swapping and hedging practices helping to achieve a more efficient allocation of the gas supplied to the various end customers.

These markets have a number of highly competitive suppliers and buyers operating within a framework that provides for a wide range of contract types and length. There are active aggregators and brokers, who bring together otherwise diverse sale and purchase requirements. Within these broader gas markets, dynamic short term markets have developed allowing buyers and sellers to deal with discrepancies between their contractual and actual usage quantities. Futures exchanges allow producers to sell, and customers to buy, their gas months ahead of actual production or supply and hedge against price fluctuations. Gas storage facilities exist near major consumption centres allowing producers and retailers to bring gas close to the point of use during times of low demand in order to sell in peak times. Storage also allows producers who are not currently able to find a buyer for their share of jointly produced gas to build up a marketable parcel or to wait for the right opportunity to sell.

The Commission recognises that the gas market in the Northern Territory is comparatively small and immature and may best be described as a ‘contract’ or ‘project’ market, where gas is only produced to meet specific contractual obligations such as the Gasgo Agreement. In such circumstances, if one producer within a joint venture wins a contract to supply, but others do not currently have buyers for their share of the gas produced, the question arises of what they are to do with their gas. In addition, it is argued that for large contracts, it is necessary to combine the production owned by each joint venture party to guarantee sufficient supply.

In other markets, these problems have been addressed through the use of borrow and loan arrangements between the various joint venture participants and/or the development of storage facilities. However, there is currently no storage available in Northern Territory and the producers submit that borrow and loan arrangements are complex and would result in additional reserves risk and facilities risk.

In the NWS Determination, the Commission noted that the balancing arrangements used in the UK and USA are typically used to deal with short term and relatively small volumes of gas. However, the present circumstances in the Northern Territory in which there is in effect only one major customer and one supplier of gas, would require balancing agreements to support separate marketing to be long term and of substantial volume.

For these reasons, the Commission accepts that separate marketing of gas in the Northern Territory by the Mereenie Joint Venture participants may not currently be feasible given the relatively small and immature market.

Nevertheless, the Commission does not accept all the arguments put forward by the applicants regarding the justification for continued co-ordinated marketing practices. In particular, the Commission rejects the assertion that gas jointly produced by joint ventures will invariably be sold on common terms to purchasers, including price, and that this will continue in Australia for the foreseeable future. The experience in other countries is evidence that separate marketing is not incompatible with joint production and suggests that the feasibility of separate marketing is more directly related to the operation of the market overall rather than the production arrangements.

As the gas industry expands and develops in the Northern Territory and other parts of Australia, the Commission believes that there is potential for separate marketing to become viable. In the NWS Determination, the Commission identified examples of potential market developments which it considers would increase the likelihood that separate marketing will become viable:

- a significant increase in the number of customers;
- the entry of new competitive suppliers;
- additional transportation options;
- development of storage facilities;
- the entry of brokers/aggregators;
- the creation of gas-related financial markets; and
- the development of substantial short term and spot markets.

The Commission and the applicants agree that nothing in this authorisation should prevent or hinder the development of a more dynamic gas market in the Northern Territory that would support separate marketing of gas by joint venture producers. Should any conduct of the Mereenie Producers that is authorised be shown to prevent or hinder the development of the gas market in Northern Territory in this way, the Commission may review the authorisation under section 91B of the Act.

6.2.3 Take-or-pay provisions and pre-emptive rights

During the authorisation process, interested parties have highlighted to the Commission the existence and operation of the pre-emptive right that is contained in the Original GPA contract between the Mereenie Producers and Gasgo. The effect of this right is that should any party, with the exception of Gasgo, seek to purchase gas from the Mereenie Producers, that negotiated tranche of gas must first be offered for sale to Gasgo thus potentially enabling Gasgo to prevent gas sales by the Mereenie Producers to third parties. The basis for the pre-emptive right as described by the NT Government is contained in a confidential submission and therefore cannot be disclosed within this *Determination*. In response to the concerns raised by interested parties regarding the pre-emptive right, the applicants submit that the issue is irrelevant for the purposes of the Commission making its determination in respect of the present authorisation applications.

In its overall assessment of the balance between public benefit and detriment, the Commission considers that it is relevant to consider whether the pre-emptive right may limit the benefits that would otherwise flow from the Gasgo Agreement and/or whether the pre-emptive right may increase the potentially anti-competitive effects that are likely to result from the performance of the Gasgo Agreement.

