



**Comments to the Australian Competition &
Consumer Commission**

on

**Victoria Natural Gas Access Arrangements and
Applications for Authorisation by VENCORP**

**By
Allgas Energy Ltd.**

March 1998

A. Executive Summary

The establishment of a competitive natural gas industry in Australia has been well recognised as a key element in assuring Australian industry and consumers world competitive energy and feedstock costs. It is also well understood that the development of this market depends intrinsically on the elimination of barriers to competition and unrestricted access to essential infrastructure facilities such as gas pipelines. Such principles have been addressed by the Hilmer Report but their implementation in the gas industry has been slow to non-existent to date.

While the Australian economy is increasingly enjoying the benefits of increased competition in the wholesale and retail electricity markets, it is unclear what kind of gas industry will emerge from this period of unprecedented industry restructuring. A patchwork of unfolding national and state reform initiatives has put the restructuring of the gas industry in motion, but, in our opinion, the gas industry has a long way to go before it begins to resemble electricity, oil, LNG, LPG, coal, and other energy industries. A cornerstone that seems to be missing from the gas industry restructuring initiatives is the lack of a wholesale bulk gas market. The development of a wholesale gas market has been delayed pending the restructuring of existing gas supply and transportation contracts to achieve fair and equitable risk sharing under the proposed new market structure.

B. Introduction

Australia has embarked on a journey to radically change its energy industry. Most would agree that a move to a free and fair energy market would significantly enhance Australia's competitiveness. It has been repeatedly demonstrated that free markets result in an efficient and healthy industry – regardless of the commodity or service of interest. The energy industry is of particular interest since the lowering of energy costs lead to a decrease in the prices of outputs from other industries, thereby strengthening national competitiveness. In the emerging global economy, any and all factors contributing to competitive advantage will have to be exploited.

Allgas Energy Ltd

Allgas Energy Ltd (formerly the South Brisbane Gas and Light Company) was established in 1885 and was the first gas utility serving an Australian capital city to convert from coal derived “town gas” to natural gas. This conversion occurred in early 1969 and was made possible by the underpinning of this pipeline (formerly operated by Associated Pipelines Limited) by Allgas Energy Ltd (“Allgas”) and a new Gibson Island fertilizer plant by Austral-Pacific Fertilizers. At that time Allgas Energy Ltd and Austral-Pacific Fertilizers committed to purchase 29 Bcf and 71 Bcf of Surat Basin gas over a 15 year period and transport such gas to Brisbane on this pipeline. These two contracts provided a minimum basis for the economic construction of the Rome to Brisbane Pipeline (the “RBP”).



Since those early pioneer days, Allgas has continued to be one of the major buyers of gas in Queensland and a major facility user of this pipeline. Furthermore, Allgas' business development initiatives have resulted in the major growth of the Southeast Qld gas market. While most other Australian gas utilities markets reached a plateau in the late seventies or early eighties, Allgas chose to continuously grow its market with such projects as the Gold Coast and Sunshine Coast extensions.

Queensland's Experience

Allgas Energy Ltd's experience with the regulation of gas pipelines by the Queensland Government is rather disappointing. With little to no understanding of the principles behind the development of a competitive commodity market, little understanding of the commercial realities of the gas industry, and no regulatory experience, the Queensland Government has developed and slowly refined its own access legislation over time. Three out of the four existing Queensland gas pipelines have derived their tariffs and access principles under the competitive tendering process. Government, not industry, was the judge of the winning tender. These pipelines were tendered over a three year period and the tariff and access structures vary considerably – a reflection of the changing maturity within Government regarding such matters.

The fourth pipeline, namely AGL's Roma to Brisbane pipeline, were derived from the regulatory processes of the Queensland access legislation. The access arrangements and tariffs applicable to this pipeline, in our view, are at best, poor. Competitive neutrality does not exist and incumbent foundation shippers such as Allgas Energy Ltd are at a severe disadvantage to new shippers. Furthermore, tariffs between foundation shippers vary by a factor of three. Tolls generally are excessive, with average tariffs exceeding those calculated on a cost of service basis by a factor of three. This is totally inconsistent with the 'Foundation Shipper' concept embraced by two of the other pipelines.

Pertaining to the RBP, Allgas has and continues to pay tolls and make capital contributions that reflect the historic regime in Queensland. For security of supply reasons, long-term facility use or transportation contracts were entered into by Allgas for the RBP under a fundamentally different pipeline tariff regime. This regime allowed AGL to charge "what the market will bear". The payments made to date for the service to date and future considerations by Allgas to AGL pertaining to the RBP reflect the past and as such are totally in favor of AGL. The average toll paid by Allgas for service on the RBP far exceeds the proposed reference tariff for either the existing or the expanded capacity. To Grand-father such arrangements and to exclude them in the calculation of AGL's return makes government intervention through regulation counter productive. Incumbents, such as Allgas, who have commercially underpinned the construction of the gas industry as we know it today will be at a severe disadvantage vis-à-vis new entrants who have the benefit of reference tariffs under Access Principles such as these.

Submission

Allgas supports gas reform in Australia generally and open access on gas pipelines specifically. We do not have a strong bias either for or against the contract carriage or the market carriage model. Allgas's objective in submitting these comments is to



continue to participate in the establishment of a competitive gas market in Australia generally and in Queensland in particular. Allgas has a considerable interest in the outcome of gas reform. Allgas has considerable experience with change over its 104 years of existence and has recently recruited senior executives with considerable experience with the restructuring of Victoria's gas industry and in the de-regulation and commoditisation of North America's gas industry.

Allgas hopes that by offering its perspective, it may assist the ACCC in its decision regarding Victoria's natural gas access arrangements and applications for authorisation by VENCORP. Our goal is to accelerate development of Australia's gas market and the efficiency gains that may be realised thereby.

B. Principles for Introducing Competition

While Allgas does not want to debate or take great exception to many of the arguments contained in either BHP Petroleum or the EPD, we have a grave concern that many of the essential elements pertaining to an open access pipeline system in Australia are missing. These include but are not limited to the following:

- Until multiple pipeline paths exist to any market or from any supply basin, tariffs on any given pipeline have to be substantially equal for any given service for any and all facility users
- Capacity release program – for the secondary market to function
- Well defined queuing procedures and advertisements (referred to as “open season” procedures in North America) for expansions and new projects
- Contract flexibility, including flexibility of receipt and delivery points; term; interruptible and firm services offered; back haul, partial haul, and forward haul
- Well defined pipeline to pipeline arrangements for both upstream and downstream facilities both existing and future additions
- Real time access to information (contract flows, capacity constraints, curtailment procedures, availability of capacity and released capacity, etc
- Rules encouraging the development of trading hubs and market centres (pooling points for transactions)

We believe that many of the comments contained in the NERA report submitted on behalf of BHP Petroleum and in the Putnam, Hayes & Bartlett Inc report submitted on behalf of the Energy Projects Division are defensive, self serving, and quite often inaccurate. Although we are most familiar with the contract carriage model, we do not believe that the model selected is as important as capturing the basic principles that lead to the establishment of a competitive market.

