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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

DRAFT REPORT INTO GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT ADELAIDE ON WEDNESDAY, 31 MARCH 2004, AT 9.01 AM

Continued from 26/3/04 in Sydney

MR HINTON: Good morning, everybody, and welcome to this first session for the Productivity Commission's public hearings here in Adelaide, for our review of the Gas Access Regime. My name is Tony Hinton, and I'm the Presiding Commissioner for this inquiry. My fellow Associate Commissioner, on my right, is Dr Michael Folie.

The inquiry terms of reference were received from the Treasurer in June 2003 and cover, in brief terms, the following six matters: first, the benefits, costs and effects of the Gas Access Regime, including its effect on investment; secondly, possible 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 institution of decision-making arrangements under the Gas Access Regime; and sixthly, the appropriateness of including in the Gas Code minimum requirements for access to users both non-price and price parameters.

The Commission is grateful to the various organisations and individuals who have already participated in the initial round of hearings last September and through earlier submissions. This round of hearings follows the release of the draft report by the Commission last December. The purpose of these hearings is to provide an opportunity for interested parties to discuss their submissions on our draft report. Participants, of course, are welcome to comment also on the views expressed in other submissions. Hearings have already been held in Melbourne, Brisbane and Sydney and hearings will be held tomorrow in Perth. The final report will be submitted to the government in mid-June, as scheduled.

We like to conduct all hearings in a reasonably informal manner, but remind participants that a full transcript is being taken. For this reason comments from the floor cannot be taken but, at the end of the day's proceedings, I will provide an opportunity to anyone who wishes to do so, to make a brief presentation. Participants are not required to take an oath but are required, under the Productivity Commission Act, to be truthful in their remarks. 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 available from Commission staff here today. Submissions are also available on the web site.

To comply with the requirements in the Australian government occupational health and safety legislation I draw the attention of those here today to the fire exits, which are directly out the door at the rear of this room and to the left. This building uses the standard emergency alarm system.

I would now like to welcome our first presenter for these hearings here in Adelaide, Mr Ralph Mignone, from Envestra. Welcome, Ralph. I invite you to get matters under way this morning with your statement. Thank you.

MR MIGNONE: Thank you, Mr Chairman - Commissioners. I would just like to start by congratulating the Commission on the excellent job so far in the draft report and in grappling with many of the issues, difficult issues to date. We would like to see the Commission continue the excellent work done so that a very useful and practical result is achieved at the end of this process.

Through the Energy Network Association there have been many issues addressed on behalf of the industry. My task here today, I think, is just to touch on our submission and some of the experiences or more practical aspects of the regime that Envestra wishes to raise with the Commission. Just to assist, there are some copies of the slides at the end of the desk, if anyone wants a copy. On pages 1 and 2 of the sheets you have in front of you, it's not deja vu but in some ways - I have got on page 1 the cover sheet of the presentation we made to the Commission back in September last year, which shows the competition train on track. I thought it was useful just to put on page 2 the progress that is being made, and I think we are on track still to progress, and hopefully the train will keep progressing down the right track.

Just on page 3 of the handout, in our presentation last year we identified some key deficiencies of the regime that we believed existed, predominantly with the cost of service approach; in that that approach was costly and time consuming, there was high regulatory risk attached with that approach, there seemed to be a regulated focus on short-term price reductions and the information requirements and reporting were onerous and very heavy-handed. On page 4, there are some draft recommendations in the report or key outcomes that will address some of these issues.

Of course, price monitoring is an option which will address to a significant extent some of these issues. The coverage test: the changes would be very welcome. There are proposed changes to the code objects clause, access pricing principles, new greenfields approach and mechanisms and, of course, the full merit review, all of which are positive steps towards a better and more even-handed regime. There was one key outcome which we disagree with, and that was the deletion of 224A of the code in relation to the service providers' legitimate business interests and investment in covered pipeline. We believe that element of the code to be fundamental and should be retained.

On to page 5, looking at those key outcomes of the draft report, the questions are asked: do they adequately cover the pipelines that are subject to access arrangements and do they address those relevant issues? The code objects clause,

access pricing principles and the full merit review we see as being particularly relevant to pipelines with access arrangements, but the question is, do they address the key deficiencies that I outlined in the earlier page; ie, costly, time-consuming, regulatory risk and so forth?

It's a difficult question but one could say that they may not adequately address all those deficiencies because high-level principles can in some ways be paid lip-service to by regulators. I point here to examples where you may read a final draft decision that says we have balanced the objectives of the code and section A, B, C, et cetera, and we determine that the answer is X. It's hard in practice to actually prove that the regulator has taken those objectives into account, and the only way one can really tackle those is through the appeal process, in which case the full merit review would obviously be very useful. But it's a step, obviously, you wouldn't take very lightly.

On to page 6: for example, I've got there a quote from the draft report which is a quote from the ACCC, I think in their submission of 18 September, in relation to the objects clause where they say, "I just don't think it would make a big difference or make any difference at all to what we do or the processes that we are responsible for." What all this points to is that I think we do need changes at the coalface of the code; ones that are clear, and it is easy to see that they have been adopted - for example, the need to take into account outcomes of recent appeals, as mentioned there in the GasNet decision. The proposed model should really be a proposed respond model. That would be a significant step in ensuring that, I guess, the outcome was more balanced. These issues are dealt with quite a bit in the Energy Network Association submission, so I won't delve into that further.

But to turn to page 7, that current model basically involves quite a bit of duplication of processes and is very information intensive and, as you're probably well aware, involves the distributor putting forward reports and the regulator putting forward their reports, and there is voluminous material counteracting each other. It's not a very efficient process. Just by the way, regarding WACC reports, for example, this is the latest one by the Queensland Competition Authority on the cost of capital for regulated entities, so it's just another one to add to the bookshelf.

MR HINTON: Yes, thank you for that.

MR MIGNONE: So one could almost liken the current process to a court case where you have the distributor being the defendant and the regulator being the prosecutor, and each trying to counteract the other. The only difference, of course, is that in this situation the regulator is the judge and the jury. The proposed model is certainly being moved towards lighter-handed regulation.

On to page 8: another area where more work is required, we believe, is in the separation of the regulator and licenser roles. In many areas there is a conflict of roles with regulators having consumer protection roles as well as code administration roles. We pointed in our submission to the Queensland examples, where there are separate bodies and we find that to be a much better model. Where the regulator also is the licenser there is opportunity for any new light-handed regime to be overriden by licensing powers. We're not sure whether this might be addressed by a move to a national regulator. The examples we have at the moment are in SA and Victoria where we do have distribution codes and metering codes which are meant to complement the regime but in some ways duplicate that and impose additional requirements.

Another area of work where I think a bit more is required is in the area of incentive regulation. Again, it's dealt with in the NA submission quite a bit, but an area where a bit of contention exists but is one that needs to be tackled in order to give service providers adequate incentives. On page 9, basically we believe it's time to restore balance to the regime. We need to recognise, as the Commission has pointed out, that regulation is not always required and that the costs can exceed the benefits. The move to heavy-handed regulation should only occur where it is required and, as the Commission has pointed out, the Gas Access Regime is at the more intrusive end of regulation.

Just moving on to page 10, to quote Prof Littlechild, "Customers often have a choice whether or not to use gas. In such circumstances the need for regulation is substantially reduced." That's a statement we definitely agree with. Of course, you have the Commission finding at 4.5, "Generally regulation involving access arrangements with reference tariff should be considered only where service providers have substantial market power." I think that's a very important statement which I'll just explain. Substantial market power in relation to networks is something which I don't believe exists to a significant degree, if to any degree. We spend at Envestra over $8 million a year in network marketing.

The question was raised, "If we did have substantial market power why would we be spending such a large sum of money?" The simple answer is we have to fight to maintain our share of the energy load. We have to fight to grow our load. We're under intensive competition from electricity and, increasingly, solar power. Reverse-cycle airconditioning has been eating into our market and continues to do so. So to say that we don't face competition or to say that we're a monopoly and we were able to exert significant power I think is just not correct.

Just on to page 11, just to draw the differentiation between transmission pipelines and networks, transmission pipelines usually rely on large foundation customers, whereas networks operate in a real energy market where people choose to

connect to gas. One important point to remember is that for networks most of our income is generated by domestic customers. As I mentioned, we do face strong competition with electricity in all areas of the domestic market. We basically rely on three gas appliances for heating, cooking and hot water. The increasing competition with alternate fuels is one that we try to tackle on a day-to-day basis.

Page 12, just moving to a couple of the administrative issues in the draft report, recommendation 11.1 regarding the backdating of reference tariffs: we believe this is fraught with difficulty and risk and I think we concur with the ACCC on this point. One of the prime reasons I think that gave rise to this recommendation was the possible delay to decisions that - or gains that could be made by service providers in delaying decisions. We don't think there is real potential for this going forward. Historically there were significant delays in several jurisdictions when access arrangements were trying to be approved, but many of the delays here we firmly believe were not due to anything but the new process being put into place.

The first round of access arrangements was a training exercise and an exercise for many of the participants. There were issues there - for example, initial capital bases - that needed to be addressed which were one-off issues. Initial capital basing in I think all jurisdictions was a significant issue. So there were various issues contributing to delays. Gaining by service providers I don't think was one of them. I don't think going forward it is going to be an issue. There are many areas where, in electricity and gas, there are synergies - cost of capital, for instance - so regulators are making use of that synergy to increase efficiencies in consultation processes and so forth. Going forward I don't think timing is going to be a significant issue.

Draft recommendation 11.3, the removal of a further final decision, we don't believe is a practical one. As stated in our submission, we don't believe it really is a further final decision process. It's really one of the regulator signing off on the paperwork, making sure the t's are crossed and i's dotted. Importantly also, it does allow the regulator to correct any minor errors which in Envestra's case has occurred in the final decision. Had it not been for the further final decision then the error may not have been able to be corrected properly.

Page 13, just to comment on the ACCC's submission: one of the main points in their submission is in relation to the analysis that was done by ACIL Tasman whereby they believe regulation has significant financial benefits to the country. We believe the analysis is fundamentally flawed on the basis that they've made an assumption there - which I quoted - "This substantial benefit arises due to lower prices which stimulate greater usage of electricity and gas." I put it to you from a network perspective that the price elasticity of gas is just not that simple. We're not talking about a product like Coke or Pepsi that you buy off the shelf and if price goes down, you stock up.

In networks we rely, as I said previously, on three main appliances: cooker, hot water and space heater. To say that the usage through these appliances is going to be more because price goes up or down slightly is just not correct. I don't know whether you do the cooking at home, but let's presume you have a wife and your wife does the cooking. Do you go home tonight and ask her, "If the price of gas goes down 10 per cent tomorrow, are you going to cook 10 per cent more or are you going to cook 10 per cent less?" These sorts of issues are not that simply addressed by a simple, economic analysis and assumptions. Hot water, for instance: if the price of gas goes down or up, are you going to load up the washing machine with identical hot water, less hot water? I don't think so.

These assumptions which I think were glossed over very briefly in the ACCC report I think need a lot more work. Another area of the ACCC's submission was on the price monitoring. This is on page 14, and I've quoted what they said there.

> The removal of a right of access at reasonable prices could substantially harm potential small entrants that do not have effective bargaining power, particularly as no enforceable right of access exists under the posed price monitoring regime.

Simply, I would think that if we did go to a price monitoring regime one of the fundamental issues there would be to ensure that there was a right of access. So for the ACCC to assume that there wouldn't be I think is incorrect.

There are also other ways by which price monitoring can be implemented with some safeguards in place. Now I point you to the recent disclosure decision on the cost recovery for REMCo, which is the retail market operator for FRC in SA. Their decision effectively says to REMCo, "We want to go to the price monitoring regime here but if your prices increase" - and I think it's by more than CPI - "then that's the trigger mechanism for us to step in and have a closer look." So there are ways to implement a price monitoring regime that I guess is not as light-handed as the ACCC would suggest.

At page 13, I just wish to make the point again that Envestra has some upcoming access arrangements with provisions due 1 October next year. So from the implementation point of view we urge the Commission to look at how we can implement the findings of the Commission in order to maximise the benefits short term. One of the problems, again from Envestra's point of view, is we are starting to undertake quite a bit of work in preparing access arrangement provisions under the current regime and if we did have some direction then of course the earlier the direction appears the better for Envestra.

Just to summarise, at page 16, we believe the draft report was very well documented. There are many positive recommendations for a more efficient regime and naturally the price monitoring option. The price monitoring option should be the default - again, pointing to the balance regime: unless one can prove that the harsher regime is required, we should start off with what is middle of the road. We need to incorporate recent appeal outcomes and especially address the deficiencies in the cost of service approach, where that is applicable. Of course, there is attention to the timing and implementation of the outcome of the Commission's findings. That basically concludes our submission to the Commission today. Thank you.

MR HINTON: Thank you very much for those remarks, Ralph. Thank you also for your submission. Your participation in this review is appreciated. I quite liked your summary at the end, too, of your presentation this morning that did encapsulate very neatly the broad thrust of your submission to us, so thank you for that. I have a number of questions and not surprisingly most of them seem to come out of the points you've highlighted this morning as well. So in some ways we'll be seeking elaboration.

The first one is in relation to transmission and distribution. You didn't explicitly respond to our view that - in the draft report - transmission and distribution are different, and you've noted that point this morning. But we've also concluded that a single Gas Access Regime covering both is appropriate with flexibility within the regime, capable of handling differences between transmission and distribution. Is that where Envestra would sit as well, with that sort of judgment?

