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Monday, 21 June 2004

Ms Deborah Walker
Analyst Gas
Independent Pricing and Regulatory Tribunal
Level 2
44 Market Street
Sydney NSW 2000

Dear Deborah

The Redefinition of Trunk Zones and the Implications for Competition

As discussed on Friday, attached is Alinta's response to AGL Gas Network's proposed Access Arrangement. This response addresses, in more detail our issues raised in previous correspondence on 27 April 2004.

Should you have any queries, please contact either Steve Livens on (03) 9685 1061 or Andrew Schille on (03) 9556 1549.

Yours sincerely

Julie Bull
Manager Regulation and Government Relations

Submission to the: Independent Pricing and Regulatory Tribunal

Re: The Redefinition of Trunk Zones and the Implications for Competition

Alinta EA Pty Ltd

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21 June 2004

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1. Introduction

This paper outlines Alinta EA Pty Ltd ("Alinta") concerns with AGL Gas Network's ("AGLGN") intention to collapse the current three Trunk Capacity Reservation Charges zones between Wilton and Horsley Park into a single zone, in its proposed access arrangements for 2005-2010. The three major concerns are:

- AGLGN's proposal would appear to be primarily aimed a achieving a re-allocation of costs away from AGLGN assets that face competition from the Eastern Gas Pipeline (EGP);
- AGLGN's proposal would appear to be driven by a desire to provide an unfair competitive advantage to gas supplied via Moomba to Sydney Pipeline (MSP), compared to gas supplied by EGP; and
- AGLGN's proposal would distort competition in the upstream and downstream markets and thus be inconsistent with the Code.

This response deals with these concerns and specifically, it:

- outlines the facts of the matter;
- identifies the key issues the proposal creates; and
- draws conclusions on the merits of the proposal.

2. Key Facts

To understand the implications of AGLGN's proposal and their importance, it is necessary to provide some background information. Therefore, this section summarises:

- the ownership of the relevant assets;
- the physical situation of the relevant assets;
- the regulatory situation of these assets; and
- AGLGN's current and proposed regulatory arrangements.

2.1. Ownership Situation

- Alinta EA Pty Ltd, a wholly owned subsidiary of Alinta Ltd, owns the EGP.
- AGLGN is a wholly owned subsidiary of AGL;

- AGL owns 30% of the Australian Pipeline Trust Limited ("APT"), which owns the MSP;[1]
- AGL also wholly owns a retail business, AGL Energy Sales and Marketing, which competes in the NSW gas and electricity retail markets. The Gas Transportation Deed between EGP and AGL contains arrangements for transmission services from Moomba to 2016. It is understood that AGLGN's affiliated retail business sources the majority of its supplies from the Cooper Basin via the MSP;
- AGL also wholly owns Agility, which operates both the AGLGN and MSP on behalf of the owners; and

  *The owners of AGLGN and MSP are related parties, as are AGLGN and AGL Energy Sales and Marketing. The relationship between these parties and the potential it creates to distort competition was noted i*n *the Minister's decision to revoke coverage of the MSP. The Minister stated that:* "…there is a substantial risk of vertical leveraging discriminating in favour of the wholesale and retail markets, given the close relationship between AGL, EAPL (ie. APT) and Australian Pipeline Limited."[2]

2.2. Physical Situation

- AGLGN owns the gas transmission and distribution network serving the Sydney and surrounding NSW market;
- AGLGN's network is supplied principally from two sources – MSP and EGP:
- gas transmitted via the MSP is delivered to AGLGN's network at Wilton. Gas transmitted via the EGP is delivered to AGLGN's network at Horsley Park (about 51 km North of Wilton), as is illustrated in Figure 1;
- the EGP duplicates AGLGN's transmission assets and the gas receiving and pressure reducing stations between Wilton and Horsley Park. The EGP connects into AGLGN's transmission system at this point (ie. outside EGP's dedicated pressure reduction station), as is illustrated in Figure 2.

