

23 April 2013

Hon. Tom Koutsantonis, MP  
8th Floor, Terrace Towers  
178 North Terrace  
ADELAIDE SA 5000

By email: [minister.koutsantonis@sa.gov.au](mailto:minister.koutsantonis@sa.gov.au)

Dear Mr Koutsantonis

**South Eastern Pipeline System (SEPS) – Coverage determination under National Gas Law**

We refer to the Final Recommendation given to you by the National Competition Council (NCC) on 8 April 2013 regarding an application by Kimberly-Clark Australia (KCA) for the regulation of the South East Pipeline System (SEPS).

Coverage of gas pipelines is intended to ensure that, when a pipeline is a monopoly infrastructure asset, there are adequate controls in place to ensure that the owner of the asset is not able to use its monopoly position to enforce unreasonable costs and access conditions – that the pipeline owner would act as if it were in true competition.

In the case of the SEPS, this gas transmission pipeline was covered until 2000 when the NCC considered that as Origin Energy had contracted all of the capacity of the SEPS under a contract that had been established under competitive controls, that regulation would serve no purpose. That contract has subsequently expired and the reasons for not regulating the SEPS therefore no longer apply.

Without the regulation, all gas consumers in the lower South East region are exposed to the exercise of market power by the owner of SEPS. The owner of the SEPS may continue to use its monopoly position to impose unconscionable costs.

It is with this in mind that KCA makes the following four key points regarding the recommendation to you made by the NCC on 8 April 2013:

**1. Importance of reasonable pipeline tariffs**

KCA is the owner and operator of the Millicent paper mill in Millicent, South Australia. As you will be aware, KCA makes a very substantial contribution to the local economy.

In recent years, KCA has been under substantial cost pressure. To reduce costs, KCA invested in an efficient co-generation facility at the Mill, supplied by natural gas. The natural gas is delivered by a natural gas pipeline, known as the South East Pipeline System (SEPS).

The SEPS is monopoly infrastructure owned by the APA Group (owner of some 80% of all gas transmission pipeline infrastructure in eastern Australia). In the absence of regulation, APA Group has absolute discretion in the setting of access tariffs. KCA considers that APA Group is overcharging for access, thereby increasing costs for all gas consumers served by the SEPS, including KCA.

**2. The SEPS pipeline should be regulated**

Last year, KCA applied to the National Competition Council (NCC) for the SEPS to be regulated under the National Gas Law. The NCC has subsequently made a recommendation that the SEPS should not be regulated. KCA strongly disagrees with that recommendation.

As you will be aware, under section 100(2) of the National Gas Law, you must make a coverage determination (leading to the regulation of SEPS) if you are satisfied that all of the pipeline coverage criteria are satisfied. There are four key criteria. Of these, the NCC concluded that criterion (a) and (d) were not satisfied. KCA believes that the NCC has incorrectly applied the law and hence you should make a decision to regulate the SEPS.

Importantly, section 99(7) of the National Gas Law specifically contemplates that your determination of coverage may be different from the NCC's recommendation.

**3. The NCC has made two critical errors in relation to criterion (a)**

Criterion (a) of the pipeline coverage criteria requires that increased access to pipeline services provided by means of the SEPS will promote a material increase in competition in at least one other dependent market. In this case, the critical dependent market is the downstream gas market in those areas served by the SEPS.

Currently, Origin Energy has a *de facto* monopoly in the downstream gas market. The High Court and the Australian Competition Tribunal have each concluded that, in such a monopoly scenario, any competition is significant, even by a small competitor. The NCC has endorsed that view in its Final Recommendation to you (see para 6.29), so that view is not in dispute.

In this light, the key consideration for the NCC was whether Beach Energy would have sufficient gas available at Katnook in order to supply gas via the SEPS. By doing so, Beach would enter the downstream gas market to compete with Origin and satisfy criterion (a). The NCC considered that this depended on whether there was a 'real prospect' of Beach supplying commercially relevant volumes of gas at Katnook within a 'reasonable time' (see para 30).

