Separate Marketing of Natural Gas

Australian Experience

Report to NGC

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May 2003

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EXECUTIVE SUMMARY

We have reviewed the Australian approach to separate marketing of gas in light of the CRA report *Coordinated Marketing of Pohokura Gas – An Economic Analysis,* with particular reference to determinations made by the ACCC, and more recent developments under the umbrella of the Council of Australian Governments.

In general, although the citations included in the CRA report are correct, the ACCC position is somewhat more qualified than the CRA report would lead one to believe. In particular, while the ACCC has authorised joint marketing in the three cases examined here, it has sent clear signals that it considers that separate marketing is likely to become viable in the future in Australia, and in fact may already be viable in some areas. (This is borne out by the emergence of separate marketing of Otway gas by Woodside into Victoria/South Australia.)

In summary, the ACCC:

- considers that separate marketing is superior to joint marketing from a competition perspective, and that the key issue in joint marketing applications is therefore whether separate marketing is feasible in particular cases;
- assesses the feasibility of separate marketing based on the maturity of the gas market, with reference to a list of market characteristics (as cited in the CRA report), on the basis that the more of the identified characteristics are present, the greater the likelihood that separate marketing will be feasible;
- does not appear to look for a level of market maturity similar to that observed in the United States or United Kingdom – indeed in the NWS determination the ACCC indicated that separate marketing may have been viable in other Australian markets at that time.

The CRA report makes no mention of more recent developments, in particular the Council of Australian Governments Energy Market Review in 2002, that take a less restrictive view than the ACCC's market structure test in assessing the feasibility of separate marketing.

The Energy Market Review Panel concluded that not all the features of a mature market need to be present for separate marketing from joint facilities to be feasible. Indeed, it found that if they were, "separate marketing itself would probably only be of academic interest, as a high degree of competition would already be achieved". In addition, some market features (specifically the existence of secondary markets) considered by the ACCC were found to be outcomes of a mature market, rather than prerequisites for separate marketing.

Instead, the Review treated separate marketing as an enabler of competition (subject to practical considerations) that should be encouraged where it can be achieved.

As a result, the Review recommended that future assessments by the ACCC should move beyond the paradigm of whether the natural gas market is a mature market and therefore able to support separate marketing.

With respect to the feasibility of separate marketing, the Review found that, while there are circumstances in which separate marketing is not practical, there are also circumstances where separate marketing is likely to be achievable and appropriate. KPMG, in a report to the Review Panel, found that, *prima facie*, separate marketing is feasible where production is substantially from existing resources, reserves and facilities, but will ***not necessarily*** be feasible for greenfield developments. KPMG recommended that the feasibility of separate marketing for future greenfield developments should be reviewed case by case.

We have identified two examples of separate marketing of new developments that may be relevant to the Pohokura application: Otway in Australia and Corrib in Ireland. Both examples occurred in markets that appear to have a lower level of maturity than implied by the list of market features identified by the ACCC, although in both cases some such features do exist. For example, the spot market in Victoria generates a transparent price that, although imperfect, would provide a basis for joint venture partners to enter into balancing arrangements. In relation to the Corrib example, the gas network in Ireland is connected to the United Kingdom system, which gives suppliers and customers ready access to alternative customers/ sources of gas.

1. INTRODUCTION

A key argument in the CRA report *Coordinated Marketing of Pohokura Gas – An Economic Analysis* ('the CRA report') is that separate marketing of Pohokura gas is not feasible, and that the appropriate counterfactual against which the benefits and detriments of the joint marketing proposal is therefore 'no development'. The CRA report relies heavily on the approach taken to joint marketing of gas in Australia.

The purpose of this note is to review the Australian evidence relied on in the CRA report, and draw conclusions as to the validity of CRA's assessment. Specifically, we:

- outline in section 2, the key Australian material cited in the CRA report;
- discuss in section 3, the context in which the views cited in the CRA report were made, and summarise recent developments in the Australian policy approach towards joint marketing of gas; and
- briefly discuss in section 4, two recent cases of separate market of gas – the Otway basin in Australia and the Corrib field in Ireland.