Surely the objective is to enable trading of gas to occur at any point during the movement of gas from wellhead to burnertip. Lower prices and better service is but an outcome of reaching this objective. We fully embrace the following comments made by Enron Capital & Trade Resources Corp in a 1996 submission to the



Queensland government titled *Issues in Implementation of Open Access Principles to Natural Gas Pipelines in Queensland*.

The natural gas industry can be broken into several generic vertical components, although the actual nature of these components may vary greatly from one geographic area to another. The physical or operational components are production, gathering, transmission and distribution. Overlaying the operational aspects of the gas industry is marketing or trading – the buying and selling of the commodity, which can occur at any or all points in the physical chain. In a given region, a monopoly may exist at any of these physical stages. Principles such as privatisation and open access can be used to eliminate the monopoly through appropriate legislation and regulation that creatively compels “closed” or essential facilities to provide services to all on a non-discriminatory basis.

This enables trading to occur at any point during the movement of gas from wellhead to burnertip. Trading hubs or market centres can develop; producers receive the benefits of serving multiple, diverse markets and buyers benefit by having a broader choice of supplies and suppliers making way for competitive forces and the development of a commodity market.

In a developed commodity market, willing buyers can find willing sellers to trade on a spot or longer term basis: daily, weekly, monthly, yearly basis or longer. Buyers, who may or may not be the actual consumers, can negotiate for any number of pricing options, allowing the buyer to lock in prices or retain pricing flexibility for the term of the deal. Pricing can be stripped from physical delivery completely, with the gas buyer arranging for deliveries of gas at market prices month after month, and “swapping” his market price for a fixed price or other type of pricing through a financial contract. An options market allows the gas buyer to purchase the right to take gas at his option at a particular time. This affords the buyer an opportunity to contract for one method of peaking service.

Through a combination of physical purchase agreements and commodity derivatives, the buyer will be able to purchase the type of deliverability he needs – base load gas, full requirements, peaking, seasonal load or fuel switching with pricing that can be fixed, indexed, or variable, also according to the buyer’s need. On the other side of the trade, the gas seller (be it a producer, aggregator, or institutional trader), can find markets that fit its economic and operation situation.

Producers can opt to sell all their gas to one user or marketer or can strip out and sell base load production to one or more buyers and then sell excess gas to different buyers for peaking needs at premium prices. Producers can lock in pricing for terms which match their



lender's requirements, thus helping them secure needed financing on favourable terms. The buyers and sellers can meet anywhere in the marketplace – the wellhead, plant outlets, gathering systems pipeline receipt or delivery points, at the inlet of the reticulator or at the city gate or consuming facility.

There are no legal or structural impediments to trading nor does any one market participant enjoy any unfair marketing or purchasing advantage because of its control over any physical asset required to gather, transport or distribute the gas.

Marketers have prepared for guiding principles leading to the development of an open market: competition, comparable access, cost of service and curtailment. These principles have been described in a pamphlet directed to local distribution companies and their regulators in the United States by a group of natural gas marketers this way:

***“Competition:** The best way to ensure that an adequate supply of any commodity is available at reasonable prices is to rely on a workably competitive market. Local distribution companies and public utility commissions must create workable competition in the natural gas marketplace in order to bring the benefits or competition to gas customers.*

***Comparable Access:** For a market to be competitive, numerous entities must be capable of packaging and marketing a competitive product. In the gas industry, the benefits of competition will only be available at the burnertip if local distribution companies make their own capacity – and capacity they control on delivering pipelines – available to others on an equal basis.*

***Cost of Service:** An efficient, competitive market cannot exist unless all services used to bring the product to the point of consumption are priced with due regard to the actual cost of providing the service. Local distribution company rate and service offerings should be reviewed to assure that they are tailored to meet the demands of a competitive market.*

***Curtailment:** In order to avoid distortions in competition, extra-market influences should be circumscribed as possible. Historic gas supply curtailment rules should be revisited to reflect the newly competitive market environment.”*

2.1 Competition

In developing a commodity market for natural gas, competition is the key element, yet the hardest to achieve. Ideally, competition must occur between producers (gas on gas) between marketers, and



between transportation providers. Gas on gas competition can be achieved in several ways. In a producing basin or area, multiple producers or interest owners can compete for markets, even though capacity out of that basin is on a single pipeline.

Different production areas will compete for the same markets, whether or not they are served by a single or multiple pipelines, as long as adequate interconnections exist to move gas across pipelines. Movement can be contractually effectuated through forward hauls or backhauls (displacement). The use of the capacity release program introduces competition for capacity on a single pipeline system. Under this system, shippers which hold firm transportation rights on the pipeline can resell their capacity to other shippers, on a firm or interruptible basis, thus having their capacity compete with capacity held by other firm shippers as well as the capacity sold by the pipeline itself.

Marketers can compete at all locations, provided they have unfettered access to production, gathering, transmission and distribution access. The more places competition can occur along the chain of production-transportation-distribution, the easier it will be for market signals to work and for prices and services to reflect those most valued in the marketplace.

2.2 Comparable Access

In a system where the pipeline or an affiliated marketing entity purchases gas for resale, comparable access levelises the playing field between the owner of the pipeline facility (including its affiliates) and other participants. The facility owner will not enjoy a competitive advantage over would-be competitors for sales or supplies, where those advantages would have derived from the facility owner's inherent ability to control and operate the system or have access to information about markets, supplies or transportation capacity not generally available to others. Achieving this condition requires several things. First, a system must be made available which will allow market-significant facility information to be transmitted to all interested parties on a real-time basis. If, for example, a situation has developed on a pipeline system that will require gas to be shut in immediately, or will require additional supplies be delivered into a market in an emergency condition, all potential shippers should be able to receive that information as soon as the pipeline knows about it, particularly where it will impact their current arrangements.

This information can be transmitted by phone, facsimile or electronic bulletin board. Other real-time information must also be accessible to shippers. They must have access to flow information to determine whether their receipts and deliveries are in balance and



match their nominations. Information about constrained points, available capacity, market and supply conditions that are in the hands of the pipeline or distribution company have to be shared with all the market players.

2.3 Cost of Service

Gas pipelines will, in most cases, represent natural monopolies, as such rate regulation designed to mimic competitive outcomes will be of critical importance. We would submit that cost-of-service regulation or at least a rate cap based on a reasonable return is the appropriate starting point for such facilities. Where a facility is the only one to service a supply area or market, it should be permitted to charge rates which it can justify on the basis of its reasonable costs incurred to provide service to those areas, with a reasonable rate or return allowed. To the extent these facilities do in fact face physical competition from other facilities, those segments of the facilities or points on these facilities can be deregulated, and market rates, that is rates negotiated between the parties at arms-length, can be charged.

