[PUBLIC VERSION]

Response to draft recommendation regarding coverage of the South Eastern Pipeline System

to

National Competition Council

by

Kimberly Clark Australia

14 March 2013

1 Executive Summary

1.1 On 20 February 2013, the National Competition Council (**Council**) issued a draft recommendation (**Draft Recommendation**) in which the Council indicated that its preliminary view was that criteria (a) and (d) of section 98 of the National Gas Law (**NGL**) may not be met in relation to the South Eastern Pipeline System (**SEPS**).

1.2 Kimberly Clark Australia (**KCA**) makes this submission in response to the Draft Recommendation. In this submission, KCA focuses primarily on criteria (a) and (d). KCA provides further information in this submission to evidence that both criteria are, in fact, satisfied in relation to the SEPS.

1.3 KCA identifies in this submission that criteria (a) is satisfied for the following key reasons:

(1) Increased access to the SEPS by Beach Energy Limited (**Beach**) will promote competition in the (downstream) market for the sale of gas for use by domestic, industrial and commercial users in the area served by the SEPS ("**downstream gas marke**t").

(2) Sufficient local gas will be available in the short, medium and longer term to enable Beach to enter the downstream gas market and provide a sustainable competitive constraint to Origin Energy Limited (**Origin**) which is currently the *de facto* monopoly supplier of gas in that market:

(a) Beach acquired the Katnook gas fields and processing facilities some 9 months ago and now, subject to some criteria, has gas which it could supply to KCA.

(b) Beach is undertaking development and exploration of other local gas resources and anticipates further local gas being available in the short to medium term to enable continued supply into the downstream gas market from Katnook via the SEPS and to the wider market.

(c) Beach's proposed exploration activities should result in local gas continuing to be available over the longer-term.

(d) All of these time frames are within the 10 year coverage period the NCC advises would apply if the Minister decides to cover the SEPS, and so are relevant to the Council's examination of future competition, with and without coverage, over that period. The High Court in *Rural Press* indicated that even a small competitor can have a material effect on a monopoly to promote competition.

(3) KCA has been in discussions with Beach regarding the supply of gas by Beach to KCA to displace gas acquired from Origin. Acquisition of gas from Beach is attractive to KCA in diversifying its gas portfolio and ensuring competitive tension with Origin in the downstream gas market. However, KCA's contracting of Beach gas would be contingent on Beach accessing the SEPS on reasonable price and non-price terms.

(4) Coverage of the SEPS is also critical for Beach so that Beach has regulatory certainty that it may access the SEPS on reasonable price and non-price terms in order to supply to KCA and other consumers of gas in the downstream gas market. Both KCA and Beach are concerned by the incentive and ability of APA to extract monopoly rent and impose unreasonable terms:

(a) APA has a clear commercial incentive to discriminate against Beach, given that Beach gas would displace Origin gas. Origin gas is carried over other APA pipeline assets, namely SESA and SEA Gas, before connecting into the SEPS, thereby providing APA with increased carriage revenue. By discriminating against Beach, APA can ensure that its revenue over its pipeline portfolio is maximised.

(b) APA also has a clear commercial incentive to discriminate in favour of Origin given that Origin has superior bargaining power to Beach. Origin is a significant customer of APA in the eastern States of Australia and can leverage that role to Origin's commercial advantage *vis a vis* the SEPS. APA has expressly identified in its submission that Origin has "countervailing power" and has provided several examples.

1.4 KCA identifies in this submission that criteria (d) is also satisfied for the following key reasons:

(1) As the Council has itself recognised, APA has grossly overstated the costs of regulation. If APA's submissions were accepted, this would set an unwarranted precedent in determining the costs of regulation for all gas pipelines in Australia:

(a) APA's regulatory costs are, in fact, pooled across APA's entire regulated pipeline portfolio. Many of these costs are sunk. The incremental impact of the SEPS on APA's regulatory costs is, in practice, likely to be *de minimus*.

(b) Moreover, KCA has accepted the Council's conclusion in the Draft Recommendation that light handed regulation would be a preferred form of regulation for the SEPS. On this basis, APA would not incur the costs of heavy-handed regulation. Indeed, if APA acted reasonably, APA should have little or no regulatory costs at all.

(c) KCA submits that it would set an unwarranted precedent for all gas pipelines in Australia if the regulatory costs for light handed regulation were based on a 'worst case' scenario in which the access provider was assumed to act unreasonably. Such an approach would actually encourage unreasonable behaviour on the part of access providers in order to inflate regulatory costs, so would be directly inconsistent with the national gas objective.

(2) The costs of regulation are therefore minimal. However, the benefits of regulation are very substantial. KCA detailed these benefits in its detailed Application for Coverage of October 2012. KCA further identifies in this submission that the benefits include:

(a) A potential reduction in the tariff set by APA for the carriage over gas over the SEPS or, more likely, preventing excessive increases in the tariff over the coverage period, in the long-term interests of all gas consumers in the lower South East of SA.

(b) A potential reduction in the gas supply price set by Origin in the downstream gas market due to the competitive entry of Beach, including preventing excessive increases in the gas supply price over the coverage period, in the long-term interests of all gas consumers in the lower SE of SA.

(c) KCA's ability to implement a more thermally efficient option to provide high pressure gas to its generation plant.

(d) KCA's ability to maintain its competitive position in those markets into which it supplies, thereby ensuring KCA's survival as a manufacturer (and source of employment) in the region.

(e) Lower gas prices that stimulate demand for gas in the downstream gas market, in turn leading to greater gas throughout on the SEPS and more efficient utilisation of SEPS as a pipeline asset.

2 The Council's draft recommendation

2.1 KCA agrees with the following conclusions of the Council in the Draft Recommendation:

(1) SEPS is appropriately classified as a transmission pipeline.

(2) Coverage criterion (b) is satisfied, as it is not possible for anyone to profitably develop another pipeline to provide the pipeline services provided by the SEPS.

