

COMPETITION ISSUES IN THE AUSTRALIAN GAS INDUSTRY: AN OVERVIEW*

During 1994 significant steps were taken towards structural and regulatory reform of the Australian gas industry. Significant developments during the past year have included:

1. The sale by the Commonwealth of the Moomba-Sydney pipeline system to a consortium consisting of AGL, Petronas and Novacorp.
2. In Queensland, State government tender processes for the construction of new gas pipelines from Ballera (SWQ Gas Centre) to Wallumbilla near Roma and to Mt Isa. At the time of writing, press reports indicate that AGL has been selected as the preferred tenderer to construct the pipeline to Mt Isa and Tenneco has been selected as the preferred tenderer to construct the pipeline to Wallumbilla.
3. In Western Australia, the disaggregation of SECWA resulting in the formation of Alinta Gas and Western Power. The domestic gas sales contract between the North West Shelf joint venturers and SECWA was replaced by separate contracts with each of these utilities and certain industrial customers, and open access principles were developed in relation to the Dampier-Bunbury Gas Pipeline to facilitate open access for industrial customers.

In addition, approval has been given to a joint venture consisting of Wesminco Oil Pty Limited, Normandy Pipelines Pty Ltd and BHP Minerals Pty Ltd to construct the Goldfields Gas Pipeline from the north west of Western Australia to Kalgoorlie with a spur line to BHP Mineral's iron-ore operations at Newman.

4. In the Northern Territory, a spur line was proposed to connect the Alice Springs-Darwin Gas Pipeline to the McArthur River Mine Site.
5. In South Australia, expressions of interest were invited in relation to the sale by the State government of the pipeline assets of the Pipelines Authority of South Australia (PASA).
6. In Victoria the enactment of the *Gas Industry Act* 1994 effected a disaggregation of the Gas & Fuel Corporation of Victoria, creating a distribution entity (GASCOR) and a transmission entity (Gas Transmission Corporation).
7. Following the release of a paper entitled "Creating an Interstate Natural Gas Grid" outlining its vision for the ongoing development of the Australian gas industry, BHP Petroleum announced that it had teamed up with West Coast Energy of the US to conduct a feasibility study in relation to the construction of a natural gas pipeline to link the Bass Strait gas fields to Sydney.

Late in the year it was reported that BHPP had concluded a long-term gas sales contract with Sithe Energies to supply a proposed cogeneration facility in the western suburbs of Sydney.

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On the regulatory front:

1. The Commonwealth government abandoned its proposal to enact the Interstate Gas Pipelines Bill.
2. The *Moomba-Sydney Pipeline System Sale Act* was enacted to facilitate the sale of the Moomba-Sydney Pipeline System, and to provide for ongoing regulation of that pipeline.
3. The Council of Australian Governments (COAG) committed itself to a reform agenda including the removal of regulatory barriers to interstate gas trade, the development of third party pipeline access regimes and corporatisation of government gas utilities by 1 July 1996.
4. The Commonwealth released for comment the draft Competition Policy Reform Bill which was developed in response to the report of the Hilmer Inquiry into National Competition Policy (released in August 1993). Pursuant to this proposed legislation, a new Pt 3A will be inserted into the *Trade Practices Act 1974* to provide for third party access to essential facilities, including gas pipelines.
5. In Western Australia the *Goldfields Gas Pipeline Agreement Act* was enacted to facilitate the construction of the Goldfields Gas Pipeline System. Disaggregation of SECWA was achieved through the enactment of an Act to set up the new Gas Corporation, an Act to set up the new Electricity Corporation, an Act to set up separate regulatory agencies and an Act to vest some of SECWA's powers in the new entity established to handle transitional issues.
6. The Trade Practices Commission (TPC) announced a review under s 91(4) of the *Trade Practices Act* of authorisation number A90424; AGL-Cooper Basin Natural Gas Sales Arrangements.
7. In conjunction with the above review, the TPC requested the Industry Commission to conduct a study into the Australian gas industry. The deadline for submissions to the Industry Commission's Independent Study of the Australian Gas Industry and Markets was 30 November 1994, following which the Commission must report to the TPC.
8. The Office of State Owned Enterprises in Victoria released an information paper entitled "The Gas Industry in Victoria — a Competitive Future", outlining the Victorian Government's reform vision in relation to the gas industry in that State.

