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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO THE GAS ACCESS REGIME

MR A. HINTON, Presiding Commissioner
DR M. FOLIE, Associate Commissioner

TRANSCRIPT OF PROCEEDINGS

AT ADELAIDE ON WEDNESDAY, 3 SEPTEMBER 2003, AT 10.04 AM

Continued from 2/9/03 in Perth

MR HINTON: Good morning. Welcome to the public hearings for the Productivity Commission's review of the Gas Access Regime. It's a pleasure to be here in Adelaide. My name is Tony Hinton. I am the presiding commissioner on this inquiry and my fellow associate commissioner to my right is Michael Folie. The inquiry started with terms of reference from the Commonwealth Treasurer in June this year, and in brief terms it covers the following six matters: benefits, costs and effects of the Gas Access Regime, including its effect on investment; secondly, improvements to the Gas Access Regime, its objectives and its application to ensure uniform third party arrangements are applied on a consistent national basis; thirdly, how the Gas Access Regime might better facilitate a competitive market for energy services; fourthly, the appropriate consistency between the Gas Code, the National Access Regime and other access regimes; fifthly, the institutional and decision-making arrangements under the Gas Access Regime; lastly, the appropriateness of including in the Gas Code the minimum - that is, price and non-price requirements for access to users.

The commission has already talked to a range of organisations, companies and individuals with an interest in these issues and submissions have been coming in to the inquiry following the release of an issues paper in July, which I'm sure you are all familiar with. We are grateful to the various organisations, companies and individuals in South Australia who have already participated in the inquiry. The purpose of these hearings is to provide an opportunity for interested parties to discuss their submissions and their views on the public record.

Following the hearings here today in Adelaide hearings will also be held in Melbourne, Sydney and Brisbane, and earlier this week we in fact had hearings in Perth. We are working towards completing a draft report for this inquiry, for public comment, by mid-December, and we will invite participation at another round of public hearings after interested parties have had a chance and time to read that draft report. That will occur in the new year.

Some of you may be familiar with our public hearings but I'd like to note that we do like to conduct our hearings in a reasonably informal manner. A full transcript is being taken. It is an on-record public hearing. Participants are not required to take an oath but are required, under the Productivity Commission Act, to be truthful in their remarks. Participants are welcome to comment, not only on their own submissions but also on other submissions. Comments from the floor cannot be taken, but at the end of the day's proceedings I will provide an opportunity for anyone who wishes to do so to make a brief presentation.

The transcript will be made available to participants and will be available from the commission's web site following the hearings. Copies may also be purchased using an order form, which is available from staff here today. As you all probably

know, submissions are available on our web site.

To comply with requirements in the Commonwealth Occupational Health and Safety legislation I note for the information of all participants, all attendees, the fire exits and evacuation procedures that operate in this building. They operate on a beep-beep whoop-whoop system, and I'm sure you are probably all familiar with that; it seems to be almost universal across Australia. The exits are immediately outside that door immediately behind you; there are two exit doors there.

That's the conclusion of my introductory remarks. I'd now like to welcome to the microphone Mr Greg Harvey, who is the chairman of the National Gas Pipeline Advisory Committee. Thank you very much, Greg. What I'd like to do at the outset is to ask you, for the sake of the transcript and to test that the sound system is working, identify yourself by name and your capacity of your attendance here today.

MR HARVEY: My name is Greg Harvey, and I'm attending in my capacity as independent chair of the National Gas Pipeline Advisory Committee.

MR HINTON: Thank you very much. That seems to be working. Thank you. What I'd like to do now is to invite you to make an introductory statement, if you so wish, of course.

MR HARVEY: Members of the inquiry, thank you for the opportunity. I would like to make a short introductory comment and then refer a little to my submission and hopefully leave enough time for you to raise any matters that are not clear or that you may wish to pursue. At the outset I want to explain, on the record, that I am defined in the Natural Gas Pipeline agreement, which sets up the code, as "the Independent Chair." And I'm sure all chairpersons wish to be thought of as independent, but that's how I'm defined. I feel, therefore, able to make my submission and to make these comments in that capacity, and at the same time emphasising, as I have in my submission, that I do not purport to speak on behalf of NGPAC.

Now, if that sounds a little Irish it's not. It is important that I affirm publicly that I do not have a mandate from the membership of NGPAC to make these comments. At the same time, having been the chair of NGPAC since its inception there is a bit of corporate memory that I wish to share, and I think, without being too precious about the whole thing, I will have formed some opinions which I feel may assist the inquiry and of course any other stakeholder or member of NGPAC is certainly free to challenge or further comment on anything I may say.

With those few health warnings, if I may also note that the inquiry will be receiving a pretty comprehensive submission from our secretariat and you may have

gathered from the care with which I have made a disclaimer already that we have had a few delays with our secretariat submission, which intends to be, as far as possible, a factual record of how the code was put together and what has happened since it has been enforced.

Inevitably, as you will see in the disclaimer to the full submission when it arrives tomorrow, I have chosen to make my separate submission leaving the secretariat officers to put together this sort of factual history. We have had some comments from some of our members about our interpretation of the facts but I am trying to make it clear to everybody that any stakeholder can dispute those facts. But I'm sure, for the record and for the benefit of the inquiry, some sort of background history, at least from the point of view of our secretariat, must be helpful.

Turning to this regime - and I note that the inquiry will look into a number of matters on which I have no expertise and into which I don't propose to stray, in relation to the broad aspects of the inquiry - I was present during the negotiation of the code and at that stage was chairman of the Australian Gas Association and, as I say, have been there to witness how it has worked. There are certain aspects that may offer some clues to the real and perceived difficulties that have arisen. The markets were very different at the time. We all know that a major utility, AGA, was already privately owned at that stage, unlike electricity where all the electricity utilities were basically publicly owned. Also we were absolutely at the commencement of a major privatisation in Victoria, where Australia's largest gas utility was about to be broken up.

Of course we had the Hilmer principles - I use the shorthand there. They were taken up in the competition principles agreement, or whatever it was called, and various other things. But in terms of the Hilmer principles I have taken these to mean - and I observed at the time that there was wide support throughout governments in Australia - bipartisan - that Australia needed access to, in this case, utility services at as cost effective a price as was possible to make Australian industry competitive, both against imports and in an export market and so on. A lot of that philosophy was built into the code, obviously.

I make the point in my submission, and I make it up-front here, that to move from the previous form of regulation of monopoly utilities, which was largely about price setting, to the new philosophy - for shorthand, drawn on the Hilmer principles - was to stop regulating the price and to start promoting the development of markets for the various services so that genuine commercial influences would be brought to bear and everybody said at the time, "Regulation will be light-handed." Some wag at the time pointed out that when you got down to it everybody wanted light-handed regulation and lots of it. So pretty soon it wasn't so light-handed after all.

Nevertheless, what certainly was required, in my view, was a real paradigm shift away from that price regulation, very consumer oriented, often politically influenced or policy influenced, and I mean that in terms of price equalisation in country areas; and that might be about decentralisation but it certainly wasn't about markets for gas, whereas the new regulatory approach was to have this complete shift away from that to something which would encourage investment in infrastructure, encourage the development of competitive markets for the sale of gas, for the very services associated with transmission and distribution. I'm not sure that everybody made that paradigm shift transition fully successfully and I think that, as I've said in my submission, is part of the reason that we seem to have quite a good tool but somehow we don't appear to have used it quite as well as it perhaps could have been used, and we have taken a long time in perhaps looking to finetune that.

Also at the time - and it's important I think to just remind ourselves - there were a lot of other matters that people thought were important at the time of doing this. For example, there were lots of preconceptions. We all have them and we still have them but they are different now. At the time governments were very worried, possibly because of some experiences in other areas, that service providers would be right into "gaming the system", and there was a lot of concern at the time about having a process that had time constraints all the way through, so that no recalcitrant service provider could actually delay the introduction of the new regime by "gaming the system" and challenging this, that and the other thing.

That had a huge impact on the perception of when a service provider could appeal or challenge a regulator and so forth. In some ways we got to a point where we were finetuning the process and somewhat forgetting desired outcomes, and I think that was a mistake and I'm sure you people would spot that early and take account of it in your deliberations.

I think a lot of governments and regulator participants in the process of putting the code together assumed that every service provider would be hell-bent on keeping users out and that they would have to be forced to the table to allow third party access, whereas the service providers immediately understood that their income was in providing a service for a fee and they had to attract customers. Unless people think - and as people did think at the time, "Well, they are a monopoly so they didn't really have to attract a customer." That was not true with gas. There was a fierce competition, and certainly in Victoria, in my home state as it were, between gas and electricity. Every household and every business in the country had to be connected to electricity. Gas was in many many cases - certainly in domestic markets - optional.

So there was always a need to get customers using the system and using the infrastructure and all the economies of scale that flow from that. There were

different alignments of expectations and suspicions, I guess. Then also it must be remembered that there were certain constitutional rights. Unlike electricity, where they were all publicly owned assets, governments could say, "Well, this is what will happen to these assets and this is how you will use them," the service providers at the time - one major listed Australian company, AGL had to take account of the fact that it had assets earning an income and, by golly, in the interests of its shareholders it wasn't just going to allow some hypothetical theoretical process to open up to third party access, to deprive without due process their right to earn a living from those assets.

So this also was taken into account and built into the code to a certain extent. Therefore, the service providers were able to achieve a number of things, which I think I've listed there. It was for the service provider to propose the form of access. It was their assets, and they should be given the opportunity to propose third-party access. The regulator, instead of trying to be an expert from day one and constructing a third-party access arrangement, will then comment on that against the code, which would put into place the various datum points.

It was also thought at the time - and one of the great failings of what happened subsequently - that a lot of people would spend time negotiating around the datum points contained in the code and, therefore, that the big players would say, "Yes, yes, yes. We know we've got to have in our access arrangement these various things." They would, nevertheless, negotiate according to their requirements of interruptibility or seasonal requirements, that sort of thing, for something around the sort of vanilla-flavoured access arrangement in the code. Because there was the huge small consumer aspect to be taken into account, there was care taken to have a vanilla-flavoured access arrangement.

Unfortunately, I think what happened was, once the code was announced, for reasons I put in my submission - which I largely attribute from just trying to sit back and think about these things - a lot of risk aversion, that people said, "Oh, well, let's work our way through this thing and we'll have our access arrangement lodged." Pretty soon, the access arrangement became the only game in town. Nobody tried really to negotiate their own bespoke access - or nobody much. So all the action was interpreting the code, and that meant very quickly regulators were perceived to have a very dominant role. Whether that's fair or not, I can't say, except that there was nobody else, and that gap had to be filled and there had to be access arrangements. I don't know why anybody expected regulators wouldn't regulate.

I feel that some of the service providers might have, earlier on, tried to cast off the baggage that everybody took with them at that time, which was sometimes inappropriate experience from overseas, particularly North America, where there were vast structures and case law, and where the outcome was a process rather than

market activity. It's big enough so that you get both in America, but you have an industry called regulation, and then you have an industry that comes after that, which is the marketing and services for gas. We have a very small and thin market in terms of how much commercial activity and competition is really yet available in terms of gas prices, switching flows of gas at a hub and exchanging volumes. That's all developing, but we had one basin per market at the time. Looking back, we should remember that we've come quite a long way from there, but all this regulatory activity was pretty focused on the constraints of the rules rather than the opportunities provided by the rules.. I hope the inquiry will find ways of recommending a reinforcement of the commercial initiative within the code, which is already allowed, and to have more of the commercial juices flow.

I'm not here to defend NGPAC's role. I am very conscious that it is highly likely, given some of the Commonwealth government, COAG statements or ministerial council statements about how they foresee a national regulator taking over and, I guess, the institution which subsequently takes on the role of supervising code change and so on. I'm not here to defend NGPAC, but I do want it to be understood and on the record that, in those early stages, the code was designed, and NGPAC recognised, that it was as framework only, a skeleton, if you like, as opposed to some other regulatory regimes - like the Tax Act, where people try to foresee every possible way of getting around it and there's an immense, complex regulatory framework.

We shunned that in negotiating the code, and we have a pretty slim code which is quite skeletal and allows flexibility for things to develop as they are required. We made a few mistakes. We wasted a lot of time, I think, on queuing policy and stuff like that, which is way down the track in most cases. I think there was some very heavy-handed application of the code to some areas that really couldn't sustain the cost of dealing with full-blown access arrangements, but a learning process has gone on. In terms of the institution itself, I've listed what I perceive are the major complaints. Some are factual, about the time taken to deal with matters, and that's there on the record for everyone; some are perceived, I think. There's been perceptions about lack of clarity between the code and Part IIIA of the Trade Practices Act. I think that was more perception than real. Anybody who actually asked the ACCC what they would do about some kind of a forum-shopping exercise between applying the code, or Part IIIA of the Trade Practices Act, would have been told very quickly by the ACCC and by a lot of senior lawyers around town that that was more perceived than real. Nevertheless, the perceptions ought to be removed, if they can be, and certainty and clarity will only assist the better operating of the code.

I'm taking far longer than I thought; of course, everybody does, I'm sure. Let me get to what I think is the main problem, which I haven't actually had raised with me personally. It's my own view. It's going to be terribly important this time round

to see whether everybody has the same understanding of what the objectives are and what the desired outcomes are. What would be very disappointing to me, and I'm sure to all the stakeholders at the end of all this, is if we get a much more streamlined process which gets us to the frustrations quicker than we are now. I've actually tried to characterise the misunderstandings in terms of the failure to make that paradigm shift. Everybody brought baggage to the table, all the stakeholders.

I think a lot of policy-makers, as I've said there, when they thought of competition policy, it was lumped together in the Trade Practices Act with consumer interest as well. Most regulators who are dealing with competition policy things also had to deal with a lot of consumer things, and that may be right but, if it is right, then it should be up-front and stated right. A lot of the frustration I saw with the service providers, and particularly people who bought assets coming in - they looked at the code. They looked at the documents leading up to the code. Nowhere is it stated that one of the real aspects of the code is consumer protection.

The consumer protection is implied by the outcomes, where you have competition, where you have a depth of market, where you have interconnections, where you have greater security of supply by infrastructure investment, wider markets and more development of gas, the consumers will benefit anyway. That was the theory, and I believe it was sound, and I think still is. If there are consumer matters to be raised, well, that's a different arena and, if those objectives and outcomes are still valid, then I think it's not beyond the governments involved to perhaps make that clear, that this code has these primary outcomes in its view and that the application of this code should be against that context, and we can quickly pick up if there are distortions and unintended outcomes along the way.

So if I can conclude by just underlining that, while these misconceptions are - in my paper I refer to - on the vertical plane, at the policy level, at the regulatory level, and I think even at the service provider level there was some misconception about how they could use the code. I was frankly disappointed that more service providers didn't push the limits of this code and look to see how it could be used to achieve their goals rather than reacted to in terms of the price-setting arrangements. So whichever forum subsequently deals with the administration of the code, I hope that the policy settings will be such that it is clear what they are supposed to do. Frankly, I hope that any such forum will include the obviously intended role of NGPAC, which it hasn't performed - that is, to be a real sounding-board for policy-makers.

NGPAC contains industry members. It contains both consumer and service provider. It has membership of regulators, which is a bit controversial in some areas, and it can make recommendations on code changes, but it is also charged up-front with reporting to ministers on how the code is travelling. That was not done, and it

was a deliberate choice of the stakeholder members not to do. One I think was a valid reason - namely, that it was very early and you don't want to move the goalposts before you really see how the game is being played. The other, which I thought was less valid, was that it seemed that there was a lack of trust and a lack of input of real intellectual horsepower into the process to actually try to spot how the code can be used proactively to achieve the outcomes, rather than reactively to get more information, or get more regulation, or limit the regulation, or doing all these technical process things.

MR HINTON: Thank you very much, Greg. Thank you for your submission, and we look forward to the comprehensive submission from the NGPAC secretariat, and I think you foreshadowed its being delivered tomorrow.

MR HARVEY: Indeed.

MR HINTON: That history will also be particularly important to us. Your past involvement and current involvement in matters to do with the Gas Access Regime bring a particular perspective to the issues that are in our terms of reference - and a very valuable one. So thank you for your participation.

I'd like to start off with an area which you particularly emphasised, and that's this so-called "paradigm shift", what was the origins of the access regime and the code and what actually got delivered. In particular, you, in your remarks this morning and in your submission, flagged this issue of consumer protection objectives that you flag as not being an inherent or important part of the origins of the access regime but, under delivery, in more recent years it has become an important part. I'd like to get you to explore further why you think that that flavour, that sort of objective became so important - whether it was the culture of the players, whether it was the code itself, or other factors that might be in play. I raise it with a looking-forward objective here - that is, if you can identify the source of that shift, from origin to outcome, if you wanted to redress that, then you'd want to look at the reasons for why it occurred. That's behind my question. So I'd welcome your comments on the forces at work that led to that outcome.

MR HARVEY: I used the "paradigm shift" phrase because to me that separates the actual institutional framework we've got - namely, the code, which I happen to think allows lots of freedoms and initiatives on the one hand - from the actual attitudes, and that's where I think the paradigm shift wasn't quite made. I think some of the attitudes didn't change. I'm old enough to have actually been through the introduction of the Trade Practices Act, and some of the same things happened then as happened during the introduction of the code - namely, lots of good lawyers, ambitious lawyers and various other experts from America and from the UK - at some pretty fancy rates per hour, I might say - came here to tell us how we could do

this, what formulas could be used in terms of average weighted cost of capital and wonderful things we hadn't really thought about very much in the gas industry. Funnily enough, we inherited some baggage of expertise.

We all understood, I think, it was a leap into a different way of doing things. I'm quite sure policy-makers were very concerned, and I don't mean this in any cynical way. Politicians in the policy seats were very conscious of this issue. In Victoria, anyway, I think the penetration to households was something like 84 per cent. So just about every voter was interested in the price of gas and, over the years, there were distortions in that pricing mechanism which could have political ramifications. They couldn't just ignore that. There were cross-subsidies, particularly in New South Wales, between industry and consumers.

These are very real problems, so I'm not blaming anybody for having difficulty. I am just saying that I think we were all a bit risk-averse. We didn't want to give up pulling the strings that we understood and so on, and I put in my paper I think - even on the service providers - I mean, what were the regulators to do? They inherited a regime, a set of rules, as they had with various other industries and so on and then their own sort of headline or their sort of constitutional basis acts - they were regulators of both consumer protection and competition and I don't blame the regulators at all for just doing their regulatory thing.

I can understand - and I have held senior positions in corporations - where people who were sent out to negotiate an access arrangement for an industry, for example, would do their very best and go back to their boards and the board would say, "Well, is that the best you can do?" and you'd say, "Well, yes, Mr Chairman." "What does the regulator say?" you know because this risk-aversion is at all levels in corporations as well as in governments and civil services and so on and I think people therefore were more than ready to look at experiences in other regimes, forgetting that we had a different market, our markets within Australia were terribly different, so I wouldn't have been surprised - in fact I am a little disappointed that there aren't more bespoke access regimes for different circumstances when you look at the difference between the market in Queensland and Western Australia, for example, to the market in Victoria: one is 50-odd per cent dominated by retail consumers with short pipelines and a big lump of gas right close by, et cetera, to Western Australia with huge industrial consumers; a pretty small - because of the climate and population - relatively small downstream consumer, retail consumer, population, and yet we've got one size fits all. I just thought we're a bit captive of this risk aversion and all look to sort of step in line and that, in the end, gives regulators the defining role as to how people behave.

MR HINTON: Some have put to us that when the code, the regime, was being designed that it was fairly late in the piece that distribution was added - that is, it had

an initial focus on transmission pipelines and that distribution came along late in the piece and that the reason for raising that with you is whether or not that particular developing was a source of refocusing on the interest of consumers as opposed to perhaps the basic origins of the code.

MR HARVEY: No. You're quite right that - of course, historically, at the time, distribution and transmission lines were owned by the same corporations, typically, and I guess at the time it was recognised that the distribution systems are really natural monopolies. The real scope for competitive assets were likely to be in the - were the transmission lines. I mean, you don't have two sets of distribution of gas pipelines in one location, to my knowledge, I don't think, anywhere in the world. I think it was tried in Hong Kong once, but anyway - that's why a lot of the emphasis was on transmission.

The history is that as people began to realise that, "Well, a lot of this is about transmission lines, what about distribution?" - we were running out of time. It was quite clear that the jurisdictions would not tolerate any further waste of time to finetune the code to have a comprehensive distribution appendix - or even a separate code - and we all thought it was better to have a code - a national, uniform code - than to sort of put it off any further and risk, by the way, going into far more detail, so then again this sort of framework approach - this skeletal approach - where you could let it develop organically, as required, was seen as the best way to go.

Personally, I don't think we have yet got to a stage where the opportunities offered by the code, as worded presently, actually constrain distributors too much. I note that distributors can apply not to be covered by the code. I know in one case that has been successful and I think others as well. I mean, commonsense and confidence in operating the system is beginning to sort of, I think, reveal that the code itself in terms of its terms has still got some legs. It hasn't reached its use-by date by a long way.

MR HINTON: Let's move on to NGPAC itself. It may be difficult for you to comment here, Greg, but given your current hat and your past hats, in the light of the experience of the operations of NGPAC would you have views on how you might have a differently constructed NGPAC today in the light of the experience of those years? Would you have different guidelines or authorities or capacities or membership? What sort of refinements do you think NGPAC might need to make it more productive than it has been to date?

MR HARVEY: I think in one word it's credibility. I think, sadly, because we all had a bit of exhaustion - regulatory reform exhaustion - we got the code and we all sort of sighed and sat back. Also we didn't want to try and move the goalposts too early in the process and there wasn't a lot of early activity other than people

scrambling to get their access arrangements in and there was a perception that it did nothing, and it did very little.