MR MIGNONE: Yes, there are enough, or there are a number of areas where of course the same issues exist. As pointed out there are also differences. The ACCC report to us dealt quite a bit with transmission rather than networks. A lot of the issues that were raised I think wouldn't apply to networks, so while for example ring fencing issues are the same, we don't believe there's enough scope to actually force one single net to different regimes, or two different codes. There's enough synergy there to have one code, but to differentiate in those areas where it's necessary.

MR HINTON: A related question that flows from that is your comment this morning, and also in your submission, that the price monitoring regime should be the default option for distribution networks, for distribution systems. And you've referred to the characteristics of the market being quite different to the characteristics of transmission market. My query with that is - my question in regard to that is in relation to - that would seem to put pressure on the monitoring regime itself; that is, there would be forces at work that would take you down a track of a more intrusive monitoring if everything, by definition, was from day one covered under a monitoring regime.

The alternative, in the draft report, was one of case-by-case assessment that if you, as a distribution network - or, for that matter, transmission - did not meet the threshold to be put into the cost based price regulation regime and you were put into the monitoring regime, then that would happen on a case-by-case basis. That would seem to set an environment more conducive to a lighter-handed, less intrusive monitoring regime, because the test has already been made up-front on a case-by-case basis, as warranting monitoring rather than cost based price regulation. Can you see that tension there in that - - -

MR MIGNONE: I suppose the way to resolve that is at the start to look at each network on a case-by-case basis and make that decision, I suppose. There's not a large number of them, so one could in practice, I suppose, tackle it on that basis and that would solve the issue.

MR HINTON: Particularly as some interested parties have expressed concern to us about the risks of regulatory creep, a tendency for the regulator in pursuing monitoring, gradually becoming more intrusive by the inherent nature of intervention.

MR MIGNONE: Yes. Going forward, I suppose there are not going to be any significant major new networks, but the starting point should be price monitoring. The point is when we go back in time and look at how it was all implemented, it was assumed that everything needed to be under the heavy-handed regime and to us that was incorrect. If you're going to start from scratch, start in the middle and, if required, you take action right away. I acknowledge we can't go back in time and do that but I guess the only way forward is to make applications along that process and assess each one on a case-by-case basis, as you say.

MR HINTON: That of course has that counterpoint that it would be administratively burdensome to do it case-by-case, as opposed to category. But just as distributors have put to us that they should be monitoring as a default option, a number of those in the transmission sector have similarly argued that, no, of course they should be subject to as-a-default monitoring as well. So that in itself is another argument for case-by-case assessment, rather than a category approach.

Still on monitoring, Envestra expresses a concern about the NCC, as referred to in the draft report, being the entity responsible for establishing the guidelines for the operations of the monitoring regime. Can you elaborate as to your thinking as to why you'd be concerned about that?

MR MIGNONE: Again, I think this was touched on in a submission but I think that historically the NCC has proven to be correct in several areas and that reflects, I guess, on the confidence level of the industry in the NCC coming up with the

goods.

MR HINTON: I suspect that the draft report is not as clear as we should have been in this. We would like guidelines for the monitoring regime to be established from day one, but those guidelines should be prepared in consultation with interested parties. It would not then be subject to regular revision by the body, NCC, changing it at whim. It would be just a system to establish the guidelines in circumstances where the Productivity Commission doesn't have any ongoing role here after this review is over. It would be a little inappropriate for the Productivity Commission to be involved. It doesn't stop us putting down in our final report significant amounts of detail as to how we think they should be operated and how the monitoring guidelines should work.

MR MIGNONE: The main point, as you said, is the involvement of the industry in consultation. If that was properly put into place, well, then we would be happy with that.

MR HINTON: The NCC are a little shy as well in taking up this task. They say it's a resource issue, but that's another matter, isn't it?

MR MIGNONE: Resources can be addressed.

MR HINTON: We would be more uncomfortable with the regulator responsible for the actual monitoring being involved in the setting of the guidelines because then you have a potential for contagion, where the regulator doing the monitoring also sets up the information disclosure: the guidelines for the actual monitoring itself. We like separation. I think if I read Envestra correctly that's what would be endorsed as well by them.

MR MIGNONE: Yes.

DR FOLIE: I have one just on the same thread, with price monitoring. I'd like your views about - if we're going to have a price monitoring regime, do you believe that the issues being monitored would be different for distribution and transmission? Then would your group start to have a view about actually what are some ideas about the appropriate levels for distribution to be monitored; the key factors?

MR MIGNONE: Well, because they are different markets it obviously would involve different forms of monitoring to some extent. I mean, the issues I touched upon before about the different energy markets and the pricing packs - there are different areas to investigate there. We haven't looked in detail at exactly what sorts of parameters would need to be monitored, but obviously, as your report points out, there are a number. Transmission pipelines and their markets are different in that I

guess there is a bit more commercial power from the consumer point of view.

So the markets are different. There would be different applications of the regime. But we haven't looked in detail at exactly how it would work in practice. I mean, you've got the extreme of no controls and no triggers and set periods of time to price caps as per the ESCOSA decision. In any case it's a bit simpler to monitor a network than a transmission market. The outcomes are more obvious and more transparent.

MR HINTON: Ralph, I've got a few more questions on monitoring that are quite detailed which may not be useful for this forum. But let me try them anyway, particularly in circumstances where we think moving from a draft report to a final report it's important we flesh out how we see the monitoring regime operating, which is why we're exploring your perspectives on some of these issues. You mention that the monitoring regime should focus on outputs rather than inputs. I was a little uncomfortable with that narrowing of what the monitoring does.

Certainly we note the importance of focusing on behaviour of the service provider when it comes to the monitoring regime, and that certainly is an output focus. We're also concerned about it not being an intrusive monitoring regime, and therefore we don't want to get into detailed information on the sort of building block approach that's inherent in the cost based price regulation regime. But nevertheless it seems to us that to understand output performance you'd really want to know something about the input side. Prices could go up, not because of misuse of market power; it could in fact be they're a true reflection of an unmanageable cost surge that the service provider has to bear. It would be important in understanding that hypothetical source of an increase in prices to understand the behaviour of the service provider. It's that delineation that I was a little uncomfortable with.

MR MIGNONE: Yes. We wouldn't object to certain inputs being monitored. The main thrust of it was to avoid the building block approach and, again, the intensive information industry. So we acknowledge that there are some key inputs where it might be desirable to monitor them on an annual basis or whatever. But the main thing would be for them to be agreed with the industry to make sure they're practical and relevant.

MR HINTON: Well, even perhaps a more detailed point about ring fencing: you endorsed the concept that it would be appropriate for ring fencing to be applied to those that are subject to the monitoring regime. In your submission you pick up the point that, sure, let's just take the existing ring fencing requirements and apply them, but let's delete some of the subpoints of that ring fencing requirement. Your submission doesn't elaborate any reasoning behind why these particular ones would not be applied for monitoring as applies today with regard to the regime more

generally. Can you help me out here?

MR MIGNONE: Yes.

MR HINTON: It is quite a detailed question.

MR MIGNONE: From memory, the ones we suggested not be included were those that have given rise to a significant and heavy-handed reporting requirement regime.

MR HINTON: But the information disclosure concern?

MR MIGNONE: It relates to production of financial accounts in a lot of detail and inconsistent with the code. The ring fencing requirements - the fundamental element that arises, we believe, is to make sure that the network provider is treating all retailers equally and fairly and that commercial information is treated fairly and in the right manner. That's the thrust of the ring fencing rules. If you like, the second bow to the rules is to do with the financial reporting and that aspect, we see, is being abused at the moment to some extent by regulators and is a further means of obtaining information well beyond the requirements of the code. So in essence what we've done is to bring the ring fencing requirements back to the core principles for which they were intended.

MR HINTON: Good. Thanks.

MR MIGNONE: They should really be fundamental to the ongoing business of any network provider.

MR HINTON: While we're on information disclosure, there is a recommendation in our draft report about powers for regulators to obtain information between reviews. You would say that not only are our regulators seeking information between reviews, they actually have powers to do so. Have you got a concern here that this cannot be tidied up?

MR MIGNONE: Well, this is precisely the clause of the ring fencing requirements that is being used by regulators to collect information; 4.1(c) I think it is. But regulators have decided that that clause is applicable and entitles them to collect information between reviews, despite information that suggests to the contrary and despite intensive debate on the issue of information collection.

MR HINTON: Is there a distinction between a regulator requiring a service provider to maintain records between reviews and when they actually get access to that information - that is, at the time of review?

MR MIGNONE: Well, that has been a point of contention.

MR HINTON: Yes.

MR MIGNONE: But the main issue is not the requirement to maintain information but the actual information to be maintained. Again the requirements they have laid down go well beyond those mentioned in the code.

MR HINTON: Let's move from monitoring.

MR MIGNONE: I mean, it's also one of those areas where again the licensing role and the code administration role come into conflict there. Even if, for example, in South Australia we were to contest those requirements under our licence we're obliged to supply that information anyway, so if the regulator can't get it one way they will get it another way. We see that as defeating the purpose of having a lighter-handed regime.

DR FOLIE: Just on that, do you see it as more complex if, as a hypothetical, the regulator was then split from the licensing, that you might end up then with two regulators, each wanting to know what the boundary was? You've at least got some way of approving it but do you think it's better to split the two roles if it were possible, or would you end up handling twice as much information?

MR MIGNONE: In Queensland the roles are split and we haven't had any issues of duplication or requirements in the area.

MR HINTON: More broadly, on this issue of licensing, Envestra is one of very few who have flagged this issue for us about this intersection of the Gas Access Regime and then a state regulator having other objectives beyond the operations of the Gas Access Regime. In theory aren't they meant to intersect in a way that the state regulator requirements can supplement and complement, but not override, the Gas Access Regime requirements? Is that an oversimplification?

MR MIGNONE: No, that's correct. I guess in practice the issue is how does one actually separate those roles. If you take, for example, the Victorian gas distribution system code, there are requirements in there that deal with the economic feasibility test under the code. You can argue is that complementing the code or is that supplementing the code?

MR HINTON: Yes. How about pricing and tariff setting? Have there been examples of conflict, that is, the parameters underpinning the tariff setting for the Gas Access Regime might have certain objectives, but the state regulator might have a supplementary objective that could lead through to tariff decisions?

MR MIGNONE: Again quoting the same Victorian code, the regulator, through the licence, has the power to determine in some instances what are reasonable charges. The issue at stake is do we have code that has a certain light-handed regime around it or do we have the light-handed regime but then supplement that with like a second code which in effect negates the advantages of having the lighter handed regime in the first place? So we have all these rules and codes and guidelines that are being grown under the licensing area.

MR HINTON: Isn't there a potential for that today as well for an uncovered pipeline, that is, even the sort of system currently existing without monitoring whereby you have a pipeline that is subject to cost based price regulation and therefore you might not have conflict with the state regulator's objectives, but if it is uncovered and there is no tariff setting or regulatory oversight then there is still scope for the state regulator to intervene?

MR MIGNONE: This is exactly the issue we are raising, that if we are going to put in a light-handed regime how do we make sure that that regime is not sabotaged, if you like, by the state licensing requirements?

MR HINTON: And so I'm after your suggestions. Any solutions?

MR MIGNONE: Not at this stage.

MR HINTON: Okay. Thanks very much. Let's come back to objectives then. In your submission but also in your remarks this morning, you expressed some unease - and that is probably an understatement - in deleting from section 2.24 as recommended in our draft report the service providers' legitimate business interests and investment as being one of the sorts of detailed objectives of intervention under the Gas Access Regime, protecting those service providers' legitimate business interests and investment. In our draft report we sought to delete a lot of those points in 2.24; not just that one but also consumer interests and prospective consumer interests with a view that it's not helpful to have in the regime a set of potentially in conflict objectives that takes the regulator nowhere.

So my point becomes one of if you endorse an overarching objects clause which I think you sort of do, doesn't it make sense to remove this sort of listing of catch-all, including any other factor that the regulator might want to take into account, from the documentation, such as 2.24, to tidy up that?

MR MIGNONE: Again, as covered in the submission, going back to the rest of the regime - and we have a regime that has been imposed upon owners of networks and owners that have put billions of dollars into grey networks - there is a legitimate

fundamental requirement that such an investment needs to be protected somehow because the regime has been imposed. There are benefits from imposing the regime on the customers and users, so if you like, the regime automatically has a benefit to users by it being in place, but it has a potential to take away value from investors who have sunk capital. So in some respects it is a balancing of the books.

MR HINTON: But what we are talking about here is an overarching objects clause and statements of objectives that by deleting that item in that area we still have, in fact, a proposal that would address the commercial interests of the service provider in the setting of the actual tariff. So we talk about the pricing principles including the point of generated revenue at least sufficient to meet efficient long-run costs. So while it's not in the objectives area it's in the pricing principles detail when you actually intervene to set a tariff. So then the legitimate business interests of the service provider are protected with regard to efficient long-run costs being met.

That is how we have approached that issue; not in any way thinking that there aren't legitimate business interests, on the contrary, but it's where you flag that needing to be taken into account, and we thought pricing principles was the more pertinent area as opposed to objectives clause for intervention.

MR MIGNONE: It probably comes down to the point about where you sit. I mean, if you look again back at the roots of the regime, this regime was formulated around the table with input from, I believe, the industry and the service providers, and a fundamental element of that was the protection of their legitimate interests. So if you see it as a core principle undermining the whole regime, then by moving it to a pricing principles area is in some ways watering down that fundamental principle.