The process of structural and regulatory reform outlined above will continue during 1995. During this year:

1. Individual States will review their existing pipeline legislation, and will seek to develop principles for third party access and tariff structures, in consultation with industry. This process will be influenced by the ultimate fate of the Commonwealth's Competition Policy Reform Bill.
2. The Commonwealth is expected to release a further draft of the Competition Policy Reform Bill for public comment. (It should be noted that the Trade Practices Committee and the Resources Law Committee of the Business Law Section of the Law Council of Australia have already lodged submissions in relation to various aspects of the first draft of this legislation.)
3. The COAG meeting scheduled to be held in Adelaide in March will consider whether to sign off on the Intergovernmental Competition Principles Agreement, which was released for public comment following the August 1994 COAG meeting in Darwin. This agreement includes procedures and

- principles relating to structural reform of public monopolies, legislation review, competitive neutrality, prices oversight and access to essential facilities.
4. Sale of the pipeline assets of PASA is likely to be effected.
 5. Construction of the gas pipeline from Ballera to Wallumbilla is likely to commence.
 6. The Australian Competition Commission (ACC) is proposed to replace the Trade Practices Commission effective 1 July 1995.

The legal issues arising from this process of profound change are many and varied. The disaggregation of vertically integrated utilities has spawned a plethora of contractual negotiations in relation to gas supply and gas transmission arrangements. Likewise, numerous contract negotiations have resulted, or will result, from the new pipeline developments and gas supply arrangements outlined above. In addition to these contractual processes, a significant volume of legislative drafting work has been generated to give effect to the reforms.

This brief paper seeks to provide an overview of the range of competition issues which currently confront the Australian gas industry and are pertinent to the changes described above. As attempts to make the gas industry more competitive escalate, these issues are likely to arise with increasing frequency. This is particularly the case as the number of transactions between industry participants increases (including as a result of the disaggregation process) and the reach of competition law expands to embrace entities that previously enjoyed sovereign immunity.

DEVELOPMENT OF THIRD PARTY ACCESS REGIMES COMMONWEALTH

In 1994 the Commonwealth government proposed a third party access regime for services provided by essential facilities as part of the legislative reform package introduced as a result of the Hilmer Report. The Hilmer Inquiry had concluded that the existing provisions of the *Trade Practices Act* were inadequate to deal with the issue of third party access. The proposal regime is to be finalised at the COAG meeting scheduled for March 1995. The government also introduced a third party access regime for the Moomba-Sydney Pipeline in the *Moomba-Sydney Pipeline System Sale Act*.

Moomba-Sydney Pipeline System Sale Act

Part 6 of the Act contains the regulatory provisions for the pipeline system which includes a third party access regime that allows for arbitration by the TPC should the owner/operator of the pipeline and a third party not be able to agree on terms and conditions of access to the pipeline.

Proposed Part 3A Trade Practices Act

Part 3 of the Competition Policy Reform Bill will insert into the *Trade Practices Act* a new Pt 3A which establishes the legislative framework for a national access regime for services provided by essential facilities. Gas pipelines are considered to be essential facilities.

The draft Competition Principles Agreement (one of the inter-governmental agreements that forms part of the Competition Policy Reform package) provides

for similar access regimes to be established by the States. If a participating State or Territory establishes an access regime for a service that accords with the Competition Principles Agreement then that service will not be subject to the national access regime.

The major provisions of the proposed Pt 3A are:

1. The access regime is only applicable to those services provided by facilities that the Minister has determined are declared services. Transmission of natural gas is one of the examples of an essential service that has constantly been used.
2. When a third party seeking access to a service and the owner/operator of that service cannot reach agreement on suitable terms and conditions for access either party may notify the ACC that an access dispute exists and upon notification the ACC must conduct an arbitration and determine the appropriate terms and conditions for access by the third party. There are a number of criteria that the ACC must take into account in making its determination including the level of public benefit, the cost of providing access to the service, existing users' reasonably anticipated requirements and the interests of all persons who have rights to use the service.
3. A determination of the ACC is subject to review within 21 days by the Australian Competition Tribunal and a decision of the Tribunal can be appealed to the Federal Court within 28 days.

STATES

The above regime will not apply to those essential services situated in States and Territories where an access regime has been implemented at a State level. The access regime must however accord with the principles contained in the Competition Policy Agreement. As a result of the proposed national access regime a number of States have decided to introduce their own third party access regulations for natural gas pipelines.

Each State has taken a slightly different approach to third party access and some are further advanced in the introduction of a regime than others.