2. THE CRA ASSESSMENT OF EVIDENCE FROM AUSTRALIA

2.1 Feasibility of separate marketing

CRA considers that separate marketing of gas in New Zealand is 'virtually infeasible':[1]

> *At a minimum, a regulatory prohibition on the coordination necessary for joint marketing would lead to, perhaps indefinite, delay in the Pohokura field's production. Furthermore, it will reduce competition because of the later availability and production of Pohokura gas and the signal it imparts for other exploration ventures that, if gas is found, marketing the gas will be a long, costly and problematic exercise.*

CRA goes on to state that:[2]

> *Our argument does not make any use of the state or structure of the gas production market in New Zealand, excepting the absence of a deep spot market.*

and[3]

> *Our conclusion is implied by the peculiar nature of the industry and the state of the New Zealand gas market. It is also the position on joint marketing of gas in*

1 Charles River Associates (2002) *Coordinated Marketing of Pohokura Gas – An Economic Analysis*, Final Report – Public Version, page 2

2 Ibid.

3 Ibid., page 3.

Australia, where the market characteristics are similar to those in New Zealand. The Australian Competition and Consumer Commission ("the ACCC") has authorised the joint marketing of gas in Australia in all cases in which applications have been made to it; the ACCC has found that separate marketing of gas is "infeasible", and that accordingly production would not commence in the absence of joint marketing.

At page 25, CRA states

The ACCC has found that separate marketing of gas in the various relevant Australian markets is infeasible. While we understand that separate marketing of gas occurs in the USA, the UK and Canada, the gas production markets in those countries are very thick and sophisticated. The ACCC has identified a list of market features that are present in overseas gas markets where separate marketing is the norm:

- *A large number of customers creating a diverse gas demand profile (for example, in 2000, there were 59,478,980 residential consumers, 5,090,586 commercial consumers and 235,064 industrial consumers in the USA)*
- *A number of competitive suppliers (for example, there are approximately 8000 in the USA);*
- *A range of transportation options creating a pipeline grid (for example, in the USA, more than 165 firms operate about 278,000 miles of transmission lines, and more than 1,300 local distribution firms operate in excess of another 700,000 miles of pipeline distribution infrastructure);*
- *Storage close to demand centres (for example, there are 5 liquefied natural gas storage sites in the UK, as well as salt cavities and depleted gas fields);*
- *Brokers/aggregators providing supply and/or demand aggregation services as well as bundled supply packages;*
- *Gas-related financial markets; and*
- *Significant short term and spot markets.*

The CRA report goes on to observe that none of these features currently exist in New Zealand, and takes the view that they are unlikely to in the foreseeable future. In relation to the spot market issue, CRA finds that, even if there were a spot market, separate marketing would continue to be very costly, because of coordination difficulties.

In evaluating the likelihood of a spot market for gas emerging in New Zealand, the CRA report discusses the wholesale gas spot market in Victoria, Australia. CRA notes that the Victorian spot market is very thin in terms of the number of players and quantities, particularly when compared to the US and UK markets (where separate marketing is common). It cites the following comment of the ACCC, made in its 1998 authorisation of the Victorian spot market rules:[4]

However, with limited supply side competition at market commencement the Commission has some reservations that spot sales will be fully competitive. This is because it is initially expected that spot sales will relate to a relatively small amount of gas needed by participants to ensure that they are in physical balance. However, as

[4] ACCC Determination *VENCORP authorisation applications for Market and system Operations Rules,* 198 August 1998, page 23, cited ibid. at page 29.

the industry develops parties may become more willing to buy and sell gas on the day at the spot price.

CRA also refers to a review of the Victorian gas market by VENCORP (the market operator) in 2001, which CRA cites as finding that the matter of limited upstream competition is not an issue that is caused by nor is it solvable solely by implementation of, or changes to, spot market or pipeline access arrangements. According to CRA, the VENCORP review found that the principal determinant of retail gas prices in Victoria is the primary Gascor-BHP/ESSO contract.

2.2 Counterfactuals

In discussing the appropriate counterfactuals to joint marketing of Pohokura gas, CRA states that the ACCC and the Australian Competition Tribunal (ACT) have found that the appropriate counterfactual for competition analysis is "no development", as both bodies have found separate marketing in Australia is not feasible.

Even though CRA contends that separate marketing in New Zealand is virtually infeasible, it evaluates two separate marketing scenarios to support its conclusion that, even if separate marketing were feasible, joint marketing would still deliver net public benefits. In assessing the benefits and detriments of separate marketing Scenario 1, CRA refers to the report of the Upstream Issues Working Group to the Australian and New Zealand Minerals and Energy Council and the Council of Australian Governments in December 1998:[5]

> *Where joint venture production is seen as the most efficient way of undertaking gas developments, the UIWG considers that prohibiting joint marketing could raise the costs and/or increase the risks of entering gas production, where separate marketing is not viable. This could act as a significant barrier to entry and could have a perverse effect on supplier competition by potentially discouraging new parties from entering the industry and by inhibiting the development of reserves.*
>
> *…*
>
> *The UIWG considers that there is merit in arguments presented in a number of submissions that mandating separate marketing under current circumstances could potentially result in an **increase** in gas prices. The view was expressed in a large number of submissions that, given the current immaturity of parts of the Australian gas market, the requirement to market separately would represent a major obstacle to both small players and new entrants into the gas industry. This could restrict supplier participation in the market and the development of reserves, ultimately inhibiting competition.*

[5] *Report of the UIWG to ANZMEC and CoAG*, pages 29 and 30, cited in CRA op cit., page 42.