KCA considers that the NCC, unfortunately, erred in its application of the concepts of 'reasonable time' and 'real prospect'. Accordingly, the NCC reached an incorrect conclusion:

- First, the NCC has misinterpreted a 'reasonable time' as the 'short to medium term'. However, case law requires a much longer time period that is consistent with the market circumstances and the proposed 10 year coverage period. Over a longer time period, there is clearly a 'real prospect' that Beach will supply substantial gas at Katnook.
- Second, the NCC's consideration of a 'real prospect' must reflect commercial reality. Beach's own submissions state that it expects to supply gas at Katnook. Beach has also invested in Katnook facilities to ensure such supply can occur. The available commercial evidence indicates that Beach itself considers there is a 'real prospect' of supply.

All of these factors are set out in further detail in **Attachment A** to this letter.

**4. The NCC should have given greater weight to consumer interests for criterion (d)**

Criterion (d) of the pipeline coverage criteria requires that increased access to the pipeline services provided by means of the SEPS would not be contrary to the public interest. Under section 100(1)(b) of the National Gas Law, the Minister must have regard to the National Gas Objective when considering the public interest.

Importantly, the National Gas Objective requires that the interests of consumers are paramount. The Standing Council on Energy Resources has itself stated that the long-term interests of consumers should be the sole criterion for determining the preferable decision.

In this manner, criterion (d) enables you to take into consideration the net public interest in applying regulation to the SEPS in a manner that will deter APA Group overcharging for access. As identified in KCA's submissions, there is already evidence of such overcharging. The proposed light-handed regulation of the SEPS will provide a critical safeguard to consumers, including KCA, in the wider public interest.

The reasoning of the NCC supports the view that if criterion (a) is satisfied, then criterion (d) should be satisfied as the benefits of regulation would then outweigh any costs.

All of these factors are set out in further detail in **Attachment B** to this letter.

For the reasons set out above, we urge you to make a determination that the SEPS should be regulated under the National Gas Law.

Please let us know if you require further information or if we can further assist

Yours sincerely

A handwritten signature in black ink, appearing to read 'Scott Usitalo', with a large, sweeping flourish above the name.

**Scott Usitalo**  
Managing Director  
Kimberly-Clark Australia Pty Limited

## Attachment A – The NCC has made two critical errors in relation to criterion (a)

### 1 Beach will supply commercially relevant volumes of gas within a reasonable time

- 1.1 As identified above, a key issue for the NCC in relation to criterion (a) of the pipeline coverage criteria was whether there is a 'real prospect' of Beach supplying commercially relevant volumes of gas at Katnook within a 'reasonable time'.
- 1.2 The NCC's identification of this issue is based on the decision of the Australian Competition Tribunal in the *Application by Services Sydney Pty Limited* [2005] ACompT 7 (**Services Sydney**). In that decision, the Tribunal concluded that the promotion of a material increase in competition in a monopoly scenario required there to be a 'real prospect' of entry by a small competitor within a 'reasonable time'.
- 1.3 In the case of the SEPS, the NCC has interpreted a 'reasonable time' as the 'short to medium term' (see para 6.34) which it explains as less than 2-3 years. KCA submits that this view is incorrect and inconsistent with case law, including the *Services Sydney* decision itself. By understating the time period, the KCA has not recognised the high likelihood of gas supply by Beach in the medium to longer term.
- 1.4 Specifically, in the *Services Sydney* decision, the Tribunal identified that: "*a time scale that is reasonable will vary from market to market*". The Tribunal then favoured a medium to longer term as the relevant time horizon, commenting for example:

*"...the actual entry of competitors into such an entrenched structure, even on a modest scale, is likely to take a **considerable period of time**... The very threat of competitive entry into the market in the **medium or long-term** will place competitive pressure upon the incumbent... We are satisfied that such entry is not precluded within a reasonable time frame."* [emphasis added]

- 1.5 The Tribunal also reasoned that an analysis of barriers to entry requires a longer time horizon (para 131). The Tribunal determined that the criterion for regulation was satisfied.

