

Final Decision

Application to waive ring fencing obligations by NT Gas Pty Ltd

Date: 13 March 2002

File No:
S2001/687

Commissioners:
Fels
Cousins
Shogren
Martin
Jones

Table of contents

Executive summary	ii
1. Introduction.....	1
1.1 Background.....	1
1.2 Application for waiver.....	1
2. Code requirements	3
2.1 Overview of ring fencing.....	3
2.2 Relevant provisions of the Code	3
2.3 Consultative process and key dates	4
3. Assessment	5
3.1 Assessment criteria.....	5
3.2 Cost of compliance	5
3.3 Public benefit of compliance	8
3.4 Review of waiver.....	9
3.5 Conclusion.....	10
4. Final decision.....	11
Attachment 1 – Minimum ring fencing obligations	12
Attachment 2 – Map of the Amadeus Basin to Darwin transmission pipeline	13

Executive Summary

On 10 December 2001 NT Gas Pty Ltd (NT Gas) submitted an application to the Australian Competition and Consumer Commission (the Commission) to have its obligations under sections 4.1(h) and (i) of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code) waived. These provisions prohibit a service provider from sharing marketing staff with an associate involved in a related business that buys or sells natural gas.

The Commission may issue a notice waiving these obligations if it is satisfied that the costs of complying outweigh the associated public benefit.

The waiver would allow NT Gas' staff to provide services, including marketing, to NT Gas Distribution Pty Ltd (NTGD). NTGD is an associate of NT Gas and carries on a related business of selling natural gas.

NT Gas has estimated the costs it would incur to meet the obligations based on obtaining a variety of services from a contracted consultant. The Commission does not regard this as the most cost-effective way to comply with the obligations. The Commission has also considered other estimates of marketing expenditure, which suggest NTGD's compliance costs would be lower than those claimed. Nonetheless, the Commission considers that they would be significant to NTGD as a proportion of its total revenue and might materially reduce its profitability.

The Commission considered a number of factors when assessing the public benefit that would be likely to accrue from compliance. Most importantly, as the Amadeus Basin to Darwin Pipeline's (ABDP) capacity is fully contracted until 2011 and there is little prospect of significant demand growth in the short to medium term, there appears to be limited scope for downstream competition in the Darwin area. Consequently, the public benefit from the two companies ceasing to share marketing staff is not likely to be significant under current circumstances.

The Commission's *Final Decision* under section 4.23 of the Code is that it will issue a notice under section 4.15 waiving the requirement for NT Gas to meet the obligations set out in sections 4.1(h) and (i). It should be noted that a waiver can be reviewed and rescinded at any time if the Commission is no longer satisfied that the grounds for the waiver are met. Significant changes in prevailing conditions such as the expiry of the ABDP foundation contract in 2011 or the introduction of gas to the region from the Timor Sea would warrant a review of the waiver.

1. Introduction

1.1 Background

NT Gas Pty Ltd (NT Gas) is the service provider for the Amadeus Basin to Darwin Pipeline (ABDP). The ABDP is a transmission pipeline that transports gas from the Palm Valley and Mereenie gas fields to Darwin (Attachment 2 contains a map of the ABDP). The largest user of ABDP transported gas is the Northern Territory Power and Water Authority (PAWA) with over 90 per cent of the gas transported on the ABDP used for electricity generation.¹ The pipeline system includes a branch supply line from the Mereenie production facilities together with small lateral pipelines at Tennant Creek and Katherine. The length of the ABDP is 1 513km. The outside diameter of the main pipeline is 355.6mm between Palm Valley and Mataranka, 323.9mm between Mataranka and the Darwin City Gate and 219.1mm between the Darwin City Gate and Channel Island.²

NT Gas Distribution (NTGD) is a wholly owned subsidiary of NT Gas. NTGD owns the distribution network in Darwin, which includes 19.5km of steel main and 6km of plastic reticulation system. The steel main is a covered pipeline under the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code) called the City Gate to Berrimah Pipeline. NTGD sells gas to several industrial customers and distributes a larger amount to a third party that in turn supplies one customer. It has also recently signed a two-year agreement to sell gas to railway sleeper plants at Katherine and Tennant Creek.