The Gasgo Agreement has the effect of providing for a further tranche of gas to be sold by the only effective gas supplier in the Northern Territory to Gasgo to supplement gas previously contracted for under the Original GPA and MSA1 agreements. As submitted by the applicants, the gas secured under the Gasgo Agreement is not insignificant as a proportion of the total amount of gas secured under gas sales agreements in the Northern Territory.

The applicants seek authorisation to give effect to the Gasgo Agreement in its entirety and not for specific provisions that may be at risk of breaching the Act. Notwithstanding the scope of the applications, the particular elements of the Gasgo Agreement which may raise competition issues include the take-or-pay provisions, the long term nature of the contract (10 years, plus provision to extend the term) and the contract quantity (67.5 PJ, plus provision to increase the contract quantity).

Although the applicants believe that the Gasgo Agreement does not substantially lessen competition, they refer to concerns expressed by the Commission in its AGL Cooper Basin determination concerning the anti-competitive detriment that may be associated with long term take-or-pay contracts. The applicants also quote from the Tribunal's determination, in which it stated:

> A distinction can be drawn between those long term contracts that are necessary to sustain substantial, long-lived, sunk investments ... and those long term contracts that create no such social utility but are, rather, an instrument of foreclosure.[109]
>
> For small markets, containing very few contestants ... and with large capital investments in relation to the size of the markets concerned, vertical agreements can have a foreclosing effect.[110]

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109 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593, at 44,216.
110 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593, at 44,217.

Notwithstanding its decision not to revoke the authorisation of the AGL Cooper Basin arrangements, the Tribunal expressed concern at some of the provisions of those arrangements, notably:

- the exclusive dealing clause;
- the first right of refusal clause; and
- the take-or-pay provisions.

With the exception of the take-or-pay provisions, the Gasgo Agreement does not contain similar provisions.

In its review of the AGL Cooper Basin gas supply arrangements, the Tribunal accepted the need for a long term commitment by AGL to purchase gas to generate cash flows to cover financial commitments and a sufficient return to justify the initial investment of the project. Nevertheless, the Tribunal queried the need for long term contracts to contain take-or-pay provisions[111] rather than an alternative pricing structure, such as a two-part tariff. The Tribunal stated:

> ... some protection to future cash flows is required, though not necessarily in the form of a take-or-pay contract and, moreover, one with a relatively high take-or-pay requirement.
>
> There are more economically efficient ways to assure cash flows, in particular the use of a two-part tariff, that is to say, a contract with a 'standing', 'reservation' or 'capacity' clause coupled with a per unit price for the quantity of gas purchased, to reflect the marginal cost of supply.[112]

The applicants state that they consider that a two-part tariff is essentially the same as a take-or-pay structure, on the basis that in both cases the customer pays for the reservation of capacity irrespective of the volume of gas supplied. Moreover, the applicants state that the operating costs at Mereenie are mainly fixed in nature. Under take-or-pay provisions, the ability of the purchaser to extend the term of the contract to take banked gas is considered by the applicants to be an advantage over two-part tariffs.

Taking account of the statements made by the Tribunal on this issue and by the applicants and interested parties during this authorisation process, the Commission considers that the combined effect of the terms of the Gasgo Agreement, including the take-or-pay provisions and length of contract, would be unlikely to result in the anti-competitive detriment outweighing the public benefits in a competitive market.

However, the market for the supply and sale of gas in the Northern Territory is characterised by a sole gas producer and one dominant purchaser which holds a pre-emptive right over the supply of gas to other potential purchasers. These circumstances are not suggestive of an open competitive environment. Moreover, the contractual volumes under the Gasgo Agreement are not insignificant in terms of the total market in the Northern Territory. The existence of a pre-emptive right in the Original GPA has the potential to hinder or prevent the entry of additional buyers seeking gas for internal use or resale and gas for the generation of electricity and subsequent retail sales in the Northern Territory.

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[111] Under a take-or-pay clause the purchaser agrees to pay for a certain percentage of the total contract quantity irrespective of whether it is used. The contract may also contain 'banking' provisions which allow gas paid for but not used to be used in subsequent periods.

[112] *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593, at 44,218.