2.4 Curtailment

To cover extreme situations, curtailment rules should be developed beforehand to ensure that human needs and property are protected in the instances where either supply or capacity is inadequate to meet market demand. These rules must provide for notice to all parties of emergency conditions as far in advance as possible, procedures for revising nominations, confiscating gas, make-up provisions, and penalties in cases where a party fails to act in a responsible way after receiving timely notice of a critical situation.¹

Competition in gas should evolve around the commodity and associated services (the contestable portion of the industry) and not infrastructure, such as pipelines, which are inherently monopolistic. To do otherwise, distorts the playing field. To differentiate pipeline tariffs between facility users on any other basis than terms of service is undue discrimination. For these reasons concepts such as incremental pipeline tolling have lost in the great debates among regulators and industry participants held over the years in North America. Since the gas industry is held hostage to the physical world of pipelines and gas plants, they should not be allowed to distort in any way the marketing, trading and ultimately the retailing of gas.

B. Queensland Situation

¹ *Issues in Implementation of Open Access Principles to Natural Gas Pipelines in Queensland: Proposal Paper for the Queensland Government* by ENRON Capital & Trade Resources Corp; dated February 1996.



Regarding the southeast gas market of Queensland it is Allgas Energy Ltd's position that the following major impediments to free and fair trade must be addressed concurrently with third party access of gas distribution in Queensland:

- 1. The lack of multiple sellers in the upstream sector of the industry resulting in cartel pricing and anti-competitive long term supply contracts containing take-or-pay and prices that are not market responsive**
- 2. The absence of cost reflective and non-discriminatory tolls on the AGL operated Roma to Brisbane gas transmission pipeline**
- 3. The substantial cross-subsidy of INCITEC's gas cost by both Allgas and the GCQ camouflaged within the bundling of the transportation arrangements from Ballera to Brisbane associated with the three gas supply contracts**
- 4. The substantial cross-subsidy of the tariff or residential demand by the industrial segment**

The first three factors, when combined with the high pipeline tolls on the EPIC operated Ballera to Roma pipeline (characteristic of any new pipeline as it ramps up its throughput volumes), have resulted in an average cost of gas at the Brisbane city gate for Allgas which far exceeds both competing intra-state CSM gas supplies and intra-state gas. This situation is further exacerbated by the unusually high fixed component of the total supply stand-by cost which is charged to Allgas whether or not quantities are delivered and by the lack of regular adjustments to the commodity price to reflect the prevailing market conditions. This price disadvantage is at an order of magnitude which is not manageable under a fully competitive market structure.

While the cost of gas is generally decreasing in Australia as competitive forces strengthen, Allgas' cost of gas at the Brisbane city gate will be approximately 12% higher in 1997/98 over the previous year due to the commencement of the new SW Qld. gas supplies. This price and other contract terms are not justified, given the economics of the development of SW Qld gas fields.

The joint venture marketing of gas by the SW Qld Production Unit and the domination of Santos' interest and concentration of ownership in most of the gas supplies presently capable of supplying long-term gas in Qld results in no intra-basin and little, if any, inter-basin competition. Consequently the terms of the three long-term gas supply contracts recently entered into by INCITEC, Allgas, and GCQ do not reflect in any way those characteristic of an open and competitive market. Numerous anti-competitive barriers are embodied in the contracts including but not limited to the following:

- Escalated commodity pricing based on market bearable conditions with infrequent re-openers
- High Take-or-Pay levels with make-up gas recovery risk
- Downstream delivery points
- Pass through of all mid stream transportation charges to buyer
- Excessively long term vis-à-vis upstream gas development project pay out



- Little pipeline to pipeline interconnection capability
- New pipeline capacity dominated by Santos

These features reflect that historically there has been an absence of a “gas market” in Australia, given that there is normally only one buyer and seller at any given transaction point along the value chain. The value of various contractual terms varies greatly from the “old world” characterised by one seller, one buyer, and one pipeline to the “new world” characterised by multiple sellers, multiple buyers, low barriers to entry and trade, and competitive neutrality – a competitive market.

Although the joint venture marketing of gas by producers has been identified by many including the ACCC as both anti-competitive and unnecessary, little, if anything, has been done to terminate such behavior. In SW Qld most of the proven gas reserves contained in Authorities to Prospect (ATP) 259P and 488P form the SWQGP Unit which was established by regulation under the Petroleum Act of Queensland. However, a marketing agreement between the producers is the subject of an authorisation by the Trade Practices Commission. These exemptions were associated with the commencement in 1994 of 300 PJ’s over a ten-year period and allow Unit members to agree on a single price for gas. There was little to no rationale for the extension of such behavior to the sale of additional gas into the Mt Isa and Brisbane regional gas markets.

In North America the practice of an upstream non-operating joint venture party not marketing its share of gas production in kind is a rare event. The many excuses given by the upstream sector regarding their inability to market gas severally does not conform with the North American experience.

Allgas Energy Ltd has three long term gas supply contracts, soon to phased into one from the SW Qld portion of the Cooper / Eromanga Basin. For security of supply reasons, it has been customary for gas distributors such as Allgas, both in Australia and overseas, to purchase predominantly long-term gas supplies on behalf of their franchise customers. Furthermore, this practice was encouraged by both the Qld Government and the new pipeline owner (previously Tenneco) in order to underwrite the capital expenditures of approximately \$500 million associated with the new upstream and midstream facilities deemed required to bail Qld out of its gas supply shortage crisis. Ironically, it was arguably the expiry of a large long-term contract between INCITEC and its gas suppliers that created the gas supply crisis. Rhetoric about gas shortages from Santos fueled the fire.

In a fully competitive market a large end user such as INCITEC would have a portfolio of gas supply arrangements, including spot gas, and price signals indicating the tightening of supply with demand would have been received by industry well in advance of a crisis. In a similar manner, a commercially driven distributor would purchase a portfolio of gas supplies both geographically and a mix of spot, short term, medium term, and long-term which best matches its portfolio of end users and associated gas contracts. For example U.S. based gas utilities, according to Washington D.C. based Foster & Associates Consulting, currently purchase 30 to 40% of their gas supplies on the spot market and most of the rest under one year contracts.



Given the aforementioned situation, Allgas found the Gas Reform Implementation Group at the meeting held in Brisbane on July 15th, 1997 proposing an obligation by gas producers in the future to unbundle prices to be most interesting. For various reasons Allgas was not offered the option of purchasing SWQGP Unit gas at the Ballera plant gate as was consistent with all other gas purchases by Allgas. The forced bundled solution with embedded transportation costs and cross subsidy costs, among other things, eliminates most, if not all, risk management options that would be normally available to a buyer such as Allgas.

A second major problem facing both Allgas and the rest of the stakeholders in the Qld gas industry is the lack of competitive neutrality and cost reflective tolls on the Roma to Brisbane gas transmission pipeline. Allgas Energy Ltd has been a substantial user of this pipeline since its construction in 1969 and has contractual arrangements in place with AGL which expire in the year 2000. Since there exists but one gas pipeline serving the SE market of Qld, Allgas has again been forced to negotiate with a monopoly for past service on this pipeline and the transportation contracts reflect this predicament. In the past, AGL has charged "what the market will bear" for service and to make matters worse, Allgas has been penalised for growing the market by the imposition of a user-funded incremental charge related to the looping costs of the pipeline. Such a growth penalty has also been proposed in AGL's recent Access Agreement for capacity above the 78 TJ/d level.

