

Application for Coverage of a Pipeline

To

National Competition Council

By

Kimberly Clark Australia

October 2012

Table of Contents

	Page
1. The Applicant	3
2. The pipeline for which coverage is sought	3
3. Pipeline classification and competition	6
4. Earlier revocation of coverage of SEPS	7
5. The reasons for KCA seeking re-coverage	9
6. Assessment against the criteria for coverage	10
7. Proposed application of coverage	24
8. Conclusions	31
Appendix 1 The reasons for KCA seeking coverage	32

1. The Applicant

This application is made by Kimberly Clark Australia P/L (KCA) under section 92 of the National Gas Law.

KCA is a registered corporation with an ACN 000 032 333

The registered offices of KCA are located at:

52 Alfred St, Milsons Point, 2061

Contact in relation to this application is to be made to:

Name	Mr Darren Williams, Operations Support Manager
Address	Kimberly-Clark Millicent Mill, Princes Hwy, via Millicent
Phone	(08) 8721 4555
Fax	(08) 8721 2251
Mob	0419 204 240
Email	darren.j.williams@kcc.com

2. The pipeline for which coverage is sought

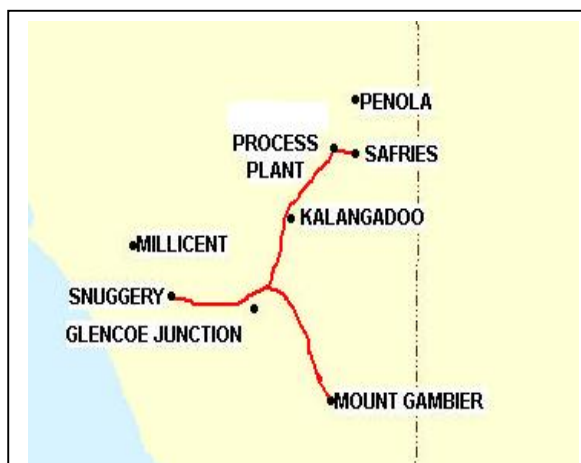
KCA seeks coverage of the South Eastern Pipeline System (SEPS) located in the lower south east of South Australia and which transports gas from the Katnook Processing Plant along one pipeline to Safries (Pipeline Licence 3 or PL3), and along another pipeline system from Katnook to Glencoe, Mt Gambier, Kalangadoo, and Snuggery (PL4).

KCA is not privy to the actual maximum daily quantity (MDQ) of gas transported on the pipeline system, but understands that the amount of gas transported annually is of the order of 3 PJ, and daily peak usage is of the order of 12-13 TJ. KCA understands that the total gas carrying capacity of the pipeline system is larger than these quantities, and Epic Energy (owner of SEPS) advises that the capacity of SEPS is as high as 25 TJ/d uncompressed and double that when fully compressed¹.

The following figure shows the approximate location and routes of SEPS.

¹ See <http://www.asx.com.au/asxpdf/20041115/pdf/3np7w3ktkdfp7.pdf>

**South Eastern Pipeline System
Application for Coverage**



The following table provides specific details of licences, pipeline route lengths, and diameters of the different elements of SEPS.

Pipeline Licence	Location/ Route	Operator	Length (km)	Pipe Diameter (mm)
	South East Pipeline System	Epic Energy Pty Ltd		
SA: PL 3	Katnook to Safries		4.5	60.3
SA: PL 4	Katnook to Glencoe		26.7	168
	Glencoe to Mt Gambier		18.9	168
	Glencoe to Snuggery		19.4	168

Whilst SEPS was initially built to transport gas from the Katnook gas processing plant to gas users, it is now connected to the SESA pipeline owned by APA Group which connects SEPS to the SEAGas pipeline. The SEAGas pipeline transports gas from Port Campbell in Victoria to Adelaide.

The history of SEPS is as follows:

- In 1990, SEPS was constructed by the SA government owned Pipeline Authority of South Australia (PASA) at the request of Sagasco, a 50% SA government owned gas Company. Sagasco was the developer of the Katnook gas field and had identified that there was a market for the gas in the Mount Gambier region. To make the Katnook gas development commercially viable, Sagasco recognised that it needed KCA as a foundation customer for the Katnook gas. KCA has consistently been using, until plant closures last year, 70-80% of the gas transported on SEPS since 1991.
- In its agreement with PASA, Sagasco contracted with it (the foundation contract) to hold all the gas transport capacity of SEPS for a 20 year period, comprising a higher tariff for the period of 15 years between 1991 and 2005,

and a lower tariff for the period of 5 years between 2006 and 2010 (the foundation tariffs)².

- In 1992, Sagasco was acquired by Boral Ltd, which in turn transferred its energy assets to Origin Energy (Origin) which Boral created in 2000. Both Boral and Origin honoured and continued the foundation contract Sagasco established with PASA
- In 1995, PASA was sold to Tenneco and then on to Epic Energy (Epic), which continued to honour and continue the foundation contract established between Sagasco and PASA
- In 1997, when the Gas Code was promulgated, SEPS was included in the register (schedule A) as a covered transmission pipeline
- In 1999, Epic sought revocation of coverage noting in its application (amongst other things) that its average tariff for gas transport was \$0.44/GJ of maximum daily quantity (MDQ),
- In 2000, the National Competition Council (NCC) recommended revocation of coverage of the SEPS and this was approved by the SA Minister for Energy later that year.
- In 2004, the Katnook gas field started indicating it was close to being exhausted and alternative arrangements were implemented to supply KCA's thermal energy needs.
- In 2005, SEPS was connected to the SESA gas pipeline which transports gas from the SEAGas pipeline to SEPS and KCA was again supplied with natural gas. The SESA gas pipeline was built by Origin and later sold to APA Group with all the transport capacity of the pipeline sold to Origin under a long term contract
- In mid 2008, Origin sold Katnook and Ladbroke Grove gas fields and processing plants to Adelaide Energy
- In 2010
 - Adelaide Energy forecast it would have gas flows into Katnook from its Jacaranda Ridge 2 gas field
 - Epic advised KCA that once its gas transport contract with Origin expired in early 2011, it would allow open access on SEPS at a postage stamp tariff of [REDACTED]
 - KCA requested that Origin seek to roll over the existing contract at the then current rates and KCA observed that Epic appeared to reject this
 - Based on information provided by Epic, KCA assumes that Origin reached agreement with Epic to a new tariff for a limited duration, [REDACTED]
- In early 2011, KCA announced that it intended closing parts of its Millicent Mill operations. The closures affected two of the four tissue machines, the pulping

² KCA considers the higher tariff recognises that the capital investment for SEPS was recovered over the minimum expected life of Katnook gas field and the subsequent lower tariff reflected the capital had been recovered

³ Epic advised that this rate was developed on the basis that the economic life of SEPS was over 60 years and that only 20 years of depreciation had occurred to this time

plant and the wood yard operations. These closures reduced gas consumption at the mill complex to [REDACTED] of its 2010 gas consumption.

- In late 2011, Adelaide Energy was acquired by Beach Energy which is continuing investigating the onshore Otway Basin of which Ladbroke Grove, Katnook and Jacaranda Ridge are part
- In early 2012, KCA announced that it intended to build its own gas to electricity co-generation plant at the Millicent Mill – this decision, when fully implemented would increase gas consumption at the site to about [REDACTED] of its 2010 gas consumption

Because of the significant interdependence of KCA (as the foundation customer), Sagasco (as the gas field developer and retailer) and PASA (as the pipeline provider), KCA was made aware of many of the unique features of the arrangements underpinning the development and implementation of the Katnook gas field and the pipeline arrangements supporting it. This allows KCA, from first hand knowledge to make certain observations regarding the arrangements impacting the SEPS.

KCA notes that although it had information provided to it at the time of the foundation arrangements being developed, KCA advises that it had some difficulty in identifying some details of the transport arrangements as the transport contracts between Origin and Epic are confidential and although it has inferred some information, KCA has no actual knowledge of these contract details. KCA suggests that the NCC seek first hand information of the foundation and other contracts for transport on SEPS from Origin and/or Epic to access important details which KCA has not been able to provide in this application.

3. Pipeline classification and competition to SEPS

In the Gas Code Schedule A, SEPS is listed as a transmission pipeline. KCA understands that there has been no attempt to change this classification since the introduction of the new National Gas Rules (which replaces the Code) and this application does not seek to change that classification.

There is no other pipeline that provides the services that SEPS provides and it therefore provides a monopoly service. This aspect is further developed in section 6.3 below.