1. The Gas Council of New South Wales is currently considering issues related to third party access to pipelines within New South Wales and has prepared a public discussion paper. Public comments on this paper were being received until 27 January 1995.
2. In South Australia the government has prepared draft legislation for third party access to gas pipelines as part of the PASA sale process. Many of the provisions contained in the proposed legislation have been taken directly from the Commonwealth government's guidelines for third party access regimes contained in the Commonwealth draft Competition Principles Agreement. Public comment on the draft legislation closed on 18 November 1994.
3. In Queensland and Victoria the respective State governments are currently in the process of developing principles for third party access regimes to gas pipelines in consultation with the natural gas industry.
4. The Western Australian approach to third party access has been to deal with the issue on a pipeline by pipeline basis rather than have one piece of legislation which covers all pipelines, both existing and proposed.

Dampier to Bunbury Pipeline

In August 1994 the WA Energy Implementation Committee published a progress report entitled "*Gas Transmission Access and Pricing Issues for the Dampier to Bunbury Natural Gas Pipeline*". The Committee stated that open access to the pipeline is a pre-condition for a competitive gas market.

The government has proposed a new tariff regime for the pipeline which would allow third parties to have access.

The WANG Pipeline

This pipeline has had non-statutory third party access provisions for some time.

Goldfields Gas Transmission System

The Goldfields Gas Pipeline Agreement contains the third party access provisions applicable to this pipeline system. The major provisions include:

- provision of non-discriminatory third party access to capacity that is not contracted or utilised;
- all requests for third party access to the pipeline are to be reported annually to the Minister and where those requests have not been met the owners of the pipeline are to provide a full explanation as to why they haven't been met;
- there is provision for third parties who are unable to reach agreement with the pipeline owners on third party access to have the matter resolved by the Minister.

MARKET IDENTIFICATION

The concept of markets and market power are central to Pt 4 of the *Trade Practices Act* and any analysis of competition issues arising under that Part.

The question whether, for the purposes of competition analysis, there exists a separate market for natural gas, or whether natural gas is supplied within a broader market for energy products, is unresolved.

This issue would have fallen for judicial consideration had the market dominance litigation between the TPC and Santos Ltd proceeded to hearing in 1993. The question is now being pursued by the Industry Commission in its review of the Australian gas industry and markets.

The issue involves a consideration of the extent to which alternative energy products such as coal, fuel oil, electricity and LPG are competitive with natural gas, and constrain the exercise of market power on the part of natural gas suppliers.

Natural gas is used in a wide range of applications by domestic, commercial and industrial users and electricity generators. With few exceptions, other energy products are available to meet these applications but the degree of substitutability differs depending upon the availability and relative cost of alternative energy sources, the capital cost of plant conversion, the time period over which substitution may take place and the effect of long-term contracts.

In the case of new market entrants and consumers who are in a position to change energy sources there is a considerable body of evidence which suggests that gas faces strong and effective competition from alternative energy products. It is this competition from a range of energy sources in relation to new customers and discretionary users which supports the existence of an energy market.

Conversely, there is a body of non-discretionary gas users, the extent of which varies depending upon the time frame adopted, which supports the existence of a separate market for gas.

In its proceedings against Santos Ltd the TPC contended for the existence of state based natural gas markets in Australia. It remains to be seen whether the Industry Commission will reach the same conclusion, and ultimately whether judicial analysis will support this view.

JOINT VENTURES AND MARKET POWER

Unincorporated joint ventures are common vehicles for the carrying out of exploration, development and production in the Australian gas industry. The reason for this, and the principal characteristics of joint ventures, will be familiar to AMPLA members.

Classically, the scope of a joint venture's activities is confined to those just mentioned and does not extend to the marketing and sale of gas. Each joint venturer typically is entitled to take in kind and separately dispose of its share of the production of the joint venture. In the case of natural gas however, for a variety of reasons which are mentioned below, it has been the practice in Australia (to the writers' knowledge with only one exception) for joint venturers to engage in the joint marketing of the product of their ventures.

Unincorporated joint ventures give rise to a number of difficult competition issues. At the core is the question whether market power is possessed by the joint venture as a whole or by the participants in the venture individually. This in turn gives rise to the question whether individual joint venturers can or do compete with one another in relation to the exploration for and the development, production, marketing and sale of joint venture products.

While the opportunities for competition between joint ventures are apparent, the suggestion that competition (in a market sense) can arise within joint ventures is novel and requires further consideration and debate.

It was contended by the TPC in the Santos case that a joint venturer may exercise and enjoy market power, through its influence within the joint venture operating committee, in relation to operational matters such as the determination and conduct of programmes and budgets covering matters such as development, production, scheduling and processing. Such an approach seeks to equate the degree of influence which a joint venturer exercises (or is able to exercise) over the control and management of joint venture operations with the concepts of market power and rivalry between competitors.

