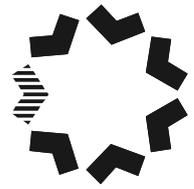


NATIONAL  
COMPETITION  
COUNCIL



## South Eastern Pipeline System

Application under the National Gas  
Law for a coverage determination for  
the South Eastern Pipeline System



**Final recommendation**

**8 April 2013**

# Table of Contents

|   |           |
|---|-----------|
| <b>Abbreviations, defined terms and glossary</b> .....                      | <b>4</b>  |
| <b>1 Pipeline classification decision and coverage recommendation</b> ..... | <b>6</b>  |
| Pipeline classification and relevant Minister .....                         | 6         |
| Coverage recommendation .....   | 6         |
| Form of regulation decision.....  | 6         |
| <b>2 Application and public consultation</b> .....                          | <b>7</b>  |
| Application.....  | 7         |
| Public consultation .....   | 7         |
| <b>3 The SEPS and the background to the Application</b> .....               | <b>9</b>  |
| The pipeline and the pipeline service.....                                  | 9         |
| Ownership of SEPS, associated pipelines and resources .....                 | 9         |
| Coverage and revocation of coverage of the SEPS .....                       | 10        |
| Contractual arrangements for the SEPS.....                                  | 11        |
| <b>4 Classification of the SEPS</b> .....                                   | <b>14</b> |
| Application and submissions .....   | 14        |
| Classification decision.....  | 16        |
| <b>5 Coverage of pipelines</b> .....  | <b>17</b> |
| Requirements of the NGL .....   | 17        |
| <b>6 Criterion (a)</b> .....  | <b>20</b> |
| Dependent markets .....   | 20        |
| Assessment of the effect of access on likely dependent markets .....        | 22        |
| Conclusion on criterion (a) .....   | 31        |
| <b>7 Criterion (b)</b> .....  | <b>32</b> |
| Application and submissions .....   | 32        |
| The Council’s assessment .....  | 33        |
| Conclusion on criterion (b) .....   | 34        |
| <b>8 Criterion (c)</b> .....  | <b>35</b> |
| Conclusion on criterion (c).....  | 35        |

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|  |           |
|--|-----------|
| <b>9 Criterion (d)</b> .....   | <b>36</b> |
| Application and submissions .....                                      | 36        |
| The Council’s assessment .....   | 38        |
| Conclusion on criterion (d) .....                                      | 39        |
| <b>10 The period of any coverage of the SEPS .....</b>                 | <b>40</b> |
| <b>11 Form of regulation .....</b>                                     | <b>41</b> |
| Form of regulation factors .....                                       | 42        |
| Effectiveness of regulation alternatives.....                          | 46        |
| Costs of form of regulation alternatives .....                         | 48        |
| Conclusion on the form of regulation.....                              | 49        |
| <b>12 Information taken into account by the Council.....</b>           | <b>50</b> |
| <b>Appendix A Map of the SEPS.....</b>                                 | <b>54</b> |
| <b>Appendix B Location of the SEPS, the SESA and the SEA Gas .....</b> | <b>55</b> |

## Abbreviations, defined terms and glossary

|  |   |
|--|---|
| APA  | APA Group   |
| Application                                      | Application by KCA under s 92 of the NGL for a coverage determination for the SEPS, received by the Council on 28 November 2012   |
| Beach  | Beach Energy  |
| Council  | National Competition Council  |
| criterion (a)                                    | Section 15(a) of the NGL  |
| criterion (b)                                    | Section 15(b) of the NGL  |
| criterion (c)                                    | Section 15(c) of the NGL  |
| criterion (d)                                    | Section 15(d) of the NGL  |
| DORC   | depreciated optimised replacement cost  |
| ECCSA  | Energy Consumers Coalition of SA  |
| Epic   | Epic Energy   |
| firm (in respect of gas transportation services) | A firm service enables a user to reserve pipeline capacity with priority over buyers with an ‘as available’ service. An ‘as available’ (or interruptible) service does not reserve capacity <sup>1</sup>  |
| Gas Code   | <i>National Third Party Access Code for Natural Gas Pipeline Systems</i> (Schedule 2 to the Gas Pipelines Access (South Australia) Act 1997)  |
| KCA  | Kimberly-Clark Australia Pty Ltd (ACN 000 032 333)  |
| LNG  | liquefied natural gas   |
| LPG  | liquefied petroleum gas   |
| national gas objective                           | see s 23 of the NGL   |
| NERA   | NERA Economic Consulting  |
| NGL  | National Gas Law, which is set out in the Schedule to the <i>National Gas (South Australia) Act 2008</i> (SA) and applied as a law of South Australia by that Act and as a law of other States and Territories by an application Act in each jurisdiction |
| NGR  | <i>National Gas Rules 2008</i> , promulgated as subordinate legislation to, the NGL   |
| Origin   | Origin Energy Limited   |
| PASA   | Pipelines Authority of South Australia  |
| relevant Minister                                | South Australian Minister for Mineral Resources and Energy the Hon. Tom Koutsantonis MP   |

<sup>1</sup> See: NERA 2008, pp 45-6.

|          |                                      |
|----------|--------------------------------------|
| SEA Gas  | South Eastern Australia Gas Pipeline |
| SEPS     | South Eastern Pipeline System        |
| SESA     | South East South Australia Pipeline  |
| Tribunal | Australian Competition Tribunal      |

# 1 Pipeline classification decision and coverage recommendation

## Pipeline classification and relevant Minister

- 1.1 The Council has decided under s 98 of the National Gas Law (**NGL**) that the South East Pipeline System (**SEPS**) is a transmission pipeline and is not a cross boundary pipeline. Accordingly, the relevant Minister is the South Australian Minister for Mineral Resources and Energy the Hon. Tom Koutsantonis MP (**Minister**).<sup>2</sup>
- 1.2 The Council’s reasons for its classification decision are set out in section 4 of this report.

## Coverage recommendation

- 1.3 The Council’s view, having considered available information relevant to the coverage criteria in the NGL and giving regard to the national gas objective, is that criteria (a) and (d) are not met in relation to the SEPS.
- 1.4 The Council’s recommendation, therefore, is that the Minister not cover the SEPS. The Council’s reasoning for this recommendation is set out in sections 6 to 9 of this report.
- 1.5 If, contrary to the Council’s recommendation, the Minister decides to cover the SEPS, the Council considers that that coverage should be for a period of 10 years. This aspect of the Council’s advice is addressed in section 10 of this report.

## Form of regulation decision

- 1.6 The Council has decided under s 110 of the NGL that, if it were to be covered, the SEPS should be subject to light regulation. The Council’s reasoning for this decision is set out in section 11 of this report.

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<sup>2</sup> Under s 2 of the NGL, for a transmission pipeline wholly within a participating jurisdiction, the relevant Minister is the ‘designated Minister’ as defined in the relevant application Act. Section 9 of the *National Gas (South Australia) Act 2008* (SA) defines ‘designated Minister’ as ‘the Minister to whom the administration of this Act has been committed.’ The South Australian Government website lists that Act as being part of Minister Koutsantonis’ portfolio: <http://www.sa.gov.au/government/minister/19>.

## 2 Application and public consultation

### Application

- 2.1 On 28 November 2012, the Council received an application under s 92 of the NGL from Kimberly-Clark Australia Pty Ltd (**KCA**) for a coverage determination for the SEPS (**Application**). The Council wrote to KCA on 29 November 2012 requesting KCA to provide further information by 7 January 2013 and advising KCA that the period for public consultation on the Application would commence on 8 January 2013. The Application, the Council's letter requesting further information and KCA's response dated 7 January 2013 (**KCA supplementary information**) were published on the Council website.

### Public consultation

#### Application

- 2.2 On 5 December 2012, the Council published a notice in The Australian advising that it had received the Application and had provided KCA further time (until close of business on 7 January 2013) to provide additional information to support the Application. The notice advised that public consultation on the Application would commence on 8 January 2013 and that public submissions on the Application were to be provided to the Council by 5.00pm on 29 January 2013.
- 2.3 On 16 January 2013, APA Group, the owner/operator of the pipeline system (**APA**), provided a submission comprising background information to assist in the assessment of the Application (**APA first submission**). This information was published on the Council website and interested parties were invited to have regard to it in preparing submissions.
- 2.4 At the close of submissions, the Council had received:
- a further submission from APA (**APA second submission**)
  - a submission from Origin Energy Limited (**Origin**)
  - a submission from Beach Energy (**Beach**), and
  - a letter from KCA addressing matters raised in the APA first submission (**KCA letter**).
- 2.5 The submissions were published on the Council's website. The KCA letter contained some confidential information and was not placed on the website until the confidentiality issues were resolved.

## Draft recommendation

- 2.6 On 20 February 2013, the Council made its draft recommendation that the Minister decide not to cover the SEPS. The Council's preliminary view was that criteria (a) and (d) are not satisfied.
- 2.7 The Council invited interested parties to make submissions and comments on its draft recommendation by 5.00pm on 14 March 2013. The Council received submissions from:
- KCA (**KCA draft recommendation submission**)
  - the Energy Consumers Coalition of SA (**ECCSA**), and
  - Uniting Communities.
- 2.8 The Council subsequently received a response to the KCA draft recommendation submission from APA (**APA draft recommendation response**) dated 20 March 2013 advising among other things that APA had commenced a process to sell the SEPS, and a letter from KCA in reply to the APA draft recommendation response (**KCA response to APA**) dated 22 March 2013.
- 2.9 The Council sought information from Beach in relation to matters raised by KCA in its draft recommendation submission. Following this, Beach wrote to the Council on 2 April 2013 summarising its views (**Beach letter**).
- 2.10 The three submissions and the subsequent letters from APA, KCA and Beach were published on the Council's website.
- 2.11 The Council took account of all submissions and the subsequent information from APA, KCA and Beach in making its final recommendation.

### 3 The SEPS and the background to the Application

#### The pipeline and the pipeline service

- 3.1 The SEPS is located in south eastern South Australia and consists of four pipeline segments in total some 70 kilometres in length:
- (a) the lateral from Katnook to Safries
  - (b) the pipeline from Katnook to Snuggery
  - (c) the pipeline from Glencoe to Mt Gambier, and
  - (d) the lateral from Kalangadoo to Nangwarry (decommissioned).<sup>3</sup>
- 3.2 The SEPS is linked to the eastern Australian gas transmission system via the South East South Australia pipeline (**SESA**). The SESA was constructed by Origin in 2005 following a greater than expected decline in production in the Katnook area to transport gas from the SEA Gas to Origin's Ladbroke Grove power station and the SEPS. The SESA connects to the SEPS at Katnook. **Appendix A** shows the location of the SEPS and the areas it serves. **Appendix B** shows the relationship between the SEPS and the SESA and the SEA Gas.

#### Ownership of SEPS, associated pipelines and resources

- 3.3 The SEPS (excluding the Nangwarry lateral) was constructed in 1990-1991 by the South Australian Government and operated by the Pipelines Authority of South Australia (**PASA**), transporting gas from the Katnook gas fields to users in Penola, Snuggery and Mt Gambier. The South Australian Government sold the SEPS to Tenneco Gas Australia in 1995. The SEPS was transferred in 1996 to Epic Energy (**Epic**), the assets of which (except the Dampier to Bunbury Natural Gas Pipeline) were acquired in 2004 by Hastings Fund Management. Following APA's 2012 acquisition of the Hastings Diversified Utilities Fund APA became the owner and operator of the SEPS. It has recently commenced a process to sell the pipeline. APA acquired the SESA in 2007.<sup>4</sup> When the SEA Gas commenced operations, International Power, Origin and TruEnergy each held one third shares. The SEA Gas is now owned equally by APA and the Retail Employees Superannuation Trust. The pipeline is managed and operated by South East Australia Gas Pty Ltd, an independent company, and is maintained by APA.
- 3.4 Beach, following its acquisition of Adelaide Energy Ltd in 2012, holds four exploration permits, three production licenses and three retention licences in the South Australian

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<sup>3</sup> The Nangwarry lateral was constructed in 2001 to supply gas to the Carter Holt Harvey Ltd timber mill at Nangwarry. The lateral was decommissioned following closure of the mill in 2010.