3. JOINT MARKETING IN AUSTRALIA

In general, although the citations included in the CRA report are correct, the ACCC position is somewhat more qualified than the CRA report would lead one to believe. In particular, while the ACCC has authorised joint marketing in the three cases examined here, it has sent clear signals that it considers that separate marketing is likely to become viable in the future in Australia, and in fact may already be viable in some areas. (This is borne out by the emergence of separate marketing of Otway gas by Woodside into Victoria/South Australia.)

Further, the CRA report makes no mention of more recent developments, in particular the CoAG Energy Market Review, that take a less restrictive view than the ACCC's market structure test in assessing the feasibility of separate marketing.

3.1 Australian Competition and Consumer Commission (ACCC)

The ACCC's current position with respect to joint marketing of gas was established in the Northwest Shelf authorisation (July 1998). Other recent ACCC decisions covering joint marketing of gas are Mereenie and the interim authorisation of the PNG pipeline proposal.

3.1.1 North West Shelf

The CRA report refers particularly to the North West Shelf (NWS) decision, and the list of market features identified by the ACCC for assessing the feasibility of separate marketing. This related to a proposed extension of the existing NWS project. Joint marketing of gas from the existing project was covered by an authorisation granted in 1977.

As a general remark, the position developed in the NWS decision is not as clear-cut as a reading of the CRA report might suggest. A number of the ACCC's remarks were qualified to some extent. The ACCC expressed a clear view that separate marketing is superior to joint marketing, and that as the market in Australia continues to develop separate marketing is likely to become more feasible. The ACCC therefore placed conditions on the authorisation to support the early development of separate marketing. In particular, the authorisation was given a relatively short term of seven years.

The ACCC sent a clear signal that its authorisation of the NWS joint marketing proposal does not necessarily mean that it will authorise further joint marketing proposals in the future. It noted that there was "considerable doubt in the market" that the continuation of co-ordinated marketing into the future is necessary or justified, especially for new projects.

a) Feasibility of joint marketing

The ACCC found that separate marketing is superior to joint marketing from a competition perspective. The central issue in the authorisation turned on whether separate marketing was in fact feasible.

In determining whether separate marketing was feasible, the ACCC relied on the views expressed by the applicants and other interested parties. In addition, it referred to the features of markets such as the United States and the United Kingdom where separate marketing takes place, to develop the list of features cited in the CRA report. However, the list of market features was not presented as a prescriptive or exhaustive list. Rather, the ACCC found that:[6]

> *While it is impossible to be prescriptive about exactly what market features need to develop before separate marketing will become viable in WA, the greater the number of the following list of market developments that are introduced, the greater the likelihood that separate marketing will be viable:*
>
> - *A significant increase in the number of customers;*
> - *The entry of new competitive suppliers;*
> - *Additional transportation options;*
> - *Storage;*
> - *The entry of brokers/aggregators;*
> - *The creation of gas-related financial markets; and*
> - *The development of significant short term and spot markets.*

The ACCC did not suggest that any one of these factors was a necessary pre-requisite for separate marketing, nor that the full list must be achieved before separate marketing would become practical. Instead, it found that these features "all contribute to making separate marketing viable".[7] It concluded that "until ***some*** of those features more commonly associated with gas commodity markets develop in WA, … separate marketing ***is likely to*** remain infeasible" (emphasis added) The qualified nature of this statement suggests that reference to the features of 'commodity' gas markets is intended as a guide and not as an absolute test of whether or not separate marketing is feasible.

We note also that the ACCC did not use the absolute size of the United States market as a benchmark for whether the above factors were present or not, as CRA appears to do on page 25 of its report.

The Commission explicitly reserved its position with respect to future joint marketing proposals in Western Australia, and the feasibility of separate marketing in other parts of Australia:

> *… the Commission believes that there is potential for the WA market to mature and for separate marketing to become viable. Indeed there are signs that it is developing and that over time some or all of the features of the functioning commodity markets we see in the US and the UK may be introduced into the WA gas market.*[8]

and

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[6] Ibid. page v. This list was developed with reference to the United States' market and to the applicants' views on what developments were necessary for separate marketing to become feasible.

[7] Ibid., page iv.

[8] Ibid., page 47.