Shippers supplying the Sydney market via the EGP must therefore utilise AGLGN's transmission network but they also bypass the part of that network between Wilton and Horsley Park.

2.3. Regulatory Situation

- AGLGN's transmission and distribution assets are covered by the Code[3] and are regulated by IPART;
- neither the MSP nor the EGP are regulated in respect of the gas transmission services they provide to the Sydney market;

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[1] Via a further 100% wholly owned subsidiary, Eastern Gas Pipelines of Australia Limited.

[2] The Hon Ian Macfarlane, Federal Energy Minister, Application for Revocation of Coverage on Certain Portions of the Moomba to Sydney Pipeline System, Statement of Reasons, 19 November 2003, para 192.

[3] The National Third Party Access Code for Natural Gas Pipeline Systems

- the MSP was regulated at the inception of the Code. In 2001, APT applied to the National Competition Council ("NCC") to have coverage revoked. The NCC recommended that the MSP remain covered. In 2003, the relevant minister rejected the NCC recommendation to retain coverage of the MSP and revoked coverage of the key services MSP provides;[4] and

- the EGP was built in the expectation that it would be an unregulated asset. In 2001, AGL's retail business applied to the NCC to have the EGP covered. The NCC recommended coverage and the relevant minister's accepted that recommendation. Duke Energy International ("Duke"), the owner of the pipeline at that time, appealed to the Australian Competition Tribunal which subsequently decided that the EGP should not be covered by the Code.[5]

The MSP and EGP therefore compete to provide shippers with gas transmission services to the Sydney market.

2.4. AGLGN's Current and Proposed Regulatory Arrangements

- AGLGN's current Access Arrangement expires at the end of 2004. Under the existing arrangements there are seven trunk zones with different prices;

- AGLGN's proposed Access Arrangements will operate between 2005 and June 2010. Under this proposal, the seven trunk zones will be reduced to five zones. This is to be achieved by collapsing the three zones spanning from Wilton to Horsley Park (Wilton, West Hoxton and Horsley Park) to a single zone (zone A), as is illustrated in Figure 2. For a customer delivering gas into the Sydney distribution network, the same Trunk Capacity Reservation Charge will apply regardless of whether the customer's receipt point is at Wilton, via the MSP, or Horsley Park, via the EGP; and

- Under the current arrangements, a shipper injecting gas into AGLGN's network at Horsley Park (ie. from the EGP) pays an annual tariff of $6.563/GJ. Under the proposed arrangements, a shipper would pay an annual tariff of $13.477/GJ for the same service.

The redefinition of zones would therefore result in a price increase of 105% for shippers injecting gas from the EGP at Horsley Park. Meanwhile, Sydney Contract customers transporting gas along the MSP would get a 16% real reduction in trunk charges in 2004-05.

3. The Key Issues

Alinta's concerns relate to the redefinition of trunk zones and the implications this has for prices. The changes would:

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[4] The Hon Ian Macfarlane, Federal Energy Minister, Application for Revocation of Coverage on Certain Portions of the Moomba to Sydney Pipeline System, Statement of Reasons, 19 November 2003. Coverage was revoked because the Minister was not satisfied that it would be *"uneconomic for anyone to develop another pipeline"* to provide the services. In essence, the Minister interpreted this criterion more broadly than the NCC in light of the market's development.

[5] Duke Eastern Gas Pipeline Pty Ltd [2001] AcompT 2 (4 May 2001), para 124. The ACT decided that EGP should not be covered because it did not have market power and therefore did not satisfy section 1.9(a) of the Code (ie. that coverage would promote competition in another market).

- unfairly discriminate against shippers or customers currently contracted to use the EGP; and
- distort the choice that shippers face between being supplied via the MSP or the EGP.