MR HINTON: Ralph, certainly others from the industry have also expressed similar concerns in a number of our hearings over the last week or so. Perhaps another detailed area is in relation to backdating. You in your submission expressed some concern about our proposal in the draft report that sought the possibility of the regulator having scope to backdate the date of effect of decisions, eg tariff setting. This idea was being driven primarily by the objective of seeking to remove an incentive for game playing or at least reduce the incentive for game playing by delaying, whether it be by service provider or consumer, if they thought the decision was going to be disadvantageous. But you express significant concern with this flexibility for the regulator. Is it because of in-principle objection or is it a practical issue?

MR MIGNONE: Practical, I guess. The practical issue of backdating, as I said in the submission, is fraught with difficulty. Contractually it can be very messy and complicated and in itself may lead to some liability issues and other actions. You have to ask the question, how strong is this issue that one needs to take the risk

associated with backdating, and what I'm saying is that the issue itself we don't see as being significant. In our experience - we have been through one round of access arrangements, and in Victoria I guess you can say the second round - the only significant delay was in an arrangement we had in South Australia and that delay was due to a number of reasons, none of which was intentional, but certainly the regulator was very under-resourced in South Australia.

It was the first time for both parties and as a consequence there were extensive delays in arriving at a final decision and that in itself posed several problems for investors of our contractual arrangements. So the uncertainty related to backdating creates, in itself, an issue and seeing that we are trying to minimise uncertainty and regulatory uncertainty then I think backdating only introduces another element of that which we should avoid at all costs.

MR HINTON: Thank you. Michael.

DR FOLIE: Yes. I've been looking at the overall scheme - we will stick, ourselves, if you like, mainly to transmission - the ACCC have had analysis done and have said that effectively they believe that the regime, from their point of view, has delivered benefits. Number 1 is that prices have gone down and, secondly, the private companies have actually performed extremely well in the stock market and they have been up, the stock level, which therefore means that to prove that the investing community are happy with them, they are getting adequate rates of return. We haven't actually had anybody from - and industry associations probably can't really answer that, but companies - you will continue to invest and you've had good stock performance - what is your response?

MR MIGNONE: Again this is one key area where there is a differentiation between transmission and networks. The ACCC's submission in that area, I think, is clearly talking about transmission pipelines. They cite the pipelines that have gone ahead. As far as networks are concerned we have no choice but to grow the network. We are obliged under the code where it is feasible to extend the network. We work on a customer by customer request and if a customer requests gas and it's economically feasible we don't have the choice to defer anyway. Greenfields networks - they are far and few between.

However, at the moment we are pursuing a greenfields network in Bairnsdale in Victoria and I can say there that the regime has definitely resulted in a material delay in that network proceeding. I think from memory we started talking with the regulator and the Victorian government early last year regarding the Bairnsdale reticulation, and we are still waiting for, I guess, the final approval. The ongoing discussions have revolved around the regulatory principles basically and the return and the pricing. All these sorts of issues would not have arisen if we hadn't been

under the current regime.

DR FOLIE: It's still my understanding that the share price performance - in other words, they have looked at the total return - at this stage the share market still believes that this is a very good investment and has performed well over the period of time. Even though the process of going through it is complex, tortuous and may be slowing it down, it still appears the argument is, from the ACCC, that you still are viewed by, so-called, the markets, that despite all the issues with the WACCs and cost of service, that the sector is actually performing quite well compared with the rest of Australia.

MR MIGNONE: From the network point of view, all I can say is that the direction which we are heading is the wrong direction and if we continue down this road then at some stage networks will also be impacted. The growth of networks: as I said, we are dependent upon the economic feasibility test of the code and that in itself also relies upon the rate of return. As pointed out in several papers by the Energy Network Association the rate of return issued by regulators is going in one direction and there will be a point in time whereby that will impact not only on transmission pipelines but networks as well.

I suppose what we're doing is raising the flag and saying, "Look, should this direction continue then there will be a problem." As access arrangements go through several iterations, we are seeing - as I said - returns diminish. I guess it's the general direction in which we're heading which poses a threat.

DR FOLIE: I have another one which is extremely detailed and slightly technical but, as you raised it, I'd like to - you've obviously had a look at the ACIL Tasman study and feel that the major issue appears to be that the elasticity of demand - in other words, the propensity to switch between gas and electricity - is inappropriate in that model and that therefore the benefits - in other words, if that assumption is flawed then the conclusion is flawed, I presume is what you're really saying; that in other words, lower prices will not necessarily occur and you won't actually get an increased demand from the lower prices for gas. Could you just elaborate if you've done a bit more work on that, because it's a major issue about - you know, it's an enormous number between 2 and $11 billion of great benefit to the Australian public, if the model is correct.

MR MIGNONE: I haven't done a lot of detailed work on that study. We just picked up the point which was that the assumption is noted in the ACCC submission. What we're saying is that based on the assumption stated there, if that is the pure basis on which they have generated those numbers, then we believe that's a false assumption. For the reasons, as said earlier, the elasticity demand for gas is not a simple thing and our network marketing people have been doing this task for a very

long time, spend a lot of time trying to get appliances to the network, and changing demand in itself for those three gas appliances is very difficult. What we try to do is try to get people to connect to the network and connect an appliance, not so much increased gas demand.

I suspect that possibly those numbers that ACIL have come up with may be based more on supply and demand in the transmission area, more than the network area, which again is why there is distinction between transmission and networks.

DR FOLIE: It's probably straying a bit from your area, but do you believe that because of its gas and electricity - if we take the distribution system - and it's mainly, as you make the point, retail customers - that therefore, as your marketing view, is there a sort of a somewhat diminishing return? In other words, you can only have so many appliances and if they're gas or electricity - depends which is your choice - but the aggregate household energy demands may not be as susceptible to lower prices. They may be switching between the two fuels but because this conclusion here is total access that in essence you only have so many energy-using appliances in a house and even if you drop the price significantly, the choice made which appliance - between whether they be gas or electricity - but the overall aggregate energy consumption is likely not to be stimulated very strongly.

MR MIGNONE: That's right. Overall energy consumption is dropping as appliances become more efficient. In addition, there is a growing move towards what is known as five-star ratings in house construction. So, you know, more efficient energy appliances, better insulation and so forth, is dropping our average gas loads. The competition with solar and electric, again, as I said earlier, is eating into our market. Overall the competition with electricity is strong and in itself poses a ceiling on gas pricing. The two are in some ways related and how that study has taken that into account I'm not sure.

I suppose the question you're asking is: is there a relationship between the two? There is. Our market grows due to new gas connections. Compared to the established market, the new connection market is only a very small percentage, but we need to make sure on a year-to-year basis that that growth is maintained and that when people replace their current gas appliance that they replace it with an electric appliance. If the price is not attractive, well, then we lose that appliance and therefore the load, so reducing gas prices from a network point of view does not automatically increase gas consumption. We look at loads as appliances and it's a falsehood to say that - as I said before - if price goes down or up the consumption in the household of gas will rise or fall. The decision is made when the gas appliance is replaced and that's a stepped difference in mode, not a gradual increase or decrease.

DR FOLIE: Thank you. I've got one more and this one is a bit - not detailed - but

it's a bit slightly technical. The issue about actually - this comes back a little bit towards information flows and managing it. It comes back to - you've actually responded that effectively standardisation of information in attachment A - the issue I would like to say, without going into all the details of attachment A is are the regulators actually getting more information than it is actually asking - listed in attachment A, or is attachment A so broad that they can actually sort of use the attachment A requirements to actually sort of disaggregate the information? The third part of the question: is fixing up attachment A really the appropriate way to go forward and would that be a basis for monitoring information?

MR MIGNONE: Attachment A is what - the requirements the regulators are seeking is far beyond what is in attachment A, so the issue can only be resolved by agreeing a set of requirements. Attachment A does say that these are examples of the sorts of information that would be required, but regulators tend to use more the requirements of the ring fencing sections of the code for sets of accounts and I guess there is quite a bit of interpretation as to what is a set of accounts and the detailed information that goes with those accounts. So in some respects attachment A to the code has almost been superseded or ignored in favour of regulators drafting their own, but like attachment A.

So the only way to resolve that is for everyone to agree, you know, what is required under the regime to, I guess, implement the cost, the building block approach and ensure that those guidelines are consistent and practical and relevant; whereas the problem now is that much information they are requesting is not relevant to their function and it's purely a means of micromanagement.

DR FOLIE: Are there any other areas of what you might call sort of rights to be able to get information from companies other than - there's attachment A which we've spoken about; there are the ring fencing arrangements. Are there any other areas that have been used to actually get what you feel was more information than was originally intended when the code was drafted?

MR MIGNONE: Not at this stage. There is a section 41 of the Gas Pipelines Access Law which is open to regulators to seek information where they need it, and in our experience that hasn't been used and hasn't been necessary.

DR FOLIE: Is it at risk?

MR MIGNONE: Possibly.

DR FOLIE: Okay, thank you.

MR HINTON: Ralph, come back to effective lower prices, or the issue of lower

prices being an important part of the ACIL Tasman study generating benefits. Presumably there's another force at work with regard to lower prices; that lower prices may or may not affect demand along the estimated path, but there's also effect on the industry more generally for lower prices - that is, lower prices by regulation could in fact have a price structure that is not long-run efficient costing of that particular good. Does that not in itself have implications for assessing whether or not the lower prices are generating benefits and costs?

MR MIGNONE: Yes, it's interesting from the ACCC report that I don't think this was actually addressed, but to say the lower prices stimulate upstream and downstream industries - which, from memory, is what they said - is a bit contradictory in some ways, isn't it? I mean, you know, in order to get the discoveries happening upstream you need the right pricing signals so - - -

MR HINTON: That was behind my question.

MR MIGNONE: Yes, that's right.

MR HINTON: Thank you. I've got one more question in relation to your submission, not touched on this morning in your remarks, and that is in relation to how the code should handle expansions of existing systems. There is a terminology issue here of expansions versus extensions, but let's stick with the word "expansion" as opposed to an "extension". We put forward in our draft report - I think it was recommendation 7.4 - that for a covered pipeline an expansion of that infrastructure would also be covered. That's generated reaction from some saying that that shouldn't be the case.

I want to explore - and Envestra takes that view in the submission, your submission to us, as well - why prima facie there is not force to the argument that if a pipeline is covered - that is, it has passed all the tests for coverage - that's not a basis to cover the expansion of that infrastructure. There's an important distinction here, not automatically covering any expansion, because an expansion of an uncovered pipeline would not automatically be covered; it would still be subject to coverage tests. It's the expansion of a covered pipeline being automatically covered by the regime. Can you give me your reaction to that, what I thought was a reasonable force of argument?

MR MIGNONE: I suppose simply it does give additional flexibility. Again, from a network perspective, it's not often we have very significant material extensions or expansions. But in the event we were to undertake one, it would be very significant and, in order to make such projects work, one does need the utmost of flexibility in the regime. To automatically have one covered, that just eliminates one area of flexibility. The approach we would suggest is one whereby there is consultation with

the regulator, as happens in Victoria and various options are looked at, but simply it does eliminate one area of flexibility.

MR HINTON: But if there is market power that warrants coverage for the existing infrastructure, it's difficult to see how the expansion of that infrastructure would in any way reduce that market power. If anything, it probably increases it, therefore by having - - -

MR MIGNONE: It depends where the expansion is to, or the extension is to, and the market in that area. There are just so many variables and unknowns that unless you treat it on a case-by-case basis, it's hard to make a general rule, I think.

MR HINTON: This is why I was exploring it with you because I think there may be some uncertainty here with the difference of terminology of expansion and extension. I can see it's quite simple for a transmission pipeline that an expansion involving compressors and loops you can argue I think quite persuasively that market power in fact if anything could be increased rather than eroded by that expansion. But when you get to distribution networks, what is an expansion and what is an extension? I think there may be some unease in your mind because you may be looking at extensions being a substitute for an expansion.

MR MIGNONE: I'm talking about extensions. Expansions from a network perspective are almost a non-issue. We don't install compressors in the network or that sort of activity.

MR HINTON: Exactly. You don't put larger pipelines down the street. You may upgrade them.

MR MIGNONE: As far as the network is concerned, we look at this as an extension which is - for example, if you take Adelaide, if we were to extend the network 10 or 15 kilometres into the Adelaide Hills, that would be a very major project, different market altogether from the elementary area, and it would be a case where we would like utmost flexibility in dealing with that situation.

MR HINTON: Wouldn't, under the code, that extension be covered if the existing infrastructure is covered, as opposed to an expansion into a rural town in Victoria, setting up a new network, a distribution network? Then that would be an expansion.

MR MIGNONE: I guess what you're highlighting is that there is a bit of a grey area here. That's exactly what I'm saying, that we haven't got a clear-cut situation here that we all know exactly what we're talking about, so let's keep the options open and treat on a case-by-case basis.

MR HINTON: I think you've illustrated the point very well that we need to look at our words in our draft report so we don't generate inappropriate reactions to what we're saying. Thank you for that. Are there any points that we haven't covered this morning that you think we really needed to focus on, Ralph?

MR MIGNONE: No, I think that's about it.

MR HINTON: Well, thank you again very much for your participation this morning and your submission. It's much appreciated. Envestra's input is valuable for us. Thank you.