> *Further, the Commission wants to make clear that the current infeasiblity of separate marketing in WA should not be taken to infer that separate marketing is not viable in other gas markets in Australia. In particular, the Commission considers that many of the factors identified above as pre-requisites for separate marketing can be observed in the south-east Australian gas environment.*[9]

This latter statement appears to contradict CRA's suggestion that "[t]he ACCC has found that separate marketing of gas ***in the various relevant Australian markets*** is infeasible." (emphasis added) [10]

In the course of debate on the feasibility of separate marketing in Western Australia, Santos Limited revealed that joint venturers in one project in which Santos has been involved had reached different terms and conditions for a particular contract. Santos also pointed to other cases in the Cooper Basin where different joint venturers only had similar terms and conditions to each other. However, the ACCC was unable to elicit further information to support these references.

b) The counterfactual

In evaluating the North West Shelf Proposal, the ACCC used a counterfactual in which the proposed expansion would not proceed in the absence of authorisation.

The applicants were of the firm view that the expansion of the NWS project would not proceed unless co-ordinated marketing was authorised. In light of this, the ACCC took the position that, if it found that the proposed expansion of the North West Shelf Project ***could*** proceed without co-ordinated marketing (in contrast to the applicants' position), it would have to demonstrate how this could be made to work.[11] As those opposing the authorisation were unable to supply evidence that the practical difficulties with separate marketing highlighted by the applicants could be addressed, or any satisfactory means of doing so, the ACCC therefore accepted that:[12]

> *… separate marketing of gas in WA by the NWS joint venture participants* ***may not currently be feasible*** *given the relatively immature and large project based nature of the gas market compared with the US or UK markets.* (emphasis added).

The applicants argued that separate marketing would be unlikely to result in effective price competition. The reasoning behind this was as follows. In order to supply large quantities, a joint venturer would most likely need more than its share of gas from the project. To make up any shortfall, a separately marketing joint venturer would therefore need to purchase some from other members of the venture. The price charged for such gas would be the price charged in the final market. Therefore, in order to avoid selling this gas at a loss, the separate marketer would have to charge a price at least equal to that charged by the other joint venturers in the final market. Price discounting would therefore be difficult under a separate

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[9] Ibid., page v

[10] CRA op cit., page 24, ACCC op cit. page 30

[11] These included reduced incentives for substantial infrastructure investment, less reliable supply to customers, greater time and costs associated with negotiations with customers, fewer economies of scale and higher transportation and storage costs. (ACCC op cit., page 30.)

[12] ACCC op cit., page 47.

marketing scenario, and pricing would most likely continue to be at an effective single price.[13]

c) Term

The Commission limited the term of authorisation to seven years, with some exceptions to allow for contracts negotiated during the term of the authorisation but with terms extending beyond the term of the authorisation. The authorisation will expire in all circumstances in 2018 (allowing for a maximum term for contracts negotiated under the authorisation of 20 years).

In deciding on this relatively short term, the Commission took the following considerations into account:

- Ongoing developments in the gas market in Western Australia – the term was based on the timing of a number of expected market developments that were expected to eventuate by 2005.[14] In addition, the Commission expressed the view that policy developments at both the production and secondary levels of the market were "likely to have a substantial bearing on the level of upstream competition in the next decade, and on the capacity of producers in joint ventures to assume the risk (if indeed, in the future, there is any additional risk) of separately marketing their product."[15]
- A concern that, should co-ordinated marketing become unnecessary in the future, its continuation could hamper the development of competition. In its evaluation, the ACCC took the view that:[16]

  > *... as new infrastructure projects … are established in the next few years, these developments will either enhance the degree of competition in the market (if producers' marketing activities are liberalised and if secondary markets develop) or will considerably enhance the concentration of upstream market power if the control of product supply remains centralised.*

  The ACCC explicitly stated that, if the Western Australian gas market develops to the point that separate marketing appears feasible, during the term of the authorisation, the ACCC may review the authorisation.[17] (We are not aware of any proposals to do so at this stage.)
- Consideration of the link between contractual supply arrangements and project financing and appraisal. The extension up to 2018 for contracts negotiated during the term of the authorisation, to provide protection for situations where the joint venture parties had entered into a gas sales contract extending beyond 2005 and containing provisions for renegotiation or redetermination during the life of the contract.[18]

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[13] ACCC op cit., page 31.

[14] Ibid., page 43.

[15] Ibid., page 41.

[16] Ibid., page 34.

[17] Ibid., page 47.

[18] Ibid., page 42.

d) Conditions

The ACCC made the authorisation conditional on the provision of alternate or additional delivery points at the customer's request, and dispute resolution processes to determine any issues that might arise in that regard.

e) Other points of interest

Common ownership

The ACCC noted that the level of actual and potential competition could ***potentially*** be hindered where parties to competing joint ventures have common ownership. However, it took the view that this did not appear to have been an issue to date on the basis that there was no evidence to this effect.