We were trying to cure virtually typo-type errors in the code and avoid internal inconsistencies we hadn't spotted, but there weren't going to be these major issues. Pretty soon therefore we had very good people attending the meetings but who weren't policy-makers in the broadest sense, and there were much bigger problems for the policy-makers to deal with in electricity and water and ports and God knows what, and I just think that we almost were victims of the appropriateness of the code - that we didn't have a lot to do early on.

That might sound a bit self-serving. It's certainly not meant to be. As to what you would do to improve the performance of NGPAC, I think you would need to have some kind of filtering device where the membership of NGPAC or a body which was to advise ministers on the effectiveness of the law and the code - ie, the regime - which NGPAC was supposed to do. That was its number 1 thing to do - number 4 was code change - but you know we just dealt with code changes.

I think you would have to have probably a limited number of meetings at a pretty high level of people who would be taking the helicopter view - the real next-to-the-policy-maker view - and that the more technical aspects of the code should be dealt with formally by some other group. I have been a bit frustrated because I believe many of these things we could have actually done within the framework we've got, but we could never overcome what I believe was a problem then and is an important issue into the future - that is, to lower the overheads, if you like. That is to say, when we started out we didn't have too many expert regulators in gas access regimes, or electricity access regimes, or any other access regimes, and I think the way that ministers are looking - that is, to have a national regulator for energy - can be the way to go in terms of reducing the overheads and filtering out some of the smaller technical things, but as long as there is no loss of focus on the differences between gas and electricity; ie, that the regulation and the outcomes of access regulation for gas are still retained very clearly.

I am sorry that that is a long answer and very unspecific. In terms of the exact membership - I still passionately believe that policy-makers can benefit from a body that actually includes in a formal sense industry representatives, not just guys picked out because they were senior in the industry as individuals on a board, but industry representative bodies saying, "Well, the industry as a whole feels that it's too heavy-handed" or, "We're not getting enough information" or something, so I think any code-change body should include industry representatives.

The question of regulated membership is a strange one. I think in classical administrative law you wouldn't really want to have the regulator who actually

applies the registration having the last say, as one inquiry suggested, in how you change the code. I think you really do need that separation. On the other hand, the regulators really do have the nuts and bolts carriage of applying - and why they shouldn't be there as consultative members. I don't see a problem with that.

MR HINTON: Given the nature of that history and the factors at work plus more recent developments, such as the suggestions coming out of the Parer report plus the existence of this Productivity Commission inquiry, where does that leave NGPAC in its current activities? I note that in your written submission you have flagged the importance of NGPAC continuing to get on with its business. Don't sit on its hands.

MR HARVEY: Yes. You see, I think there can be a danger - not in this inquiry, I'm sure, but at some earlier times - that we were talking about hypothetical situations and certainly some of the earlier problems, I think, in NGPAC were that many of those who were there negotiating the code were then sort of supposedly administering the code but actually were looking at the need to change the code and, while we're all clear that it was now operational, sometimes it was easy to forget that this - we have legal obligations - constitutional, legal, whatever you like to call them, but I mean the ministers cannot change the code, as it stands, without a recommendation from NGPAC.

NGPAC cannot make a recommendation without conducting an inquiry where there are significant issues involved, et cetera, et cetera. We can't just sort of put everything on hold, although we are putting on hold as many things as can sensibly be put on hold, but matters that have to be dealt with should be dealt with by NGPAC and can be dealt with by NGPAC, in my submission, under our present arrangement, but it will require, I believe, some commitment of the major stakeholders of the resources necessary to make that happen, so I don't want to hear complaints - for example, from service providers - that they can't get anything done, they've got to await the outcome of the inquiry.

It can be done now, and we have actually shown on one incident - in the case of one particular set of circumstances - that NGPAC is capable of getting itself stirred up and moving relatively quickly. It is always a problem that because each minister has to approve and because in any given quarter - or certainly half-year - there is going to be a state election somewhere - that can slow things down - but the commercial activity can get a very, very clear steer in a relatively short time if the effort is put in - if the resources are put in.

DR FOLIE: Greg, going back, and a slightly more detailed question - going from Hilmer through to the paradigm shift - one reads a lot and that appears to have been the intention. The code, as it then emerged - this is where I have the gap into actually what happened or what the dynamics were - is very much a price-regulatory

document. I mean, the scale of section 8, the issues it requires, then, into that - really is basically price regulations and therefore the outcomes and the issues we're seeing at the moment are then follow-throughs from that because the regulators have to follow what's in there. What sort of happened that that heavier emphasis came through in between - because there was a consensus. It got signed up and everybody went with it - somewhere the paradigm shift got lost in the making of the code or did it not?

MR HARVEY: Call me naive, and I probably deserve to be called naive - naive in this instance - but I think everybody understood that you had to have a dispute resolution mechanism. The consumer groups - and at that time we're talking about the Business Council of Australia, which was then an enormously powerful body - represented at extremely high level by the way. The chief executive of a very major company in Australia was there every session and so it had to be clear, or I'm sure the policy-makers would not have accepted it, that there was a path to get to an access arrangement that was transparent in the way that the tariffs were charged.

In fact, we even put in the code that the tariff must - I can't quote it, but the essential part was that it must be clear in the access arrangement the basis on which the tariff is derived. You know, a lot went on about, "Yes, but there is an asymmetry in information available," et cetera, and pretty soon we were getting more and more definitive about how you could get to a regulator-approved tariff.

I think because of some of this baggage of the process in other places, and for the risk aversion that I've already referred to, there was a tendency to exhaustively thump that tub, really go down all the highways and byways when, in my view, and this is the naïve bit I suspect, if the outcome was to allow access that had a commercial basis that allowed people to get on with their businesses, and it had the capacity to limit any tendency to extract monopoly rents, then a lot more freedom could have been operated on.

But this baggage thing, I mean, I refer to the behaviour of the regulators, which I don't criticise. I mean, regulators regulate and they regulated against a background of the Trade Practices Act, and various other things, pretty comprehensively. Nobody ever guided them and said, "Ease up, guys. Let's get this show off and running and we can revisit these things. You know, a fraction of a cent here and there, is it really so important for the consumer?" You know, really and truly, what is the cost of gas element in some of the tariffs? Remember, this is the vanilla-flavoured tariff. Anybody can just walk in and take it.

So, you know, I just felt that far too much detail and risk aversion was built into that process of setting those tariffs. Now it is done, but as new projects come on board you can see the sensitivity and one of the really truly perceived - whether it is

justified or not, the truly perceived problem is that there is a growing sovereign risk with our regime, and I don't think there should be. I don't think the regime, even as it is, is that bad. Therefore I think some riding instructions - that's why I say, you know, all the policy settings, including the role of the regulator, need to be aligned for what the agreed outcomes are, and we ought to have the courage to say, "If the greater benefit is" - I'll give you an example - people along the Murray used to shiver through their winters, because they couldn't have gas from the Gas and Fuel Corporation, because the Gas and Fuel Corporation wasn't allowed to sell gas at more than city price. You just couldn't put those assets in.

We had a stupid situation where at that time along the Murray the cost of central heating was twice the cost in electricity as it was for the actual commercial cost of putting the gas in, which itself was 50 per cent higher than the city price. So we got voters along the Murray and said, "Go and tell your MP, 'We will be happy to pay more than the city price for gas if we can just have the bloody assets there, because it will be half the cost of the electricity.'" I'm afraid that we are getting some of that kind of thing - nobody will ever be cheated in Mildura about the tariff in the distribution system there, because you know we've gone through it with a fine toothcomb. I mean, maybe the people in Mildura just want the bloody gas - I'm sorry, we're on the record here, but I get a bit passionate about these things - - -

MR HINTON: Greg, I'm going to try my hand at three issues that seek to - get you to comment on - areas you have already cast comment on, but see how that might take you down the track of leading to refinements in the Gas Access Regime and the code. That is, you flagged issues, but I'm now trying to get you to be slightly more specific about what that might mean for specific change. I know that's speculative, but we'll see how we go. The first one was in relation to commercially negotiated outcomes. You expressed some concern that these were not occurring to the extent that was initially envisaged, and that they were reverting to the default option of regulated outcome. What can be done to the system to address that particular criticism, is my first question, in this broad category?

MR HARVEY: To the system?

MR HINTON: Too tough?

MR HARVEY: No, I'm sort of philosophically caught - I'm hoist on my own petard, because I believe, and have always stated very openly, that you cannot create competition. You can facilitate it. You cannot create markets. You can facilitate their growth. We may be somewhat captives of the stage of maturity of our gas markets. Let me give you an example: in other markets where the industry, for example, relying on the systems is more diverse, deeper, bigger and so on, there are more opportunities to finetune and consequently there is experience of finetuning.

The example I give is the oil refinery that during the summer months wants all the refinery gas it can get its hands on to convert to motor spirit, whereas in the winter it is making perhaps a slightly different mix of products and can actually use some of its own internal refinery gas.

So we put to a refinery in Victoria - this is when I was in Gas and Fuel - "Why don't you look at striking a deal with us, where you pay less for gas in summer and more for gas in winter, because you don't need it as much in summer and we need it more in winter." This is the natural gas. You can sort of then start to balance loads and systems, and I'm sure this is all going on now. Maybe we are somewhat captive of that process getting a little more mature and transparent to actually come down to forcing people - not only taking them to water, but forcing them to drink. I also recognise that I'm a little bit out of the game now and I don't have specific examples, but I can remember prompting one senior executive of a gas company who was complaining bitterly about not being able to get access to a line and may have to build its own, that they really should test the rights available to them - had they actually taken a QC's opinion as to what they could do to force their way in, and so on.

You know, that's what the whole idea of an access regime is, that people have rights and they have got to exercise those rights. So I'm really fudging this one, I know, but also seriously issuing a bit of a caution to say the more we try and anticipate what people ought to be doing and changing the regulations to suit that, I think before the ink is dry we will have found we have actually provided for a situation that is slightly askew to the one that will arise. I think governments can encourage. I think industry associations can encourage, and I think professional organisations can be more imaginative in how to use the tools. I am very leery about changing the tools before they have actually identified what the uses are. I would rather design a tool for a use than a use for a tool.

MR HINTON: My second question in this category relates to your passing comment, rather than direct comment, on timing issues, that efficient regulation is timely regulation in simple terms, the implication being from your comments that some of the outcomes from regulatory intervention prove to be less than timely.

MR HARVEY: Yes.

MR HINTON: And certainly some others have alluded to that as well. What sort of mechanisms, techniques or refinements might be possible to seek to improve that?

MR HARVEY: So long as people are determined to take the adversarial legalistic route I'm not sure that you can do anything other than impose time barriers along the way, and then you will leave people unsatisfied anyway, ie that a regulator only has a

certain amount of time to approve an access arrangement, then the regulator may call for more information. That information has to be replied to, or supplied, in time for the regulator to take it into account within his time frame, et cetera. Pretty soon, if people play this - I've got to be careful - not gaming it, but just sort of going to the risk-averse extremes, it is going to be a time-consuming matter, and I think that the length of time for approval of certain access arrangements has much more to do with risk aversion than to the technical provisions of the code.

If I had one sort of magic wand to wave, it might be to provide the regulator with a safety valve, which would allow the regulator to say, "Right, this looks to be pretty much okay, and I haven't heard anybody say that a finetuning of the tariff to this percentage point will actually kill any industries around this place, so let's run with it." I mean, this is a service provider, he has got a living to make. If people go out of business because he's charging too much, who - I mean, he's living, he's looking a bit shaky. So let's believe what we said we believed and give the regulator perhaps the technical ability to maybe revisit a tariff.

Of course, this immediately runs into the problems of uncertainty and so on, but for the sake of timeliness people are going to have to make judgment. Would they prefer a timely assessment of an access arrangement, with the trade-off being the ability to revisit if things don't look right, or are we just going to go ahead and play this hard ball, risk-averse, legalistic thing? Then you've got to accept the time, cost and frustration and the creation of an industry of regulating as opposed to promoting industries in the use of gas services.

MR HINTON: My third category is a bit broader than the last two - - -

MR HARVEY: I nearly got specific there, by the way, didn't I?

MR HINTON: I saw that. My third question in this category is a bit broader than the last two. That is in relation to your comments that what was needed was rather than a refinement of process, though that be useful, what was more fundamentally needed was a consensus around desired outcomes about basic objectives regarding the code, the access regime. Do you have any suggestions about how that can be delivered? For example, you might wish to comment on having a more explicit specific prescriptive objects clause that could also include in fact things that it's not about - that is, a negative list as well as a positive list. Do you have any views on whether that area is some sort of rich vein of possible improvement?

MR HARVEY: I know that in, I think, the Productivity Commission's inquiry into the access regime as a whole, that the question of an objects clause in Part IIIA I think was raised. I personally thought that that had more than a modicum of merit, if I may be so bold, because in the absence of something like that people have kind of

nowhere else to go but the straight rules on the page. I just draw the attention of the inquiry to the remarks in the code itself. I think, slightly unusually, there are quite large italicised notes and those italicised notes are referred to in the body of the code as intended to be some guidance as to what was - you know, how people should sort of approach the code.

For example, it stated in there - I remember, because I was a bit passionate about getting it in and I paraphrase - but, you know, the date and points must be contained in the vanilla-flavoured access arrangement. But it is envisaged that people would negotiate around those things. That could have been taken up by regulators, if they had been encouraged to do so, to say, "Look, let's try this a bit. We don't know yet that people are going to get very adversely affected if we are .1 of a per cent out in this or that calculation."

I'm starting to lose the thread here, but there is something I really do want to say. We also should remember, in case somebody says consumer protection is a very important part of all this: who are the consumers under our code? Big ugly companies are the consumers of these services. We're not talking about the energy consumer here.. We're talking about marketing companies, who also market electricity now, marketing gas and buying distribution or transmission services. Do we really think they are incapable of doing some calculations of their own? Does it have to be exhaustively thrashed out by the regulator in every detail? Couldn't the regulator be encouraged in some way to say, "I don't see that there's a big problem here. I shouldn't be taking the role of exhaustively going through anything here. If anybody's got a complaint, they're big and ugly enough to come along and put their case to the regulator." I'm exaggerating here, and that happens to a certain degree, but I really think that should happen. Could you just remind me of the main thrust of your question? I really will try to answer it.

MR HINTON: You have touched on it, Greg, this objects clause.

MR HARVEY: The objects clause, yes. Yes, I really think that's probably worthwhile. The other thing, however, I did bear in mind as you asked that question, there will be at some point the temptation by jurisdictions and their supporting civil services to have a nice elegant and, hopefully, uniform approach to regulation of energy. That's certainly terrific and, in terms of the administrative steps and overheads in that process - documentation and all that - marvellous. Let's have one body doing it, but I do think that there are major differences between gas and electricity. I think this just heightens my keenness to see riding instructions, for want of a better term, to regulators in that they are administering a discrete Gas Code at the moment and, hopefully, into the future a code that is discrete in terms of how it affects gas and takes into account the physical differences between gas and electricity, if that isn't too Irish, so that we don't get one size fits all.

For example, you've referred to a different code for transmission and distribution, let alone gas and electricity - I think riding instructions for the regulator embedding the flexibility to have some differences still between gas and electricity and how they're regulated, taking into account the sort of nature of the investment. A couple of things - you can build a generating plant for electricity anywhere you like. I mean, there are cost factors, but you can get an engineering firm and they will put it up for you. Gas is where God puts it, so you can't say, "Well, let's have a transmission line A to B," unless you've got the gas and a bayside customer and those kinds of things. So there are differences.

MR HINTON: Thank you very much again for your submission and your appearance today. We appreciate the time and energy you've taken to contribute.

MR HARVEY: Thank you, Mr Chairman. Can I specifically make an offer to appear before you again, because I think I'm the only person who could possibly appear, when you've had a chance to look at the large submission from the secretariat. I emphasise that I would do so only to clarify any points, and I will not make this rambling discourse again. But it's a large document, and I would be happy to try to assist you if you wanted to do that in open hearing or in any other way.

MR HINTON: We'll be in contact with you on that exact point. We've got a schedule of hearings, as I foreshadowed in my introductory remarks, but I'm sure there is some flexibility at some point. Thank you very much, Greg. We are scheduled to have a morning tea break for five minutes. Some of you don't need it, perhaps. Some of us might. We'll return here at 20 past 11 and we'll move to the second session after that.

MR HINTON: Let's move to the second session of this morning's public hearing. I now invite Mr Lewis Owens and Mr Adam Wilson of the Essential Services Commission of South Australia to take up the microphones, please. In my introductory remarks this morning, I noted that the commission prefers informality in its public hearings, and that's the way to proceed. We find that most constructive for useful public hearing information gathering. What I'd like you to do at the outset is, for the sake of the transcript and double-checking the sound system, to identify yourselves and who you represent, please.

MR OWENS: My name is Lewis William Owens. I am the chairman of the Essential Services Commission of South Australia.

MR WILSON: Adam David Wilson, principal policy officer, Essential Services Commission of South Australia.

MR HINTON: Thank you very much. I now invite you to make an introductory statement, if you so wish. It's not essential, but it's certainly usually very useful if that were to occur. So if you do have an introductory statement, I'd welcome it.

MR OWENS: Thank you, Commissioner. We have made a written submission, a short one, to the inquiry, but perhaps if I can at least emphasise the main points in that submission and start off by emphasising that ESCOSA, as we call ourselves, the Essential Services Commission of South Australia, has had only very limited experience in the gas access regime. Our responsibilities commenced on 1 July this year so, in effect, we've only had two months of experience in operating with the gas access regime. It goes without saying, therefore, that your commission should treat our comments with caution, as we simply haven't been involved in any meaningful regulatory activities on gas. What we can offer are some preliminary observations about this regime and perhaps some comparisons with other regulatory regimes that we have been involved with. Our responsibilities in South Australia include electricity, gas, the ports of South Australia and the Darwin railway. I'm also an associate commissioner on the energy committee of the ACCC and, through that, have had some limited exposure to gas issues when they come before the ACCC.

We make four main points in our brief submission, and perhaps if I just touch on them: the first one relates to the question of the objectives of the gas access regime, whether they are sufficiently clear, whether they are comprehensive and whether there should be a clearer statement of those objectives in the code. It goes without saying that this issue has been compounded by the Western Australian Supreme Court decision relating to sections 8.1 and 2.24 and how the regulator considered, or did not consider, those appropriate matters, and further compounded by the recent Victorian Supreme Court decision on the decision of the Electricity Tribunal about not explaining why a piece of information was not used.

I'd point out that under our own legislation, the Essential Services Commission Act, we also have an obligation, when we are carrying out our responsibilities as regulator, to have regard to a number of other objectives. With respect to gas, the recent amendments to the gas legislation in South Australia unusually but specifically excluded one group of those objectives in our act from being applicable to our decisions in gas. Section 6 of our act, which sets the primary objective and the subsidiary objectives that we are to have regard to in making our normal regulatory decisions - have been banned from consideration when we exercise our powers in the gas access regime. But they didn't exclude the objectives in section 25.4, which deals with factors that we have to have regard to when we're making pricing determinations. Those things do introduce an additional set of objectives that the regulator is required to have regard to in addition to whatever criteria and objectives are set out in the gas arrangements.

The issue there that people talk about is either a lack of clarity or, secondly, a potential conflict between these objectives, and they are seeking some form of greater certainty about how a regulator may go about their job. My comment on that is that it is that complexity and the need to balance multiple objectives, some of which are mutually contradictory, are exactly the reasons for setting up a regulator who is independent of government and independent of the industry and who has the responsibility to have regard to that multitude of factors, analyse them and comment on them but, ultimately, to make the call as to what is the appropriate balance.

So whilst I can appreciate why people are looking for greater certainty and some greater clarity, at the end of the day I think they need to understand that these decisions are never black and white. They will always require a regulator to balance a number of these objectives and, as long as the regulator is able to explain why they are giving appropriate consideration to certain factors and why they are giving less consideration to other factors, that's what a flexible and a responsive regulatory regime is all about.

The second issue that we touch on is this question about the handling of distribution versus transmission aspects of the regime. It seems to me that there are different issues, that transmission regimes tend to be more nationally oriented. Their customers are clearly the retailers, whereas distribution networks are more local, and the main impact of the distribution regulatory decision is an individual consumer impact, even though the arrangement may be between the distribution network and the retailer. The impact in terms of service standards and prices are on customers as individuals rather than specifically on the businesses.

So my view at this stage would be that it is appropriate to have two different regimes, or at least to treat them differently within the regime, to recognise that the

factors that drive investment in transmission networks are quite distinct and different from the issues that drive investment in distribution networks. It would seem to me, with my considerable two months of experience, that the problems that the industry has raised seem to be more to deal with transmission investment and regulation of transmission networks rather than with the distribution networks. That may be too early, that the distribution network problems haven't had as long to emerge, but the question will be whether a different regime would be more appropriate, and my answer to that is I think it would be appropriate to try to treat them in some way differently.

The problem that I see with the transmission network seems to have been the issues about whether there is competition between alternative sources, and that can be a very esoteric, academic debate as to whether supplies from two different sources are in competition with each other in a particular market. The other problem that has emerged with some existing transmission pipelines is how governments set them up for sale and how they locked in the value of the asset at the time of sale. It seems to me that if governments had been a bit more specific at the time, then some of the issues now dealing with those existing assets might not be as problematic as they currently are.