For a period, during 2004 and 2005, there was insufficient gas available from Katnook to supply all the contracted gas supplies in the Mount Gambier region, including the gas needed by KCA. During this time, it was identified that the lowest cost option for meeting these needs was to replace natural gas from Katnook with liquefied petroleum gas (LPG) at the KCA Millicent site. This was implemented but the cost for this was excessive, and as a result Origin constructed a connection (SESA) between SEAGas pipeline and SEPS in order to limit its cost exposure. This indicates that there is no credible alternative to supplying gas via SEPS

The experience of 2004 and 2005 demonstrates that there is no credible commercial alternative to using natural gas as a source of thermal energy to meet the needs of

the lower south east of South Australia, supporting the view that SEPS provides a monopoly service.

4. Earlier revocation of coverage of SEPS

As noted in the history of SEPS above, Epic sought, and the NCC recommended, revocation of coverage.

Revocation was addressed by the NCC under four criteria:

- a. that access (or increased access) to services provided by means of the pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the services provided by means of the pipeline;
- b. that it would be uneconomic for anyone to develop another pipeline to provide the services provided by means of the pipeline;
- c. that access (or increased access) to the services provided by means of the pipeline can be provided without undue risk to human health or safety; and
- d. that access (or increased access) to the services provided by means of the pipeline would not be contrary to the public interest.

In its recommendation, the NCC recommended revocation because coverage did not pass criteria (a) and (d).

The NCC considered that under criterion (a)

- As Boral had advised there was “...little real prospect of competition from new producers ...” the NCC concluded there was unlikely to be any “...commercially developable gas discoveries in the region apart from those at and around Katnook...” eliminating the potential for increased upstream competition.
- As all of the pipeline capacity was contracted to Boral there was little opportunity for Epic to extract higher transport tariffs from Boral and therefore coverage was unlikely to “...promote cheaper tariffs”. The NCC then added that it could therefore assume that the foundation tariffs did not include a monopoly element.

On these and other bases, the NCC considered that coverage would not improve competition.

The SA Minister for Energy supported these NCC views when he observed in his decision that:

“... given that the pipeline system is in a relatively isolated location and there are presently no commercially developable gas discoveries in the region (apart from those...currently under production) and therefore it is unlikely that third parties will seek to interconnect their pipelines with it in the foreseeable future, I am not satisfied that access to the [SEPS] would promote competition in another market.”

The NCC considered that under criterion (d) as all of the capacity of SEPS had been contracted to Origin at agreed rates, the costs incurred by developing regulated tariffs for third party access would exceed any cost benefit and therefore coverage would achieve no net public benefit.

However, it is clear from its comments in its recommendation, the NCC considered that there may be a need for a review of the revocation at a later stage, as the NCC noted its assessment was based on "...short to medium term..." expectations.

Revocation was formally approved by the SA Minister for Energy.

It is pertinent to observe that the NCC recommendation for revocation was predicated on a number of assumptions about the future that have changed significantly with the passing of time, or are now incorrect. In particular:

- The NCC considered that the existence of a long term contract between Boral and Epic provided no ability for another party to utilise the pipeline capacity. Based on comments from Epic, KCA believes that the contract between Boral (Origin) and Epic has now expired and Epic has implemented new conditions for the use of its pipeline with new users being able to access the pipeline capacity.
- The NCC did not expect there to be any other source of gas than that from the Boral (Origin) owned Katnook gas plant, implying an assumption of a synergistic arrangement between Boral and Epic. The premature exhaustion of Katnook gas fields means this assumption is no longer valid.
- The NCC considered that there would be no new gas discoveries made in the region but the recent work by Adelaide Energy (now Beach Energy) indicates this assumption is no longer valid.
- New gas supplies from SEAGas pipeline can now be injected into SEPS and this allows a gas other than from Katnook to be injected into SEPS

In both the NCC recommendation and the Minister's decision there was a clear view stated that the decision to revoke coverage was made on the basis that should there be significant change in the medium to long term, reapplying coverage was an option in regard to SEPS.

In his decision the Minister observed

"I note, however, that in the event of a third party does seek access to the Pipeline in the future, it would be possible for that party to seek re-Coverage of that pipeline under the mechanisms provided in the Code"

KCA considers that several of the key assumptions that both the NCC and the Minister relied on to reach their position, have now changed so dramatically re-coverage is now a sensible option.

5. The reasons for KCA seeking re-coverage

Epic has advised that with the expiry of the contract between it and Origin, Epic will allow others to seek access to SEPS but on a different basis to that applying under the foundation contract. This new basis includes that Epic will not contract the entire capacity to Origin, allowing others to use capacity not used by other shippers. In principle KCA does not object to this.

What KCA finds unconscionable is that in allowing this increased access to SEPS, Epic is using its monopoly position to set shipping rates for use of the capacity of SEPS at levels which clearly include a significant monopoly rent. Specifically Epic initially sought a [REDACTED] increase in the rates for shipping on SEPS than applied for the last five years of the foundation contract, although recent negotiations have resulted in a tariff less than that initially sought, but considerably higher than those applying in the last five years of the foundation contract.

Origin has subsequently entered into a [REDACTED] contract with Epic for haulage of gas on SEPS acting as an intermediary (retailer) between KCA and Epic. KCA is of the view that the tariffs used by Origin include a significant element of monopoly rent. Although KCA is not privy to the exact detail of the contract between Origin and Epic, Epic has offered haulage on SEPS to KCA [REDACTED] which KCA considers is a rate considerably higher than the haulage rate that applied in the last five years of the foundation contract between Origin and Epic.

The bases KCA has used for assessing that Epic is seeking a monopoly rent are provided in appendix 1.

KCA has commenced implementation of its own gas fired generation facility at the Millicent mill. Historically, KCA required gas delivery at 850 kPa and gas was provided at the Epic metering point at a pressure significantly higher than this (probably in excess of 4000 kPa). Epic reduced the pressure for delivery to KCA at its metering point into gas piping owned by Envestra for delivery into the KCA mill.

As a result of the need for gas at higher pressure to serve the generation plant KCA requested of EPIC two changed aspects for gas delivery:

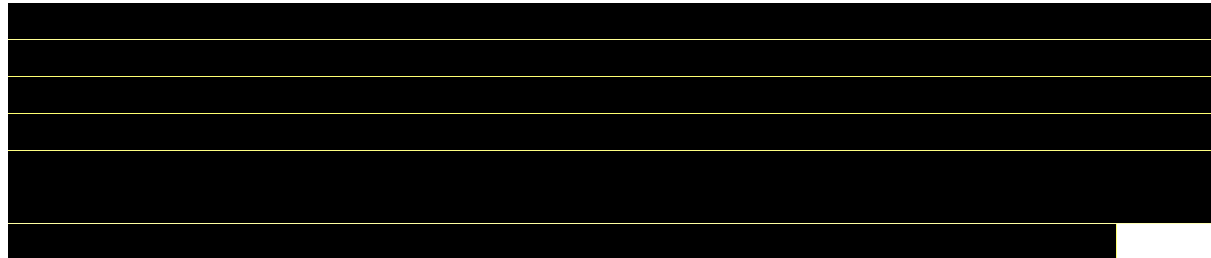
- A higher delivery pressure (notionally at about 3500 kPa); and
- A new high pressure metered connection to SEPS

In the negotiations with Epic, KCA was advised that there would be a premium charge for delivery at the higher pressure⁴, [REDACTED]

[REDACTED] These costs (the base

⁴ Epic advises that this premium is to provide a guarantee that the higher pressure will always be available. Apparently guaranteeing a higher delivery pressure has the potential to reduce the carrying capacity of the pipeline and therefore reduce the ability for Epic to sell this capacity to another shipper. That there is already considerable spare capacity in the SEPS or that there is unlikely to be another shipper to increase haulage to this level is immaterial to Epic.

haulage charge, the high pressure premiums and the costs of the new connection) were so excessive that KCA has concluded that it is more commercially viable to receive the gas using the existing low pressure delivery arrangements and to purchase and operate gas compressors to recompress the low pressure gas to the levels required by the generation plant.



KCA has had considerable dialogue with Epic regarding the level of the monopoly rents it seeks to impose on the use of its pipeline and despite this Epic has maintained its view as to what it will charge for use of the pipeline regardless of the issues that KCA has raised in regard to costs for haulage, timing of connection works and the contractual commitments KCA had to agree to prior to any work commencing. This was possible because there was no credible alternative to using the SEPS for gas haulage to the Millicent Mill.

Because Epic provides a monopoly service in the transportation of gas from Katnook to all gas users in the region, KCA considers that coverage of the pipeline is the only feasible way for the establishment of shipping rates and the cost of new connections that do not contain monopoly rents.

6. Assessment against the criteria for coverage

The NCC is required to assess an application for coverage against a number of criteria. These are:

- The National Gas Objective
- Criteria (a), (b), (c) and (d) detailed in section 15 of the Schedule to the National Gas Law

Subsequent to Australian Competition Tribunal decisions, to determine that coverage should apply, the NCC must determine that criteria (a), (b) and (c) must all be supportive of coverage and that criterion (d) must not be determined in the negative.