<sup>4</sup> APA also owns 33.4 per cent of Envestra, the South Australian gas distributor, and operates and maintains Envestra's network, including the Mt Gambier reticulation network.

part of the Otway Basin. Beach's interests include the gas fields in the Katnook area, the development of which prompted the initial construction of the SEPS, and the Katnook gas plant which is a receipt point on the SEPS. Origin owns and operates the Ladbroke Grove power station.

## **Coverage and revocation of coverage of the SEPS**

- 3.5 The SEPS was listed in Schedule A of the *National Third Party Access Code for Natural Gas Pipeline Systems (Gas Code)* and was therefore a covered pipeline from the commencement of the Gas Code. In December 1999, Epic applied for revocation of the coverage of the SEPS. The Council recommended revocation in March 2000 and the relevant Minister revoked coverage on 6 April 2000.
- 3.6 In considering the revocation application the Council considered whether access would promote competition in gas sales markets by:
- encouraging new producers to compete for the business of gas users
  - enabling gas producers to offer gas at cheaper prices encouraging users to switch from other energy sources to gas, or
  - encouraging other pipelines to seek interconnection with the SEPS to assist inter-regional gas transport.
- 3.7 The Council was not satisfied that access would promote competition in any of these ways primarily for the following reasons.
- There was little prospect of competition from new local producers and there was no evidence access might stimulate greater exploratory work. Should new discoveries in the area lead to a situation where access would promote competition, it was open to parties to seek re-coverage of the SEPS.
  - The only source of gas at the time was the Boral joint venture, which held all capacity on the SEPS. Epic therefore had little opportunity to extract higher transport tariffs, so access was unlikely to result in lower tariffs.
  - Given the patterns of supply and demand at the time and the relatively isolated location of the SEPS, there was no evidence that other parties would seek to interconnect to the SEPS.
- 3.8 The Council was not satisfied that criterion (a) was met. It also concluded that the costs of access were likely to outweigh the benefits and that criterion (d) was therefore not met.
- 3.9 For the purposes of the current Application the Council has considered the revocation recommendation but found it to be of limited assistance given the changes in the south east of South Australia since 1999. Further, at the time of the revocation application the

early depletion of the Katnook gas fields prompting the interconnection to SEA Gas via the SESA was not anticipated, nor was the decline in KCA's demand for gas.

## **Contractual arrangements for the SEPS**

- 3.10 KCA was a foundation customer for gas produced at Katnook and has been (and remains) the largest single user of gas shipped on the SEPS. It is the only gas user to negotiate transportation directly with the pipeline owner (now APA). The only other shipper of gas on the SEPS is Origin, which currently provides gas to KCA and the Safries facility (a potato processing plant near Penola owned by McCain Foods Australia) and reticulates gas to Mt Gambier. Origin previously supplied gas to Carter Holt Harvey at Nangwarry.
- 3.11 Under the foundation contract between SAGASCO and PASA, SAGASCO contracted for all of the capacity of the SEPS on a firm forward haulage basis<sup>5</sup> until 2010. SAGASCO was the South Australian gas company 51.7 per cent owned by the South Australian Government. The SAGASCO assets were sold to Boral in 1993 and the transportation rights under the foundation agreement were ultimately transferred to Origin. When the foundation contract expired at the end of 2010, Origin entered into a new three year agreement with Epic for approximately 55 per cent of the capacity of the SEPS (Origin submission, p 1). This means that since the expiry of the foundation agreement, there has been uncontracted capacity on the SEPS. By contrast, when Origin sold the SESA to APA, Origin entered into a 15.5 year transportation agreement for the SESA (commencing 2 July 2007) reserving all of the capacity of the SESA. Origin is the only shipper using the SESA and also the SEPS (despite available uncontracted capacity on the SEPS).
- 3.12 The Application has arisen out of negotiations between, initially, Epic (now APA) and KCA for gas transportation following the expiry of the foundation contract.
- 3.13 KCA submits that under the foundation contract a higher tariff applied from 1991 until 2005 and a lower tariff for the last five years to 2010. KCA submits that it was informed by Epic that open access to the SEPS would be available upon expiry of the foundation contract but at a higher tariff.
- 3.14 KCA seeks coverage of the SEPS because it considers that Epic (now APA) provides a monopoly service and coverage 'is the only feasible way for the establishment of shipping rates and the cost of new connections that do not contain monopoly rents' (Application, p 10). KCA submits that APA (and formerly Epic) is able to maintain its position as to what it will charge because there is no credible alternative to the SEPS for gas haulage to KCA's Millicent mill. It argues that were the SEPS subject to regulation, the

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<sup>5</sup> A firm service enables a user to reserve capacity with priority over buyers with an 'as available' service. Priority tends to be more important where a pipeline is at or near capacity since 'as available' services will be delayed until firm commitments are met. 'As available' (or interruptible) tariffs are typically 30% higher than for firm services but are paid on quantities delivered rather than reserved capacity (NERA 2008, pp 45-6).

transport tariff would be lower because a regulator would set the initial capital base at a level significantly lower than the value that Epic has used to determine its new tariffs (Application, pp 32-34). In this regard, KCA states that the depreciation profile that APA has used in setting the charge for the SEPS is incorrect, and that ‘the proportion of fixed costs falls [from the figure of 90 per cent claimed by APA] if the pipeline is properly depreciated (KCA draft recommendation submission, p 19).

3.15 Although not privy to the contract between Origin and Epic, KCA considers that Origin is paying considerably more than Origin had paid under the foundation contract and that the charge includes a significant element of monopoly rent (Application, p 9).

3.16 APA submits that KCA approached Epic in late 2011 seeking:

- a firm transportation service of a certain (confidential) maximum daily quantity (which was later scaled back)
- an interruptible transportation service of additional gas (of a confidential quantity), and
- a 3 600 kPa pressure service—KCA has historically required gas delivery at 850 kPa, but requires delivery at higher pressure to serve KCA’s gas fired generation facility at the Millicent mill.

3.17 APA submits that Epic responded to KCA’s requests for firm and interruptible services by offering KCA the same transportation tariffs (escalated by CPI) as those available under Origin’s 2011–2014 gas transportation agreement. KCA accepts that this is the outcome of its negotiation with Epic/APA but says that when it first approached Epic (in early 2010) the tariff that Epic proposed was substantially higher. It claims that Epic offered a lower tariff only after KCA advised that it would make an application for coverage of the SEPS (KCA draft recommendation submission, p 19).

3.18 Further APA states that KCA is seeking a higher pressure service and that this represents a significant change in the nature of the service provided by the SEPS. According to APA providing a higher pressure service would involve:

- constructing a new meter/regulating station at KCA’s delivery point, with the cost to be recovered through the monthly delivery point capital and operating charges which would be determined once front end engineering and design work had been carried out, and
- the sterilisation of approximately 3.6 TJ/day capacity on the Katnook to Snuggery pipeline to guarantee the higher delivery pressure, with the costs to be recovered through a monthly pressure service charge calculated on the same basis as under the Origin agreement (APA and KCA differ on whether the sterilisation charge is warranted).

3.19 KCA and APA differ as to the sequence of events surrounding negotiation of the construction of a meter/regulating station (APA first submission and KCA letter) and the

cost of doing so. Ultimately, KCA decided to install its own compressor at the custody transfer point to increase the pressure of gas into its plant.

- 3.20 APA disputes KCA's contention that the proposed tariff includes 'a significant element of monopoly rent'. It submits that the foundation contract is not the appropriate reference point for a new tariff because the foundation agreement made no provision for the recovery of operating expenditure, capital expenditure or return on capital over CPI. APA submits that the reduction in reserved capacity on the SEPS following the expiry of the foundation contract means the largely fixed costs of the pipeline must be spread across lower demand (APA second submission, [3.28]). Regarding the valuation of the asset, APA states that Epic when establishing its initial tariff position had recourse to a depreciated optimised replacement cost (**DORC**) methodology. It considers the DORC methodology to be a well-recognised asset valuation method used by a number of regulators. Moreover it says that the tariff eventually agreed with Origin implies a 'substantially lower asset value' than would have been the case under the DORC methodology (APA second submission [3.29]).
- 3.21 APA acknowledges that the risk of bypass of the SEPS is low, but submits that its ability and incentive to exercise market power to the detriment of competition in dependent markets is constrained. It says that, because the pipeline is operating at 20-30 per cent capacity while the bulk of the costs (~90 per cent) are fixed, the pipeline owner actually has a 'commercial imperative' to encourage greater utilisation of the SEPS (APA second submission, pp 22-23).
- 3.22 APA advises that it is in the process of selling the SEPS (APA draft recommendation response). It is selling the SEPS as a package with the Moomba to Adelaide Pipeline System, which it is required to divest pursuant to a s 87B undertaking given to the ACCC in relation to APA's acquisition of the Hastings Diversified Utilities Fund. The Council does not consider that the potential change in ownership of the SEPS is relevant to its consideration of the Application: if the criteria for coverage are met then the Council would recommend that the SEPS be covered regardless of the owner. However, the Council is not satisfied in respect of criterion (a) where APA owns the SEPS. Thus, a change in the ownership of the pipeline would not cause the Council to alter its recommendation.
- 3.23 Coverage and, more broadly, regulation of access under the NGL is not directed to eliminating monopoly rents by providing for control of pipeline tariffs. It is only where coverage (and consequent regulation of access terms and conditions) will be likely to materially promote competition in a dependent market and the other requirements in the coverage criteria are met that a pipeline may be covered. The fact and detail of the disputes over the prices for transporting gas on the SEPS is, in itself, of little or no relevance to the question of coverage. It appears to the Council that much of KCA's approach to seeking coverage of the SEPS is directed to reducing the price it will pay for the pipeline services it receives from the SEPS *per se*, rather than matters that go to the coverage requirements of the NGL.

## 4 Classification of the SEPS

- 4.1 Where an application is made for a coverage determination, s 98 of the NGL requires the Council to classify the pipeline as either a transmission or a distribution pipeline and determine whether it is a cross boundary pipeline.
- 4.2 The Council must apply the pipeline classification criterion in s 13(1) of the NGL. The criterion requires a pipeline be classified according to whether its primary function is to:
- reticulate gas within a market—in which case the pipeline is a distribution pipeline, or
  - convey gas to a market—in which case it is a transmission pipeline.
- 4.3 Without limiting s 13(1), s 13(2) requires the Council to have regard to a range of factors in determining the primary function of a pipeline. Those factors are:
- (a) the characteristics and classification of, as the case requires, an old scheme transmission pipeline or an old scheme distribution pipeline;
  - (b) the characteristics of, as the case requires, a transmission pipeline or a distribution pipeline classified under this Law;
  - (c) the characteristics and classification of pipelines specified in the [NGR] (if any);
  - (d) the diameter of the pipeline;
  - (e) the pressure at which the pipeline is or will be designed to operate;
  - (f) the number of points at which gas can or will be injected into the pipeline;
  - (g) the extent of the area served or to be served by the pipeline;
  - (h) the pipeline's linear or dendritic configuration.

### Application and submissions

- 4.4 KCA notes that the SEPS was previously classified as a transmission pipeline in Schedule A of the Gas Code (Application, p 6). In its submission on the draft recommendation (at [2.1]), KCA confirms its view that the SEPS is appropriately classified as a transmission pipeline.
- 4.5 APA submits that the SEPS should be classified a transmission pipeline, having regard to the pipeline classification criteria, including the characteristics and function of the SEPS. Origin also describes the SEPS as a transmission pipeline (Origin submission, p 2).
- 4.6 APA's views as to the characteristics of the SEPS in relation to the factors outlined at 4.3 above is outlined in Table 4.1 below.