The Australian Competition and Consumer Commission (the Commission) is the gas transmission pipeline regulator under the Code in all Australian states and territories other than WA, which has its own independent regulator, OffGAR. The Commission also regulates distribution pipelines in the Northern Territory.

1.2 Application for waiver

On 10 December 2001 NT Gas submitted an application to the Commission to have its obligations under sections 4.1(h) and (i) of the Code waived. These provisions prohibit the sharing of marketing staff with an associate involved in a related business.³ The waiver would allow NT Gas' marketing staff to provide services to NTGD and to enable other staff of NT Gas to act as marketing staff for NTGD. NTGD is an associate of NT Gas for the purpose of the Code and carries on a related business.

NT Gas seeks to continue to provide commercial, management and marketing services to NTGD as required, and to enable the General Manager of NT Gas to also perform

¹ ACCC *Draft Decision* Access Arrangement proposed by NT Gas Pty Ltd for the Amadeus Basin to Darwin Pipeline, 2 May 2001 p. 5

² NT Gas Pty Ltd Access Arrangement Information for the Amadeus Basin to Darwin Pipeline, 25 June 1999 p. 37

³ 'Related business' means the business of producing, purchasing or selling natural gas, but does not include purchasing or selling natural gas to the extent necessary: for the safe and reliable operation of a covered pipeline; or to enable a service provider to provide balancing services in connection with a covered pipeline.

the functions of General Manager of NTGD. The marketing services to be provided to NTGD would usually be provided by the General Manager and/or the Manager Commercial of NT Gas. However, other staff of NT Gas may also provide these services at times.

A waiver of these obligations means that NT Gas will effectively carry out the marketing and sales functions for the transmission, distribution and retail arms of natural gas supply in the Darwin area.

2. Code requirements

2.1 Overview of ring fencing

Ring fencing is designed to assist the introduction of effective competition into markets traditionally supplied by integrated monopolies. It involves putting structures in place to prevent flows of information and personnel within an integrated utility and between related businesses. An integrated firm or group of related businesses is likely to be faced with incentives for anti-competitive behaviour. This may include providing preferential treatment to upstream and downstream operations or related entities, joint marketing and/or the sharing of information between operations or related businesses.

Ring fencing limits the scope for these types of anti-competitive behaviour. The Code provides minimum ring fencing obligations with which service providers must comply. The Commission has the responsibility of monitoring compliance with these obligations in respect of transmission pipelines. It may waive certain minimum requirements, require additional measures and/or establish mandatory accounting guidelines.

2.2 Relevant provisions of the Code

The minimum obligations are set out in section 4.1 of the Code (see Attachment 1). Sections 4.1(h) and (i) of the Code relate specifically to marketing functions and broadly require that NT Gas' marketing staff do not also work for an associate that takes part in a related business (in this instance, NTGD) and that none of NT Gas' staff should undertake marketing for such an associate.

The Code recognises that in some cases it may be impractical and inefficient for an organisation to implement some of the ring fencing obligations. It allows for the relevant regulator, in this case the Commission, to waive the obligations in sections 4.1(h) and (i) if it is satisfied that the criterion outlined in section 4.15(b) of the Code below is met.

4.15 The Relevant Regulator may by notice to a Service Provider waive any of a Service Provider's obligations under:

.....

(b) Sections 4.1 (h) and (i) where the Relevant Regulator is satisfied that the costs to the Service Provider and its Associates that would be incurred solely as a result of complying with that obligation (other than costs associated with losses arising from increased competition in upstream or downstream markets) outweigh any public benefits that would arise from the Service Provider complying with the obligation.

Sections 4.16 to 4.24 of the Code set out the procedures to be followed in considering an application to waive ring fencing obligations. The Code does not allow for extensions in this process, and the deadlines are determined by the date that the applicant lodges the request.

2.3 Consultative process and key dates

The Commission received NT Gas' application on 10 December 2001. After determining that the application was not made on vexatious grounds, an *Issues Paper* was distributed to interested parties and a notice placed in the *Australian Financial Review* and the *Northern Territory News* on Friday 21 December 2001. Submissions were required by 1 February 2002. One submission was received from NT Gas on 1 February 2002.