The third issue is the question of access regulation and new investment. As I've indicated, we don't see, at this stage anyway, the question of investment in the distribution network as the real issue. The regimes for the gas access regime arrangements for distribution networks seem to be more predictable. The investment in expanding those is reasonably predictable, and I would have thought that the arrangements that have been created provide sufficient incentive for the continued expansion of the distribution network.

The problem seems to be more with transmission, and particularly in the greenfields situation of how can an investor justify investing in a new transmission line, given the great uncertainties about that greenfield investment. In our submission we have drawn a comparison with the arrangements that we have put in place for the Darwin railway. Clearly, in our view there are similar characteristics associated with that risky investment in a service with an unknown future demand and the regulatory regime that we have put in place there we are suggesting might be one that can be used in looking at transmission investments for the gas industry.

We have given the commission our determinations in the rail area. They are reflected in the commission's assessment of the access regime overall, in terms of truncating returns and the impact of removing the blue sky potential by a regulatory decision which sets a WACC at a lower level, given the wide range of returns that a greenfields investment could expect. We believe that the approach that we've taken on the Darwin railway is one possible model to address that. Clearly there are others.

The commission itself has talked about access holidays.

Our view would be that some people might feel uncomfortable about letting an investor have a long period of time without any regulatory protection. If they want some regulatory system in place then the approach on the Darwin railway is one that gives some minimal regulatory guidelines but essentially leaves it to the market to sort out commercial arrangements and is a particularly flexible approach for doing so. So people have comfort that there are some rules associated with that project. But at the end of the day we would hope that the regulatory regime is not needed at all, that the investor and the users of that service are able to sort out their own commercial arrangements and that the regulatory regime is never called upon. I'm happy to talk about that as a possible model although accept that there are other approaches that are perhaps equally valid.

Finally, we comment in our submission on the regulatory approach, and this probably is a bit presumptive on our part because, as I say, we haven't been exposed to the Gas Access Regime for very long. But it does appear to me, in these early days, that the Gas Access Regime, from a regulator's perspective, is a very reactive regime. The regulator was put in a position where the regulator waits for the proponent to come forward; it waits for the proponent to advance matters. The regulator seems to me to be almost powerless in terms of time lines and moving things along.

I, as a regulator, prefer a much more proactive approach by a regulator. We have in ESCOSA what we call our ABC of regulation, a philosophy or an approach to regulation where the A is simply achieving the objectives of the act, B is balancing the regulatory bargain and C is in a climate of regulatory collaboration. Our approach is to work up-front, proactively with the industry, to help them define what is the service that is to be provided, what is the investment that is appropriate for that delivery of that service and to jointly develop the regulatory system, as opposed to an approach which has the regulator as this superior entity responding to proponents' documents, seeking consultants, critiques of those, and creating what I see as a litigious and dispute-oriented approach to regulation rather than a collaborative or a joint seeking of desirable outcomes.

Now, it appears to me that the way the Gas Access Regime is designed is not conducive to that approach. The timing and the initiation are very much in the hand of the proponent. The proponent is able to drag out, for a considerable period of time, the processing of that application, and you have some horrendous examples of the length of time taken to get some of these regimes put in place, whereas I would be looking much more for a collaborative and joint approach, as we have put in place with regard to the railway and the electricity industry and the South Australian ports. As I said, it's a gratuitous observation. It may not be the actual situation but it is

certainly my observation in the first couple of months of dealing with this industry, relevant to some of the others.

In conclusion, I certainly believe that the Gas Access Regime is different than the other regimes that we've had to manage. Some of that is due to the fact that gas is a different product. I used to work in the gas industry. I believe I have a little insight into the ideology and the values of that industry, and they are different from what applies in the electricity industry and the various other ones, and that's reflected, I think, in the approach to the regulatory regime that the industry has created.

So it is different. Gas is a different product. But on the other hand we are committed to, wherever possible, creating a regulatory regime in gas that is similar to the regime in electricity. We can certainly do that at the bottom end, at the retailing end dealing with consumers, and indeed we are currently working on - Mr Wilson has recently produced a draft energy retail code that would apply to both electricity and gas retailers rather than having a separate electricity retail code and a gas retail code, and we believe that that is achievable and possible and gives greater certainty to consumers because the rules would be similar and would look similar.

The further up the chain you go, that becomes more difficult. We don't envisage at this stage that it's possible to have an energy distribution code. We think we will probably end up with an electricity distribution code and a gas distribution code and similarly up the chain, but at least if we start at the consumer end we believe this convergence has some potential benefits to consumers, in terms of understanding the way in which the energy industry works.

As I indicated, our early assessment of the regime is that it puts the regulator in a reactive position, unable to show initiative and innovation, and that that tends to result in a more litigious or dispute-oriented approach than one where a more collaborative arrangement or more parties working together to get the right outcome could deliver.

For two months that's probably as far into the territory as I would wisely go. I have probably gone too far already. I just come back to my early qualification. I urge the commission to take my comments with caution. We've got a lot to learn. We look forward to the lessons that the commission receives from parties who have been involved in the industry for a lot longer than we have and so we are certainly very keen to follow the course of this inquiry, to learn from it, to hear what the stakeholders are saying about it and, where possible, to apply those lessons in what we do in our role as well as to see what changes at the national level. I'm very happy to try and explain some of those views and plead for kindness and sympathy perhaps if you push too hard into some areas that we are not real experts on.

MR HINTON: Always kindness and sympathy from the commissioners. Thank you for those comments. I suspect you are doing yourself a disservice. Thank you also for your submission and thank you also for sending us those determinations with regard to the rail determinations. My comments about disservice was not so much on what you said but your self-deprecatory words that I don't think did you justice. I had better clarify that for the record because it was ambiguous actually.

MR OWENS: That's how it was taken.

MR HINTON: It's the danger of transcripts. I'm particularly interested in your comments, and grateful for them, regarding the intersection of your responsibilities regarding Gas Code and Access Regime, relative to other legislation that you are obliged to administer under South Australian law and how the two relate. That is an issue for the commission regarding this inquiry, across a number of jurisdictions, so thank you for that. It's that issue that in some ways illustrates quite dramatically the first area of your four areas for comments in your submission and your remarks today, that is, this issue of objectives of the Gas Access Regime.

Some have put to us in very blunt terms that - it's a bit like the old debate with monetary policy: single instrument, single objective. As soon as you seek to have more than one objective for a single instrument you end up with the worst of all worlds: you don't achieve any of the objectives. But in case of regulation as opposed to monetary policy - I won't take the analogy any further - there is an issue of regulatory uncertainty, it seems, and that message has been loud and clear to us in terms of the experience with the Gas Access Regime, and part of that uncertainty derives from lack of clarity as to what is this intervention about? What is it trying to achieve?

Therefore I'm a little puzzled by your qualifying remarks, on the one hand saying, "Greater codification, more explicit codification of the objectives is something we should be pursuing." But then you go on to talk about, "Well, trade-offs are good. Flexibility is important." Prima facie that seems to be hard to sustain if one of the objectives of refinement is to bring less regulatory uncertainty. So if that's my starting point - it's not necessarily my view; that's my starting point - in this discussion, the issue then becomes one of, "Well, maybe there are other ways to achieve those other objectives, other instruments." Let's take the consumer protection or consumer interest aspect of the objectives.

If the code cannot address that because it's addressing something else, such as an efficient energy system or a gas access system, then maybe consumer interests should be addressed by other policy instruments available to government and then it would be government making judgments about those relative trade-offs rather than a

regulator, which at the end of the day is regulating legislation. Can you react to that sort of blunt formulation?

MR OWENS: You have raised a large number there so I will have try and remember which ones to pick on. In terms of whether it should be government or regulators, in terms of setting these consumer protections, it seems to me that this whole access regime legislation was about getting government out of its position to be able to make whimsical choices and to change the rules, that it was to be put in the hands of an independent person who didn't dance to the tune of the government and wasn't in the pockets of the industry but who had some objective of trying to balance those interests.

I would certainly be supportive of a view that says many of these consumer-oriented protections should not be in the gas high-level documents: the codes and regimes. That is certainly what we try and do, and we are having this issue with the gas industry at the present time. The gas industry wants to put them into gas market rules and are developing a document that is hundreds and hundreds of pages thick in the gas market rules, as opposed to us saying "Keep the rules as tight as possible," relating to the dealings between the industry and the companies within the industry, and we will handle the consumer protections in codes that are issued under the Essential Services Commission Act. We have the ability to produce codes that are binding on licensees in these industries.

We feel that once you tie all of those consumer protection issues up in the higher level documents you introduce a degree of complexity and inflexibility that you don't have if you put them - for example, if these market rules have lots of process-oriented things in them, that you will respond to a consumer within three days, or da da da da da, if a business operating under those rules doesn't do that and takes four days to answer they have broken the market rules, they have breached their licence. Breaching a licence condition has a much greater significance in the legislative regime than if under a code you have gone for four days instead of three days and that's a best-endeavour objective.

So my belief is that there is a philosophical reason why regulators should be with the industry and with consumers setting these appropriate standards, not governments. Indeed, that is the B in the ABC of regulation - balancing the regulatory bargain. I mean, what we are doing here is we are saying, "Consumers want and are prepared to pay for a certain level of service. This is how we will define that in terms of the number of interruptions, how quickly telephone calls will be answered, how long it will take for a connection to be made" - those sorts of service standards. "That is what we will now agree, a price that equals that bargain."

You increase the standards, you increase the price. You lower the standards,

you lower the price. The regulator is in that position of having to balance them, so we need to be involved and given the right to set the standards, otherwise we are setting a price with one hand tied behind our back. It's a bit like the ACCC often does - sets a price without actually ever setting the standard or the bargain that goes with that.

In terms of the very first point that you raised - the contradiction between saying that it would be greater to have the objectives clearly spelt out and the advantages of having multiple objectives and the ability of the regulator to be flexible and make that judgment - I think what I was saying was that because there are so many different objectives that we are called upon to make judgment about - and in the gas regime, in my case, it will now be section 8.1 and 2.24 and section 25.4 of my own legislation, and they are all different groupings of factors - that it mightn't hurt to try and at least reduce the number of them because - without trying to get it down to a simple objective - what has been the implication of the Supreme Court decision in Western Australia and the Supreme Court decision in Victoria is that the size of our determinations now are about three times what they would otherwise have been.

The two messages we have got are that we have to - from WA - make a comment on every factor that is spelt out and indicate, "We have given consideration to it and this is the appropriate treatment and it has influenced our decision and here's the final answer." That's the view of the Epic decision. The view of the Victorian Supreme Court is that in accepting evidence to come to a particular decision we not only have to explain why we have preferred that particular piece of advice; we also have to include in our determination why we have not taken another piece of advice that we've rejected.

That's fine. I mean, it's what we're doing all the time but perhaps in the past some regulators haven't been as compliant as they should have been in terms of putting all of those views into their final decision, so to have fewer of them to be able though at the end of the day to say, "Well, I've had regard to each of these factors. This is the appropriate analysis of them" I think still then encapsulates the reason that a regulator exists, which is to deal with a complicated, multidimensional, often contradictory set of objectives, and to come up with a decision, which is ultimately appealable.

Just very quickly, it was interesting that the Essential Services Commission of South Australia was actually created last September - it's our first birthday this coming Friday. We took over from an organisation called the South Australian Independent Industry Regulator, which was created in late 1999 and, to all intents and purposes, it is the same organisation, it is the same person leading it, it has the same staff, essentially the same legislation, but there were some subtle changes.

The South Australian Independent Industry Regulator had a set of objectives that were about eight in number and the regulator was required to make decisions and balance those eight factors and to give whatever weighting we wanted. The change in the legislation to set up the Essential Services Commission changed that and created a primary objective, which is to protect the long-term interests of South Australian consumers of essential services with respect to price, quality and reliability of supply, a primary objective, and the commission is required to have regard to, alongside that primary objective, these other factors.

Those other factors include the financial viability of the industry and the need to encourage investment but, indeed, if you go back to the primary objective itself it talks about the long-term interest of consumers, and so one can certainly argue, "Well, whilst a short-term interest of a consumer might be to reduce the price, if the impact of that is to stop investment in the infrastructure then that is not in the consumer's long-term interest, so there is a justification even in the primary objective for having a long-term view on the network, but it is rather interesting I thought that this subtle change between having to balance a number of objectives equally emphasised in the legislation to one now of a primary objective and then the secondary one.

What I said is potentially contradictory, but I guess I am observing that the more of these different sections that you have to have regard to, the harder it is in writing the final determination to ensure that you have ticked them all off, especially in our case, where we have different situations for different industries, so the Darwin railway doesn't come under our work as the Essential Services Commission, so the criteria don't apply to that. It partly applies to the gas and not all of it. It all applies to electricity. We have to be very careful when we're changing hats to ensure that we are addressing all of them and some rationalisation of that would be appropriate.

One final comment, because you did raise a whole host of them when going through - talking about getting the rules right versus other ways of achieving that regulatory certainty, and I bring that back to the C in the ABC of regulation. The collaborative approach to regulation that we adopt is intended to have no surprises. We start an issue with an initial thoughts paper. It's a bit like your own approach to an inquiry.

We have initial thoughts. We'll have a discussion paper. We'll have a preliminary conclusion. We'll have a draft determination.. We'll have a final - before we even put those papers out for public comment we sit down with the company or companies that are most affected and say, "This is what we're going to put out. Are there any issues here? Any errors of fact?" so before it even hits the general public there is - and we have a consumer advisory committee to ensure that

the consumer

has also an opportunity to think about this issue before it goes out for general consultation - that approach to regulation can remove a lot of this regulatory uncertainty about, "What are they going to do? Which way are they going to go? What balance are they going to adopt?"

I think if that approach can be facilitated by a regime rather than a regime which says, "You will put in your proposal. We won't have had any chance to talk about what the average standards that you're going to deliver are or what the options are. You're going to put it in. We're going to then employ a consultant to pull it apart. You're going to employ a consultant to pull apart our consultant's assessment. Then we, as the all-important regulator, will give our final decision and, if you don't like it, you can take us to court" - I mean, that sort of approach is designed to create uncertainty, dispute and high cost, and it's not one that I believe in.

DR FOLIE: I would like to follow up on that point a little bit. To what extent does the current code preclude a process somewhat akin to that or how much is it actually the way a regulator - and maybe the way his act is set up that he then discharges his duties? The code seems to give a certain amount of flexibility also as to actually how you might go through the process, even though you do have the proposed "dispose" element to it, and we know that there are many ways that one can actually do things in parallel.

MR OWENS: Yes, and I guess that's where I need more time in the industry and an opportunity to see how flexible it can be to allow me to apply the approach that we want to adopt. All I am doing at this stage is observing how it seems to me it is being applied and has been applied in the past and that does seem to be a very reactive approach. It is initiated by someone coming forward with a proposal; the regulator then starts work after the event - after it has been received - and this train of argument and counter-argument is put in place.

Whether it could be done differently I don't know, but it does seem to me that the code puts everything back on the proponent whereas that is not how we would work in the electricity. We would see ourselves as a co-driver and having time lines that we work to together whereas it seems to me that this has the regulator saying, "I don't like what you've done and I'd like you to address these things, so you go away and you do it and then come back to me when you're ready and I'll then have a look at that and, if I don't like that then I'll send it back to you again," rather than the regulator being able to say, "Well, I don't like it and this is how it will be. Now, let's talk about how we move forward." I don't think this access regime or this code does allow that sort of approach.

DR FOLIE: Now, under that sort of philosophical approach of trying to do it, would you - and I understand the two months very carefully, somewhat

simplification of some of the - in other words, all of the multiple factors and things that are within the code, if they could be sort of somewhat reduced - - -

MR OWENS: I would pull as much process out of the code as I could, yes, and focus on outcomes.

MR HINTON: Lewis, one final question, and it is to do with your third category of comment to do with access regulation and new investment. You put forward an alternative approach to say a greenfields approach of having access holidays of one of - something similar to the approach you take with regard to the Tarcoola to Darwin railway station - if I understand you correctly - and that is that the rate-of-return parameter becomes crucial with regard to greenfields, and you're suggesting that a regulator that can be fully cognisant of the need to have some scope for blue sky return is an imperative for any judgment about not being a disincentive for greenfields investment. Is that the basic framework - I know it's a simplification of what you said but, if I read you right - really my question is, have I read you correctly?

MR OWENS: Yes, pretty much so. The interesting thing about why you have regulation for a monopoly asset is that economic theory would suggest that the distribution of returns for a monopolist will be far off to the right in terms of the rate of return for that project. Because it's a monopoly they can set the price, therefore the expected distribution of returns would be out in the 20-30 per cent range, and you create a regulator to bring that allowable rate of return back to a level which you try and estimate would apply if it was a competitive market.

With the Darwin railway - and by inference I am suggesting that similar considerations can apply to a greenfield gas transmission line where the volume of sales is not known; where the future income is quite difficult to predict - you find a distribution of returns that perhaps can go from a negative return up over a very widespread - and that leads to the question, "Why do you need regulation at all?" and certainly on the Darwin railway I could mount a very strong argument that we're not necessary.

In that particular instance if the rail operator tries to charge more than the cost of taking the freight by road - which is already alongside the rail track, and trucking companies have been taking product up that way for many, many years - then people will continue to use the road freight and the rail will not attract business, so where is the need to regulate the operations of that railway when there is an alternative that's the current mode and is cost-competitive anyway? The reason that regulation was brought into that role was a need for some public comfort, that you were building a monopoly asset. It was a unique thing and it had perhaps the potential for being abused, and so there was a community need for some belief that this couldn't be

abused. As I indicated before, it is highly unlikely that it will never be needed because of the actual constraints in the market that won't allow them.

MR HINTON: Constraints of power.

MR OWENS: Indeed the regulatory regime says - like all access regimes - "Let the parties commercially negotiate and if they can reach agreement on a price, fine, why should we worry?" It is only when the parties can't reach agreement on the price that under the Darwin regulatory regime we can appoint an arbitrator, and the arbitrator is required to follow these guidelines that we have created in terms of an allowable rate of return on the investment.

We have had to set a floor price to protect the investor, a ceiling price to protect the potential above-rail user and an indication to the arbitrator as to what would be the allowable rate of return when he has to determine an actual price. We have set that in a way where initially it is reasonably high, because we don't want to truncate the potential for upside returns early on in a project life, and we have set it in a way where, over time, depending on how financially successful the project is, that rate can be reduced back down to the project-specific WACC, which is higher than normal, because of the risk to the investors of the project, but it is not the WACC that would apply from day one.

I think that has elements - better people than I would need to know whether that is an approach that would work in the gas industry, but if the alternative is to have nothing at all then you do run the risk that the community would not be comfortable with a potentially unregulated arrangement. If the community is happy with that, maybe that's the best way to go, but if they are not then a regime like the Darwin one may give the public the comfort, but not interfere with the investment.

MR HINTON: Thank you very much. Thanks again for your participation both by way of submission and your appearance today. It's appreciated.

MR OWENS: My pleasure, thank you.

MR HINTON: Thanks, Adam.

MR WILSON: You're welcome.

MR HINTON: Let's move to the next segment of the public hearings here in Adelaide.. I now invite the representatives of Envestra Ltd to come up to the table and microphone. We have Mr Andrew Staniford, Mr Ralph Mignone and Mr Greg Meredith. Thank you. Welcome to this public hearing. At the outset I should say apologies for a slightly later than scheduled appearance, and I hope it hasn't inconvenienced you too much. We have some flexibility, subject to your availability, to go into our lunchtime anyway. So we would certainly like to do full justice to your participation in terms of available time, but apologies for the late start. As for others, I would be grateful, for the record, and checking the sound system, that you can identify yourself and who you represent at the outset, thank you.

MR STANIFORD: Andrew Staniford from Envestra.

MR MEREDITH: Greg Meredith from Envestra.

MR MIGNONE: Ralph Mignone from Envestra.

MR HINTON: Thank you very much. I understand that you have got an introductory statement that you would like to make at the start of this part of the inquiry. Thanks very much, Andrew.

MR STANIFORD: Thank you very much for the opportunity to present today. We have got a presentation of which we have given copies to the commissioners. I'm sorry we haven't got enough for the public, but I'm sure you can follow along with me anyway. I guess the objective of this presentation is just to summarise some of the issues that we raised in our submission to the commission. We have titled the presentation Getting Regulation Back on Track, and I guess that is quite deliberate in that we feel that in the gas industry at the moment we are coming to a juncture where, in the evolution of the gas industry, there are some very important decisions to be made. I guess for those that can see the presentation we have depicted a train going along with the pick of two routes.

One is what we call the lower price route, and that's really a continuation of the current direction, a trend towards increasingly intrusive regulation in our view, a trend that is based on the competitive economic model and a trend that emphasises lower prices. We contrast that with the other track, which we call the Hilmer line, which, in our view, was an opportunity to recapture the vision that Hilmer originally had. That was all about encouraging investment in gas infrastructure, improving competition, but at the same time putting checks on behaviour to prevent any anti-competitive behaviour. We believe that alternative vision must be the objective for this Productivity Commission review.

The central thesis of our submission that we made to the commission is that the

Gas Access Regime is impeding investment in natural gas infrastructure and, as a result of that, it's preventing the industry from making its full contribution to the economy. We believe that over time things are going to get worse. However, we also acknowledge that this is a very difficult issue to make a judgment on. Unfortunately we are not in the situation where we have a counterfaction. We now have a gas access regime. We don't know what it would be like under any other alternative regime, and also given the maturity of our industry we are still in a growth phase. So a lot of the benefits that we are claiming are not being realised are benefits that we are yet to enjoy anyway, so we need investment to actually get some of these benefits.