Moving beyond that issue, the question arises as to whether, in the process of joint marketing, individual joint venturers can exercise market power, or whether such power is only exercisable by the group as a whole. This involves a consideration of the joint marketing process, including the requirement in practice that unanimity must be reached prior to the conclusion of any gas sales contract or contracts between joint venture sellers and a buyer involving uniform terms and conditions for each seller.

COMPETITION BETWEEN JOINT VENTURERS

A related and very significant issue is the extent to which it is possible or likely that competition will "break out" between joint venture suppliers in relation to the sale of their jointly produced gas. The question of whether it is

practicable, feasible or likely that joint venture producers of gas will sell in competition with one another is central to the application of Pt 4 of the *Trade Practices Act* to joint venture marketing, and also lies at the heart of current attempts on the part of various regulatory and reform bodies to stimulate further competition within the Australian gas industry.

While a separate paper would be required to fully do justice to this question, for the purposes of this overview it is sufficient to note that there are a number of practical, legal and commercial factors which result in gas which is jointly produced by joint venture parties almost invariably being sold by those parties to a common buyer on common terms and conditions, including price. These factors include:

1. Under the terms of the petroleum legislation and governing joint venture arrangements, joint venturers beneficially own, in proportion to their participating interests, as tenants in common, all joint venture gas production until the gas is taken and separately disposed of. No joint venturer is entitled, at least in the absence of agreement of all the others, to separately produce gas from the area the subject of the lease.
2. Separate or differential production is inconsistent with the co-operative and proportionate approach envisaged by joint venture principles and involves an alteration of the ownership situation in relation to the gas produced.
3. There are problems of "reserves risks" and "facilities risk" associated with consensual "borrow and loan" or "gas balancing" arrangements which significantly diminish the likelihood of joint venturers agreeing to such arrangements.
4. There are major limitations on the volume of gas which can be stored in tank storage, and while gas can be stored in large quantities in underground reservoirs there are costs and risks which detract from the appeal of underground storage.
5. It is very expensive to liquefy natural gas and accordingly pipeline transportation is favoured. Gas in a pipeline moves at a common rate under uniform pressure in a common stream which exhibits common compositional characteristics. Accordingly, gas once produced is generally delivered in a continuous stream to consumers via a pipeline system.
6. Due to the transportation and storage factors mentioned above there is a direct and unbroken relationship between the production of gas and its sale. As a general rule, gas is not produced by producers unless there is a contracted market demand for it.
7. The fact that gas sales contracts typically require the supply of guaranteed volumes over long periods of time generally necessitates joint venture producers combining their entitlements to make up contract quantities.
8. Joint venturers selling to common purchasers eliminates the risk of problems arising due to joint venturers having differing supply obligations, such as may necessitate differential production rates.
9. The selling by joint producers to common purchasers via a single pipeline allows little if any scope for the agreement of differential terms, such as delivery rates or gas specifications. Equally, commercial factors suggest that it is extremely unlikely that either the buyer or any seller would accept differential pricing (ie, the supply by one joint venture producer at a different price to that accepted by the others).

THE "JOINT VENTURE EXCEPTION" IN THE TPA

While on the subject of joint ventures, it should be briefly noted that the Competition Policy Reform Bill proposes a minor amendment to s 45A(2) of the *Trade Practices Act*. This is the section containing the so called "joint venture exception" to the operation of the *per se* provisions of s 45A, in relation to price fixing.

It has been widely accepted since the inception of the *Trade Practices Act* that s 45A(2) has a very narrow application, as it requires a precise correspondence between the parties engaged in the joint venture production, and the sellers under the joint marketing arrangements. (See, eg, the paper by D G Williamson QC published in [1989] AMPLA Year Book, p 39). The effect of these deficiencies has been to compel joint venturers to seek authorisation under Pt 7 of the *Trade Practices Act* because, on a strict reading, s 45A(2) did not apply to their circumstances. An opportunity now exists through the Competition Policy Reform Bill to seek to broaden the scope of s 45A(2) to overcome some of the deficiencies which have been identified by practitioners over the years.

Problems associated with the section, and which may be overcome by appropriately drafted amendments, include:

1. Joint marketing arrangements are generally not made or arrived at "for the purposes of" the production joint venture, as required by the section.
2. Not all of the production joint venturers will necessarily be parties to the joint marketing arrangements, as required by the section.
3. There are a number of circumstances in which the supply of joint venture product will be effected other than in proportion to the interests of the parties in the production joint venture, such as where one joint venturer does not join in the sales arrangements, or where disproportionate entitlements arise as a result of the operation of default or non-consent provisions.
4. There are numerous circumstances under which the product which is collectively marketed cannot be accurately described as goods jointly produced by the parties in pursuance of their joint venture. This will be the case, eg, where goods produced by a number of production joint ventures are processed (and physically commingled) through a common processing or transportation facility. This issue will become more pronounced as third parties increasingly seek to negotiate access to processing or transportation facilities owned by others.

