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15 February 2005

Mr Mike Buckley
General Manager
Regulatory Affairs - Gas
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

Dear Mr Buckley

RE: Application for Authorisation of Joint Marketing by PNG Gas Project Participants

Comalco is pleased to accept the opportunity to provide a submission, as attached, in relation to the Application by the PNG Gas Project Participants for Authorisation to jointly market gas for the life of the PNG Gas Project.

If required, we will be happy to address any issues of clarification or subsequent requests for further information.

Yours faithfully

Paul Arnold
General Manager - Gas Projects

Comalco Submission to ACCC on Application for Joint Marketing of PNG Gas

Introduction

Comalco welcomes the opportunity to provide the Australian Competition and Consumer Commission ("Commission") with a submission on the Issues Paper regarding the Application for authorisation by the PNG Gas Project ("Project").

Comalco Limited ("Comalco") is an integrated aluminium producer covering bauxite mining in Queensland, alumina refining in Queensland and Italy, and aluminium smelting in Queensland, Tasmania, New Zealand and Wales. Comalco is a wholly-owned subsidiary of Rio Tinto Limited.

Comalco has had a long association with, and been a supporter of, the PNG Gas Project. This association began in 1997 when discussions began on the supply of gas to Comalco's planned greenfields alumina refinery in Gladstone, Queensland. In July 2003 Comalco reached agreement on a conditional Term Sheet with the PNG Gas Project and Energex Retail Pty Ltd for the supply of gas to the Comalco Alumina Refinery ("CAR"). The Term Sheet is for gas supply over a 20 year term.

Comalco's involvement with the PNG Gas Project also extends through its 38.6% shareholding in Queensland Alumina Limited, which signed a conditional 20 year term sheet for the supply of gas in October 2004. This submission represents the views of Comalco.

Summary of Views on Application

The Commission has invited comment from interested parties on the Application by the PNG Gas Joint Venture Applicants ("Applicants") for authorisation for negotiation on common terms, joint marketing and entering into contracts on common terms for the Project.

The Applicants have requested that this authorisation be granted for the life of the Project defined as "...up to 30 years"[1] and that it be expressly stated to apply to future Participants in the Project.

In summary, Comalco:

- Supports the application for authorisation for the existing Applicants in relation to gas supply contracts entered into up to the time of Financial Close[2]. Comalco believes that the Applicants have not established the case that there are net public benefits from joint marketing for the subsequent 30 year period.
- Submits that the authorisation should be conditional on the Commission requiring appropriate ring-fencing confidentiality arrangements being put in place for ExxonMobil along the lines of the 2000 interim authorisation.[3]

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[1] Application p.5 para 1.8
[2] Comalco accepts the definition provided by the ACCC – see Issues Paper p.9 footnote 3.
[3] R F Shogren "PNG Gas – Application for Authorisation, authorisation No.A40081, Interim Authorisation" letter to Mr M Wilton Deacons 13 October 2000

- Supports the authorisation applying to any future Participants in the Project which do not, at the time of joining the Applicants, market gas to customers from the interconnected pipeline system of which the PNG gas pipeline is part. If the new Participant does market separate gas through these pipelines then a new authorisation should be sought and, if granted, should be subject to the same confidentially arrangements described above.
- Expresses the view that the Commission needs to gain an understanding of the likely access regime before it can assess the effect of the Applicants' joint marketing arrangement on competition.

Questions Raised by the Commission

1. Market Definition

This section seeks to identify the options available to Comalco as a large energy user, when considering the purchase of gas.

Comalco agrees with the Applicants' approach, based on recent decisions of the Tribunal and the Federal Court in two AGL cases[4], that in determining the extent of lessening of competition, the Commission should look at the evolving nature of markets over time. The proper time period which the Commission should examine will be determined by the duration of the authorisation.

When considering the anti-competitive effects of the arrangements, the Commission needs to consider the effect of the arrangement:

(a) On customers such as the calcining operations of alumina refineries for whom there is no obvious fuel substitute for gas;
(b) On refinery customers, who may have a choice between gas and coal for greenfield or additional brownfield steam requirements; and
(c) On customers who have already made a decision to commit capital based on the use of gas for co-generation or other gas-specific purposes.

Given the environmental impact and price of liquid fuels, alumina refineries typically favour gas for the calcining process. Prior to a capital investment decision on steam supply, refineries have a defining choice between coal or gas. While theoretically a refinery could go back to the other option, it would involve additional capital for alternative facilities. If gas co-generation were chosen then the refinery is effectively locked into using gas.

If the Application is granted, then CAR will be faced with joint marketing of PNG gas for an extension of the supply term beyond the 20 year foundation contract. This suggests a much narrower market definition of the gas market in Gladstone. Comalco believes that as a large customer locked into gas, it will not have "...significant countervailing bargaining power"[5].

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[4] See Frontier Economics "Implications of emerging patterns in energy markets for the PNG Joint Venture" Annexure 2 pp1-3

[5] Application p. 45 para 8.4

> With PNG gas proceeding with joint marketing for the life of the Project, Comalco believes that the development of a competitive gas market in Gladstone will be very constrained.