I guess it's my expectation that as the commissioners have gone around there are a number of people who are claiming that the industry is fine, that investment is happening and there is really not much to worry about. I guess that is not our view. We can actually point to you, in financial statements, where some expenditures have been cut as a result of regulatory decisions. We can see that there are problems in our industry that are emerging, one being the threat of, say, reverse-cycle airconditioning to gas heating, which is the important part of our industry. Our view is that unless these issues are addressed somehow, in the end it will be the consumers of our system that are disadvantaged. Either their prices are going to need to increase, or consumers that might be able to have access to natural gas will in fact be denied having that access, because investment will not be in the ground.

So what we want to do today is look at three key issues. I want to first start looking at taking a high level view of the industry to try to paint the big picture as to where we're headed. Then I want to comment specifically on some deficiencies of the current regime and then look at some of the improvements that we would like to see made. The first problem is that there is clearly insufficient infrastructure in place to use Australia's natural gas reserves and to increase competition in our energy industry. On the eastern seaboard we are basically totally reliant on two gas basins, the Cooper and the Bass Strait basins, which are both ageing basins. We have got ample gas in Australia, but we need to get it to the market. To do that we are going to need some kind of a transmission system. I think it's clear, when you look around, that the code is not bringing on this kind of transmission investment. All the investment in transmission is in fact outside of the code, and it is an example where the code, I believe, is failing us.

Perhaps the next point, which is more of a distribution issue and follows on from that transmission point, is that there are insufficient households in Australia that have access to natural gas. In the slide, for those that can see it, I have put some penetration rates for natural gas by state. You can see from that table that penetration rates are low. One thing that is clear from these numbers is that natural gas does not have a monopoly as, say, electricity would have, where you would see

99.9 per cent penetration. We are looking at 9.7 per cent penetration in Queensland. The highest is Victoria with 82.2 per cent. The point I'm making is that if we are going to increase access to natural gas for the customers in these states that currently don't have access, we are going to need further investment in the gas distribution system - - -

MR HINTON: Excuse me, Andrew, can I briefly interrupt, and I apologise for this interruption. For the record, and for the others here today, the commission will put these charts that you are referring to onto our web site so that the transcript can be interlinked with that web site for the charts that have been referred to. So while the numbers are before some of us today, they will be part of the public record. I'll clarify that now, so that it will be clear not only for the record, but for those present. I apologise for interrupting.

MR STANIFORD: We are happy with that. Going on to the next slide, the other observation we would like to make is that if we do not fully use our natural gas reserves to the maximum benefit our environment is going to be worse off as a result, and it is well accepted now that natural gas is desirable, from a CO_2 emission point of view, and we put some data there just to demonstrate that. The next point I would like to make about the problem with the industry is that unlike some of the other industries, natural gas is still in a growth stage. In this slide we have shown the increase in natural gas consumption from 1980 to 2000 and then the forecast to 2019-20.

The thing is that it's the most rapid-growing fuel as a source of primary energy. I guess our view here is that if we're going to actually realise the future growth, the potential growth, that is here, we are going to need a lot more investment. Really, that is what this inquiry is all about, making sure that we have the regulatory regime in place that is going to enable that growth to occur. I would like to now comment on some of what we see as the key deficiencies of the regime. The first one is that it is costly and time-consuming. We have been involved with a number of these access arrangement reviews. We have come to the conclusion they are very data-intensive. In some instances we have been asked to provide invoices to actually justify our claims. The amount of correspondence that is exchanged between us is high. The time is high, up to five years to complete a review. The cost is high, $2 million for a large network, plus there are a whole lot of other costs that regulators and other parties incur.

I guess one of the critical questions for the commission to answer is, is the approach that is embodied in the Gas Code the best approach going forward? Do the benefits outweigh the costs? I guess we have come to the view that no, they don't. We acknowledge that there are some benefits from the Gas Access Regime, but most of those, we believe, could have been delivered without the code. They come from

providing third party access. Just the act of providing for third party access, and also couple that with the vertical change or vertical desegregation that has happened in the industry, we believe has set up a framework where competition can occur and that has led to some benefits that certain parts of the economy have benefited from. Perhaps the big example there is the readjustment of tariffs and the removal of cross-subsidies.

But beyond that we see little benefit from the code process. The costs are large and the risks and the impacts are small. On the next slide we have tried to depict that. We have tried to examine what would happen if a regulator reduced our prices by 5 per cent and we come to the conclusion - we have done the analysis here for both large customers and small customers. For a large customer the reduction in end price, or the cost of gas for the user, would be a 1 per cent reduction, but for a small customers, and I'm talking about a domestic customer here, the average reduction, or the impact on their budget, is equivalent to about three or four cups of coffee a year for a 5 per cent reduction in our revenue.

So the allocated efficiency benefits of pursuing price reductions are quite small in our view, and in fact the benefits from focusing on taking out monopoly profits, or the last cent of monopoly profit, really pales into insignificance compared to the potential cost of greater investment. We have also put some comments there about the upstream sector, which I won't comment on at the moment. I think one of the other deficiencies with the regime is that there is a conflict of roles in the regulatory offices that leads to an inordinate focus on short-term price reductions.

We have used the Victorian example here, where originally the code was set up as a means of providing an access arrangement, or negotiating an access arrangement, between a retailer or a large user, and a service provider or distributor. What has happened is that in setting up the regulatory offices, various pieces of legislation have been put up that have actually widened the scope of the regulator.

For example, in the ESC Act, the primary objective is long-term interests of consumers and that takes precedence over the need for investment in the industry et cetera. We believe that this extra layer of regulation that has been built into the process was not envisaged when the code was put forward and, in fact, has led to some biasing in the regulator's decisions towards customers and against investment.

One of the key factors that we'd like to point out to the commission is that regulators seem to assume that because we are a natural monopoly - and we are a natural monopoly - we will use or exert monopolistic behaviour. I think that assumption needs to be challenged. We know that gas is the fuel of choice. We've already put up some penetration rates there to show that not everybody has access to natural gas. We know that distributors have to pay to reticulate gas in subdivisions,

unlike electricity, where the developers do that and it's built into the price of land.

We know that gas appliances are more expensive than their electrical equivalents. Installation is frequently more complex because you need fluing, you can't just plug it in, and there is obviously a limited range of gas appliances anyway. The question is: how much monopoly power does a gas distributor really have? What we'd like to suggest is that when we put a new subdivision in, we have very little monopoly power. We've got to work hard to get customers on that line to actually make that investment pay. Even for our so-called captured customers, I would argue then that the monopoly power that we have is also quite small. At most we could only price up to our competition, and we have competition in the marketplace.

I think the implication is that if there is enough competition - and maybe electricity is the equivalent - if electricity is the monopoly and that is regulated and equivalent at an appropriate rate, what is the cost to society of continuing to regulate, say, parts of the distribution sector on the basis of this monopoly profit theory? Our view is that while we are a natural monopoly in certain areas, it's very hard for us as an industry to exert monopolistic behaviour.

The other point we'd like to make is that we believe we are in a high regulatory risk regime. On this chart we've tried to depict the average life of an asset - say, 100 years - and mark on there the times during the life of that asset when a regulator can change the assumptions that relate to the revenue that could be earned from that asset. The point is we need to make a decision to invest at the start of the process and then, every five years thereafter, regulators can change the rate of return, the operating cost, turn-on assets, et cetera.

This is an important issue and, in fact, just as an aside, we've just been - you might have heard that Envestra announced its results on Friday and we've just been going - having a number of briefings with analysts. I guess the story we've been trying to tell the analysts is that we now have access arrangements in place and we are a relatively stable business. However, they keep bringing up again and again, "But what's going to happen when the next regulatory reset comes due?" That's not due until 2006-07 now, but it's still an issue that is high in the minds of regulatory analysts - of business analysts. I think it's an example of just what kind of regulatory risk a company like ours is under.

I want to move on to slide 15, if I can , now. One of the other key deficiencies of the regime that we've talked about is the extra state regulation that has been put in place alongside the Gas Code. When the Gas Access Regime was put together initially, we thought we'd have a natural access law, a regulator, an access code, a distributor and an access arrangement. But what we've found is that the state Gas

Act and the state Regulator Act, in the various jurisdictions, has put together another regime which sits alongside our Gas Access Regime; one that's usually based on licences, with a series of licence conditions, and then a series of codes that sit under that, providing guidelines.

The point we'd make is that we acknowledge that we need to be regulated by the state for technical and safety reasons - no problems with that - and licensing facilities, but the state based regulation component seems to have grown to a much larger size than we would have ever envisaged. We think that imposes significant costs on the industry, but perhaps more importantly, on some occasions it actually conflicts with the access arrangement. On the next slide I've put a couple of examples to demonstrate that.

In the Victorian gas distribution system code, for example, there is some guidance provided there on how we need to calculate the economic feasibility test, which is referred to in the code. There is also some guidance of what is an estimate of incremental revenue and cost. But what we would like to see is that all of the access-type issues are treated in the one document, because we believe that's where everything could be consistent, and it will be all whole. But when you have these side documents under the stated based legislation, that can change when the state regulators decide they can change, there is an element of risk and inconsistency which is established. We are concerned that in the future there will be more of these types of guidelines issued - for example, guidelines on how to make demand forecasts, or guidelines on how to set tariffs. We believe that's becoming more and more intrusive. The problem with the regime is that it breeds more and more regulation.

I will also just make a comment - this is outside the terms of the inquiry - but just make a comment that there are a number of complementary reforms that were initially meant to have taken place in the energy sector that really haven't taken place, and some of those are having an impact on the industry. Perhaps the classic example is retail price regulation. We've got an example in Queensland where governments have continued to set retail prices, and the prices they have allowed the retailers to recover from their customers there don't actually allow full pass-through of the network costs. The implication is that we, as a network, are being asked to forgo margin and we believe that's an inconsistency that's making our business harder to run there.

Okay, what are the improvements? We've summarised our improvements under four broad areas. The first one is that we think there is a need to improve regulatory processes. Secondly, we say we need to create incentives for investment; thirdly, we'd like to provide for alternative access pricing models; and fourthly, we'd like to minimise the role of the regulator in matters which we think are better handled

in a commercial sense.

If I can look at those one at a time, firstly, the improved regulatory process: there has already been some discussion today about objectives. We believe there's a strong need to clarify the objectives. We feel that regulators are trying to weigh up too many objectives and there would be some benefit in understanding what we're really trying to do here. Particularly we'd be recommending that given the stage of the industry, given what we're trying to do is to grow the industry to provide increased access to natural gas, that the key requirement is that the objectives have to recognise that investment is important. Investment is the most important thing that we need to focus on here, otherwise we're never going to get the growth that's been forecast and we're never going to get people with access to natural gas.

We're also advocating that there should be separate roles for, or a clarification of roles in regulatory offices. We've mentioned in our submission how the regulator seems to have a dual role - one of a customer advocate, where it's developing a prosecution case on behalf of the customer, but then wears another hat - it wears the judge hat, where it's actually weighing up the customer views and the user views, plus the service provider's views. We believe that that combination of roles is just bad policy and it makes it very difficult for the regulator to operate in an unbiased manner.

We've also found that on a number of occasions, in the regulatory process, regulators make recommendations in a draft decision, they also make recommendations in a final decision and sometimes there's a change in that process but we feel that they haven't fully consulted on those changes. To us, that's just creating a more adversarial situation that is going to be difficult to manage. We think, as part of improving regulatory processes, we need to look at making sure we have - or explored the extent to which we can have appropriate discussion on the issues before they are finalised, a collaborative approach and also look at the opportunities for low-cost arbitration process, or dispute resolution processes, if that's necessary.

A key component of our recommendations is that we need to put in incentives to create investment. I guess this is perhaps an area where, like I said, it's difficult to make a judgment on investment at some stage, but when you look at the various components of where we invest, it is clear to us that investment has declined. I've got a few examples here: firstly, investment to increase network utilisation, or load growth through the network which, in turn, flows through to lower prices. We can show you numbers where that expenditure has been basically cut in halves. That has no short-term impact. We'll continue to go on. We've got all our customers. We are actually living on the legacy of some work that was done in the past to get customers connected. Our concern is what is going to happen in the longer term, especially

given the competitive nature of the market and the fact that gas has to fight hard for market share, and whether in 10, 20 or 30 years, we're going to be in the same situation.

Greenfields extensions: we've already talked about that, but basically none of them have come through the code process. It's clear that the code is not encouraging investment in greenfields extensions and we need to do something about that. Research and development: gas companies used to do a lot of research and development into alternative fuels, such as natural gas for vehicle fuels and air cooling, microturbines and that kind of thing. Basically all of that has been cut out of our industry, and it may be that we're not the best people to do it, but the question is: who is doing that? If we are really serious about moving towards a renewable economy with distributed generation, et cetera, someone has got to be doing that work.

The other area where I'd make some comments on investment is in the infill of the existing networks. There are basically two ways we can connect customers: one is that we can establish a new reticulation system in a new estate, and that's usually the most cost-effective way for us to do that, because we can get a lot of houses connected at the same time. The other one is to try to backfill or to infill on our existing networks, where there are houses that are currently unconnected. What we're finding is that with the decline in returns that are provided, really we've been limited to just the first option; to look at new estates. There is not the incentive to look at backfilling.

We think the best way of creating incentives for investment is to somehow reduce the number of rules or regulations that we have to comply with. We've got to somehow allow more commercial negotiations and development of commercial arrangements. If regulation is necessary, we argue that we need swift approval processes. There's one example I'll just talk about here and mention Bairnsdale. Bairnsdale is a town in Victoria. The access arrangement in Victoria has some provisions relating to putting gas reticulation systems in a new town, a regional town.

Unfortunately the provisions in the access arrangement aren't clear enough to deal with all the regulatory risk issues. So we went back to the regulator on 30 May with a proposal as to how this could be done. Even today we still haven't heard back from the regulator whether - or how that is going - what arrangements will apply in Bairnsdale. The effect of that is that we are now unable to meet our target, which was to get gas to Bairnsdale in winter 2004. But it's just an example where, if we have regulation, and we have a process that we go through, it's inevitable that it will lead to delays.

We think there is a time to change. One of the examples that's frequently

quoted in the industry is the model T Ford example. I don't know whether you've heard of this. It sounds like you have. Really, when Ford produced their first car it was only black, you couldn't get any other colour. Even though users or consumers might have wanted a different colour, they couldn't get it. We argue it's the same with a covered pipeline under our former regulation. The only form of regulation that we can get is a cost of service regulation. We think that's far too limiting and that's prevented the industry from reaching its full potential.

We think that the regime needs to be amended to provide an increased range of pricing models. Obviously the objects clause is important in this process, to be able to lay the framework for it, but we can see a whole range of different pricing models from a non-priced monitoring - which could be a negotiate and arbitrate type of arrangement, right through to price monitoring, to external benchmarks, to the current heavy-handed cost of service base regulation.

There's a whole range of models there and some of those might be appropriate in certain circumstances. We put in a possible approach here, and I accept that this is only a proposal at this stage and we are happy to talk about this further.. I guess our view at the moment is that the code currently applies for coverage and uncovered pipelines. We still believe that that's necessary. There will always be some networks - like our Mildura network and our Alice Springs network - where the cost of this type of regulation just doesn't warrant the regulatory regime applying. So we think those should be uncovered.

You could also argue when there's a lot of competition in the market that it should be uncovered. Indeed, Queensland is an example of where there is a lot of competition and maybe that should be an uncovered network. Certainly in greenfields networks we need to think about how they are going to be treated. We also recognise that there will be some networks that will be covered and what we are proposing is that the service provider should be able to elect the type of price model or regulation model that would apply to that particular network.

We could make this recommendation to the regulator, but I guess we are concerned that if you do that the regulator has this, firstly, propensity to want to regulate more than less and we think there might be benefit in perhaps some other independent party making a decision on what type of regulatory model should be applied in a particular network and in this example we are suggesting the Productivity Commission. Now, whether that's the right body or not we are open to debate on that.

We think that the service provider should be able to put forward a proposal to have a price-monitoring regime on a certain network, there should be an analysis of why that's an appropriate way to go forward, somebody makes a decision and then

the regulator should be bound by that decision. The regulator can then come in and approve the price-monitoring arrangements and monitor those as necessary, and as part of that process we would also need to clarify the conditions under which the regulator could intervene under a more light-handed model. I guess that's one way of going forward, and we are still thinking about that to see whether there are better options there.

The last area that we think needs some improvement is that we need to keep regulators out of some matters that are best handled by the business. I think the classical example here is Queensland, where we put forward a tariff proposal to the regulator. The proposal that we put forward provided for a smooth increase in tariffs over a whole range of energy consumption levels. However, by the time the regulator had done his bit to it, we ended up with this distorted line, which is shown on this graph.

In effect, what it means is that anybody consuming just less than 10 terajoules of gas has to pay 25 per cent more for their network charges than someone using just over 10 terajoules. It has led to a huge distortion in the market and it's the example, in our view, of where regulators have set tariffs and gone well beyond their ability to understand what they are doing. But, secondly, it's an area that is not necessary for them to get involved in if they are really interested in managing anti-competitive behaviour and preventing monopoly pricing.

Just another example of where we think regulators are getting out of their comfort zone: again, in Queensland, we put some proposals to the Queensland regulator on network utilisation to improve load. He looked at our proposal and in the end solved it by going to other regulatory determinations, which are summarised in this chart and making a calculation of what the costs were per customer in each of those regulations. He then had a look at those, calculated the average, but then came to the conclusion that one of them was an outlier and therefore needed to be removed, and that has got the cross against it. That was removed and as a result of that the average was also made lower.

The one that was removed was Sydney. It was AGL. When you look at the environment, the conditions of supplying gas in Sydney and Brisbane, you'd have to say there is a lot more in common there than there is with say Victoria, which is the rest of them, mainly. We just feel this is another example of where regulators have made a decision. There is no commercial analysis around this; it seems to be an arbitrary judgment and we would question whether regulators are really able to make that kind of decision.

So just our concluding comments: we feel excited about our industry. We believe it has a large contribution to make to Australia's future development. We

think there are some positive steps that we have taken over the last few years with the Gas Access Regime, particularly the provision of third party access and the restructuring that has happened in the industry. However, on the code side of it there are a number of deficiencies, which I hope I have gone through, and we believe that they need urgent attention. Just to conclude the presentation, we go back to our original opening slide and would ask the question, "Which track will we be taking?"

MR HINTON: Andrew, thank you very much for that. I reiterate my earlier comment, that we will seek to have those charts, those tables; those pages put on our web site, which will then therefore be cross-referenced to the transcript that will also be on our web site in due course. Thank you also for your substantive submission, comprehensive submission, that in fact meshes very neatly with your presentation this morning, naturally. It brings with it a particular perspective regarding distribution; I think you would endorse that.

MR STANIFORD: Yes.

MR HINTON: Thank you - but, therefore, very valuable. My prior question then becomes, can you see the code being split in two, one for distribution networks and one for transmission?

MR STANIFORD: In effect you could argue that it's almost split in two now, the way that the industry has developed. It was originally designed as a transmission code and I think over time the transmission companies are exiting those arrangements, for very good reasons, and what we are left with is a code that is really being applied to distribution businesses and we would have no problem with that. If that's the case it does need to be revised to be appropriate for a distribution business, so it can be done.

I think the other thing is that there is a lot of flexibility in the code and I can still see, if you take some of the proposals that we have put forward here, where you can choose different regulatory pricing models under different circumstances. You could actually have a generic code that applies everywhere, with flexibility to put in place certain pricing or access arrangements, access regimes, for the different networks and take into account the characteristics of those networks. So it could go either way.

MR HINTON: Thank you.

MR MIGNONE: I'm sorry, can I just add there - - -

MR HINTON: Please.

MR MIGNONE: Mr Owens mentioned earlier that he would take a lot of the processes out of the code and focus on the outcomes. If that were in fact the case then there wouldn't be that big a need to differentiate between transmission and distribution.

MR HINTON: Thanks for that added point. I had a very specific question about page 5, regarding, "The environment is worse off" - problem 3, it's not fundamental to the code but it's part of the background and colour that's an issue in terms of alternative sources of energy. You talk about the average CO_2 emissions, regarding environmental impact, as an indicator in environmental impact, and you put down - the chart shows that natural gas is the bottom of the range of a whole range of alternatives, such as LPG back up to brown coal and coke, with heating oil in the middle. Does that include the CO_2 emission associated with the creation of the gas once taken out of the field or is that an additional CO_2 emission? Is this just the use of the gas, not just the actual inclusion of the CO_2 emission to produce the gas, to clean it up?

MR STANIFORD: I can't say 100 per cent, just looking at - sorry, I should say these are AGA statistics that were quoted here, but looking at the title it appears to be for the combustion of fossil fuels, so I suspect it's only the combustion but I'm not 100 per sure. I could find that out.

MR HINTON: An interesting point then might become what the numbers would look like if you included the CO_2 emissions associated with getting the gas into deliverable form. The much broader question, in fact significantly broader question, before getting on to discussions of some of your proposals, is that I'd welcome your comments on the nature of the industry today, relative to say when the code - the Gas Access Regime - was first implemented six, seven, whatever years ago, depending upon where you are - whether or not those events, those developments that have been quite substantive in some areas, in themselves have implication for whether or not the code needs refinement. Are we not comparing like with unlike when it comes to comparing the application of the code today, to a sector that's quite different to what the sector was X years ago? I'd welcome your comments on that.

MR STANIFORD: Could I just ask a clarifying question? What sorts of differences are you really referring to there?

MR HINTON: Particularly related to connectivity of pipelines such as you can move gas around different markets.

MR STANIFORD: Transmission.