The *Draft Decision* was issued on 8 February 2002. Submissions were required to be received by Monday 25 February 2002. One submission was received from NT Gas on 28 February 2002. A service provider or any other party that has been adversely affected by this *Final Decision* has the opportunity to lodge an application to have the decision reviewed by the Australian Competition Tribunal (the relevant appeal body for Commission decisions).

3. Assessment

3.1 Assessment criteria

Pursuant to section 4.15(b) of the Code, the ring fencing obligations in sections 4.1(h) and (i) may be waived if the Commission is satisfied that the costs that would be incurred solely as a result of complying with the obligations outweigh the public benefits that would arise from compliance.

The Commission has examined these issues as they relate to the sharing of marketing staff between the two companies. For the purpose of this analysis it is assumed that NT Gas would continue to comply with the remaining ring fencing obligations (the minimum obligations are outlined in Attachment 1).

Submissions from interested parties

In response to the *Draft Decision*, the Commission received one submission, which was from NT Gas on 28 February 2002. NT Gas noted that the costs of compliance would be the costs of obtaining marketing services for both itself and NTGD because it was unfeasible, given its size and structure, for it to re-distribute the duties of staff to ensure compliance with the Code. The second comment made by NT Gas in its submission is that GSN is not a comparable business and that GSN's marketing costs do not reflect the higher costs of obtaining consultancy services in Darwin.

Although no written submissions were received from customers, potential competitors or other interested parties, Darwin Galvanising, a customer of NTGD provided oral comment in response to the *Issues Paper*. It was suggested that it may be appropriate to place a sunset clause on the waiver, if granted, as future developments might change market conditions substantially. Following advice that the Commission has the power to review/revoke the waiver at any time, Darwin Galvanising expressed support for the application.

3.2 Cost of compliance

In its application, NT Gas considers the costs of complying to be those that would result from NTGD obtaining commercial, management and marketing services from an external source. NT Gas has provided the Commission with estimates of the cost involved in doing this. However, NT Gas has requested that the estimates be kept confidential. It argues that publication of the estimates may harm the commercial interests of NTGD as the information would be available to firms it considers to be its competitors. The Commission has agreed not to release the estimates.

The compliance model used in NT Gas' application is one in which its general manager performs the duties of general manager for NTGD. A separate team would perform all other functions currently provided by the general manager and the manager commercial. NT Gas proposes that the most practical approach is to obtain these services as and when required through consultants on a contractual basis. Factors that support using contracted consultants include the low volume and irregularity of work and the skills and experience required.

Other estimates of marketing costs

To assist its assessment of the reasonableness of the cost estimates provided by NT Gas the Commission considered available benchmarks. Estimates of gas transportation marketing costs that provide potential benchmarks include data available from the assessment by the Independent Pricing and Regulatory Tribunal (IPART) of a waiver application by Great Southern Energy Gas Networks (GSN)⁴ and NT Gas' access arrangement documentation for the ABDP⁵.

In its submission of 1 February 2002, NT Gas discussed the use of other companies marketing costs as benchmarks. In particular, NT Gas noted that there is likely to be differences in the marketing costs for transmission and distribution businesses due to the nature of the businesses, as well as differences between distribution companies resulting from different operating environments. The Commission considered that, although not directly comparable, such benchmarks would assist in its determination of the reasonableness of NT Gas' estimate of compliance costs.

GSN waiver decision

IPART considered a waiver application from GSN in relation to sharing marketing staff with its parent company in 1999. In its application, GSN estimated that to employ a marketing executive on a part time basis or to outsource this work would cost \$30 000 to \$50 000 a year with the total annual cost of outsourcing marketing services being between \$60 000 and \$90 000. IPART considered this to be a realistic estimate.

NT Gas

In 1999, when proposing its access arrangement, NT Gas forecast its total expenditure on sales and marketing to be \$138 000 for the year ending 30 June 2002. This amount includes expenditure relating to advertising and promotion of gas transportation services, investigation and feasibility studies for potential gas consuming projects, commercial negotiations relating to gas transportation services, and general contract management and administration activities.