Comalco agrees with ACIL Tasman 's comment on the central Queensland region that "...PNG becomes the dominant supplier in the region..."[6] and ACIL Tasman's conclusion that "CSM Bowen" is supplying only about 15% of Gladstone demand by 2020[7].

2. Feasibility of Joint Marketing

The Applicants argue that:

> "the Australian gas industry lacks the requisite depth and liquidity to support separate marketing, and that there are a number of specific features that require further development before separate marketing could be considered feasible"[8]

Various reports are cited on what is required structurally for the gas market to support separate marketing. Some recent examples of separate marketing are listed and the Applicants seek to differentiate these from their position.

Comalco believes that the examples of separate marketing are an indication of the maturing of the market. It may be early days, but 3 years ago, before any of these separate marketing instances were occurring, joint venture producers were arguing that the market's structural characteristics were such that this would not occur. Another example not listed by the Applicants is Tipperary Oil and Gas (Australia) Pty Ltd which is able to market its share of gas from the Comet Ridge CSM project in central Queensland. It recently announced three new contracts. While Tipperary has completed the marketing, the other JV interests have the right to participate in the contracts based on their pre-royalty revenue interest in the project.

Comalco submits that the Commission should consider how much more the market will change over the next 30 years. Comalco believes that the market is maturing and the entry of PNG gas will hasten this maturing process. This is supported by comments in both the ACIL Tasman and Frontier Economics reports[9]. The latter comments that the Project would:

> "confirm the development of the eastern gas market ... and highlights the value of the Project in the evolution of the gas industry in Australia"[10]

The Parer Report, quoted by the Applicants, commented that all the features of a mature market do not have to be present to support separate marketing[11]. It is difficult on this basis to accept the Applicants' implicit opinion that sufficient, if not all, requirements for a mature market would not be achieved for the next 30 years. It

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[6] ACIL Tasman op cit p.27
[7] ACIL Tasman op cit Figure 33
[8] Application Annexure 7 p.1 para 1.1
[9] Frontier Economics op cit paras 82-85
[10] Frontier Economics op cot para 139
[11] Application Annexure 7 p.5 footnote 15

is confusing to see that the Applicants agree separate marketing can add value[12] but not until beyond 30 years and yet the Application refers to the separate marketing currently underway by Oil Search[13].

Comalco believes that joint marketing for an extended period of time may prevent or at least hinder the development of a more mature market and help sustain market inflexibilities.

Comalco agrees that separate marketing may add to costs for individual Applicants, but submits that this does not necessarily lead to higher prices[14]. Comalco does not support the view that:

> "...separate marketing would not yield any meaningful price competition ...because the Applicants all face the same or very similar cost structures..."[15]

because different risk adjusted rate of return requirements will drive offered prices. The Applicants seem to imply this:

> "Parties such as Oil Search, MRDC and Merlin which have limited experience and/or a relatively small entitlement to Project gas are likely to have little bargaining power with large sophisticated buyers"[16]

Oil Search is showing is its current marketing activities to large customers in PNG and New Zealand that it does not lack the experience to market its large entitlement to PNG gas.

Large customers like Comalco value the comfort provided by reputable companies being involved ensuring the Project proceeds and is constructed on time and then operated to the highest standards. This is a key reason for supporting joint marketing until Financial Close. Subsequent to a successful Project start-up and operation, if Comalco required additional gas it would be willing to engage in discussions on commercial terms with the Participants separately.

In summary, Comalco believes the Applicants have not provided sufficient evidence that the structural impediments to separate marketing will be sustained for the next 30 years. Unless the Commission is satisfied that separate marketing will not be possible for the next 30 years, then the suggested course is to grant a relatively short term authorisation to enable the parties (and if necessary, the Commission) to review the development of the market.

3. Public benefits and anti-competitive detriments and Term of authorisation

Comalco agrees with the Commission view, stated on many occasions, that separate marketing is preferable "[17]. The issue for the Commission is whether the public benefits of joint marketing outweigh the public detriments caused by anti-competitive arrangements.

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[12] Application Annexure 7 p.16 para 19.5
[13] Application pp42-43 para 6.56
[14] ibid
[15] ibid
[16] Application p.34 para 6.15
[17] Merenee Producers - Gasgo Sales Agreement (1999) ATPR (Com) 50-271 at 53,126-7; see also North west Shelf Project (1998) ATPR (Com) 50-269 at 55,747

Comalco agrees that the Project will bring significant benefits through expanding gas markets at reduced prices, particularly in minerals processing industries like CAR. Comalco agrees that the Applicants need the ability to negotiate firm contracts to underpin their decision to invest[18].

By definition, the Project will not reach Financial Close unless the debt and equity providers have a high degree of confidence that their required risk adjusted returns will be met. Comalco agrees that it will be difficult to reach Financial Close without joint marketing. Comalco agrees that the public benefits would outweigh the detriments up to Financial Close.

