Final Recommendation

Application for Revocation of Karratha to Cape Lambert Pipeline from Coverage under WA Gas Access Regime

September 1999

National Competition Council

Introduction

This document contains the National Competition Council's Final Recommendation regarding Robe River Mining Company Pty Ltd's application for revocation of coverage of the Karratha to Cape Lambert Pipeline from the Western Australian Gas Access Regime.

The Council's Final Recommendation is that coverage of the Karratha to Cape Lambert pipeline be revoked. The Council considers the pipeline does not meet criteria (a) or (d) of the criteria against which coverage is assessed.

The document comes in two parts.

Part A explains:

- the legislative background to the WA gas access regime;
- the concepts of coverage and revocation under the Regime; and
- details of the application, including specification of the relevant pipeline.

Part B contains the Council's detailed assessment of the criteria against which the Final Recommendation is made.

The next step is for the WA Minister for Energy, Resources Development, and Education to consider the Final Recommendation and decide the matter.

Part A – Coverage and Revocation under the Gas Access Regime

Legislative Background

Western Australia has enacted a gas access regime to provide parties with a method for seeking access to gas transmission and distribution pipelines located in Western Australia. The regime is contained in the *Gas Pipelines Access (Western Australia) Act 1998* (the WA Gas Pipelines Act) and the *National Third Party Access Code for Natural Gas Pipeline Systems* (the National Code), at Schedule 2 of the WA Gas Pipelines Act.

The regime assists parties that wish to transport gas to negotiate a fair and reasonable contract of transportation with pipeline owner/operators. For example, a mining company may wish to buy gas from gas producers on the North West Shelf and transport it to a gas-fired power station at their mining site. Under the gas access regime, they have the opportunity to negotiate a contract for transport of the gas with the owners/operators of pipelines covered by the regime. In the absence of the regime, the owners/operators of pipelines might, by virtue of their monopoly over the transport of gas between the particular geographic regions, refuse to transport gas or demand a monopoly price for the transport of gas.

Coverage of Pipelines

Pipelines can become covered under the WA gas access regime where they are listed in Schedule A of the National Code or meet the coverage criteria in section 1.9 of the National Code (see Appendix 1).[1]

The Karratha to Cape Lambert pipeline is listed in Schedule A.

Where pipelines are covered, the owners/operators of the relevant pipelines must comply with certain obligations under the WA Gas Pipelines Act and the National Code. The WA Gas Pipelines Act and the National Code contain rules determining whether pipelines should be covered by the gas access regime, the operation and content of access arrangements (which specify the terms, conditions, and prices on which owners/operators must offer access), the provision of information by the owner and/or operator of a pipeline to parties seeking access, dispute resolution principles, and pricing principles.

Revocation of Coverage of a Pipeline

The Code allows any party to seek revocation of coverage of a pipeline. The party must apply to the National Competition Council asking the Council to recommend to the relevant Minister that coverage of a pipeline be revoked. On receipt of the

[1] Pipelines can also become covered in other ways.

Council's recommendation, the relevant Minister must then decide the matter. In this case, the relevant Minister is the Western Australian Minister for Energy, Resources Development, and Education.

In reaching its recommendation, the Council is required to consider the criteria for coverage in section 1.9 of the National Code. Where it considers that a pipeline does not meet all the criteria in section 1.9, it must recommend revocation of coverage of that pipeline.

Where revocation is granted, the owner/operator of the pipeline is released from its obligations under the WA Gas Pipelines Act and the National Code.

The Council's detailed assessment of the application against the criteria in section 1.9 of the National Code is contained in Part B of this document.

The Application[2]

The revocation application relates to the Karratha to Cape Lambert Pipeline.

The applicant is Robe River Mining Company Pty Ltd (Robe River), the operator of the pipeline.