It is therefore worth investigating the reasons put forward by AGLGN to support the redefinition of zones. AGLGN suggests that the proposal is designed to create a *"trading hub in conjunction with a gas swap service"*.[6]

There is, however, no mention of the trading hub in AGLGN's proposed access arrangements (eg. describing what it is, its benefits etc).[7] The gas swap service is, however, mentioned. It is described as a *"service which entitles Users of Trunk Reference Services to have gas delivered at an alternative Receipt Point on a Day, or transfer gas from one User to another User on a Day, after that gas has been delivered to the network."*[8]

This service is further described as *"a new service, offered as part of the 2004 Access Arrangement in response to retail and market calls for flexibility in utilising different receipt points and different sources of gas for a short term and at a short notice. Charges for the service are the estimated incremental operating costs to provide the service. The incremental operating costs have not been included in the development of other tariffs."*[9]

The gas swap service would involve a transaction charge of $0.0385/GJ.

There are two key points worth making about AGLGN's proposals.

First, the proposed transaction charge suggests that the price changes associated with the redefinition of zones is driven almost exclusively by a reallocation of sunk costs. The reallocation of sunk costs is unlikely to have any economic merit and may have economic costs (in terms of unduly increasing the uncertainty associated with new investment, and providing distorted pricing signals to shippers). In fact, the proposed charges treat the receipt points at Wilton and Horsley Park as having identical costs.

Such a proposition would be clearly inconsistent with the Reference Tariff principles set out in section 8 of the Code, which essentially require that the Charge paid by any User of a Reference Service be cost reflective, and that Reference Tariffs should not distort investment decisions in Pipeline transportation systems or in upstream and downstream industries. Moreover, the construction of the pipeline is the clearest possible demonstration that the proposed cost re-allocation is an artificial device designed to deliver an unfair competitive advantage to AGLGN and its affiliates, rather than a reflection of the underlying economics.

Second, while there could be merit in the introduction of such a gas swap service (eg. possibly to improve the reliability of supply):

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[6] AGL, AGLGN 2004 Access Arrangement Submission Presentation, 19 February 2004, slide 16.

[7] This concept was also mentioned in: the Hon Ian Macfarlane, Federal Energy Minister, Application for Revocation of Coverage on Certain Portions of the Moomba to Sydney Pipeline System, Statement of Reasons, 19 November 2003, para 68.

[8] AGL Gas Networks, Access Arrangement for NSW Network, December 2003, page 28.

[9] AGL Gas Networks, Access Arrangement for NSW Network, December 2003, page 61.

- it is not obvious that there is an overwhelming demand for such a service (AGLGN provide little evidence to back its claims) and, assuming there is a demand;
- nor is it necessary to aggregate zones (and reallocate costs) in order to introduce such a service. Presumably, the transaction charge could apply in any case given its objective is to facilitate the short term movement of gas, presumably in response to short term needs.

The decision to introduce a gas swap service would not therefore appear to be the main reason for the redefinition of trunk zones.

3.1. Alternative Explanations

An alternative explanation for the redefinition of trunk zones is that it reallocates costs in a way that is favourable to AGLGN and its associated businesses, by reallocating costs away from assets facing competition.

In assessing, revising and ultimately approving AGLGN's current access arrangements, IPART stated as follows:

> *"The Tribunal is concerned with the sharing of costs between asset groups, eg to the Wilton-Wollongong transmission pipeline. This issue has also been raised in submissions, where it is suggested that AGLGN's choice of allocation methodology has shifted costs away from assets facing competition.*
>
> *These factors have been considered by the Tribunal in its final decision on cost allocation to assets and customer segments. As the discussion in chapter 5 indicates, the Tribunal's final decision to set the ICB of the transmission pipelines at DORC will result in a greater proportion of revenue being allocated to the transmission system than in AGLGN's PSTC document."*[10]

It is worth noting that the current arrangements, including those originally proposed by AGLGN, were also developed in full knowledge of the impending completion of the EGP.