**Table 4.1: APA’s response to Section 13(2) matters**

| Characteristic  | APA Response   |   |
|---|--|---|
| Characteristics and classification of an old scheme transmission or distribution pipeline       | The SEPS was originally classified as a transmission pipeline under schedule A of the Gas Code.  |   |
| Characteristics of a transmission or distribution pipeline classified under the NGL             | At the time the NGL was implemented, the SEPS was not a covered pipeline. No consideration was therefore given to the status of the SEPS when the NGL was developed. |   |
| Characteristics and classification of pipelines specified in the NGR                            | The NGR do not currently provide for this specification.   |   |
| Diameter of the pipeline  | Katnook to Snuggery and Glencoe to Mt Gambier: 168.3 mm  | Diameter is not really a measure of whether a pipe is transmission or distribution. It is really about pressure.  |
|   | Katnook to Safries: 60.3 mm  |   |
|   | Kalangadoo to Nangwarry: 88.9 mm   |   |
| Pressure at which the pipeline is designed to operate (Max Allowable Operating Pressure (MAOP)) | Katnook to Snuggery, Glencoe to Mt Gambier & Katnook to Safries: 10,000 kPA  | Pressure above 1,050 kPA is generally considered transmission pressure. The operating pressure of the SEPS is therefore consistent with a transmission pipeline.                            |
|   | Kalangadoo to Nangwarry: 9,850 kPA   |   |
|   | Although the SEPS has a MAOP of 9,850 - 10,000 kPA, gas currently enters the pipeline at Katnook at around 5,000 kPA.  |   |
| Number of injection points  | 1 (Katnook)  |   |
| Area served by the pipeline (Pipeline length)   | Katnook to Snuggery: 46.1 km   | The SEPS services a number of discrete delivery points that are located some distance from Katnook, which is consistent with the characteristics of a point to point transmission pipeline. |
|   | Glencoe to Mt Gambier: 18.9 km   |   |
|   | Katnook to Safries: 4.5 km   |   |
|   | Kalangadoo to Nangwarry: 18.9 km   |   |
| Linear or dendritic configuration of the pipeline   | While there are two laterals branching off the SEPS, it essentially has a linear configuration, which is consistent with a transmission classification.              |   |

Source: APA second submission, p 49

## Classification decision

- 4.7 The SEPS was classified as a transmission pipeline in Schedule A of the Gas Code. While the Gas Code classification ceased when coverage of the SEPS was revoked in 2000, the previous classification remains informative as the services the SEPS provides. Moreover its characteristics have not changed since the pipeline was first classified for the Gas Code.<sup>6</sup>
- 4.8 APA states that “the primary purpose of the SEPS is to convey gas to various locations in the south east corner of South Australia and *not* to reticulate gas within the locations serviced by the pipeline” and these are the reasons why the SEPS was originally classified as a transmission pipeline (APA first submission, p 2).
- 4.9 The maximum allowable operating pressure of the SEPS and its configuration (being largely linear with two laterals—one used and one decommissioned) are consistent with SEPS being for the conveyance of gas.
- 4.10 The SEPS has been used by Origin (and its predecessors) since the pipeline was first commissioned to ship gas to large end users at Snuggery, in the Penola region and to commercial and residential customers in the Mt Gambier region via the gas distribution network of Envestra. Gas is no longer supplied via the Nangwarry lateral.
- 4.11 Although the source of gas for the SEPS has changed during the life of the pipeline, the Council is satisfied that the SEPS continues to carry gas from the point of injection to a market. As such the Council considers that the SEPS should be classified as a transmission pipeline.

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<sup>6</sup> While the Kalangadoo to Nangwarry lateral has been decommissioned, as this pipeline segment was constructed and commissioned after the revocation of the SEPS’ coverage this change is immaterial in the context of the SEPS’ previous classification.

## 5 Coverage of pipelines

### Requirements of the NGL

- 5.1 Natural gas pipelines in Australia may be subject to access regulation according to the NGL and associated rules. In particular a person may apply to have a pipeline ‘covered’. The effect of coverage is to subject to regulation the terms and conditions on which the pipeline’s services are provided.
- 5.2 Where a person has applied for a coverage determination, the Council must apply the pipeline coverage criteria and make a recommendation to the relevant Minister that the pipeline be a covered pipeline or not be a covered pipeline (NGL, s 96).

### The coverage criteria

- 5.3 The pipeline coverage criteria, set out in s 15 of the NGL, are:
- (a) that access (or increased access) to pipeline services provided by means of the pipeline would promote a material increase in competition in at least 1 market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline (**criterion (a)**)
  - (b) that it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline (**criterion (b)**)
  - (c) that access (or increased access) to the pipeline services provided by means of the pipeline can be provided without undue risk to human health or safety (**criterion (c)**), and
  - (d) that access (or increased access) to the pipeline services provided by means of the pipeline would not be contrary to the public interest (**criterion (d)**).
- 5.4 The Council must recommend in favour of a coverage determination where it is satisfied that all of the coverage criteria are met and must recommend against making a coverage determination if not satisfied that all the coverage criteria are met (NGL, s 97(2)). In considering the Council’s recommendation and making his or her decision the relevant Minister must consider the same matters and meet the same requirements as the Council (NGL, ss 97 and 100).<sup>7</sup>

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<sup>7</sup> The ECCSA submits that the requirements on the Council and relevant Minister differ slightly (ECCSA submission, footnote 3). However, this is not the case. The Minister must give effect to the criteria in the same manner as the Council. Sections 97 and 100 of the NGL differ in that the latter provides that the relevant Minister, in deciding whether to make a coverage determination, must have regard to the national gas objective, the Council’s recommendation and any submissions received under s 99(4) and may take into account submissions made to the Council.

## The national gas objective

5.5 In deciding whether the coverage criteria are satisfied the Council must have regard to the national gas objective, set out in s 23 of the NGL. The national gas objective states that:

The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

5.6 KCA addresses the national gas objective as a separate consideration (see Application, pp 11-13). In its submission on the draft recommendation, KCA contends that the national gas objective is relevant particularly to the concept of the public interest, and identifies a range of benefits from coverage that it considers are consistent with the long term interests of consumers of natural gas. In this regard KCA considers that the national gas objective should influence particularly the examination of criterion (d) (KCA draft recommendation submission, section 8).

5.7 KCA submits that ‘the concept of the public interest should be construed in [a] manner consistent with’ the objective and that ‘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’ (KCA draft recommendation submission, [8.3]).

5.8 The ECCSA makes a related submission, contending that the purpose of the objective is ‘over-riding’ and that the Council has erred in considering that the coverage criteria override the objective. It argues that the Council must have regard to the long-term interests of consumers when assessing the criteria. (ECCSA submission, p 2)

5.9 Lower gas transport tariffs *per se* do not necessarily best serve the long-term interests of consumers. Outcomes for consumers also depend on there being appropriate incentives for investment in and the operation of natural gas pipelines so that efficient services are available. In this regard the Council reiterates that the national gas objective is aimed at the promotion of economic efficiency in investment in, operation of and use of natural gas infrastructure. Economic efficiency relevant to the long term interests of consumers depends on appropriate incentives for investment and pricing based on efficient costs, over time.

5.10 Further, an objects clause ‘cannot cut down the plain and unambiguous meaning of a provision if that meaning in its textual and contextual surroundings is clear.’<sup>8</sup> Criterion (d)

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<sup>8</sup> *S v Australian Crime Commission* [2005] FCA 1310, [22], Mansfield J. In *Minister for Urban Affairs and Planning v Rosemount Estates Pty Ltd* (1996) 91 LGERA 31, 78; [1996] NSWSC 348, Cole J said that ‘whilst regard may be had to an objects clause to resolve uncertainty or ambiguity, the objects clause does not control clear statutory language, or command a particular outcome of exercise of discretionary power’. See also Pearce, D.C. and Geddes, R.S.

is a test of whether coverage might not be in the public interest. (Unlike affirmative public benefit tests (such as in ss 90(5A)—90(9) of the *Competition and Consumer Act 2010 (CCA)*), the criterion does not test whether coverage is in the public interest.)

- 5.11 Read together, ss 97(1)(a) and s 97(2) of the NGL provide that the Council must give effect to the coverage criteria by recommending in favour of coverage where the Council is satisfied that all coverage criteria are met and recommending against coverage where it is not satisfied that all the criteria are met. In considering the coverage criteria, the Council has regard to the national gas objective. The Council cannot recommend coverage where any coverage criterion is not satisfied.

## 6 Criterion (a)

### 6.1 Criterion (a) requires that

access (or increased access) to the pipeline services provided by means of the pipeline would promote a material increase in competition in at least 1 market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline.

6.2 The decision on coverage is directed to the question of whether the environment for competition in a market other than the market for the pipeline services (that is, in an upstream or downstream market, referred to as a dependent market) would be improved. The issue is whether access or increased access to pipeline services on reasonable terms and conditions would improve the opportunities and environment for competition in a dependent market(s) so as to promote materially more competitive outcomes in that market. The assessment is concerned with the process of competition, rather than the particular commercial interests or pursuits of any party. If a dependent market is already effectively or workably competitive then it would be unlikely that access would improve the competitive environment such that criterion (a) is satisfied.

6.3 In assessing whether criterion (a) is satisfied, the Council:

- identifies relevant dependent (upstream or downstream) markets
- considers whether the identified dependent markets are separate from the market for the pipeline service, and
- assesses whether access (or increased access) would be likely to promote a materially more competitive environment in the dependent market(s).

### Dependent markets

6.4 In the Application and in its supplementary materials KCA suggests several markets where it considers access or increased access to the SEPS would promote competition. KCA refers to:

- the Australian (and global) markets for paper tissue products (KCA supplementary information, p 2 and Application, p 15) and other product markets in which local users compete (such as the potato processing market in which McCain Foods Australia's Safries facility operates)
- an (upstream) gas supply/production market centred on Katnook comprising local producers and other shippers delivering gas to Katnook via the SEA Gas and SESA pipelines, and
- a (downstream) market comprising 'usage of gas for industrial, commercial and domestic purposes in the lower South East region of SA' (KCA supplementary information, p 2) but also states that 'there would be no

increased competition (or loss of competition) [for domestic users in Mt Gambier] should coverage be granted of SEPS' (KCA supplementary information, p 4).

- 6.5 APA submits that KCA identified: 'the upstream gas market at Katnook; the Australian tissue market; and the retail gas market in Mt Gambier' (APA second submission, [3.14]).<sup>9</sup>
- 6.6 Uniting Communities comments on effects on residential energy consumers in the Mt Gambier area, expressing concern that following the revocation of retail energy price caps (on the basis that competition in energy markets is now effective), 'there is now no countervailing competitive pressure on either Origin Energy or APA Group to constrain their ability to set prices in Mt Gambier in excess of what are reasonable prices'.
- 6.7 The ECCSA considers that coverage is a key to Beach being able to enter the Mt Gambier gas market (even if it cannot provide sufficient gas for all users in the region) and that coverage would also enable KCA to reduce its input costs and pass cost reductions through to consumers of its products in the form of lower prices so increasing competition in the paper tissue products market.
- 6.8 Having considered these submissions, the Council considers that the most relevant dependent markets are:
- (a) a (downstream) market for the sale of gas for use by domestic, industrial and commercial users in the area served by the SEPS
  - (b) an (upstream) market for the production and sale of gas, and
  - (c) Australian markets for paper tissue products and other products.
- 6.9 In responding to the draft recommendation, where the Council adopted the markets identified in 6.8 above, KCA submits that for the purposes of the Application it agrees with the Council's definition of the relevant dependent markets. The Council notes that KCA 'reserves its position' as to whether the downstream market for gas sales to domestic, industrial and commercial users in fact comprises 'different domestic and industrial gas consumption markets segmented by annual volume and demand profile of consumption' and that KCA argues that if the downstream market is more segmented then its case is stronger. At no stage however has KCA sought to provide any information supporting these contentions.
- 6.10 The Council is satisfied that the markets identified in 6.8 are distinct from the market for services provided by the SEPS because:

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<sup>9</sup> APA states that it has adopted the markets specified by KCA and, as it has not conducted its own analysis to identify relevant markets, does not endorse the markets as identified by KCA (APA second submission, [3.40] and footnote 46).

- (a) the parties that provide the SEPS pipeline services and operate in the markets identified above are different, and
- (b) the provision of the SEPS pipeline services involves the use of facilities that are distinct from the facilities used in the identified dependent markets.