The pipeline is owned by the participants in the Robe River Iron Associates Joint Venture, which comprises:

- Robe River;
- Mitsui Iron Ore Development Pty Ltd;
- North Mining Ltd;
- Cape Lambert Iron Associates (a business carried on under that name by Nippon Steel Australia Pty Ltd, Sumitomo Metal Australia Pty Ltd, and Mitsui Iron Ore Development Pty Ltd); and
- Pannawonica Iron Associates (a business carried on under that name by Nippon Steel Australia Pty Ltd, and Sumitomo Metal Australia Pty Ltd).

[2] Much of the information in this section is drawn from Robe River's application.

Table 1 summarises details of the Karratha to Cape Lambert pipeline.

TABLE 1 Pipeline Subject to Revocation Application

Pipeline Licence	Location/ Route	Operator	Length (km)	Diameter (mm)	Regulator
WA: PL8	Karratha to Cape Lambert Pipeline	Robe River Mining Company Pty Ltd	57	273	WA Office of Gas Access Regulation

The pipeline runs from main line valve number 7 near the head of the Dampier to Bunbury Natural Gas Pipeline to the joint venture's Cape Lambert power station. The pipeline broadly follows the North West Coastal Highway, passing approximately 5 kilometres south of the Karratha town site. After 30 kilometres, it deviates north east towards Cape Lambert.

The pipeline was constructed to supply gas to the Cape Lambert power station. The power station generates electricity for the township of Wickham, and for the joint venture's operations at Cape Lambert. These operations include a pellet plant, which is currently decommissioned but may be recommissioned at some future time.

The pipeline has a nominal capacity of 95 TJ per day. If the pellet plant were recommissioned, then demand could be expected to reach approximately 57 – 66 TJ per day, leaving uncommitted capacity of about 29 – 38 TJ per day. At present, demand is less than this.

The pipeline currently has one third party user.

Revocation Process to be followed under National Code

The process for dealing with revocation application is specified in sections 1.24 to 1.39 of the National Code.

The Council received the application on 22 June 1999. The Council wrote to over one hundred interested parties inviting submissions and released an Issues Paper setting how it would assess the application. It also advertised the application in the *West Australian* and *The Financial Review*, and contacted the third party user. The Council did not receive any submissions in response to this process.

On 6 August, the Council released Draft Recommendations setting out its preliminary views on the applications. The Draft Recommendations recommended revocation of the pipeline. The Council then contacted a number of parties to invite submissions in response to the Draft Recommendations. In particular, the Council wrote to the Karratha District Chamber of Commerce and Industry, asking the chamber to circulate the draft recommendation among its members since some of these members could be potential users of gas transported through the pipeline and might have been interested in access. The Council did not receive any submissions in response to this process.

The Council has now released its Final Recommendation.

Now, the following steps must be taken:

- the Minister has 21 days to decide whether or not to revoke coverage;

- the Minister must provide copies of his decision and reasons to relevant parties, including the owner/operator and any party who made a submission; and

- if the Minister decides to revoke coverage, his decision cannot take effect for at least 14 days. Under section 38 of the *Gas Pipelines Access (Western Australia) Act 1998*, (contained at Schedule 1 of the WA Access Act) any person adversely affected by the Minister's decision may appeal to the Western Australian Gas Review Board for a review of the Minister's decision.

Part B – Consideration of Criteria in Section 1.9 of the National Code

Under the National Code, the Council must consider whether the Karratha to Cape Lambert pipeline meets the criteria for coverage contained in section 1.9. The Council must recommend revocation unless the pipeline meets *all* the criteria.

Criterion (a) **that access (or increased access) to services provided by means of the pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the pipeline.**

Background

The rationale for this criterion is that access regulation is only warranted where access is likely to generate tangible benefits (for example, reduced prices or improved quality) which will flow through to at least one market beyond the market for the services of the particular gas pipeline.

Before it concludes that a pipeline meets this criterion, the Council must be convinced:

- the service to which access is sought is not in the same market as the market in which competition is promoted; and
- access would actually promote more competitive *outcomes* – such as lower prices – in that other market. Greater competition in another market will be less likely where that other market is already highly competitive, or where the other market is a monopoly (in the second case because cost savings are unlikely to be passed on to consumers).