(3) Coverage criterion (c) is satisfied, as access to pipeline services provided by means of the SEPS can be provided without undue risk to health and safety.

(4) Should the Minister decide to cover the SEPS, the appropriate period of coverage should be 10 years with a further review of coverage after this period.

(5) Should the Minister decide to cover the SEPS, a light regulation determination should apply.

2.2 For the purposes of this submission, KCA agrees with the Council's definition of the relevant dependent markets in the Draft Recommendation, namely that those markets should be defined as follows:

(1) a (downstream) market for the sale of gas for use by domestic, industrial and commercial users in the area served by the SEPS ("**downstream gas market**");

(2) an (upstream) market for the production and sale of gas ("**upstream gas market**"); and

(3) Australian markets for paper tissue products and other products ("**indirect downstream markets**").

2.3 Given the different characteristics of domestic and industrial consumption, KCA reserves its position whether the downstream gas market in fact comprises different domestic and industrial gas consumption markets segmented by annual volume and demand profile of consumption. KCA submits that if the downstream gas market were more narrowly segmented, this would further support KCA's submissions (as set out in this submission) that criteria (a) and (d) are, in fact, satisfied.

2.4 KCA also agrees with the Council's conclusions in the Draft Recommendation, that:

(1) APA has overestimated the costs of light regulation of the SEPS.

(2) Some of the costs that APA has attributed to the regulation of SEPS will have already been incurred by APA in the regulation of other APA pipelines or would be incurred regardless of coverage of the SEPS.

(3) The regulation of SEPS will not involve unusual regulatory costs.

(4) The low volumes of gas transported on SEPS create an incentive on the parties to avoid dispute resolution.

2.5 KCA <u>disagrees</u> with aspects of the Council's analysis in the Draft Recommendation in relation to the application of criterion (a). KCA's disagreement is based on new evidence that was not previously submitted to the Council and that should assist the Council to form a clearer view on the ability of Beach to effectively compete in the downstream gas market. KCA also respectfully submits that:

(1) The Council has understated the importance of Beach, particularly given Origin's current *de facto* monopoly in gas supply.

(2) KCA will seek to displace some Origin gas to ensure KCA has a gas supply portfolio and to ensure Origin is subject to sufficient competitive tension; so APA's submissions are incorrect that Beach's gas volumes are insufficient for KCA.

(3) The time period proposed by the Council for coverage (should the Minister decide that coverage is appropriate) is 10 years, hence that time period should also be considered when applying criterion (a). Gas from Beach is already available with further gas availability progressively scheduled to occur over the next 3 years. Beach's current exploration activity should see further gas supply in the longer term, potentially include substantial new gas reserves. In this regard, Beach has advised KCA that having a customer of KCA gas demand would be of significant interest to them and that, subject to appropriate pricing on SEPS, Beach sees that this outcome will increase its interest in further exploration

2.6 The Council stated in the Draft Recommendation that its conclusions were based on the information available and that it was difficult for the Council to be confident of expressing a view based on that information. KCA submits that this submission does provide sufficient information to enable the Council to change its view on this issue.

2.7 KCA has also identified some factual inaccuracies in the submission made by APA Group dated 29 January 2013 (**APA submission**). Some of these facts are material to the Council's reasoning and are corrected by KCA in this submission. Given the number of inaccuracies in the APA submission, KCA generally suggests that the Council independently verify the information provided by APA before relying on that information in the final recommendation.

2.8 If KCA's submissions in relation to criterion (a) are accepted, KCA identifies in this submission that it then follows that criterion (d) would be met. As identified by the Council, APA has grossly overstated the cost of regulation. However, the public benefits of regulation are substantial. KCA has set out detailed submissions on these issues in this submission and in its original Application for Coverage.

2.9 Accordingly, if KCA's submissions in relation to criterion (a) are accepted, it follows that the Council should change its draft recommendation to the Minister. The Council should alternatively recommend in favour of coverage of the SEPS.

3 Increased access to SEPS services by Beach will promote a material increase in competition in downstream gas markets

3.1 A fundamental issue raised by the Council in the Draft Recommendation is the extent to which coverage of the SEPS will facilitate Beach supplying gas into the downstream gas market. This issue is critical to the Council's conclusion whether criterion (a) is satisfied.

3.2 As the Council identifies in the Draft Recommendation, Origin is the only shipper currently using the SEPS to supply gas into the downstream gas market. In effect, Origin is currently the only supplier of gas into the downstream gas market, so holds a current *de facto* monopoly in the downstream gas market.

3.3 Origin's full contracting of SESA capacity also means that Origin has the incentive and ability to deny third parties supplying gas external to the region into the SEPS in competition with Origin's own gas supply. While such denial would remain subject to Origin's obligations under various relevant provisions of the *Competition and Consumer Act 2010 (Cth),* KCA has little confidence that this would be sufficient in the circumstances.

3.4 Given the extent of Origin's control, Beach's role as a source of competitive tension to Origin in the downstream gas market is paramount. Any regulatory arrangements that facilitated Beach supplying gas in competition with Origin in the downstream gas market would necessarily promote competition:

(1) Any scope for downstream gas consumers to displace Origin gas will ensure that Origin is subject to competitive tension in relation to the supply of those gas volumes.

(2) An increase in competition from no competition to actual competition, however limited, is necessarily a *material* increase in competition. The High Court in *Rural Press* indicated that even a small competitor can have a material effect on a monopoly to promote competition.

(3) Moreover, as KCA identifies below, the volumes of gas that will be supplied by Beach are, in fact, material in the context of the current level of consumption of gas in the downstream gas market. Given the total volumes of gas are relatively small, supply of gas by Beach has the ability to significantly affect competition.

3.5 In this manner, if the coverage of SEPS would facilitate Beach supplying gas into the downstream gas market, if necessarily follows that criterion (a) would be satisfied.

3.6 KCA makes a number of submissions below, and provides new evidence to the Council (based on KCA's discussions with Beach), to show that coverage of SEPS <u>would</u> facilitate Beach supplying gas in competition with Origin in the downstream gas market.