Commission's considerations

The Commission notes that the estimates provided by NT Gas as part of its waiver application are substantially higher than those of NT Gas (for the ABDP access arrangement) and those used in the IPART decision. In its submission of 1 February 2002, NT Gas claims that the nature of a distribution business rather than a pipeline business means that it is possible that the marketing costs for NTGD would be higher than those for NT Gas (ABDP). The Commission acknowledges that there are likely to be some differences due to the nature of the two businesses. However, this position appears to be inconsistent with the claim that there is not sufficient regular marketing work to justify employing marketing staff specifically for NTGD.

⁴ IPART, *Final Decision*, Great Southern Energy Gas Networks Pty Limited Application for waiver of certain ring fencing obligations, November 1999

⁵ NT Gas Pty Ltd Access Arrangement Information for the Amadeus Basin to Darwin Pipeline, 25 June 1999 p. 35 (forecast in dollars of the day)

In addition, NT Gas suggests that the comparison with GSN's marketing costs may not be relevant. It submits that, in order to be a meaningful benchmark, the cost information would have to relate to a similar sized business operating in a similar environment (that is, commercial, cultural and climatic). NT Gas has submitted that GSN's marketing costs do not reflect the higher costs of obtaining consultancy services in Darwin.

The Commission considers that the primary reason for the difference between the GSN and NT Gas estimates may be that NT Gas' figures include the costs of outsourcing services other than marketing, such as management and commercial services for NTGD. The cost estimates for GSN relate only to marketing services. To comply with the obligations in 4.1(h) and (i) it is necessary only to ensure that non-marketing staff of NT Gas do not directly undertake marketing for NTGD and that any staff directly involved in sales and/or marketing for NT Gas do not provide any services to NTGD.

Since NT Gas has stated that there is insufficient regular work to employ additional staff, even on a part time basis, it seems reasonable to consider the costs of complying would be those of obtaining marketing services from an external consultant. The Commission considers that obtaining the full suite of commercial and management services, rather than just marketing services, from a consultant on a contractual basis may not be the most cost effective way of complying. Consequently, the Commission will not consider the costs of obtaining those services in its analysis.

In its submission of 28 February 2002, NT Gas has submitted that the size and structure of NT Gas makes it unfeasible to re-distribute the duties of the staff of NT Gas to ensure compliance with the Code and accordingly, the costs of compliance will be the cost of obtaining external marketing services for both companies. The Commission is unable to determine whether NT Gas' submission is reasonable, based on the information provided. While the Commission considers that it would be reasonable to anticipate that the costs of compliance might be higher in circumstances where NT Gas and NTGD both obtain external marketing services, based on the information provided, the Commission is unable to determine whether the re-distribution is unfeasible. The Commission has not sought further information on this issue as it considers that the cost of compliance would be significant and therefore it is not necessary to delineate precise costs.

The relevant costs for the Commission's analysis are the net costs of compliance. For NTGD the net costs include the costs associated with NTGD obtaining marketing services from an external source less the cost of obtaining these services from NT Gas, as is currently done. NTGD would continue to obtain marketing services from NT Gas should the waiver be granted. As such, the cost of this arrangement would be borne by NTGD in the absence of compliance with the ring fencing obligations and cannot be considered part of the compliance cost. If the cost of NT Gas obtaining external marketing services was also considered, NT Gas' net costs of compliance would need to account for the costs associated with NT Gas obtaining marketing services from an external source, less the cost of obtaining those services internally from existing staff, as is the current situation. The Commission considers that NT Gas' submission does not take into account the cost benefit to NT Gas as a result of not using internal staff to provide these services.

NT Gas has provided financial information for NTGD to the Commission to assist in its assessment of the compliance costs. As indicated above, the Commission has agreed not to release this information. The Commission does not regard NT Gas' estimate of compliance costs as reasonable, particularly given the inclusion of commercial and management services. However, it does consider that the cost of complying with the ring fencing provisions in question would be substantial in relation to the revenue of NTGD.

3.3 Public benefit of compliance

NT Gas states that neither it nor NTGD currently face any competitors or potential competitors in the sale of natural gas and, as a result, complying with ring fencing obligations would not produce any public benefit. NT Gas also contends that the benefits intended by the Code would not be realised without the introduction of retail competition in the Northern Territory.