The Council must also consider whether access charges are a sufficiently significant input into the other market to have a material effect on competition. In general, while a trivial increase in competition would not be sufficient, the Council considers access would not need to substantially promote competition in order to satisfy this test.

The Council's approach is to:

- verify that the market in which competition is said to be promoted is separate from the market for the service; and (if so) then
- determine if access (or increased access) would promote competition in this separate market.

Applicant's Views

The application argued that access (or increased access) to the Karratha to Cape Lambert pipeline would not promote competition in upstream or downstream markets, such as markets that might broadly described as the markets for gas production or energy consumption.

Robe River stated in its application that:

> *[it] is not aware of any energy user (other than the one with whom it has concluded an access arrangement), gas provider (other than the North West Shelf producers), potential energy users or potential gas producers which have an energy requirement to warrant a gas intake or off-take to the Pipeline and operate or intend to operate within economic proximity of the Pipeline.*

In particular, while the pipeline runs south of the Karratha industrial area, the applicant was not aware of any industry in the industrial area that had an energy requirement that would warrant an off-take. Nor did the applicant consider access would be likely to increase the number of gas suppliers based on the North West Shelf or elsewhere.

The Council received no information from other parties in response to its public processes about whether access would promote competition in other markets.

Analysis

The Council considers if access *did* promote competition in another market or markets, it would most likely be in market in which gas producers sell gas to users operating in the region of the Karratha to Cape Lambert pipeline.[3] These users would most likely be medium to large industrial users.

The first issue for the Council is whether this market for gas sales is separate from the market in which access would be sought.

In considering this issue, the Council has been guided by a test developed by Professor Henry Ergas.[4] In essence, the Ergas test points to separate markets if:

- the services supplied by the gas pipeline are separable, from an economic point of view, from the other service or services. This involves an assessment as to

[3] This market may be part of a larger market for energy in the region of the Karratha to Cape Lambert pipeline. Users would be interested in obtaining access to the cheapest source of energy that meets their requirements, whether it is provided by gas, electricity, solar, wind-power, wave-power, or by some other source.

[4] Ergas, H, submission to the NCC in support of an application by Carpentaria Transport Pty Ltd, pp. 1-3.

whether the transaction costs in separate provision at the two layers would not be so great as to prevent such separate provision from being feasible; and

- the assets used to provide the gas pipeline services are sufficiently specialised that supply side substitution is not achievable so readily as to unify the field of rivalry between the two layers.

The market served by the Karratha to Cape Lambert pipeline could best be characterised as the market for gas transportation services in the Karratha/Cape Lambert region.[5] Although the Karratha to Cape Lambert pipeline may provide other services, its primary service is a gas transportation service.

The Council considers the market occupied by gas transportation services is separable from the market in which gas sales take place. First, the market in which gas transportation services are provided involves the use of specialised pipeline facilities that are distinct from those required in the gas sales market. Second, the Council observes that different parties typically participate in the gas transportation and gas sales markets. Parties buy and sell gas without entering the gas transportation market.

The second issue is whether access to the Karratha to Cape Lambert pipeline would, to a non-trivial extent, promote competition in the gas sales market.

There are a number of ways access *might* promote competition. For example, access might promote competition in the gas sales market by providing a cheaper source of energy to alternative sources of energy, or a source of energy that better meets the requirements of users, to users in the region of the Karratha to Cape Lambert pipeline. Alternatively, access might also promote competition by, for example, encouraging gas producers to develop new gas fields. These producers could then obtain access to users through the Dampier to Bunbury Natural Gas Pipeline and the Karratha to Cape Lambert pipeline.

However, the Council was not presented with evidence that access to the Karratha to Cape Lambert pipeline would promote competition in another market. The Council wrote to major gas producers advising of receipt of the application from Robe River. None of these producers raised with the Council any arguments that access (or increased access) to the Karratha to Cape Lambert would promote competition in the gas production market. The Council also sought to contact potential users in the region through the Karratha District Chamber of Commerce and Industry, but did not receive any responses.