4 Will sufficient local gas become available in the short to medium term?

4.1 As identified above, KCA is concerned that Origin is currently the sole supplier of gas to KCA (as well as all other consumers of gas in the downstream gas market). As a result, Origin has substantial bargaining power. Moreover, KCA's operations are currently dependent on a single gas supplier, exposing KCA to supply risk (for example, in the event of an outage of the SESA pipeline).

4.2 To address these issues, now that KCA is aware Beach has gas available now at Katnook, it can now consider acquiring gas from both Origin and Beach, thereby creating a gas portfolio, diversifying supply risk, and ensuring competitive tension in the supply of gas to KCA.

4.3 With this context in mind, KCA is concerned by the following comment by the Council in the Draft Recommendation (at para 6.20):

> "It is difficult to be confident at this time that sufficient local gas will become available in the short to medium term. Beach will not know the extent of its gas reserves until it completes exploratory drilling scheduled for 2013 and 2014, and has if found may not be available for some time.

4.4 KCA understands this statement as indicating that the Council has had insufficient information before it on which to assess whether KCA would be able to acquire gas from Beach.

4.5 KCA has therefore approached Beach to formally confirm the extent to which Beach will have capability to supply gas to KCA. KCA has Beach's support in making the following submissions to the Council. Following discussions with KCA, Beach has indicated that it would be willing to have further discussions with the Council on these issues.

4.6 Specifically, KCA has had a meeting with Beach to identify the issues related to the potential for upstream and downstream competition in gas supplies. In these discussions, Beach advised:

(1) Beach considers that there is remaining gas in place in the existing Katnook field and in seeking commercialise this, recognises the need for an appropriate gas buyer and favourable economics on the incremental investment required. These project economics will be enhanced by recent increases in gas prices but are also dependent on a sufficiently low tariff being charged for the SEPS.

(2) Beach is also exploring for new discoveries of high volume conventional and unconventional gas in the region and if it found this, it would consider tying directly to SEA Gas pipeline. As well, they would also seek to sell to a large volume gas user in the region via SEPS and consider that the KCA gas demand would be very attractive

(3) Whilst Beach is seeking large gas volumes in the region, if it found smaller but commercial supplies, it would want to develop these as soon as possible for use in the region providing there was a buyer.

(4) The tariff arrangements on SEPS are very important to Beach as increased stability of the regime will enhance the interest Beach has in exploration in the region. Coverage of SEPS would increase this stability and provide a greater degree of certainty for its investment decisions

(5) Well drilling is currently occurring in the region and gas from the new fields (eg Sawpit 2) could be available by 2015-16

4.7 KCA also submits the following as further evidence to the Council:

(1) In relation to the supply of gas from the Katnook field:

(a) Based on Beach's response to KCA above, gas is currently available in the existing Katnook field. Beach wishes to commercialise this gas by selling it to a gas buyer, such as KCA, in the downstream gas market.

(b) KCA has indicated to Beach that KCA is prepared to be a buyer of gas from the Katnook field.

(c) KCA understands that Beach views the load and size of KCA demand as attractive and therefore is keen to sell to KCA.

(d) KCA understands that Beach will be required to make investments to extract the remaining gas in the Katnook field. In effect, Beach is seeking to contract with KCA to provide sufficient certainty in demand that such investment can occur. Once a contract is signed, such investments will be economic and will occur.

(e) Such arrangements would be contingent on SEPS being subject to light coverage regulation such that Beach could deliver the gas to KCA via the SEPS on reasonable price and non-price terms, as identified in further detail below.

(2) In relation to the supply of gas from other local gas fields:

(a) Jacaranda Ridge (operated by Beach) is one of four key producing assets in the Otway Basin.[1] The Jacaranda Ridge field was the subject of extended production testing over 2011-2012 with production levels at 302,905m3[2].

(b) While the P2 reserves of Jacaranda Ridge are currently under 1 PJ, KCA could still acquire such gas as part of its gas portfolio in order to displace Origin gas and diversify supply to KCA.

(c) KCA understands that the commercial viability of other reworking fields, such as Redman and Jacaranda Ridge, is underpinned by sale of gas to consumers such as KCA. The Council has already identified that Beach anticipates being able to inject this additional "new" gas into the SEPS within 2 years.

(d) Based on Beach's comments above, well drilling is currently occurring in the region and substantive gas from new fields (such as Sawpit-2 in PEL-495) should also be available within 2 years. The Council has already identified that Beach has committed to an exploration programme and anticipates substantive gas discoveries that will increase its 2P reserves in the region.

(3) In relation to timing, KCA understands that:

(a) Gas is currently available for supply to KCA, provided that Beach can obtain access to the SEPS on reasonable price and non-price terms.

(b) Any gas found as a result of the 2013 exploration would be available within around 12 months, subject to access to the SEPS on reasonable price and non-price terms.

(c) Any gas found as a result of the other exploration activity would be available within 2 to 3 years, subject to access to the SEPS on reasonable price and non-price terms.

(d) Beach's continuing exploration activity should result in further gas becoming available in the medium to long-term as Beach continues to increase its 2P reserves in the Otway Basin.

(4) Beach has already identified to the Council that it has reviewed and upgraded the operating systems at the Katnook gas plant. The plant has all regulatory approvals and is ready for gas processing. All relevant gas would be transported to Katnook for processing. KCA understands that Beach therefore has short-term, medium-term and long-term capability to process gas for delivery to KCA via the SEPS.

4.8 Importantly, **all of these time periods are within the proposed 10 year period for the coverage of SEPS** (should the Minister apply this), so would result in Beach supplying gas to KCA in competition with Origin over that period.

4.9 KCA understands that Beach is searching for high volume shale gas (i.e., natural gas trapped within shale formations) in the region, known colloquially as 'unconventional gas':

(1) KCA understands that Beach considers that the area has substantial potential. The area is rich in exploration targets and the Otway Basin has already demonstrated that gas is available in commercially viable quantities.

