Coverage of NSW Gas Transmission Pipelines **[Incitec submission]**

1. Introduction

The NCC has published papers regarding the application for coverage of the Eastern Gas Pipeline and the application for partial revocation of coverage of the Moomba to Sydney pipeline system. Incitec wishes to provide the following information in order to help the NCC come to a view as to how these two pipelines should be regulated, if at all.

2. Background

Incitec operates a plant at Newcastle which manufactures ammonia from natural gas, and in turn, nitric acid and ammonium nitrate from ammonia. Ammonia and ammonium nitrate are marketed as both fertilizer and as industrial chemicals. The majority of ammonia is sold into the cotton and wheat markets of northern NSW. On the other hand much of the ammonium nitrate is sold to the coal industry, mainly in the Hunter Valley, for the production of coal. The site has a replacement value of approximately $500million and employs 260 people full-time. The products manufactured displace imports, to an annual value of $100million per year.

Incitec annually consumes approximately ten PetaJoules of natural gas each year. This represents around 50% of the Newcastle demand and perhaps 10% of the NSW demand for natural gas. The Incitec load at Newcastle underwrote the extension of the natural gas line from Horsley Park to Newcastle.

Natural gas represents nearly 90% of the variable cost of ammonia and about 60% of the fully absorbed cost. Natural gas is therefore the single most critical element in determining the economics of manufacture. Ammonia is a freely traded commodity on the world market and Incitec operates ocean terminals which can import, and have readily imported, ammonia. The ammonia prices on the world market have recently cycled to very low levels and are considered highly likely to do so again within the next year. This is due to continued construction of new plant in parts of the world where natural gas is very cheap compared with gas costs in this country. As an example new plant is being built with gas costs of approximately A$1.50/GJ against current Newcastle prices of perhaps $4-5/GJ. It is obvious from these overseas gas costs that no competition can be provided from alternative energy sources, ie LPG, oil, electricity etc. Coal is clearly rejected on capital investment and environmental grounds. Only natural gas can provide the quality and costs required for competitive ammonia production in this country.

Regulation of gas pipelines has seen important improvements in the cost of transmission of natural gas.

3. Incitec Position on Coverage

The experience of Incitec in this country to date has been that deregulation, unbundling of tied services and the resultant re-regulation of natural monopolies has been extremely beneficial, particularly in the gas industry but also in the electricity industry and even in the supply of water. It is against this secure experience of successful outcomes that the view of this company is that the reforms put in place are working and should be encouraged. It is also however Incitec's experience that the regulated monopolies, in all industries in all states tenaciously retain their advantages and make concessions only when clearly forced to do so. It is Incitec's view that with transmission pipeline regulation in NSW it is far too early to decide that competition has swept the market. The question that Incitec chooses to answer is should the Moomba to Sydney, and Longford to Sydney pipelines be covered, or not?

3.1 Duopoly Market

In Wollongong, Sydney and Canberra gas transmission services comprise a duopoly. Advice from economic theory demonstrates that duopoly "competition" will produce a price somewhere between monopoly pricing and a perfectly competitive market. That is, there is such a thing as a duopoly rent, which is extracted when both parties settle down to their optimum market share, in spite of there being spare capacity. This point is known as "Nash's equilibrium". Regulation, if properly effected, can eliminate this "duopoly rent".

The most obvious example of a duopoly market and duopoly rents is of course the airline industry in eastern Australia dominated by Qantas and Ansett. Parties will recall the sharp drop in fares from these two companies during the era of Compass 1 and Compass 2, and their recovery following the demise of Compass. Obviously the advent of the third player was enough to create a competitive market. Both major airlines currently charge $500 - $600 for a return flight between Sydney and Melbourne. Once again we are seeing two new airlines entering the market. Impulse will offer approx $280 and presumably Virgin Airlines a similar fare. It is clear that the major airlines will follow suit if only by creating "Bi-Lo" brands.

The damage that is done to the country as a whole is that industries that can operate at competitive gas prices will establish or at least continue to operate however will not at duopoly or monopoly prices.

3.2 Gas Producer Monopoly

The competitive situation is in fact less competitive than even a duopoly market might suggest. At the supply end of each of these two pipelines are monopoly gas producers with a clear track record in promoting their gas price upwards. The possibility is strong that in the unlikely event that these two monopoly producers may compete on price, that this price reduction would immediately be taken up by the pipelines; and conversely, should the pipelines compete, then some or all of the competitive advantage would be taken up by the producers. The effect of all this would be to limit competitive impulses. It would seem to be a very thin market indeed in which to declare that a perfect competitive market exists.

3.3 Residual Monopolies

It needs to be noted that Wollongong, Sydney, Newcastle and Canberra will gain what benefits may flow from Duopoly competition, if the pipelines are uncovered. This is of course the bulk of the market. There will, however, be situations where competition is not available, presumably Wagga, Nowra, Lithgow, Dubbo etc and while the demand may be small, nonetheless these parties can expect the protection that was intended to flow from the reform process in re-regulating monopolies.

3.4 Unravelling Effect

There will also be a problem if these lines are fully or even partially uncovered. Where does this process stop? Obviously the Wodonga to Wagga link could then be uncovered. If this link is uncovered why is the Victorian link between say Wodonga and Melbourne covered? Will there be an argument to uncover the Papua New Guinea to Brisbane line and the Ballera to Brisbane lines?

4. North American Experience

There are plenty of examples in the United States where pipelines run generally in parallel and therefore compete. An example may be the Natural Gas Pipeline Limited and the Panhandle Eastern Pipeline, from Texas to Chicago. These pipelines do provide discounts at various places but not all. Nonetheless FERC still provides a maximum tariff for these pipelines in their entirety.

In the USA pipelines span thousands of kilometres and cross both areas where no other pipelines exist and areas where many exist. Competition is therefore applicable to regions or even singular locations rather than by the overall pipeline company. Even locations where multiple pipelines may be in close proximity their individual operational pressures and load profile may inhibit their ability to serve certain customers and thus provide no competitive alternative.

Given that the FERC does regulate these pipelines it would be quite inappropriate to lift regulation in full or in part from 2 pipelines in NSW that have not yet demonstrated publicly that they are prepared to compete on price.

5. Recommendation

5.1 It is recommended that coverage be applied for the EGP in its entirety, ie the Canberra to Sydney section should be fully covered, without inhibiting the ability of EGP to provide discounts below this tariff. The Regulator should be cautious that these discounts are not reapplied to those sections of the pipeline that retain the strong monopoly characteristic.

5.2 It is recommended that the coverage of the Moomba to Sydney pipeline system be retained in full and as is, without inhibiting the ability of the pipeline owner to discount.

5.3 The National Gas Code was of course set up to define the regulation of natural gas transmission and distribution networks. Whatever the advantages to the service provide may or may not be, the protections to the consumer are considerable, with respect to restriction on asset valuations and also the provision of information, over and above coverage determined under Part III of the Trade Practices Act.