Although Allgas has been and continues to be subject to excessive and discriminatory tolls on this pipeline, (INCITEC's consultants have estimated that the Roma to Brisbane toll would be in the order of \$0.30/GJ if operated in the U.S. Allgas does not have any preferential rights to low priced capacity on the depreciated pipeline after the expiry of our transportation arrangements or revenue sharing over the interim – foundation shipper concept. Furthermore, Allgas' new gas supply contract from the SWQGP Unit is based on a city gate delivered price with the associated subleasing of Allgas' current pipeline capacity to Santos over the interim period – 1997 to 2000. This lack of competitive neutrality becomes much worse if AGL is allowed to double their capacity to Brisbane and discount tariffs to new expansion shippers as recently announced in the press.

A basic principle of a competitively neutral market is common tolls for the same type of service on any given pipeline. Pipeline tolls or tariffs should not unduly discriminate against various facility users. The status quo tariff regime of the Roma to Brisbane pipeline unduly discriminates against Allgas due to the incremental tolling structure involving a wide band of tariffs for the same service depending on whether the capacity in question was as originally built, expansion via compression addition, or expansion via looping.

For a gas market to be or become competitive, it has been demonstrated overseas that pipeline services must, at least in the primary market, be readily available on an equal basis. The absence of such competitive neutrality over any given pipeline results in but the displacement of one abusive and dominant market power position for another. Pertaining to the RBP, the dominant position of AGL will simply be replaced by the



facility user(s) holding the lowest cost capacity on the pipeline. A “level playing field” must exist not only between the owner/operator of the pipeline facility (including its affiliated companies) and other market participants but also between the other market participants. In Queensland the only gas pipeline where this principle is in effect is the PG&E pipeline.

A “rolled-in” tariff structure where every facility user or shipper pays the same tariff has been generally adopted in North America after much debate. A deviation from this principle applies only when expansions of an old pipeline are relatively large and thereby would result in a rate shock. Furthermore the posted tariffs in AGL’s third party access principles are significantly less than those charged to Allgas, one of its foundation shippers and a customer of significant capacity for some 28 years.

Given Allgas’ history, it seems to be rather inconsistent with the spirit of gas reform for Allgas to be at a disadvantage vis-à-vis other facility users, both existing and prospective, regarding the use of this pipeline. For competitive neutrality to exist in the gas industry, pipeline tolls must be non-discriminatory and cost-based with no cross-subsidisation among the various users. Costs of pipelines, which vary with distance, should be allocated on a volume and distance basis, with the use of zones as appropriate. This is the basis of the tolls in effect for the PGT Qld owned and operated pipeline in this state.

The Queensland example is offered to remind the ACCC that it is not the model selected that is most important, but rather the implementation of the model! The contract carriage model which underpins the most competitive and sophisticated gas market in the world – that of North America – has been poorly implemented in Queensland to date. In our view, the Queensland regulator was unwilling or unable to heed the advice offered in 1996 by Enron – the undisputed leader in energy reform in North America, if not worldwide.

C. Spot Market

Today Australia’s natural gas industry has significant domestic demand and exports, an impressive portfolio of developed producing supply, and a high-grade resource base by world standards, but no gas ‘market’ yet exists. A fundamental characteristic of any commodity market is the existence of a vibrant spot market. It is difficult to imagine an open market or free and fair trade in Australia for natural gas while such a spot gas market remains absent. The reform sweeping Australia’s electricity industry has focused, among other things, on the establishment of a healthy spot market.

Australia’s gas industry is relatively young and remains immature and unsophisticated in comparison to those gas industries located overseas which have commoditised gas and in some cases also many of the associated activities such as transportation. The genesis of the gas industry of Australia is fairly similar to that of most countries or continents and exhibits the following features: long-term take-or-pay supply contracts between reputable companies; marketing franchises which underwrote the capital expenditures associated with gas supply development, pipeline and distribution



infrastructure construction, and the conversion to natural gas from other energy sources; and a parochial industry containing protected participants.

While such arrangements were deemed necessary to initiate a gas industry, the longer term result is a plateauing of demand, a thin industry, black box pricing, the stifling of investment in the industry, large barriers to entry, cross subsidisation between various market segments, and many more impediments to the development of a market for gas. In Australia this situation has been exasperated by the general lack of interstate trade in gas. The interconnection of each state's supply and demand via a gas pipeline grid is one of the many prerequisites for the development of a gas market in Australia. By most performance indicators the gas industry of Australia is grossly inefficient in comparison to world's best practice. Given its resource position, Australia has the potential to enjoy the benefits of much lower delivered prices to consumers and a much larger robust industry while maintaining healthy upstream, midstream, and downstream sectors.

While Allgas Energy Ltd believes that Australia's gas industry has much latent potential, such potential will only be materially realised if and when a competitive market emerges. The recent privatisation results surrounding Victoria's electricity industry illustrates the aggressive positioning of private companies when there is a high degree of confidence in the market structure of any given commodity. Such confidence has also been displayed historically by those involved in the many commodities that are openly traded on the world market such as oil, copper, ammonia, cotton, etc. While companies involved in such commodities may not like the prices from time to time, they all take great comfort in price discovery, liquidity, contracting efficiency, futures, financial risk management options, etc inherent with a working market. The establishment of a spot gas market in Australia is one of the basic building blocks toward a gas market.

A spot market essentially provides a clearinghouse role. Such a clearinghouse is an efficient mechanism for the closing or settlement of contractual obligations, be they financial, commodity trading, or transportation services. In North America the spot price is extensively used to quickly settle temporary defaults in transportation balancing and firm supply or delivery obligations.

Spot markets are a normal mechanism by which commodity traders reconcile imbalances of supply and demand when, as, and if they occur. For example, spot markets in crude oil, petroleum products, and coal are generally within the range of 15 percent to 30 percent of overall consumption.²

As the gas market of Australia becomes increasingly competitive the value of various positions will change more rapidly than in the past, thereby favouring shorter term arrangements. A portfolio of contracting arrangements which include a sizeable portion of spot enables adequate levels of both liquidity and stability in any given market.

² *Commoditization of North American Gas Markets: Trading Gas - Trading Capacity* paper by Benjamin Schlesinger and Associates, Inc; Executive Enterprises Inc. Natural Gas Futures Conference, September 20, 1993, Houston Texas, page 4.



A second need which a spot market satisfies is an efficient price discovery mechanism. A market must have a physical cash component from which floating or market prices are confidently derived. Furthermore, buyers and sellers in the brave new world of a competitive gas market will need current gas pricing information at various locations along the value chain in order to be adequately informed regarding the economics of each decision facing them. Inter-regional price relationships develop and regional pricing inefficiencies tend to evaporate given a robust spot market. Any given spot market, in order to confidently discover the market price, must have sufficient depth in terms of the number of transactions and participants and must be of sufficient size to not be overly influenced by the actions of any given participant. Such price discovery allows for the confident correlation of various regional spot markets or as is the case in North America - gas hub indices. In the brave new competitive world any given market participant is unlikely to survive very long to the extent that the price of gas is either above or below the market for any sustained period of time. As hedging simply transfers risk, short-term forward markets will simply eliminate price shocks associated with price volatility.