MR HINTON: The alternative sources of supply are now a little different to that

which applied some years ago, for example. That's one that comes readily to mind. There could very well be others. But that seems to me to be, in itself, something that has occurred. The counteraction of what would have occurred without the code is another issue, but the fact that it has occurred in itself raises questions as to whether or not the code needs to be refined in the light of those different competitive environments that might operate today, relative to X years ago.

MR STANIFORD: I guess the major changes that I would see are firstly, there has been a significant change in the structural arrangements within the industry and I suspect that has - I mean, it's hard to disentangle all of this because it was all part of a common microeconomic reform thrust at the time, but certainly the establishment of specialist network companies and specialist retail companies has changed the behaviour or sharpened the behaviour in those segments of the industry, and that has probably led to some of the - has influenced how the industry has developed over that time.

When it comes to transmission, it's my view that the whole thrust of the free and fair trade approach for gas was all about doing exactly what is happening: getting more transmission pipelines put in place, getting more interconnectivity in the transmission network. I think you'd have to say that we are further down that track now than we were five, six, seven years ago, and that's probably a good thing.

Having said that, I still think that the other change that has happened since then is that we now perhaps have a better feel for how the code processes that were developed six or seven years ago now apply. I guess my recollections of those days were that there was a completely different expectation as to how these arrangements were actually going to work in practice, and it was seen as very much that the code was going to be a light-handed regime, there were going to be these reference tariffs and service policies that you could buy off the shelf if you wanted to, it would be a very easy and cheap method of getting access to transmission and distribution pipelines and there would be very little dispute because of that.

In effect what has happened is that we've built up another industry around getting to that point, which I would argue you need to offset against the cost of any potential disputes under a more conventional negotiate-arbitrate type model, which is perhaps more typical in access regimes. So I think that to me has been the clear change, that we now understand more about how the prescriptiveness of the code has been applied by the regulators and how industry has responded to that, and there are some parts of that that we don't like and that's really what we are trying to change because we think it's stymieing investment.

DR FOLIE: In your recommendations - and once again the theme has come up a couple of times already this morning - is the issue where you say, "full consultation

and recommendations into final decision." Is it the normal practice that you do put something in and there's no feedback before you get a final determination or rather not dialogues - running dialogues with the regular - other than - more substantive than just saying, "I need more information." In other words, is there any - as these thought processes evolve that you are then involved in at all?

MR STANIFORD: Most of the time I'd have to say there is fair consultation. I'm not saying the regulators are using this as a means of getting recommendations into final decisions without consulting with us. I think most times regulators really go out of their way to try to consult with industry, and we respect that. However, I guess what I'm really trying to say here is that sometimes I still feel there is too much of a difference between decisions - recommendations in a draft decision vis-à-vis a final decision.

I think what regulators need to be able to do is get to the point where a draft decision is really a draft final decision and it's not a draft decision with a whole lot of areas saying, "We are going to look at this. Further work needs to be done here," because it just makes it very difficult. You then have those discussions over the next three months, between the issuing of the draft and the final. Then suddenly the final is out and there's no opportunity to perhaps address the specific issues that might have arisen, and that has happened in a couple of occasions. I wouldn't want to make a big thing of it. It's not a major problem but it has happened.

MR HINTON: Andrew, your presentation this morning very colourfully illustrates the two tracks of the train - the Hilmer line and the lower prices feed-off - and in fact some earlier presentations this morning did touch on that same sort of analogy. A question that I in fact asked earlier today I would also like to ask you: what forces have been at work that have taken the Hilmer objectives as the starting point and then diluted them significantly - if I understand your diagram correctly - to shift away from those basic objectives to ones that are much more driven by a consumer protection objective associated with lower prices, whether they be short-term, long-term, medium-term outcome for prices is another matter - we can debate that.

The question then becomes, is it the culture of the regulator? Is it the culture of policy-making? Is it the history of the sector? Is it the code itself? Is it the sort of gas access regime being interpreted because there's imprecision. The reason for asking is, the better we can examine or identify, disentangle, the factors at work, at least prima facie, would lead you to possible conclusions about possible refinements, so I would be interested in your perspective as to what you think might be driving that train swinging off to the right.

MR STANIFORD: I mean, this is a really interesting question and I am not sure that I can do it justice. I go back to a point I made earlier - that when the code was

being put together the whole thrust of the COAG agenda at that time, Hilmer, microeconomic reform, was all about getting investment in essential infrastructure. It was increasing competition in markets and there was a clear - in fact the whole agreement was called Free and Fair Trading Gas. It was all about getting that gas moving around. That was the critical objective.

I think it was against that framework that the code was drafted. It was seen as an instrument to help achieve those objectives, but of course what has happened over time is that - at that time there were no regulators in existence, apart from the ACCC, or certainly not in the gas area - there has been a whole set of regulatory infrastructure that has developed. Often I think it has been biased by perhaps the operations of the regulator in other areas. For example, electricity might be an issue where retailers - regulators do perhaps have more dealings with individual end-use customers than they do in the gas industry.

The Gas Code is really all about the relationship between a distributor and a retailer rather than a distributor and a householder or a factory owner or somebody else, so I think that kind of - the other experience of the regulators' officers, just the development of the approach to regulation, which has been - and regulators would say this, that really the way we drafted the code invited them to adopt a cost-of-service approach, and that's exactly what they have done. They have gone into this cost-of-service approach and they have developed their skills and their thinking about that, and so all of those things together I think have led to - perhaps as an industry we have lost sight of the original objective, which was to increase investment and to get gas flowing to more places, and my concern is that unless we can somehow correct this balance we are going to go further down that track.

MR MEREDITH: We'd also say that it's to do with the default paradigm that is employed by the regulator. It seems to be this theoretical competitive market that is always referred to when they analyse certain things like tax or prices, where they're trying to set the lowest possible price that the competitive market would sustain.

MR HINTON: Let's move on to one of your key improvement comments. It's covered by pages 22 and 23 for those of you who have got the presentation. Chart 22 covers a range of pricing models from light-handed out to heavy-handed, and chart 23 gives a possible hypothetical approach - or exploratory approach, I suppose, Andrew, is the term you used - that might apply within that overall framework, and there are a couple of questions that come to mind here: one is the entity making the decision - whether it is to be covered or uncovered, would it be the same as the decision of the nature of what regulatory framework would apply, once covered? Who would be the decision-makers in each of those cases?

But the prior question becomes, what criteria do you think would fit into this

sort of approach, and the criteria would seem to be relevant for the first decision - that is, for covered and uncovered - and then there is a second issue, what sort of criteria would apply as to the nature of the regulation that would then apply, once covered. Maybe they are the same things, but I would welcome your elaborative comments on that sort of issue of criteria.

MR STANIFORD: In relation to criteria of uncovered and covered, we are of the view that currently the Gas Code is basically consistent with the Trade Practices Act in terms of setting criteria for a pipeline or a network being uncovered, and we think that's an appropriate principle to strive for so there is consistency across the gas access regime with other general access regimes. What I am really saying there is that whatever the criteria are in the Trade Practices Act for having facilities declared or undeclared, or whatever it might be, should also be consistent with what we're doing here in having them uncovered and covered.

In terms of the criteria for choosing different models, I think it really does end up being based on an analysis of market power and the market that that product has been supplied to, how competitive it is, what is the potential for anti-competitive behaviour to emerge, so it's kind of - I haven't really thought this through in terms of definitive criteria. There are probably some aspects of the criteria that might apply across both to determine whether they are covered or uncovered or whether it's model 1, model 2, model 3, but I just need to give that a bit further thought, I think.

In relation to decision-makers, the NCC currently is - it's arguably the minister who is actually the decision-maker on covered or uncovered versus - on the recommendation of the NCC. We would argue that the role of the minister sometimes is a delaying factor in all of that and we would wonder whether it's necessary but, having said that, there is still a policy issue in making that decision, and that needs to be worked through. We haven't actually proposed any changes to that. We're saying that the NCC is still the body responsible there.

In respect to this other - whether it's model 1, model 2 or model 3, we haven't really given it a lot of thought. I guess our main criteria here is that it needs to be somebody independent of the regulator's office because certainly the way the regulator's offices are constructed at the moment - with a consumer advocacy role as well as a regulatory role - means that they are not particularly well placed to make that kind of judgment.

MR HINTON: But could that not be part of the coverage decision itself; that is, the NCC could make a judgment to switch on or off. The switch is on for coverage and then, in doing that, it would be making judgments about the nature of the then regulatory structure to apply, such that it would be an integrated decision of the nature of the coverage, as well as the decision to cover, and then - NCC being

different to the regulator, which would then administer the system that is then in place. That would be consistent with your - - -

MR STANIFORD: That would be consistent with the model we are proposing.

MR HINTON: Prima facie it seems difficult to disentangle a decision to cover and a decision to apply the regulatory system that would apply. The two seem to be enmeshed fairly closely and would need to be consistent, which is partly behind my question about criteria.

MR STANIFORD: Yes.

MR HINTON: If market power is an important part of the judgments about the nature of the intervention - the regulation - then, prima facie, that suggests market power should be a crucial criterion with regard to whether it should be covered or not covered.

MR STANIFORD: The two criterion that come to mind are really market power because that is sort of obviously the basis for regulating or not. The other issues that need to be taken into account I think are the costs and benefits of regulation. If you are going down a particular model, what are the costs of doing that relative to the benefits that are likely to emerge and are there more cost-effective ways of getting the kind of regulatory outcomes we would want to see in those networks?

MR HINTON: Thank you for that. My next question was in relation to your fourth area of improvement, which is, in your words, "Keep regulators out of commercial matters." It's a big call, that one, in circumstances of - that's the nature of regulation, isn't it? I don't mean to be flippant. I will rephrase my question in the sense of saying that - what you mean by that - are you talking about the degree of forensic examination by the regulator of the accounts of the company being covered - or the activity being covered? Is that what you are getting at?

MR STANIFORD: Yes.

MR HINTON: Regulation by its very nature does touch on commercial imperatives.

MR STANIFORD: Yes. That probably isn't a particularly well-worded clause there, but what we really mean is the level of involvement of the regulator. I guess the example we use there is, to us, an example of where the regulator, in setting a reference tariff - which is what he is authorised to do under the code - has gone too far in making decisions that (a) he is not qualified to make and (b) have ended up having a perverse impact on the market. We would argue that really, except - - -

MR HINTON: This is page 24, for the record.

MR STANIFORD: - - - that regulation will affect the commercial position of a business - and that's obviously what it's there to do, but what we would like to see is perhaps - in this situation the regulator should not be able to change the reference tariff provided it's efficient, it's within the bound lines that there is no monopoly profit in there and, secondly, it is within the bounds of efficient pricing, which is anywhere from marginal cost to stand-alone costs, one would argue.

What the regulator has done here is actually said, "No. It can't be five. It's got to be four," and we think that sort of level of intrusion is going too far. Really, the objective of the regulator - and this gets back to I think setting the objectives of the regulator: what are the objectives that the regulator needs to focus on? It really is making sure that there's no anti-competitive behaviour or, you know, impeding access or monopoly pricing. They're the things they need to focus on rather than these detailed matters, which I think are best left to business. Businesses understand the market they are operating in. Businesses are able to set tariffs.

There are a lot of regulators who have used different approaches, which I think are quite acceptable, for example, the price. The tariff basket approach that is used by some regulators overcomes these kind of problems because it sets an overall price control, which I think regulators should be able to set if we are going down this type of regulation, but it allows flexibility for businesses to adjust tariffs for individual components or submarkets to reflect the reality of the market, and that's an appropriate level of intrusion versus this, which is an inappropriate level.

MR HINTON: Thanks for that clarification. Michael?

DR FOLIE: Two questions, both of which can be sourced on 17, but they are sort of addressed also in your written submission. These are really the top end and the bottom end of the gas markets relating to that and of course here we are inquiring about the effectiveness of the code. To what extent do delays in implementing FRC - for retail competition - is it code-impeding or is it just the government is doing it and once that is implemented will that then drive the change?

MR STANIFORD: Yes. This is not particularly a code issue - I think you are accepting that.

DR FOLIE: Yes. I am very careful not to get out of the bounds of this inquiry.

MR STANIFORD: I would have to say that when we embarked on this process of disaggregation, codes, retail competition, et cetera, et cetera, no-one had any idea

what full retail contestability was going to involve, and I think it is only as we have got further into that process that we have started to realise just what it involves in terms of cost and in terms of the complexity of arrangements that need to sit around the industry to enable full retail contestability to occur.

So I think as we became aware of that there have been delays in just getting it done, because it proved to be a lot more complicated than what anybody had thought of. I think initially we just thought - you know, it used to run glibly off our tongues as if it could be done the next day, but obviously it can't be. That's the main reason why there has been a delay. I think full retail contestability is an important aspect of the whole regime, because it does - if you're going to have open access it does provide that increased choice to customers, increased competition, which I think is something that we are trying to develop here.

So I think it is a positive thing and I think once we get FRC happening there will be some spin-offs that come from that. However, having said that, it is very costly and I think in some areas you could argue that the costs of putting in FRC - well, you could ask the question, "Are the costs of putting in FRC worth the benefits that are coming out of it?" I know there are some governments that have decided they are not.

DR FOLIE: The second one, and you have responded to it also in detail in your written report, is the issue that the upstream used to be so-called reformed. The theme has come across in various stages. I'm just interested as to why - has there been a forestalled agenda there? What do you believe you would get out of - you have obviously a model of your own reform.

MR STANIFORD: I guess I'm just making the point here that if you really are looking at competition in the energy markets you've got to look at the whole energy chain. I suppose as a gas distributor we feel that over the last five, six, seven years what has happened is that a lot of the other parts of the chain have not been subjected to reform and therefore - as much, say, the distribution sector. As a result of that we are now getting some mismatches perhaps between the industry chains, and there has been some discussion and even some work has been done to look at sort of upstream reform.

But it seems to me that that is a real opportunity for getting further competition in the natural gas industry, but it needs to be complemented with other initiatives such as investment in transmission, et cetera, to provide the kind of basin-on-basin competition that is going to underpin all of that. So the more that we can get those competitive arrangements working, the more fluid and more competitive the industry is going to be with benefits all around.

MR HINTON: Okay, I think that brings us to a conclusion of our morning session unless, Andrew, Greg or Ralph, you've got something that we need to re-examine, look at or whatever we haven't touched on already both in terms of your written submission, your presentation or the question and discussion session this morning. We might finish there then. Thank you again for your attendance and participation. It's very important that we have this sort of input, and thank you very much for your substantive and comprehensive submission. We will now break for lunch and return here at 1.45 for commencement of the afternoon session. Thank you very much.

(Luncheon adjournment)

MR HINTON: We will commence the afternoon session of 3 September, here in Adelaide, of the Productivity Commission's public inquiry. In my introductory remarks this morning I indicated our wish to be informal. This process is informal, although we do have a transcript of the proceedings which will, of course, be made available to all participants and will be on our web site as well.

What I'd like to do at the outset is invite the representatives of Santos, Mr Robin English and Mr Bruce Wood, to identify yourselves for the purpose of the transcript and to ensure the sound system is working properly, and note who you are representing. Over to you.

MR ENGLISH: Thank you very much, commissioner. My name is Robin English and I do a bit of the regulatory work for Santos Ltd. Bruce Wood is the manager, gas commercialisation and marketing for Santos, and there is a possibility that we will be joined by Paul Woodland, who is the manager for government affairs for Santos. Would you like me to just go on and make some introductory remarks?

MR HINTON: Yes, please, Robin, if you have one there, and I understand you do. We would be very pleased for you to make an introductory statement to facilitate proceedings, thank you.

MR ENGLISH: Thank you. We'll make some comments supplementary to our submission. I'll start off and perhaps Bruce will come in at the end with some further comments. Santos has noted that part of the scope of the inquiry of the Productivity Commission originally included upstream and downstream competition, but we've been assured that the focus of the inquiry is on transmission rather than those. We would like to just make some comments, though, on upstream competition in the gas industry, seeing as we have this opportunity.

Perhaps we can do that by commenting on a little bit of the history of the Cooper Basin in South Australia and south-west Queensland. Up until 1999, Santos had two petroleum exploration licences covering most of the Cooper Basin in South Australia and some complementary licences in Queensland. Through those licences and in pursuit of our obligations on them, Santos over 30 years or so made many gas and oil finds and has invested some billions of dollars in the basins in exploration, processing and infrastructure.

The licences expired in 99 and the South Australian government chose not to renew them, as it was entitled to do, and that land then became available for other explorers in the basin. Most of the ground has now been taken up and the native title formalities have been gone through and exploration has commenced. The new explorers have already, in some cases, made some petroleum finds - so far mostly oil, but it's only a matter of time before one of them finds some good gas.

Despite an uncertain start, Santos has welcomed the new explorers and the vitality that they bring to the basins, and has been able to negotiate commercial arrangements whereby they have obtained access to our infrastructure, which has been built up over those years, and that is both in South Australia and south-west Queensland. Some examples of that are that we are providing them access to our airport and our scheduled air services to the basin, oil transport and processing facilities, emergency services - as we have an established set of them in the basin and it's expensive and difficult for others to provide them; water supplies and various others, too numerous to mention, including of course all the roads. We've developed some thousands of kilometres of roads in the basin.

We entered into commercial negotiations with the new explorers and came to agreement and the system appears to be working well. If you add this to the competition engendered upstream by the expanded pipeline network, it's our view that competition upstream - certainly for Santos in the Cooper Basin in Australia - is alive and well, and very healthy.

Putting that aside for the moment, Santos competes in most states in Australia for gas exploration and production and we confirm our view that the code has provided incentive for improved competition in the transmission of natural gas. Since the introduction of the code there have been new pipelines built, new intrabasin connections - although, as you would all recall, one of those connections was the result of an emergency in gas supply in Victoria - and the gas transmission market in south-eastern Australia particularly has become more flexible. As gas demand increases there's no reason why this process should not continue and intensify.

Santos and other producers have found that flexibility has improved competition in the upstream industry as trading of gas amongst producers has been enhanced, hence Santos's view, expressed in its submission, that the access regime should not be the subject of extensive change. We also have a concern about gas prices which we thought we'd put before the commission in this forum. If you compare gas prices to consumers in Australia, as compared to the rest of the world, particularly the OECD, we have some of the lowest priced gas in the world. It's our view that regulators and governments in Australia shouldn't concentrate too closely on absolute minimum prices being the aim of the process. The long-term needs of the industry need to be considered and the long-term needs would include a need to continue to engender investment both in exploration and production and transmission.

Our comments on extensions and expansions policy, those policies that are in the code and have been expressed in various access arrangements, are contained in

our submission. It's our view that this is a place where the code could be improved. We suggest that parts can be improved and look forward to the comments of others who might make submissions to the commission, and the commission itself. Our view is that weak extensions and expansions policies that are allowed to creep into access arrangements, and at present - although this access arrangement hasn't yet been accepted by the ACCC - that seems to be the case on the Moomba to Adelaide pipeline. They really are the weak link in making transmission competitive and therefore improving competition in both upstream and downstream areas of the gas industry.

The holders of capacity and the service provider itself have no obligation to extend or expand that capacity or trade it. They can, for reasons of their own, choose not to do that. The effect of the code in trying to provide open access to pipelines at reasonable and fair rates for all is markedly diminished if these policies are allowed to continue. If an extension or expansion is required to provide a new access seeker with further access to pipelines, and as suggested in our submission, the access seeker is prepared to fund the extension or expansion by one of the methods suggested, then there should be minimal ability for the service provider to refuse to provide the extension or expansion. The risk to the service provider, in our view, would be very low, of those sorts of extensions and expansions.

The access seeker could undertake to provide a certain amount of throughput at a certain price for a certain period which will ensure that the constructor of the expansion has the return of his capital plus some return, and will make the profit allowed for him on that return as well. Then there are incentive mechanisms in the code whereby, with the extra facilities, he may pick up some extra returns. In the end, the extension or expansion belongs to the service provider. I think that's all I wish to add to our submission. Perhaps Bruce would like to make some supplementary comments.

MR HINTON: Certainly, Bruce, if you wish.

MR WOOD: Thank you, commissioner. Robin has spoken of our comments in the area of gas access and I just wanted to say - if it was allowed - for a few moments - some comments on the regulation of the gas industry in general, albeit that part of that regulation is clearly in the area of transmission. It's a plea on behalf of the gas industry that in order for the gas industry to be able to maximise its position in the Australian economy, we feel that there are some areas that may not have been in the forefront of the designers of regulation.

We bring three concepts we'd just like to put out. It's not rocket science, but it's simply saying that we think the systems of regulation across our industry need to be more broadly understood across our industry. As we travel the gas industry we

find that a lot of our regulation is not well understood by the participants in the industry. Part of that understanding, we believe, must come from the regulation being as simple as it possibly can. The totality of the regulation must give results that are predictable. We think there are three messages that we'd like to put out there for people to consider in the totality of the regulation of the gas industry, albeit knowing that specifically today we're here to speak about the access to the transmission system.

When we spoke for the first time in our office, we mentioned our issues regarding general access, general regulation of the industry and, as part of that, just following on very, very briefly from that with the underlining of the goal that we would like to see our regulation simple, understandable and predictable. We would just like to point out perhaps one takeaway, as I close, which is to recognise that - to put Australia in some perspective in round terms - Australian gas production is of the order of 1 per cent of world gas production. We are around 1 per cent of the world. The United States is, in round terms, 25 to 28 per cent of world gas production. We are a very small player in the world gas industry.