*"...declaration is concerned with improving the conditions for competition, by removing or reducing a significant barrier to entry. Other barriers to entry may remain and **actual entry may still be difficult and take some time to occur**, but as long as the tribunal can be satisfied that declaration would remove a significant barrier to entry into at least one dependent market and that the probability of entry is thereby increased, competition will be promoted..."* [emphasis added]

- 1.6 Accordingly, the very decision that the NCC cites as authority for the concept of a 'reasonable time' takes the view that a reasonable time is a "*considerable period of time*", involving the "*medium or long-term*". NCC has clearly misapplied the relevant case law on this issue.
- 1.7 Specifically, KCA submits that the concept of a 'reasonable time' in the context of the coverage of the SEPS inherently requires a medium to long-term analysis:
  - (1) The coverage period for the SEPS is proposed at 10 years. Accordingly, the competitive effects of regulation of the SEPS should be assessed over the full coverage period, namely the short, medium and long term.
  - (2) Gas exploration and supply activities involve long-term contracts and long-term investments. The gas industry adopts a medium to long-term focus, given that natural gas extraction and supply involve substantial lead times.
  - (3) The SEPS pipeline infrastructure itself is a long-term asset and its pricing is based on long-term costing methodologies. The inherent focus of a gas pipeline is long-term.

1.8 The implication of the NCC's incorrect interpretation is that it has understated the likelihood of Beach having gas available at Katnook within a reasonable time. The NCC has not sufficiently recognised that Beach should have substantial gas available in the medium to longer term. Accordingly, the NCC has erred in its decision and should have determined that criterion (a) was satisfied.

**2 There is a 'real prospect' of Beach supplying commercially relevant volumes of gas**

2.1 Based on case law, KCA also considers that the NCC has misapplied the concept of a 'real prospect' of Beach having gas available at Katnook. In effect, the threshold applied by the NCC was far higher than the case law indicates it should have been.

2.2 The discussion by the Tribunal in the *Services Sydney* decision indicates that a 'real prospect' is a "*likelihood of increased competition that is not trivial*". Other case law supports this view, including *Re Virgin Blue Airlines Pty Ltd* [2005] ACompT 5. In *Virgin Blue*, the Tribunal commented:

*"...we need to be satisfied that if [the relevant service] is declared there would be a **significant, finite probability** that an **enhanced environment for competition** and greater opportunities for competitive behaviour – **in a non-trivial sense** – would arise in the dependent market."* [emphasis added]

2.3 In the *Services Sydney* decision, Sydney Water (who opposed regulation) argued that access to its water network was "*highly speculative, with clear technical and financial impediments to its success*", hence the likelihood of increased competition was "*no more than trivial*". The Tribunal dismissed this argument on the basis that there was no evidence that the access proposal was not technically feasible, even if it was "extremely ambitious".

2.4 In this manner, the *Services Sydney* decision clearly indicates that a 'real prospect' of entry should be regarded as existing even where access is highly speculative and does involve an extremely ambitious proposal with clear technical and financial impediments. Moreover, the *Virgin Blue* decision requires that speculative possibilities must involve significant probabilities that are finite.

2.5 In the case of SEPS, this threshold for a 'real prospect' is therefore clearly surpassed. While Beach's exploration activities do involve some speculative activity, these investments are not 'highly speculative' or 'extremely ambitious' in the same manner as *Services Sydney*. Moreover, they will involve a significant and very real probability of gas becoming available at Katnook in commercially relevant quantities. Accordingly, Beach's activities are well within the relevant legal thresholds for a 'real prospect' as identified in the relevant case law.

2.6 Moreover, the NCC's consideration of a 'real prospect' must reflect commercial reality, as evidenced by the facts before it and the commercial decisions of the market participants. Beach's own submissions to the NCC state that Beach expects to supply gas at Katnook, both from existing fields and from new gas discoveries. Beach has also invested in Katnook facilities to ensure such supply can occur. The available commercial evidence indicates that Beach itself considers that there is a 'real prospect' of supply.