Upon sufficient confidence by financial institutions in such price discovery and liquidity, a futures market may or may not develop pending the volatility exhibited by any given commodity and the size of the market. It is interesting to note that gas has been the most volatile commodity introduced to the NYMEX prior to electricity. Furthermore, there is a great deal of pricing flexibility and price efficiency when sales and purchases associated with a physical portion of a commodity market are indexed to a liquid underlying hedge index. The ultimate power of this structure is provided by the ability of either counter party to freely fix, float, or adjust its pricing structure in a number of other ways independent of each other. In other words, transactions become highly efficient due to wider contestability of many more components of each gas deal.

An economically efficient and competitive market is characterised by a spectrum of diverse contracting arrangements and the efficient management of risks associated with physical delivery of the commodity and price.

Efficient management of risk, including risk due to price volatility, is one of the functions that competitive markets perform well. In a highly evolved commodity market, there will exist a diversity of contractual forms and options, which permit the risk of price volatility to be transferred to those parties who can bear the risk most efficiently. This diversity of contractual forms is absolutely necessary for market participants to be able to hold portfolios of supply options that yield a better combination of risks and prices than can be achieved through sole reliance on spot pricing³

³ Oversight of Regulated Utilities' Fuel Supply Contracts: Achieving Maximum Benefit From Competitive Natural Gas and Emission Allowance Markets, by Adam B. Jaffe and Joseph P. Kalt of The Economics Resource Group, April 1993, page i.



While this study was performed to examine the dangers of the dominant U.S. spot market, a sole reliance on long-term contracts with escalated pricing and infrequent price re-openers is, in my opinion, an even more dangerous situation. Until a paper market exists for gas, market participants will have to manage risks either internally through vertical or horizontal integration or commercially by pursuing a portfolio of contractual terms that diversify its mix of price and supply reliability.

A spot market has the potential to substantially minimise transaction costs to the industry. This, however, may not be realised immediately since like many good things there may be some short-term pain prior to long-term gains. The transaction costs are linked to such other factors as the synchronisation of the necessary gas transportation arrangements.

Australia's gas market to date has been as shallow as it gets - essentially one marketing joint venture representing one supply basin captive to one pipeline and selling to one gas utility representing a franchise or captive customers. A small spot market for gas has emerged in Queensland as a result of the recent initiation of coal seam methane testing into gas pipelines as opposed to prolonged flaring and the supply transition from the declining Surat and Denison Trough basins to the South West Qld portion of the Cooper / Eromagna basin and associated new pipeline infrastructure. The discontinuity which struck Qld was the gas supply crisis and the threat of gas rationing. Allgas Energy Ltd has been purchasing small quantities of 30-day spot gas since January 1997 from both BHPP and Conoco. As of July 1st, 1997 a surplus of long term take-or-pay gas flooded Qld, thereby essentially killing the Qld spot market. Its only savior will be either a significant growth in demand without additional long term supply contracting or a re-structuring of the supply arrangements for that state.

Since most, if not all, gas demand in other states are more than sufficiently covered by long-term gas supply contracts, it is rather doubtful that any other spot markets exist in the primary 'market'. The trading of gas in a secondary market has not really developed as yet for a number of reasons. The state of Victoria has proposed, after many industry debates, a gross pool model. The short-term impact of such a model is debatable, given the lack of competition in the primary wholesale market. Regions such as Melbourne and the Pilbara, which are well situated vis-à-vis gas supplies have the most potential in terms of the origin of a sustainable spot gas market in Australia.

In a competitive market the price mechanism plays a vital role in the channeling of available gas supplies to willing buyers and of available markets to willing sellers. The benefits of competition are founded in its ability to serve consumers and avoid waste. Competition tends to push revenues toward costs (where costs include a rate of return sufficient to attract and hold capital) Competition also leads to prices that are based on marginal costs, i.e., the costs of bringing incremental output into an industry. Although unsustainable long run marginal costs are a factor, such costs tend to be fairly elusive and dynamic due to the increase in innovation and good business practices in competitive markets and declining industry costs due to advances in technology. While some participants may wish to sign long term contracts, in a competitive market, unlike the past, participants may be exposing themselves to more rather than less risk by entering into long term contracts.



As a spot market emerges in the gas industry it is important to note that once a market is established for gas in Australia it may very well quickly grow to a size that is many times greater than its historical supply/demand volume of some 800 PJ/a. For example, if Australia were to follow North America the spot market for gas would reach 2800 PJ/a (800 PJ/a demand times 7 trades per GJ on average between production and burner tip times 50% spot market share of total transactions). Posted cash prices have been used extensively around the world in many commodities and are the backbone of a competitive market and a pre-requisite for a gas futures market.

In conclusion, a healthy spot market for pipeline natural gas in Australia is an integral component of effective gas reform for it will revolutionise the manner in which business is conducted in the gas industry. It has been proven over and over again that the capacity of the free market to innovate and to improve is boundless. The birth of a spot market for gas in Australia while not without pain is a key feature of such a free market.

D. Spot Market Models

The Traditional Model (North American Genesis)

At least two distinct main stream models exist for the establishment of a competitive spot market structure and each has a unique set of operational and commercial considerations. What is often referred to as the more traditional model was perfected in what is now the super competitive gas market which covers Canada and the lower 48 states of the U.S. This model is based on the following: a strict regulation of both transmission and distribution infrastructure; a ring fencing of businesses within vertically integrated companies; the unbundling of the commodity or the gas molecule from all other services, open competition in the trade of gas, transportation, financial derivatives, storage, etc; and open access and non-discriminatory behavior regarding the offering of infrastructure related services. Trade is based on the public outcry system patterned after the stock market and all buyers and sellers are free to contract for whatever level of services throughout the value chain deemed sufficient to conduct the business of their choice and each party bears the full consequences of such decisions.

Consequently a deep market of bilateral arrangements characterises the spot gas market under such a structure. The posted index at any one of many gas trading hubs is the price that according to an independent party best represents where the majority of spot market trading occurred during the bidding period of interest. The majority of spot trades are based on a monthly period and the famous bid week ritual occurs prior to each month, thereby establishing the index for the prompt month. All remaining contractual arrangements referencing the posted index for a particular trading hub as either a bid or offer price would then be established for the month. Furthermore, the index established at the Henry Hub, the delivery point for the NYMEX, would set the cash price for the closing of all NYMEX gas futures contracts. The relationship between this cash price and futures price is referred to as price basis risk by



participants of the futures market.

It is important to note that there exists two commonly used methods of determining the index in the North American spot gas market. While most publications of index prices use the mean or weighted average cost of all reported gas trades, one substantial publication uses the mode of the distribution curve. Since natural gas trades are not random events, the mean and the mode will not necessarily be the same.