## **Assessment of the effect of access on likely dependent markets**

### **Gas sales around the SEPS**

- 6.11 Competition in (downstream) gas sales is likely to be promoted if coverage of the SEPS enables (or significantly encourages) new entry by parties selling gas to users in the region of the SEPS: that is entry by a party other than the current supplier (Origin) or potential entry that at least constrains Origin’s market behaviour in a material manner.
- 6.12 The key to increased competition in the gas sales market around the SEPS is the likelihood of entry or the threat of entry by gas suppliers in competition with Origin and the Council has assessed the application on this basis. The two potential sources of new gas supply into the region around the SEPS are gas supplied from outside the region of direct interconnection with the SEPS (via the eastern Australian transmission network and the SESA) and locally extracted and processed gas injected into the SEPS at Katnook.<sup>10</sup>

#### *New gas supply—external to the region of the SEPS*

- 6.13 The connection to the transmission network through the SESA and the SEA Gas provides the means for gas producers outside the region of direct interconnection to the SEPS to supply gas to users and potential users in the region of the SEPS in competition with existing suppliers.
- 6.14 Although all firm capacity on the SEA Gas is contracted until 2019 (or 2029 if the foundation customers exercise their option to extend) (APA second submission, [3.47]), the Council considers that gas transmission and supply is generally competitive to the point of interconnection between the SEA Gas and the SESA. That is, a prospective supplier of gas to users in the SEPS region could obtain gas at the point of interconnection of the SEA Gas and the SESA and transport it via the SESA to the SEPS at Katnook.
- 6.15 Origin holds a contract for 100 per cent of the capacity of the (uncovered) SESA until 2023. APA cannot sell any capacity on the SESA to another intending user for the period of the Origin contract. Prospective gas suppliers located in other basins seeking to use

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<sup>10</sup> KCA identifies a localised gas supply/production market around the entry point of the SEPS as a separate market. However, gas produced locally would be either used downstream in the gas sales market in the area of the SEPS or exported via the interconnected Australian pipeline network in which case it would form part of the upstream gas production and sales market.

the SEPS to supply downstream users will therefore need to enter an arrangement with Origin (the incumbent shipper) or agree with APA to fund an expansion of the SESA in order for APA to provide a service on the SESA in addition to that available to Origin.

- 6.16 APA submits that the ability of gas producers in basins outside the region of the SEPS to supply gas to the region depends on obtaining access three pipelines: the SEPS, the SESA and the SEA Gas (APA second submission, [2.39]). KCA notes that access to the SEPS is unlikely to result in increased competition from shippers with access to the SEA Gas because Origin holds all capacity on the SESA. KCA considers that this effectively prevents a SEA Gas shipper (other than Origin) from injecting gas into the SEPS (KCA supplementary information, p 1).
- 6.17 Use of both the SEPS and the SESA is necessary for an alternative supplier from outside the region of direct interconnection with the SEPS to provide gas to Katnook and beyond. With Origin holding 100 per cent of the capacity of the SESA until 2023, an alternative non-local supplier would likely have to fund an expansion of the SESA in order to obtain the capacity on the SESA necessary to transport gas to Katnook for injection into the SEPS. In this environment the Council agrees that it is unlikely that an alternative supplier from outside the region would be able to deliver gas to users such as KCA downstream of Katnook more cheaply than would Origin.<sup>11</sup>

#### *New gas supply—local*

- 6.18 The only likely new entrant that might be able to inject additional gas at Katnook is Beach (or its associated companies), which owns local gas fields, including fields that have produced gas in the past, and the Katnook processing plant.
- 6.19 KCA submits that coverage of the SEPS would encourage Beach to explore and develop its fields and inject this gas into the SEPS where it would be available in competition with gas supplied by Origin via the SEA Gas and the SESA. Regarding this, KCA submits that Beach has advised that it considers there is remaining gas in the Katnook fields which Beach is seeking to commercialise (recognising the need for a gas buyer and favourable economics including ‘a sufficiently low tariff being charged for the SEPS (KCA draft recommendation submission, [4.6(1)]). KCA’s argument is that

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 supplementary information, p 2).

- 6.20 Following the Council’s draft recommendation (in which it expressed doubt about whether there is sufficient available local gas such that coverage of the SEPS would materially promote competition in the downstream gas sales market), KCA contends that Beach will have sufficient gas in the short, medium and longer term to enable it to

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<sup>11</sup> It might be that the SESA could become a covered pipeline but it is unclear to what extent coverage could result in meaningful additional access to it.

provide a sustainable competitive constraint to the incumbent supplier Origin. KCA advises that it has had discussions with Beach and that as a result of these discussions it understands the following.

- Beach has gas in the existing Katnook fields that it could supply to KCA. KCA and Beach each see an advantage in reaching an agreement for Beach to supply gas to KCA. KCA considers that this would provide competitive pressure on its current and only supplier (Origin) and would diversify supply risk. KCA says it has indicated to Beach it is prepared purchase gas from the Katnook fields and that Beach considers KCA's level of demand is attractive. For this to occur KCA says that Beach will need to make investments to extract the remaining gas in the Katnook fields, and that these investments would require KCA to contract to purchase gas, such that Beach has sufficient certainty regarding gas sales to warrant the investment necessary to extract the gas.
- Beach is undertaking development and exploration of other local gas resources and anticipates additional local gas being available in the short to medium term to supply the market downstream from Katnook and the wider market. Regarding other local gas resources, KCA states that Jacaranda Ridge (operated by Beach) is one of four key producing assets in the Otway Basin. It was subject to production testing in 2011-12: current P2 reserves are less than 1PJ. Whether other reworking fields are commercially viable depends on Beach's capacity to sell to buyers such as KCA: any gas could be injected into the SEPS within two years. Beach is also exploring and drilling in other local fields: any gas found would be available within 2-3 years.

6.21 Consequently, KCA believes that Beach's current drilling and proposed exploration activities should result in local gas being available, and continuing to be available over the longer term (KCA draft recommendation submission, [1.3(2)]).

6.22 KCA says that a commercial arrangement between itself and Beach is contingent on coverage of the SEPS (under light regulation) such that Beach can deliver gas to KCA on reasonable price and non-price terms (KCA draft recommendation submission, [4.7]). KCA says that both it and Beach are concerned that APA has an incentive to discriminate against Beach because gas supplied to KCA by Beach would displace that currently supplied by Origin. KCA says that this incentive arises because APA transports Origin gas on other APA pipelines before connecting to the SEPS thereby providing APA with revenue from gas carriage. KCA also states that Origin has superior bargaining power to Beach (because it is a significant customer of APA elsewhere) and can as a result extract a commercial advantage over Beach in relation to use of the SEPS.

6.23 KCA goes on to say that '[a]n increase in competition from no competition to actual competition, however limited, is necessarily a material increase in competition' and '[t]he 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' (KCA draft recommendation submission, [3.4] and [8.1]). KCA cites as authority the High Court in *Rural Press Ltd v ACCC* [2003] HCA 75.<sup>12</sup>

- 6.24 APA rejects KCA's submission that APA has a 'clear commercial incentive to discriminate in favour of Origin *vis-à-vis* Beach'. It notes, in particular, that it has offered KCA access to the SEPS at the same price (CPI adjusted) (and by inference would do the same for Beach) and that any reduction in volume of gas transported on the SESA and the SEPS would have little effect on APA revenue because Origin charges are capacity based and fixed for the term of the contracts (APA draft recommendation response).
- 6.25 Beach says that it is currently exploring in existing (depleted) fields near Katnook (during first quarter 2013) and is proposing exploration in other areas capable of connection to Katnook in 2014 (Beach submission, pp 1-2). It says that the commercial viability of reworking fields such as Katnook, Redman, Jacaranda Ridge and others depends on both determining that the technical risk is acceptable and establishing satisfactory economic and market conditions for the sale of gas, including reasonable tariffs for transport of gas. Beach advises that it is attracted to exploration in the South Australian part of the Otway Basin due to its geological characteristics and its proximity and connectivity to other gas markets. If exploration results in discovery of high volumes, Beach would consider tying directly to the SEA Gas. It says that although production ceased at Katnook due to reservoir depletion its subsequent investment in the Katnook plant and hydrotesting of flowlines reflects Beach's optimism for further gas production in the areas.
- 6.26 Beach says that before committing to further work on its currently shut-in fields, it will seek to establish that there is an opportunity to sell any gas produced and that production and sale of gas can be maintained. It sees KCA's gas demand as a logical opportunity in the potential restarting of gas production in the Katnook area. As yet Beach has had no gas marketing discussions but expects it will approach KCA if technical review results are positive. Beach says that the likely quantity of gas in the Katnook fields means that it would be unlikely to meet KCA's entire demand so KCA would need supply options in addition to Beach. Beach also would be unable to offer firm supply until its assessments of its fields show there is sufficient volume. According to Beach, any gas found as a result of the 2013 exploration in the Katnook fields would be available in about 12 months and any gas from the proposed exploration activity in about 2015-16 when it expects tighter Australian demand and supply conditions.
- 6.27 Beach's exploration (current and planned) does not depend on coverage of the SEPS (since Beach is already exploring without coverage) although Beach considers that reasonable tariffs for use of the SEPS are critical to the development of the Katnook fields. Beach advises that it would also canvass other gas sales opportunities, and would

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<sup>12</sup> Specifically at [46] (where Gummow, Hayne and Heydon JJ said that the 'presence of even one competitor of that kind tended to dilute the impact of the existing monopoly').

expect to engage with Origin and the owners of the SEPS and the SEA Gas in determining the economic and gas marketing framework for production from existing fields (Beach letter). The Council notes that if Beach is able to transport gas via the SEPS and also via an arrangement involving the SESA (such as a gas swap with Origin) and/or the SEA Gas then it will have options to supply gas both to users around the SEPS and to those in broader gas markets.

- 6.28 APA concedes that, with declining demand on the SEPS, the prospect of the SEPS being bypassed is low. However, APA submits that most of its costs in respect of the SEPS are fixed and that with spare capacity on the pipeline it has an incentive to accommodate entry by a competitor to Origin if that entry would result in more gas being transported on the SEPS. It also submits that the pipeline owner would be expected to act in a non-discriminatory manner with respect to the price and non-price terms and conditions of access to the SEPS (APA second submission, [3.22]) and suggests that this is borne out by Epic having offered transportation services to KCA at the same tariff (adjusted for CPI) as that payable by Origin Energy (APA second submission, p 24, footnote 36).

#### *The Council's consideration*

- 6.29 In *Rural Press* the High Court considered the effect on competition of the removal of a small competitor who had already entered the market. The case was cited as authority by the Australian Competition Tribunal (**Tribunal**) in *Application by Services Sydney Pty Limited* [2005] ACompT 7, where the Tribunal said (at [135]) that the promotion of competition is 'a relative, rather than an absolute concept' and that, in circumstances where there was effectively no competition (in that case because of Sydney Water's control of the sewerage infrastructure), the 'facilitation of **any** competition ... is of significance' (emphasis in original).
- 6.30 A material promotion of competition may arise where there is a potential entrant (that is, it does not require actual entry). However, in *Services Sydney*, the Tribunal went on to say (at [136]) that 'there must be some real prospect of entry into the dependent market within a reasonable time for competition to be promoted'. For actual or potential entry to act as a competitive constraint on the incumbent, the threat of entry must be credible. In the case of the market for gas sales around the SEPS, the strength of the competitive threat posed by Beach depends upon the prospect that it has or is likely to have sufficient commercially recoverable gas that it can transport to users via the SEPS.
- 6.31 The evidence available to the Council indicates that proved and probable (**P2**) gas reserves in the Katnook area are, and for the last six years have generally been, less than 1 PJ.<sup>13</sup> Table 6.1 below sets out the P2 figures for the three Katnook-area petroleum

<sup>13</sup> KCA submits that 'information in the public domain indicates the current substantial scale of the existing gas reserves of the Otway Basin' and cites the Core Energy Group's 31 December 2011 estimates as authority (KCA draft recommendation submission, [4.9]). However, the figures KCA cites are for the entire Otway Basin. The only producing asset listed by Core Energy for the southeast of South Australia is Jacaranda Ridge, with less than 1PJ of P2

production licences as reported to what is now the South Australian Department for Manufacturing, Innovation, Trade, Resources and Energy between 2007 and 2012.

| Date             | Owner           | P2 reserves |
|------------------|-----------------|-------------|
| 31 December 2007 | Origin          | 0.03PJ      |
| 31 December 2008 | Origin          | 0.10PJ      |
| 31 December 2009 | Adelaide Energy | 1.16PJ      |
| 31 December 2010 | Adelaide Energy | 0.69PJ      |
| 31 December 2011 | Adelaide Energy | 0.38PJ      |
| 31 December 2012 | Beach           | 0.38PJ      |

Source: Origin 2008 and 2009; Adelaide Energy 2010, 2011 and 2012; Beach 2013.