KCA considers that assessments under the Objective and under criteria (a), (b) and (c) are all supportive of coverage being applied and the assessment criterion (d) does not prevent coverage being applied.

KCA provides a detailed assessment of each in the following sections.

6.1 The National Gas Objective

The National Gas Objective (NGO), which is the starting point for all assessments made under the National Gas Law, states:

“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.”

In the second reading speech the Minister (Conlon) observed⁵:

“The national gas objective is an economic concept and should be interpreted as such.

The long term interest of consumers of gas requires the economic welfare of consumers, over the long term, to be maximised. If gas markets and access to pipeline services are efficient in an economic sense, the long term economic interests of consumers in respect of price, quality, reliability, safety and security of natural gas services will be maximised. By the promotion of an economic efficiency objective in access to pipeline services, competition will be promoted in upstream and downstream markets.”

Whilst the second reading speech on the National Gas Law in relation to the NGO is relatively brief, the principles behind the NGO are fully mirrored in the National Electricity Law which uses the same words in the National Electricity Objective except the word “electricity” replaces the word “gas”. This means the principles behind the concept of the NGO are identical to the concepts in the National Electricity Objective and so the same constructs can be applied.

In the second reading speech in 2005 by the Minister (Hill for Conlon), when referring to the National Electricity Objective, the Minister made a more expansive observation in reference to the import behind the objectives for the energy laws. The Minister observed⁶:

“The market objective is an economic concept and should be interpreted as such. For example, investment in and use of electricity services will be efficient when services are supplied in the long run at least cost, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities.

The long term interest of consumers of electricity requires the economic welfare of consumers, over the long term, to be maximised. If the National Electricity Market is efficient in an economic sense the long term economic interests of consumers in

⁵ SA House of Assembly - Wednesday, 9 April 2008, Hansard Page 2884

⁶ SA House of Assembly Wednesday 9 February 2005, Hansard page 1452

respect of price, quality, reliability, safety and security of electricity services will be maximised.”

The NGO is structured so that the achievement of the Law will be measured in economic benefits to consumers over the long term. In essence the issue of price for consumers is a core element of the Objective as is the need to ensure there are sufficient rewards to those providing investment to maintain the energy infrastructure, to continue to do so. The Objective also implies there is an expectation that infrastructure is used to deliver the greatest possible benefit to consumers.

The clear import of the Objective, and the explanation provided about the Objective in the second reading speeches, is that access to a pipeline is not just provision of physical access, but that the access must be provided in an economically efficient manner. It is insufficient that just physical access be granted, but that the access must also be provided in a manner that is economically efficient for consumers over the long term.

Economic efficiency is not just that the price for access must be the lowest price, but in deriving a regulated price for access, the approach used will provide a clear signal to others contemplating investing in the provision of gas services, that regulation will allow a fair return for the investment market with a high degree of certainty over the long term. Equally, there is an expectation that infrastructure that exists will be used to its maximum capability until there is no remaining capacity and, at that point, ensuring there is an incentive for a new asset to be provided to meet future needs.

There are therefore two fundamentally competing elements that the NGO addresses – that the price for the services is the least cost over the long term and that in setting the price, future investment in gas transportation is not curtailed. This means that a decision on coverage must result in consumers having access to the least cost for the services whilst not constraining future investment.

The “long term interests of consumers” requires the NCC to address the application in such time frames. There is unlikely to be any “long term” negative impact of coverage of SEPS to consumers directly connected to SEPS, as there is more than adequate unutilised capacity in SEPS to allow for future growth in demand; even after 20 years of operation, demand still is only 25% of the total rated capacity of SEPS. Additionally, there has been modest new usage of the SEPS for gas haulage, and the demand for gas haulage by KCA has reduced as a result of closure of some elements of its operations at Millicent (see section 2 above). This means that even in the long term no new pipeline will be required to duplicate SEPS.

However there is a need to assess whether coverage will cause a negative impact on consumers elsewhere. Coverage for other pipelines (eg Dawson Valley Pipeline) has been granted in the recent past, indicating that there is general acceptance that coverage, per se, does not negatively impact on the incentive to build necessary future gas transportation infrastructure.

In section 6.3 below, it is detailed that SEPS is a unique pipeline system, in that it comprises the only pipelines that deliver gas to consumers the lower south east region of South Australia. Also explained (in section 3 above) there is no credible commercial alternative to natural gas to meet the needs of thermal energy in the region. This means that effectively SEPS is one of a very limited number of ways to delivery thermal energy to the lower south-east region of South Australia. As alternatives are considerably more expensive, there are few competitive constraints on the price charged for such transport by Epic. Coverage will mitigate the ability to exercise the market power that is apparent from recent negotiations KCA has had with Epic.

The applying coverage on SEPS meets the intention of the NGO because:

- Coverage should result in the least cost price for gas transport on SEPS, as the tariff for transport on SEPS in the last five years of the foundation contract is lower than the tariff initially offered by Epic [REDACTED]. [REDACTED] The tariff for the last five years of the foundation contract was set in the full knowledge of the costs to build SEPS and the likely period over which these costs would be recovered. This implies that the foundation tariff reflects the actual costs involved in providing the service. Therefore coverage will result in consumers using SEPS to benefit. This aspect is further developed under criterion (a) in section 6.2 and in section 8 below.
- SEPS has an uncompressed capacity of 25 TJ/d⁷ (and a fully compressed capacity of 50 TJ/d) but the capacity currently used is of the order of 12-13 TJ/d, demonstrating there is no need for additional pipeline capacity to be constructed for many years. Increasing the usage of SEPS will result in a benefit for consumers as tariffs set under a regulatory review provide for the pipeline costs to be amortised over the larger consumer base. Increased usage will result in the tariff to use SEPS being the least cost, meeting the intention of the objective as outlined in the second reading speech for the National Electricity Law. This aspect is further developed under criterion (b) below in section 6.3.
- Coverage of SEPS will not cause detriment to consumers not connected to SEPS as applying coverage to other pipelines has not been seen to result in detriments to other consumers.

Overall, KCA considers that coverage of SEPS meets the intention of the Objective by mitigating the market power Epic has shown that it has in relation to gas transport in the lower south east region.

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

⁷ See section 6.3

At the most basic interpretation of this criterion in relation to coverage of SEPS and to KCA, for this criterion to be satisfied, KCA access to SEPS must be the service where competition will be enhanced (ie that KCA will be more competitive), and that coverage would provide a more competitive outcome (such as a lower price) in the markets KCA operates in.

Epic originally offered open access to SEPS at the postage stamp rate of [REDACTED] of MDQ. This was a [REDACTED] increase from the foundation tariff rate, and in applying this rate, Epic would receive some [REDACTED] in revenue for the gas transportation SEPS provides of between 12 and 13TJ of MDQ that currently flows on the pipeline. Even at the reduced tariff currently being offered Epic would receive considerably more than if the foundation tariff applied. Adding the high pressure premium required by Epic provides the revenue to Epic that it would achieve with the initial open access tariff offered.

Based on the average tariff quoted by Epic in its application for revocation of coverage, the foundation tariff in the contract between Epic and Origin would now deliver some [REDACTED] in revenue to Epic based on 12-13 TJ/d of MDQ, noting the pipeline has been considerably depreciated over the past 20 years. If the pipeline is assessed by the regulator to be fully depreciated then the tariff will fall further than under the foundation contract rates, perhaps to a range of \$0.05-0.10/GJ of MDQ which would deliver to Epic an annual revenue of up to \$0.5m pa.

As Epic set such a high increase in its tariff, it appears that Epic is seeking a significant monopoly rent for the provision of its monopoly asset.

If the tariff is maintained at the foundation contract or lower rates, this has the potential to increase gas usage and improve downstream competition because of lower input costs. In its 2000 recommendation NCC was of the view that as the contracts then in place with Boral had been developed to reflect the costs involved, this implied monopoly rents could not apply whilst the contract was operational. This assessment is no longer applicable in light of the expiry of the contract and Epic's claim for increased tariffs.

Gas from SEAGas is now being injected into SEPS and this is the prime source of gas transported on SEPS. However Beach Energy (which acquired Katnook when it acquired Adelaide Energy in 2011, which in turn had acquired Katnook from Origin in 2008) has advised that it anticipates injecting some gas into SEPS from the new Jacaranda Ridge 2 gas field⁸ (located near Katnook) to add to any injected from Katnook and Ladbroke Grove gas fields. Open access to SEPS at a reasonable tariff has the potential to allow these marginal gas supplies to be made commercially viable.