Proponents of this model for the determination of spot prices are strong believers in its inherent competitiveness and individual freedom to take and manage risks. Such supporters argue that this model truly captures the essence of free and fair trade and the spirit of competition in gas commodity trading while curtailing if not eliminating any rents associated with monopolies.

The Pool Model (U.K. Genesis)

The second most popular market structure which not only fosters a spot market but indeed forces one to dominate the market is commonly referred to as the pool structure. There are two categories of such a model - namely gross and net pools which refer to mandatory and discretionary participation respectively. The gross pool concept has been embraced in Australia on a national basis for the emerging reformed electricity market and in Victoria for the emerging reformed state gas market.

The essence of the gross pool market structure is that the primary market for all physical transactions is essentially a spot market with all associated transmission infrastructure from primary supply points to the trading hub operated by a centralised operator. This “big brother” concept is a much more socialistic model than the previous described one, for the system operator ensures that the balancing of physical flows with commercial arrangements is conducted in an orderly manner. In such a pool, the spot price is determined by the tendering of supply to meet demand over the established trading period, with the theory that the marginal cost of the last unit of required supply setting the price for the entire participating pool.

Opponents to this structure believe that gaming or non-competitive participation can more easily occur from time to time when pool trading replaces bilateral trading. In Victoria the short term (day ahead) and the real time balancing of pipeline gas supply and demand will constitute a spot gas market. Although transmission (TUOS) and distribution (DUOS) capacity charges will be “regulated”, as has been adopted in the electricity market, market participants are not responsible for contracting such capacity. Therefore, there will be no secondary market for transportation services. While this is perhaps the only model which supports the light handed regulation objectives of Victoria, it remains to be seen as to whether it will deliver any real value to the marketplace. Regardless of the merits of either model, the initiation of an instantaneous spot market in both electricity and gas in Victoria strongly reflects the



views of the Victorian government that a robust spot market is an integral part of its gas reform program.

E. Divergence of Gas from Electricity in Australia

Gary Hamel's statement that "the future has already happened, it's just not evenly distributed" seems very appropriate today in Australia's gas industry. Our best guide to the future of the industry lies in where we are today and what we have learned from experiences in other competitively restructured industries. Successful restructuring of any commodity related industry has involved first the creation of a robust wholesale market and then moved on to greater and greater retail competition. Australia has to date ignored this principle. The savings to consumers diminishes as one goes from wholesale market reform to retail market reform due to the greater complexity and the smaller transaction size intrinsic to this sector of the value chain.

The North American gas market is without a doubt the most sophisticated and efficient gas market world wide and yet robust competition at the retail level of the market is but emerging – some ten years after the introduction of competition at the wholesale level. A thorough cost / benefit analysis was performed on the gas industries of Canada and the U.S. by their respective governments revealing better than expected results some ten years after de-regulations initiatives and industry restructuring in the late 1980's. The following are but a sample of the impressive statistics associated with the North American gas industry:

- With about 17 percent of the world's potential gas resources, holds only about 6 percent of proved gas reserves
- In 1996 the average netback gas price to the producers plant gate was US\$1.81/MMbtu compared to US\$1.15/Mmbtu for the rest of the world
- 26 Tcf of gas demand in 1996 compared to 77 Tcf worldwide
- Delivered prices to end users among the lowest in the world
- In excess of 50% of the world's gas pipelines exist in North America
- 45% growth rate projected between 1996 and 2015

Source: 1997 Enron ENERGY OUTLOOK

Without a doubt, Australia's gas industry is inefficient as bench marked against world's best practice. Retail competition is a good goal, for global competitive forces and customers demand supplier choice and greater value offerings. Open access on transportation and distribution pipelines also represents good progress, but in isolation will not result in a gas market. A market is characterised by price discovery, liquidity via a sufficiently deep spot market, standardisation of contractual terms and operational procedures, numerous efficient and effective risk management tools, and often a forward market. Commodity markets have volatile prices; especially electricity and gas. Market participants are subject to supply / demand fundamentals



as market clearing prices become king. Cost based rates and open access for all transmission and distribution services on an unbundled basis facilitates competition with respect to commodity and capacity trading. Furthermore, an efficient industry is one exhibiting efficient use of capital and a level playing field for all participants throughout the value chain.

While a commodity market has emerged in the electricity industry in most eastern Australia states, the gas industry remains hostage to producer cartels as is evidenced by monopolistic pricing and other anti-competitive contractual terms at the wholesale level. To date the industry has been focused exclusively on open access issues and the introduction of competition at the retail level. This seems to be cosmetic and will no doubt lead to much frustration and disappointment given the following facts:

- there is but one shipper on most gas pipelines
- 99+% of the gas transactions in the wholesale bulk market are conducted under what may be referred to as long term traditional contracts

Regarding the transportation of gas through transmission pipelines, only two pipelines in Australia conduct their business on a truly non-discriminatory basis – namely PG&E Qld and AtlintaGas Transmission. All other pipelines have refused to re-structure their transportation contracts with shippers so that all users are charged the same rate for the same or similar service. To not do so results in major distortions in the market.

Current and proposed legislation does not address this fundamental flaw in the market structure. The market carriage model proposed for Victoria addresses the need for a level playing field regarding transportation. Despite this and the recent re-structuring of the gas supply contracts with Esso/BHP, most industry advisers believe that the gas supply contracts will severely hinder the implementation of the proposed market model.

Unlike the electricity industry, in which generation, transmission, and distribution assets have been generally owned by state government, the economic structure of the gas industry historically has been one of little vertical integration and a mixture of state, federal, and the private sector. Consequently, producers sold gas under supply contracts to either a gas utility (WA, NSW, Victoria, & ACT), large end users directly (Qld), a pipeline company (SA), or a state owned power generation company (WA, SA, Victoria). Gas was transported on either government owned or privately owned transmission pipelines to either the city gate or, as was the case of Qld, directly to major end users under long term transportation contracts. Since, until recently, no economic regulation was in existence, the buyer had to, in theory, negotiate a toll with a monopoly pipeline company. In reality, the pipeline company dictated the terms, including the toll, and the buyer had little recourse but to either accept the terms or exit the gas industry.



These contracts were long term in duration (10 to 30 years) and contain many terms and conditions that, although quite appropriate at the time, are not consistent with an open and competitive market. Such contracts materialised after drawn out negotiations and reflect, among other things, the power struggles and insecurities present at the genesis of the industry. Although the majority of these contracts date back to the late sixties and early seventies, a few have been added in the late nineties. Unfortunately for Allgas Energy Ltd many of the more recent ones pertain to Queensland.

Instead of dealing with this issue, regulators have elected to uphold the sanctity of contracts regardless of the cost. Industry participants have to date generally been either unwilling or unable to re-structure such gas supply and transmission contracts to reflect the emerging market conditions. As previously mentioned, in my opinion, only PG&E Qld, AtlintaGas, and the Gas Reform Unit of Victoria have addressed this major barrier to open competition. Most of the efforts have been targeted in the retail area. I suggest that buyers and shippers have little, if any, leverage for initialising the re-structuring of contracts. At present it rests with the attitude of producers and pipeline companies and with the fortitude of state and national regulators.