Purchasers' countervailing power

The applicants argued that, with respect to very large quantities of gas, individual or joint purchases would generally have sufficient market power to ensure prices are competitive under a joint marketing scenario. The ACCC did not agree. Instead it took the view that countervailing power can only be exerted where purchasers have the option of backward integrating to supply themselves (or going without gas), and found that "bargaining power at the purchaser level appears to be limited".

f) Context for the decision

At the time of the authorisation the market in Western Australia was still being liberalised. Retail contestability was in the process of being introduced, and was expected to be complete by January 2000 – 18 months from the date of the authorisation.[19] At the time, the North West Shelf Project was the dominant producer of natural gas in Western Australia, with proven reserves of 18,830 PJ. The combined proven plus probable reserves of the other producers in the market at the time amounted to around 870 PJ, although significant undeveloped additional reserves were expected to be brought into production within two to seven years of the decision. (Annual natural gas consumed in Western Australia in 1994/95 was 261.1 PJ.) The NWS joint venture claimed a 66 percent share of gas supplied to the Western Australian market.

Statutory restrictions were in place in the retail market, and were not scheduled to be fully lifted until June 2005. As a result of the phased introduction of retail contestability around this time, a number of individual natural gas supply contracts had been negotiated with large customers – 31 such contracts were in place at the time of the decision. Of these the NWS joint venture had missed out on only one contract in the 24 months preceding the decision. This suggests that not only was NWS the key supplier in the market, but that the level of competition between suppliers was low.

3.1.2 Mereenie

The ACCC took the same approach in the Mereenie case as it had in the NWS case:

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[19] We understand that the introduction of retail contestability has been delayed and is now not expected to be complete until 2003.

- Again it emphasised that separate marketing is to be preferred to joint marketing from a competition perspective, and that the key issue was therefore whether separate marketing is feasible.
- The ACCC rejected some of the justifications for joint marketing put forward by the applicants, in particular the Commission rejected "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."[20] The ACCC stated:[21]

  The experience in other countries is evidence that separate marketing is more directly related to the operation of the market overall rather than the production arrangements.
- In determining whether separate marketing was feasible, the ACCC referred to the same list of market characteristics that it developed in the NWS determination. Again this was not provided as a prescriptive list. The ACCC prefaced the list by stating that it believes that there is potential for separate marketing to become viable as the market in the Northern Territories develops, and the list comprises "examples of potential market developments which [the ACCC] considers would increase the likelihood that separate marketing will be come viable."

3.1.3 PNG

The ACCC has issued several interim authorisations for a proposal to install a pipeline from gas fields in PNG to Queensland, and to jointly market the gas so transported. As the authorisations are interim only, they do not include substantial analysis of the competition issues. There are two points about this case worth noting:

- The most recent interim authorisation (issued on 13 October 2000) is conditional on a confidentiality agreement designed to ringfence joint marketing activities from other operations in Queensland in which the parties have interests.
- The ACCC has stated that, in considering the application for final authorisation, it will focus on whether separate marketing of gas is feasible, as it is "clearly more competitive" than joint marketing.

3.1.4 Submission to the UIWG

The ACCC made a submission to the Gas Reform Implementation Group on Upstream Issues in October 1998.[22] In its submission, it emphasised the following points:

- Intra-basin competition is an important medium- to long-term goal. Inter-basin competition by itself will not be adequate, as this will result in a market(s) with two to three suppliers which is rarely sufficient for a competitive market. Inter-basin competition was viewed as an important first step towards a fully competitive gas supply industry, and a desirable and appropriate short term objective, with intra-basin competition as the medium- to long-term objective.

[20] ACCC, *Applications for Authorisation: Mereenie Producers – Gasgo Sales Agreement*, 7 April 1999, page 33.

[21] Ibid.

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

- The majority of producers the Commission had dealt with up to that date had stated a preference for separate marketing as soon as markets are sufficiently mature.
- A market structure based on 'contract' or 'project' markets, where gas is only produced to meet specific and often long-term contractual obligations (such as in Australia), may create practical problems which mean separate marketing is not feasible.
- Separate marketing is more competitive than joint marketing, and is to be preferred, however the ACCC considered separate marketing was not viable at that time. In its submission, the Commission noted the ongoing evolution of gas markets in Australia and stated that it had identified a list of market features which are present in other gas markets where separate marketing is the norm, including those features referred to in the 1998 North West Shelf authorisation.

