Suite 1, Level 2,
19-23 Prospect St
BOX HILL Victoria 3128
Telephone: (03) 9898 3900
Fax: (03) 9898 7499
Email: euaa@euaa.com.au
Web page: www.euaa.com.au

18 February 2005

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

Dear Mike

EUAA Comments on ACCC Issues Paper PNG Gas Project Application for Authorisation

The Energy Users Association of Australia (EUAA) appreciates the opportunity to provide a submission to the Australian Competition and Consumer Commission (ACCC) on its Issues Paper.

The attached submission sets out our views on the PNG Gas Project Application for Authorisation. The views are formed solely on the basis of what is in the best interests of energy users. The EUAA is uniquely placed to provide the ACCC with such a view, given its involvement in both national and state issues and its position as the national association of energy users.

If you have any queries regarding our comments you can contact Renate Vogt, Manager, Policy and Regulation on telephone number (03) 9898 3900 or e-mail renate.vogt@euaa.com.au.

Yours sincerely

Roman Domanski
Executive Director

Suite 1, Level 2,
19-23 Prospect St
BOX HILL Victoria 3128
Telephone: (03) 9898 3900
Fax: (03) 9898 7499
Email: euaa@euaa.com.au
Web page: www.euaa.com.au

PNG Gas Application for Authorisation

1 Introduction

The Energy Users' Association of Australia (EUAA) is pleased to make this submission to the Australian Competition and Consumer Commission (ACCC) in response to the ACCC's Issues Paper on the PNG gas project application for authorisation.

The EUAA is a non-profit organisation focused entirely on energy issues. Members determine EUAA policy and direction. The EUAA represents a wide spectrum of end-users in all Australian States and has over 75 Members (and growing), predominantly business end-users with activities across all states and many sectors of the economy. Currently, the EUAA has eleven members with Headquarters in Queensland and many other members have business operations in Queensland. EUAA activities cover both national and sub-national issues. [See http://www.euaa.com.au/ for more information on the EUAA.]

The EUAA has, in forming comments to the ACCC's Issues Paper, consulted with a number of our members in Queensland. This will help to ensure that the ACCC is provided with a view on this authorisation, which is relevant to large gas users in Queensland. This should be important to the ACCC, given its charter of promoting both competition and consumer oriented outcomes. It is also consistent with the need for gas market reform to benefit gas users.

The EUAA understands that the joint venture participants in the PNG gas project have applied to the ACCC for authorisation to:

- negotiate the common terms and conditions (including price) under which gas produced by the project will be offered for sale;
- jointly market that gas to a common buyer or common buyers; and
- enter into and give effect to contracts, arrangements and understandings between the participants relating to common terms and conditions (including price and price arbitrations/determinations) upon which gas will be offered for sale and sold by the participants to buyers.

The key issue raised by the ACCC for consideration is whether the public benefits outweigh the anti-competitive determinant for the *joint marketing arrangement.* The applicants have focused on the benefits arising from the project. The EUAA agrees that there are a number of benefits arising from the project *but* that is not the issue for consideration. The applicants should be required to make the case that the public benefits outweigh the anti-competitive determinant for the joint marketing arrangement before the ACCC proceeds with evaluating this application

The applicants claim that the project will not go ahead if the authorisation for the joint marketing agreement does not apply for the life of the project. The EUAA considers this as an unproven claim with insufficient supporting evidence.

We are not convinced that the project will only go ahead on the basis of joint marketing for 30 years and that the application is not simply an ambit claim. The applicants seem to equivocate on this anyway, sometimes saying that the project will not proceed and other times saying it may not proceed, sometimes saying that they need 30 years, other times "long term" authorisation.

The EUAA recognises that joint marketing maybe necessary at this stage to ensure that a sufficient volume of gas can be delivered in order to obtain customers and reach financial close [1]. However the EUAA believes that there is no justification for maintaining a joint marketing arrangement.

If the ACCC authorises this arrangement beyond financial close the EUAA strongly believes the PNG gas producers will, in the medium term, come to dominate the Queensland gas market, dictating the price, terms and conditions to customers. This would be an unfortunate result, as competition would be impeded and the applicants will capture the potential benefits of the project.

In addition, we note that the development of the gas market in Australia over the past decade or so has made lengthy joint marketing arrangements unjustifiable and undesirable. To restrict the development to major new gas field in such a way would be a retrograde step in terms of the future of competitive gas markets in Australia.

2 Definition of the market

The EUAA considers that the market definitions as defined by the applicant are too wide in the context of the PNG gas project. The EUAA believes that if the PNG gas project proceeds under a joint marketing arrangement it will be difficult for gas producers of alternative sources to compete for Queensland customers.

It is expected that the PNG gas project will supply initially up to 200 petajoules of gas per annum to eastern Australia. However, the alternative gas sources such as coal seam methane (CSM) and the Cooper-Eromanga Basin (Cooper Basin) will not provide sufficient competition to match the supply of gas from PNG.