This lack of resolve in the gas industry has not been adopted in the electricity industry – which leads to the statement that, unlike the rest of the world, the industries are diverging in Australia at the present. The electricity industry has addressed both transmission and power purchase agreements (PPA's) in a very timely and effective fashion.

Regarding transmission, the electricity code stipulates the services and tariffs for the use of the wire capacity. Unlike, gas, no user contracts were in place prior to the implementation of electricity reform. In the pool structure or market carriage model selected for the electricity market, each and every facility user of the transmission wires is charged the same for any particular service; a fundamental principle in order to achieve an efficient market. Again, the gas industry, with the exception of Victoria, has selected an alternate path.

The selection of a contract carriage model where capacity is contracted for and traded in a secondary market, while different, can facilitate an efficient and competitive market as has been demonstrated in North America. Two models for electricity versus gas will, in our opinion, always lead to some inefficiency for those wanting a seamless energy market. The major issue, however, is the loss in gas reform of the principle that for commodity market forces to work, freight costs associated with monopoly infrastructure such as gas pipelines must be common for all market participants. Otherwise competitive advantage is distorted and, commercially, all transactions remain bundled. The wholesale bulk market cannot function and trading hubs do not evolve. This would be tragic for Australia.

Although most of Australia's resource development industries are accustomed to the notion that market forces drive investment decisions, for some reason the upstream sector of the gas industry has been sheltered from such principles. Historically, long-term gas supply contracts have underwritten the development of gas fields and transmission / distribution infrastructure – not unlike the PPA's of the electricity



industry. Such arrangements were typical of first generation contracting procedures worldwide. However, gas supply contracts with producers have evolved significantly in many other regions of the world as traditional contracting methods have been replaced with more contemporary procedures. It has been generally accepted that such an evolution has delivered much mutual benefit to all stakeholders.

F. Comments on Victoria's Proposed Model

As previously mentioned, we believe that both the NERA and the Putnam, Hayes & Bartlett Inc reports contain extreme positions on many matters. Allgas Energy Ltd is of the view that either model, the contract or the carriage, can offer non-discriminatory access to pipelines and distribution systems on a reasonable basis. It is Allgas Energy Ltd's position that the objectives of full cost recovery, economic efficient pricing, equitable treatment of all users, transparency and simplicity can be achieved by either model upon proper implementation.

Although Victoria's gas industry is currently lacks liquidity, it is important to recognise that the degree to which the benefits of competition are realised is not a linear function of the number of market participants. Rather, the impact of market participation follows the law of diminishing returns.

The greatest benefit of competition flows from the introduction of choice into a monopoly system. Simply allowing participants choice between two suppliers (better yet two supply regions) or between two buyers will generate a major impact. Benefits will increase to the extent that there are a number of market participants, but beyond even a few market competitors the benefits of additional entry will be difficult to measure. This is evidenced in some very concentrated industries such as US auto manufacturing that exhibit very competitive behavior. Consequently, going from no competition to only a little should prove quite significant in the areas of cost reduction and increased service.

A second factor to consider is that parties who argue that there will be few competitors may not have a good understanding of what constitutes a supplier in a competitive system. The introduction of competition should allow parties other than gas producers to supply gas services in the wholesale market. This was certainly true in the US and Canadian experience in the gas industry, where aggregators, brokers, and market makers stepped between the producers and the end-use customer to repackage gas contracts and services into more user friendly and more valuable service contracts. In fact, in North America, such intermediaries have flooded the market and have resulted in the sale of gas many times in the wholesale market – between the primary producer and the retailer or consumer, as the case may be.

To the extent that a competitive market allows for this type of innovation, a geographic region or gas market that has only a few gas producers will generate a number of gas suppliers, and thus obviate concerns over limited market participation. This trend became strong in North America to the extent that large producers such as AMOCO, Shell, EXXON, and Chevron recently terminated their direct marketing



activities. For economic efficiency sake, they have chosen to sell gas at market prices at the processing plant gate or in many instances into a processing plant owned and operated by a third party. Many of the larger gas processing plants located in North America are not owned by upstream players.

Regarding equity and non-discrimination in pipeline and distribution services, it is our view that the proposed structure in Victoria is far superior to that which exists in the rest of Australia. In particular, the issue is whether all users who receive the same service from such facility owners should receive the same price. This issue was addressed in Canada several years ago and was the subject of debate recently at the FERC in the US. Los Angeles base RECON Research Corporation offers the following comments in this regard:

Generally, analysts reviewing competition within the North American market feel that paying an identical price for an identical service should be a fundamental tenet of gas transportation. Any deviation from this principal costs more in social equity than it gains in economic efficiency.⁴ In our view, this should be the fundamental feature of any non-discriminatory pipeline policy adopted by NSW as well.⁵

⁴ In this regard, Recon recently testified on behalf of the Canadian Association of Petroleum Producers at the FERC in Docket No. PL94-4-000 on Pricing Policy for New and Existing Facilities Constructed by Interstate Natural Gas Pipelines. This testimony read in part:

“CAPP is particularly concerned that pipeline tolling policies be fair, equitable and facilitate a competitive gas market. To achieve these objectives tolling should be guided by four fundamental principles:

1. Same-Rate-For-Same-Service: All shippers receiving the same service from a regulated utility should pay the same rate, regardless of the vintage of the capacity being utilized to provide such service. In our view, the long run marginal cost of providing service is the most efficient signal which rations its use, and a rolled-in pricing structure (average cost pricing) best approximates this signal.
2. Demands of All Shippers Trigger Expansion Requirements: The need to expand a pipeline system stems from the lack of sufficient capacity to meet the requirements of all shippers. A reduction of demanded service by any shipper would reduce the required expansion facilities. Thus, existing shippers and potential expansion shippers are both equally responsible. Both should be given the ability to evaluate their real capacity demand in a freely competitive market.

CAPP also believes that all shippers should share in the cost of operating any pipeline system. If an expansion results in increased rates, these should be shared by all. This may be distasteful to some existing shippers who assume they purchased the rights to all existing benefits in some “freeze frame” cost of service rate making. In reality, of course, all they have acquired is the right to be served at a tariffed rate level, where ever that may be set over the course of pipeline service.”

⁵ This would not, however, preclude parties contracting for capacity from being able to broker that capacity to others at market determined prices in instances where pipeline capacity brokering is authorized by the regulatory body. This is one way in which to allow flexible pricing while maintaining transparency and ability to monitor non-discrimination, as desired by the Council at page 49. Capacity brokering may also be the answer the complex questions raised by the Council in Section 6.8 regarding the definition of, and access to, “spare capacity”.



Comments on ACCC Submissions Prepared for the EPD by Putnam, Hayes, & Bartlett Inc.

Although Allgas Energy Ltd does not intend to comment in detail regarding the above referenced submissions, we offer the following comments for consideration by the ACCC.