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1 Core Energy Group 'Eastern & Southern Australia: Existing Gas Reserves & Resources', April 2012

2 See Beach Energy Annual report for PEL 255, Onshore Otway Basin, South Australia for 2011/2012.

(2) Information in the public domain indicates the current substantial scale of the existing gas reserves of the Otway Basin. The Core Energy Group's estimate of conventional gas in the Basin as at 31 December 2011 was 902 PJ of 2P reserves, of which 156 PJ was uncontracted, 902 PJ of 3P reserves and 171 PJ of 2C reserves. Prospective reserves of conventional gas in the Basin are estimated at up to 10,070 PJ (including a significant offshore component). Substantial exploration is underway to identify unconventional gas reserves.

(3) If substantial volumes of shale gas are found by Beach, KCA understands that:

(a) Beach would wish to sell such gas to KCA via the SEPS. Beach would also wish to use the SEPS as a means of accessing other forms of demand in the downstream gas market (including demand which arises from substitution from other energy sources).

(b) Beach may also wish to negotiate with Origin and/or APA to obtain access to SESA (via back haul) and enter into gas swap arrangements.

(4) If substantial volumes of shale gas were not found, but Beach rather finds smaller volumes of gas, KCA understands that Beach would wish to sell such gas to KCA and other consumers of gas in the downstream gas market, subject to access to the SEPS.

(5) Such gas would therefore be commercialised during the 10 year period of coverage. The speed of commercialisation would depend on the magnitude of the gas volumes, but could occur quickly and within as little as 2 years.

4.10 KCA understands that the Council may be concerned regarding the volumes of gas that could be supplied by Beach into the downstream gas market. In the Draft Recommendation, the Council comments (at para 6.20):

> "No locally sourced gas was supplied into the SEPS in 2012 and in the four previous years local production was between 0.4PJ/a and 1.0PJ/a (APA second submission, p 16). Current estimates of proved and probable (P2) reserves are 1PJ and have been at this level for the last five years. According to APA, throughput for the SEPS declined to 1.43PJ in 2012 (APA second submission, p 14). Current P2 local reserves therefore represent about one year's gas demand for KCA".

4.11 In this respect, KCA believes that the evidence it has submitted above demonstrates that the volumes of gas that will be supplied by Beach are, in fact, material in the context of the current level of consumption of gas in the downstream gas market. Moreover, KCA also highlights the following key points:

(1) Beach only acquired its relevant interests in relation to the locally sourced gas (i.e., Katnook) in early July 2012, following Beach's acquisition of Adelaide Energy Limited. In the 9 months following that acquisition, Beach has already ensured the Katnook plant has processing capability and would seek to contract with KCA for the supply of gas. Beach is demonstrably taking the necessary steps to supply into the downstream gas market.

(2) Given Beach's recent entry. the historic production of gas from Katnook, as noted by APA in the APA submission, is irrelevant. Beach has different ambitions to the previous owner of the relevant gas fields. Historic production is not an accurate predictor of future production as market circumstances have fundamentally changed.

(3) As identified above, Beach is currently undertaking exploration activity that will raise the estimates of proved and probable reserves. The fact that the reserves had not previously changed over the last five years, as identified in the APA

submission, reflects more that the previous owner did not have the same exploration ambitions as Beach. Contrary to the inference from the APA submission, it is highly likely that the 2P reserve levels could substantially increase over the coming years. Beach has advised KCA that a stable and appropriate cost structure on SEPS will provide Beach with a greater degree of certainty for its investment decisions

(4) The APA submission indicated 2P reserve levels that are well below those established by Beach (i.e., APA appears to have understated the actual 2P reserves in its submission). The Council has referred to APA's figures in the Draft Recommendation. KCA recommends that the Council independently verify the 2P reserves rather than relying on APA's information alone.

(5) In the Response, APA notes that from 2005 onwards, the SEPS has been transporting gas sourced from off-shore fields in the Otway Basin in addition to gas produced in the Katnook gas fields to end users. However, the figures APA provides at Table 2.8 of the Response only shows proven and probable reserves from the Katnook area. The 1 PJ of total proven and probable reserves in the Katnook region should not be considered in isolation. The total proven and probable gas reserves in the area that could supply gas into the SEPS, has far greater gas producing potential.

(6) Even where APA's figures are relied upon, the amount of <u>current</u> available gas is sufficient to meet the total supply requirements of KCA for one year, or Safries (another key consumer of gas on the SEPS) for ten years, or other, smaller downstream consumers into the long term. The volumes are therefore significant and do have the potential to have a material impact on competition in the downstream gas market. As exploration activity continues, the 2P reserve levels are likely to increase.

(7) Given KCA is considering acquisition of gas on a portfolio basis (to increase competitive tension and to diversity supply), KCA would acquire gas notwithstanding that volumes were lower than the volumes currently supplied by Origin. APA is therefore incorrect in the APA submission in inferring that KCA would not acquire gas from Beach. In fact, as identified above, KCA and Beach have already been in discussions regarding such supply.

4.12 KCA therefore submits that:

(1) contrary to the Council's views in the Draft Recommendation, sufficient local gas is available from Beach in the short to medium term to introduce real and sustainable competition into the downstream gas market in the short to medium term;

(2) Beach's exploration activities will see its 2P reserves increase such that sufficient local gas will also be available to Beach to enable supply into the downstream gas market in the longer term;

(3) local gas will certainty be available over the 10 year period of coverage and possibly in substantial quantities;

(4) given Origin's *de facto* monopoly over gas supply, any new gas will displace Origin's existing gas and introduce real competition in the downstream gas market; and

(5) given Origin's *de facto* monopoly over gas supply (and hence a complete absence of any competition), any such increase in competition would necessarily be material and introduce price tension.

5 How important is coverage of SEPS to the delivery of Beach's gas into the downstream gas market ?

5.1 The impact of coverage of SEPS on Beach's ability to deliver gas to KCA and other consumers in the downstream gas market is also critical to the Council's reasoning in the application of criterion (a).