For Beach Energy to be forced to transport its gas away from the lower south east of SA will add a significant cost impost for transportation to other consumers by it

⁸ See

http://www.pir.sa.gov.au/_data/assets/pdf_file/0018/151812/20100304_2010_Year2_PEL_255_Annual_Report_Adelaide_Energy_wwwy.pdf

having to use SESA and SEAGas pipelines and so incur considerably higher transport costs. Providing access to SEPS at a reasonable tariff will allow Beach Energy to compete in the provision of gas to lower south east gas consumers thereby increasing upstream competition.

KCA has advised both Origin (its current gas retailer) and Epic that it has plans to invest in order to increase overall energy efficiency of the KCA mill operations. Such an increase in energy efficiency is essential if KCA is to maintain competitive parity with overseas suppliers of tissue based products. Further, increasing energy efficiency of manufacturing operations is a stated goal of both the Commonwealth and SA governments.

Part of this increase in energy efficiency is tied to the tri-generation plant now committed by KCA for the Millicent Mill. This project will generate electricity for the mill use (with some export), provision of steam for one tissue machine and hot air drying for the other tissue machine⁹. Unless KCA does increase its energy efficiency (and so maintain competitive parity with tissue imports) then KCA faces the potential of having to further reduce its operations at Millicent and thereby use less gas. Already KCA has to pay a higher premium for gas transportation as it not only transports gas on SEPS, it now has to pay for gas transport on SEAGas and SESA pipelines as well. The additional impost posed by the tariff increase for transport on SEPS adds to the considerable price pressures already facing KCA in its energy supply cost structure.

Access to SEPS at a reasonable tariff has the potential to make KCA mill operations more competitive in the global market for tissue based products.

Millicent mill product is sold in to a wide range of product categories within the Australia and New Zealand national markets. In the Consumer market it competes in Facial Tissue, Bathroom Tissue and Kitchen Tissue whilst in the B2B market it competes in both Bathroom and Facial Tissue product categories. The competition in these markets comes from a range of imported manufactures and Eastern seaboard based local manufactures – both branded and private label. Downward price pressure in both the Consumer and B2B markets has become more intense in recent years as the major retailers compete in an aggressive price war and the B2B distributors look for ways to deliver more cost savings to their customers. There are no indications that this focus on price will reduce in the future meaning that survival and success in our product categories will rely increasingly on the lowest cost of manufacture.

As a regional manufacturing facility the Millicent mill already operates at a cost disadvantage to the competitors with 100% of our production having to be line hauled to the capital city based distribution points and a longer supply chain for raw material inputs. Energy costs make up ████████ of our mill cash costs and in recent years have been increasing at an annual rate of over 20% before taking in to account the impact of the Carbon Tax. This is putting us at an increasingly large

⁹ This increase in thermal efficiency reflects the pressure provided by the Commonwealth and State governments to better utilise Australia's energy resources and reduce carbon emissions.

disadvantage versus our domestic and international competitors and is putting at risk the longer term viability of the facility. A reasonable tariff for access to SEPS should thus enhance competitiveness in the market.

Similarly, Safries (the second largest user of gas transported on SEPS) and other gas using manufacturers in Mount Gambier will become more competitive in their markets should access be provided on SEPS at reasonable tariffs.

Based on the foundation tariff being discounted for the last 5 years of the pipeline contract and a current demand of 12.5 TJ/d, Epic would have received some [REDACTED] from providing SEPS services under the foundation contract. Increasing this tariff along the lines proposed by Epic, Epic would receive considerably increased revenue, perhaps as much as a [REDACTED] in revenue, an increase that is material. Reducing this transfer of wealth from consumers to Epic can only lead to an increase in competitiveness for those gas using manufacturing entities like KCA and others connected to SEPS.

Subsequent to the plant closures, KCA uses some 50-70% of the total gas (in MDQ terms) transported on SEPS. This means that at the new Epic tariffs, KCA would be paying considerably more for its gas transport than would apply if the pipeline costs (as KCA contends) reflected the full depreciation of SEPS. KCA will face an increase in costs as a result of Epic's decision making KCA less competitive in the international market in which it competes¹⁰.

In section 3 above KCA observed that for a period over 2004 and 2005, it had to use LPG as the lowest cost alternative to using natural gas because of the failure of Katnook gas fields. The fact that the SESA pipeline was built by Origin to connect Katnook to SEAGas pipeline as a priority, indicates that the continued use of the LPG was non-commercial compared to using natural gas.

At the time KCA was using LPG due to the large reduction in gas availability from Katnook, all other users of natural gas connected to SEPS continued to be served by the limited gas supplies from Katnook gas fields. To convert other users than KCA to LPG at this time was seen as uncommercial and technically difficult to implement. On this basis, the loss of natural gas supplies would have imposed considerable commercial harm to all gas users connected to SEPS, and reduced (and even eliminated) their abilities to continue commercial operations. KCA is not privy to detailed information as to the actual impacts that such loss of supply would have imposed on other users, but is aware that these would have been quite severe.

Increasing haulage tariffs on SEPS (as proposed by Epic) will result in all gas users connected to SEPS suffering a loss of profitability and reducing their ability to compete in their markets.

¹⁰ It is pertinent to note that the cost structure of the Millicent facility is seen by the Australian Government is marginal and that any cost imposts could change the viability of the facility and thereby impact downstream markets. The Australian Government has issued the Millicent facility with Partial Exemption Certificates (PECs) to limit the cost imposts resulting from the application of a cost of carbon on electricity prices and from the imposition of renewable energy requirements for electricity supplies.

The experience of 2004 and 2005 demonstrates that there is no credible commercial alternative to using natural gas as a source of thermal energy to meet the needs of the lower south east of South Australia, and supports the view that SEPS provides a monopoly service.

In its 2000 recommendation, NCC determined that there was no short to medium term expectation for increased competition. This assessment was based on the assumption that the contracted tariffs between Boral (now Origin) and Epic were fixed for the ensuing 10 years, were reasonable and did not include monopoly rents. The decision by Epic to increase tariffs above those applying in the contract now makes this assessment no longer applicable.

Open access to SEPS at a tariff implied by the KCA modelling will result in greater upstream competition and greater competition downstream. As Epic is applying tariffs which are greater than those in the foundation contract, implies that coverage will result in greater competition and will deliver a material benefit to consumers, and so satisfy criterion (a). Allowing Epic to set a tariff which includes monopoly rents will damage both upstream and downstream activities.

6.3 Criterion (b) – it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline.

In its recommendation in 2000, the NCC concluded that it would be uneconomic to develop another pipeline where the pipeline has existing spare capacity¹¹. The growth in demand for transporting gas on SEPS has been modest at most, despite there being a number of larger users in the Mount Gambier area ceasing operations which resulted in reductions in gas demand.

Since the NCC reached this conclusion changes in terms of utilisation have been modest and have not resulted in SEPS reaching its rated capacity. The recent reduced gas consumption by KCA (by far the largest consumer of gas transported on SEPS) merely reinforces that the growth in demand in SEPS service is modest at best and is unlikely to fully utilise the SEPS capacity in the long term.

In fact, as is developed in more detail below, SEPS is currently only using about half of its uncompressed capacity and it has the ability to double its existing capacity by further compression.

On this basis alone, it is clear that it would be uneconomic to duplicate SEPS.

The NCC advises that, in relation to criterion (b), it will assess the following aspects in order to assess whether a pipeline is a natural monopoly.

- (a) the size of the initial or start-up investment
- (b) the cost structure of operating the pipeline services

¹¹ It is also pertinent to note that pipeline costs have increased since the NCC reached this conclusion, and therefore, if anything, cost increases would strengthen this observation

- (c) the existence of any other pipelines that provide the pipeline services
- (d) the nature of demand for the pipeline service, particularly the dynamic aspects such as growth or otherwise in demand
- (e) the current and maximum potential capacity of the pipeline, and
- (f) the existence of any environmental, planning or other regulations that prevent anyone else from building their own pipeline.

Each of these aspects is addressed below.

SEPS comprises four elements – a pipeline from Katnook to Safries (a dedicated pipeline to serve a food processing plant owned by McCains), a shared pipeline from Katnook to Glencoe to serve consumers at Snuggery and Mount Gambier, a dedicated pipeline from Glencoe to Mount Gambier to serve the Mount Gambier region and a dedicated pipeline from Glencoe to Snuggery, primarily to serve the gas needs of KCA. Each element of the SEPS has a unique purpose and none has a competitor pipeline which might be able to offer an alternative to using SEPS.

KCA does not know the financial details regarding the actual investment made by PASA when it built SEPS, but it is aware that the costs of materials used at the time of construction were significantly less in relative terms than the costs which now apply¹². KCA is aware that, at the time the investment was made, PASA had no expectation for it to have an economic life that beyond the life of Katnook gas field, or that there would be a need for gas transportation beyond the expiry of Katnook gas field¹³. This implies that PASA would have structured its initial investment so that it would recover its investment during the operational life of Katnook.