MR MIGNONE: Thank you.

MR HINTON: That brings us to about quarter past 10. We did have pencilled in another session here before morning tea at 10.45, but there's been a cancellation of that so we have now got a gap in our schedule, with the next appearance now occurring at 11 am from the Energy Consumers Coalition. What I suggest we do is break for morning tea early, work on the basis we will definitely return here at 11 am to have that second session for this morning's hearings in Adelaide, but if the coalition turn up early, there may be scope to start a little earlier than otherwise would be the case. If we'd had more than 45 minutes, we might have even broken fully till that 11 o'clock commencement again, to let people do other things like leave the area; but I think as we've only got 45 minutes, let's work on that flexible basis. We'll be back here definitely no later than 11 am. Thanks very much.

MR HINTON: Welcome back to this last session here in Adelaide of the Productivity Commission's public hearings in relation to the Commission's inquiry into the Gas Access Regime. I now have the pleasure to welcome to the microphones the representatives of the Energy Consumers Coalition of Victoria and the Electricity Consumers Coalition of South Australia. Welcome. What I would like to do, for the benefit of the transcript, is to have you identify yourselves and then I invite you, if you so wish, to make some introductory or opening or summary statements that would help proceedings. Thank you very much.

MR HEADBERRY: Thank you. I'm David Headberry, secretary of the Electricity Consumers Coalition of South Australia.

MR ADAMO: I'm Mario Adamo from Holden Ltd and also representing the Energy Users Coalition of Victoria.

MR WILLIAMS: Darren Williams from Kimberly-Clark Australia.

MR HINTON: Thank you. This is both amplification and recording for the transcript, so it will go through the room fairly easily, I suspect Mario.

MR ADAMO: Okay. As just introduced, I'm Mario Adamo and I represent the views of the Energy Users Coalition of Victoria. I'm actually representing the chair as the chair is unable to attend today. I'm currently the purchasing manager for Holden in Australia and part of the General Motors Corporation. In addition to that, in addition to the steel manufacturers, BlueScope and OneSteel, the EUCV is predominantly composed of companies involved in the auto industry in Victoria and, as such, we also represent the wider interests of the second and third-tier suppliers in that industry. Across our representation we also cover very large and medium users of natural gas and we comprise a major element of the Victorian manufacturing economy.

What I'd like to cover off on today - and I'll just give you a summary of the points we'd like to sort of brief you in a bit of detail on, our opinion of the draft code: firstly, we'd like to just discuss the state of the Victorian gas industry and productivity outcomes; secondly, we'd like to look at the draft Gas Code and the restriction on consumer input; thirdly, what is the impact on the total industry value chain, what are the drivers of investment, what is the visibility of pricing decisions, other effective regulatory models across the world, discussion around onus of proof and a couple of other minor issues we will just discuss briefly and then I'll conclude.

We go on to talk about the gas industry in Victoria. The ready availability and low cost of natural gas in Victoria has been one of the key elements underpinning the economic growth of Victoria since about the 1960s. Gas transport is a significant

element of the supply chain cost and increases will result in commercial pressures on industry where there are already strong competitive pressures from overseas. Unlike the transmission pipeline in other states, the Victoria transmission system was grown organically, penetrates into most areas of the state and has many features of a network. The distribution network is very well established and has a high consumer penetration.

Investment in gas transport in Victoria has occurred as required with the South-West Pipeline and new regional connections being made and full recovery of costs being permitted by regulators. The state government has provided gas injections to support regional penetration, where gas demand is insufficient to warrant augmentation. All this is occurring under the present Gas Access Regime, so we do not understand the need to change the Gas Code. In essence, our position on that is that the Gas Code is currently working for the value chain or the supply chain of that state.

We move on to the second area we'd like to highlight, which is consumer views. The EUCV has joined with the EMRF of New South Wales and the ECCSA of South Australia in preparing a joint review of the PC draft report. The EUCV supports the views of the EMRF and the ECCSA as represented to the Commission, so that report has been lodged, or will be lodged in full. We see the draft report recommends the reduction of the end-user input into the controls placed on the gas transport monopolies. I would just like to repeat that. We see that the draft report recommends the recommendation of end-user input - a fairly important point for us.

We note that the Commission recommends reduced control of the gas transport monopolies by the regulators. We also note that the Commission is of the view that there will be increased investment in gas pipelines if these controls are relaxed. What we don't see is any factual analysis which shows that there are pipelines which are needed that have been prevented by the current Gas Code. To the contrary, in fact, we note that the ACCC observes that there's been a massive investment in pipelines under the current Gas Code in recent times. Hence rhetorically the question is: where is the problem with the current Gas Code?

What we don't see is any analysis which shows that reducing controls will result in the building of additional pipelines which are currently needed that aren't being built. Why is the Commission so sure there will be more pipelines built, and where will they be if, indeed, we adopt the proposed code? We have seen reduction in the delivered gas prices in Western Australia but this came from competition between gas wells, not from competition between gas pipelines or relaxation of controls.

I want to move on to another point we would like to make which is: what is

the impact on the total industry value chain? Another rhetorical question. Our assessment of the draft report is that the Commission has a responsibility to ensure that their recommendations reflect the needs of all Australians, not just part of an industry or a player in any industry sector in isolation. The report is heavily focused on the benefits that the gas pipeline industry will get from reduced controls, but there is no analysis on the benefits or detriments upstream or downstream industries will have by allowing this monopoly sector to benefit from relaxation of regulation, not to mention consumers at large.

The Commission makes the observation that it cannot prove that the investment in gas pipelines has been affected by the Gas Code, but says that conceptually it probably does. Therefore the observation is equally valid that conceptually downstream investment will be reduced by greater freedom of gas transport to set its own prices and extract rents. If gas transport costs increase due to increased investments but there is no increase in demand, this will reduce the competitive position of downstream industry, restricting investment in a much larger downstream industry sector. The Commission makes no attempt to analyse the impact of the downstream industry of its recommendations.

I want to move on to what are the investment drivers here, and if we look at investment in general in the marketplace - and we'll restrict this discussion to the Australian marketplace for the sake of the argument - one key driver in investment is the amount of return that will eventuate and the second driver is basically the magnitude of the reward relative to the risk of that investment. Thus, the discussion by the Commission of the risk profile of the pipeline industry in isolation and without comparative quantification back to the risk reward available in the total competitive industry arena for investment shows a major shortcoming in the report.

In our response to the draft report we have provided the Commission with factual evidence that the regulated businesses have every interest in increasing investment through being awarded returns higher than the Australian industry gets. If such high rewards are already going to the pipeline industry, why does the Commission propose less control?

I will just talk about visibility. Quite clearly with the awarding of easements for the granting of pipeline construction, it's not feasible to see two pipelines running parallel; in addition the demand in most cases cannot support two pipelines running in parallel. Thus the grant of an easement by the government is an effective grant of monopoly to a pipeline. There is plenty of practical evidence to support that. To ensure a pipeline does not abuse its position it requires some independent oversight. Currently we enjoy that oversight through the regulation which is in place. Sound regulation provides visibility to all, to ensure that the monopoly is not abused. Predatory pricing or monopoly rents produces upstream and downstream investment

and ultimately global competitiveness.

Benchmarking shows whether a monopoly service is competitive. Visibility is needed to ensure there is no predatory pricing by comparison to benchmarks. The purpose of eliminating vertically integrated suppliers was to provide visibility at the various steps. How can consumers prove there was predatory pricing when the visibility has been removed? The recommendations reduce the ability to access information in a form useful for consumers to make that assessment.

If we look at the types of models of regulation across the globe, the United States has extensive networks of over 300 privately owned transmission pipelines. By general agreement the United States has a far more intrusive regulation of gas pipelines than the Gas Code. This supposedly intrusive regulation has not impeded investment in gas pipelines in the US. Canada also has many gas pipelines and strong regulation. The UK initially tried light-handed regulation of gas transport and now uses a much more intrusive regulation to eliminate the monopoly rents which have occurred under the light-handed approach in the past. The Commission does not investigate and explain why the Gas Code has reduced or will reduce gas transport investment in Australia, where in other parts of the world strong regulation has not had that effect.

Our final point we'd like to raise is the onus of proof. A single provider to a gas pipeline requires government sanction and easement and hence is a monopoly and has market power. A monopoly is in a position to extract rents. Conceptually a monopoly should be regulated to ensure it does not use this position to extract monopoly rents. The Commission proposes a reversal in the onus of proof to require evidence that not only is the monopoly in fact extracting rents, but it then recommends that the consumer must provide evidence that it is economically efficient to regulate the pipeline to prevent extraction of these rents.

This raises two fundamental issues: due to a lack of visibility from having reduced regulation there is no information readily available to regulators or consumers to assess the issue and so either identify, if there is a problem, or to debate it. If the principal accepted that the onus of proof lies with the consumer, then this approach runs entirely counter to the Trade Practices Act which requires that a monopoly prove that it is not using its market power to the disadvantage of the community. It would be more efficient to assume the monopoly is extracting rents and should be regulated, unless it can be proven that it is not able to do so.

Just a few other minor issues and then I would like to conclude with closing comments. The recommendations suggest that consumers should negotiate with the gas pipeline owners but the recommendation will increase the difficulty due to the lack of visibility. The recommendation includes, for extended regulation-free

periods, to give certainty to pipeline investors; the Commission has not examined the impact where either up or downstream users of the pipeline are extracting monopoly rents. For instance, a period of five years is more than sufficient for an up or downstream business to go out of business and cease trading with no avenue for recall.

Under regulation, pipeline revenues include all regulatory costs and pass them through to end-users, hence why the pipeline owners carry on the fuss about costs. The Commission refers to the time frames taken to complete regulatory reviews as providing a deterrent to pipeline investment but makes no attempt to identify the causes of these delays. Investigations indicate that the main cause was the approach taken by the pipeline owner and provided needed information for approval in the first place. During a recent Moomba crisis, the cost for delivered gas in New South Wales and South Australia increased dramatically. The main beneficiary of these rises were the SEA Gas and EGP pipelines. This provides a clear example of the market power that the gas pipelines have and the rents they can extract.

In conclusion, the Gas Code as written is seen by consumers to provide a balance between their interests and those of the gas pipeline industry and, in essence, the supply chain as a whole, including consumers and customers in the marketplace. In writing of the Gas Code all governments accepted the principle that all existing gas pipelines were monopolies and required regulation. Since then, some covered pipelines have been uncovered, after a transparent review process.

By concentrating exclusively on investment in the gas pipeline industry, the Commission has failed to address the upstream, downstream and community-wide implications of its recommendations. There is almost no quantification of the Australia-wide benefits arising from the recommendations and no quantitative analysis of the detriments of the proposed changes. The recommendations are predicated on the assertion that the cost of regulation is too high, but then there is no quantitative analysis to support this assertion relative to the detriments that would accrue to the consumers in its absence. The Commission has provided a qualitative view from the gas pipeline industry perspective as to why the current requirements of the Gas Code should be relaxed, but has not provided any quantifiable reasons to change from the current Gas Code as written. That ends our formal presentation.

MR HINTON: Thank you, Mario. David, did you also wish to make a statement?

MR HEADBERRY: Yes, if you don't mind. It's probably better if we do the two presentations together, because there are obviously similar concerns, and we can then address the issues.

MR HINTON: Makes a lot of sense, I think.

MR HEADBERRY: My name is David Headberry. I'm secretary to the Electricity Consumers Coalition of South Australia, better known in South Australia as ECCSA. I'm standing in for Mr Rod Davidson, the chair of the group, who can't be here today, and he sends his apologies. I also would like to point out that I was also a member of the gas report task force, the consumer representative on that task force. I took on that role when Warren Haynes of Orica died. So I was intimately involved in the actual preparation and the writing of the Gas Code as it's written. I'd also like to thank the Commission for the opportunity to personally present our views today.

As Mario made comment, the presentation that was our formal presentation was a joint effort, done on behalf of the Energy Market Report forum, the Energy Consumers Coalition of Victoria and the ECCSA, so probably our views have some degree of commonality.

Just a background on the ECCSA: it comprises companies which are the biggest gas users in South Australia. It includes Adelaide Brighton Cement, Holden, Kimberly-Clark, Mitsubishi, OneSteel and Pasminco and it should be remembered that these are the largest employers in regional South Australia and in Adelaide and each of them provides considerable further employment through their many suppliers, second and third tier suppliers. Pasminco is based at Port Pirie and basically Port Pirie is predicated on Pasminco operations. OneSteel is at Whyalla and is the prime employer in that area and Kimberly-Clark is the prime employer in the Mount Gambier area.

I think probably we should also point out that the break-up of the vertically integrated government controlled gas businesses combined with the implementation of the Gas Code has provided a high degree of transparency to the various cost structures of each of the elements that comprise the gas supply chain. This is an essential element of the requirements of business, downstream business, to identify what its costs are and in fact if those costs are reasonable; bearing in mind that, with the reduction in tariffs that Australian industry has seen over the last 10 to 15 years, we are in a much more competitive environment than some of the more protected industries which are not so exposed to the international pressures.

I was going to make a brief comment about the gas supply in South Australia, a comment about competition, a comment about investment in pipelines, reduction of users' input into the review process, the cost of regulation, a little bit about regulatory risk, and then I'll sum up. South Australia is probably unique in the whole of the nation because it's become one of the key drivers of economic growth in the state, although companies that operate in South Australia are both subject to competition from other states and also on the international arena, so the supply of gas at competitive prices is essential to the wellbeing of South Australia and its economy.