The physical configuration of the EGP is a direct consequence of AGLGN's behaviour during the planning and construction of the EGP.

In June 2000, the NCC made a final recommendation on the application (by AGL's retail business) for coverage of the EGP.[11] As a part of this process, the NCC considered what drove Duke to duplicate parts of the services provided by AGLGN (ie. from Wilton to Horsley Park). The NCC concluded that Duke was not offered terms that made using AGLGN's assets attractive relative to constructing its own assets, despite the economic logic for doing so from a market perspective. This is obvious when considering the evidence the NCC relied upon in forming this view:

> *"NERA's report for BHP argued that Duke was forced into the construction of a second pipeline by AGL's refusal to negotiate access:*

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[10] IPART, Final Decision: Access Arrangement for AGL Gas Networks Limited Natural Gas System in NSW, July 2000, page 170.

[11] National Competition Council, Final Recommendation: Application for Coverage of Eastern Gas Pipeline, June 2000.

Duke has had great difficulty in securing rights on [AGL's] trunk [ie. transmission] network as a part of its Eastern Gas Pipeline…project from the Bass Strait. Exasperated by [AGL's] stalling of the negotiation of capacity rights, Duke spent approximately $28 million to effectively loop an entire segment of [AGL's] trunk network. (NERA, 2000, page 9).

NERA quote a news release of 5 January 2000 by Duke that states:

We [Duke] could not justify economically using AGL's assets [at the terms they were offering] and that will leave AGL's 50 kilometers of pipe terribly underutilised (NERA's bracketed insertions) (NERA, 2000 page 9).

NERA argue that AGL had little incentive to permit Duke access on reasonable terms and conditions to its pipeline between Wilton and Horsley Park because AGL can pass the costs of its pipeline between Wilton and Horsley Park to customers on the distribution network. [12]

In this context it is worth reiterating and emphasising that Duke's decision to construct the EGP was a rational commercial response to AGLGN's conduct and Reference Tariff policy. One of the fundamental assumptions underpinning Duke's investment decision was that the structure and level of Reference Tariffs applying to AGLGN's network would remain consistent with those in place at the time. This assumption was based on the reasonable expectations that:

- the Reference Tariffs applying to AGLGN's network would remain cost reflective, in accordance with the Reference Tariff Principles set out in Section 8 of the Code; and
- a material re-allocation of costs by AGLGN (to achieve the outcomes it is now seeking through its proposed Access Arrangement revisions) would not be consistent with section 8.1 of the Code, and would therefore not be approved by the Relevant Regulator.

4. Conclusion

In conclusion, Alinta reiterates the key points of this paper identified above are that:

- AGLGN's proposal would appear to be primarily aimed a achieving a re-allocation of costs away from AGLGN assets that face competition from the EGP;
- AGLGN's proposal would appear to be driven by a desire to provide an unfair competitive advantage to gas supplied via MSP, compared to gas supplied by EGP; and
- AGLGN's proposal would distort competition in the upstream and downstream markets and thus be inconsistent with the Code.

It is Alinta's position that AGLGN proposal to alter Reference Tariffs by redefining trunk zones is not consistent with the requirements of the code and is anti-competitive.