Without significant demand for access in the Karratha/Cape Lambert region for access to gas transport capacity in the pipeline, it is difficult for the Council to reach a conclusion that access would promote competition in another market.

[5] although the services of the Karratha to Cape Lambert pipeline may not be limited to the gas transportation market.

The Council concludes that on the evidence available to it the Karratha to Cape Lambert pipeline does not satisfy criterion (a).

Criterion (b) **that it would be uneconomic for anyone to develop another pipeline to provide the services provided by means of the pipeline.**

Background

The rationale for the WA Gas Pipelines Act and the National Code is that access regulation should be limited to infrastructure where it is not economically viable to build competing facilities. As such, access regulation should normally be confined to infrastructure with monopoly power, and usually to infrastructure exhibiting *natural monopoly* characteristics – that is, where a single facility can meet market demand at less cost than two or more facilities. Such a facility is normally characterised by large up-front investment costs and low operating costs, resulting in economies of scale across a broad range of output – that is, as output increases, average costs per unit of output continue to decrease across the range of output sought by the market.

The Council has interpreted this criterion consistent with its previous interpretations of section 44(G)(2) of the *Trade Practices Act 1974* (Commonwealth). The Council notes that section 44G(2) contains slightly different wording in that it provides for declaration of facilities where "it would be uneconomical for anyone to develop another facility to provide the service". However, the Council considers the words in this criterion are consistent with the Council's interpretation of the words in section 44G(2), particularly since the Gas Reform Implementation Group (in formulating the coverage criteria under section 1.9 of the National Code) indicated that they intended to replicate the words of section 44G.[6]

In examining whether it is economic to develop another facility, the Council applies a *social* test rather than a *private* test of the costs and benefits of developing another facility. The social test looks at whether all of the benefits associated with the development of another pipeline outweigh all of the costs, for example, whether it would be better for an industry to share infrastructure because new investment would substantially raise industry costs and therefore affect the prices paid by consumers or Australia's competitiveness overseas. Where construction of a new facility might proceed in the absence of access, but would be socially wasteful because existing facilities can fully and more efficiently meet demand, the social test indicates that the development of another facility is uneconomic.

[6] See GRIG Policy Paper on the National Gas Access regime, p. 7, quoted in *National Gas Access Regime: Recommendation to the Gas Reform Implementation Group on the National Third Party Access Regime for Natural Gas Pipeline Systems*, (National Competition Council) at p. 13.

Some of the factors relevant to a consideration of whether it is uneconomic to develop another pipeline are:

- whether there is significant excess capacity in existing pipelines;
- whether current and projected levels of demand are most cheaply supplied by one party;
- whether average and marginal costs of production per unit continue to decline for all likely levels of demand;
- whether the costs of developing another pipeline to provide the transportation capacity sought by the third party outweigh the costs of expanding the capacity of the existing pipeline to meet the third parties' needs while ensuring the owner/operator and existing users do not lose amenity;
- the number of pipelines currently supplying the market for transport of gas between the regions sought by third parties;
- the height of barriers to entry (such as large upfront costs of developing another pipeline, particularly costs that cannot be recovered if the new investment were to be abandoned).

Gas pipelines are typically characterised by high construction costs and low operating costs such that the marginal cost of transporting a unit of gas is very low. Moreover, up to the point of fully expanded capacity, average costs of transportation of a unit of gas decline. This means that gas pipelines exhibit natural monopoly characteristics. In lay terms, this means it is almost always cheaper to transport gas through existing pipelines (if spare capacity exists or can be added) than it is to build another pipeline to transport the gas.

Moreover, investment in new pipelines is, in economic language, 'sunk'. That is, the investment is fixed or committed, and if the investment is a failure, little or none of it can be retrieved. This means that incremental or gradual entry – a common form of entry in other industries – is not feasible in the gas transportation industry.