We should remember that the South Australian gas industry is dominated by a single gas retailer, who has effective management of the entire gas distribution network and has also significant ownership in gas transportation. When we actually broke down the supply chain of gas, we found out that for our members and for the wider community of South Australia, the gas transport varies between 30 and 60 per cent of the delivered price of gas, so that's quite a large chunk of the supply chain for gas and supply of energy.

We should also remember that the transport capacity - both the Moomba-Adelaide pipeline and the SEA Gas pipeline - is essentially controlled through foundation contracts, which effectively prevent third party access. Intriguingly, though, both those pipelines separately accommodate the bulk of South Australia's gas needs and so we will see there is significant spare capacity when SEA Gas comes on line and when the gas starts being pumped out of Minerva. The investory distribution network is already in place so to try and even contemplate replacing it is probably an absurd proposition. In fact, it only needs augmentation to meet the future needs.

So the transport of gas in South Australia is essentially a monopoly. There is no real competition - maybe a tad between the SEA Gas pipeline which comes from one gas field and the MAPS, which comes from a totally separate field. So what we need to ensure is that there are adequate controls on this infrastructure that ensures the monopoly rents are not being levied and will not be levied in the future. The South Australian economy cannot tolerate that sort of freebie given away to another party.

The transport costs are of serious interest to all South Australian gas users and consumers and by and large we see that the Gas Code, as currently crafted, provides a transparent method for ensuring that these transport costs are maintained at a reasonable level. We have a real fear that, by relaxing the controls as is being proposed in the draft report, it is really going to put South Australian downstream industry at severe risk.

I think it's worthwhile actually having a look at competition. The first thing we identified when we analysed the issues is that the gas pipeline industry is not an end in itself. Pipelines are not built unless you have two precursors: that is, there has to be a supply of the gas at one end and at the other end there has to be a consumer prepared to pay the price being asked. So really the linking of the two requires two other parties to have achieved both a supply and a demand position. I think the development of the SEA Gas pipeline highlights this point. In that case there's a low-cost supply out of the Minerva and out of the Thylocene and Geographe wells, and there are willing consumers in South Australia because the South Australians

have been paying a high price for gas transport in the MAPS. They've been paying a high price out of the Moomba field.

Then we looked at that and compared that say to the Papua New Guinea pipeline which has had a lot of airplay over the last three or four years. In fact the big problem that they face is that, whilst they have a source of low-cost gas out of Papua New Guinea, there aren't consumers willing to pay the price associated with it. Those consumers are actually going to other sources. So the reason that the PNG pipeline hasn't proceeded has got nothing to do with the Gas Code but a lot to do with the fact that there aren't willing consumers at the far end of the pipeline. I think we need to recognise that the outcomes both in one case, the SEA Gas, the positive outcome, and the negative outcome in the case of PNG, haven't been driven at all by the Gas Code. They've been driven purely by economics.

The Commission makes a lot in its report about the competition in the gas industry - I use competition in quote marks in that regard - between fuels and between pipelines. But in fact there's not a lot of reality in that supposed competition. When you start to look at it, in South Australia natural gas is predominantly used for generating electricity - about half of the gas, maybe a tad more, and the other half is used for heating, whether it's at domestic level or whether used by industry. In other jurisdictions, gas is also used as a feedstock.

So we actually looked at what the various cost drivers are between the two, between gas and its supposed competitors. Coal is cheaper than gas. There's no doubt about that, on a dollar per gigajoule basis, but to use coal in that way requires quite a significant investment in infrastructure. Kimberly-Clark, who's here, used to use briquettes for providing steam at the mill near Millicent, and it's converted over to natural gas for a number of reasons; but to revert to briquettes would be almost impossible, for a number of reasons, particularly the capital involved.

If you look at the price of oil, it is so highly priced compared to gas that you can't really consider oil as being a fair competitor; and the same thing with electricity. You can't use electricity for many of the purposes that we use natural gas for. If you go to the next step, if you want to use natural gas as a feedstock, the actual costs associated with converting the up-front end of a factory or a refining industry to go from natural gas to another feedstock, you're looking at a massive investment to do so. The other thing which isn't even touched on in the report is that natural gas is an essential part of Australia's attempt to reduce air pollution and greenhouse gas emissions. So to reconvert to coal or oil from gas would be environmentally unacceptable. By any measure, to assume that natural gas has energy competition is, in our view, arrant nonsense. The numbers don't stack up and the environment doesn't stack up in favour of it.

The most concerning to us is that there's no attempt to assess the implications to Australia of the proposed changes to the Gas Code. It's rather looked at the implications of the Gas Code on a gas pipeline industry in isolation and virtually excluded any assessment of the impact on downstream industry and on the community as a whole. So that's one of our major concerns, that we haven't looked at the wider implications of the recommended changes to the Australian community and the an interest.

We actually looked at investment in pipelines. Again, our reading of it is that much of the Commission's recommendations to ease the apparent constraints of the Gas Code requirements really come down to the view that investment in pipelines is being or will be reduced unless changes are made. On page 108 of the draft report, the Commission notes that:

> Judgments on whether investment on pipelines is being affected by the Gas Code must be made on a conceptual basis -

and that, "Regulation has a chilling effect on investment."

The stated reason for the need to revert to concept rather than looking at the actuality is that the Australian pipeline industry doesn't seem to be able to provide any real support for the assertion that needed investment has been prevented by the Gas Code; in fact, from any cause other than that there's a low economic return on the investment. So our assessment of all of the assertions made by the pipeline industry is that they all come down to an economic driver and not so much to the fact that the Gas Code has prevented them carrying out investment.

We then looked further and we found that there are almost no locations in Australia that could currently benefit by a natural gas pipeline, where there's a sound underlying economic basis for the reticulation. In Victoria, which the pipeline industry do refer to, we've noticed the Victorian government is providing seed capital - not just seed capital, quite significant chunks of capital - to pick up the difference in the economics between the likely return that's going to come from the number of consumers and the actual cost of the capital that's needed to service them, so the Victorian government has recognised that it's not a Gas Code issue. It's a money issue.

The other thing is that the draft report doesn't seem to look into is what happens elsewhere in the world. Now, Australia doesn't operate in isolation, so we looked at the US and Canada and we have identified that all of them have strong regulation of the gas pipeline industries, but they don't seem to suffer the supposed problem that there is a lack of investment, so we are at a loss to understand why we have come down - just basing our assessment that the Gas Code needs to be changed

purely on a conceptual basis.

There is no quantitative analysis of the national benefit which might come from a total freedom to build pipelines and levy whatever charges; in fact the building of a duplicate pipeline to parallel another which is built would be considered economic suicide, and TXU, Gas Net and Duke found that out when they looked at building a competitive pipeline to the SEA Gas pipeline. Ultimately TXU, Origin and International Power came to a pragmatic solution and said, "Why doesn't TXU hop onto the SEA Gas pipeline?" and they increased the capacity by about 60 per cent to do that but, conceptually, investment is driven by the likelihood of returns, particularly if they exceed market expectation for security, so it's not so much that regulation might be impacting on this.

It is more the fact that we're going to make a decent slug of money out of making our investment, so we actually looked at what are the returns that you get in business, and our submission - to which we appended a report on returns that industry-wide gets - clearly indicates that the regulators are being overly contributory to the profitability of the gas pipeline industry, when you compare the returns they're awarding under the WACC to the actual returns that industry makes at large - that's the whole of the weighted average of Australian industry.

We were at a loss to understand why the Commission actually hadn't done further investigation in its report to work out - no, investment is driven by the returns - why you hadn't looked at the returns that were being achieved by Australian industry, which does invest on a regular basis and looks at the returns that the gas pipeline industries have been getting from the regulators, which obviously does drive investment. The thing we were most concerned at is that we believe that as part of your report you must at the very least quantify the benefits for the nation of what reduction of regulation of the gas pipeline industry will give and not just what you think the pipeline industry will get for itself, and we need to quantify whether the cost of regulatory decisions exceeds the level of reward needed for all future investment, and that includes, as Mario said before, investment both upstream and downstream. You can't look at the pipeline industry in isolation without looking at the impact on the downstream.

We then looked at the proposals which affect the reduction of user input into the processes and, as I said at the outset, I was the consumer representative on the gas reform task force and it was always seen as being an essential element that the end user has to have - there is an equal say in the process. If you start reducing the ability of the consumer and the end user to participate in the process you have got a problem.

Half of the gas supply industry is the end users. The other half comprises the

pipeline industry and the gas producers, so to eliminate or reduce the power of one of those sectors in any review process is really unfairly disadvantaging one of the parts of the industry as a whole, and one of the things we actually attempted to do in the Gas Code itself was to empower end users and to make sure there was a balance of interest between those supplying the service and those who are taking the service and the draft report doesn't really address and doesn't keep that element at top of mind - that we must always make sure that the demand side of the industry has the power to influence the outcomes which directly impinge on it; in fact the controls are being reduced on the unproven assumption that the supply side will then increase its investment.

After all, as we make the point in our written submission, the community grants the pipeliner a monopoly right of easement, so there is a need to provide controls over the pipeliner to ensure that it does not use its monopoly power to the detriment of the community at large. There is a lot made in the draft report about the costs of regulation; in fact I think at one stage it refers to the heavy cost of regulation to the gas pipeline industry. The first thing that seems to be lacking is a quantification of that - what is the true cost - so I listed on the back of my metaphorical fag packet the difference of view between say the owner of the pipeline between Moomba and Sydney and the ACCC is about 10 to 15 cents a gigajoule for transport on that pipeline. Equally we could have looked at the difference of view between the Dampier-Bunbury pipe - the owner of the Dampier-Bunbury pipeline -I think it is still Epic - and what the WA regulator came up with.

Across that you could say that there is at least a difference of 10 cents a gigajoule between the two; in fact it is a greater amount and it could get up to 20 or even over 20 cents, but even if we assume that it is 10 cents a gigajoule, that the regulator has decided he is inappropriately being levied by the pipeline owner for use of that pipeline, when you extrapolate that across the whole of the gas demand in Australia that returns a benefit to Australia of over $100 million a year. I didn't see any number of quantifications of that sort of number, or anything like that, in the draft report.

The cost of regulation in Australia does not exceed $100 million a year, so just on my fag packet analysis regulation is providing a benefit to Australia Inc, which would otherwise accrue to the pipeline owners if they were given much more freedom. In addition to that we should remember that the costs of regulation are ultimately borne by the end use consumer, by the consumer of the gas - all regulatory decisions. The costs incurred by the regulated businesses are allowable costs into the regulated revenue cap. The costs that the regulator passes through in licence fees or the like are also allowed to go into the revenue cap and therefore are recovered back from consumers, so at the end of the day the regulatory process is a cost borne by the consumers.

The only time a regulated business is potentially subject to unrecoverable cost is where he appeals the decision of a regulator and is found to be wrong, so that's a discipline on them not to go and waste other people's money, including their own. The Productivity Commission notes all the way through its report about the high cost of regulation and all of the quotes are being made by the pipeline industry. It's the pipeline industry talking about how much it costs. It's the pipeline industry which says, "Yes, we've got a problem here. If we got rid of regulation we'd be able to reduce costs," yet they don't wear that cost. The consumer does, and I couldn't read anywhere in the draft report where a consumer had complained of the high cost of regulation.

Now, if anyone is entitled to complain about the high cost of regulation it is the consumer, so it seemed ironic that we actually have the beneficiaries of the looser controls - or the relaxed controls - complaining bitterly about the cost of regulation, which they're allowed to pass on to consumers anyway. I did the fag packet calculation, but I didn't even find a fag packet calculation in the draft report, highlighting what the costs in dollar terms per year were to industry - to consumers for regulation - and what the national benefit would be by the relaxation of these controls and the potential detriments that might come by the relaxed controls.

We then looked at regulatory risk and the pipeliners again have said, "We don't want to have this oversight and there's all this regulatory risk that's impacting on us and there's all this risk asymmetry and now we've got this truncation of upside potential." Yes, these are true, but you have got to look at that in the context of the risks faced by competitive enterprise; for instance, truncation of upside potential. If I come up with a brilliant idea and set up a shop and try to levy a handsome return, as sure as God made little apples right next door to me will be another shop setting up, doing exactly the same thing because they can see there is a lot of money to be made and, if that isn't truncation of upside potential then I will stand in George's window.

The thing is that the draft report doesn't go into the quantification of what these risks are and whether those risks are being carried by any other industry in a competitive environment, and in fact they do. In fact probably industry in competitive environment faces many more risks than does a regulated gas pipeline, and yet when we look at what the regulators award a regulated gas pipeline as a return on its investment we find that the rewards are even higher for the gas pipeline than you get in competitive industry, so why do we have to give them a benefit? They have already got it.

Rather than saying, "Well, let's reduce regulatory risk, if there is an overall residual risk that the pipeliners face" - and that's arguable - "that's not faced by those in competition" - then we should actually look at the returns that regulators give to

ensure that there is an adequate benefit that comes from the regulatory risk rather than trying to eliminate the regulation itself and, as I said before, the regulators are giving a better return to the regulated businesses than the wider industry gets, and that is the whole purpose of the paper we appended to our written report, and so there is no quantification in the report which quantifies the magnitude the risk pipeliners face to see whether any residual risk has been accommodated by the returns. That would be a better way than saying, "Let's see if it's real. If it's real put a value on it, and then we can quantify whether it is better to reduce regulation" or whether we say, "Let's give them a slightly increased return."