Relevant issues

Key issues relevant to the assessment of the public benefit of compliance include the existence and impact of barriers to entry, the extent of spare capacity on the ABDP, the level of demand for NTGD's services and the extent of competition in the area served by NTGD.

Barriers to entry

Potential competitors are less likely to consider entry viable where incumbents are perceived to have an advantage. This could arise where existing companies are engaged in joint marketing and appear to be vertically integrated. In this case, compliance with the minimum ring fencing requirements in the Code could have a public benefit if it resulted in efficient firms entering the market and competing effectively. The public benefit would then include all the flow on effects of competition.

ABDP transmission capacity

The ABDP is fully contracted until 2011, predominantly for the purpose of electricity generation. The capacity of the pipeline is fully committed to users under pre-existing transportation contracts leaving little scope to grow the market. As a result transportation services are unlikely to be available to third parties unless the pipeline system is expanded or extended.⁶ In the absence of additional supply capacity, there would appear to be little scope for active marketing at the transmission or distribution level.

Level of demand

NTGD was established in 1995 and its viability largely depended on the growth of the Trade Development Zone, which did not eventuate. NTGD originally employed two staff. However, the business was not considered to be financially viable with this structure. Consequently, NTGD no longer employs any staff directly and all operations of the NTGD business are carried out by NT Gas.

⁶ ACCC *Draft Decision* Access Arrangement proposed by NT Gas Pty Ltd for the Amadeus Basin to Darwin Pipeline, 2 May 2001 p. 68, 98

The natural gas reticulation system in Darwin is fairly small in terms of volume. During 2000-01 there were seven customers of the distribution network with a total annual volume of 14.7TJ. Potential domestic demand for natural gas is limited due to Darwin's climate. Consistent with this is NT Gas' submission that the existing and potential market for reticulated natural gas in Darwin is limited due to the size of the city, its small industrial and commercial base, climatic conditions and the availability of alternative fuels. NT Gas submits that as a result of these factors there is no real prospect for the development of a competitive market for the supply of natural gas in Darwin.

Extent of competition

At present NTGD does not have any competitors in the supply of natural gas. NT Gas states that it does face competition from suppliers of Liquefied Petroleum Gas (LPG). While LPG has similar applications to natural gas it is not directly substitutable with natural gas for all customers. LPG can be mixed with air to produce a synthetic or simulated natural gas that may be compatible with natural gas systems. This provides some scope for users to switch between the two.

Commission's considerations

The Commission has considered the barriers to entry that currently exist in the region served by NT Gas. No submissions were received from potential competitors expressing concern that the sharing of marketing staff would deter entry to the market for natural gas. As noted above, the capacity of the ABDP is fully contracted until 2011. This is likely to be a more significant barrier to firms wishing to compete in downstream activities than the sharing of marketing staff.

Further, the delivery figures and financial information for NTGD support the claim that the demand for natural gas in the Darwin area is relatively low. Importantly, as the region has quite high minimum temperatures throughout the year, solar heating is a cost-effective option for hot water systems and there is no demand for space heating. These are considered to be two major drivers of domestic connections in southern Australia. Although NTGD is currently the only distributor of natural gas in the area its profitability has not developed as anticipated. The Commission would expect that the level of demand would be a more substantial deterrent to potential competitors.

From the information regarding the NT natural gas market, the Commission considers that as a result of the market environment, there would be little public benefit in requiring NT Gas and NTGD to separate their marketing staff.

3.4 Review of waiver

The Commission has identified a number of potential changes to market conditions in the region served by NTGD that might substantially alter the level of downstream competition and affect the factors considered in the current analysis. These include significant changes in prevailing conditions such as the expiry of the ABDP foundation contract in 2011 or the introduction of gas to the region from the Timor Sea.

The Code does not allow a regulator to impose conditions or a sunset clause when granting a waiver. However, the Commission does have the power to revoke or vary a waiver subject to a similar consultation process to that of the initial application. The

Commission may do this at any time should it no longer be satisfied that the criterion in section 4.15(b) is met. The Commission considers that significant changes in prevailing conditions, such as those noted above, would warrant a review of the waiver.

3.5 Conclusion

The Commission has examined NT Gas' claim regarding the cost of complying with sections 4.1(h) and (i) of the Code. It does not accept that the estimates provided by NT Gas are reasonable. However, the Commission does accept that the compliance costs would be substantial in relation to the revenue of NTGD and might materially reduce its profitability.