As outlined above, issues that originate outside the conduct for which authorisation is sought, such as the pre-emptive right, are considered insofar as they impact on or alter the balance between public detriment and benefit arising from the Gasgo Agreement.

Section 90(6) of the Act requires the Commission to consider the 'detriment to the public' constituted by any lessening of competition resulting (or likely to result) from the proposed conduct. The effect that the provisions of the Gasgo Agreement will or are likely to have on competition will depend upon the state of existing and anticipated competition within the relevant market. The Commission considers that the pre-emptive right is relevant to assessing the level of competition.

Notwithstanding the arguments raised by the applicants, the Commission considers that the Gasgo Agreement and pre-emptive right attached to the Original GPA do operate together in the sense that the existence of the pre-emptive right is likely to increase any anti-competitive effects that are likely to flow from the other contracts negotiated by the Mereenie Producers including the Gasgo Agreement. Accordingly, the Gasgo Agreement cannot be considered in isolation from the provisions of the Original GPA.

The Commission is concerned that the Gasgo Agreement, in association with the pre-emptive right contained in the Original GPA, has the potential to prevent or hinder the entry of new gas purchasers who could compete in downstream markets, such as electricity wholesaling and retailing, by limiting the availability of gas for supply in the Northern Territory. This is particularly relevant given the limited number of electricity suppliers in the Northern Territory and the high price paid by consumers for this product relative to the Australian average.

The Commission considers that the non-exercise of the pre-emptive right to date does not in any way reduce the competition concerns raised by the right nor justify its continued existence. Power Facilities notes that the pre-emptive right requires the disclosure to Gasgo of the terms and conditions of any potential supply contract between the Mereenie Producers and a third party. The mere existence of the pre-emptive right may potentially deter entry by alternative gas buyers and suppliers of electricity into the Northern Territory markets and therefore the impact of its existence cannot be discounted.

The Northern Territory Government argues that the pre-emptive right is necessary to ensure that adequate gas supplies are available to generate electricity for the Northern Territory. However, it is arguable that in this case Gasgo's gas supply is secured contractually via the three supply contracts Gasgo has negotiated with the Mereenie producers and that the further protection afforded by the pre-emptive right is not justified. As a general principle, the Commission is opposed to the use of any pre-emptive right that potentially limits competition directly or via related markets for incremental supply above the contract quantities contained in the contract in which the right originates.

For these reasons, the Commission considers that, when compared with the likely future situation if the Gasgo Agreement were not put into effect, the detriment to the public constituted by the lessening of competition that would be likely to result from the performance of the provisions of the Gasgo Agreement, in particular the take-or-pay, length of the contract and quantity of gas contracted, is significant. This detriment is greater than it would be if the pre-emptive right contained in the Original GPA did not exist.

6.3 Public benefits

Although public benefit is not defined in the Act, the concept of public benefit is given a wide ambit and may encompass any conduct that produces direct or indirect benefits to the Australian public. Private benefits that accrue to the applicants or some other limited group are not relevant unless they also have a beneficial impact on the public at large. Moreover, general statements about public benefits should be supported by factual material.

Public benefits arising from the Gasgo Agreement need to be distinguished from public benefits that may have arisen from, and do not extend beyond, the previous supply contracts and associated investment in the Mereenie field. When assessing the public benefits, the Commission needs to consider public benefits emanating from the Gasgo Agreement itself. Public benefits associated with past investments will be largely irrelevant, unless it can be demonstrated that continuation of those benefits is contingent on the conduct for which authorisation is sought.

The Gasgo Agreement is one in a series of three contracts for the supply of gas to Gasgo and ultimately resale to PAWA for the generation of electricity. The applicants and the Northern Territory Government in particular have submitted that the supply of gas has generated considerable public benefits to the economy and society of the Northern Territory. They state that the Gasgo Agreement builds on previous contracts and will ensure a continuation of those benefits. While not doubting those claims, the Commission is required to consider the public benefits emanating from the Gasgo Agreement itself.

Many of the benefits claimed may be considered as 'sunk' and not directly related to the Gasgo Agreement. The benefits arising from the investment in infrastructure, such as gas processing facilitates and pipelines, and the introduction of gas into the Northern Territory have been realised and will continue to be realised even in the absence of the Gasgo Agreement.