5.2 As identified above, Beach has indicated to KCA that stability of the access regime (price and non-price terms) to the SEPS will be an important part of any decision by Beach to commercialise the gas.

5.3 In Beach's submission to the Council of 29 January 2013, Beach specifically stated that:

(1) Access issues would "*obviously be a concern to Beach in regard to go forward decisions on risk capital investment in the region*" (page 2).

(2) Motivation for exploration "*is dependent on the commercial position regarding both gas transportation and sale*" (page 2).

(3) The revived gas production in the Otway Basin, as occurring with Beach's current commercial activities, will "*provide new opportunities to source and utilise gas in this region creating additional downstream competition*" (page 2).

5.4 In this manner, greater access to SEPS via coverage regulation will enable Beach to commercialise the Otway Basin gas by ensuring it can be delivered to consumers such as KCA on a timely basis at reasonable carriage rates. Beach will have regard to its ability to obtain regulated access to SEPS when determining whether to undertake the necessary further investments to extract some of the gas identified above.

5.5 KCA is concerned by APA's current ability to inhibit access to SEPS and/or charge excessive costs for carriage of gas via SEPS. Beach expressly identified similar concerns in its submission of 29 January 2013.

(1) Specifically, the ability of Beach (or KCA) to arbitrate price and non-price terms under a light coverage model would provide an important incentive for APA to act reasonably. Access to the SEPS at a reasonable tariff may, for example, determine whether or not some of the more marginal sources of gas will be commercially viable to supply to KCA.

(2) APA would be much less likely to provide price or non-price terms that were discriminatory in favour or Origin. Origin has substantially greater bargaining power than Beach (and, indeed, APA has pointed to Origin's countervailing bargaining power in the APA submission)

5.6 In this manner, KCA submits that coverage of the SEPS provides the necessary pre-conditions for competition by Beach in the downstream gas market in both the short, medium and longer term:

(1) In the short-term, access to the SEPS on reasonable price and non-price terms will be essential to the conclusion of commercial arrangements between Beach and KCA to enable supply of gas to KCA to displace some Origin gas.

(2) In the medium term, access to the SEPS on reasonable price and non-price terms will be essential to Beach delivering its gas into the downstream gas market in competition with Origin in order to meet demand from KCA and other existing and potential gas consumers. Such access will also be essential in providing regulatory certainty to Beach such that it can make production investment decisions.

(3) In the longer term, access to the SEPS on reasonable price and non-price terms will be essential in determining the level of investment that Beach makes in the local area in relation to gas exploration activity, Again, greater regulatory certainty will enable Beach to undertake greater gas exploration activity, in turn ensuring that local gas will continue to be available as a source of competition to Origin's gas.

5.7 KCA also wishes to respond to some specific points made by APA in the APA submission which KCA considers are inaccurate. APA has submitted in the APA submission for example:

(1) At paragraph 3.18 of the APA submission, that "*the owner of the SEPS can be expected to have every incentive to encourage greater utilisation of the pipeline*" and that various factors "*counter any incentive it may otherwise have to exercise market power*".

(2) At paragraph 3.19 of the APA submission, that "*although Origin Energy is unlikely to be in a position to bypass the SEPS, it still wields a considerable degree of countervailing power in its negotiations with the owner of the SEPS* ".

(3) At paragraph 3.22 of the APA submission, that APA "*can therefore be expected to act in a non-discriminatory manner, with respect of the price and non-price terms and conditions of access to the SEPS*".

5.8 KCA believes that these submissions by APA are, with respect, disingenuous. APA's actual conduct to date (via its recent acquisition of ownership of Epic Energy), as identified in KCA's submission, indicates that APA is clearly willing to exercise its market power in the knowledge that KCA and other users of the SEPS have no alternative but to acquire carriage from APA. APA is in a monopoly supply position and is willing to use that position for APA's own commercial advantage.

5.9 In response to the specific points made by APA regarding APA's commercial incentives:

(1) KCA agrees that APA has an incentive to encourage greater utilisation of the pipeline. However, KCA has indicated that it is seeking to displace Origin gas with Beach gas, which will not necessarily increase the utilisation of the pipeline. APA's submission with respect to utilisation is therefore irrelevant.

(2) The displacement of Origin gas with Beach gas will result in reduced demand for gas from Origin, and hence a reduction in the volume of gas carried over the SESA pipeline and, in turn, the SEA Gas pipeline. Importantly, both the SESA and SEA Gas pipelines are owned in whole (SESA – 100%) or part (SEA Gas – 50%) by APA. APA therefore has a clear commercial incentive to maximise the volume of gas supplied via the SESA pipeline and SEA Gas pipeline so that APA can benefit from carriage arrangements (subject to their terms) and ensure that those pipeline assets are efficiently utilised.

(3) In this manner, contrary to APA's submissions, APA in fact has a very clear commercial incentive to discriminate in favour of gas to Origin and to discriminate against the supply of gas to Beach. By doing so, APA can ensure that it optimises its carriage revenue from, and the utilisation of, its other pipeline assets (namely SESA and SEA Gas) by maximising the flow of gas through those pipeline assets.

(4) Contrary to APA's submissions, APA actually has little or no commercial incentive to offer Beach access to SEPS on terms and conditions comparable to those of Origin. Rather, APA has the strong commercial incentive and ability to offer unfavourable terms to Beach in order to ensure that gas continues to be supplied by Origin in the downstream gas market.

5.10 APA has submitted that Origin has countervailing power in its negotiations with APA. As a significant customer of APA in the eastern States of Australia, Origin holds a strong negotiating position in the negotiation of transport of significant volumes of gas via APA. APA makes specific reference to Origin's ability to leverage its bargaining power in footnote 35 of APA's submission, in which APA comments:

> "For example, if Origin energy was seeking to transport gas to Sydney and could utilise either the Eastern Gas Pipeline (EGP) or the Moomba to Sydney Pipeline (MSP), then in its negotiations with APA on the use of the SEPS, it could threaten to utilise the EGP if APA did not offer competitive terms on the SEPS. Given Origin Energy's transportation requirement for the Sydney market is likely to be considerable larger than its SEPS requirement, the threat of bypass in the Sydney market can be expected to have a significant bearing on APA's behaviour in any negotiation relating to the SEPS".