The cost structure of SEPS shows that, at a minimum, the pipeline asset value has already been depreciated by some 20 years of operation. A new pipeline to provide the service that SEPS currently provides would have a cost structure much greater than SEPS as a result of higher construction costs and no depreciation to reduce the regulatory asset base. Further, sharing the same or even modestly increased gas flows between two pipelines would mean that both would be operating well below optimum capacity. Epic has an incentive, in order to prevent competition, to provide a tariff on SEPS which is marginally less than a tariff a new duplicate pipeline would have to charge (ie by applying “Ramsay” pricing), but the history of SEPS indicates that a tariff marginally below the cost of a new bypass will still deliver to Epic a significant monopoly rent.

There is no doubt that there is no other provider in the region that could provide the services of that SEPS does, as there is no other pipeline providing this service. Under this definition of being a monopoly service, SEPS has a current monopoly.

¹² See section 8

¹³ This is because KCA was made aware of the same time horizon in relation to gas supplies that it could expect from this gas supply project. This was an essential element of the decision by Sagasco to proceed with the commitments, as without KCA involvement, the project was not viable.

The amount of gas that can be carried by SEPS is limited to the capacity of SESA (connecting SEPS to SEAGas) and the injection of gas from Katnook and any newly discovered gas field such as Jacaranda Ridge. The current indications are that the potential injection of gas at Katnook from both sources will not exceed the expanded capacity of SEPS, especially if it increased its operating pressure to the maximum level. Equally there is little likelihood in the medium to long term of gas demand in the region served by SEPS exceeding the maximum capacity of SEPS. In either case, there would be no commercial driver to duplicate SEPS.

To allow growth in the supply of gas to consumers in the lower south east of SA, requires the utilisation of SEPS. As advised in section 3 above, there is no credible commercial alternative to using natural gas. The only other competition to SEPS is to use LPG such as was the case when the Katnook gas field failed and Origin had to install LPG facilities at the KCA mill. As advised in section 3, this alternative was not cost effective compared to using natural gas.

Similarly to allow gas supplies from Katnook and Jacaranda Ridge gas fields by Beach Energy requires either the use of SEPS to allow the gas to be used by consumers in the lower south east, or the use of SESA to deliver the gas to SEAGas and onto other consumers. Haulage costs to deliver gas to any other consumer than those connected to SEPS (via SESA and SEAGas) would dramatically reduce the commercial viability of the Beach Energy gas fields.

With the closure of the KCA assets, this daily consumption has reduced significantly. The inclusion of the gas fired generation at KCA will alleviate this reduction to a large extent. Growth in gas demand from other consumers served by SEPS has been modest but consistent, probably less than doubling over the past decade. That the utilisation of SEPS is currently about 50% of its rated uncompressed capacity attests to this.

This observation is supported by Epic itself. In its 2004 Product Disclosure Statement¹⁴ Hastings Funds Management Ltd (operator of Hastings Diversified Utilities Fund which is owner of the Epic assets including SEPS) stated (page 33)

4.2.4 South East Pipeline

The SEP is a 70 km pipeline that was built in 1991 to deliver gas from the Katnook processing plant near Penola in the south east of South Australia to Snuggery and Mount Gambier. Whilst it has a capacity of 25 TJ/d with a net inlet pressure of 5 MPa, the SEP has a MAOP¹⁵ of 10 MPA and thus could potentially double its current capacity. The SEP is not a covered pipeline under the Gas Code, its original coverage having been revoked.

Origin is currently the only shipper using SEP and has contracted the full capacity of the pipeline until 2011. Origin has recently announced its intention to connect the SEP to SEAGas, ensuring long term availability of gas supply for the pipeline.”

¹⁴ Available at <http://www.asx.com.au/asxpdf/20041115/pdf/3np7w3ktdfp7.pdf>

¹⁵ Maximum allowable operating pressure

If SEPS has significant spare capacity for transporting of gas (and the current capacity used is approximately half its rated uncompressed capacity) then it is more efficient to utilise the current spare capacity, than to duplicate the existing SEPS. Further expansion of SEPS is possible by the doubling the compression on the pipeline, and adding compression would also achieve a lower cost than duplicating the pipeline.

It is clear that SEPS has unutilised capacity in its uncompressed state, and therefore there is little likelihood that there could be a commercial case to support building an alternative pipeline to duplicate any of the four elements that comprise SEPS at a cost less than SEPS can deliver the gas transportation services. Even if increased demand exceeded the uncompressed capacity, pipeline operators and owners advise that increasing capacity by increasing compression is a lower cost option than building a duplicate pipeline¹⁶.

There is a clear argument that supports the fact that SEPS has a monopoly position in relation to the transport of gas to consumers in the lower south east of South Australia. As there is considerable unused capacity within SEPS, it would be uneconomic to duplicate the assets and therefore criterion (b) is satisfied.

6.4 Criterion (c) – 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.

In its recommendation in 2000, the NCC considered that, as Epic and others had not advised that access (or increased access) could not be provided safely and, at the time, gas was being safely transported for Boral, there was no risk of a safety issue in relation to providing access to others on the SEPS.

Further, when KCA raised the issue of potentially increasing its demand for gas, the aspect of safety was not raised as a potential reason for not being able to accommodate increased gas demand. In fact the idea of increased demand was welcomed with no qualification at all.

KCA also broached the concept of receiving gas at a higher pressure than that it currently receives its gas at, at a new connection point and Epic raised no concerns that such might be impacted by undue risk to human health or safety.

Initially, SEPS was a covered pipeline and there were no concerns raised that the pipeline could not be operated safely. For the past 10 years SEPS has not been covered and gas demand has slowly increased, again with no concern that this increase in demand could not be accommodated safely. Epic has advised that the uncompressed capacity of SEPS is rated at 25 TJ/d which is twice the current utilisation. Epic has further advised that SEPS is capable of being compressed and

¹⁶ KCA notes that the High Court has recently determined in favour of a 'private profitability' test for duplication of a facility in the analogous section 44H(4) of Part IIIA of the Competition and Consumer Act 2010 (Cth). KCA's analysis in this submission clearly indicates that it would not be profitable for any current or potential participant in the marketplace (including KCA itself) to construct an alternative pipeline.

nominally doubling its capacity, again without concern being raised that this would impinge of the safe operation of the pipeline.

Gas is currently being transported on SEPS and there is not expected to be a significant step increase in gas demand as result of coverage being applied. Implicit in such an observation is that safety will not be impacted by coverage being applied.

This later advice reinforces the NCC 2000 conclusion and supports this current assessment that criterion (c) remains satisfied.

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

As a result of a Competition Tribunal decision, the NCC guideline on coverage advises that criterion (d) does not have to be affirmatively satisfied, but rather that the benefits of coverage are to be not less than the costs that coverage will entail. Further the definition of “public interest” is not defined in the NGL but the NCC considers they would cover aspects such as:

- (a) “ecologically sustainable development
- (b) social welfare and equity considerations, including community service obligations
- (c) government legislation and policies relating to matters such as occupational health and safety, industrial relations, access and equity
- (d) economic and regional development, including employment and investment growth
- (e) the interests of consumers generally or of a class of consumers
- (f) the competitiveness of Australian businesses, and
- (g) the efficient allocation of resources.”

In this regard, KCA advises that allowing access to SEPS will result in a number of positive outcomes in terms of public interest will result. Addressing each aspect in turn, KCA observes:

- (a) KCA advises above that at the tariff Epic is seeking, it is possible that KCA’s ability to achieve reductions in costs via increased energy efficiency will be reduced. Increased energy efficiency is a core element of the Commonwealth government’s goal to reduce greenhouse gases and is also a goal of the SA government for the same reasons. Thus allowing KCA to be able to implement its intentions with regard to energy efficiency will support national and state ecological goals.

Further, Epic decision to charge higher prices for the delivery of high pressure gas have had the practical effect of requiring KCA to implement a less thermally efficient option to provide high pressure gas to its generation plant. KCA considers it bizarre that high pressure gas is reduced in pressure and

then has to be recompressed when gas at pressures higher than the required pressure are already available. For Epic to seek to impose costs on KCA that are greater than those needed to recompress the gas clearly implies that it is seeking monopoly rents

- (b) KCA is not aware that coverage will negatively impact the aspects of social welfare and equity considerations, including community service obligations, but coverage could provide a social welfare benefit as it should result in lower tariffs for all.
- (c) Coverage will not negatively impact many of these elements, but will positively impact access and equity elements.
- (d) KCA is the largest single employer in the lower south east of SA. Loss of or a reduction in KCA activities will have a major impact on employment in the region where there is unlikely to be a manufacturing operation which could absorb the loss of jobs from the KCA mill. Further KCA has indicated that as part of its program to increase its energy efficiency, investment will be required.