Nevertheless, the Commission acknowledges the interrelatedness of the three contracts and that public benefits accrue to the Gasgo Agreement, which is designed to provide (as reasonably as is possible) a continuation of a guaranteed source of supply of gas for the generation of electricity. Currently, the supply of gas to Gasgo is greater than the uninterruptible capacity of the processing facilities. Underpinning the Gasgo Agreement is investment in additional production facilities designed to increase the uninterruptible capacity of the plant.

Gasgo is the predominant purchaser of gas in the Northern Territory. In the absence of alternative buyers, the Mereenie Producers are seeking the assurance that a long term take-or-pay contract gives to underwrite the investment in the additional facilities. Likewise, in the absence of alternative suppliers, Gasgo is seeking the security of a long term contract to ensure the secure supply of gas for the generation of electricity.

The Commission accepts that there is significant public benefit in providing for the continued and secure supply of gas into the Northern Territory over the term of the Gasgo Agreement.

However, Power Facilities argues that the same public benefits would be delivered by a contract with less anti-competitive provisions. Therefore, according to Power Facilities, the claimed public benefits should be discounted by the Commission in its assessment of the applications for authorisation. The applicants dispute this and argue that arrangements with similar provisions to the Gasgo Agreement would have to be implemented for the additional production facilities to be constructed and the public benefits achieved.

An assessment of alternative, potential contracts needs to be undertaken in the context of the state of the market in the Northern Territory. As mentioned earlier, the Commission recognises that the gas market in the Northern Territory is small and can be described as a 'contract' or 'project' market – where gas is produced to meet specific contractual obligations. Accordingly, until the market develops and brokers/aggregators, gas-related financial markets and short term and spot markets emerge, long term contracts such as the Gasgo Agreement may be necessary to underwrite the capital expenditure in infrastructure development.

It may be argued that the long term take-or-pay nature of the contract and the significant contract quantities of gas involved have anti-competitive effects, as they tie the purchaser to the supplier for a considerable period of time. However, in some cases these factors may be intrinsic to the public benefits that derive from long term agreements, such as the Gasgo Agreement. The public benefits associated with the Gasgo Agreement include the construction of additional gas production facilities, additional field development work and the security of an uninterruptible supply of gas for the generation of electricity.

Take-or-pay provisions may be required to generate the cash flows needed to finance investment in the additional facilities and field development work and thereby reduce the risk associated with high capital costs. While take-or-pay provisions may bind the purchaser to the supplier for a considerable period of time, at the same time they discourage opportunistic behaviour on the part of both the supplier and purchaser. In general terms, the risk of the supplier's assets becoming stranded is reduced, as the purchaser is discouraged from seeking alternative suppliers. Likewise, the purchaser is reasonably assured of a stable supply of gas, as the supplier is prevented from supplying scarce resources to alternative buyers.

The Commission notes the comments of the Tribunal in its review of the AGL Cooper Basin gas supply arrangements of the need for a long term commitment by AGL to purchase gas that is sufficient to generate cash flows to cover financial commitments and a sufficient return to justify the initial investment. The Commission also notes the Tribunal's comments that alternative pricing structures, such as two-part tariffs (a capacity charge coupled with a per unit price for the quantity purchased to reflect the marginal cost of supplying gas), are more economically efficient.

The Commission supports the comments of the Tribunal and, generally speaking, is of the opinion that alternative pricing structures may encourage competition at the margin and encourage the purchaser to seek a market for any excess gas rather than bank it. However, the Commission's assessment of the provisions of the Gasgo Agreement need to be considered in light of market conditions in the Northern Territory. The Commission also notes the applicants' comments that the costs of supplying gas are largely fixed and marginal costs are not significant. In the applicants' opinion, little practical difference exists in this case between take-or-pay provisions and two-part tariffs.

In the context of the market situation in the Northern Territory, it is problematic whether alternative pricing structures (which are designed to achieve the same objective of take-or-pay provisions of guaranteeing requisite cash flows) are likely to be significantly less anti-competitive than take-or-pay provisions, particularly when viewed in conjunction with the length of the contract and the quantities involved.

Although Power Facilities expressed concern at the take-or-pay provisions, it did not rule out the existence of similar provisions in any arrangements that it may negotiate for the supply of gas.