The submission also included some discussion of long-term contracts which, while providing some benefits (financial certainty) can also have anti-competitive effects (see page 10). The general tone of this discussion was that the project-focused nature of the market, with its reliance on long term contracts and 'take-or-pay' conditions was a potential barrier to competition developing. For example, in its conclusion, the Commission stated:[23]

> *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…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 … an environment sustaining greater competition between producers, if complemented by upstream reform initiatives in relation to … replacement of take-or-pay by more efficient two-part tariffs.*

3.1.5 Summary of the ACCC's position

In summary, the ACCC:

- Considers that separate marketing is superior to joint marketing from a competition perspective, and that the key issue in joint marketing applications is therefore whether separate marketing is feasible.
- Where separate marketing is considered not to be feasible, uses a counterfactual of 'no development'.
- Assesses the feasibility of separate marketing based on the maturity of the gas market, with reference to a list of market characteristics (those noted in the CRA report), on the basis that the more of the identified characteristics are present, the greater the likelihood that separate marketing will be feasible.
- Does not appear to look for a level of market maturity similar to that observed in the United States or United Kingdom – indeed in the NWS determination the ACCC indicated that separate marketing may have been viable in other Australian markets at that time.

[23] Ibid., page 11.

3.2 Upstream Issues Working Group

The UIWG found, as cited by CRA that where gas markets are immature, prohibiting the joint marketing of gas could raise the costs and/or increase the risks of entering gas production, and so could potentially have a perverse effect on competition.[24] However, the UIWG agreed with the ACCC's argument that separate marketing is more competitive than joint marketing.[25] The UIWG stated that:[26]

> *Whilst parts of the Australian gas market can currently be considered as immature, the UIWG believes that markets are evolving in ways that can support separate marketing by individual joint venture participants. Thus, whilst joint marketing of gas may be appropriate in many Australian gas markets in the short-term, it recommends that* ***the policy objective in this area should be to encourage separate marketing whenever and as soon as this is feasible****.* (emphasis added)

The UIWG recommended that in assessing the actions of joint ventures, the ACCC should give consideration to matters such as the ability of individual participants in joint ventures to market their output separately if they so desire, together with sole risk and pre-emptive rights provisions in joint venture agreements.

The UIWG adopted a similar list of market features to that adopted by the ACCC, that "are usually present in other gas markets where separate marketing is the norm", namely:[27]

- A large number of gas customers, ensuring a diverse gas demand profile.
- The expansion of interlinks between pipelines leading to intensified inter-basin competition, thereby increasing the number of competitive suppliers.
- The existence of gas brokers or aggregators, providing supply and/or demand aggregation services.
- The use of gas storage facilities, close to demand centres.
- The widespread use of borrowing and payment systems, balancing of accounts and other tools by joint venturers that will facilitate separate marketing.
- The existence of spot, secondary and/or futures markets for gas.

3.3 Council of Australian Governments (CoAG) – Energy Market Review

In 2002, the Council of Australian Governments undertook a review of energy market regulation. The issue of separate marketing was considered in a report by KPMG commissioned by the Energy Market Review on *Separate Marketing of Natural Gas in Australia,* and in the final report of the review, *Towards a Truly National and Efficient Energy Market*.

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[24] Upstream Issues Working Group, *Report of the UIWG to ANZMEC and CoAG*, December 1998, page 4 and 30.

[25] Ibid., page 29

[26] Ibid., page 4.

[27] Ibid., page 30 to 31.

3.3.1 KPMG Report

The KPMG report takes a wider view than that taken by the ACCC and UIWG previously. In particular, KPMG emphasises that focusing on market structure alone is unhelpful in deciding whether or not separate marketing is feasible. Key points made by KPMG are:

- The required level of market maturity regarded by some as necessary is such that separate marketing would then be of little use in increasing competition. (page 7)
- Joint marketing by joint ventures is unlikely to assist competition between fields/basins where there is a substantial degree of cross-ownership. (page 11)
- Separate marketing would impact on prices – initially separate marketing would increase costs, but over time it would be expected to result in significantly reduced upward pressure on prices (if not in lower real prices). (page 15)
- The United States market is not viewed as a useful analogy - it is sufficiently mature and liquid that the way in which particular producers market has little impact on the competitive environment. European markets were seen as a better analogy for Australia. (page 16)
- Separate marketing is treated as one of a set of options for increasing competition - separate marketing is not a panacea but may be part of the solution in appropriate circumstances. Other factors are also important. For example, open access to pipelines is already having an impact in south eastern Australia. (page 18)
- An examination of the feasibility of separate marketing needs to be based on more practical criteria than a list of “the hallmarks of market maturity”, particularly:
  - The time horizon. The feasibility of separate marketing for a given joint venture will vary according to the changing stages of development of the joint venture. For example, separate marketing may be less practical for greenfield ventures than for existing joint ventures supplying from existing reserves and facilities.
  - The risk that a producer may face in securing an adequate market.
  - The state of market maturity – not all features of a mature market need be present.
- Producer market risk is dependant on a relevant degree of market maturity, but all (or most) of the features of a mature market do not need to be present for separate marketing to be feasible. If they were, separate marketing would probably be of academic interest, as a high degree of competition would already be achieved. (page 23, 24)