In summary, the gas transport industry has strong market power, and we could actually see the rent-taking during the recent Moomba crisis - the cost of transport on SEA Gas and EGP went up quite dramatically during those two months. Under the Gas Code as we have got at the moment there is strong evidence of investment in the pipeline industry, and we have also seen investment in upstream - we know that the actual development of the Otway fields is a very good case in point - and also downstream investment. We've seen a lot of upstream investment in the gas production in the North West Shelf as well, and the supposed significant costs of compliance haven't been established by the Commission nor have they been balanced against the benefits.

We believe the code is working and we don't believe that the draft report actually provides an objective and quantitative case for change. The interest of consumers must be retained in the code. The clauses stating "prevent the abuse of monopoly power, fair and reasonable right of access, interest of users and prospective users" - which, from my background, I was very pleased to see incorporated in the code - they must be retained in the code because demand side is the other half of the business and a concern that we had was the definitional issue of "significant" versus "material" regarding coverage. If we were worried about the cost of regulation I reckon that that's going to feed the lawyers for many, many years - when we debate the difference between "significant" and "material", and that's going to be a cost that consumers will wear, and we don't particularly want to wear that one.

In conclusion, we believe that the Commission has failed to address the core requirements of the review and that it consider the nationwide benefits and detriments of the recommendations that it makes to the changes to the Gas Code. We believe that the draft report relies predominantly on assertions, because it is singularly deficient in quantitative analysis of the benefits and detriments. Of great concern to consumers that - we've gained the view that the draft report essentially comprises views put by the pipeline industry and, to a large extent, ignored the views put by end users and evidence contrary to the pipeline industry view.

Overall, the draft recommendations have the potential of reversing the benefits that we've obtained from the operation of the Gas Access Regime over the past six to seven years. I know the Gas Code has only been in place for five years, but we actually used the draft code when we did the review of the AGL regulatory review back in 1996. So why do we have to change? It's working well. Thank you.

MR HINTON: Thank you very much, David, and also Mario for those comments. Thank you also for the two coalitions' participation in producing this substantive coordinated written submission to our inquiry. The Commission appreciates the input and involvement in this inquiry from the coalitions and therefore the interests of users of gas more generally. It's important that the process of consultation by the Commission be as widespread as possible, with regard to interested parties, and clearly your coalitions represent significant players and significant interested parties and therefore input is crucial.

I've got a couple of questions I'd like to explore in the available time this morning, not page by page with regard to reference to your submission, but more of a thematic approach that addresses some of the clearly different directions from which you are coming relative to our draft report. My first one is in relation to the nature of the sector in the sense that we took some pains to point out in the draft report about the continuum nature of market power across market participants. It's not a black and white situation of there is monopoly power and there isn't, and therefore you can make judgments, quite clear-cut judgments.

In fact, the market as we see it, the sector, sorry, as we see it, has much more characteristics today of a continuum, in circumstances where there may be natural monopoly power leading to very substantial market power, relative to say the natural monopoly characteristics exist, but other factors at work counter that natural monopoly power to make it a competitive environment. Clearly in the former case intervention is warranted. The nature of intervention may be debatable. Clearly in the second case intervention is not warranted.

You don't have intervention regulation for the sake of regulation, for the sake of intervention; you have to have a raison d'etre or a rationale to address market imperfections, misuse of market power. Therefore a thematic approach to explore why your perspectives are quite different to our draft report - I'd welcome your views on this idea of the concept of a continuum with regard to market power.

MR ADAMO: Indeed, Tony, I think that's probably - I think what you're saying is fair to say, "Okay, let's look at it from a continuum," and obviously through, if you like, deregulation and also the opening of access, you end up with a continuum where yes, it's fully market competitive versus it's just a pure monopoly and it's fully regulated and nobody has any ability to influence. Our position is that if we were to

assess on that continuum where most of the major pipelines are and based on the anecdotal evidence of what people have done and not done and be able to do with pipelines, then I would be making a comment to say that on that continuum we are not in a position where I believe we are at the open market fully competitive end of the continuum; we're still at probably somewhere 25 per cent down that continuum from a pure monopoly position.

So our concern is, I suppose, number 1, what is pushing people down that continuum? So at the end of the day something forces somebody down that continuum, because otherwise we've changed the nature of the industry with regulation, with codes, with access agreements, et cetera, to push people down that continuum, and also make us a much more competitive, if you like, country ultimately. My concern and our position is how do we continue to push people down that continuum, to achieve where you want to get to and we want to get to, and that is to have a fully open market competitive situation? Is it ever possible? Our assessment at the moment is probably not, given a number of factors including the granting of easements, et cetera, and that restriction.

If I was to look at this from an analysis of the forces on this industry - and I did a little diagram while we were talking here - I'd say to you today, alternative sources - there are many barriers to entry. New entrants, many barriers to entry. From the supply side to the pipeline there might be some force there, there might not be in the segmentation of that and the disintegration of that industry certainly created a bit of force there, but you've got to really look at that very closely and I think it's on a case-by-case basis. So then our position says the only way you can continue to put market force on this particular part of the industry is to look at it from a user perspective.

If we take away the current code and say, "We'll take away your ability to influence that and have visibility of what's going on there," then from my perspective it says: moving down that continuum to an open market foursome situation is going to be hindered.

MR HINTON: Further elaboration or do you want to - - -

MR HEADBERRY: I would like to add to what Mario has just said. There are two major barriers to entry which creates increased competition: one is the economic driver, which both Mario and I talked about. If there is no economic driver no-one is going to invest; no-one is going to put in a parallel pipeline because there's no demand that can be picked up by the existing asset. So there's the capital and return driver which is a significant barrier.

There is also a significant barrier to entry by easements. No government is

going to award a second easement down the highway or on some private land if there is no need to. So effectively, by the grant of an easement you create a monopoly and until that particular pipeline that is being used has got no ability to play games with the new entrant, then there is a major barrier to entry because the government shouldn't allow another easement to be run.

I think we really need to look at two other aspects. There are really two parts of the gas transport industry: one is distribution network which goes down the streets of the various towns and the like, and there is the other part of it which is the transport of gas from the supply points, from the wellhead effectively, to the points of distribution. I think you need to look at these two separately. The Gas Code as written applies to both distribution and transmission gas pipelines. There is never going to be a case for a competition for a distribution network. There can't be - we talk about concept, but conceptually it would be utterly stupid to say, "Right, we're going to dig up the road again, so we can put another pipeline down there so we can have Origin gas and AGL gas, exactly the same gas, running down in two separate pipelines, having one pipeline going to 73 Longview Road, which is my place, and another pipeline - a separate pipeline going to 75 Longview Road." It just doesn't make any sense.

When you look at the distribution network, by and large, as it is, and bearing in mind it's the bulk of the gas - you know, there's a very high penetration of the distribution gas in most major cities in Australia - but there is no basis for ever saying there is going to pipeline on pipeline competition between the two. So let's say that therefore all distribution pipelines must be regulated because there's never going to be any competition, but they are in a position to exercise monopoly power unless someone is watching over them, and allowing us, as the consumers, to recognise that what we pay for is a fair and reasonable amount.

The other part of the gas pipeline industry is the pipeline between the wellhead and the distribution networks, what we call the transmission pipelines. Again, what we've got there is that the pipeline, when it was originally put in - you know, the SEA Gas pipeline from Minerva and Geographe and Thylocene is sized to take most of the gas out of there, over the given period of time that the fields are going to be in place. So is there ever going to be another pipeline between Port Campbell and Adelaide? Probably not, because there's no reason to do so. So is there ever going to be competition for the SEA Gas pipeline itself? No, there's not going to be another easement awarded down the way.

What will happen is we might get a tee-off to - you know, just adjacent to Millicent, so that will go through to Mount Gambier and provide the big gas users in the lower south-east of South Australia - but it will be a tee-off existing pipeline. So when you look at it conceptually that pipeline is never going to have another pipeline

running down next to it to provide those selfsame consumers that are along that pipeline.

Is it going to have competition between that pipeline and the MAPS which goes from Moomba to Adelaide? It's debatable, but there are problems there because we know and we keep on being told by Santos that the gas that's coming out of the whole of the Cooper Basin area is really running down and it might only last for another five years, 10 years, depending on which day you talk to them and to whom they are talking. You know, it will be five years, 10 years - soon - but that pipeline then will be out of operation. So it will be a hole in the ground but it won't be doing anything because there's no gas coming into it.

Is there going to be competition for that pipeline? Is anyone going to build a competition for the MAPS pipeline? Is SEA Gas and MAPS in competition? Possibly, but not really, because the drivers are different at the wellhead end and the way it's used at the other end. I think that we need to take that and let's have a look at that. In fact, the Gas Code as it's written now allows for that "looking at" to happen. It says, "If we think that there's not a good case for it to be a monopoly, let's have a look at it and put it through the NCC." The NCC can go and have a look at it and say, "Yes, well, we think both economically and conceptually it's probably not a good idea to regulate it any further."

A good example of that is the pipeline between the Katnook field and Snuggery. That was a covered pipeline when the Gas Code was written and in 1999 an application was made by Epic, who owned it at the time - they still own it; they haven't sold it yet - that it shouldn't be a covered pipeline and they put a very good case to the NCC and the NCC said, "Yes, you're probably right. We'll take the coverage requirements off and you can operate as an uncovered pipeline."

The implication of why it was put in there was that there was one supply point, one pipeline and one major consumer, therefore the pipeline itself was a monopoly and could charge monopoly rents and that was why it was initially covered by - the South Australian government said it should be a covered pipeline. The NCC, after debating it, decided no, that wasn't really - probably didn't really need to be covered any more. The cost of coverage was pretty high compared to the amount of money that was being recovered from it. Mind you, the people who paid for the pipeline itself think that they are paying monopoly rent.

So I think that rather than saying, "Yes, we're 25 per cent down the continuum, or wherever," you actually have to break down the whole of the system and say, "Right, are we really going to get ever beyond 10 per cent down the continuum, because it really is very difficult to go and put in true competition"?

When you go and look at the overseas - now, Australia is not unique. What we do in Australia is, well, try hard to be a bit innovative. Someone has probably tried it somewhere else and we can learn from them. Despite the fact that we've got a lot of pipelines in Canada, United States and the UK, they have quite extensive and what the pipeliners here in Australia call "intrusive regulation". It's probably for a very good reason. So I think that, yes, in principle you could actually say we're heading off the continuum. I think when you actually break down the way the whole market sits at the moment - the whole of the pipeline industry sits at the moment - and you break it down into its constituent parts, the only part that possibly has some argument along what you've been proposing is the transmission end. Even there I don't think we're very far down that continuum of saying there is a lot of competition because we don't - now, our gas demand is in the south-eastern part of Australia by and large and there are limited gas fields in south-eastern Australia.

MR HINTON: But let me stay with this thematic issue because it does reflect the difference in your submission relative to our draft report - your reactions to our draft report - in that the Gas Access Regime as I think you, David, pick up already, has judgments involving coverage, judgments about revocation - that is, a system whereby a regulator makes a judgment as to whether intervention should occur; whether regulations should apply. That already then prima facie suggests that different infrastructure across the sector has different characteristics. In certain circumstances regulation is warranted and in other circumstances it's not.

The structure in the draft report applies that same concept, a structure whereby an approach - a construct of regulation which says it might apply in certain circumstances and not apply in other circumstances. More importantly the nature of the intervention will vary, when intervention is warranted, in different circumstances as well, where the benefits are greater than the costs. We're not proposing scrapping the cost-based price regulation structure of the current Gas Access Regime. That would still apply in certain circumstances. There would also apply a monitoring regime. There would also apply non-coverage for another set of infrastructure, just as the case is today. We are therefore rather puzzled by the consumers' reaction to our proposals, as if we were scrapping the Gas Access Regime. On the contrary, the Gas Access Regime in concept continues. We have elaborated further the nature of intervention in certain circumstances.

MR HEADBERRY: I think, reading it from a consumer's viewpoint, that it works well now. Why do we have to change it? You know, "If it ain't broke, don't fix it" is a very good start. It allows the flexibility that you're talking about but, in our view, you've gone too far - way, way too far. In fact why can't we accept the principle that if we have one service provider providing a unique service, but ipso facto that is a monopoly, then we can look at it to see whether it isn't. In fact what you're proposing - or what the draft report proposes - is that we move away from that and

that we accept ipso facto there is competition. But if it looks a bit suss let's go the other way.

MR HINTON: But on the contrary, David - - -

MR HEADBERRY: That's the way consumers are reading it.

MR HINTON: On the contrary, while some have put to us that there should be right from day one with the revised system a generic statement that all distribution networks should be in monitoring and not cost-price price regulation, even some transmission service providers argue they should be put in the monitoring tier as well. Our draft report proposal is one of case-by-case assessment as to which particular form of regulation should apply or whether or not it should be not be covered at all - that is, it would still be a case-by-case assessment; not to put you in the monitoring bucket to start with. You would be subject to an evaluation as to whether or not intervention is warranted. It is not throwing out through the window or whatever the current Gas Access Regime.

MR HEADBERRY: No, I concede that the current access regime is still there. Sorry, it's a regime that's there. There is a gas access regime, but it is not the regime that gives the balance of the interests between the supply side and the demand side. That's what we're seeing. What we fought for in the current Gas Code as it's written was a balance of views and that there was sufficient information that had to be provided by the service provider so that we could ensure that this was a fair and reasonable price for providing that service. What we're looking it is a moving away from that.