2.7 Accordingly, the NCC has again erred in its decision and should have determined that criterion (a) was satisfied.

## **Attachment B – The interests of consumers are paramount to criterion (d)**

### **1 The National Gas Objective gives paramount importance to consumer interests**

- 1.1 As identified above, criterion (d) of the pipeline coverage criteria requires that increased access to the pipeline services provided by means of the SEPS would not be contrary to the public interest. Under section 100(1)(b) of the National Gas Law, the Minister must have regard to the National Gas Objective when considering the public interest.
- 1.2 The National Gas Objective 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." (emphasis added)
- 1.3 A number of submissions relating to the National Gas Objective were made to the NCC on this issue and are relevant to your decision, including a submission by the *Energy Consumers of South Australia* dated 12 March 2013. These submissions all emphasise the importance of the long-term interests of consumers in the context of the SEPS.
- 1.4 Additional guidance on the interpretation and meaning of the National Gas Objective was recently provided by the Standing Council on Energy and Resources (SCER), which issued a Statement of Policy Intent in December 2012. In that Statement (which, the Productivity Commission has indicated, shifts the focus of the National Gas Objective), SCER stated that:
- "...in interpreting the ... National Gas Objective, the long-term interests of consumers (with respect to price, quality, safety, reliability and security of supply) are paramount in the regulation of the energy industry..."
- "...the long-term interests of consumers should be the sole criterion for determining the preferable decision, both at the initial decision-making stage and at merits review..."
- 1.5 In this manner, the National Gas Objective requires that the interests of consumers are paramount. The SCER has also stated that the long-term interests of consumers should be the sole criterion for determining the preferable decision.

### **2 Consumer interests clearly favour that the SEPS should be covered**

- 2.1 The various submissions set out in detail to the NCC why consumer interests clearly favour that the SEPS should be covered and are all relevant to your decision:
- (1) The Uniting Communities made a submission on 13 March 2013 and the Energy Consumers Coalition of South Australia made a submission on 12 March 2013, both which set out the concerns of both bodies in relation to the long-term interests of gas consumers. The existence of those submissions illustrates that consumers are concerned by the need for the SEPS to be regulated.
  - (2) This application is also unique in that KCA itself is a major gas consumer. Most applications for pipeline coverage are made by gas wholesalers, not major gas consumers. KCA has been sufficiently concerned by APA Group's conduct, that KCA has undertaken the unprecedented step of itself seeking to have the SEPS subjected to regulation.
- 2.2 In its Final Recommendation, the NCC identifies that criterion (d) requires it to consider whether increased access would not be in the public interest, rather than whether it would be in the public interest. However, the criterion still requires the net public interest to be identified (i.e., the costs of regulation must be balanced against the public interest in imposing

regulation). In this manner, the benefits of regulation as identified by KCA, Uniting Communities and the Energy Consumers Coalition are critically relevant.

- 2.3 Moreover, the phrasing of criterion (d) (requiring that increased access to the pipeline services provided by means of the SEPS would not be contrary to the public interest), has the effect of reversing the onus of proof in a manner favourable to regulation. In effect, the onus is on the pipeline owner to provide evidence that regulation would be contrary to the public interest, not the onus being on the access seeker to demonstrate that regulation would be in the public interest. The clear legislative intent was therefore to favour regulation, except where it would be demonstrably harmful.
- 2.4 Importantly, the NCC does not appear to have considered the public interest considerations in detail in its Final Recommendation. Rather, the NCC has focussed on criterion (a) and determined that because criterion (a) is not satisfied, it follows that criterion (d) is not satisfied. KCA submits that this is not the correct approach for the following key reasons:
- (1) First, criterion (d) is independent of criterion (a). The NCC should have independently assessed whether there was sufficient public interest in regulating the SEPS independent of its conclusion in relation to criterion (a). KCA submits that there clearly is such a public interest, given APA Group's ability to charge monopoly rents as against the very low cost of regulation. In effect, criterion (d) is independently satisfied.
  - (2) Second, criterion (d) permits the decision-maker to have regard to wider public interest factors beyond the matters set out in criterion (a). A relevant public interest factor is monopoly pricing. The National Gas Objective requires that the interests of gas consumers should be paramount.
- 2.5 For these reasons, KCA submits that:
- (1) The Minister should conclude that criterion (d) has been independently satisfied, given that the public interest is clearly in regulating the SEPS, irrespective whether or not criterion (a) has been satisfied. More precisely, increased access to the SEPS would not be contrary to the public interest.
  - (2) If criterion (a) is satisfied, as KCA has identified above, it follows from the NCC's own reasoning that criterion (d) is then satisfied. The NCC has identified that APA Group has overstated the costs of regulation, so there are few (if any) detriments from regulation.
- 2.6 Accordingly, the NCC has erred in its decision and should have determined that criterion (d) was satisfied