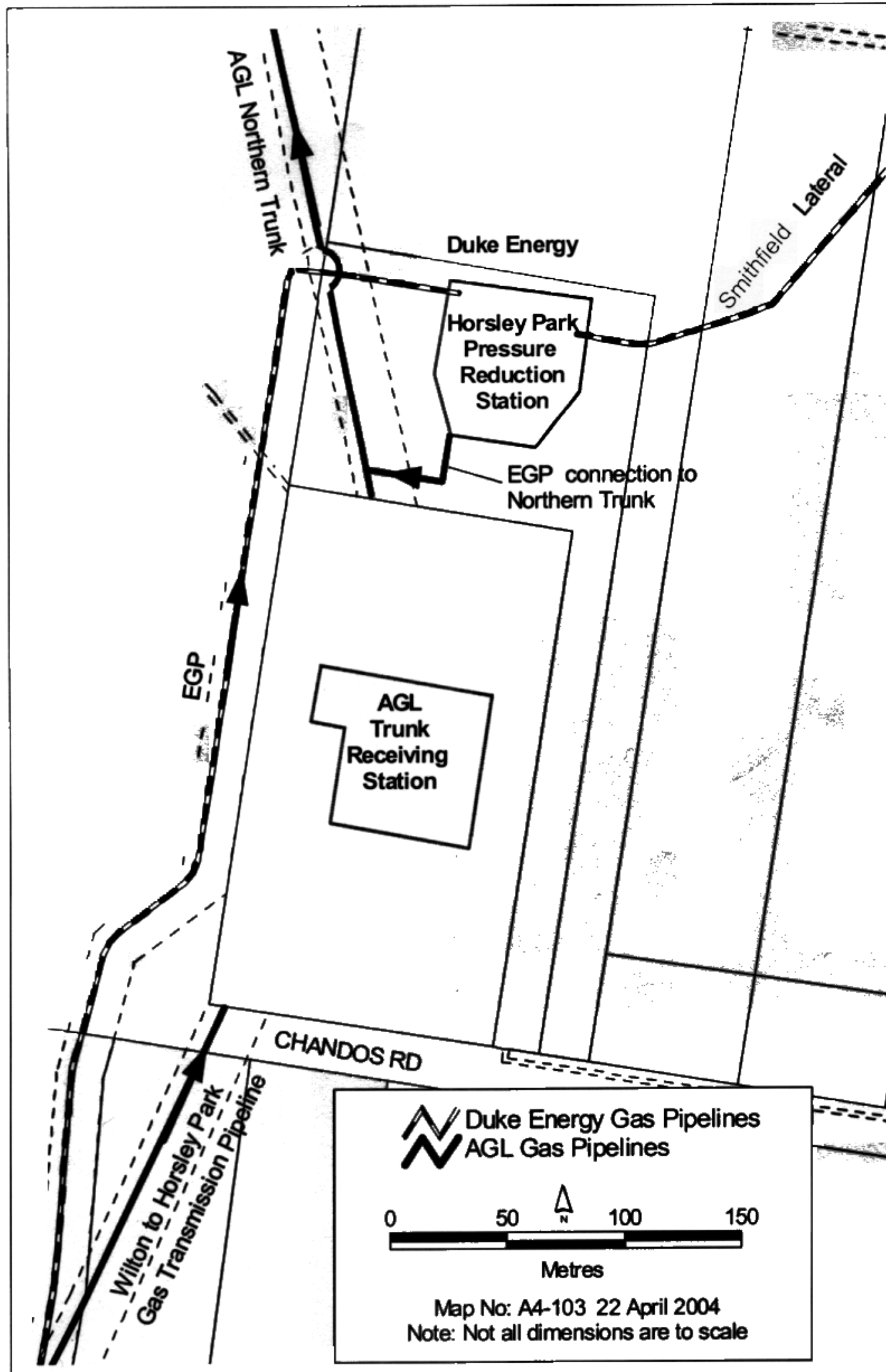
[12] National Competition Council, Final Recommendation: Application for Coverage of Eastern Gas Pipeline, June 2000, page 56.

Alinta therefore believes that the re-definition of trunk zones should be rejected.

Figure 1 Shows the Three K Routes into the Sydney Market

Alinta

Figure 2



Alinta

Table 1: Key statistics for EGP and MSP

	EGP	MSP
Cost	$450m (2000 build cost)	$534m (1994 sale price)
2003 volume (PJ/a)	54	95
2003 volume to Sydney (PJ/a)	35	77
Capacity – uncompressed (PJ/a)	65	160
Capacity - compressed (PJ/a)	105	290