In recent years KCA has invested considerably at its mill with the addition of a new tissue machine in 2003. Maintaining a reasonable cost for its energy supplies will allow it to access internal funds for its energy efficiency improvement program, for which engineering assessments have already been implemented. One of these programs is the investment in its own generation plant which uses the gas transported on SEPS as a fuel.

- (e) Not all the gas transported on SEPS is used by KCA, and a significant proportion is used by small business and residential users in Mount Gambier and the surrounding district. Coverage is likely to result in a lower cost of gas transport for every consumer using gas transported on SEPS and therefore all gas consumers connected to SEPS will see a benefit.
- (f) As noted above, reducing the cost of gas transport on SEPS will benefit both KCA and other gas using manufacturers in the lower south east of SA, resulting in all being more competitive.
- (g) SEPS has significant unused capacity. As noted above, to attempt to replicate SEPS is not economically efficient. A reasonably assessed tariff for gas haulage on SEPS is more likely to encourage greater utilisation of an already under-utilised asset.

In the discussion in section 6.1, it was identified that an aspect of coverage that should be addressed is if coverage might result in a disincentive for future investment in needed gas pipelines elsewhere in the country. As was noted in 6.1, the decision to impose coverage on the Dawson Valley pipeline was not seen as causing a detriment to consumers by providing a disincentive for future investment.

In an overall qualitative sense, coverage is likely to provide a significant public benefit.

In the application for revocation of coverage Epic advised that, as the total capacity of the SEPS was contracted to Boral, the regulatory costs that Epic would incur as a result of coverage would provide no value but would be a cost that Epic and others would have to incur. There is no indication given whether the contract between Epic and Boral would allow Epic to recover these costs from Boral who might in turn pass these costs onto Boral's customers. As Epic had contracted all of its capacity to Boral, it considered the costs incurred would effectively serve no purpose.

Epic advised that it expected its costs to comply with the regulatory requirements might total \$150,000 (or 13% of its annual revenue). To this Epic considered needed to be added another \$150,000 to cover regulatory and other third party costs, giving a total regulatory impost of \$300,000 that coverage and a review by the regulator would cause.

The NCC pointed out in its final recommendation that these costs would be a "once off" cost and therefore amortised over the regulatory period of probably 5 years, implying an annual cost of some \$60,000. Regardless of the quantum, the NCC considered that as the costs would not result in increased competition (because all the capacity was contracted to Boral), it could not see that "in the short to medium term" there would be a net public benefit by continuing coverage.

This assessment has now been superseded by the expiration of the Boral/Origin contract with Epic, and with Epic's decision to increase the tariff for using SEPS. The KCA analysis indicates that, in all probability, a regulator might decide to reduce the tariff that applied under the contract to reflect:

- There has been an increase in the gas transported on SEPS since Epic divulged its average tariff in 1999
- The likelihood that there has been greater depreciation of the SEPS assets than Epic has allowed for in its new tariffs
- That a regulator might not use an ICB based on DORC methodology using current costs
- As there is a significant [REDACTED] increase from the foundation tariff to the new tariff, the regulator might not consider such a step change to be appropriate
- The costs for new connections would be assessable by the regulator to ensure that costs were reasonable (see KCA comment on connection costs in section 5 above).

Based on this KCA considers that there is a strong probability that a regulated tariff might be considerably lower than the tariff Epic has offered to the market, and to KCA specifically. Further, KCA considers that the costs for new connections will be lower than those set by Epic.

If the KCA contentions are correct, then there is every expectation that the costs of regulation would provide a significantly reduced tariff and lower connection costs. In

1999, Epic advised that its costs for regulation would be \$150,000 with a further \$150,000 for costs incurred by others. An equivalent cost might now be ~\$420,000 (allowing for inflation) or \$85,000 pa when amortised over a five year regulatory period.

Under the currently advised tariff of [REDACTED] and the current gas transportation usage of 12-13 TJ/d, Epic would receive [REDACTED] annually. The regulatory impost of \$85,000 in annual current costs would comprise a very small component ([REDACTED]) of the new Epic revenue. It would only require the regulator to determine that a reduction in the tariff of more than this [REDACTED] to deliver a net public benefit in terms of costs to add to the qualitative benefits noted above. As the ACCC and the Competition Tribunal delivered tariff reductions of 12% (ACT) and 20% (ACCC) in relation to the reference tariff for MAPS (see section 8), there is every expectation that a regulator might impose a reduction in the SEPS tariff by much more than [REDACTED], thus providing a net financial benefit to consumers.

A regulated tariff is also likely to assist in increasing both upstream and downstream competition (see commentary in relation to criterion (a) in section 6.2) possibly resulting in the continued modest increase in gas usage seen over the past 10 years, causing a further reduction in the regulated tariff.

As there is a strong indication there will be a net benefit to consumers as a result of regulation of SEPS, there will be not be an outcome from coverage that would be contrary to the public interest, thereby satisfying criterion (d).

7. Proposed Application of Coverage

The process for assessing coverage by the NCC allows the NCC to concurrently assess whether the application of coverage should be either full regulation or light handed regulation (LHR).

Full regulation requires a regulator to effectively determine what are an acceptable set of reference tariffs for the provision of services a pipeline provides, whereas LHR provides for a negotiate/arbitrate approach to setting tariffs. Initially KCA and Origin “negotiated” at length with Epic for many months and it appears that Origin agreed to a significantly higher tariff than it was then paying [REDACTED] because there was no alternative gas transport. Subsequently KCA has “negotiated” with EPIC for a reasonable tariff and connection arrangement, but to no avail. Many of the principles used in developing tariffs under the Gas Rules have been discussed between the parties but despite this Epic has maintained a view that their interpretations are the correct ones and therefore they are of the view that a new tariff has to be increased significantly from the foundation tariffs previously used.

As discussed throughout this application, there are number of critical but basic areas of interpretation where Epic and the users of the services are unable to reach consensus. As there is such as massive difference of view between the proponents after a number of years of dialogue, it is considered that resolution by a negotiate/arbitrate model (ie LHR) is unlikely to result in consensus.

In making a decision as to which form of regulation should apply section 122(1) of the Gas Law requires the NCC to assess:

- The likely effectiveness in promoting access
- The likely costs the provider, efficient users and end users will incur

Section 122(2) posits that the NCC is to have regard to the Gas Objective, the form of the regulation factors and any other factors the NCC considers pertinent. The form of the regulation factors covers:

- a) The presence and extent of barriers to entry
- b) Interdependencies between services offered on the same pipeline
- c) Interdependencies between the pipeline services offered and services offered by the provider in other markets
- d) The potential for market power mitigation
- e) The presence of substitutes and elasticity of demand for the services
- f) The presence of substitutes and elasticity of demand for energy
- g) The availability and extent of information allowing a user to negotiate on an informed basis.

7.1 NGL Section 122 (1)

KCA considers that under section 122(1) LHR will not provide as an effective outcome as will full regulation as there is such a massive difference between the views of Epic and KCA in regard to the fundamentals used to develop a mutually acceptable outcome. A determination by a regulator is seen as an essential step to setting the basic parameters needed to reach consensus on the outcome.

In section 6.5 above KCA provides information that the costs of full regulation can be accommodated and still provide for a net public benefit.

When these two observations are considered together, KCA considers that LHR is not a feasible alternative.

7.2 NGL Section 122(2)

KCA has provided a detailed analysis of coverage against the Objective. Many of the points made in section 6.1 above tend to support the view that the least cost to consumers will be provided by full regulation because until there is understanding and acceptance of the fundamentals for developing a tariff, LHR is unlikely to be the best alternative for consumers.

The NCC details seven forms of regulation factors (a) to (g). The KCA comments against each factor 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) As noted in section 3 above 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 energy¹⁷ 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.

7.3 KCA reasons for seeking full regulation

KCA is of the view that in light of the approach taken by Epic so far, the NCC should recommend that full coverage should be applied, at least for the initial review by the regulator. Light handed regulation best applies where the regulator already has a good understanding of the reasonable costs incurred in providing the services being regulated. This understanding comes from previous assessments where the regulator has detailed information about the service from previous regulatory reviews. Based on this knowledge the regulator has sufficient information on which to assess proposals from the service provider and so either agree or reject proposals made under light handed regulation.

In the case of SEPS the pipeline has never undergone a regulatory review and as a result the regulator has no previous knowledge which it could use to assess the reasonableness or otherwise of a proposal put to it by Epic. In addition to advice the regulator would get from Epic in respect of seeking approval of its tariffs under LHR, the only knowledge available in the public domain that a regulator could use to assess the reasonableness of the information provided to it by Epic, would be the

¹⁷ This recognises that electric heating for the bulk provision of heat is commercially not feasible

information provided by Epic to the NCC in its request for revocation of SEPS and, very indirectly, information divulged by Epic in the regulatory review of MAPS.