In summary, the applicants dispute Power Facilities' argument that, in the absence of the Commission's authorisation of the Gasgo Agreement, a less restrictive contract would be executed and the public benefits would still be realised. The applicants state that the additional investment, which underpins the public benefits, would not proceed on a different basis, but rather the Gasgo Agreement or an agreement with equivalent terms is required. While some provisions of the Gasgo Agreement may be anti-competitive, it is appropriate to examine the net public benefit of the whole agreement, as the public benefits of the agreement may emanate from the anti-competitive provisions. The gas market in the Northern Territory today can be described as a 'contract' or 'project' market. Accordingly, long term contracts similar to the Gasgo Agreement may be necessary to ensure the requisite cash flows to underwrite investment and deliver the associated public benefits. However, this is not to say that the situation will not change in future as the market develops.

6.4 Scope of the authorisation

6.4.1 Successors to the authorisation

The applicants are seeking to extend the authorisations (A90637-A90645) to any successor or assign who becomes a party to the Gasgo Agreement in the future. The NT Government expressed concern at this proposal and suggested that recent amendments contained in sections 91A-91C of the *Trade Practices Act 1974* may be a more appropriate method to address the issue if and when it arises.

The matter of extending an authorisation to new parties in the future was considered in the authorisation for the North West Shelf Project. In the Western Australian gas industry there are nine production projects that are already developed as well as a number of undeveloped ventures. While these projects compete to supply gas to numerous customers, the Commission noted in its Determination that there was a degree of common ownership between projects. In addition, the NWS authorisation was sought for the co-ordinated marketing of gas produced and supplied under the Incremental Joint Venture.

Accordingly, the Commission was concerned that extending the authorisation to future assigns and successors to the NWS participants may result in further common ownership between competing projects and increased information flows between these projects. The Commission decided that:

> … any proposal to significantly expand the scope of the joint venture activities or to add or substitute parties should be brought to it for consideration. Otherwise, the producers would potentially enjoy the benefit of an authorisation for conduct that could have marketplace effect equivalent to a substantial merger of interests between producers supplying gas or with the potential to supply gas in WA, while not technically falling for consideration as a merger or acquisition.[113]

The Commission noted the arguments raised by the NWS applicants for granting the authorisation pursuant to section 88(10) of the Act but concluded that the most appropriate course of conduct would be to limit the authorisation to the present applicants. Any changes to the parties involved in the NWS Project could be addressed by the Commission through the application of sections 91A-91C of the Act. These new provisions allow for minor variations, revocation and substitution of authorisations.

In contrast to the NWS, the authorisations sought by the Mereenie Producers would apply only to conduct pursuant to the Gasgo Agreement. At present the only alternative gas field to Mereenie is Palm Valley. In addition, there is no other major buyer of gas as Gasgo (or PAWA itself) buys all the gas needs for PAWA's power stations.

While the Commission shares the concerns raised by the Tribunal[114] regarding the level of concentration of interests at the production level, it considers that limiting the present authorisations to the named applicants and requiring new parties to apply to the Commission for authorisation would be unlikely to affect competition within this authorisation. Accordingly, the Commission accepts the applicants' request to extend the authorisations to their respective successors and assigns.

6.4.2 Term of the authorisation

APIA raised in its submission that it would expect the Commission to place a time limit on the authorisation for co-ordinated marketing if authorisation was to be granted.

The Commission considers that the development of upstream access regimes and changes to acreage management to encourage new entrants will also encourage competition in production and marketing of gas by producers. Whether these reforms occur, and when, impacts on the level of upstream competition over the coming years. This includes the adoption of separate marketing. However, should continued reliance on co-ordinated marketing through a contract such as the Gasgo Agreement become unnecessary then its continuation may hamper the development of a competitive gas industry. The Commission does not consider the indefinite authorisation of co-ordinated marketing between gas producers to be appropriate.

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113 ACCC, *Determination – North West Shelf Project*, 29 July 1998, p. 37.

114 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* (1997) ATPR 41-593.

However, the applicants do not seek an indefinite authorisation term in this instance. The Mereenie Producers have requested that the term of the authorisations be aligned with the term of the Gasgo Agreement. The Commission considers this is the most appropriate term for the present authorisations as they relate to the implementation of that contract. In its *Draft Determination* the Commission proposed that the term of authorisations A90637-A90645 would be until the earlier of 1 July 2009 or completion of delivery of 67.5 PJ.

