7th January 2013

Mr Ross Campbell
Director
National Competition Council
GPO Box 250
Melbourne, Vic. 3001

By email to: Ross.Campbell@ncc.gov.au

Dear Ross

Application for Coverage of the South Eastern Pipeline System (SEPS)

Thank you for your letter dated 29 November 2012 seeking more information regarding the application by Kimberly-Clark Australia (KCA) for coverage of the South Eastern Gas Pipeline system located between Katnook, Mount Gambier and Millicent in South Australia. In that letter and in the earlier telephone conversation between you and Mr Headberry you seek additional information regarding criteria (a) and (b).

Criterion (a)
This criterion addresses whether coverage of the gas pipeline would materially increase competition in markets either downstream or upstream of the pipeline. The following comments and observations are made in addition to those included in the application.

- KCA is aware that recently APA acquired the assets of Epic Energy, including the ownership of SEPS. This means that APA now has ownership of all the gas transmission assets from the SEAGas connection (APA owns 50% of SEAGas and is its operator) to all the connected users of SEPS. KCA understands that Origin Energy has contracted all of the capacity of SESA but its contract for all of the capacity of SEPS has expired, allowing other shippers to access use the capacity of SEPS. Despite the ownership change of SEPS, this has not impacted on the availability of access to SEPS by shippers other than Origin Energy.

- As all of the capacity of SESA pipeline is contracted to Origin Energy, KCA is aware that this effectively can prevent any other shipper of gas injecting gas from SEAGas pipeline into SEPS. This means that there is currently no competition from other shippers with access to SEAGas to use SESA to provide gas injection into SEPS, so coverage of SEPS will not result in increased competition by shippers with access to the SEAGas pipeline unless Origin Energy provides consent to allow the use of the capacity of SESA by another shipper.

- Epic Energy has publicly provided a tariff for haulage on the SEPS at $0.5132/GJ of MDQ commencing 1 January 2011 (escalated annually) at pressures between 5000 and 6000 kPa (see http://www.epicenergy.com.au/media/docs/SEPS_Key_Commercial_Terms.pdf). There is already an estimated flow of 12-13 TJ/day of gas hauled on the SEPS, implying SEPS would generate an annual revenue in excess of $2.5m pa ($2013). The bulk of the gas hauled on SEPS is delivered to KCA, clearly indicating the cost of haulage is material to KCA and would be similarly so for other users.

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- In its final recommendation to revoke coverage of SEPS, the NCC identified that the transport of gas on SEPS was a separable market to the downstream and upstream markets. As gas usage on SEPS has not changed, there is no change which would justify changing this conclusion – that the gas injection and usage comprise separate markets from the gas haulage market. The NCC also concluded that there were three different markets impacted by the gas hauled on SEPS – an upstream market where there was competition between producers, an upstream market where there was connection to other supply pipelines providing competition to producers injecting at Katnook and a downstream market where gas was consumed.

  As noted below, there is now potential competition between two upstream sources of gas – gas provided by the gas producers actively seeking gas in the region and gas delivered by SEAGas pipeline (connecting Port Campbell in Victoria and Adelaide in SA) via the SESA gas pipeline purpose built to connect SEAGas pipeline with SEPS. Epic has already provided open access to SEPS (see next dot point) but unless this open access is provided at cost reflective pricing (as would occur under coverage) this upstream competition might be prevented. This point is expanded in comments made below.

  The downstream gas market comprises usage of gas for industrial, commercial and domestic purposes in the lower South East region of SA. As noted in the application and below, the gas sales market is currently controlled by Origin Energy and the gas consumed predominantly provides for the thermal energy needs of the users of the gas. Therefore the downstream markets are essentially indirect rather than a separate gas sales market in its own right. KCA expands below on the benefits of coverage to downstream users.

- KCA identified in its application that Beach Energy was exploring for new gas fields west and south of Katnook (see http://www.beachenergy.com.au/irm/content/otway-basin.aspx?RID=274) to support its ownership of Katnook gas field. With all capacity on SESA contracted to Origin Energy, should Beach Energy seek to sell any of its gas it either has to reach agreement with Origin to export its gas via SESA to SEAGas (which currently has all its capacity contracted to others, although interruptible capacity is available) or to sell its gas through SEPS to end users connected to SEPS. Beach would have to discover a very large gas field to cover the costs of exporting through SEAGas, but for small gas fields (similar in size to Katnook or smaller) it would be more commercially viable to export into SEPS for the local gas market as was the case in 1990 when Katnook was initially developed. Access to SEPS by Beach Energy will increase upstream competition in gas supplies by allowing it to compete with Origin Energy which currently controls all gas injection into SEPS from SESA.