One of the issues we face - and when I say "we" - we, as the industry, face is that across the totality of our industry it's generally accepted that we face around 10 areas of regulation. This is outside technical regulation, but in terms of access, commercial and retail regulation generally we have about 10 regulators. We would just put that down and say that we welcome the current debate in the community and in the gas world with regard to the simplification of the numbers or of the amount of regulation we face. We think that's a great step forward and we will be supporting that in all ways we can - a debate along the lines of attempting to minimise the complexity of our regulation and the number of regulators we face.

Having said that, in the transmission area, clearly, the structure is somewhat more simple in terms of numbers of regulators. So my comments didn't necessarily relate exactly to that, but we do think it's something we would like you, as the commission, just to put in the back of your mind in terms of the larger picture. Thank you.

MR HINTON: Thank you very much, Robin and Bruce, for those comments. Also, thank you for your submission. I think it's very important that we hear your perspective on the matters before this inquiry. Your particular role, capacity and involvement in the sector overall is very significant and therefore we welcome your participation in our inquiry and we thank you for that involvement.

I would like to pick up a number of things that have been raised by you this afternoon, but also in your submission. The first one is one that is in your submission rather than in your introductory comments, regarding greenfields issue.

Here you refer to the ACCC guidelines, published by the ACCC - draft guidelines I think they are - regarding perhaps changing or improving the environment for greenfields investment in this sector, and you properly note that those emphasise existing mechanisms within the gas access regime, but then you go on to say that the ideas being floated regarding access holidays or regulatory holidays would be inadequate. I would like you to explore further or elaborate for us why you have reached that conclusion about this concept of the inadequacy of a regulatory holiday not really addressing what you perceive to be an adverse environment for investment in greenfields.

MR ENGLISH: Sure. Our view of the greenfields regime is that each situation has different commercial complications and you wouldn't be surprised that Santos believes that the commercial market can usually deal with those complications. When regulators get involved it gets extraordinarily difficult for them, I think, to understand all the complications and respond to them in an efficient way.

Our comments and our submission are, really, we have a difficulty that the proposed, or talked-about, response to that difficulty is a regulatory holiday. I think that is too simplistic. I think it is much more complicated than that just by the nature of what we're talking about. Just focusing on regulatory holidays for a second, how would you determine what the length would be? Why would you determine what the length would be? Would the length be the same for each commercial situation? In our view it shouldn't be. Is a regulatory holiday in this particular situation, as opposed to that, the appropriate answer?

Then if you say it isn't the appropriate answer, what is, to stimulate investment in greenfields pipelines? I suppose of course you really want me to provide you with some answers, but I think those answers need to emerge from the debate that is going to come out of this review. We find at times that as transmission isn't really our business, although it affects it directly, we need to put more time into the analysis of what is happening in transmission and come up with some more provocative thoughts but, at times, it's not possible under the pressures of time, so I don't know what the solutions are. I want the debate to range as widely as possible, including regulatory holidays and their nature.

MR HINTON: This morning during the hearings a participant mentioned to us that - in fact it was ESCOSA, the South Australian regulatory body - suggested that an approach that put greater weight on opportunities for some blue sky returns from a greenfields investment might prove to be a more fruitful way to approach addressing the sort of adverse impact of regulation on greenfields investment and they referred in fact to the approach they might take with regard to some railways. Do you have any reaction to that sort of alternative way of looking at addressing this problem?

MR ENGLISH: Yes. My first reaction would be support, just depending on how it panned out in detail but, agreed, there has to be some greater incentive for the investors to get some super returns if everything goes really well.

MR HINTON: I suppose the key word that I used, and they used, was "some opportunity". How large a proportion of blue sky opportunity you actually get is another matter.

MR ENGLISH: In the current climate it wouldn't be large. I would be really surprised if the blue sky offered by a regulator was particularly exciting, but he should push himself a little, I would imagine.

MR HINTON: A related issue that has emerged through the course of our contacts with interested parties, and in hearings, has been a perception - a fairly widely held perception - that there is inadequate or too much emphasis, in fact focus, on lower prices for consumers, and in fact you pick this up in your own written submission, as well. It has also been put to us that that in fact is inconsistent with the origins of the gas access regime, given its basic origins link to the Hilmer report. Do you have any feel for why that sort of environment has emerged from the operations of the gas access regime? What sort of forces are at work to have shifted this environment to focus on price to consumers rather than investment?

MR WOOD: Perhaps I might just be able to comment on that. If we could just put a little bit of background in terms of Australia as Australia in the world - and I always get some assistance myself from considering Australia in the world. Australia is a very large holder of gas reserves. There are numbers published on it, but Australia has not been extensively explored for gas. In terms of something like the United States, Australia could be argued by some geologists to have comparable remaining reserves. Very large gas reserves.

We are currently 1 per cent of world gas production and, at the same time, we have the lowest producer-gas prices in the OECD. There is something fundamentally happening in this, and I was painting that because I think to some extent that goes to us painting your question in a different way. If Australia's gas prices are so low why isn't the industrial uptake of those gas sources happening in a way that allows Australia's gas production to go up, economies of scale to occur and more gas development to happen?

Perhaps one of the issues Australia should always consider is the importance of the electricity industry to the gas industry. The volume of gas consumed by growing expansion of the electricity industry worldwide and the position of the Australian coal industry, where the uptake of gas into the Australian electricity generation has been, by world standards, very low, so the gas industry in Australia finds itself

struggling against coal to feed power stations and so consequently gas developments that are taking place really have to take place on their own merits.

There is not an easily identified electricity market that can actually supply the base for the greenfields development - the base customer. It's very hard to get the base customer into the greenfield developments. In other parts of the world electricity plays a lot more important part. Perhaps it's a long way of saying that when we come to the Australian circumstance of encouraging new gas development and, inevitably, greenfields, we're out there very much more at the cutting edge of world competition.

We're having difficulties getting the electricity market there with us. The gas market is more difficult to get and it's the ability to try and pull together the whole of the chain for a greenfields development - the upstream, the midstream, downstream - each of them exhibiting quite significant issues and difficulties, and pulling all that together in a manner that allows the whole chain to be financed I think is putting us in a position where we're generally lagging in being able to have those developments happen. We're trying to argue that the system is difficult for producers, difficult in the midstream - particularly in the area of regulation we're talking - market is probably under-represented.

We're trying to pull all these things together, to get them financed, and this is all happening in a circumstance where gas prices are very low and it goes right back almost to the beginning of the chain, where gas prices are low, producers have less incentive, and it seems to flow right through the whole system. I believe it's quite a conundrum as to why Australia is not, as a nation, managing to use more of its gas resources in its industrial development. I think it's just a complex situation where each element of the chain is being affected.

MR HINTON: By regulation?

MR WOOD: That really comes in the middle. I mean, we can start to talk about unique things. If we want to go upstream we can't consider the position of the upstream industry. Most of the large gas resources are offshore and the tax regime offshore is a particular problem. The PRRT tax regime is a very significant negative on the development of further gas resources offshore and it goes right through the whole system and to the far end, where we're competing with very cheap coal resources.

MR HINTON: I am pleased to say our terms of reference don't take us down that track.

MR WOOD: And you're looking at the middle.

MR HINTON: Go ahead, Michael.

DR FOLIE: Again, when one is talking of the upstream, we do have a mandate about actually looking overall at the competition, just broadly, and going through your presentation, the issues you raise about actually - sitting where you are, being the major supplier of gas into all of eastern Australia, one interpretation one could see is that you feel you could actually sell more gas at the moment out of your system but the operation of the code is actually limiting, if you like, access to be able to actually develop the market a little bit further, and the issues about difficulty - the capacity trading issue, other such things. Are some of these issues in the code actually impeding the development of some additional markets - obviously nowhere near the large quantums, but certainly you could put more gas into various parts of eastern Australia at various time frames if the code was working better.

MR ENGLISH: I wouldn't go so far as to put it that definitely. As you would probably be aware, most of our gas is sold on a long-term contract and we've been around for so long. There is a history in the way we dispose of our gas. We have at times come across difficulties in - let me go back one step, as well. As you would also probably be aware, most of our gas is sold at the exit flange of the plant, so it's really somebody else's problem to get it down a pipeline, although it becomes ours very, very definitely, as well.

When we have tried to seek capacity for ourselves - for our own commercial purposes - in a pipeline we have sometimes been terribly frustrated. That's the short-term view. Further down the track, as the pipeline network expands and more and more players get into the game, I think the expansion, extension and trading policies in access arrangements need to be much more flexible to cope with the speed of transaction and the speed of need - that's a dreadful phrase, but the need to respond quickly to new needs as they emerge and, at the moment, it feels to us that it is very cumbersome.

DR FOLIE: They're hypothetical and I'm not putting you on a difficult spot, but effectively where the two blocks of gas are assigned - Sydney and South Australia - but from time to time, you could actually have additional - and there may not be any reason why Santos couldn't actually become, if you like - it's why you have access because, upstream, people can actually get access to pipelines.

MR ENGLISH: Yes, agreed.

DR FOLIE: In other words, it's new regime from the regime when the history of these fields went on and so you have been a little bit frustrated - in other words, access hasn't worked, which is part of what the code is about - actually getting third

party access into pipelines.

MR ENGLISH: Yes, I would agree with that.

DR FOLIE: You happen to be wearing multiple hats. I realise that.

MR HINTON: Another part of your submission is in relation to commercially-negotiated outcomes. Certainly as we understand the origins correctly, the designers of the access regime had in mind that there should be scope and sufficient flexibility within the access regime for commercially negotiated outcomes. Representations and submissions to us put it fairly clearly that that hasn't been the outcome. Regulatory outcome has been the default option. Your submission refers to that and goes on to say, "Well, no-one is going to get a worse deal than the regulated price," but that's after the event. Why would not two parties under the code seek to pursue a commercially negotiated outcome? Why is the regulated outcome the default option? Do you have any views on what impediments are occurring out there, under the regime, which seem to be inhibiting commercially negotiated outcomes?

MR ENGLISH: May I just clarify? You're talking about commercially negotiated outcomes before coverage?

MR HINTON: That is a possibility, yes, but also it would seem to be that's the most prevalent case before coverage. After coverage then all sorts of activities get under way; that seems to defer any sort of negotiation and it then leads to regulatory intervention.

MR ENGLISH: After coverage, the ACCC seems to have done its work really well in most cases and the margins are already low. I'm sure you would find pipeliners saying the margins on their pipelines are relatively low after coverage. They're not going to negotiate down from there. Prior to coverage, wouldn't it be - this is a thought that's in response to your question, but isn't the concern of the pipeliner that coverage applications may be made at any time despite their commercial arrangements? Then their commercial situation becomes a contorted one, with more than one chunk of gas with different prices and different commercially negotiated or regulatory outcomes on the price. I think that threat is the thing that would concern most people, but please don't misinterpret me. I don't say that the way pipelines are covered is necessarily bad. We chose not to address that in our submission.

MR HINTON: The question then arises then, if that threat of regulatory intervention in itself represents an impediment to a commercially negotiated outcome, how could the code or the access regime be changed to shift the incentive

more to a commercially negotiated outcome? Creative ideas would be welcome.

MR ENGLISH: Maybe we'll have to provide our creative ideas after this hearing. I'm not quite sure. I think it's a very good question.

MR WOOD: Is there an element of the newness - the immaturity - of our system whereby the expectations of both sides are perhaps too far apart or there is not yet a well enough established likely outcome? If you have two parties generally thinking the outcome of a regulatory process is within a fairly tight band, and they will negotiate within that tight band, one would think that something should come out of it. If there's too large a range of possible outcomes in the minds of the negotiating parties, that's the sort of pressure that keeps them apart. I was just listening to that and wondering whether part of it isn't the newness of our system and, as people become more and more sure about where the outcomes are going to lie, they're more likely to negotiate within those outcomes.

MR HINTON: Some have put to us the points that we've already been discussing a moment ago, that is, an over-emphasis on regulatory outcomes that puts the pursuit of lower prices at too high an objective, in fact, favours the consumer, not the investor. Therefore, a regulatory regime that puts greater weight on the need to encourage investment, as opposed to producing lower prices for consumers, in itself may shift the balance back to commercially negotiated outcomes.

Rather than having regulatory pursuit of commercially negotiated outcomes, change the nature of the intervention itself that does leave scope for blue sky returns and does leave scope for appropriate returns on investments that warrants the investment in the first place. That's a view that's been expressed to us. I'm not expressing a conclusion of my own view.

MR ENGLISH: Could you put it a different way - the same proposition - and that is long-term and short-term focus is part of what you're saying, I think.

MR HINTON: Yes.

MR ENGLISH: Part of what they have put to you must be long-term and short-term focus, because long term you'd have to focus on both objectives. You want the investment and you want low consumer prices. You can't have one and not the other. Sorry, that's the wrong way to put it. You shouldn't pursue one to the exclusion of the other, because if you pursue low prices to its nth degree no investment occurs and prices must rise in the end as the system collapses commercially and vice versa. If you have lots of gas pipelines and no customers, that will also collapse the system, so the difficulty is the balancing act between the two.

MR WOOD: I think that's a very good point that you made there, Robin. Perhaps there could be some investigation done of the current New Zealand situation. It's a bit of an example that's slightly outside transmission, but is an area where effectively the pursuit of very low and the contracting of very low prices into the gas industry has created a fundamental under-supply situation and now there is a gas price shock working its way through the industry. Perhaps there are some interesting analogies there of where that balance may not have been right.

MR FOLIE: I'd like to ask a delicate question possibly. It does come back to, if you like, in our issues paper things like 7.1 about the benefits and costs upstream. With access regimes, in a way it's - you've got a block of gas assigned to South Australia with a price profile associated with it and you've got a block of gas assigned effectively to New South Wales, as I understand it, with a price block to it and you deliver according to that. Is there any inhibition on the two parties who are taking that gas to then under their own commercial arrangements - of swapping, but rather than within pipelines, between pipelines?

In other words, for whatever reason - I'll take as a hypothetical New South Wales could decide if the South Australians wanted to pay for it, you could then dispatch that down to New South Wales. In other words, is there a major customer block? Is that competition allowed or is that actually precluded under some state regulation, that those blocks are clearly dedicated to each of those two states and they can't be traded at the willingness of the two customers?

MR ENGLISH: No, I think it can be traded at the willingness of the customers.

MR FOLIE: Right. So there is competition between the blocks?

MR ENGLISH: Yes.

MR FOLIE: Thank you.

MR WOOD: In fact, commonly people talk about those contracts as blocks of gas to particular states. They're actually contracts to individual customers and then within the rights of the individual retailers - the individual will place that gas as they choose across the network.

MR FOLIE: Thank you. I was just trying to get another handle on the nature of - because you want basin to basin competition and it's not there and I think something like that is just useful - a bit of extra factual understanding.

MR ENGLISH: May I just make a supplementary comment?

MR FOLIE: Yes.

MR ENGLISH: There are in South Australia some legislative obligations on the producers to supply and have in reserve - and I can't remember the terms of those - a certain amount of gas, but it's nowhere near the gross amount of gas that is supplied. Effectively, the answer we've given you is correct, but there are things in the background that need to be considered.

MR HINTON: Robin, during your presentation you made some reference to the issue of extensions and expansions of capacity and your written submission also gave some significance to this issue as well. In fact, you came up with some possible refinements to the code and you made some interesting suggestions.

MR ENGLISH: They're made to stimulate discussion.

MR HINTON: I'd like to explore some of them with you. The first question that comes to mind is that some would say to us that the code is sufficiently flexible and, in fact, is explicitly designed to handle actions to expand capacity on existing pipelines and that, with all sorts of arrangements that can, in fact, lead to outcomes, new demand can be met by an expansion of existing capacity. Why isn't that working? They say it's there. You clearly think it's not working.

MR ENGLISH: No, I don't think it's working. I think it's mainly due to the fact that the code may have the provisions, but those provisions sometimes don't find their way into the access arrangements as they get negotiated to conclusion. That's part of it. Of course, you referred earlier to some delicate stuff, and we shouldn't say who we've been dealing with, but our experience is we have been unable to achieve what we wanted to achieve through expansions and extensions policies.

When we have engaged in the toing and froing between a pipeliner and the ACCC and provided comment when access arrangements are being negotiated, we have found that the ACCC has been unwilling in the end to make the extensions, expansions and trading policies of those access arrangements have teeth. Of course, referring to a comment made a few minutes ago, yes, we would as a producer at times - and we envisage that we will want to secure pipeline capacity for ourselves. I'm sure everybody who's engaged in the industry wants as much flexibility as possible, and the extensions and expansions policies that we've come across so far don't do that. Maybe it's between the code and the access arrangement. Maybe it just needs a little more pepper introduced into getting the right terms into the access arrangement.

MR HINTON: There's been a tendency for a bit of dust to be thrown in the air on this one, in terms of at what price the new demand consumer might get the gas at

relative to, say, foundation member customers, relative to MFN clauses and whether or not that is a sufficient return to meet the cost of the expansion and extension. Can you give me a better feel for sort of the parameters that work here, in terms of under your formulation and refinement to the code, as to how the pricing to the new customer might be worked out? What parameters would be applied, in terms of meeting those sorts of tensions I've just described?

MR ENGLISH: I think the first thing that's not happening is there's not enough transparency when those things occur, when the terms are negotiated into the access arrangement and when an access seeker goes to the service provider and says, "I want some more access." I'll try and address your question at the end. Really, the first thing that needs to be improved is the process from when somebody wants access to whether he gets or does not get it.

Part of that, of course, is the price and the cost of providing the extension or expansion. There are procedures, as you know, in most access arrangements and the code whereby the cost of the expansion or extension is estimated and communicated to the person seeking the access and you go backwards and forwards and decide whether it's okay and whether it can be. When you come to the point where the extension that you seek is determined - the technical nature of it - and the cost is determined - and the ACCC should be a player in that, so that it can provide some balance to perhaps some rather fierce commercial negotiations - that's when you'll have to determine price, and it must be related to the cost of the extension or expansion to the service provider.

It is trite to say that, but I don't think I can answer your question directly other than to say, when you get to the price that the extension or expansion is going to cost, out of that will fall calculations for how much the price to the end user should be. Your question then addresses should the new guy pay more or less than the foundation customers? I'm speaking off the top of my head. I'd probably have to think about this a bit more, but in principle why should he pay any different? Assume you've got a simple situation where you've got a group of customers and one extra. Why should he pay any different price for the transport of gas than anybody else, assuming that the expansion that is required is another compressor? In other words, not extra distance, but just some more compression capability.

The answer is I don't think there is any reason why he should pay anything more or less. It's not his fault that he's worked out he needs gas from this pipeline 10 years later. After all, the end result of all of this is to provide high quality gas delivery services to industry to stimulate industrial development and get Australia on the move. A later new user of gas investing in industry is penalised. It doesn't seem to make sense. If there's a really good reason why his particular gas supply costs a particular extra amount to deliver and there's a reason that, even in the face of that,

he still will go ahead with his request for capacity, then perhaps he should pay more, but I think in principle one pipeline delivering one fungible product should be at the same price.

MR HINTON: If the cost of the expansion, if funded by the consumer, gives a lower price of gas than the foundation customers', prima facie through MFN clauses that would lead to a lower price for the foundation customers.

MR ENGLISH: Yes.

MR HINTON: That means that the owner of the pipeline then doesn't get the full return over the life of the pipeline that would have been spent to fund the construction of the pipeline. Isn't that the tension?

MR ENGLISH: Yes, I think it is the tension, and certainly the owner of the pipeline shouldn't be disadvantaged. So you might have to adjust both prices to make that equitable in that circumstance.

MR HINTON: So my question then becomes is the regulator, in looking at expansions, sufficiently cognisant of these sorts of factors at work? In your judgment, you're saying that the code is not working with regard to expansions. I'm trying to explore why it's not working. It doesn't seem to be going anywhere.

MR ENGLISH: I'm interested in your question. I don't think it is working, and I think you're right - the regulator perhaps isn't aware. Wouldn't one of the solutions to the problem be more transparency at the time of extra capacity being sought? The regulator would be in a position then to have more of the facts at his fingertips in a clearer way, and so would everybody else. You can't just throw it open to everybody who wants to look at everything. We have to have some faith in the ACCC that they are sophisticated enough - and I believe they are - to give the process more transparency. Within the flow of information that then results, I think you'll get an equitable answer.

MR HINTON: A related question becomes one of the sort of incentive to build pipelines - transmission pipelines in particular - greater than known capacity; that is, to feed in at the initial stage access to surplus capacity. It's been put to us that the nature of the access regime, the nature of the code in fact, is a strong incentive to build to known capacity, known demand, and it's a strong disincentive to build in surplus capacity because of the regulatory risk associated with the return on the cost of that investment to build surplus capacity. Do you have a feeling for those sorts of factors at work under the access regime?

MR ENGLISH: I don't have a strong view about who's right in that argument.

But, talking in theory a little, you would have to say that, whether you build over capacity or at capacity, if there is an extra access seeker - and this response wasn't designed, and it sounds as though I'm sticking the knife in - and if you had an adequate expansion policy, why would it matter whether you built to design or not? If the expansion policy worked well, it would be expanded.

MR HINTON: I did say it was a related question.

MR ENGLISH: Yes. If you over build and there is no regulation and there's no application to the NCC to have coverage, does the fact that you overbuild the pipeline attract regulation? Theoretically, it shouldn't; it should have the opposite effect. If the pipeline has extra capacity and he wants to earn more money, he's going to make a deal with you.

MR HINTON: Get commercially negotiated outcomes.

MR ENGLISH: That's right. It's commercial and it keeps regulation away. Of course, there's capital risk in that, in the sense that he's spending a lot more capital before he has to. So the answer is probably for the pipeliner to build to capacity for commercial reasons. Is he building to capacity out of the fact that he has a vile view of commerce? I doubt that. I think he's making sensible decisions about capital, interests and how much it's costing him to do these things.