The Commission has decided that the term of the authorisation will coincide with the duration of the contract to allow, under the current provisions of the contract, for the possibility of, first, the term of the contract being extended to cater for any gas that is still banked after 1 July 2009 and, secondly, any increase in the contract quantity. This does not mean that the term of the authorisation is open-ended, as the both the extension period and the extent to which the contract quantities can be increased are limited. Neither situation should increase significantly the anti-competitive detriment of the Gasgo Agreement.[115]

6.5 Conclusion

The pre-emptive right contained in the Original GPA has been a major consideration in the Commission's assessment of the applications for authorisation for the reasons outlined in this *Determination.* While the Original GPA is not the direct subject of the applications for authorisation, the assessment of the applications has been undertaken in the context of the competitiveness of the gas market in the Northern Territory, which is strongly influenced by the pre-emptive right.

The Commission has considered the applicants' submissions and submissions from other interested parties. While the Commission takes the view that the level of detriment to the public constituted by the lessening of competition that is likely to result from the performance of the Gasgo Agreement is substantial, and that level is greater than it would be if the pre-emptive right contained in the Original GPA did not exist, it has concluded that the public benefits arising from the Gasgo Agreement and the associated marketing arrangements outweigh the likely detriment.

This conclusion was based on a number of factors including information provided by the applicants regarding the ongoing adequacy of gas reserves in the Mereenie field to supply other potential purchasers and Gasgo over and above the gas contracted for supply under the existing contracts and the Gasgo Agreement.

[115] At the pre-determination conference (see Record of conference, p. 5) Power Facilities stated that, according to their calculations based on forecast demand and the various gas supply contracts between the producers and Gasgo, a gap of 20-30 PJ between gas demand and supply (revised to about 40 PJ in Power Facilities' submission 1 February 1999) will emerge over the term of the Gasgo Agreement. Power Facilities expressed concern that the contract quantities under the Gasgo Agreement could be increased to cater for the shortfall and that this, in Power Facilities' opinion, would increase the detriment arising from the Gasgo Agreement. While the precise details of the extent to which contract quantities can be increased under the Gasgo Agreement are confidential, the percentage increase is finite and well below the levels mentioned above.

Power Facilities argues that, if authorisation is granted, it should be conditional on (i) the applicants securing from Gasgo waiver of its pre-emptive right and (ii) that supplies of gas in excess of 1 PJ should reflect the price paid to large users and that the ACCC should arbitrate disputes. However, the Commission cannot impose the conditions as put forward by Power Facilities.

In respect of the first proposed condition, the Commission cannot impose a condition that the applicants cannot unilaterally meet. While the original GPA requires the applicants to offer to Gasgo in the first instance any tranche of gas sought by a third party, the discretion to accept that offer or waive the pre-emptive right rests with Gasgo. The applicants have no authority to require Gasgo to waive its pre-emptive right. In respect of the second proposed condition, the Commission has no legislative power to set prices and arbitrate pricing disputes. In any event, the Commission believes that, where possible, prices should be a matter for negotiation between parties. The proposal itself may be considered anti-competitive and lead to inappropriate pricing outcomes.

In reaching its decision, the Commission also had regard to the applicants' statements that the pre-emptive right has not been exercised to date and statements by representatives of the Northern Territory Government at the pre-determination conference that the pre-emptive right would not be exercised except in the case of a major event where electricity supplies are threatened.

In the event that the pre-emptive right is exercised, the Commission is concerned that the balance between public benefit and detriment may become sufficiently altered to require review of the authorisation under section 91B of the Act. Accordingly, the Commission imposes as a condition of the authorisation that the applicants inform the Commission of any future requests by the Mereenie Producers to Gasgo seeking consent to sell or offer to sell any quantity of gas from the Mereenie field to a third party (pursuant to the terms of the pre-emptive right provision contained in the Original GPA) and the outcome of each such request.

Notwithstanding that the pre-emptive right has not been exercised to date, the Commission is concerned that the very existence of the pre-emptive right is anti-competitive. The pre-emptive right requires the disclosure to Gasgo of the terms and conditions, including price, of any potential agreement for the supply of gas between the applicants and a third party. The Commission considers this in itself to be a barrier to entry to the gas market and to electricity generation. In the Commission's view it is also contrary to the public interest in developing the competitive markets envisaged by the CoAG reforms.