We believe that the submissions contain much rhetoric about the inefficiencies of the North American gas industry. As previously stated, the gas industries of Canada and the US are considered worldwide to be the leader in the creation of a competitive gas market. In fact the major gas players, namely Enron and the Clearinghouse, have quickly gained a dominant market share in the US electricity market as it has re-structured to a commodity market. It is our view that such sophisticated players will also enter and dominate Australia's wholesale energy market – both gas and electricity – upon the demonstration that they are competitive commodity markets. To state that “the resulting markets are still inefficient”⁶ seriously questions the credibility of Putnam, Hayes, & Bartlett Inc.

This lack of general knowledge is further demonstrated in the following statement: “there is good reasons to doubt that the traditional contract carriage concept that more or less ‘works’ on massive North American systems and on simple point-to-point transportation system could be successfully adapted to the small but relatively complex Victorian system”⁷. The former Alberta Gas Trunkline System, now called Nova Gas Transmission, balances several PJ's/d on a four hour basis and has nearly one thousand receipt points and several hundred delivery points. Furthermore, open access to distribution systems has been operative in North America for some time, and they certainly are not simple point to point systems! This report seems to be full of outrageous statements that, in our view, are not factual.

Another example of extreme rhetoric is contained on page 16 of the same report: “In North America's contract carriage system, it has taken twenty years to develop even the limited flexibility and tradability that now exists, even though there are dozens or hundreds of competing market makers and brokers.” One of our executives participated in the North American experience and hereby testifies that change toward a competitive market occurred much quicker than as has been demonstrated to date in Australia! Furthermore, the flexibility and tradability that exists in the wholesale gas market in particular in North America is limited only by ones imagination – as has been clearly demonstrated by Enron Capital & Trade Resources. Again one of our executives was once a Vice President with Enron Gas Services and hereby testifies that the gas market of Canada and the US better resembles a competitive commodity market than the Australia's electricity market of today.

Allgas Energy Ltd has difficulty with the extreme views offered by Putnam, Hayes, & Bartlett Inc given such statements. We believe that their credibility as an advisor in such matters is questionable. We, however, do agree with the general statements that BHP Petroleum seems to be generally “self-serving” regarding the evolution of the gas market in Victoria and not necessarily interested in the public best interest. It is

⁶ *Comments on Economic Aspects of BHP's Response to the ACCC* by Putnam, Hayes, & Bartlett Inc. dated 6 February 1998, page 2.

⁷ *Ibid* page 5



always tempting for incumbents with such market power to adopt such a position. However, neither Allgas Energy Ltd nor Putnam, Hayes, & Bartlett Inc. is in a position to can judge BHP's intent in such matters.

Comments on ACCC Submissions Prepared for BHP Petroleum by NERA and Mallesons Stephen Jaques.

Allgas Energy Ltd is of the opinion that BHP Petroleum has a valid point regarding the creation of a sub-market within Australia's gas industry. However, as previously mentioned, the piece meal approach and the light handed regulatory approach in Australia has, in our view, already created radically different rules for the "market" to operate under in various states and territories, and in various regions within states and territories. The consistency argument seems to have been lost long ago. We agree that the creation of sub markets, inconsistent rules, and materially different structures across Australia may significantly retard the creation of a competitive national gas market. This is particularly true if applied to the wholesale market.

The corollary of course is the danger inherent with the creation of a sub-market for gas versus electricity, oil, LPG, coal, etc in the energy industry. Allgas Energy Ltd does not offer any solution to this conundrum, but merely offers it to the ACCC for consideration. Ideally, Australia should have consistent market structures and rules across all primary energy and their derivatives.

Allgas Energy Ltd is of the opinion that there are many features of Victoria's proposed gas industry model structure and operating rules that may be far superior to that currently in place across the rest of Australia. A fundamental question that should be addressed is how efficiently will the various sub-markets interface?

Another major concern that Allgas Energy Ltd shares with BHP Petroleum is the reliance of the market on a company such as VENCORP to meet all of its needs in a timely manner. All markets function more efficiently with depth as previously mentioned, and it has been demonstrated in North America that excess market power by a transmission company deters innovation. Nova Gas Transmission and Westcoast Transmission are two VENCORP type examples in this regard. The provinces of Alberta and British Columbia where these two pipeline companies respectively had entrenched dominant positions significantly lagged corresponding supply basin states of the US in the evolution to a market characterised by a menu of efficiently priced storage, hub, and pipeline services. History has proven that system wide needs as identified by Nova and Westcoast were either inappropriate or not efficiently priced for the prevailing market needs. This structure merely led to an uproar within industry and bypass opportunities.

Allgas Energy Ltd is sympathetic with the argument that complexity of the MSO rules and the many adjustments that will inevitably be required over time inherent with the application of a new model for an industry will cause confusion among market participants. The question perhaps is whether or not the public benefit outweighs this problem. In our view Victoria's gas industry, on both a physical and commercial basis, is immature and shallow. The benefit that is offered to the general public by



this model is questionable at this time. Such a mode may very well offer excellent benefits if applied throughout Australia or even through eastern Australia.

G. Conclusion

Allgas Energy Ltd would prefer to see a common model or market structure across the eastern states and territories for the gas industry and we believe that it will be increasingly important for the gas industry to be consistent with the electricity industry. We believe, however, that the first priority for Australia is to quickly salvage the gas industry through the introduction of aforementioned principles that lead to the evolution of a competitive market.

The piecemeal gas reform initiatives to date are not sufficient. Among other things, they ignore many of the principles associated with and the pre-requisites of free and fair markets. Gas reform represents an important opportunity to enhance Australia's competitiveness and to level the playing field between states and territories.

Historically the state with the most indigenous gas and the most consumer oriented gas supply contract with the producer had a clear advantage in attracting gas intensive industries or attaining windfall profits, as the case would be. The continental gas market of Australia is akin to that of Europe or South America, in that each state or territory has historically behaved in a parochial manner with little to no consideration for the collective benefit of the nation or continent.

The historical long term gas supply and pipeline transmission contracts remain a major impediment to moving forward to achieve the objectives of the Hilmer Report and the CoAG Agreement. For regulators the message is that while sanctity of contracts is a noble statement, the majority of Australia's long term gas contracts are not appropriate for the espoused post reform market structure. Intervention in gas as was done in electricity is paramount. It is time to move boldly to forge an open market, in which competition and choice are the rules and not the exception. Well established principles that lead to competitive commodity markets must be embraced.

The incumbent producers and pipeline companies must make a contribution. A robust wholesale gas market is a pre-requisite to all other reform initiatives. To ignore this principle tends to make a mockery of the whole process and invites cynicism. Allgas Energy Ltd hopes that this oversight will soon be corrected. Markets must be viewed as forces to be worshipped rather than a tool to be manipulated. We believe that there exists much evidence in Australia that Esso Australia, BHP Petroleum, and Santos have not accepted the former vis-à-vis natural gas. This attitude associated with the major producers of gas in Eastern Australia is retarding progress.

We realise that the challenge in front of the ACCC at this time is tremendous and we appreciate the opportunity to participate in the debate. We hope that the ACCC and others find our comments to be constructive.