MR HINTON: But that's when the regulator gets involved. If there is a perception or assessment of market power, then the on-selling of that surplus capacity is deemed appropriately to be regulated - if there is market power.

MR ENGLISH: In a perfect world, wouldn't we have sophisticated, expansive pipeline builders who approach the question with the idea that they want the most lucrative asset therefore built and expanded to capacity that is required and made a good return on that? So I think if you approach it from that angle, even though perhaps there is evidence that that is not how some pipeliners approach it, and that's fine, that's their commercial choice, but with expansions and extensions, you should overcome the problem anyway. I'm not pooh-poohing this. That's my response. I understand the arguments, but I would hope that, over time - in support of Bruce - as we become more sophisticated in the industry those difficulties become less and less.

MR HINTON: He did touch on it earlier. I think Bruce made some comments on it as well, Robin, and that's linked to this issue of expansion capacity - whether or not we have an effective capacity trading system. You passed some not quite derogatory comments, but certainly not favourable comments, on that in terms of current environment. Do you have any insights into mechanisms by which a system of capacity trading might be better developed for the gas sector in Australia?

MR ENGLISH: Perhaps the only thing I'd like to add is I have a deep and inherent suspicion of lack of transparency. Once you start having regulators and all sorts of commercial interests involved and the information, which is the currency of competition in more sophisticated economies, is unevenly held, then I think the abuses flow. An example would be somebody seeking access to a pipeline and they are told that the pipeline is full, and then they might have some technical knowledge about the pipeline and know that its rated capacity is X. Five customers off the end of the pipeline can only be buying Y because we know what the Y is.

There's a gap that capacity is available, and we don't have any way of exposing the information, even if it's in a confidential way, to the ACCC, who deals with it in a sophisticated manner for access seekers and current owners and protects their commercial interests. We don't have a way of finding out whether we're right or wrong, so we end up disgruntled. So our concern about trading is let's have some transparency of information. Let's have more comfort that, when we are told things, they are actually happening, and I'm sure a lot of those difficulties will disappear.

MR HINTON: But capacity trading is also a dynamic concept as well - that is, it's not a static demand versus availability. That demand can shift; it can free up available gas.

MR ENGLISH: Sure.

MR HINTON: It seems very difficult to bring a transparency to that sort of dynamic environment.

MR ENGLISH: The access seeker may be happy with interruptible, depending on how the demand on the day or in the week, however it's judged in a particular circumstance. That person may be happy to take it interruptible, and that will overcome some of it. Of course, if that doesn't, then it indicates an expansion, and we start going back in circles again.

MR HINTON: Do you see a role for the regulator to be setting up a market?

MR ENGLISH: No, I don't see that. I see a role for the regulator to ensure transparency and then let everybody else trade.

MR HINTON: Got your message.

MR ENGLISH: We can't trade without that.

DR FOLIE: One of the submissions, which had nothing to do with your area, was

that access is allegedly inhibited because the gas spec down the pipeline is a very narrow, specific gas spec, which therefore means additional gas finders, who might then want to have access, really have difficulty because of the way the customer base has been spread. The reason I ask you the question is that you have multiple fields, clearly, in the Cooper Basin, so presumably the gas from each of them is slightly different. Do you have a broad gas spec, and is that fairly normal custom and practice which then again enables any third parties who might find additional gas to be able to then get access to the pipeline? In other words, the gas spec can be an inhibitor towards access.

MR ENGLISH: My initial response to that is it probably isn't. We have contractual gas specs with our major customers, which are somewhat different to the gas spec which is slowly being accepted nationally. The national gas spec is perhaps a spec that everybody should be able to live with and has gone through endless rounds of consultation, so I would expect that to be true. The raw gas coming in from all our different fields is vastly different in quality, but it's all processed through one plant and conformed to the spec before it becomes sales gas and shoots off down the line, so it's not a problem for us, I don't think.

I think the query seems to me to be a little concerning in that you can't - I feel as though I shouldn't be lecturing you on gas specs. The gas in the line is fungible, and the customers get whatever comes past the exit point when it comes past. So to have different specs in the line would be impossible. The absolute limits of the spec seem to me to be designed to meet the needs of the users and, if the spec is eased too much, a lot of equipment might become in need of amendment. So I think that doesn't seem to me to be a worry.

DR FOLIE: In other words, what you're saying is it's not an issue - it's an issue that can be resolved by the upstream processing plant in most - - -

MR ENGLISH: Yes, I agree with that.

MR HINTON: Is there anything we've neglected to focus on that you think we should be focusing on?

MR ENGLISH: No, but I'm sure we'll have an opportunity to hector you with some more sometime later in the process, if we may.

MR HINTON: I'm not so sure that would be the right verb for Santos. Thank you again for your participation and involvement, both in terms of written submission and your appearance today. As I said right at the start, you bring a particular perspective to the issues, given your sector involvement, so thank you again. We appreciate it.

MR ENGLISH: Thank you.

MR HINTON: Welcome back. This is the last session of our public hearings in Adelaide. I welcome to the microphone the representatives of Epic Energy, Mr Anthony Cribb and Ms Talya Barry. Thank you very much for your time today. At the outset, what I'd like you to do, for the purposes of the transcript and the sound system, is to identify yourselves and where you're from. As already discussed prior to the start, we'd give you an opportunity to make an introductory statement, if you would so wish, and then we can move on to questions and discussion thereafter.

MR CRIBB: Thanks very much. My name is Anthony Cribb. I am a manager of regulation and risk for Epic Energy.

MS BARRY: My name is Talya Barry. I'm the legal and regulatory specialist at Epic Energy.

MR CRIBB: First of all, we'd like to thank the commission for giving us the opportunity and also extending the indulgence of allowing us to provide a draft of our submission within the time frame. We do intend to provide a final version of our submission before the end of this week. I also must extend an apology from our CEO, who was intending to present at today's hearing. Unfortunately, he has a meeting with our syndicate banks for the DBNGP due to the regulatory decision and our refinancing timetable there. He does, however, intend to participate in the industry association presentation to be made in Sydney at the commission hearings.

We'd like to make a couple of introductory comments in addition to the previous ones. It's Epic's intention to make a substantial amount of information available to the commission and, in so doing, to make as much of that information available on a public basis. However, there will be some information that cannot be disclosed publicly due to confidentiality and commercial sensitivity constraints. But our best endeavours will be to provide as much as we can on a public basis. We have also contributed significantly to a submission through a number of industry associations that Epic Energy is associated with, primarily the Australian Pipeline Industry Association's submission which, I understand, will also be provided to the commission shortly.

We don't intend to take you through every point in the draft submission that we've made to date. However, we'd like to focus on the most important aspects, as we see it, from the submission and also to provide a couple of examples to demonstrate our point - real life examples. One of the first things that we'd like to put forward to the commission is responding to the perception that seems to have arisen over a number of recent inquiries that have been undertaken as to whether the claims of disincentives to investment are ambit claims made by service providers. Are the service providers crying wolf? We have cited in our draft submission today a number of actual examples of investment fundamentally changing the way our

investors approach investing in infrastructure.

From Epic's perspective, there are a number of examples of regulatory application which have caused this change in approach to our company and also our investors' approach to investing in regulated transmission pipeline infrastructure. The DBNGP draft decision and the DBNGP process, which has been receiving fairly widespread public commentary, is not just a one-off aberration. The important thing to note from the DBNGP process is that the regulator, in applying the code, was slavishly following the east coast regulator's approach to the interpretation of the code and the application of the code in that instance. So there is a fundamental problem with the code and its application by regulatory institutions that Epic Energy sees as being the primary cause for the disincentive to invest in regulator transmission pipelines.

There's an increasing acknowledgment from a number of stakeholders, not just transmission service providers but also stakeholders upstream and downstream of transmission pipelines, that there is something wrong with this current regulatory regime that is acting as a disincentive to investment. Recently at a national power and gas conference, the general manager of - I might have his title incorrect - commercialisation and marketing of gas at Santos, Bruce Wood, made comments about the gas regime being one of the key impediments to investment and to market development. Similarly, as I understand it, Alcoa made a presentation at your hearings in Perth on Monday, claiming that there were significant disincentives to invest in pipeline infrastructure. So we don't see this as an ambit claim made by a particular party with a vested interest in this process. These are claims which are widespread amongst the industry.

It's important also to understand, as we've set out in our submission, where we sit in the industry we are, as a transmission service provider, a pure transmission pipeline owner. We do not operate upstream and downstream. In fact, it was a key strategy of our owners that that be the area that they wanted to invest in. We also have to bear in mind that a number of the pipelines that Epic Energy owns were either purchased from government entities or were constructed with the imprimatur of state governments at a time when the regulatory framework was being developed. Governments made a conscious policy decision that the private sector would be a primary investor in providing such a critical public utility infrastructure as gas transmission pipelines.

The other introductory point we'd like to make is that Epic Energy, as a transmission pipeliner, deals with a very small number of sophisticated, large and informed customers who have well-established positions in their markets in which they operate. This is a point we raise, and we provide you with the evidence in our submission as to who we actually deal with. Probably the best example is the

Moomba-to-Adelaide pipeline system, where we have only four customers on that pipeline.

The key issues that we've raised in our submission are the regulatory certainty is a key investment incentive, but the framework and the application of that framework is leading to significant levels of uncertainty for our investors. We've sought to categorise the uncertainty at two levels; the first is in relation to the structure of the code. Given the manner in which the current ownership of the pipelines arose and the timing of it relative to the introduction of the national competition policy reforms, it was only appropriate that service providers relied upon their understanding at the time, as represented to them by governments, as to how the code would be structured. Key amongst the objectives was an approach to light-handed regulation; this has not occurred. The code is one of the most prescriptive and intrusive forms of regulatory instruments that exists in Australia, and it applies to a market which a number of previous inquiries has acknowledged is an emerging market.

The second level of uncertainty arises in relation to the application of the code. Epic Energy has experienced, and it has been shown by the courts, the focus of regulators to date on lowest-cost outcomes, coupled with the risk of the regulatory resets, is proving a fundamental misapplication of regulator statutory functions. One of the other examples we've pointed to in our submission about the regulatory uncertainty is in relation to the certification of effectiveness of the Queensland Gas Access Regime. That regime contains a number of derogations relating to pipelines which were constructed at a time when the south-east Queensland market was running out of gas. There was a critical need to invest in infrastructure. The government acknowledged this through the establishment of certainty for the developers of those projects in relation to pricing. That was reflected in the intergovernmental agreement signed in 1997.

The process, which has taken since 1998 until today, which is still not finalised, is currently heading down the path of the regime in Queensland not being certified as an effective regime pursuant to the Trade Practices Act. The whole purpose of the intergovernmental agreement was to further the national competition policy reforms, which were underpinned by the competition principles agreement. The National Competition Council has recommended to the relevant Commonwealth minister that the regime is not effective because of the derogations contained in the Queensland Gas Access Regime, those very derogations which were required to enable the development of the pipeline infrastructure in Queensland to occur. The level of regulatory uncertainty is a key example of how the regulatory intrusion is acting as a significant disincentive to investment.

One of the other aspects - and this is a fine, technical point but is a substantial

point that we seek to raise in our submission - relates to the approach to assessment of access arrangements by regulators. The code sets out in a very detailed way the assessment process. Section 2 of the code is quite detailed as to how a regulator should approach an assessment of an access arrangement. That section 2 is coupled with section 3 and, in addition, section 8 of the code, section 8 being the pricing principles. As Epic understands it from the Supreme Court decision in the Dampier to Bunbury Pipeline legal challenge of the draft decision, the process that a regulator must follow is a process of assessment of an access arrangement not a process of determining what elements of an access arrangement should be. That may seem a fine point.

As we understand it, the regulator's current position, following the DBNGP case, is that its role in the regulatory approval process is as follows, if I can categorise it into three steps. There will always be a range of values that can be used or adopted for each of the variables required in assessing an access arrangement - in particular, the tariff-setting elements. However, the code vests the regulator with a broad-ranging discretion. That discretion must be exercised in accordance with the objectives and particularly in accordance with the principles and factors contained in section 2.24 of the code.

However, because the regulator is left with that ultimate discretion, it is left to the regulator as to where it should land within that range of values. That points to the regulator adopting a determinative approach to assessing an access arrangement, not an assessment of what the service provider has put forward. Our view, from the DBNGP court decision, is that that is a fundamental misconstruction of a regulator's statutory function. The regulator's role should be to assess what is put forward, whether that is reasonable. That is a role which is consistent with the competition principles agreement. That is a role which is consistent with the intent of the national competition policy reforms.

If a regulator is to adopt an intrusive, prescriptive and determinative approach, that is fundamentally inconsistent with what the intent of the competition policy reforms were about, which was ensuring that a user had a legislated right of access, which was to be assessed to ensure that the terms and conditions of access for that user were fair and reasonable, balanced in accordance with a number of objectives, which are strikingly similar to those contained in section 2.24 of the National Gas Code. We seek to show in our submission examples of where that approach has not been adopted by regulators.

The next issue which we have raised in our submission, and which we seek to highlight today, is the protection of appeal rights. If we can go back to the Hilmer committee report - which, of course, is the genesis of the national competition policy reforms, of which the Gas Code is a part - appeal rights were a fundamental

underpinning of an effective access regime. The Hilmer committee was well aware of this fact, particularly given that many of the facilities for which access rights would be required were at that time publicly owned. Governments, however, were proposing to privatise the enterprises that owned these facilities, and so any attenuation of private property rights in the public interest needed to be carefully considered.

The Hilmer committee was also conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. There needed to be appropriate appeal rights in those instances as well, so we consider any attempt to water down the existing appeal rights - as limited as they currently are - must be resisted at all costs. In fact, I think our position is that those appeal rights are too limited at this stage. There is, we believe, evidence to warrant recommending the implementation of more expansive appeals processes. This is particularly if the regime, as it is currently being applied and currently structured, has its main focus on intrusive lowest-cost access pricing. If that regime is to remain on foot, there must be a strengthening of the appeal process, because that application of the code is inconsistent with competition principle perform objectives.

We have outlined in our submission a significant number of appeals which have been brought or which are intended, as we understand, to be brought in relation to regulatory approval processes. Those appeals span 1999 until 2003. The table that we have put forward doesn't include arbitrations. Those arbitrations are about access, not about regulatory process. It can't be said that the appeals process is being used by stakeholders, in particular service providers, to better their commercial positions. I don't think it could also be argued that the appeals process has been used to gain a system by regulators, particularly given that, as Epic Energy understands, of all of the legal challenges that have been commenced to date by service providers, only one of those decisions has been decided unfavourably against the service provider. There is obviously a fundamental problem with the application of the regime.

We also have shown in our submission about the misapplication of statutory functions by regulatory bodies, as is borne out in the DBNGP decision. In the case of service providers, I think there's appropriate reason as to why there should be appropriate appeal rights, given the case of Epic Energy where a significant amount of its revenue is generated from regulatory revenue, or regulated infrastructure. Talya was going to talk about the timeliness of regulatory process, so if I could hand over to Talya.

MS BARRY: Thanks, Anthony. Epic Energy views the timeliness of decision-making by the regulators as a further flaw in the code. Whilst we

acknowledge that there have been delays which, for example, as a result of the need for parties to commence judicial review process in order to protect their property rights, we feel that it must be recognised that the system gives a regulator total control of the regulatory timetable, and the service provider is actually given no control over the time frames in the assessment process.

We do in our submission provide a number of examples of the delays that have been experienced, but with the time constraints of today I just wanted to focus on the two processes that Epic is involved in to demonstrate the lack of timeliness, being that the MAPS which is currently being determined by the Australian Competition Tribunal, the duration of that process to date is four years and five months. It's perhaps only a coincidence that the process was formally started on April Fool's Day in 1999 - just to put in a joke there.

DBNGP: the regulator is currently assessing Epic's revised access arrangement, and the duration of that process to date is three years and nine months. While this process has generated a significant number of submissions, we believe that surely this cannot be used to justify such a lengthy process and, even if one were to take out the 12 months for the DBNGP legal challenge process, the time frame, we feel, is still quite unacceptable. Timeliness is a critical issue, particularly when the regulators get to change the point in time at which they assess the rate of return allowed, effectively allowing the return to be adjusted during the regulatory process, and this doesn't fit in with the commercial reality when investors are required to sink capital and fix their returns at that time.

MR CRIBB: One of the points we want to make there is that we file an access arrangement, we put forward a particular rate of return at the time of filing; regulatory decisions have proceeded on the basis that they assess the rate of return immediately prior to their relevant decision. Given that we've gone through four years of some regulatory processes, we get totally different rates of return from the ones we filed, primarily because of a change in market rates. We can't take advantage of those changes, nor can we insure against the risk of those changes reducing over time because we have to invest our capital at the outset, and it's at the outset where we structure our financing and that's when we have to lock in our interest rates. So there's a fundamental mismatch between commercial reality and regulatory application.

MS BARRY: Generally, from Epic's perspective, the delays are unacceptable and, given the comments of Ofgar during its presentation in Perth yesterday, Epic is clearly not alone in this thinking. Finally, it can't be argued that the delays will not arise in any subsequent reviews of access arrangements, because the regulator still has total discretion over the timetable.

The other areas that I wanted to talk about were transparency and accountability. These are further concerns of Epic Energy and, again in our submission, we provide a number of examples to demonstrate the lack of transparency. However, I'm just going to focus on one of those today, being the issue of consultants. In both the MAPS and the DBNGP approval process, there was extensive use by the regulator of consultants. However, in many cases, Epic was actually refused the opportunity to have access to and also to make submissions on the advice that was provided by those consultants. In fact, in some instances, Epic Energy wasn't even aware of certain consultants having been engaged.

There are statutory provisions regarding conflict of interest by the decision-maker, which should apply equally to those who provide assistance to the regulator and, without a transparent process, the service providers are unable to be certain of who is providing the assistance to ascertain whether, in their view, there may be a conflict in such person providing assistance and, if warranted, to object to the use of certain consultants.

MR CRIBB: The additional comment we have to make is that Epic Energy doesn't object to the use of consultants in the process. What it believes should occur is there should be a transparent use of consultants. It is only appropriate that a regulator, who doesn't have the knowledge of running a pipeline, gets particular advice if it believes there is something inconsistent in what a service provider is putting forward. That's a point that we wanted to make clear: this shouldn't be seen as a consultant-free process.

MS BARRY: The final issue that I want to talk about is the lack of accountability of regulators. I'm going to use the example of the consultants again for this. In WA in particular, due to funding regulations, the regulator is not responsible for the costs incurred by the use of consultants because such costs are actually paid by the service provider. This creates the situation of lack of transparency in the use of consultants and lack of accountability in relation to the costs, which in a user-pays system is likely to lead to further problems.

We have included in Epic's submission a summary of the recent WA Supreme Court decision relating to the funding regulations, which has gone, we feel, some way to dealing with these issues. One of the declarations of the court was that the regulator may only impose service charges that pass on reasonable costs of a type which it was reasonably necessary or convenient for the regulator to incur. We consider the accountability issue is likely to become even more significant from a national perspective, given the Ministerial Council on Energy announcement recently that it intends to implement a user-pays system to fund regulatory agencies.

As a final example of accountability - that actually relates to what the role of a

regulator should be - the role should be one of applying legislative frameworks in accordance with the stated objectives of the frameworks. However, the decisions of regulators have sought to reinterpret these objectives, and the focus is now on lowest-cost outcomes. This amounts to regulators playing a key role in the setting of policy-making but not being accountable for such intervention. The clearest example of this relates to the role of the NCC in its assessment of the Queensland government's application for the certification of the Queensland version of the Gas Access Regime, being a reinterpretation of the intergovernmental National Gas Pipelines Agreement.

MR CRIBB: The other issue we wanted to make about accountability is, Epic Energy has experienced a significant increase in the costs that it has to bear for funding of the regulators' activities over time. These are costs which are both directly related to the regulatory process for a particular pipeline and also the general overheads costs of running an office. Epic Energy has been unable to challenge to date any amount which has been incurred by a regulator, except by means of judicial challenge, which it has sought to do and has been vindicated in such an approach.

There has been a proposal by the MCE to move to, I guess, a super-regulator, which not only deals with national gas issues but also multi-industry regulatory functions. That, we believe, will only lead to an increase in costs. Studies that have been undertaken to date show that the creation of the super-regulator bodies only creates additional costs. It does not generate any cost savings. We have referred to in our submission a number of studies that have been undertaken which confirm this.

We believe that without appropriate checks and balances to ensure that these costs are being properly incurred, if it is the requirement that industry pays for these costs, that the checks and balances need to ensure that there can be a vetting to ensure only reasonable costs are incurred and, secondly, that the service providers who obtain no benefit at all from the regulatory process to date are able to pass on 100 per cent of those costs to those who are supposedly benefiting from this process - the users. The example we give is that, in the Dampier to Bunbury pipeline, Epic Energy has been required to bear 100 per cent of the regulator's costs; has been refused the ability to pass on those costs which now total over $3 million.

The next point that we seek to make is a response to claims by regulatory bodies in relation to the lack of information that regulators obtain, the information asymmetry argument that regulators have put forward. This, in our view, is a myth. In fact, it's a curious claim that regulators make when they say they're unable to get appropriate information to make decisions yet, on the other side of the coin, regulators have the most expansive information-collection power that one could imagine, a compulsory information-collection power. Furthermore, regulators in their decisions are now saying that their values that they come down with are the

most precise and accurately quantified value that you can achieve. How can the regulators say they don't have the information, yet on the other side say, "This is the most correct value that should be adopted." There's a significant inconsistency I think in that argument.