The Commission has also considered the market environment in relation to the potential public benefits of complying with sections 4.1(h) and (i). The Commission considers that the capacity and demand factors currently prevent the development of effective competition in downstream markets. It has also concluded that they are likely to have a more significant impact on entry than the sharing of marketing staff. The assessment suggests that current market conditions may support a natural monopoly structure. The Commission considers that the public benefit from NT Gas ceasing to share marketing staff with NTGD would not be significant unless market conditions changed substantially.

The Commission also notes that the imposition of ring fencing obligations that appear to have little public benefit at this point in time might constitute a regulatory burden that would limit the ability of NTGD to attract customers currently using LPG. This may have a negative impact on competition that would not be consistent with the intention of the Code.

The Commission has concluded that the cost of complying with the ring fencing obligations currently outweighs any associated public benefit and will waive the obligations. The granting of a waiver at this time will not preclude the Commission from reviewing the waiver if market conditions change substantially at any time in the future.

4. Final decision

In accordance with section 4.23 of the Code, the Commission will issue a notice under section 4.15 waiving NT Gas' ring fencing obligations in sections 4.1(h) and (i) of the Code. The Commission is satisfied that the cost NT Gas would incur in complying with sections 4.1(h) and (i) of the Code would outweigh any public benefit from meeting these obligations. The notice will allow staff of NT Gas to undertake marketing and sales work for NTGD, which is an associate company that carries on a related business.

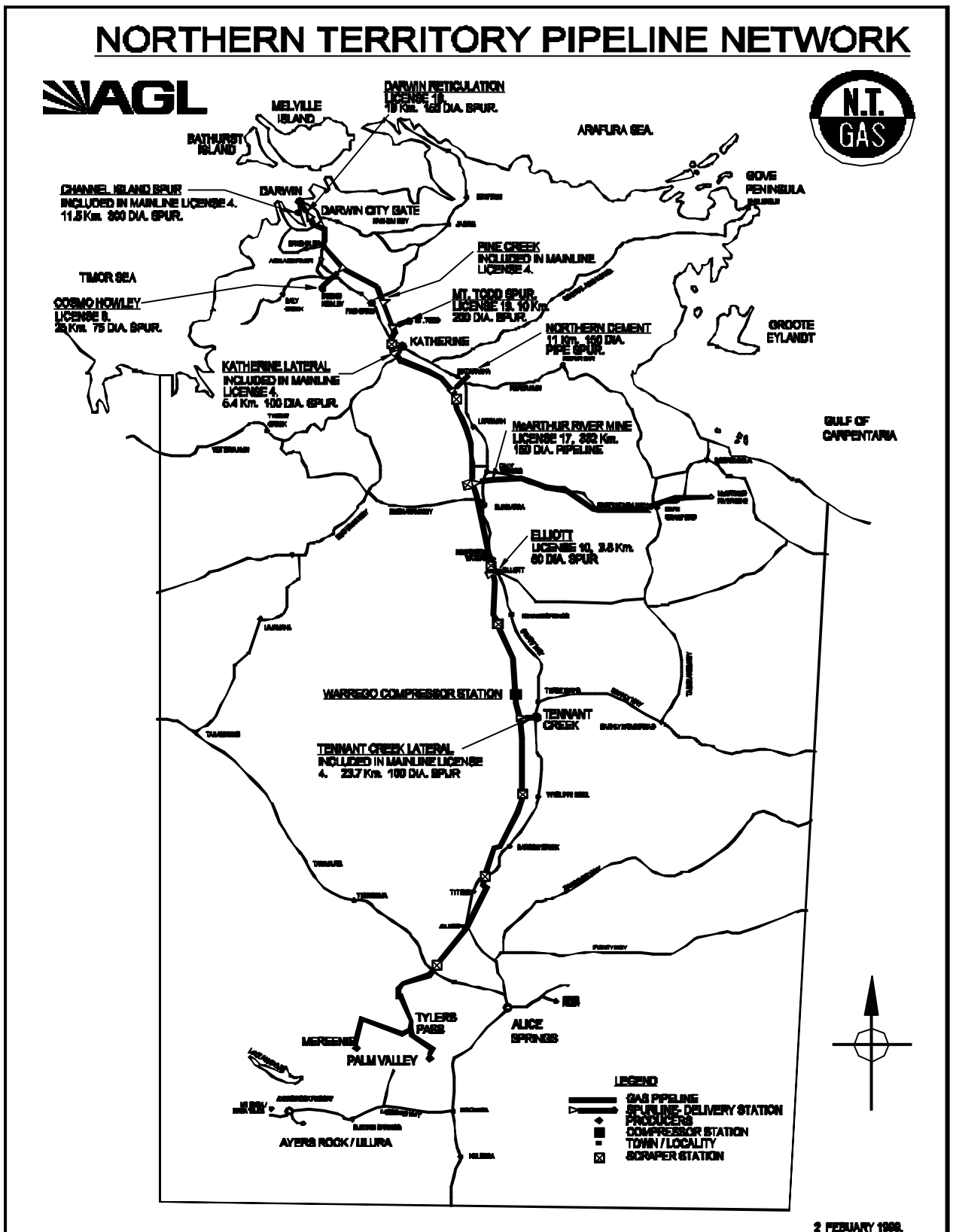
The Commission has the power to revoke or vary a waiver at any time if the Commission is no longer satisfied that the grounds for the waiver are met.