These matters are the subject of a detailed submission which has been made to the Commonwealth by the Resources Law Committee of the Business Law Section of the Law Council of Australia, in support of a widening of the scope of the section.

OTHER IMPEDIMENTS TO THE DEVELOPMENT OF COMPETITIVE MARKETS

The following is a list of additional factors influencing the operation of competitive processes in the Australian gas industry.

1. *State regulation*: Historically, State governments have exerted considerable regulatory influence and control in relation to the gas industry at every level. In addition to State-based licensing and operational controls under the petroleum legislation, State governments have sought to regulate gas pricing

and the interstate sale of gas (a factor identified by numerous observers and commentators including Professor Hilmer as an impediment to free and fair trade). The fact of State ownership of petroleum resources, coupled with the natural inclination of State governments to seek to provide first and foremost for the gas consumption needs of their own States, would appear to guarantee a continuing influential role for State governments in the regulation of the industry, possibly in conflict with national policy objectives.

2. *Monopsony purchasers:* The aggregation of market demands under single utilities such as AGL and the Gas & Fuel Corporation of Victoria facilitated the development of major gas fields such as the Cooper Basin and Bass Strait fields. The interposition of these large utilities has acted as a counterweight to the market power of gas producers, however in recent years there have been increasing calls for consumers (particularly large industrial customers) to have "direct access" to contract with gas producers. Recent developments in Western Australia are indicative of processes which are under way in other States including South Australia, Victoria and New South Wales to facilitate such direct access. The development of third party access rights in relation to gas pipelines is integral to this process.
3. *Long term sales contracts.* The development of the Australian gas industry has been characterised to date by long-term sales contracts typically of 20-30 years duration. Such contracts were required to support the very high cost of field development and pipeline construction and to provide an impetus for further exploration to discover and prove up additional gas fields to meet growing market demands. As a consequence however, significant volumes of existing gas reserves in Australia are now committed under such contracts to large utilities such as AGL and GFCV, and are not available for supply to third parties. A significant issue confronting would-be reformers of the Australian gas industry is how to procure a breaking up of these long-term contracts to facilitate a more "competitive" environment.
4. *Physical and commercial aspects of the gas industry.* Whilst it is not the purpose of this overview to describe in detail the physical and commercial factors which influence the discovery, development, production, transportation and sale of gas, it would be remiss not to allude to them particularly as they tend to distort and frustrate attempts to apply pure economic/competition theory to the gas industry. In addition to those factors mentioned elsewhere in this paper, factors which are relevant include:
 - (a) the vagaries and risks of petroleum exploration;
 - (b) the location of natural gas discoveries relative to markets;
 - (c) the sequential development of gas fields based on market requirements;
 - (d) the relationship between the identification of markets and the development of gas reserves;
 - (e) the relationship between pipelines and markets;
 - (f) the differing qualities of raw gas and, consequently, the differing levels of production and processing infrastructure which may be required;
 - (g) the propensity to form joint ventures for the purposes of risk sharing;
 - (h) the tendency of processing and pipeline facilities to exhibit natural monopoly characteristics (in varying degrees depending upon the cost of developing competing infrastructure relative to the availability and cost of capacity in existing facilities); and
 - (i) the economies of scale which can be achieved by joint development.

These are, on the whole, unchanging features of the industry which will continue to govern the manner of its operation, regardless of any policy-driven reforms.

CONCLUSION

As the above overview has indicated, participants in the Australian gas industry are living in interesting times. The storm clouds of change are building, however it remains to be seen whether they will bring much rain.

The processes of structural and regulatory reform in the industry are part of a much broader reform process which is presently sweeping through the Australian economy. Many of the principles which are being articulated and implemented are quite general and industry non-specific. Consistent with the recommendations of Hilmer, the enforcement of competition policy and the implementation of principles such as third party access have been left in the hands of a general regulator, and the concept of industry specific regulators has been spurned.

Nonetheless, the rhetoric of competition policy reform needs to be fashioned to accommodate the particular circumstances of specific industries. The collision which is currently occurring between the reformist agenda and long standing realities of the gas industry has sparked lively and stimulating debate in industry circles.

The challenge and the opportunity for resource lawyers is to keep pace with this debate and to contribute to it from a perspective which combines an understanding of resource industries with a lawyer's understanding of government policy formulation and legislative and regulatory processes.