- 6.32 Consistent with the above data, Core Energy’s 2012 report states that P2 reserves for Jacaranda Ridge are less than 1PJ (Core Energy 2012, p 33).
- 6.33 In the draft recommendation (at [6.20]), the Council noted that 1PJ roughly equates to one year’s gas demand for KCA and that known local reserves are therefore unlikely to be sufficient to significantly affect the extent of competition in the gas sales market around the SEPS. Responding to this KCA submits that even on these estimates (which KCA disputes), local gas reserves are sufficient to meet KCA’s requirements for one year, Safries’ requirements for 10 years or smaller downstream customers’ demand ‘into the long term’. It considers that these ‘volumes are therefore significant and do have the potential to have a material impact on competition in the downstream gas market’ (KCA draft recommendation submission, p 10).
- 6.34 While acknowledging that Beach is currently exploring and proposes further exploration in 2014 and has some prospect of recovering gas, the Council’s judgment is that the probability of sufficient local gas becoming available in the short to medium term (so as to materially affect the competitiveness of the gas sales market in the region served by the SEPS) is low. The Council is not aware of any locally sourced gas having been supplied into the SEPS in 2012, although it accepts that local fields are a recent acquisition by Beach and that Beach is optimistic about its prospects for gas production in the area. While Beach has invested in the Katnook processing plant (so the plant is fit for future gas processing), all of its wells in the region are currently shut in. Before committing to development work so it can extract gas from its existing Katnook fields Beach would need to establish opportunities for selling that gas (such as a contract with KCA on terms that enable Beach to invest in development). As yet no marketing discussions have occurred. In any case, the volume of gas that might be extracted would be likely to at most satisfy only part of KCA’s demand. The volume of gas in other fields where Beach is proposing exploration in 2014 is (understandably) unknown, as Beach will not have detailed knowledge on the extent of its gas reserves until it completes its exploratory drilling. Any gas found in these fields (which are not currently connected to the Katnook

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reserves. The Council was advised by Core Energy that the figure of 10 070PJ of prospective Otway reserves in its report (to which KCA refers) was an error and that that figure is in fact the prospective reserves for the Bass Basin.

plant) will not be available for 2-3 years. The discovery of gas in these fields (and subsequent commercialisation of the discovered gas) is likely critical to Beach being able to supply to KCA such that competition in the gas sales market is enhanced by covering the SEPS.

- 6.35 The Council does not accept the argument put by KCA that, because the timeframe for Beach's exploration and development activity is within the 10 year coverage period that the Council considers should apply if the Minister decides to cover the pipeline (see section 10), it should find that coverage would promote a material increase in competition because there is some prospect that gas will become available during this period. The Council would need to see greater surety as to the availability of sufficient gas and be convinced that coverage is instrumental before it could conclude that coverage would materially promote competition in the downstream gas sales market.
- 6.36 Further, the Council has no evidence that Beach is or will be unable to reach a commercially acceptable gas transport arrangement with the owner of the SEPS. Beach has had preliminary discussions with Epic and has foreshadowed an intention to talk with APA and Origin. The Council understands that the foreshadowed discussions are yet to occur.
- 6.37 The Council has considered the comments of Uniting Communities concerning the Mt Gambier retail market. The Council considers the Mt Gambier retail market is appropriately considered as part of the gas sales market around the SEPS. In any case, any promotion of competition in a separate Mt Gambier gas market consequent upon access or increased access to the SEPS would depend upon there being new entry or the threat of new entry that would materially constrain the behaviour of Origin. The analysis is therefore the same as for the more broadly defined gas sales market. In this case, however, it would appear that gas sales by Beach might at most supply some of KCA's demand: Beach would appear to have insufficient gas to also supply residential consumers in Mt Gambier. Accordingly, coverage of the SEPS would not materially promote competition in a separate Mt Gambier retail market.

### **Upstream gas production and sales**

- 6.38 Australia's network of transmission pipelines provides for basin on basin competition in southern and eastern Australia. The transmission network enables, for example, gas producers in the Surat–Bowen, Cooper, Gippsland, Otway, Bass and New South Wales basins to sell gas to customers across Queensland, New South Wales, Victoria, South Australia, Tasmania and the Australian Capital Territory so enhancing the scope for competition in the areas served by the network (AER 2012, pp 94 and 99).
- 6.39 Gas from south east South Australia upstream of the SEPS is part of this competitive market. Producers (including Beach) are able to transport gas for supply to a range of locations in southern and eastern Australia using the transmission network. Any gas produced by Beach for example could be transported using the SEPS or using the SESA

and the SEA Gas via an arrangement with Origin and others. Coverage of the SEPS (while potentially important to the competitive position of a local gas producer) is therefore unlikely to promote an increase in competition in the upstream gas production market.

- 6.40 In any case as noted above the information available to the Council suggests that the known volume of gas in the area of the SEPS is low, with P2 reserves for the Katnook region at 1PJ or less.<sup>14</sup> Beach continues to explore in the Katnook area and considers that this area contains gas that could be available within 12 months under appropriate economic conditions. It is proposing new drilling in 2014, but it will not know the scale of gas reserves for some time.
- 6.41 The Council considers that access to the SEPS is unlikely to promote a material increase in competition in the already competitive (upstream) gas production and sales market.
- 6.42 No party disputes this conclusion.

### **Tissue and paper products (and other product markets)**

#### *Tissue and paper products*

- 6.43 In the Application, KCA states that access to SEPS has the potential to make KCA mill operations more competitive in the Australian and global markets for tissue based products. KCA submits that reduced transmission tariffs will enable it to lower its prices and, given its market share, the outcome would be downward price pressure on all suppliers and thus an increase in competition in the Australian tissue market. The ECCSA also makes this argument (ECCSA submission).
- 6.44 KCA submits that tissue manufacture is highly energy intensive and increasing energy costs compound the cost disadvantage of the Millicent mill putting the long term viability of the mill at risk. The implication of this is that KCA believes that its capacity to obtain appropriate energy costs, achieved by coverage of the SEPS, is relevant to the extent of competition in the paper tissue market.
- 6.45 However KCA also states that its products (facial tissue, bathroom tissue and kitchen tissue) face competition from manufacturers located on Australia's eastern seaboard and that there is 'considerable competition' from imports. KCA advises that it has 'in the mid 30% range' of the Australian tissue market but that Australian manufacturers' market share is being eroded by imports (KCA letter 7 January, p 2). In responding to the draft

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<sup>14</sup> In contrast, the Otway basin in Victoria produced 102 PJ in the year to June 2012 and as at August 2012 had P2 reserves of 847 PJ, while the corresponding figures for the Cooper Basin in South Australia and Queensland were 95 PJ and 1 740 PJ (AER 2012, p 87). In 2012, Australian P2 reserves of natural gas were 98 000 PJ (plus 42 000 PJ of coal seam gas) and Australia produced 1 924 PJ of gas, of which 55 per cent (1 058 PJ) was for the domestic market (AER 2012, p 85).

recommendation, KCA does not seek to advance the argument that coverage of the SEPS will promote the competition in the Australian paper tissue market.

- 6.46 APA considers that KCA's characterisation of the tissue market suggests that the market is already effectively competitive but also that KCA considers that if KCA was to scale back its operations at Snuggery then there would be a material reduction in competition (APA second submission, [3.50]). APA submits that it has no incentive to adversely affect competition in this market and that the viability of the SEPS is inextricably linked to the ongoing viability of gas users. APA says that this is especially so in the case of KCA, the largest user on the SEPS (APA second submission, [3.52]—[3.54]). APA also submits that the SEPS tariff is a relatively insignificant element in KCA's total input costs (detailed in APA second submission, [3.32]—[3.35]) and it is difficult to see how access or increased access could have any effect on competition in the national tissue market (APA second submission, [3.55]—[3.56]).
- 6.47 The assessment required under criterion (a) is whether access or increased access would promote a material increase in competition in a related market, not whether any single user or group of users would become more competitive in their own market. In the draft recommendation the Council outlined its view that the Australian paper tissue market appears to be already effectively competitive. There are four major Australian manufacturers: KCA (which holds about 35 per cent of the market), SCA Hygiene Australasia Pty Ltd (holding around 30 per cent of the market in 2008: RISI 2008a), Encore Tissue Pty Ltd and ABC Tissue Products Pty Ltd. While KCA and SCA Hygiene Australasia are historically the two largest participants, ABC Tissue Products has gained an increasing proportion of the market (PPISG 2010, p 13, RISI 2008a and RISI 2008b). Further, imports are increasing: for example, toilet paper imports doubled between 2004 and 2008 (ACS 2008, p 28) and in 2008 comprised a greater share of the Australian market than any single independent tissue company (RISI 2008a). Moreover, the high Australian dollar, by making tissue imports more price competitive, is likely to be facilitating the expansion of supermarket private label products (Euromonitor 2012).
- 6.48 The Council reaffirms its draft recommendation view that the paper tissues market is likely to be already effectively competitive, such that coverage would not promote competition. In these circumstances, the Council considers that access (or increased access), even if it is assumed to reduce the price of delivered gas for KCA, is likely to have little effect on competitive conditions in the Australian paper tissue market. To the extent that it is relevant to identify a global tissue market the Council considers that access would not materially promote competition.

#### *Other product markets*

- 6.49 KCA submits that other local gas users will become more competitive in their respective markets should access to the SEPS be available, so promoting competition in these markets. KCA states for example that 'Safries [which processes potato products] and

other gas using manufacturers in Mount Gambier will become more competitive in their markets should access be provided on SEPS at reasonable tariffs’ (Application, p 16).

- 6.50 APA submits that cheaper imports are accounting for a growing proportion of the market for processed potato products and are starting to act as a substantial constraint on Australian manufacturers. APA also submits that the owner of the SEPS has no incentive to act in a manner that would cause the Safries facility near Penola to reduce its gas use and that the gas tariff would account for only a very small proportion of Safries’ input costs (APA second submission, [3.64]—[3.65]).
- 6.51 The potato processing market in Australia is dominated by McCain Foods Australia (which has manufacturing sites in Australia near Penola (South Australia), Ballarat (Victoria) and Smithton (Tasmania)) and Simplot (Birdseye) with imports increasing. In these circumstances the Council accepts that coverage of the SEPS (which would be relevant only for the McCain plant near Penola) would be likely to have little effect on the competitive environment in the Australian potato processing market.
- 6.52 KCA notes the Australian engineered wood market (giving the example of the Carter Holt Harvey mill at Nangwarry) but makes no express submission on the state of this market with or without access to the SEPS. The Council has no reason to dispute APA’s submission that gas tariffs were not material to the closure of Carter Holt Harvey’s Nangwarry mill and that reduced tariffs would therefore be unlikely to materially influence Carter Holt Harvey (or any other industry participant) to recommence mill operations at Nangwarry.
- 6.53 KCA does not seek to progress these arguments in its response to the Council’s draft recommendation. Neither McCain Foods Australia nor Carter Holt Harvey (identified by KCA as significant users of gas delivered via the SEPS) provided a submission on the Application or the draft recommendation suggesting that coverage of the SEPS may not be a significant factor in promoting competition in either the potato processing or engineered wood products market.

### **Conclusion on criterion (a)**

- 6.54 The Council considers that criterion (a) is not satisfied.