Any person adversely affected by the Commission's *Final Decision* may apply, pursuant to section 4.24, within 14 days of the date of this *Final Decision* to the Australian Competition Tribunal to review the decision.

Attachment 1 – Minimum ring fencing obligations

- 4.1 A person who is a Service Provider in respect of a Covered Pipeline (regardless of whether they are also a Service Provider in respect of a Pipeline that is not Covered) must comply with the following (but in the case of paragraphs (a), (b), (h) and (i), as from the date that is 6 months after the relevant Pipeline became Covered):
- (a) be a legal entity incorporated pursuant to the Corporations Law, a statutory corporation, a government or an entity established by royal charter;
 - (b) not carry on a related business;
 - (c) establish and maintain a separate set of accounts in respect of the Services provided by each Covered Pipeline in respect of which the person is a Service Provider;
 - (d) establish and maintain a separate consolidated set of accounts in respect of the entire business of the Service Provider;
 - (e) allocate any costs that are shared between an activity that is covered by a set of accounts described in section 4.1 (c) and any other activity according to a methodology for allocating costs that is consistent with the principles in section 8.1 and is otherwise fair and reasonable;
 - (f) ensure that all Confidential Information was provided by a User or Prospective User is used only for the purpose for which that information is provided and that such information is not disclosed to any other person without the approval of the User or Prospective User who is provided it, except:
 - (i) if the Confidential Information comes into the public domain otherwise than by disclosure by the Service Provider; or
 - (ii) to comply with any law, any legally binding order of a court, government, government or semi-government authority or administrative body or the listing rules of any relevant recognised Stock Exchange.
 - (g) ensure that all Confidential Information obtained by the Service Provider or by its servants, consultants, independent contractors or agents in the course of conducting its business and which might reasonably be expected to affect materially the commercial interests of a User or Prospective User is not disclosed to any other person without the approval of the User or Prospective User to whom that information pertains, except:
 - (i) if the Confidential Information comes into the public domain otherwise than by disclosure by the Service Provider; or
 - (ii) to comply with any law, any legally binding order of a court, government, government or semi-government authority or administrative body or the listing rules of any relevant recognised Stock Exchange.
 - (h) Ensure that its Marketing staff are not also servants, consultants, independent contractors or agents of an Associate that takes part in a Related Business and, in the event that they become or are found to be involved in a Related Business contrary to this section, must procure their immediate removal from its Marketing Staff; and
 - (i) Ensure that none of its servants, consultants, independent contractors or agents are Marketing staff of an Associate that takes part in a Related Business and, in the event that any servants, consultants, independent contractors or agents are found to be the Marketing Staff if such an Associate contrary to this section, must procure their immediate removal from their position with the Service Provider.

Attachment 2 – Map of the Amadeus Basin to Darwin pipeline



Source: NT Gas Pty Ltd Access Arrangement Information, p. 53