From the information available to it, the Commission considers that the existence and/or the bringing into effect of the pre-emptive right contained in the Original GPA may well be a breach of Part IV of the Act. The Commission has recently brought this concern directly to the notice of Gasgo and is actively considering legal action against Gasgo.

The Commission is adopting this approach as the pre-emptive right is contained in a prior agreement and not the agreement for which authorisation is sought (the Gasgo Agreement). Had the pre-emptive right been contained in the Gasgo Agreement, the

Commission would not have granted the authorisation as sought by the applicants, or at least would not have granted authorisation to those provisions comprising the pre-emptive right.

7. Determination

For these reasons, the Commission grants conditional authorisation for each of the authorisations sought by the applicants to give effect to the Gasgo Agreement for the marketing and sale of natural gas by the Mereenie Producers to Gasgo Pty Limited. Authorisation is granted on the condition that the applicants advise the Commission in writing, within seven days, of:

(a) any request by the Mereenie Producers to Gasgo seeking consent to sell or offer to sell any quantity of gas from the Mereenie field to a third party (pursuant to the terms of the pre-emptive right provision contained in the Original GPA); and

(b) the outcome of each such request.

The duration of the authorisation will be limited to the terms of the Gasgo Agreement, as lodged with the Commission as part of this authorisation application. The authorisation will not apply to any changes to the provisions of the Gasgo Agreement.

The Commission extends this authorisation to the respective successors and assigns of the Mereenie Producers.

This authorisation is made on 7 April 1999. If no application for a review of the determination is made to the Australian Competition Tribunal it will come into force on 29 April 1999. If an application for review is made to the Tribunal, the authorisation will come into force:

- where the application for review is not withdrawn – on the day on which the Tribunal makes a determination on the review; or
- where the application for review is withdrawn – on the day on which the application for review is withdrawn.

Subject to any order made by the Australian Competition Tribunal, interim authorisation is granted for the period:

(i) commencing on 7 April 1999; and

(ii) expiring on the date on which the authorisation comes into force.

Appendix A: Mereenie Producers' interests

Producers and ownership percentages

Mereenie Producers	Ownership (%)
Moonie Oil Pty Ltd	21.00
Magellan Petroleum (NT) Pty Ltd	20.00
Canso Resources Pty Ltd	15.00
United Oil & Gas Co (NT) Pty Ltd	15.00
Transoil Pty Ltd	9.00
Petromin Pty Ltd	7.50
Farmout Drillers Pty Ltd	6.25
Santos Exploration Pty Ltd	6.25

Source: Applicants' submission 2 December 1997, attachment 3.

Appendix B: Submissions

The following parties made written submissions to the Commission:

Australian Pipeline Industry Association

Envestra Limited

Gasgo Pty Limited

Mount Isa Mines Limited

Northern Territory Chamber of Commerce and Industry

Northern Territory Government

Pegasus Gold Australia Pty Ltd

Power Facilities Pty Limited

Appendix C: Conference attendees

Organisation	Name
ACCC	Allan Asher, Deputy Chairman Mark Pearson, Senior Assistant Commissioner, Gas Group Suzie Copley, Director, Gas Group Sydney John Bastick, Industry Analyst Meredith Hooper, Industry Analyst
AGL	Michael McCormack, Manager Regulatory Affairs Pipelines Sandra Dureau, Manager Regulatory Affairs Strategic Support
Envestra	Ollie Clark, Managing Director
Magellan Petroleum	Hedley Howard, Commercial Manager
NT Government	Peter Caldwell, Director, Gasgo John Tarca, General Manager, Gasgo David Anderson, Deputy Secretary, Attorney-General's Dept. Dennis Bree, Ministerial Officer, Minister for Essential Services John Morgan, Allen Allen & Hemsley Jenny Zaverdinos, Allen Allen & Hemsley James Noonan, James Noonan Solicitors Geoff Witham, James Noonan Solicitors
Power Facilities	Paul Everingham, Chairman Jeff Hutchison, Director John Bowman, Director Shane Doyle, General Counsel
Santos	John Anderson, Corporate Counsel Barrie Brandt, Senior Marketing Officer Peter Rose, Freehill Hollingdale & Page