## 7 Criterion (b)

- 7.1 Criterion (b) requires that ‘it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline’.
- 7.2 This coverage criterion is essentially the same as criterion (b) in the declaration criteria in Part IIIA of the CCA. The interpretation of the two provisions is inextricably linked with Court and Tribunal decisions in relation to each being adopted in respect of the other.
- 7.3 In *The Pilbara Infrastructure Pty Limited v Australian Competition Tribunal* [2012] HCA 36 (***Pilbara appeal decision***) the High Court considered how declaration criterion (b) should be interpreted and held that the provision ‘is to be read as requiring the decision maker to be satisfied that there is not anyone for whom it would be profitable to develop another facility’ (at [77]). In doing so the High Court overturned previous interpretations of this criterion, which had focussed on the presence of natural monopoly characteristics.
- 7.4 The wording of declaration criterion (b) and coverage criterion (b) is essentially the same. Furthermore, Part IIIA of the CCA and the NGL share a similar genesis, as do the declaration and coverage processes and criteria contained in each. In the Council’s view there is no basis for distinguishing the interpretation of coverage criterion (b) from that given to declaration criterion (b) by the High Court.
- 7.5 On this basis coverage criterion (b) asks whether anyone could profitably develop another pipeline to provide the pipeline services provided by the SEPS.

## Application and submissions

- 7.6 KCA submits that criterion (b) is satisfied noting that:
- the SEPS is currently only using about half its uncompressed capacity and capacity could be doubled with compression
  - a new pipeline would have a much higher cost structure than SEPS as (although KCA does not know the financial details) PASA would have structured its initial investment to recover its investment within the operational life of the Katnook gas fields and the pipeline asset value has already been depreciated by some 20 years of operation
  - two pipelines sharing the same or moderately increased gas flows would both operate well below optimum capacity
  - the only way another entity could profitably transport gas from Katnook to Millicent is for shippers to underwrite the costs of duplicating the SEPS, which would require shippers to pay more for the alternative transport than the cost of shipping on the SEPS. Epic (APA) can thus prevent a new entrant by pricing transport on the SEPS at marginally less than the alternative, and

- advice it had received it from APA on the viability of building a pipeline to bypass the SEPS to connect either to the SESA or the SEA Gas was that, while this would be possible, the costs would be unlikely to be less than haulage on the SEPS (KCA supplementary information, p 5).

7.7 APA acknowledges that criterion (b) is likely to be satisfied, considering that it would be unlikely to be profitable to develop another pipeline to provide the SEPS service either as a stand-alone pipeline or as part of a larger project. APA's views in summary are as follows.

- The costs of constructing a stand-alone pipeline, even if some optimisation of the size of the pipeline is undertaken, would be substantially higher than the written-down value of the SEPS because: construction costs have increased in real terms since the SEPS was constructed; an optimised (smaller) pipeline would not be materially less expensive to develop (and in any case best practice is develop pipelines no less than 6" in diameter); and easements can be costly to negotiate. With the SEPS operating at 20-30 per cent of capacity and demand at around 1.4—2.9PJ/a, a new entrant would be unlikely to find it profitable to develop a new pipeline unless it was able to charge a much higher tariff, even if all current users of the SEPS switched to a new pipeline.
- Beach is one party who might find it profitable in the future to develop a new pipeline as part of a larger project. Gas produced at Beach's Katnook gas plant has a locational advantage over gas produced in offshore Otway fields which must be transported to the entry point of the SEPS. However for the development of another pipeline to be profitable Beach must be able to produce sufficient volumes of gas and there must be sufficient demand for that gas. APA submits that, given the low level of P2 reserves in the Katnook fields (around 1PJ for the last five years) and low production volumes (between 0.37 and 1.01 PJ/a from 2008—2011 with no gas supplied into SEPS in 2012), the prospect of Beach profitably developing a new pipeline in the short to medium term is low.<sup>15</sup>

## **The Council's assessment**

7.8 No party submits that criterion (b) is not met. The Council notes in particular KCA's submission that it sought advice from APA on the viability of building a pipeline to bypass the SEPS to connect either to the SESA or SEA Gas and was advised that the cost of this would be unlikely to be less than the cost of haulage on the SEPS.

7.9 The Council has itself considered whether anyone might profitably develop another pipeline to compete with the SEPS. While Beach might contemplate building another

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<sup>15</sup> APA submits that it has no information that enables it to comment on the likelihood of any large end-user of gas developing a pipeline as part of a larger project.

pipeline, the Council considers such an outcome to be unlikely, certainly in the short to medium term. Beach would need to discover a viable commercial quantity of gas. While Beach is exploring in the South Australian on-shore Otway Basin and is assessing the potential to restart production from existing fields, it may not know the potential volume of gas resources capable of injection into the SEPS for some time. If its exploratory drilling finds commercial volumes, these would likely not be developed significantly until 2015-16. Further, if Beach did find sufficient volumes it may, in the view of the Council, see greater benefit in duplicating the SESA to connect to the broader transmission network or in engaging with Origin (which holds all capacity on the SESA) to transport gas through a gas swap or similar arrangement.

### **Conclusion on criterion (b)**

7.10 The Council considers that criterion (b) is satisfied.

## **8 Criterion (c)**

8.1 Criterion (c) requires that

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

8.2 The safe use of natural gas transmission pipelines through appropriate operator practice and regulation is well established in Australia. The Council is not aware of any reason why access to the services provided by the SEPS would compromise human health or safety.

8.3 No party submits that criterion (c) is not met in respect of the SEPS.

8.4 KCA notes that there have been no concerns raised about the safe operation of the SEPS over its lifetime. Further, KCA reports that Epic (prior to acquisition by APA) advised that the uncompressed capacity of 25TJ/d is twice the current utilisation and capacity could be safely increased with compression.

### **Conclusion on criterion (c)**

8.5 The Council considers that criterion (c) is satisfied.

## 9 Criterion (d)

9.1 Criterion (d) requires that

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

9.2 ‘Public interest’ is not defined in the NGL. However the term imports consideration of a wide range of matters.

9.3 Criterion (d), being expressed in the negative, does not require the Council to be satisfied that access would be in the public interest, only that access would not be contrary to the public interest (*Re Services Sydney Pty Ltd* [2005] ACompT 7, [192]).

### Application and submissions

9.4 Both KCA (Application, p 21, KCA draft recommendation submission, pp 16-18) and APA (APA second submission, [3.88]) approach criterion (d) as an assessment of whether the benefits of coverage outweigh the costs.<sup>16</sup>

9.5 KCA argues that the concept of the public interest should be construed in a manner consistent with the national gas objective and refers to certain extrinsic material as support for the proposition that ‘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’ (KCA draft recommendation submission, [8.3]).

9.6 KCA raises a number of affirmative public benefits it says would flow from coverage of the SEPS (Application and draft recommendation submission). It submits that the most significant public benefit is the facilitation of competition from Beach constraining Origin’s gas price. It submits that the costs of light regulation of the SEPS are *de minimis* while the benefits are very significant and coverage ‘would clearly fulfil’ the national gas objective (KCA draft recommendation submission, section 8).

9.7 KCA’s submissions also include that ‘[i]n an overall qualitative sense, coverage [of the SEPS] is likely to provide a significant public benefit’, and ‘[a]s there is a strong indication there will be a net benefit to consumers as a result of regulation of the SEPS, there will not be an outcome from coverage that would be contrary to the public interest, thereby satisfying criterion (d).’ (Application, pp 23 and 24.) KCA says that Epic enjoys monopoly rents for transport on the SEPS and that this is ‘unconscionable’ (Application, p 9) or

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<sup>16</sup> Both KCA and APA also refer to the Council guide on the coverage, revocation and classification of pipelines (*Coverage, revocation and classification of pipelines*, May 2012) as indicating that the Council has previously approached criterion (d) on this basis. The Council is in the process of updating its guides to take account of the *Pilbara appeal decision*.

‘inequitable’ (KCA supplementary information, p 4). KCA submits that access will have a number of public benefits including:

- allowing KCA to implement its energy efficiency intentions
- supporting ecological goals
- providing social welfare, access and equity benefits
- protecting regional employment
- lowering gas prices for all gas users served by SEPS
- making gas using manufacturers more competitive
- encouraging greater and more efficient utilisation of an underutilised asset (Application pp 21-22),
- send a signal to the market that ‘excessive pricing will not be tolerated’ (KCA draft recommendation submission, [8.7]).

9.8 APA challenges KCA contentions in regard to these benefits (APA first and second submissions). APA submits that the costs of coverage outweigh the benefits because there are no tangible competition or other public benefits of coverage but significant regulatory costs (APA second submission, [3.99]—[3.102]). APA submits that there will be neither competition benefits nor any other public benefits arising from coverage (APA second submission, [3.99]—[3.101]).

9.9 APA submits that the costs to all parties for coverage of the SEPS over 10 years would be \$2.35 million for full regulation. On the basis that the parties are unable to agree tariffs and therefore the light regulation dispute resolution provisions are triggered, APA estimates the costs for 10 years to be \$970 000. It submits that the costs are particularly significant in light of the small volumes of gas transported on the SEPS: assuming gas throughput on the SEPS remains at around 1.4 PJ/a, 10 cents per GJ and 6 cents per GJ would be added to the cost of gas transport for full and light regulation respectively (APA second submission, [3.96]—[3.97]).

9.10 KCA disputes APA’s estimates of the costs of regulation of the SEPS, arguing that APA has ‘grossly overstated’ these (KCA draft recommendation submission, [1.4], [2.8], [6.3], [7.1] and [7.6])<sup>17</sup> and (at [7.2]) that APA’s regulatory costs are pooled across their portfolio and many of the costs are sunk, thus the ‘incremental impact of the coverage of the SEPS on APA’s regulatory costs is, in practice, likely to be *de minimus*.’ On this basis, KCA estimates the cost of regulation at \$30 000 over 10 years.

<sup>17</sup> Parts of KCA’s submission may be interpreted as implying that the Council considered APA’s estimates to be ‘grossly overstated’ (KCA draft recommendation submission, [1.4], [2.8] and [7.1]). However, in the draft recommendation, the Council stated (at [9.13]) ‘that APA may have overestimated the costs of light regulation of the SEPS’.

## The Council's assessment

- 9.11 The Council's task under criterion (d) is to identify whether there is any matter that might result in access (or increased access) to the pipeline services provided by the SEPS being contrary to the public interest even if the other coverage criteria are met. Criterion (d) is concerned with identifying reasons why a pipeline should not be covered even when the other coverage criteria are satisfied.
- 9.12 At best any affirmative benefits from access might offset public costs that would otherwise be assessed under this criterion. But where another coverage criterion is not satisfied that is the end of the matter—coverage is not available. Under the NGL, positive public interest factors cannot overcome a failure to satisfy one or more coverage criterion to allow coverage of a pipeline. That, for example, access might help preserve employment in a region, result in lower gas transport tariffs or result in lower gas prices for consumers does not allow coverage of a pipeline when the pipeline would not materially promote competition in a dependent market.
- 9.13 For the reasons set out in paras 5.5—5.11 above, the Council does not accept the approach advocated by KCA regarding the influence or effect of the national gas objective on the assessment of criterion (d).
- 9.14 The Council has considered (as is required by the NGL) whether there are any matters, including matters identified in the Application and submissions, that lead to the conclusion that access or increased access would be contrary to the public interest. Accordingly, the Council has considered whether the costs of regulation of the SEPS might be such that, when compared to the benefits of access, access or increased access would be contrary to the public interest. The Council has identified no unusual regulatory or other costs involved in the regulation of the SEPS relevant to this assessment.
- 9.15 As the Council has determined that the SEPS, if covered, will be subject to light regulation (see section 11 below), APA's higher end estimates of the costs of regulation are not applicable. The Council considers that APA may have overestimated the costs of light regulation of the SEPS. While APA's submission that the costs of regulation would substantially increase transport tariffs because of the low volumes of gas transported on SEPS may have some basis, 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, arbitration is unlikely to be necessary beyond the setting of the tariff or the basis upon which the tariff is to be determined. In addition, because the costs of dispute resolution are likely to quickly dissipate any potential gain in the form of a higher tariff for APA or a lower tariff for KCA, the low volumes of gas transported on the SEPS may create an incentive on the parties to avoid dispute resolution.