7.3.1 The foundation tariffs

In particular the information made available in the revocation process for SEPS included the following observation by NCC in its final recommendation for revocation (page 10):

“The Boral joint venture based at Katnook is the only source of gas in the short to medium term, and has secured the right to all the capacity of the South East Pipeline System in its current configuration until 2011. This means Epic, as the owner of the South East Pipeline System, has little opportunity to extract higher transport tariffs from Boral than those it presently charges, and therefore access is unlikely to promote cheaper tariffs.

Having said this, the Council recognises that the above reasoning assumes that the [foundation] tariffs do not contain a monopoly element which access under the SA Gas Pipelines Act might address. It also assumes Boral will not need additional transport capacity (which could be provided by expansion of the pipeline) in the period until 2011.”

The import of this observation is twofold. Firstly, that the foundation arrangement is based purely on the provision of gas from Katnook and secondly an assumption that the foundation tariff arrangements does not include a monopoly element.

The assumption about monopoly rents has validity as the decision to develop the Katnook gas field reflected mutual reliance on the reasonableness of the costings for the various elements. For example, PASA would be aware that if its charges were too high then the development would not proceed and it would not benefit at all. However, once SEPS was constructed and SESA connected it to the SEAGas pipeline (therefore no longer tying its continued viability to the life of the Katnook gas field), Epic has the ability to provide a longer term service and apply monopoly rents.

From its initial involvement as foundation customer, KCA is aware that the foundation tariff arrangements include a tariff comprising two elements – for the first 15 years (ie from 1991 to 2006) the tariff was significantly higher (possibly by at least twice) than for the last five years (from 2006 to 2011) of the foundation contract. The average tariff of \$0.44/GJ of MDQ Epic advised the NCC that applied in 1999, was during the first high tariff period of the foundation contract. KCA is also aware that the tariff that applied to KCA over the last five years of the foundation contract is, in real terms, [REDACTED].

In contrast, Epic formally advised KCA in 2010 that the tariff to apply from 2011, was to be [REDACTED], implying that the tariff is to increase dramatically from the foundation tariff levels. Based on the changed offer from Epic to KCA, KCA assumes that subsequent negotiations between Origin and Epic resulted in a lower tariff, but

still much higher the tariff for the last five years of the foundation contract. This lower tariff has been negotiated to apply to KCA gas transport [REDACTED].

7.3.2 Development of a tariff - comparisons

There are a number of other disturbing aspects of the Epic development of the SEPS tariff.

1. As a point of comparison, the Moomba Adelaide pipeline system (MAPS) (also owned by Epic) is a pipeline system of some 1000 km in total length. On completion of the 2000 review by the ACCC, Epic sought a reference tariff of \$0.50/GJ in its revised access arrangement (submitted 2 July 2002) but ultimately the ACCC determined a reference tariff of \$0.40/GJ in 31 July 2002. The ACCC set tariff was revised as a result of a Competition Tribunal ruling in December 2003 to \$0.44/GJ.

In contrast, Epic initially advised a reference Tariff for SEPS of [REDACTED] for haulage on 70 km of pipeline registering a peak flow of 12-13 TJ/day. The import of these two observations is that:

- a. Historically Epic claims appear to be inflated
 - b. The cost of haulage on SEPS appears significantly overstated when compared with the costs of haulage on another of Epic's pipelines
2. In its application for a review of MAPS in 1999, Epic advised that the cost for the laterals off the main pipeline was \$20,000/km.inch¹⁸. This was a value quoted by Epic only 8 years after SEPS was constructed.

The implied equivalent unit construction rate for SEPS used by Epic in setting the 2011 tariff for SEPS and deflated to \$1999, is \$52,000/km.inch, This is more than two and a half times the construction rate Epic advises was appropriate for similar pipelines in 1999, indicating that Epic is using grossly inflated values for assessing the optimised replacement cost for SEPS, and a rate that totally overstates actual costs for a pipeline that was constructed in 1990.

7.3.3 Depreciation of SEPS

KCA has deduced that:

1. As Katnook has always had a life expectancy of 15-20 years, there is a clear implication that as the tariff fell after 15 years to a value of less than half that applying for the first 15 years of the foundation contract, a significant amount of depreciation was included in the tariff for the first 15 years which was no longer needed to be recovered in the final 5 years of the contract.

It would make business sense for PASA when it first developed the tariff for using SEPS, knowing that the gas field had an expected life of 15-20 years, it

¹⁸ Epic: Access Arrangement Information for the Moomba to Adelaide Natural Gas Pipeline (1999) attachment page 24

would recover the capital of its investment over a period less than the expected maximum life of the gas field. As KCA understands from its knowledge as foundation user, this is confirmed by the structure of the foundation tariff structure that the first 15 years of the contract had a higher tariff and the last 5 years is a much lower tariff, implying there was no longer a need to recover some costs that applied in the earlier 15 years.

KCA considers that a reasonable assessment of this information is that all of the depreciation for the pipeline would be recovered in the first 15 years and the tariff applying for the final 5 years reflected that all depreciation had been recovered.

2. As the NCC considered in 2000 that the foundation contract arrangements did not include a monopoly element, an increase in the tariff beyond the foundation tariff arrangements would imply the inclusion of a monopoly element.
3. There is historical support for a view that an extension of the foundation contract tariffs would reflect the actuality of historical recoveries of depreciation and eliminate the inclusion of monopoly rents.

It is clear that as a result of SEPS now having a much longer economic life as a result of the construction of SEAGas pipeline which can deliver large amounts of gas to the lower south east of SA and the building of SESA pipeline which delivers gas from SEAGas to Katnook, the expected useful life of SEPS has dramatically increased from the original 15-20 year expectation based on the life of the Katnook gas field to one based on the engineering life of SEPS.

Epic would have appeared to have developed a new tariff for SEPS based on a current optimised replacement cost depreciated by 20 years out of a total engineering life of 60 years. KCA considers that such an approach is incorrect based on what has occurred in the past and the approach should reflect the basis of the historical tariffs and what they recovered in terms of depreciation. In this KCA considers that historic tariffs would have fully recovered the capital initially invested in building SEPS and therefore the resultant tariff should reflect this.

Alternatively, if not all of the capital has been recovered, then the capital base of SEPS should reflect the actual cost of building SEPS (inflated by CPI as is current regulatory practice) and not current day costs. KCA is concerned that Epic, in using current day assessments, will be garnering unearned benefits as a result of using a replacement cost based on current costs where the prices of oil, steel and labour are much higher than CPI adjusted prices applying when SEPS was built.

Because there is such a major difference in the approach used by Epic and an outcome based on what probably did occur, and where there is such a large differential between the tariff proposed by Epic and the foundation contract tariff, to use a light handed regulatory approach is unlikely to result in achievement in an equitable outcome, and therefore not in the long term interests of consumers.

If, as KCA deduces, SEPS has already had all of its capital returned, then this will create a major issue which must be addressed as part of a regulatory review. The approach to setting the required revenue under the regulatory approach outlined in the National Gas Law and National Gas Rules is that the allowed revenue comprises four basic elements, viz:

- Return on the capital base ($WACC^{19} \times RAB^{20}$)
- Return on new capital investment ($WACC \times capex$)
- Return of capital (depreciation)
- Non-capital costs (operating and maintenance costs)

From these elements an allowable revenue is determined which is then divided by the forecast gas flows to provide a reference tariff, stated in terms of \$/GJ of MDQ

The implication of the regulatory approach is twofold.

Firstly, that an asset is depreciated over the economic life of the asset and in most cases this economic life is assumed to be the engineering life of the asset. At the end of the engineering life the asset is assumed to be no longer “used and useful”. In the case of SEPS, KCA considers that SEPS has undergone accelerated depreciation to reflect the limited life of the Katnook gas field. When the tariff was first set in 1991, this accelerated depreciation made sense as the “used and useful” life of SEPS was tied to the life of the Katnook gas field due to be exhausted after 15-20 years. With the development of SEAGas and SESA pipelines in 2005, the “used and useful” life of SEPS was extended beyond the original expected life, yet the rate of depreciation remained accelerated reflecting the limited life expectation²¹.