- KCA uses its gas supplies to generate product for the Australian tissue market – Kleenex, Kotex, VIVA and Huggies are some of its local brands. There is considerable competition in the national tissue market from imported products and whilst local Australian tissue manufacturers are able to maintain some market share (for example KCA has a share of the national tissue market which overall is in the mid 30% range), this is eroding with the high Australian dollar ($A) allowing easier access to the local tissue market from overseas suppliers. This high $A pressure has already led to KCA closing two of its tissue machines and its pulp mill in the past 12-18 months and these closures have created a considerable loss of employment in the region.

  Local tissue manufacture creates competitive pressure on import prices for tissue products and the continued viability of local manufacture will continue to provide these price constraints on importers of tissue products. The continued need for competitive local tissue

manufacture is typified by the Commonwealth Government decision to provide KCA and other local tissue manufacturers some exemption from the impost of the carbon tax and the renewable energy levies. KCA is a beneficiary of this partial exemption.

The production of tissue is very energy intensive and to maintain production costs at a competitive level, the cost of energy needs to be closely controlled. Paying an unnecessary premium for energy supplies, reduces KCA's ability to keep its prices at levels that impose competitive pressures on imports and other local manufacturers in the Australian market for tissue products. The loss of KCA providing tissue products at competitive prices into the national market will lead to increased imports and higher prices as other manufacturers provide product to replace the KCA market share of these products that is lost by unnecessary high input costs.

KCA believes that coverage will result in considerably lower gas haulage prices for use of SEPS by the elimination of monopoly rents. Eliminating monopoly rents from the haulage of gas to KCA will enable KCA to reduce its costs of production and therefore reduce its selling prices. Because of its market share, KCA reducing its selling prices will result in downward price pressure on all suppliers of tissue products thereby increasing competitiveness in the national tissue market. Allowing monopoly rents to be included in the cost of gas delivered to KCA will reduce KCA's ability to impose competitive pressure on the national tissue market and therefore make the national tissue market less competitive

- KCA has contacted other significant users of gas which draw from SEPS – two such companies are Safries (a division of McCains) and Carter Holt Harvey – about this issue and comments from them will be provided in due course.

- As advised in the initial application, natural gas is the preferred source of thermal energy. Whilst there are other forms of thermal energy available (eg electricity, LPG, coal, wood and biomass), none of these have the combined benefits of relatively low cost and low environmental impact. KCA has used all of these alternative forms of energy at its mill and can advise from first-hand experience that natural gas is the lowest cost form of thermal energy available in the region served by SEPS. For KCA to change from using natural gas will involve considerable infrastructure investment.

- There are many residential users of the gas hauled on SEPS. Whilst there is the potential for competition in retailing gas into the Mount Gambier gas market, the cost of gas haulage on SEPS will be the same for all retailers as SEPS provides a monopoly service. Therefore there is no clear increase in competition at the residential level that will result from coverage of SEPS.

Domestic users of gas in the Mount Gambier region are currently served only by Origin Energy as Origin has all of the capacity of the SESA pipeline under contract. Origin is unable to use its monopoly position for serving domestic users as there is a retail price cap applying to domestic gas (and electricity) sales. The SA Government advised in December 2012 that, as of February 2013, this retail price cap will be removed allowing Origin to charge full cost recovery for domestic gas sales in the region. In turn, this will reduce any pressure on Epic to control its prices for haulage for domestic gas used. The only constraint on prices for gas usage will be alternative forms of thermal heating and none of these have the combined benefits of relatively low cost, convenience of use and low environmental impact. To change to other forms of thermal energy will require significantly higher cost and considerable infrastructure investment to allow a conversion.