In the Interim Application in September 2000 the then applicants only sought authorisation until Financial Close[19] to secure the necessary customers to underpin the Project[20]. Now the Applicants submit that the Project will not proceed unless they receive authorisation "...for the life of the Project...[21]" with the contracts entered into subsequent to FEED:

> "needed into the future in order for the Project to reach its required investment return."[22]

It is unclear from the Application what has changed in the interim. The implication is that prices would be higher with joint marketing and this would deliver the required investment return.

It is unclear whether the ACIL Tasman report assumes joint marketing for the life of the Project. The report's methodological approach to measuring Project benefits through the impact of a lower gas price in a general equilibrium model suggests that the Project's public benefits are lower at a higher gas price[23]. The report has not shown what the public benefits would be with/without joint marketing beyond Financial Close.

Comalco believes that this higher return to the Applicants beyond Financial Close is a *private* benefit and submits that this is insufficient evidence provided by the Applicants that this is exceeded by the public benefits. The Commission's approach in these circumstances of private benefits was clearly stated in the Mereenie decision and Comalco supports this approach:

> "Private benefits that accrue to the applicants...are not relevant unless they also have a beneficial impact on the public at large."[24]

Post Financial Close all projects have some residual risk to the equity providers and equity takes this market risk[25].

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[18] Frontier Economics op cot para 25
[19] PNG Gas Project "Application for authorisation to the Australian Competition and Consumer Commission" 12 September 2000 p.1
[20] ibid p.7
[21] Application p. 4 para 1.4
[22] Application para 6.50
[23] There is no evidence provided by ACIL that the price elasticity of demand changes for prices within a reasonable range below the assumed PNG gas price.
[24] Mereenie Producers op. cit at 53,130

Further, if different JV participants have different rate of return requirements, the Applicants are asking the Commission to authorise joint marketing to underwrite the return of all participants at the level of the highest return required by any single participant. There may be participants that may be happy with a lower rate of return that the Applicants implicitly assume would arise with a joint marketing authorisation finishing at Financial Close.

The Commission showed in the North West Shelf case that it had "...grave reservations about issuing open ended authorisations."[26]. The seven year authorisation was approved given the then immature West Australian market but the Commission recognised that the market was evolving and may support separate marketing at some time in the future.

Comalco believes that the eastern states gas market in 2005 is considerably more advanced down the maturity pathway than the Western Australian market in 1998.

In summary, Comalco believes that the public benefits of joint marketing exceed the anti-competitive detriments up to the time of Financial Close. However, Comalco believes that the Applicants have not established the public benefits case beyond Financial Close.

4. Scope of authorisation

Comalco's support of joint marketing up to Financial Close is conditional on appropriate ring-fencing confidentiality arrangements being put in place for ExxonMobil along the lines of the 2000 interim authorisation.

Comalco supports the authorisation covering any future Applicants in the Project which do not, at the time of joining the Applicants, market gas to customers on the interconnected pipeline system of which the PNG gas pipeline forms part. The applicants give the example of the State of PNG that has the right to acquire equity in the Project. Comalco would support this authorisation applying in this case.

However, if a new Participant does, at the time of becoming a Participant, separately market separate gas through these pipelines then a new authorisation should be sought and, if granted, should be subject to the same confidentially arrangements described above for ExxonMobil. This Application gives no reasons for why the project can proceed without Santos' gas, contrary to the application for Interim Authorisation in September 2000[27].

In summary, Comalco believes that the Commission should take the same approach in this matter that it took in the North West Shelf Application on 29 July 1998 (A90624) which limited the authorisation to the named applicants, with the exception cited above.

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[25] Macquarie Bank (2002) "Issues for Debt and Equity Providers in Assessing Greenfields Pipelines" Report to the ACCC p.15.

[26] NW Shelf at 55,787

[27] "PNG Gas Project "application for Authorisation to the Australian Competition and Consumer Commission" 12 September 2000 p.5

Other matters

Comalco is concerned that the competition impacts of this Application should not been seen in isolation from any competition impacts that may arise in the access principles for the pipeline and liquids processing facility in both Papua New Guinea and Australia.

The Applicants comment about the impact of the Project on encouraging other producers in PNG and Australia to tap into the pipeline[28]. However this can only happen with unrestricted third party access to these pipelines in both PNG and Australia.

The previously approved access principles for the Queensland pipeline provided for an exclusion of backhaul services for the first six years that would work against competition for the Applicants. However, the NCC has recommended that the Queensland Access Regime for Gas not be approved as an effective access regime. In any event, there must be some doubt as to whether the PNG pipeline as now configured falls within the derogations to the Queensland Gas Code. It follows that the access regime (if any), which will apply to the pipeline, is uncertain. In Comalco's view the Commission needs to gain an understanding of the likely access regime before it can assess the effect of the Applicants' joint marketing arrangement on competition.

Comalco
15 February 2005

[28] Application p.47 para 9.12