The other big assumption was that if it looks like a duck and walks like a duck and quacks like a duck as a monopoly, then it probably is a monopoly and we then have to go and prove that it's not a duck rather than say, "Well, yes, we think that it might be a duck but it might be a goose and we're not quite sure and we're going to have different ways of addressing it." Let's stick with it and let's have certainty that it will be regulated. Now, we talk about regulatory risk. Why don't we say, "Hey, you're regulated unless you can prove to us you shouldn't be regulated." That gives certainty to the distribution networks and to all of the transmission pipeliners.

That gives certainty about the whole issue and that's what the Gas Code as written did to provide certainty, "Yes, you are covered. Now, if you're wanting to become uncovered go and talk to the NCC and put a case for them so you can be uncovered." The NCC then does both a qualitative and a quantitative analysis of what should happen.

MR HINTON: Some have portrayed the implementation of the Gas Access

Regime that way; that everything was covered to start with and then a process of case by case. Individual infrastructure then continued to be covered or revocation occurred. But we've moved on from that now. We've now got a Gas Access Regime where some are covered and some aren't. So to now say that every new proposal should be covered and subject to intervention, as opposed to making judgments about whether they should be covered, seems to me to be a wrong way to start it. Should that new proposal be subject to coverage?

MR HEADBERRY: If it looks like a duck, let's assume that it is a duck.

MR HINTON: But doesn't that judgment have to be made as opposed to presuming natural monopoly has market power? Why would you want to intervene in principle, as a matter of course?

MR ADAMS: I think, Tony, it's a very valid question. My reaction would be what is the process of making that evaluation?

MR HINTON: Yes.

MR ADAMS: If that process doesn't give me comfort then - fundamentally I think if I looked at the whole thing and stood back from all the detail I'd say, "As a consumer how do I know what I don't know if I don't have an opportunity to know what I don't know?" and hence what is the mechanism for saying, "Here is a proposal. Here is potentially a pricing mechanism" or "Here is a situation where you will now access your gas through this particular situation and this is the set-up." Well, what I'd like to be able to say is, "Yes, okay. Let's have a look at it. Is this competitive?" How do I then say I'm comfortable that it is?

Ultimately regulation for the sake of regulation is not what we're about because that obviously bears cost. I don't think we disagree on that so the issue is more around, picking up on your point, if the position is that there is a new situation and how do we make that assessment, what we're really arguing for is to make sure that we've got a balanced view and a mechanism which we're all happy with that says, "Let's make that assessment."

MR HINTON: Yes, so you need criteria by which judgments can be made as to whether or not intervention should occur?

MR ADAMS: Yes, and there's got to be some way of saying from time to time during that arrangement that if you make a judgment at a point in time you need to go back because the continuum will move, the market will move, the industry players will move, as they've done in the last few years, and be able to say, "What is the correct period for a review of that? How do you go about that?" and "What does a

user have?" - and users are only one player in this game, but if you talked about all the stakeholders, how do all the stakeholders feel comfortable that they're not unduly (1) excluded or (2) have too much power in that discussion?

MR HINTON: These are difficult judgments by the regulator, and therefore the clearer the criteria can be established which bring reduced regulatory uncertainty, the better. So that's partly behind what is driving the draft report as well; trying to bring clarity to the criteria when judgments are called for, which takes me to, I think, David's example of the distribution network. There is a set of pipelines down streets, delivering gas to households, and it would be ridiculous to duplicate that network of underground pipelines; a natural monopoly position - regulate. But the distributors would argue very strongly that they're competing with a source of energy that is obligatory; well, virtually there.

Gas is an energy source of choice. Electricity competes with that gas delivered to your household. Whether you heat your water with electricity or gas is your decision and so doesn't the pricing capacity of gas delivery to your house run up against - or the market power inherent in that natural monopoly is eroded dramatically by the fact that electricity there heats your water or heats your house or cooks your breakfast?

MR HEADBERRY: That's an argument that's been put on a regular basis in all of the debates that I've had with gas providers. The best way to go back and address that is to actually look at the numbers. Again one of the concerns I've got about the report is that there is no quantification. There is an assessment made that there is competition, but in fact when you look at the numbers the cost of electricity per gigajoule delivered to a household, or whether it's delivered to a factory or wherever - depending on the amount of distribution and transmission costs that is attributed to it - is about $30 a gigajoule. You pay for electricity at, what, 12 cents a kilowatt hour. Bring that into gigajoule terms. Electricity costs you $40 a gigajoule. I get that same gigajoule of gas delivered to my home for 10.

Now, my gas heater is not as efficient as an electric heater but it's not that inefficient, and so to say that I'm contemplating converting my gas hot water service to an electric hot water service is absurd for two reasons: the first one is that the cost of using electricity to heat your water is between two and three times the cost of gas to heat that water. The second thing is that I then have to go and chuck out my old gas heater and put in a new electric heater, which is a significant capital cost. From my own viewpoint I've got to spend something like 8 or 9 hundred dollars to go and put in a new electric heater.

MR HINTON: But they're arguing the other way around. The electricity is there already in your street.

MR HEADBERRY: So is gas.

MR HINTON: No, well, not in capital cities throughout Australia - in Sydney.

MR HEADBERRY: If I have electricity and someone said, "We're going to put gas on," you start looking for gas for space heating particularly. Gas for space heating is much more efficient than electric heating, and if gas is reticulated then you will go for gas over electricity purely on economic bases and that is what happens. As soon as gas is available people do convert across from electric to gas space heating. You have got to have a place that's cold enough to want heating in the first place though. So you don't do that in Brisbane very often.

MR HINTON: Good point.

MR ADAMO: But I think, Tony, the issue really is there are certain segments of cost of gas getting to the user, and we are talking about households but I think if we talk about industry for a moment there are grave concerns about the fact that we don't have visibility of a very large expense to our business or components of that visibility. So there's competitiveness in certain parts and we can see that that's just a natural outcome of the market forces around that part of the industry - fine, no problem. If there is a mechanism for us agreeing that that's the issue, then fine, we all accept that judgment and we move on.

Where we have a concern, I think the bigger concern is that the pipeline or the trunk, if you like, or whatever you want to call it, which is the very large amount of investment by the pipeline owner, number (1); number (2) is that very large investment has to be borne by somebody sooner or later and it's ultimately industries and other consumers, and not to be able to have a mechanism where we feel comfortable that the assessment of whether that is market competitive, whether there are market forces there, whether there is an ongoing ability to review that and say, "By the way, there is absolutely no competition here," and if we look at the return of this based on acceptable investment returns, then if we don't have that mechanism in place and quantify that - because we can all get passionate and look over the fence and say that person makes more money than this, et cetera, then I think we lose the objective quantitative assessment of this.

I think we also need - and that is one of our points, I think, that we would like to say, you know what, at the end of the day if this thing is truly market competitive let's look at the quantitative assessment of that, number (1), and let's all have, as stakeholders, an input into that assessment and the validity of that assessment. The New South Wales gas open access agreement went through huge amounts of debate around the AGL - not only the cost per gigajoule but also what was the value of the

asset, and you can debate that.

At the end of the day enough intelligent people in the room can eventually agree that, okay, we accept a position, and I think we need to be able to say, yes, we have an input into that - example, for instance, of what is that pipeline worth, if it's historical, what's fair as a return on such an investment which would establish that, what is the market payer of that particular investment, what's the acceptable return and, by the way, if there are costs incurred above the normal risks that are still associated with that investment that are beyond other market investments, fine, let's compensate for that.

So there are things in there which say to us, we are sitting here very uncomfortable about what we see from our interpretation of the report, I've got to say, for some of the things you have said; maybe clarifying the report, but I think at the end of the day where we come from is to say we need to have the ability to influence and also have a say on an ongoing basis.

DR FOLIE: In both of your presentations you actually gave, if you like, a broad brush example of something I would actually like to explore because it's actually quite interesting.

MR HEADBERRY: Sorry, before I say that, Michael, Mario has to catch a plane at 1 o'clock.

DR FOLIE: That's all right.

MR HINTON: What time would you like to leave, Mario?

MR ADAMO: In the next 10 minutes would be good.

MR HINTON: Okay. You can walk out without answering my question.

DR FOLIE: I'll get on with it anyway. Basically we had the Moomba explosion and then a shortfall in the eastern state gas supply and you said as a result of that you had very strong price rises following it. What I would like to do is get some more insight into the source and as consumers you actually sit at the end of the chain, which you have made, so you get more from you than you do from anybody in between the chain because they only see one part. Could you actually indicate the sources of where those price rises came from because some will be from the alternative gas suppliers or maintaining gas from the crippled supply system. One will be through the pipeline, and the other one through the pipeline system or then having to reroute gas? I'm just trying to understand the nature of - the price went up.

MR ADAMO: I certainly know a fair bit about the situation obviously because we hung onto our - sort of perched on the edge of the building, as it happened. I think what we experienced was a number of different factors in there, including our political influence at the time - and I'm now talking about a particular consumer.

DR FOLIE: Yes.

MR ADAMO: And that's from a holder's perspective, and we applied a significant amount of political pressure, as you do, and subsequently we got certain outcomes. I think there are a number of factors in what happened there, but quite clearly there was an issue around - here was a source that suddenly wasn't there for a period of time, and the nature of the alternatives was very limited. In fact if you talk about true market competitiveness, if you look at that situation, we sat down in the very first two or three hours after this occurred, once we knew, and tried to actually say, "Well, what are we going to do here?"

We looked at a number of alternatives of how can we bring gas into our operation, for instance, and unfortunately when you look at it, there are many barriers to you doing that in that situation, and I suppose the only thing that saved us was our ability to influence the outcome politically. So there were two factors that occurred there. We certainly paid some price premiums. There was no two ways about that. We could show you some historical data and rather than talk anecdotally we could send you some evidence of that and what have you, and no doubt you would know already.

But I think if we didn't have the political influence - and there were parties that weren't as fortunate as we were, I've got to say, and the steel producers certainly suffered significantly through that crisis both from a price perspective but also just a pure supply perspective. There was a decision made by a regulatory body at the time as to how that was going to be allocated and it was fine and we accepted the judge's decision, if you like, or the referee's decision. So it's a complex issue but quite clearly there was a lot of opportunity for the people that are in the industry to exert their power without us being able to do anything about it.

DR FOLIE: Can you elaborate a bit further because what you say is a background. Of course when you have a massive contraction then there are going to be people - there's a ration and there ain't going to be any gas around, but you need to actually then get some gas flowing and gas did start to flow. So to what extent were the price rises due to actually increase costs of actually having to then get some gas flowing into the system? For instance, Santos, I think I read somewhere, had to bring in special purifying high cost catalysts to purify the gas stream as a substitute for a normal process, which they get a bit through. So if you've got to air freight that in from the Middle East or wherever you might be getting it from, that's going to be a

huge cost, but you will only do that if you are then likely to be able to actually pass it on. You may have to source gas from different fields. You know, you have to ramp up somebody else's gas supplies - can't quite cope with the extra lift so they may actually have to spend more money running things harder to get things out. So I'm just - - -

MR ADAMO: I think Santos spent a lot of money. I would say Santos spent a lot of money they didn't - - -

DR FOLIE: I think this is the important point, where are the sources coming from? Are the pipeliners then - if they have got virtually nothing going through the pipeline, wouldn't they rather turn the pipeline off, which they can't do, or then just cover their costs of putting through a tenth of their throughput? Is it monopoly power? Is it actually people then just recovering costs in rationing to provide a lower throughput? I don't know.

MR HEADBERRY: Actually we have concentrated on the pipeline's Moomba costs - or Santos cost in pipelines from Moomba. In fact the pipelines that benefited were the EGP and SEA Gas pipelines.

DR FOLIE: Yes, I realise that. Did they have to put more through their system, so they could do it - - -

MR HEADBERRY: No, the gas that was supposedly coming from Moomba - because Origin, IP and TXU were using the SEA Gas pipeline, but they're the foundation shippers on the SEA Gas pipeline, anyway, but they were then on-selling that gas at a premium that they were getting from the Victorian supply system into the South Australian market. The same thing was happening in New South Wales. There was gas out of Longford going up the EGP, which is prior to the Moomba kerfuffle. It was running at about 50 per cent capacity and so it had spare capacity to go ahead.

If you look at it on a marginal basis, you should have been able to say, "Oh, no, for the good of the country we'll just put the extra gas through," because there was gas available out at Longford. Longford is rated at about 1000 terajoules a day and the normal demand that comes out of Longford - out of the Victorian system - is about 400 terajoules a day during that period. There was a lot of gas available out at Longford. There was a lot of capacity on the SEA Gas and on the EGP pipelines and that's where we actually saw that there was a monopoly pricing on those pipelines.

MR HINTON: I'm worried about Mario's plane.

DR FOLIE: I was just trying to get the point. How much was transported? How

was then, if you like, the upstream supply - - -

MR HEADBERRY: If you don't have the requirement to break down the cost - - -

DR FOLIE: Yes.

MR HEADBERRY: For instance, SEA Gas is an uncovered pipeline, so there's no requirement on the SEA Gas owners to actually divulge what the costs are or - they don't have to give an access regime other than what might come under Part IIIA, so who knows what they did.

DR FOLIE: Right.