  The process of seeking to define relative market maturity simply by reference to lists of attributes can be akin to self-fulfilling prophecy. For example, the existence, of say, secondary markets, intermediary trading, spot markets and financial hedges are outcomes of a mature market, rather than prerequisites for separate marketing. Separate marketing itself could be regarded as one of the ingredients that in the appropriate circumstances helps to create competition and thereby a more mature market. (page 24)

- When examining the feasibility of separate marketing, the existence of some attributes of maturity will be more important than others. This is partly dependent upon the nature of the market in question. (page 25)

- In general separate marketing is more likely to be feasible where the risk of finding buyers at a competitive price is small. (page 23)
- Separate marketing could erode the development of large scale (greenfield) projects as the extra delay may lead to some customers going elsewhere, and necessary demand threshold therefore not being met, and given the importance of securing markets with significant demand is a precondition for a greenfield development. (page 36) (This presupposes the availability of alternative sources of supply, in contrast to the current situation in New Zealand, where Pohokura is expected to be the only significant source of uncontracted gas post-Maui.)
- Other factors impacting on the feasibility of separate marketing are:
  - Demand growth in the market – this impacts on the ease of obtaining sufficient contracted demand to proceed with a development. (In relation to expansions) KPMG found that, if a growth market is judged by a joint venture to exist, then it should be feasible to jointly proceed with expansion on the basis of separate marketing. (This suggests that separate marketing is more likely to be feasible in the context of demand growth.)
  - The availability of a transparent gas price, which facilitates financial balancing arrangements. KPMG noted that this issue has arguably been ameliorated in Victoria with the availability of an after day spot market price.
  - Supply flexibility - the flexibility provided by gas storage can be provided by other producers in the market, transmission line pack and demand side management via interruptible contracts.
  - Transmission infrastructure - the feasibility of separate marketing is enhanced to the extent that new pipelines are added to the national infrastructure, as this permits access to greater and broader markets. (page 48)
  - Remoteness of gas fields from major demand centres, which reduces the feasibility of separate marketing. (page 37)
- KPMG stated that it did not regard availability of gas storage as an impediment that would prevent the progressive introduction of separate marketing. (page 45)
- With respect to allocation and balancing, KPMG noted that, in Australia, detailed lifting, allocation and balancing agreements exist for separate marketing of oil, condensate and LPGs. Although the product markets may differ, the systems would not appear to be so complex or costly as to be insurmountable obstacles to separate marketing. (page 44)
- KPMG considered the practicality of separate marketing in a range of 'real world' situations. It found that, *prima facie*, separate marketing is feasible where production is substantially from existing resources, reserves and facilities. However, it found that separate marketing will not necessarily be feasible for greenfield developments. KPMG therefore recommended that the feasibility of separate marketing for future greenfield developments needs to be reviewed on a case by case basis.
- KPMG cited examples of separate marketing elsewhere. It stated that: (page 44)

> *A number of the oil and gas companies operating in Australia … already separately market and sell gas production from joint ventures abroad. In one particular case, following European Union initiated proceedings under Article 81(1) of the EC Treaty, ExxonMobil, Shell, TotalFinaElf, Conoco, Fortum and Agip agreed to discontinue all joint marketing and sales activities. The point is not made in respect of the appropriateness or otherwise of separate marketing in that case,* ***but the fact that incumbent producers managed to employ systems to separately market gas****.* (emphasis added)

- KPMG concluded by stating that: (page 51)

  > *We do believe however that significant evolution has occurred in the last decade and that the first step towards encouraging greater competition through separate marketing should now be taken.*

3.3.2 Energy Market Review Final Report

The Report of the Energy Market Review Panel was released in December 2002. Some key points made by the Panel were:

- While it may have been appropriate to exempt joint marketing from the TPA to encourage the original field development, this may no longer be the case. (page 35)
- The objective should be to have producers separately market as much as possible, subject particularly to practical considerations. (page 36)
- Not all the features of a mature market need to be present for separate marketing from joint facilities to be feasible. If they were, "separate marketing itself would probably only be of academic interest, as a high degree of competition would already be achieved." (page 199)
- The existence of secondary markets with associated financial products are outcomes of a mature market rather than prerequisites for separate marketing. (page 199)
- In relation to the market features necessary to support separate marketing, for each gas producing joint venture, some market features will be more important that others in considering the feasibility of separate marketing. (page 199)
- The Panel acknowledged that there are circumstances where separate marketing is not practical. Nevertheless, it found that a number of factors suggest that there are circumstances where separate marketing is likely to be practical: (page 203)
  - The significant differences that can exist between 'greenfield' developments and additional/incremental contracts from existing reserves and facilities
  - The recent public announcements by Woodside that suggest it will separately market gas from a new joint venture development in the Ottawa Basin
  - The stated preference by ExxonMobil to separately market gas but that it considers that technical complexities preclude it in the Gippsland Basin
  - The fact that companies, some of which operate in Australia, manage to satisfactorily allocate and balance production for separate marketing in other countries, albeit in different circumstances
- Overall, the Panel found that separate marketing, where it can be practically implemented, will encourage a more competitive natural gas market. It stated that, "[g]iven the significant evolution in the Australian gas market in the last

decade, the first steps should now be taken toward encouraging greater competition through separate marketing where this can be achieved." (page 204)