- 9.16 While considering that APA has likely overstated the costs of regulating the SEPS the Council does not accept the argument by KCA that the costs of light regulation are *de minimis*. KCA's estimate of \$30 000 for the cost of light regulation of the SEPS (in effect the 'marginal cost' to APA of light regulation of the SEPS) ignores that APA will incur ongoing costs as a result of having to maintain regulatory expertise and that a portion of those costs are attributable to the cost of regulating the SEPS, should the Minister determine that the pipeline should be covered.
- 9.17 Overall, the Council accepts that the costs of light regulation will not be inconsequential. In such circumstances (where the Council is not satisfied under criterion (a) that there will be a public benefit resulting from a material promotion of competition and has identified costs from regulation) the Council considers that generally it cannot be satisfied in respect of criterion (d).

### **Conclusion on criterion (d)**

- 9.18 The Council considers that criterion (d) is not satisfied.

## **10 The period of any coverage of the SEPS**

- 10.1 While the Council’s recommendation is that the Minister decide not to cover the SEPS, the Council is giving consideration in its recommendations to an appropriate period of any coverage so that advice is available to the Minister should he decide to cover the pipeline.
- 10.2 Should the Minister decide to cover the SEPS the Council considers that the appropriate period of coverage is 10 years. If the SEPS were covered for this period then coverage would end at about the same time that the contract held by Origin for 100 per cent of the capacity of the SESA will expire. At the end of the Origin contract it might be expected that gas producers located in basins outside the region of the SEPS will have greater incentive to supply gas to users in the area downstream of Katnook via the SESA and the SEPS pipelines.
- 10.3 No party disputes that, were the Minister to make a decision to cover the SEPS, a period of coverage of 10 years is appropriate.

## 11 Form of regulation

11.1 When making a coverage recommendation, the Council must also determine whether to make a light regulation determination that will apply to the pipeline services should the pipeline be covered (NGL, ss 109 and 110). If the relevant Minister decides to cover the pipeline services, then the Council's determination decides the form of regulation that applies to the covered pipeline services.

11.2 Section 122 of the NGL sets out the principles governing the making of light regulation determinations. The section provides:

(1) In deciding whether to make a light regulation determination ... the NCC must consider—

(a) the likely effectiveness of the forms of regulation provided for under this Law and the Rules to regulate the provision of the pipeline services (the subject of the application) to promote access to pipeline services; and

(b) the effect of the forms of regulation provided for under this Law and the Rules on—

(i) the likely costs that may be incurred by an efficient service provider; and

(ii) the likely costs that may be incurred by efficient users and efficient prospective users; and

(iii) the likely costs of end users.

(2) In doing so, the NCC—

(a) must have regard to the national gas objective; and

(b) must have regard to the form of regulation factors; and

(c) may have regard to any other matters it considers relevant.

11.3 In essence, determining whether to make a light regulation determination turns on a comparison of the effectiveness and costs of the two forms of regulation provided for in the NGL. This requires an examination of the effectiveness of light regulation as compared to full regulation in constraining the use of market power and promoting access to pipeline services, and the relative costs of the two approaches. If light regulation is similarly effective as full regulation but involves lower costs, then light regulation is the more appropriate form of regulation.

11.4 The key difference in the forms of regulation is that a covered pipeline that is subject to full regulation must submit a full access arrangement to the AER for approval. An access arrangement provides for up-front price regulation in that it must specify a reference

tariff to be approved by the AER. Service providers of a light regulated pipeline are not required to submit an access arrangement, although they may voluntarily submit a limited access arrangement to the AER for approval.<sup>18</sup> The negotiate/arbitrate model that exists under light regulation substitutes ex-post regulation for ex-ante regulation. It does not remove regulatory oversight of prices.

- 11.5 In the event of an access dispute concerning a light regulation pipeline, the dispute may be dealt with via arbitration following notification of the dispute. In an arbitration the AER can determine access prices and others terms and conditions of access. This process is similar to the negotiate/arbitrate model for services declared under Part IIIA of the CCA. To date, no access disputes concerning a light regulation pipeline have been notified to the AER or the Economic Regulatory Authority (the regulator in Western Australia).<sup>19</sup>
- 11.6 Irrespective of which form of regulation applies, service providers must under the NGL and NGR disclose a range of information concerning a covered pipeline, although the scope of that disclosure is less for a light regulation pipeline than for those subject to full regulation. Many of the other obligations on covered pipelines under the NGL apply to both full and light regulation pipelines.

### **Form of regulation factors**

- 11.7 Section 16 of the NGL sets out the form of regulation factors the Council must have regard to in deciding whether light regulation is the appropriate form of regulation for the SEPS, should it be covered. These factors—(a) to (g)—are set out in the first column of Table 11.1. More generally, Table 11.1 summarises the Council’s views on how each form of regulation factor might, in principle, affect its determination of a light regulation application.

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<sup>18</sup> The requirements for a limited access arrangement are set out in r 45 of the NGR.

<sup>19</sup> Three pipelines regulated by the AER are subject to light regulation. One pipeline in Western Australia, regulated by the Economic Regulatory Authority, is subject to light regulation.

**Table 11.1: The form of regulation factors and circumstances surrounding their application**

| Form of regulation factor (s 16)   | Circumstances conducive to light regulation  | Circumstances where light regulation less likely   |
|--|--|--|
| (a) the presence and extent of any barriers to entry in a market for pipeline services   | Barriers to entry present but are relatively low   | Barriers to entry relatively high  |
| (b) presence and extent of any network externalities (that is, interdependencies) between a natural gas service provided by a service provider and any other natural gas service provided by the service provider          | Stand alone pipeline activity, where a service provider has no other pipeline operations<br><br>Rights to pipeline capacity readily tradeable<br><br>Transmission services and other end to end services generally involve less interdependence with other pipelines   | Greater interdependence, where a service provider has other pipeline interests in the same regions as a pipeline for which light regulation is sought<br><br>Rights to pipeline capacity not readily traded<br><br>Distribution services (especially established ones) are likely to be more interdependent with other pipeline services |
| (c) presence and extent of any network externalities (that is, interdependencies) between a natural gas services provided by a service provider and any other service provided by the service provider in any other market | Service provider has no involvement in upstream or downstream markets (at least in areas served by a pipeline for which light regulation is sought)<br><br>Ring fencing and other regulatory requirements effectively prevent a service provider from taking advantage of market power in upstream or downstream markets | Service provider has upstream or downstream involvements in gas or other energy businesses<br><br>Upstream or downstream involvements are in related but not ring fenced activities, or ring fencing of pipeline operations is ineffective   |

| Form of regulation factor (s 16)  | Circumstances conducive to light regulation  | Circumstances where light regulation less likely  |
|---|--|---|
| (d) the extent to which any market power possessed by a service provider is, or is likely to be, mitigated by any countervailing market power possessed by a user or prospective user (countervailing market power) | <p>Large or concentrated users</p> <p>Users with by-pass opportunities</p> <p>High interdependence between users and service provider</p> <p>Users involved in pipeline services elsewhere (such users may face lesser information asymmetry given their direct knowledge and experience of pipeline operations)</p>   | <p>Many small users</p> <p>Users have limited resources</p> <p>Diverse user interests (for example where users span different industries or economic sectors)</p> <p>Significant users have the capacity to pass through higher pipeline service costs (these users may have less incentives to expend resources to resist increases in pipeline costs)</p> <p>Poorly represented users</p> |
| (e) the presence and extent of any substitute, and the elasticity of demand, in a market for a pipeline service in which a service provider provides that service   | <p>Greater substitution possibilities exist</p> <p>Relatively high elasticity of demand suggesting bypass or other substitution opportunities exist</p> <p>Transmission pipelines (demand is generally more elastic than for distribution services)</p> <p>Availability of large (independent) storage capacity</p> <p>Ability to defer gas production/expansion for significant periods</p> | <p>Fewer substitution options</p> <p>Low elasticity</p> <p>Distribution pipelines (especially established distribution pipelines with a high market penetration)</p>  |
| (f) the presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be)  | <p>Fuel choice available to significant proportion of users</p> <p>Narrower relative prices per unit energy produced from different fuel sources</p> <p>Use of multi fuel plant</p>  | <p>Wider relative prices between fuel types</p> <p>Gas dependent users</p> <p>Other energy sources have efficiency disadvantage</p> <p>Dedicated gas plant</p>  |

| <b>Form of regulation factor (s 16)</b>   | <b>Circumstances conducive to light regulation</b>   | <b>Circumstances where light regulation less likely</b>  |
|---|--|--|
| <p>(g) the extent to which there is information available to a prospective user or user, and whether that information is adequate, to enable the prospective user or user to negotiate on an informed basis with a service provider for the provision of a pipeline service to them by the service provider</p> | <p>Previous regulated pipelines (a significant base of publicly available and regulator tested information will be available for use on negotiations)</p> <p>Historic pipeline costs available and previously exposed to public/industry scrutiny</p> <p>NGL information disclosure requirements operative</p> | <p>Previously unregulated pipelines</p> <p>NGL information requirements impeded (for example through use of related party contracting which prevents effective scrutiny of underlying costs)</p> |

## Effectiveness of regulation alternatives

11.8 KCA initially sought full regulation of the SEPS. Its views on each of the form of regulation factors were as follows:

a) Due to SEPS having such large amounts of spare capacity, it is not economically efficient to build duplicate assets. This is a major barrier to entry for any new entrant

b) SEPS effectively only provides one service – that of gas transportation to three major usage points (Safries, KCA and Mount Gambier)

c) Epic does not provide any other energy service in the region

d) Any user of gas in the region must use SEPS unless they are sufficiently physically close to SESA or SEAGas pipelines that bypass is feasible. This means that Epic has a monopoly of gas transportation over much of the lower south east region of SA and all gas users have to use the services offered by Epic. That Epic has consistently sought a large increase from the foundation tariff for future gas transport and that KCA has resorted to seeking coverage, attests to consumers having little countervailing market power to combat the market power held by Epic

e) ...there is demonstrably no substitute for the service provided by SEPS. Equally there is no elasticity of demand for the service required.

f) As there is no commercial alternative form of thermal energy in the region there is no substitute nor does varying demand for gas influence on the cost of the service provided by Epic.

g) There is sufficient information publicly available which provides evidence that Epic is seeking a monopoly rent. However much of the data needed to assess the extent of this rent is not available because it requires a regulatory assessment to be made of all the circumstances surrounding SEPS and the historical recoveries made under the 20 year foundation contract between Origin/Sagasco and Epic/PASA, in order to develop a sound basis on which to establish the principles that should apply to a reasonable and equitable tariff for use of SEPS. A regulator would have access to this information, which supports the view that full regulation of SEPS is required, at least for the initial setting of tariffs. (Application, pp 25-26)

11.9 KCA now accepts that light regulation is appropriate (KCA draft recommendation submission, pp 3, 4, 13 and 14).

11.10 Should SEPS be covered, APA considers that light regulation would be as effective in promoting access as full regulation with lower costs being imposed on the owner and users of the SEPS and is also more likely to promote the national gas objective than full regulation (APA second submission 4.2). APA submits that light regulation would be no less effective than full regulation because:

- any purported market power of APA as the owner of the SEPS will be offset by its commercial imperative to address the largely fixed costs (~90 per cent) in operating the pipeline by increasing the pipeline's utilisation beyond its current level of 20-30 per cent and any market power of APA will be further offset by the countervailing power of Origin Energy
- existing and prospective users would have sufficient information, incentives and ability to negotiate effectively with the owner of the SEPS, and
- dispute resolution under light regulation will impose a further discipline on the owner of the SEPS and provide users with an appropriate level of protection if negotiations break down (APA second submission, 4.3).

11.11 Drawing on the Council's findings and conclusions concerning the promotion of competition in respect of coverage criterion (a), the Council considers that any market power available to the owner of the SEPS is likely to be tempered by the current underutilisation of SEPS and the largely fixed nature of its operating costs. The Council considers that it is reasonable to assume that a rational service provider will have commercial imperatives to increase throughput on the SEPS.

11.12 The prospect of alternative fuel sources being available may also act as a constraint on any market power of the service provider. For example, KCA states in its application that at a time when gas was in limited supply it was able to replace the natural gas it sourced at Katnook to use in its mill at Millicent with liquefied petroleum gas (Application, p 6). While KCA states the costs are 'excessive' the availability of substitutes is a relevant consideration in terms of form of regulation factors (d)-(f) and demonstrates that substitution possibilities do exist as the KCA Millicent mill is not entirely dependent on natural gas for its operations. The availability of substitutes may also serve to mitigate the potential market power of a service provider.