5.11 However, this does illustrate, contrary to APA's submissions, that APA is therefore much more likely to enter into arrangements on more favourable terms with Origin than with Beach. Indeed, APA could provide more favourable price and non-price terms to Origin, ostensibly to recognise Origin's greater commercial relationship with APA and greater volumes of gas supplied over SEPS (and at the same time APA would maintain gas flows through the SESA and SEA Gas pipelines, coincident with APA's commercial interests). This means, in KCA's submission, that there is a very high likelihood that APA would provide access to Beach on less favourable terms.

5.12 KCA therefore submits that coverage of the SEPS is critically important for the following key reasons:

(1) APA has a clear commercial incentive to discriminate against Beach, given that Beach gas would displace Origin gas. Origin gas involves carriage via other APA pipeline assets that provide APA with gas carriage revenue (subject to the terms of carriage that have been agreed between Origin and APA). Accordingly, by discriminating against Beach, APA can ensure that its revenue over its pipeline portfolio in the region is optimised.

(2) APA has the ability to discriminate against Beach, given that the pipeline is not regulated and APA is subject to no obligation to offer the same terms and pricing to Beach as it offers to Origin.

(3) APA also has the incentive and ability to discriminate against KCA for the same reason, namely that APA can then ensure that KCA does not use gas supplied by Beach but rather uses gas supplied by Origin.

(4) APA has a commercial incentive to discriminate in favour or Origin given Origin's superior bargaining power as a significant customer of APA in the eastern States of Australia.

(5) Light regulation of the SEPS would deter APA from discriminating in favour of Beach, given that Beach could seek arbitration if any discrimination occurred.

5.13 Given the conclusions above, KCA submits that criterion (a) is satisfied. Specifically, increased access to the SEPS by Beach will promote competition in the downstream gas market. In the absence of coverage, Beach's ability to compete in the downstream gas market could be significantly impaired and it may decide against commercialising the relevant gas that would provide competition to Origin.

6 The benefits of access outweigh any regulatory costs

6.1 As the Council is aware, criterion (d) requires consideration of whether granting access to the SEPS would not be contrary to the public interest.

6.2 The majority of the Council's reasoning in the Draft Recommendation is directed at the costs of coverage. In relation to the benefits of coverage, the Council has relied on its conclusion that criterion (a) would not be satisfied.

6.3 KCA sets out below its view that the costs of coverage have been grossly overstated by APA.

6.4 KCA has identified above that criterion (a) is, in fact, satisfied. In this manner, the benefits that KCA has identified above from increased competition in the downstream gas market should be taken into consideration by the Council in the final recommendation to the Minister.

6.5 KCA has also identifies below some additional benefits from coverage below that are clearly in the public interest.

7 APA has grossly overstated the costs of light coverage regulation

7.1 As the Council has itself recognised, APA has grossly overstated the costs of regulation. If APA's submissions were accepted, this would set an unwarranted precedent in determining the costs of regulation for all gas pipelines in Australia.

7.2 APA's regulatory costs are, in fact, pooled across APA's entire regulated pipeline portfolio. Many of these costs are sunk. The incremental impact of the coverage of the SEPS on APA's regulatory costs is, in practice, likely to be *de minimus*.

7.3 KCA understands that the Council recognises this and will factor this issue into its final recommendation to the Minister. For example, the Council comments at paragraph 9.13 of the Draft Recommendation:

> "The Council considers that APA may have overestimated the costs of light regulation of the SEPS. Some of the cost that APA has attributed to the regulation of the SEPS will have already been incurred in the regulation of other APA pipelines or would be incurred regardless of coverage of the SEPS. Further, it should not be assumed that recourse will be had repeatedly to the dispute resolution provisions since the principal ground of dispute is the transport tariff, so arbitration is unlikely to be necessary beyond the setting of the tariff or the basis upon which the tariff is to determined".

7.4 Moreover, KCA has accepted the Council's conclusion in the Draft Recommendation that light handed regulation would be a preferred form of regulation for the SEPS. On this basis, APA would not incur the costs of heavy-handed regulation. Indeed, if APA acted reasonably, APA should have little or no regulatory costs at all.

7.5 By way of illustration, APA has made the following submission in relation to the costs of light-handed regulation of SEPS:

(1)	Cost of APA preparing annual compliance reports	$50,000
(2)	Cost of APA publishing prices and other terms of access	$65,000
(3)	Cost of APA involvement in arbitration	$500,000
(4)	Cost of APA responding to rule change proposals	$50,000
(5)	Cost of access seeker involvement in arbitration	$200,000
(6)	Cost of AER preparing assessment	$10,000
(7)	Cost of AER involvement in arbitration	<u>$100,000</u>

Total cost over 10 years **$975,000**

7.6 KCA submits that these costs of regulation are grossly overstated by APA for the following key reasons:

(1) APA owns a significant number of pipelines which are currently subject to regulation. APA possesses the necessary resources to ensure compliance with regulatory requirements.[3] APA's annual compliance reports will be prepared for its entire pipeline portfolio, so costs will be pooled and reduced. In any event, APA will likely prepare such reports as part of its normal business activities, so information will be readily at hand and there would be little or no incremental cost.

(2) APA will have already developed terms of access for its other pipeline access that it can apply to SEPS. In this manner, APA should already have "off the shelf" access arrangements or precedent contracts which could be readily adapted to SEPS. APA already has a website on which it can publish such information. In this regard, it is pointed out that SEPS has already been subject to a gas transportation contract that was recognised by the NCC (in its revocation of coverage of SEPS in 2000) and was considered by the NCC to be reflective of an arrangement structured on competitive terms.