Secondly, the regulatory approach uses the forecast of gas flows to set the reference tariff – it does not develop the tariff based on the possibility that a new entrant might connect at some time in the future. In the recent discussions between Epic and KCA, Epic has advised that its tariff structure needs to reflect the possibility another shipper might want to use some capacity and that the high pressure KCA sought would reduce the capacity available for sale. As the regulated tariff is based on a “price cap” approach, Epic is able to retain the benefit of increased sales of capacity until the next revenue reset. Using the benefit of the increased sales offsets any cost premium Epic might incur as a result of having to increase the pressure in SEPS to enable the additional capacity to be sold. At the revenue reset, the increased operational expense would be recovered by Epic in the regulated allowance but the costs would be amortised over the larger volume sold. Thus a regulatory approach

¹⁹ Weighted average cost of capital

²⁰ Regulatory asset base

²¹ This coverage application creates potentially the first example of where a regulated asset would have a continuing “used and useful” life although it has been fully depreciated, and therefore having a regulatory asset base of zero. As the current regulatory approach provides all of the profitability for use of an asset within the WACC, if the asset value has been reduced to zero, there is no profit element for the asset owner. The only revenue a fully depreciated asset provides to the owner, is the direct cost of the non-capital activities involved in operating the pipeline and a return on any new capital invested. The setting of the allowed revenue for a regulated asset which has such a large element of depreciation to be included in the assessment, can only be addressed in a full regulatory review

would not allow Epic to charge a premium tariff for delivering gas at a higher pressure.

7.3.4 Conclusion

Therefore KCA considers that, at least for the initial setting of a tariff for SEPS, a full and detailed regulatory review is essential to ensure that the tariff set provides Epic with sufficient revenue to continue the commercial operation of SEPS into the future, but to also reflect that Epic does not gain a monopoly rent from the service SEPS provides, particularly as a result of depreciating the asset more than once.

8. Conclusions

Since the NCC made its recommendation in 2000 to revoke coverage of the SEPS there have been a number of significant changes that warrant re-coverage of the pipeline. These are:

- The foundation contract between Boral/Origin and Epic ceased in January 2011
- KCA understands that Epic has not agreed to “roll over” the foundation contract terms
- Epic has formally offered open access to the SEPS at a postage stamp tariff of [REDACTED]
- Gas transportation on SEPS appears to have shown a modest increase since the 2000 NCC recommendation was made
- Gas is available into SEPS from Victorian and Moomba gas fields and SEPS is no longer purely reliant on gas from Katnook
- A new gas provider could inject gas into SEPS from its newly developed Jacaranda gas field near Katnook
- KCA has reduced its gas consumption significantly by the closure of a large part of its operations but has subsequently sought gas at a higher pressure to replace much of the earlier reduction.

Based on these changes, and that apparently Epic is seeking to garner a monopoly rent for using SEPS, KCA considers there is a strong argument that re-covering SEPS so that a fair and reasonable transport tariff can be set for these monopoly assets. Full regulation would better reflect the amount of depreciation consumers have already paid and a balanced approach to setting the ICB would result than the approach used by Epic.

Appendix 1

The reasons for KCA seeking coverage

KCA has been advised by Epic that Epic has elected to allow open access to its SEPS from 2011 at a tariff developed as if the SEPS was a new pipeline with a 60 year economic life but where 20 years of its life has elapsed. KCA has two major concerns with this approach, viz:

1. The assumption that such an approach is the way a regulator would apply the National Gas Rules. KCA has identified there is a growing concern that such an approach will deliver significant benefits to a service provider where an asset was built at a time when costs were lower, but where the replacement cost is based on current unit costs which are significantly inflated due to international price pressures significantly increasing the price of oil, steel and copper.

KCA considers that a regulator is unlikely to accept the use of a depreciated optimised replacement cost (DORC) approach without assessing if such an application would deliver a significant unearned reward to an owner whose asset was built or purchased under a less aggressive cost regime.

2. There is considerable regulatory and other history surrounding the assets Epic acquired from PASA (via Tenneco). The bulk of the assets acquired by Epic comprise the Moomba Adelaide pipeline system (MAPS) which had a regulatory review by the Australian Competition and Consumer Commission (ACCC) in 2000. In that regulatory decision, significant information was provided by Epic in relation to costs for providing pipelines in South Australia, and the actual purchase price of the PASA assets was divulged as part of the assessment to set the Initial Capital Base (ICB) for MAPS. Reference in this assessment was made to other assets acquired at the same time, and this is a reference to SEPS because MAPS and SEPS were the only assets involved in the acquisition.

In that regulatory review, the ACCC set an ICB for MAPS which was higher than the acquisition price, implying that the purchase value for SEPS was very low. For Epic to use a new value (such as DORC) for SEPS as the basis for its calculation of the new tariff, assumes that the regulator will totally disregard the actual amount Epic paid for SEPS, and the revenue it has received in the interim period.

Epic has advised that it has used the DORC approach only in assessing the ICB for SEPS as part of its development of the new tariff. In setting the ICB for a pipeline, the National Gas Rules require the approach set out in the superseded Gas Code to be used for setting the ICB. The Gas Code requires a regulator to assess many more approaches than just the DORC value to

assess the value of a pipeline asset, including the amount paid for the asset and the depreciated actual cost (DAC) of a pipeline.

The regulator is not required to decide that just one method will be used exclusively and is permitted to set a value at a point between the two extremes of DORC and DAC.

Because there is significant recorded information available for the regulator to make a detailed assessment of ICB based on a variety of methodologies, KCA considers there is a strong possibility the regulator will set an ICB significantly lower than the value used by Epic.

3. In its application for revocation, Epic provided some actual costs and average tariffs. It advised that the costs it would incur to comply with regulation would be of the order of \$150,000 or 13% of its annual revenue. The implication of these amounts is that Epic received some \$1.154m in revenue from SEPS. At the same time Epic advised that its average tariff was \$0.44/GJ of MDQ, again implying that it was transporting some 7.2TJ of MDQ at that time. Currently SEPS is flowing gas at a rate of some 12-13TJ of MDQ of which (in 2010) KCA was using well over [REDACTED].

This means that the tariff applying in 1999 should have fallen since then reflecting the increased flow on the pipeline, and a current equivalent tariff would be more than 40% lower now based purely on gas flows.

4. The SEPS was built in 1991 to provide a gas transport service for the Katnook gas field. At the time of its construction, there was no expectation there would be a new gas field developed that would use the SEPS once the Katnook gas field was exhausted. This was made clear to KCA at the time it committed to the project as the foundation customer of the gas. Even as late as 2000, there was still no expectation that the life of Katnook (and therefore SEPS) would extend beyond the planned 20 year life of the project.

Implicit in such a project is that SEPS was built as a specific purpose pipeline with a life expectation tied to the life of the Katnook gas field. It was always expected that the life of the Katnook gas field would be no longer than 20 years, based on the amount of gas in the Katnook field and the demand of KCA and that of other gas users in the region. In fact, Katnook gas field exhausted in 2004, some 5-6 years earlier than the expected 20 year life, and now gas is delivered into SEPS from Victoria via the SEAGas pipeline.

KCA considers that the tariff Sagasco negotiated with PASA (and which was assigned to Boral/Origin from Sagasco and to Tenneco/Epic from PASA) would have included a significant element of accelerated depreciation; such a decision would be commercially sensible considering the expected usage life of Katnook and SEPS. From its involvement as a foundation customer, KCA is aware that the tariff for transport on SEPS was initially set at a high value (which Epic advised NCC in 1999 was an average of \$0.44/GJ of MDQ) but falling after 15 years (in 2006) to a much lower figure to reflect that all of the

initial capital invested on building SEPS had been recovered over the first 15 years. KCA has entered into similar arrangements for other energy assets with a limited life expectation.

Modelling of the revenue Epic would receive for SEPS based on unit cost data applying when SEPS was built, and the amount of gas transported on SEPS, supports the view that the revenue Epic received for SEPS from the average tariff Epic advised the NCC it received for SEPS in 1999 (ie \$0.44/GJ of MDQ) includes significant amounts of depreciation. This revenue stream supports the view the SEPS was fully depreciated over the first 15 years of operation. This modelling therefore gives credence to the observations made to KCA that the pipeline is fully depreciated.

As KCA was, and continues to be, the major user of the gas transported on SEPS, KCA has contributed significantly to the recovery of the capital used by PASA to build SEPS.

It is acknowledged that since Epic offered its open access tariff of [REDACTED] Epic has accepted a lesser tariff (at about [REDACTED]). Offsetting this reduction, Epic has advised KCA that it wanted a tariff premium for delivering gas at a higher pressure – this premium would bring the total tariff back to [REDACTED]. Even at the lower tariff currently in operation, KCA still considers that Epic has not included for the amount of depreciation that has already been recovered in the foundation contract tariffs established between Sagasco and PASA in 1990.

KCA is therefore of the view that the open access tariffs provided by Epic from 2011 onwards include a significant element of monopoly rent. As such a view will be tested in a regulatory reset review, KCA considers that imposing coverage on SEPS will result in a regulatory determined outcome that delivers a significantly reduced open access tariff.