11.13 Form of regulation factor (g) examines the extent to which there is information available to a user or prospective user and the appropriateness of that information to enable informed negotiations between a user/prospective user and the service provider. While full regulation would require greater disclosure by the service provider, the Council considers that information imbalances are likely to be more or less the same irrespective of the form of regulation. The statements by Origin that an access arrangement will not necessarily provide tariffs for all of the services sought by KCA and that additional services would continue to be negotiated services separate to an access arrangement (Origin submission, p 3) are informative in this regard.

11.14 The Council considers that the light regulation regime will be as effective as full regulation in protecting users and other parties dependent on access to the SEPS. This is due to the disclosure requirements of the service provider for the SEPS under light regulation and the availability of dispute resolution via arbitration by the AER. The Council considers that the AER is in no less a position to determine an appropriate outcome via arbitration than it would be if the SEPS were subject to full regulation.

Indeed, the Council considers that should arbitration be necessary, the access outcomes may even be enhanced on what could be available to users via an access arrangement because the arbitration determination may address bespoke arrangements in response to particular access issues. Neither the pipeline owner nor KCA as a significant user disputes this assessment.

## **Costs of form of regulation alternatives**

11.15 APA claims substantial cost savings are associated with light regulation. KCA estimates that in a light regulation scenario where a single arbitration of the terms and conditions of access occurs, the costs of light regulation for the owner and users of the pipeline would be 40 per cent lower than if full regulation applies (\$86 000 per annum as compared to \$140 000 per annum). In the event of no disputes giving rise to an arbitration, these costs savings could grow to as much as 90 per cent (APA second submission, 4.3 and Table 3.2). These figures and purported savings derive from APA's claim that an initial access arrangement would cost \$500 000 to prepare, with subsequent access arrangements costing in the vicinity of \$400 000, which the Council considers may be overstated. APA also claims it would have sizeable ongoing compliance costs which are either reduced substantially or eliminated in the light regulation scenario.

11.16 In this regard, APA submits that a single arbitration would cost it approximately \$500 000 and cost the access seeker \$200 000 (APA second submission, Table 3.2). KCA disputes APA's estimates of the cost of arbitration but adds that arbitration may be unnecessary because it expects that both parties will act reasonably to avoid incurring costs and APA will offer prices that are consistent with its expectation of the outcome of an arbitration. KCA's estimate of the cost of light regulation of the SEPS for 10 years is \$30 000 (KCA draft recommendation submission, pp 15-16). This estimate does not include any costs of arbitration. As noted above, the Council considers this to be an underestimate of the cost of light regulation given that it excludes attribution to the cost of regulating the SEPS of any portion of the ongoing cost to APA of maintaining a regulatory capacity.

11.17 The Council accepts there is potential for cost savings under light regulation to be eroded by lengthy or numerous arbitrations of access disputes. However, the Council anticipates the number of access disputes to be low (notwithstanding that there may be a number of matters in contention in any one dispute). Where there are few disputes, light regulation is likely to be less costly for APA than would full regulation, although the savings may not be of the magnitude APA claims. Some reductions for other parties, such as the AER, users and consumers may also be achieved, although they are likely to be small.

## **National gas objective**

11.18 In making a light regulation determination, the Council must have regard to the national gas objective in s 23 of the NGL, which provides:

The objective of this law [the NGL] is to promote the efficient investment in, and efficient operation and use of, natural gas for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

11.19 In the Council's view, where light regulation is similarly effective to full regulation but involves lower cost, it is the more suitable form of regulation and a light regulation determination is consistent with the national gas objective. The Council accepts that light regulation for the SEPS will involve lower costs than full regulation. Further, the Council considers it unlikely that light regulation would disadvantage pipeline users, given the availability of recourse to binding arbitration and the powers of and scope of considerations that the AER may address in an arbitration.

### **Other matters**

11.20 The Council does not consider that there are any other matters arising from submissions received or otherwise, that are not encompassed within its consideration above and as required under s 122(2)(c) of the NGL.

### **Conclusion on the form of regulation**

11.21 Having considered the form of regulation factors, the costs of regulation and the national gas objective and having regard to the current utilisation of and arrangements concerning the SEPS, the Council considers that light regulation is likely to have similar effect as full regulation and will be a lower cost means of regulation.

11.22 Under light regulation users and prospective users may notify an access dispute and in such an instance the AER is no less able to address issues in dispute and any other matters concerning access than it would be in the case of full regulation.

11.23 Therefore, if the Minister decides to cover the SEPS, the Council concludes that it should make a light regulation determination for the SEPS.

## 12 Information taken into account by the Council

**Table 12.1 Application and submissions**

| Author   | Date            | Title   | Confidential                   |
|--|-----------------|---|--------------------------------|
| APA  | 16 January 2013 | <i>Response to SEPS coverage application: Background material provided to the NCC (APA first submission)</i>  | No                             |
|  | 29 January 2013 | <i>Response to SEPS coverage application (APA second submission)</i>  | Yes, redacted version provided |
|  | 20 March 2013   | <i>Letter to Council, Coverage Application—South Eastern Pipeline System (SEPS) (APA draft recommendation response)</i>   | Yes, redacted version provided |
| Beach Energy   | 29 January 2013 | <i>Letter to Council, Re: Application for Coverage of South West Pipeline System (Beach submission)</i>   | No                             |
|  | 2 April 2013    | <i>Letter to Council (Beach letter)</i>   | No                             |
| ECCSA (Energy Consumers' Coalition of South Australia) | 12 March 2013   | <i>Letter to Council, KCA Application for Coverage of the South Eastern Pipeline System (SEPS) (ECCSA submission)</i>   | No                             |
| Kimberly-Clark Australia Pty Ltd                       | October 2012    | <i>Application for coverage of a pipeline, received by the Council 28 November 2012 (Application)</i>   | Yes, redacted version provided |
|  | 7 January 2013  | <i>Letter to Council responding to Council request for further information, Application for Coverage of the South Eastern Pipeline System (KCA supplementary information)</i>   | No                             |
|  | 29 January 2013 | <i>Letter to Council, Application for Coverage of the South Eastern Pipeline System (KCA letter)</i>  | Yes, redacted version provided |
|  | 14 March 2013   | <i>Response to draft recommendation regarding coverage of the South Eastern Pipeline System to National Competition Council by Kimberly Clark Australia (including cover letter dated 13 March 2013) (KCA draft recommendation submission).</i> | Yes, redacted version provided |
|  | 22 March 2013   | <i>Letter to Council, Coverage Application—South Eastern Pipeline System (SEPS) (KCA response to APA)</i>   | No                             |
| Origin   | 29 January      | <i>Letter to National Competition Council,</i>  | No                             |

|                     |               |  |    |
|---------------------|---------------|--|----|
|                     | 2013          | <i>Application for coverage of the South Eastern Pipeline System (Origin submission)</i>               |    |
| Uniting Communities | 13 March 2013 | Letter to Council, <i>Re: KCA Application for Coverage of the South Eastern Pipeline System (SEPS)</i> | No |

**Table 12.2 References**<sup>20</sup>

| Author                                       | Date  | Title  | Confidential |
|--|-------|--|--------------|
| Adelaide Energy (Adelaide Energy Limited)    | 2010  | <i>Petroleum Production Licence No. 62, 168 &amp; 202 (Katnook &amp; Ladbroke Grove Complex) 2009 Annual Report</i>  | No           |
|  | 2011  | <i>2010 Annual Report, Production Operations, Katnook &amp; Ladbroke Grove Complex</i>   | No           |
|  | 2012  | <i>2011 Annual Report, Production Operations, Katnook &amp; Ladbroke Grove Complex, Petroleum Production Licences PPL62, PPL168 &amp; PPL202</i>   | No           |
| AER (Australian Energy Regulator)            | 2012  | <i>State of the Energy Market 2012</i>   | No           |
| Beach (Beach Energy)                         | 2013  | <i>2012 Annual Report, Production Operations, Katnook &amp; Ladbroke Grove Complex, Petroleum Production Licences PPL 62, PPL 168 &amp; PPL 202</i>  | No           |
| Core Energy Group                            | 2012  | <i>Eastern &amp; Southern Australia: Existing Gas Reserves &amp; Resources, April 2012</i>   | No           |
| Euromonitor                                  | 2012  | <i>Tissue and Hygiene in Australia, April 2012 (summary only—obtained at <a href="http://www.euromonitor.com/tissue-and-hygiene-in-australia/report">www.euromonitor.com/tissue-and-hygiene-in-australia/report</a> on 5 February 2013)</i>  | No           |
| NERA (NERA Economic Consulting)              | 2008  | <i>The Gas Supply Chain in Eastern Australia, A report to the Australian Energy Market Commission, March 2008</i>  | No           |
| PPISG (Pulp & Paper Industry Strategy Group) | 2010  | <i>Final Report, March 2010</i>  | No           |
| RISI   | 2008a | <i>Producers great and small—taking a close look at the Australian tissue business (<a href="https://www.risiinfo.com/magazines/March/2008/PPI/Producers-great-and-small-taking-a-close-look-at-the-Australian-tissue-business.html">https://www.risiinfo.com/magazines/March/2008/PPI/Producers-great-and-small-taking-a-close-look-at-the-Australian-tissue-business.html</a>)</i> | No           |

<sup>20</sup> Table 12.2 lists, for the purposes of s 261(7)(e) of the NGL, the reports and materials relied on by the Council in making its recommendation.

| Author                 | Date  | Title   | Confidential |
|------------------------|-------|---|--------------|
|                        | 2008b | <i>Taking on the giants—ABC Tissue successfully challenged the global players in Australia</i><br>( <a href="https://www.risiinfo.com/magazines/pulpandpaper/magazine/international/April/2008/Taking-on-the-giants-ABC-Tissue-challenged-global-players-in-Australia.html">https://www.risiinfo.com/magazines/pulpandpaper/magazine/international/April/2008/Taking-on-the-giants-ABC-Tissue-challenged-global-players-in-Australia.html</a> ) | No           |
| Origin (Origin Energy) | 2008  | <i>Petroleum Production Licence No. 62, 168 &amp; 202 (Katnook &amp; Ladbroke Grove Complex) Development Plan and 2007 Operational Review</i>   | No           |
|                        | 2009  | <i>Petroleum Production Licence No. 62, 168 &amp; 202 (Katnook &amp; Ladbroke Grove Complex) Development Plan and 2008 Operational Review</i>   | No           |

**Table 12.3 Legal sources**

|   |
|---|
| <b>Tribunal and court decisions</b>   |
| <i>In the matter of Fortescue Metals Group Limited</i> [2010] ACompT 2; (2010) 242 FLR 136  |
| <i>Minister for Urban Affairs and Planning v Rosemount Estates Pty Ltd</i> [1996] NSWSC 348; (1996) 91 LGERA 31                   |
| <i>Re Services Sydney Pty Ltd</i> [2005] ACompT 7; (2005) 227 ALR 140   |
| <i>Rural Press Ltd v ACCC</i> [2003] HCA 75 ; (2003) 216 CLR 53   |
| <i>S v Australian Crime Commission</i> [2005] FCA 1310  |
| <i>The Pilbara Infrastructure Pty Limited v Australian Competition Tribunal</i> [2012] HCA 36<br><b>(Pilbara appeal decision)</b> |
| <b>Legislation</b>  |
| <i>Competition and Consumer Act 2010</i> (Cth) ( <b>CCA</b> )   |
| <i>National Gas Rules 2009</i> ( <b>NGR</b> )   |
| <i>National Gas (South Australia) Act 2008</i> (SA) ( <b>NGL</b> )  |
| <b>Secondary sources</b>  |
| Pearce, D. C. and Geddes, R. S. 2011, <i>Statutory Interpretation in Australia</i> (7 <sup>th</sup> ed)                           |

## Appendix A Map of the SEPS



Source: APA second submission (referring to Epic Energy, Pipeline Licence No. 3 and 4 Annual Report, 2011)

## Appendix B Location of the SEPS, the SESA and the SEA Gas



Source: APA second submission (referring to South East Australia Gas Pty Ltd *Annual Report (PL 13), 2004-2005*)