- The Panel did not consider that a 'blanket' mandating of separate marketing is appropriate going forward. It recommended that a thorough case by case assessment of each individual situation is the most appropriate means to determine whether there is a net national public benefit in allowing joint marketing from a particular project, and the feasibility of separate marketing in each case. (page 218)
- The Panel recommended that future assessments by the ACCC should move beyond the paradigm of whether the natural gas market is a mature market and therefore able to support separate marketing. (page 218)

3.4 Review of Victorian Gas Market Arrangements

VENCorp, the operator of the Victorian Gas Market, undertook a review of the market arrangements in 2001. While it considered upstream issues to be beyond the scope of the review, issues relating to the upstream market did arise during the course of its process. In its report, VENCorp noted that:[28]

> *A fundamental theme underlying many of the concerns raised by parties during the review was a recognition of the effects of current limitations of upstream competition in gas production and supply …*

and:[29]

> *Access to supplies is a [sic] therefore a pre-requisite for the entry of new retailers and the enhancement of retail competition. Retail competition is more likely to be influenced by limited access to supplies than by any particular features of the transport management regimes. …[The issue of limited upstream competition in gas] is not an issue that is caused by nor is it solvable solely by implementation of, or changes to, spot market or pipeline access arrangements.*

4. EXAMPLES OF SEPARATE MARKETING

We are aware of two recent examples of separate marketing of natural gas that we include here:

- Separate marketing by Woodside of gas from the Otway Basin in Australia.
- Separate marketing of gas from the Corrib field in Ireland.

4.1 Otway

In the case of Otway, Woodside (the major joint venture partner and field operator) has entered a contract to separately sell its share of gas from the Geograph and Thylacine fields in the Otway Basin to a single customer. This gas will be used in the Victorian and South Australian markets. The Victorian market is the largest, and probably the most mature gas market in Australia. A spot market has been in

[28] VENCorp, *Review of Victorian Gas Market Arrangements,* 15 March 2001, page i.

[29] Ibid., page ii.

operation for several years. However, that market is still small and shallow relative to other international markets (particularly the often-cited United States and United Kingdom markets). The Victorian market has some features that have been identified as supporting separate marketing, namely a transparent published spot price, storage capacity, and infrastructure that enables access to alternative customers / suppliers (for example, pipelines linking the market in Victoria to New South Wales). However, in practice the market experiences some limitations:

- VENCorp, in its 2001 review of the Victorian gas market, noted that scale and scope is limited in south eastern Australia by both size of the gas sales market and the industry structure. While being large in Australian terms, the gas market in Victoria is small by comparison with markets in US and Canada where secondary markets for forward trading of capacity rights are in operation.
- Price competition is limited – in practice retail prices (while transparent) are heavily influenced by the Gascor contract.
- There is little depth in secondary markets. VENCorp found that "At this stage there is little depth in secondary markets and they are poorly developed and illiquid in both Victoria and NSW."
- In addition, Victoria has only one main pipeline, one main producer, and one main storage. [30]

4.2 Corrib

The other example, Corrib, is a development off the south cost of Ireland. The joint venture partners sought approval from the European Commission to jointly market their product for the first five years of production on the basis that this was necessary to countervail the strong bargaining power of potential customers. The joint venture partners subsequently withdrew their application, and announced that they would proceed on the basis of separate marketing.

The Bord Gáis (the state owned company responsible for supply, transmission and natural gas in Ireland) claims that Ireland is the fifth most open market in the European Union, with approximately 85 percent of the market open to competition.[31]

On the information available to us, the domestic gas market in Ireland appears to meet only a small number of the market maturity indicators identified by the ACCC. We understand there is one off-shore gas storage facility in Ireland, which came onstream in 2001. However, the Irish gas network is connected to the United Kingdom market, from which it meets a substantial part of its gas demand. This connection appears to provide sufficient ability to balance unders and overs in the market for separate marketing to be feasible in this context.

We understand that the Irish market is also experiencing rapid demand growth, which is one of the factors identified by KPMG in its report to the Australian Energy Markets Review as supporting separate marketing.[32]

[30] VENCorp op cit., page 18.

[31] www.bge.ie

[32] Speed by Peter O'Neill, Head of Gas Division, Irish Department of Public Enterprise "Corrib Gas: - Flagship for Developing the West?, 23 August 2001.