Whilst there would be no increased competition (or loss of competition) should coverage be granted of SEPS, it is inequitable that the provider of gas haulage on SEPS should be able to enjoy a monopoly rent as a result of its ability to set prices which are considered to be significantly higher than the cost of the service provision. Coverage (and the setting of haulage prices by the regulator) would ensure that the many residential users of gas are not paying an unnecessary premium for their gas supplies. The fundamental question regarding residential consumers is whether the charge Epic levies for haulage includes a monopoly rent and whether this impacts on the assessment of criterion (a). The other three criteria (b, c and d) do not address the impact of monopoly rents on residential consumers at all, so the NCC needs to assess how it will address criterion (a) in terms of residential consumers where there would appear to be no ability to address increased competition in this downstream markets.

The advent of gas injection by a new producer at Katnook (eg by Beach Energy) will permit competition for retail gas suppliers for the domestic market.

Criterion (b)

- KCA is aware of the impact of the High Court decision on how this criterion is to be addressed. In its application, KCA considered that the substantive aspect that duplication or alternatives to hauling gas on the SEPS would not be feasible. In particular, KCA can observe that the only way that another entity could profitably provide transport for gas from Katnook to Millicent and Mount Gambier would be if the shippers were to underwrite the costs of such duplication. This means that, from its own investigations regarding a duplication, it would not be profitable for another entity to duplicate the existing SEPS (in order to provide an alternative transport) unless the shippers were to pay more for an alternative than the cost of shipping on SEPS. This analysis implies that Epic Energy can price its gas transport on "Ramsay" pricing principles at marginally less than the cost of an alternative. "Ramsay" pricing by a monopoly is most unlikely to be efficient but when it is applied, users are likely to pay monopoly rents.

- In its final recommendation in 2000 to revoke coverage, the NCC concluded that criterion (b) was satisfied – that it would be uneconomic to duplicate the SEPS assets. Since that time, there has been modest growth in gas consumption which has been offset in recent times by the reduction in demand for gas by KCA in recent months, implying that there is still adequate capacity in SEPS that is still to be utilised. At the same time, construction costs for gas pipelines have increased, implying that it would be even less economic to duplicate SEPS.

- Further to its responses to criterion (b) in the application, KCA is able to provide some additional information surrounding alternative sources of thermal energy to replicate the transport of gas on SEPS

  - KCA advised that when the gas from Katnook failed, its gas provider Origin Energy supplied LPG in lieu of natural gas but quickly built the South East South Australian pipeline (SESA) to connect SEAGas pipeline to SEPS as this was a lower cost solution than continuing to supply LPG. In this regard, LPG can be mixed with air to provide a gas which has similar properties to natural gas (called syn gas) which can be used as an alternative to natural gas. The price of LPG varies with the quantities purchased but prices for large quantities of LPG are negotiated and are confidential. There is a publicly available price for LPG for use in cars – currently about $0.729/Litre (Caltex on 9/12/12) which equates

to nearly \$30/GJ. Bulk prices would be considerably cheaper, but even at half the price (\$14-15/GJ) this is nearly three times the price of delivered natural gas purchased on the Victorian spot market (currently \$3.90/GJ on 9/12/12) when haulage is added. Forms of energy other than natural gas (including LPG) require significant infrastructure to be provided to allow their use, regardless of the price of the alternative form of energy

- KCA did contemplate duplicating the SEPS by seeking advice from APA on the viability of APA building a pipeline to bypass SEPS connecting to either SESA or to SEAGas. APA advised that such a bypass was possible but the costs would be significant and unlikely to be less than the haulage on SEPS which was already significantly depreciated.

  In this regard it is important to note that a new pipeline would be built at current day prices whereas SEPS was built with prices applying at 1990. With a lower capital cost and a pipeline depreciated at least by 1/3rd (KCA is of the view that SEPS has been fully depreciated), the unit costs for haulage on SEPS would be significantly lower than a new pipeline would require. This high level observation supports the advice from APA that building a new pipeline would not be commercially feasible.

  KCA also points out that, although a new pipeline might be sized to transport a lesser amount of gas, the capital costs for a smaller pipeline would be similar to those of a pipeline of similar diameter to SEPS.

  APA also added that obtaining easements for a new pipeline would be a significant hurdle to overcome. This would delay building a new connection and could add to the capital cost of a new pipeline.

We trust the foregoing addresses your need for additional and better information. I have asked Mr Headberry to contact you regarding a meeting to discuss this letter and any other additional information you might require.

Yours sincerely

Darren Williams
Operations Support Manager