In relation to information provision by Epic Energy, I think the Dampier to Bunbury Pipeline case is a fantastic example of information provision by not only a service provider but also stakeholders in the process. There have been submissions made in that process. That adds to the burden of a regulator in collating that information and we don't shy away from I guess the added burden that the regulator has in that process. However, it should be seen that if the regulator already has a significant amount of information provided to him, or to the regulatory body, why is there a need for further information-collection powers which the regulators are pushing for? Regulators have been pushing for this need for information-collection power for over three and a half years through the NGPAC process and they will continue to seek further information-collection powers which we argue is inconsistent, once again, with the competition policy reform objectives.

I guess the final problem that we've identified is tying it back to the original competition policy reform objectives. The intention of the Hilmer reforms was to promote competition in upstream and downstream markets. If the evidence of promotion of competition is lower prices, if the evidence of promotion of competition is greater participation in those markets, the code has failed in both respects. We've provided the empirical evidence in the submissions to, we believe, support that, to show how that objective is not being achieved.

Another objective is in relation to the creation of a national market for gas. To create that national market, one needs more infrastructure. Epic Energy and its investors are on the public record as saying they will not invest in further infrastructure. There have been a number of public comments made today in relation to the future ownership of the DBNGP. One always needs to be cautious about reading into media speculation - that does not necessarily mean that there are buyers just waiting outside Epic's door to buy the asset. There needs to be a key understanding of the rationale behind some of these proposed investors as to what their intentions are. I think the need for investment in infrastructure is the primary reason for us saying that there is a need for fundamental change to the existing regime.

It is stifling the investment, not only through the outcomes but also through the processes. If the Dampier-to-Bunbury pipeline had continued with the regulatory regime that existed beforehand - and let's bear in mind that there was a regulatory regime that existed prior to the code in Western Australia. That regime allowed for the same structure in essence as the code yet since the implementation of the code.

In fact, since the application of the code, the assessment of the access arrangement, there has been no decision by Epic Energy to commit to the further expansion of the DBNGP, despite the fact that Epic Energy committed, at the time of purchasing the asset, to expand that pipeline by $875 million over the first 10 years of its ownership.

Turning to the solutions, we've worked quite closely with the Pipeline Industry Association putting forward a model. I don't necessarily want to steal the thunder of the APIA in its submission and we refer to the APIA's submission to rely upon the greater detail of that proposal. Our proposal is for a more light-handed approach to regulation. That is the approach which will provide - or not act as a disincentive to investment. We talk about investment. Epic Energy as a service provider is in the game of efficiently investing in infrastructure.

Our submission has put forward the evidence which shows that building spare capacity up-front will lead to cheaper prices for customers. Building pipelines to meet foundation customer load will lead to higher prices for those foundation customers and even higher prices for future customers. That is hardly an efficient outcome. We have suggested, therefore, that the third-party access framework should be based upon the framework set out in Part IIIA of the Trade Practices Act, the National Access Regime.

There should be a negotiate-arbitrate model. That is consistent with the original intent of the Hilmer reforms. That is consistent with the competition principles agreement. The negotiate-arbitrate model should give greater acknowledgment to commercially negotiated outcomes. There is sufficient protection in that regime, coupled with the existing provisions of the Trade Practices Act, for consumer protection. We must bear in mind that nowhere is there an objective in the code specifically about consumer protection. There is an objective which requires the balancing of the interests of users and service providers.

The other solution we believe is that there needs to be the continuation of a coverage test for transmission pipelines. Coverage tests must be strengthened in accordance with the decision of the eastern gas pipeline case. There must be a strengthening of part of that test, we believe, to focusing on - regulation should only apply where that application will substantially benefit. That was a key recommendation I think as part of the Productivity Commission's previous assessment of the National Access Regime and we would endorse that.

Funding of regulators: if the industry is to pay, service providers should not be required to bear any portion of funding. There needs to be a funding regime which is transparent and accountable and there also needs to be an ability to pass on those costs to those who are benefiting from the application of the regulatory framework. Our promotion of a negotiate-arbitrate model should not be seen as an attempt by

Epic Energy and other service providers to escape from regulatory application. It always envisages that there is a role to play for a regulatory framework. However, it must be borne in mind that the gas industry is an emerging market.

It shouldn't be subject to such intrusive, prescriptive regimes which focus on lowest-cost outcomes and therefore act as disincentives to investment at a time when a number of projections forecast a greater uptake of gas. Even conservative estimates project a greater uptake of gas. The current producing basins do not meet that demand, so therefore there's a need for greater infrastructure. Any regime which acts as a disincentive to ensuring that that infrastructure is built cannot be allowed to continue.

The other change that Epic Energy believes needs to be made to the code is ensuring that, if there is to be a price-setting regulator in price, that regulator must approach an assessment process to determine whether what is put forward is reasonable. It is only then if it can be demonstrated that it is not reasonable, should there be a change from what the service provider puts forward. There are many ways to skin a cat. If a service provider puts up something which is reasonable - and in many instances service providers have put forward innovative changes to the development of the market through, I guess changes to service offerings; those, particularly in the case of the DBNGP, have been struck down as inappropriate. That, to us, is something which further underscores the disincentive to investment if we can't be proactive in the market.

We didn't intend to talk to anything further in our submission. We'd like to spend as much time as we can answering questions, clarifying our specs if the commission or anyone else has any questions to ask of us.

MR HINTON: Thank you very much, both of you, for that presentation. I think that, given your involvement in the sector, you both, like some others, bring a particular perspective with direct experience regarding the operations of the access regime that is very important for the issues that arise from our terms of reference. So thank you very much for your involvement. You've alluded to your draft submission. Thank you very much. We look forward to having it in final form, as you said, before the end of the week.

You also referred to your involvement in the APIA submission and that's a very useful process as well, the umbrella organisations - and there are several of them - will be and are participating in this exercise, so I appreciate that it's not quite double-dipping but it's certainly a double contribution, so thank you.

You referred also, early on, to commercial-in-confidence material. There is full scope for the commission's processes to appropriately protect that information

that's provided, commercial-in-confidence. We do not seek to in any way erode the commercial integrity of any entity participating in our public inquiry, though it is important that claims of commercial-in-confidence have integrity in themselves. That is, sometimes we get - not that I'm suggesting you are - approaches for commercial-in-confidence or in-camera hearings that don't really have substantiation. But the concept is there, the approach is there, the principle is there and we are very pleased to be able to provide that option, though in many circumstances we doubt that commercial-in-confidence material in itself is necessarily germane to the public policy issues we're expressing to examine. Sometimes substantiation of a view does rely on commercial experiences. Then I can understand the link, why that might arise.

Your presentation and your submission are both very comprehensive, and thank you for that. I have a number of matters that I wanted to explore with you, though I may be anticipating APIA's submission which will be seeking to put forward in concrete terms specific proposals regarding refinements to the access regime. So feel free to say, "Watch this space" if you like, given the time we've got left. But let me start off with this reference to the investment aspect that you put significant weight on very early on. There are two parts to this. There are lots of parts to it, but two parts I want to explore. One is greenfields. Then secondly at the moment I want to talk about expansion of existing capacity, particularly for transmission pipelines.

For greenfields there is around, of course, the ACCC's draft document on guidelines that's put forward capacities, mechanisms and techniques within the existing regime, within the code, that can perhaps provide some comfort for investment in greenfields. Similarly, there's the Parer report that touches on the possibility of regulatory holiday-access holiday periods. We've also heard earlier this morning the idea of leaving open scope for some blue sky return from investments in greenfields.

We'd welcome your comments on where are the deficiencies in the code, in the access regime, regarding greenfields in circumstances where these options are emerging, or these ideas are emerging, where you might stand in relation to these recent developments.

MR CRIBB: If we start talking about greenfields pipelines, greenfields pipelines will always be a function of what the market wants and a view of what the service provider believes will occur in the future. We have, therefore, taken the view that, because it is the market that will determine whether a pipeline proceeds or not, because pipelines are competing not only with other potential proponents of new pipelines but also with other sources of energy, the prices, the terms and conditions and the services that get offered, or that are agreed to with those customers, must be

the basis upon which the access is granted to future customers. You have to also bear in mind that, if it is the case that it's been the market that's determined whether that pipeline proceeds or not, why is there a need for regulation.

There is a fundamental disconnect, as Epic has put forward in its submission, to the regulatory process that is required to be followed and the way you go about negotiating for a new pipeline. Our owners have made a determination, through their experience with the code, that they need either regulatory risk totally removed from the equation, or they need to have it practically managed so that, while it might be a covered pipeline, the foundation customers and the tariffs that are negotiated with those foundation customers make it a viable concern.

To deal with the first aspect - that is, the removing of the regulatory uncertainty - it requires a regulatory process, an approval process, to be followed. That approval process, as we've demonstrated in our submission, the timetable that we put forward, shows that you have to go out and start the regulatory approval process at such an early stage that you actually don't really have all the information to hand that a regulator would require for the regulator to make a binding ruling.

In addition, because you have to go out at such an early stage in getting the regulatory approval, that process is a public process by virtue of the code requirements, you are, therefore, disclosing information which your competitor - that is, the competing pipeline proponent - and, let's face it, the prospective pipelines that are being forecast are all competing pipelines. A northern Australian pipeline is projected to come either through the east coast, down through the centre, or from the Carnarvon Basin. So there will be competing proponents for the supply of northern Australian gas. If you are required to disclose your sensitive information relating to how you're structuring your pipeline, you immediately give your competitors critical information. That's inconsistent, I guess, with the way a pipeline should be proceeding and the negotiation that is undertaken with the customers.

The other issue relates to the fact that there needs to be a recognition of those market derived tariffs if the pipeline is to be regulated, and I guess we take a view that, if you've got a pipeline up and running, most of those projects will be marginal at best because, if they weren't marginal, they would have been built already, because some monopoly service provider would have tried to take advantage of the great returns on those projects. At this stage, there is obviously a need to ensure the market grows and there's appropriate market there to justify the viability of the project. That doesn't yet exist.

The need for recognition of market derived outcomes must be critical in any regulatory process. The application of the code to date has not reflected market derived outcomes. So we take the view that there shouldn't really be an application

of the code to greenfields pipelines. We would think that the coverage test would confirm that, but I guess there's only been one test of that, and that's supported our view that it shouldn't necessarily apply to greenfields pipelines.

If a pipeline is to be regulated, there is no demonstration that market derived tariffs should be accepted by a regulator. We're not talking about a greenfields pipeline here, but Epic Energy put forward, as part of its Moomba to Adelaide pipelines system access arrangement, a total revenue structure which capped the total revenue equivalent to the revenue it was earning under its existing contracts. That was rejected by the regulator in that instance.

So we're still faced with a cost-of-service derived approach, the building block approach to regulation, which won't necessarily match with the market derived tariffs, the negotiated tariffs that have been negotiated with the foundation customers.

MR HINTON: It's been put to us that where the regulators apply the code there's a potential for greater revenue risk for that component of a new pipeline that is surplus to known demand, a sort of initial excess capacity. That in itself sets an environment that encourages greenfields to produce only to known capacity in the first instance, which may not be an efficient use of investment longer term. Is that your perception?

MR CRIBB: As I said beforehand, our investors have made a decision not to expose themselves to regulatory risk. So either they do it through getting certainty from a regulator as to how the code will be applied to that pipeline, and the framework of the code just doesn't allow that to occur with the timetable and with the information provision, et cetera, the public process of it or, secondly, the other way you remove the regulatory risk is by ensuring you only build for your foundation load. As we've demonstrated in our submission, that leads to higher prices for those foundation customers and also for future customers, given that it's so much cheaper to build spare capacity up-front than it is to add on in the future.

MR HINTON: It's been put, though, that the counterpoint is that there is scope to expand capacity through loops and compressors and that the code is sufficiently flexible to not only have that option within the code but supposedly is meant to actively encourage a process by which expansion can occur within an overall environment of regulatory framework.

MR CRIBB: I'd like to keep taking you back to the fundamental premise that a greenfields pipeline shouldn't be regulated, given that its viability is being assessed in the market. However, moving to if it is regulated, why shouldn't you just build for capacity and then add on in future? I'd like to make two points about that. The first point is the point that I made earlier about inefficiencies in pricing. You're going to

have higher prices for that incremental capacity. The second issue is in relation to the certainty of the expansions being allowed to be rolled into the regulated asset base, the capital base.

The code is deficient, as we set out in our submission, in relation to the new facilities investment provisions. The deficiency arises at a number of levels. There are, essentially, only three categories of new facilities investment that can be allowed to be rolled in. They are set out in section 8(16) I think of the code. Furthermore, you cannot get certainty as to the quantum that will be included in the capital base until after you've committed that expenditure.

Even further, the only amount that you will be able to include in your capital base will be the amount which a regulator determines is an amount which a prudent service provider, acting efficiently and in accordance with generally accepted standards, would determine should be allowed to be incurred as the capital cost. I guess that's unsatisfactory from Epic Energy's position. The service provider knows best as to how it builds. It has to build in accordance with certain standards.

In relation to the three categories of expansion, or new facilities investment, the first being the information of the expansion required for what I'll call the system integrity and to meet existing contracts, once again you're limited with the amount that you can include in that instance, and you're also limited to not knowing what it is until after the event, until after you've spent the money. In addition, there is no provision in the code that we can see which seeks to give comfort to regulators that there is a greater risk in providing new capacity which might be not contracted on the basis that you hope will be satisfied. There is no comfort from Epic Energy and its investors that the regulator would allow a greater return to reflect the more let's say blue sky prospects of that capacity being utilised in the future.

DR FOLIE: I noticed in this discussion about greenfields, et cetera, there is a route actually where there is laid down, if you like, a competitive tendering and negotiation process, which is in the hands of the pipeline builder, the service provider, which, if you go through that process, would get a tick. What are you views about the process? You've not mentioned it.

MR CRIBB: There have been a number of attempts to use the competitive tendering processes to date. While regulators have given ticks to I think it's two processes, if I recall correctly - and I stand to be corrected on this - I don't think either of those pipelines have actually proceeded. The problem, as we see it from the competitive tendering process, is the focus on the lowest cost. Once again, the lowest cost has got to be the primary objective of a tendering process. Epic Energy, when it tenders for projects - which is does on a routine basis for any of its work that it needs to carry out, any contractors it needs to engage for major construction work -

doesn't necessarily choose the lowest price.

We had a great example in the Moomba to Adelaide Pipeline System access arrangement, where the ACCC, as the regulator in that instance, chose as the cost of line pipe the lowest price. Epic Energy has challenged the correctness of that approach. That's before the competition tribunal at this stage, and so we await the outcome of that. We see a fundamental disconnect between the objectives of the code and that approach to lowest cost outcomes.

DR FOLIE: In relation to capacity expansion, there are people in the existing pipelines all using the pipeline, they've all got contracts, and then you go and get access arrangements which may have a tariff element to it. But a key part of the original setting of the code was also about actually growing the market, et cetera, so capacity expansion becomes an important part of it. It seems from divining through the various submissions that in fact capacity expansion is difficult and this, if you like, is an area that's going around, that really it's very difficult to induce a service provider to actually then put in capacity. It's the one area where the service provider really can't be forced to do something by the regulator. There is a growing frustration about this. In a better code how do you think some of this could be overcome?

MR CRIBB: There is nothing in the code that can stop an expansion occurring. What the code prohibits is a requirement that a service provider fund in expansion and that ties back to one of the key recommendations from Hilmer, that no-one should be compelled to provide access on unreasonable terms, so if it is the case that it's not commercially viable for a service provider to expand then it shouldn't be forced to fund that expansion.

I think probably a great example that Epic Energy can provide - which it has in its submission - is in relation to the Dampier to Bunbury pipeline. When it bought the pipeline it committed to expanding that pipeline. It committed that it would spend $875 million over 10 years to expand that pipeline on the basis that everyone would pay the same price - both existing users and future users would pay the same price - so there's a great leveller there.

We put forward that proposal to the state at the time, fully aware that the regulatory regime would apply. The result is that the regulator has not adopted the tariff path that we said to the state we would commit to that expansion program because any tariffs lower than that would not be commercially viable to us. The regulator's tariff in his final decision is at a level which would preclude Epic Energy from committing to that expansion program on the basis that it was commercially viable for Epic Energy, so there's a great opportunity lost, as we put forward, for that expansion to occur on a basis which is for the benefit of the entire state of Western

Australia.

In relation to expansions in our other pipelines there are probably two issues I would like to just draw to the commission's attention; that is, should an expansion be part of a covered pipeline or should it be unregulated? Is an expansion any different to a greenfields pipeline? There has been a significant debate with the ACCC as regulator of the Moomba-Adelaide pipeline on this particular issue years before the competition tribunal and we hope that that issue will be resolved as to whether expansion should be included as part of a covered pipeline or not part of the covered pipeline.

The other issue comes back to the provisions about new facilities investment in the code, 816. I guess one of the limbs of new facility investment that I didn't touch on before related to system-wide benefits. The ACCC has concluded in the Moomba to Adelaide Pipeline System that an expansion that includes compression as part of it isn't necessarily likely to satisfy the system-wide benefits test, so if compression is not able to satisfy the system-wide benefits test of the new facilities investment provisions, what will? That's, I guess, a further uncertainty from Epic's perspective - as to why you're not going to go down the new facilities investment provision until you have got certainty both in relation to the principle of what goes in and what doesn't go in the capital base and, secondly, the quantum of that investment.

MR HINTON: Anthony, I have a whole range of questions on objects clause, coverage, light-handed regulation. I am going to defer those until perhaps we have APIA before us, given the way the time clock is ticking at us now. I am going to restrain myself and limit myself to one more question relating to something else that you both put some emphasis on and that's this issue of timeliness of regulatory outcomes - timely decisions.

On the one hand you said that you don't want any review, appeal rights, eroded - you want that protected - though some have argued that the existence of those, the extent of them in fact, is a contributing factor to delays, but my question really is in relation to the nature of the regime itself. If it were changed to be less forensic in its approach for the regulator, less prescriptive in terms of detail being looked at, with a clearer objects clause - and presumably the information requirements would be less for the regulator, which would be consistent with your views this afternoon - but also that the scope for regulatory uncertainty and therefore regulatory appeal or process of review would also seem to be reduced. Is that a fair formulation of your mind-set with regard to this issue of timeliness?

MR CRIBB: Can I first say that going back to the objectives of national competition policy reforms, key planks - as we see it - were an ability to have an appeal right and also an ability for, I guess, legislated right of access through a

negotiate-arbitrate model. All we're doing, I guess, with moving away from the current intrusive and prescriptive framework of the code is to come back to that original intent of a light-handed negotiate - or legislated right of access through the negotiate-arbitrate model, so we're bringing back to that intent of the national competition policy reforms - it should not be seen therefore that you should erode the other key plank of that in relation to appeal rights. Our position would be that the existing appeal rights should remain, particularly when government has made that critical, conscious policy decision that the private sector was to be the primary developer and owner of public utility infrastructure, such as transmission pipelines.

MR HINTON: Thank you for that. Michael, please?

DR FOLIE: I would like a fairly macro response for this question and you will see when I ask the question as to why I put that. You're in a position of actually operating under the code in different states and you are actually in a unique position also of actually having different regulators. Broadly, do you see - and this is why you need a macro, because there are specifics each time you are doing something - the way the code is being administered as being pretty well independent of the regulator and both regulators are doing similar-ish types of things, or is there more regulatory discretion in how they are actually applying the code?

MR CRIBB: When you say "administer" you mean "apply"?

DR FOLIE: They're applying, and the processes you are going through are being run differently. Are there differences between the way the regulators are interpreting the code? As you see the failings of it, to what extent does a regulator impact on it or is it more the code?

MR CRIBB: I guess the Western Australia regulator - whose decisions have, to a large extent, come after the east coast regulatory decisions and it has followed the regulatory precedent of the east coast regulators. The issue of state-based versus national regulator versus a super industry regulator - I think those institutional issues are a bit of a red herring, a bit of a divergence from the key issue from our perspective and, that is, the framework that is applied and, I guess, the application of the framework as well.

If we can't get those two elements correct, it doesn't matter who you have got regulating. There will always be a focus to look at other decisions - and that's natural. You always look at what has been done in the past to try and see, well, are you stepping out of the bounds here of reasonable approach, but I guess we're saying - well, the fundamental starting point with regulatory application is wrong, so no matter how many you have or how few you have, you are still going to have a key problem, so the focus on institutional arrangements from Epic's perspective shouldn't

be seen as the primary focus of either this review or any other review that's being conducted or that has been conducted.

MR HINTON: Thank you very much, and let me thank you both again for your participation today and also your ongoing participation through both written submissions and umbrella organisations.

MR CRIBB: Thanks. We again reiterate the offers we have made previously to clarify our submission if you would like further information. We do intend at this stage that there will be more information to provide to the commission and this is a major priority for us but, unfortunately, there are even greater priorities at this stage.

MR HINTON: We fully appreciate the competing demands on your time.

MR CRIBB: Some of the information provided will be provided on a piecemeal basis.

MR HINTON: I understand. Thank you again. That brings us to the conclusion of today's scheduled proceedings. However, in accordance with established commission processes we now have an opportunity for anyone else from the floor to speak - to come to the microphone, identify themselves, and make a presentation if they so wish. It sometimes occurs. It doesn't occur frequently, but it is open for anyone if they so wish. This invitation hasn't been taken up, so I will therefore adjourn these proceedings and the commission will resume these public hearings on 11 September in Melbourne. Thank you very much, all of you, for attending and for participating.

AT 4.16 PM THE INQUIRY WAS ADJOURNED UNTIL
THURSDAY, 11 SEPTEMBER 2003