The applicants claim that CSM will be a viable competitor to PNG gas and this will ensure competition for consumers. EUAA believes that while there has been considerable expansion in the CSM production in the last couple of years, the industry is still in its infancy. Bringing in PNG gas will restrict that growth, particularly for CSM's ability to compete for large customer loads. ACIL Tasman commented on this

[1] Financial close is defined as the time when key approvals and agreements required for the project to proceed are obtained and reached. They include conditional sales agreements having been entered into, firm financing having been obtained and regulatory approvals necessary for the project to proceed having been obtained.

issue by stating "…PNG becomes the dominant supplier in the region[2]…" and "….Bowen Basin CSM remains a competitive source". But this at best is applicable to small volumes.

The principle impediment to the growth in the production and uptake of CSM in Australia is the cost of production. In the case of CSM, a supplier's ability to increase (or in fact decrease) production is very dependent on geological factors and significant increases in flow rates are often commercially impractical. [3] Other impediments are deliverability and pipeline infrastructure

In regard to the Cooper Basin, it will only provide limited intra-basin competition. The basin's reserves are expected to taper off in coming years, perhaps as low as 150 petajoules a year by 2019-20.[4] Even if there are sufficient uncontracted reserves, the Cooper basin's competitive position is impeded by high transport costs.

Given this scenario, the PNG gas supply will dominate the market.

The volume of PNG gas supply is not the only potential constraint on competitors. Once customers make the decision to use gas they are faced with limited opportunity to shift to alternative sources such as coal. The reason for this constraint is that contracts are often long-term for up to 30 years and customers have to invest in sunk assets in order to receive the gas supply.

In summary, if the ACCC grant the PNG gas producers an authorisation beyond financial close, the EUAA believes that the joint marketing arrangement will impede competition. Once the PNG gas producers have captured the market, they will be able to dictate the price, terms and conditions. Consumers will have limited ability to negotiate a competitive price or find an alternative supplier. This situation will be exacerbated given that the pipeline will be unregulated and thus not restricted in its practices by any regulatory control.

3 Feasibility of joint marketing

3.1 Is separate marketing feasible for the PNG gas project?

The applicants claim that without the commercial and regulatory certainty of long term authorisation, it will not be possible to attract sufficient customer commitments necessary over the life of the project to justify the substantial costs and the financial risks to the participants.

The EUAA recognises that joint marketing may initially be necessary to ensure that a sufficient volume of gas can be delivered in order to obtain customers and to cover the cost of the investment. However, once the foundation contracts have been established there is no reason why separate marketing is not feasible.

---

2 ACIL Tasman, *PNG Gas Joint Venture Project application authorisation. A40081*, Annexure 4.

3 A. Dickson and K. Noble, *"Eastern Australia's Gas Supply and Demand Balance"*, APPEA Journal 2003.

4 A. Dickson and K. Noble, *"Eastern Australia's Gas Supply and Demand Balance"*, APPEA Journal 2003.

The applicants claim that the institutions providing project financing will require a high degree of security that the project is financially viable. These institutions will get this comfort at financial close and marketing efforts will continue until sufficient firm take or pay contracts are in place to cover debt services requirements.

The EUAA notes that the applicants submitted for the interim authorisation in 2000 that the project would only precede if sufficient volumes of gas were committed to sale in Australia. For this to occur, the applicants needed to:

- discuss, between themselves, the terms upon which they would agree to the supply of gas to foundation customers; and
- negotiate the terms of supply with foundation customers.

At that time, the parties did not seek an authorisation for the joint marketing agreement beyond the financial close of the project. The applicants themselves highlighted only the need for the foundation contracts to be established for the project to go ahead. The applicants have provided no further evidence as to why they now need an authorisation for the life of the project, which is currently estimated to be up to 30 years.

The applicants claim for this authorisation that, without the ability to engage in joint marketing, customers are likely to be concerned about individually contracting with Oil Search, MRDC and Merlin. They state that these companies do not have an existing presence in Australia, and are viewed by customers as being inexperienced in the Australian gas industry and lacking the necessary skills to separately market and supply gas.

The EUAA has had feedback from members in Queensland that this simply is not the case. These members have stated that they are quite comfortable in individually contracting with gas producers. Further, members have argued that inexperienced gas producers can simply contract out services such as the marketing of gas.

3.2 Are you aware of any instances in Australia where separate marketing has occurred?

The EUAA is aware of at least two separate marketing arrangements for the sale of gas in the Australian market. The first arrangement relates to the sale of gas produced from the Minerva gas fields. Santos proposes to sell a ten percent share of gas production from the Minerva field through subsidiary Santos Direct to industrial customers and into the Victorian spot market. Santos stated that having greater flexibility and the option to market separately from the joint venture builds on Santos' commercialisation and marketing expertise to deliver better returns for their shareholders.

In addition to the Minerva gas fields, Tipperary Oil and Gas (Australia) Pty Ltd has entered into a gas supply agreement to be fulfilled by the Company's Comet Ridge coal seam gas project in Queensland. Tipperary and its subsidiaries hold a 75.25 percent capital interest and a 71.7 percent pre-royalty revenue interest in the Comet

Ridge project. The other working interest owners may elect to participate in these gas contracts for up to 28.3 percent of gas deliveries.