(3) APA has suggested it will spend some $500,000 on an arbitration compared to an access seeker's $200,000. Even $200,000 seems excessive to KCA.

(a) An estimate of $500,000 suggests that APA would hire the most expensive lawyers and economists and provide extensive legal submissions. With respect, over-spending on litigation by an access seeker to deny access is contrary to the National Gas Objective and should be discouraged by the Council.

(b) In order to be consistent with the National Gas Objective, the Council should assume that APA will act reasonably and the threat of arbitration will be sufficient to persuade APA to offer reasonable price and non-price terms.

(c) On this basis, KCA submits that the cost of arbitration should not be included in the assessment of the costs of regulation, as an arbitration will only arise if an access seeker is being unreasonable. As a starting point, APA could merely extend the contract which expired at the end of 2010 and which the NCC considered did not to contain monopoly rents (p10 NCC final decision on revocation of SEPS 2000) and therefore were considered to be reasonable. In its initial negotiations with APA (Epic Energy) KCA suggested this process, but this was rejected by APA (Epic Energy) which sought considerable increases.

(d) KCA submits that it would set an unwarranted precedent for all gas pipelines in Australia if the regulatory costs for light handed regulation were based on a 'worst case' scenario in which the access provider was assumed to act unreasonably. Such an approach would actually encourage unreasonable behaviour on the part of access providers in order to inflate regulatory costs, so would be directly inconsistent with the National Gas Objective.

(e) Many of the issues addressed in an arbitration, including pricing, would be considered in any event in the context of commercial negotiations.

[3] Regulated pipelines owned by APA include the Goldfields Gas Pipeline, Kalgoorlie Kambalda Pipeline, Amadeus Gas Pipeline, Roma Brisbane Pipeline, Carpentaria Gas Pipeline, Central West Pipeline, Central Ranges Pipeline, Central Ranges Network and the Victorian Transmission System (see http://www.apa.com.au/our-business/energy-infrastructure.aspx).

Accordingly, much of the material for an arbitration would be already available to the parties. On this basis, even if arbitral costs were included, the incremental costs may be relatively low.

(f) Moreover, an arbitration may not be necessary for the initial calculation of the transport tariff, as KCA expects that:

(i) both parties will act reasonably to avoid incurring costs; and

(ii) APA will offer prices that are consistent with its expectation of the outcome of an arbitration, including the pricing methodology.

(4) The cost for APA to respond to rule change proposals is not unique to SEPS and will occur in any event, so is not a cost that should be attributed to SEPS.

(5) The cost of AER preparing an assessment is discretionary and will not involve an incremental cost for AER given that staff are available at AER, as a sunk cost, to undertake this task.

7.7 Based on KCA's analysis, a more reasonable and appropriate estimate of the regulatory costs is therefore as follows:

(1)	Cost of APA preparing annual compliance reports	$10,000
(2)	Cost of APA publishing prices and other terms of access	$20,000
Total cost over 10 years		**$30,000**

7.8 KCA therefore submits that the actual regulatory costs arising as a result of light regulation of the SEPS are *de minimus*.

8 The public benefits of regulation of SEPS are very significant

8.1 The Council has previously recognised that the most significant benefit of coverage is that access will facilitate competition.[4]

(1) The effect of new competition in the downstream gas market, even by a small scale competitor, will have a clear positive effect by constraining the existing market power of Origin as the *de facto* monopolist. The High Court held in *Rural Press* in relation to the impact of a small competitor on a monopoly that "*The presence of even one competitor of that kind tended to dilute the impact of the existing monopoly*".[5]

(2) Coverage of the SEPS will create a level playing field between Origin and Beach, thereby facilitating competition in the downstream gas market. In this manner:

(a) Origin's pricing of its gas will be constrained by the competitive presence of Beach.

(b) This means that it is irrelevant whether or not the SEPS tariff constitutes a small component of the overall retail gas price, as coverage of SEPS will impact on both the price of carriage (by APA) and the underlying gas price (by Origin).

4 NCC, Final Recommendation, Dawson Valley Pipeline, August 2005.
5 See *Rural Press Ltd v ACCC* [2003] HCA 75, at 44 and 46.

8.2 KCA also refers to its detailed submissions at section 6.5 of its Application for Coverage in which KCA identified the range of positive outcomes that would arise from coverage. In summary, these outcomes included:

(1) KCA will be able to implement a more thermally efficient option to provide high pressure gas to its generation plant. This will reduce carbon based emissions reducing the need for buying offsets.

(2) Consumers in the downstream gas market should receive a lower gas tariff (or avoid future substantive increases in the gas tariff), including small businesses and residential users in Mount Gambier and the surrounding district. The reductions will apply both to the carriage aspect of the tariff (as determined by APA) and the supply aspect of the tariff (as determined by Origin), given that Origin will no longer be a *de facto* monopoly.

(3) KCA will be able to maintain its competitive position in those markets into which it supplies, thereby ensuring KCA's survival as a manufacturer in the region (with attendant employment and economic benefits for the region).

(4) Lower gas prices should stimulate demand for gas in the downstream gas market, thereby leading to greater gas throughput on the SEPS and more efficient utilisation of SEPS as a pipeline asset.

8.3 KCA also submits that the concept of the public interest should be construed in manner consistent with the National Gas Objectives (**NGO**). Section 99 of the National Gas Law, for example, provides that in the Minister's consideration of whether or not criteria (a) to (d) are satisfied, the Minister must have regard to the NGO. This means that the NGO should influence the examination of criterion (d):

(1) The NGO is to "*promote efficient investment in, and efficient operation and use of, natural gas services <u>for the long term interests of consumers of natural gas</u> with respect to <u>price,</u> quality, safety, <u>reliability and security of supply</u> of natural gas.*" (emphasis added)

(2) The Minister in his second reading speech for the *National Gas (South Australia) Bill 2008* relevantly stated:

> "The long term interests of consumers of gas requires the economic welfare of consumers, over the long term, to be maximised".

KCA provided further detail in relation to the context to this concept in section 6.1 of its original Application for Coverage.