Finally, it is not uncommon for existing pipelines to have spare capacity. It is often better to cater to the unpredictability of future requirements by building a larger capacity pipeline. This is because the costs of laying a new pipeline rise slowly compared with increases in the capacity of that pipeline. In other words, it is much less expensive - per unit of capacity - to lay a large capacity pipeline than a small capacity pipeline.

In summary, therefore, it is generally not economic to develop another pipeline where an existing pipeline has existing spare capacity (or can develop it through greater compression and/or looping). Having said this, the Council recognises it will always be necessary to consider the facts of particular pipelines.

Analysis

Robe River's application to the Council did not address this criterion. The Council notes the point made by Robe River under its discussion of criterion (a) that the Karratha to Port Hedland pipeline runs near the Karratha to Cape Lambert pipeline for part of its length.

Determination of whether it is economic to develop another pipeline to provide the services provided by the Karratha to Cape Lambert pipeline depends on the circumstances of the particular pipeline. It is difficult to make this judgment based on the scant information available to the Council.

It is unlikely to be economic to develop another pipeline to provide the same gas transportation services as the Karratha to Cape Lambert pipeline. This is because, on the evidence available to the Council, it appears that the Karratha to Cape Lambert pipeline has significant spare capacity, and can more than adequately cater to demand in the region for gas transportation services. While the Karratha to Port Hedland runs near the Karratha to Cape Lambert pipeline for part of its length, it was not argued to the Council that the presence of the two pipelines indicated it was economic to develop another pipeline to provide the services provided by the Karratha to Cape Lambert pipeline.

The Council concludes that the Karratha to Cape Lambert pipeline meets criterion (b).

Criterion (c) that access (or increased access) to the services provided by means of the pipeline can be provided without undue risk to human health or safety.

Background

The rationale for this criterion is that the National Code should not be applied to pipelines where this may pose a legitimate risk to human health or safety.

Analysis

The application did not address this criterion.

The Council was not provided with any evidence to suggest it would be dangerous to provide access to the pipeline. The Council notes that access is currently being provided to one third party, and there is no evidence this poses a risk to safety.

The Council concludes that access (and increased access) could be provided safely, and that the pipeline meets criterion (c).

Criterion (d) that access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest.

Background

In revocation matters, the Council considers whether access to a pipeline is contrary to the public interest. This assessment examines, among other matters, whether regulatory or compliance costs outweigh any benefits of access, such as cheaper prices and more efficient use of resources. The Council also takes into account the effect access might have on the environment, regional development, and equity.

Applicant's Views

The applicant argued access to the pipeline was contrary to the public interest.

The applicant stated that it had only been approached on one occasion for third party access, and in that case it had agreed to provide access. The applicant considered it was unlikely other parties would seek third party access.

The applicant considered that in these circumstances, access provided no real benefits while imposing costs such as the costs of preparing an access arrangement, and having it approved and overseen by a regulator.

Analysis

As discussed under criterion (a), the Council has no evidence at this time to suggest that third party access to the Karratha to Cape Lambert pipeline would promote competition in another market.

Therefore, the Council can see few benefits in continued coverage of the pipeline. At the same time, the Council sees that continued coverage would impose costs on the owner and operator of the pipeline, and on the Western Australian Office of Gas Access Regulation in assessing and overseeing the access arrangement.

The Council therefore considers continued coverage would be contrary to the public interest.

The Council concludes that the Karratha to Cape Lambert pipeline does not meet criterion (d).

Appendix 1: Criteria for Coverage in Section 1.9 of National Code

The Council must recommend revocation of coverage of a pipeline – either to the extent sought, or to a greater of lesser extent than sought in the application[7] – if the pipeline does *not* satisfy one or more of the criteria for coverage in section 1.9 of the National Code.

The criteria in section 1.9 are:

- that access (or increased access) to services provided by means of the pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the pipeline;
- that it would be uneconomic for anyone to develop another pipeline to provide the services provided by means of the pipeline;
- that access (or increased access) to the services provided by means of the pipeline can be provided without undue risk to human health or safety; and
- that access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest.

[7] Taking account of any part of the pipeline that is necessary to provide services that potential users may seek access to (section 1.29).