Further the best example is provided by the applicants in their discussion of Oil Search's separate marketing on PNG gas. It was recently announced that Oil Search had reached agreement with Mitsubishi and Itochu fore the supply of up to 86 PJ/yr for 20 years for petrochemical plants in Papua New Guinea. Oil Search is also actively marketing CNG to New Zealand. This suggests that Oil Search has considerable marketing skills that could be brought to bear in a separate marketing situation.

The EUAA argues that if these producers are able to successfully separately market the sale of gas in the Queensland market this clearly demonstrates that the Queensland market is developed well enough for separate marketing to work. Given the arguments outlined in the PNG gas producer's application there is no justification for why separate marketing is not feasible in the next 30 years.

4 Public benefits and anti-competitive detriments of joint marketing

4.1 What are the public benefits associated with the arrangements for which authorisation is sought?

The EUAA recognises that there are many public benefits associated with the *project* such as increased competition and increased investment but that is not the issue. The key issue for consideration is whether the public benefits outweigh the anti-competitive determinant for the *joint marketing arrangement,* not the project.

The EUAA considers that the benefit of joint marketing does outweigh the anti-competitive detriment at the point of financial close. The benefit of joint marketing is that it ensures a sufficient volume of gas can be delivered in order to obtain customers and establish foundation contracts. However, once foundation contracts have been established the project can go ahead under a separate marketing arrangement.
The EUAA considers that the only benefit from joint marketing is that it may reduce transaction costs in negotiating with separate producers. However, the anti-competitive detriment where PNG gas producers dominate the Queensland gas market will substantially outweigh the benefits of transaction cost savings.

4.2 What are the anti-competitive detriments associated with the arrangements for which authorisation is sought?

The joint marketing arrangement would lessen competition between participants in the PNG joint venture and between the gas basins. The supply of gas from PNG will dominate the market, as the Cooper Basin reserves rapidly deplete and CSM continues to remain an uneconomic source of major supply. Further, customers are unlikely to switch suppliers in the near future as contracts cover long periods for up to 30 years and customers have to invest in sunken assets in order to receive the supply of gas.

A scenario such as this can only lead to an increase in prices. The price will not be constrained by other producers as claimed by the applicant. In the case of alternative producers such as CSM or the Cooper Basin (whose reserves are depleting) they may not be able to ensure large volumes of supply to customers in the long-term. In order to make up for any shortfall, an alternative producer will need to purchase some gas from the PNG gas producers. In these circumstances, the PNG gas producers would sell to the alternative producer the gas price they charge in the final market. Hence, in order to not sell at a loss, the alternative producer would have to charge a price at least equal to that charged by the PNG gas producers in the final market.

If the PNG gas producers marketed their gas separately this scenario would not eventuate. Each supplier of PNG gas would have to compete for customers, offering more competitive prices, terms and conditions. This would encourage maximum competition and lower gas prices to a level, which would more than offset the higher negotiation costs. This would result in the very benefits that the PNG gas producers claim a joint marketing agreement could achieve.

The applicants claim that, if the PNG gas project did go ahead under a separate marketing agreement:

- customers would not be prepared to negotiate with participants separately; and
- even if customers were prepared to negotiate with participants separately, there is likely to be a significant disparity in bargaining power between the potential large foundation customers of the project and each producer.

The EUAA considers this argument to be incorrect, as Queensland members have stated that they are quite comfortable in negotiating separately. The idea that major producers are potentially vulnerable from sophisticated buyers is questionable given that customers have a limited number of sources of gas to purchase from and so-called inexperienced producers can simply contract out services such as the negotiation of gas. It should also be noted that customers are intermittent players in the market while suppliers are core players who are going to understand their own business better than anyone else.

4.3 Weighing up the public benefits and anti-competitive detriment

The EUAA urges the ACCC to understand that the key consideration is not whether the public benefits outweigh the anti-competitive detriment of the project. The PNG gas project is not the issue for consideration. The issue for consideration is whether the public benefits outweigh the anti-competitive conduct of the joint marketing arrangement.

The EUAA considers that the only benefit from the joint marketing arrangement might be a reduction in negotiation costs in dealing with only one single supplier. However, this benefit is clearly offset by the scenario that PNG gas producers will dominate the market, impeding competition and increasing price.

5 Recommendation

The EUAA recognises that joint marketing maybe necessary at this stage to ensure that a sufficient volume of gas can be delivered in order to obtain customers and to cover the cost of the investment. However, once the project has reached financial close and the foundation contracts are established there is no reason why separate marketing cannot be feasible.

The EUAA considers the Queensland market to be mature enough for separate marketing to take place as illustrated by a number of examples where separate marketing is operating successfully. The EUAA urges the ACCC to consider what the market will look like over the next 30 years and query whether the Queensland market will be so under developed as to require separate marketing. We do not believe this to be the case.

The EUAA recommends that the ACCC authorise this arrangement but only up to financial close. If the ACCC goes beyond this, the PNG gas producers will dominate the Queensland gas market dictating the price, terms and conditions to customers. This would be an unfortunate result, as competition would be impeded and the applicants would capture the potential benefits of the project, which will not flow through to customers.