(3) Further guidance on the interpretation and meaning of the NGO was recently provided by the Standing Council on Energy and Resources (**SCER**), who issued a Statement of Policy Intent in December 2012 as part of its Limited Merits Review for energy access regimes. In that document (which has been indicated by the Productivity Commission to have shifted the focus of the NGO)[6], SCER affirmed that:

> "…in interpreting the … National Gas Objective, the long-term interests of consumers (with respect to price, quality, safety, reliability and security of supply) are paramount in the regulation of the energy industry…"

[6] Australian Pipeline Industry Association Ltd, 'Response to Issues Paper – Productivity Commission Review of the National Access Regime', 8 February 2013, p 8.

> "…the long-term interests of consumers should be the sole criterion for determining the preferable decision, both at the initial decision-making stage and at merits review…." [7]

(4) In this manner, the key public interest focus under criterion (d) should be the long-term interests of consumers, specifically the price they will pay over the proposed 10 year coverage period and the reliability and security of supply over that period.

8.4 As with KCA's original Application for Coverage, KCA continues to submit that the coverage is in the long-term interests of gas consumers in the downstream gas market. The benefits of coverage substantially outweigh any regulatory costs:

8.5 Moreover, even if APA and Origin were both able to evidence before the Council and the Minister that they were not currently overcharging for gas in the downstream gas market, there is no guarantee that this situation would continue if coverage did not occur.

(1) APA would not be subject to regulation, so could optimise its pricing in its own commercial interests, including by discriminating in favour of Origin to deter the use of local gas supplied by Beach.

(2) Origin could increase the pricing for its gas in circumstances where Beach was not able to enter the downstream gas market due to complications in accessing the SEPS on reasonable price and non-price terms.

8.6 Also relevant to the public interest consideration is the potential precedent effect of any Council decision on the approach to be applied to any other pipeline asset in Australia:

(1) There are a number of unregulated pipelines in Australia whose owners do have some discretion to increase prices to extract supernormal rent from consumers. In effect, such pipeline owners have market power and may therefore increase prices. The pipeline owners include APA itself

(2) The threat of having a pipeline covered will act as a deterrent to a pipeline owner charging excessive and inequitable tariffs for carriage services. If SEPS is not covered in circumstances where excessive prices are being charged, this does risk sending a signal to other pipeline owners that there is scope under the NGL and NGO to increase prices without resulting in coverage.

(3) KCA respectfully submits that this is the wrong message for the Council (and the Minister) to send into the Australian market at this time. This is the case particularly in light of the recent High Court decision in the Pilbara Part IIIA access litigation. In that litigation, the High Court adopt the 'private profitability test', which will, in practice, make it more difficult for criterion (b) to be satisfied in future applications for coverage (and applications for revocation of existing coverage)

8.7 In summary, KCA considers the costs of coverage and light regulation are de minimus. However, the benefits of coverage are very significant and coverage would clearly fulfil the NGO. The coverage of SEPS would also establish a useful precedent and signal that excessive pricing of pipeline assets will not be tolerated.

9 APA's most recent submission contains factual errors

9.1 KCA has also identified some factual inaccuracies in the APA submission. Specifically:

(1) APA has made assertions regarding the nature of KCA's business and operations that are not substantiated and that are factually incorrect.

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7 SCER Statement of Policy Intent: Limited Merits Review December 2012

(2) APA's characterisation of certain facts gives a misleading impression.

9.2 Many of these factual inaccuracies are irrelevant. However, some of these facts are material to the Council's reasoning in relation to the issues identified above. Where that is the case, KCA has corrected the errors below or earlier in this submission.

9.3 Given the number of inaccuracies in the APA submission, KCA generally suggests that the Council independently verify the information provided by APA before relying on that information in its final recommendation.

Negotiations on SEPS

9.4 APA has mischaracterised its historic negotiations with KCA in 2011. APA seeks to infer from its mischaracterisation that it treats all users of the SEPS on a non-discriminatory basis. KCA respectfully submits that this is not correct.

(1) APA's account of the negotiations is not accurate. APA claims that KCA approached Epic Energy (**Epic**) in late 2010 seeking forward haul and pressure services in the SEPS, and that "acting in good faith", Epic offered to provide the haulage service at the same rate provided to Origin.[8]

(2) APA then asserts (at paragraph 3.26 of the APA submission) that "*Given Epic Energy offered to provide the transportation services on comparable terms to those faced by Origin Energy… there is, in APA's view, no basis for KCA's contention that Epic Energy sought to exert market power in these negotiations*".

(3) However, in fact, KCA had initially approached Epic in early 2010 so a considerable delay occurred. Epic finally advised KCA that access would cost [CONFIDENTIAL], some [CONFIDENTIAL], the publicly stated price at that time.

Charging and costs assertions made in the APA Response

9.5 APA has made a number of assertions in relation to its haulage tariff charges that are either inaccurate or are unsubstantiated. APA has also omitted to mention relevant facts. Of most relevance are the following two matters:

(1) APA asserts that "90% of the costs of operating" SEPS are fixed.[9]

(a) The Council refers to that assertion in its reasoning in the Draft Recommendation in paragraph 6.19. That paragraph is part of the critical aspect of the Council's decision relating to the ability of Beach to supply gas into the downstream gas market. Accordingly, APA's assertion seems to have influenced the Council.

(b) However, APA's assertion is based on a particular depreciation profile in its costing methodology for the SEPS, which KCA submits is incorrect. The proportion of fixed costs falls dramatically if the pipeline is properly depreciated.

(2) APA omits to mention that in the context of the negotiation of the 2011 Origin Gas Transmission Agreement (**GTA**), the tariffs originally requested by Epic and Origin were substantially higher than those eventually agreed upon. The prices offered by Epic (now APA) were only reduced after KCA communicated to Epic (now APA) that it would make an application for coverage of the SEPS.

8 Response, paragraph 3.25.
9 Response, paragraph 3.18 and FN 43.