MR HEADBERRY: They don't have to tell us. What Mario is saying is that unless we can actually see what they're asking for, we're reverting back to the old system where the state governments used to control the whole of the supply chain from what we pay the producers right through to what you get out of the meter at your facility, wherever that is, and that's the number you're going to pay. We don't give a bugger whether you care how it's made up or not. We will decide. That is what is happening at the moment. The breakup of the industry allowed us to see the actual cost elements in the supply chain. If you don't have that, then suddenly you're at the risk and this is Darren's problem at Kimberly Clark. One gas field, one supplier, one pipeline and the owner of the gas field owns all the capacity on the pipeline and they give - this is the price.

MR HINTON: I've got another six questions, but let Mario catch his plane.

MR ADAMO: Thanks for the opportunity of hearing our submission here today. I look forward to further discussions.

MR HINTON: So you two gentlemen are going to stay?

MR HEADBERRY: Yes.

MR HINTON: We've got a few more minutes then. Thank you, Mario, for your participation. Six was an exaggeration. I was really making Mario feel twitchy, I think.

Let me change the tack slightly and at the risk of asking David to once again take out his fag packet, without lighting up, raise the point or express the view that I'm a bit uncomfortable with the formulation that on his calculation this reduction in the price of gas generates those millions of dollars of benefits which are clearly much larger than the cost of compliance or admin costs; which seems to have a mindset

that - let's continue that formulation to a much lower price indeed again. That would even generate more benefits.

MR HEADBERRY: I'm quite in favour of that, from a consumer's viewpoint.

MR HINTON: Well, that's the point. That's exactly the point.

MR HEADBERRY: I will qualify it. As consumers, whether it's an industrial consumer or a domestic consumer, we have an interest in making sure that the facility will be there in the medium to long term, because - - -

MR HINTON: Not only that facility; even future facilities. That's the judgment I thought that we need to be very careful about with regard to the benefits of regulation, if the regulation benefits are seen simply as lower prices, in that the price still has to have some substantive basis to be "the right" price, however measured. Maybe it's efficient pricing; longer-term funding needs of investors. That's the issue that underpins my concern about fag-packet calculations that show lower prices mean benefits, ipso facto end of story. That is not the end of the story.

MR HEADBERRY: Yes, but if you go back to the calculation I quoted, that the Moomba-Sydney gas pipeline was charging I think 65 cents - I'm going off the top of my head, so it's somewhere around about 65 cents a gigajoule for transport from Moomba to Sydney. The ACCC came in on the original assessment of saying it should be something like 45 to 50 cents. The ACCC is implying - not me, the ACCC is implying that on their independent analysis, there is a monopoly rent there. I said, "Well, if there is a 10-cent differential" - and the same thing happened in Western Australia. The West Australian regulator looked at the Dampier-Bunbury pipeline, what service it provided for what value, and came up with a much lesser number than did Epic, who were the owners of the pipeline - for whatever reason. Let's not debate that.

We're just saying what is the value of the service? I just took a number and said, "At least 10 cents has been identified by the regulators on those two pipelines as being an overstatement of what the true value of that is." Therefore, that gives you the $100 million - somewhere near $100 million. I then looked at the basis on which the regulators had made that decision and then I looked at the returns that they had awarded to the pipeline owner, and those rewards - the WACC is much higher than the WACC or return on assets that you would get in Australian competitive industry. So therefore the regulator had already made some concession, whether it was right or wrong, in their analysis for saying that there does need to be a longevity element of the decision that they're making.

MR HINTON: That's where we seem to have this difficulty of discussing the draft

report, in that our draft report has that sort of outcome in concept - continued to be a result of intervention, continued to be a result of the Gas Access Regime in those cases where those costs will be judged to be less than the benefits; that is, based upon market power, a threshold test of when coverage leads to price based cost regulation. We also go on to say that that should only occur in those circumstances where it's likely that the benefits will be greater than the costs. We're not saying it shouldn't happen; we're saying it only should happen where the benefits would be greater than the costs.

We would like a Gas Access Regime that has scope to not apply regulation inappropriately, hence this threshold test for monitoring without cost based price regulation. We are not rejecting your cases where intervention is warranted. We're trying to bring precision to the criteria that identifies those cases where intervention is warranted. That's why I think we keep talking a little at cross-purposes here as to what is really in the draft report.

MR HEADBERRY: But the onus of proof is being changed.

MR HINTON: No, it's case-by-case assessment by the coverage regulator.

MR HEADBERRY: But the onus of proof is changed from what it is at the moment. The onus of proof is that the pipeline owner has to prove that he is not a monopoly. As I said, if it looks like a duck and quacks like a duck, it probably is a duck, and it's up to the duck owner to prove that the duck is a goose, and that's the principle behind the Trade Practices Act as well. That gives us a degree of certainty that we have the information to be able to debate the issue.

MR HINTON: How is the onus of proof changed?

MR HEADBERRY: The thing is that if you assume that the pipeline shouldn't be covered - - -

MR HINTON: We haven't.

MR HEADBERRY: It's got to be one or the other.

MR HINTON: If it's existing pipeline, the starting point is its coverage decision. That is if it's covered or not covered. Then there is scope to shift it from the cost based price form of regulation to the monitoring tier on a case-by-case assessment. I'm not saying automatically shift it to monitoring. There would still be a coverage decision by the NCC against the criteria for monitoring as opposed to cost based price regulation. There is no shift of onus of proof. It is a case-by-case assessment with interested parties seeking revocation.

MR HEADBERRY: But we don't have the information.

MR HINTON: This is for existing infrastructure. For new infrastructure, once again, the onus is still unchanged. There is scope for another idea of a regulatory-free period for binding rulings for 15 years for certain greenfield proposals that pass certain criteria but, once again, it's an ex ante judgment in our draft report on that. We haven't touched on greenfields much because we're talking about existing - but we're running out of time too.

MR HEADBERRY: We keep on coming back to the issue that we believe that one pipeline doing one service is a monopoly and, therefore, it should be covered. We then have to go through the extensive process of going through the other route, and that was what the whole principle behind the Gas Code was: if it looks like a monopoly and acts like a monopoly, it probably is.

MR HINTON: But we've moved on. We've now got decisions and revocations - - -

MR HEADBERRY: But even a new pipeline can do the same thing because, as the community, we have granted that new pipeline monopoly rights by having an easement.

DR FOLIE: In fact you've led into my question. A fair amount within your submission, if you like, is about the nature of the easement. There's actually a particular exclusive property right given by government and you're quite concerned about this. There are licensing principles in annexe F, the 1997 Intergovernmental Natural Gas Pipelines Access Agreement, that really say that giving easements and licensing must not be used by government as a way to actually sort of prop up power. In other words, if you so want to build another pipeline, you wouldn't be able to get that right to be able to build up. In other words, you would have to pass the normal environment areas. I don't really see that it's such a substantial sort of - the land access is not a major source of monopoly rent.

MR HEADBERRY: It is to the farmer or to the landowner. It's quite a significant issue to actually annex the usage of that land. So it is an issue. I know that if someone wants to run an easement - because someone is about to run a pipeline, a water pipeline, through my property and I'm not all that thrilled with where they want to run it, but it suits them to run it where it's inconvenient to me, I get quite upset, as a landowner, that my rights are being suborned "to the greater good". If that's the case, I don't want the person or the organisation that's been given the right to use my land against my wishes to the detriment of the community as a whole - and, therefore, the only way we can actually ensure that that detriment to the

community as a whole is not being created is by regulation or examining in detail the issues. This is where we keep on coming back up against the problem.

DR FOLIE: This right is one that of course transcends beyond gas pipelines. It's roads, it's other things, and probably gas pipelines are one of the less intrusive forms of easements.

MR HEADBERRY: It doesn't matter, it's still an intrusion. As I said, the property I've got - if someone wants to run a pipeline down my property because of the unique circumstances of that property, it's very inconvenient to what I might want to use my property for at a later time, even though it's underground and it only chops down a few trees.

DR FOLIE: Your point is noted, but it is an overall part, and I think that the important thing is that effectively there have been provisions, and what you're saying is that you don't like those provisions. In other words, it's a requirement not to be able to use - the governments themselves may not, if you like, dream up an answer not to give right to a pipeline because of easement issues. But your objection is one philosophically overriding - the government should be careful about giving easements over anything.

MR HEADBERRY: No. I'm prepared to concede that there is a wider community benefit but I don't want the owner of that asset, that new pipeline that's going in there, to use that right that's been granted them to the detriment of the community, and that's really the whole thrust of the proposal of what we've put in our written submission.

MR HINTON: But given the continuum we discussed right from the first question, the owner of that right, that facility, still might not have significant market power because of other factors. Therefore, to prima facie say, "Therefore, I want regulation intervention because you've given the easement," seems to me to be prejudging the outcome, as opposed to established criteria by which a judgment can be made whether intervention is warranted.

MR HEADBERRY: No, the Gas Code itself provides for the owner to come back and say, "Look, it doesn't make any sense to have that close control over how I use that right that I've got." What I'm saying is that the onus of proof has got to be - they have to prove that it's to the benefit of the community as a whole not to be regulated, whereas I'm saying - sorry, the draft report says, "Let's not make that assumption to start off with."

MR HINTON: Let's judge it.

MR HEADBERRY: I'm saying that it's got to be for the benefit of the community and they have to prove that it's not in the interest of the community to remain in your covered pipeline - - -

MR HINTON: Yes, we've got a philosophical issue there. Can I shift the focus slightly - in fact significantly. Our terms of reference covers a lot of things, as you know, but one of the items in it talks about regional development considerations. I think it was you, David, rather than Mario who referred to this idea, this point about regional interests. Have you got a particular perspective on this in terms of the workings of the Gas Code, the Gas Access Regime?

MR HEADBERRY: The Gas Access Regime doesn't say you can't augment the system. In fact, it says quite clearly that you can augment the system, and in fact even gives monopoly rights to the existing asset owner to say yes, you can augment within certain areas because it doesn't make sense to do anything different. The point that we're making is that it's not so much that the augmentation shouldn't happen; it's the driver - now, why would a distribution company say, "I want to include part of the Bellerine Peninsula?" I think it's TXU owns that part of the network - you know, we want to augment into the Bellerine Peninsula but at the moment there aren't enough gas users in that area to warrant growing the pipeline, because we're going to spend $15 million but we're only going to get a return on $5 million. How do we actually make it worthwhile for us? The government has said, "We think it's a good idea that the Bellerine Peninsula gets that money. We're prepared to put in the other $10 million. You'll get a return on your $5 million investment from that. We'll be making a grant."

What used to happen under the Gas and Fuel, when it was a vertically integrated enterprise, is the Gas and Fuel said, "We're going to take it down to the Bellerine Peninsula and, even though it's uneconomic, it's in the community good, and we're going to make the community as a whole pay for it."

MR HINTON: Other consumers.

MR HEADBERRY: Other consumers.

MR HINTON: As opposed to the other examples where the taxpayer pays.

MR HEADBERRY: Yes. I don't have a problem either way, but at the moment TXU says, quite rightly, "It's not economic to go and pick up those customers because we're not going to get a return - the amount of money we're going to put in there is not worthwhile." So it then becomes a community service obligation. Now, how do you fund a community service obligation? The rules are quite clear. If the regulator says you can recover that CSO within the tariff, then that's okay. But if the

regulator says you can't, probably you shouldn't because it's a community service obligation, not the gas consumers' obligation. Therefore, it's quite appropriately being picked up by the government as a taxation measure, which is what all other community service obligations - where it's involved with private enterprise it comes out of the government purse, because the government is getting the benefit. The voters benefit by whoever is providing the CSO.

MR HINTON: Thank you for that perspective. Michael, how are you going?

DR FOLIE: I'm fine, thank you.

MR HINTON: Is there anything, David and Darren, that we've not focused on and you think we should do justice to in the remaining time?

MR HEADBERRY: I've got a couple of questions. The report itself is full of assertions and qualitative commentary and the like, but it's very light on quantitative analysis, like the very brief analysis I did.

MR HINTON: Like the fag packet analysis, yes.

MR HEADBERRY: In your final report are you going to put quantitative analysis in to support the conclusions you reach in your final report, as distinct from those that you've got at the moment, because at the moment the quantitative analysis that we've done indicates that you've probably come to the wrong conclusion.

MR HINTON: We'll be seeking to flesh out the draft report into the final report. There will not be any special econometric general equilibrium model run that will seek to do economy-wide benefits, but we'll be seeking to articulate or substantiate our views in the final report relative to the draft report.

MR HEADBERRY: So from that I gather that you are not intending to look at the wider national benefit of the recommendation that you're making, on a quantitative basis.

MR HINTON: We consider we have done that, not on a quantitative basis, but an analytical basis, and reached conclusions. We will also be responding to the attachment to the ACCC's submission from the ACIL Tasman modelling that was done for the Parer review that is now being put back to us, as well, as relevant. We'll be making some comment on the assumptions inherent or underpinning those sets of conclusions.

MR HEADBERRY: One of the points we actually made - we talked about the implications of regulation overseas. The US, the UK and Canada have significant

investment. Are you looking to include into your final report the - - -

MR HINTON: Yes, we would like to do more on that. We did a little bit in the draft report. We'd like to do more. However, we would caution against conclusions drawn on other countries' experiences in circumstances of a very different history, very different regulatory structure, as not necessarily leading to robust conclusions for review of the Gas Access Regime here in Australia.

MR HEADBERRY: Just coming up to the last one, my fag packet calculation, you state that the regulatory costs are seen as being too high. Are you going to pick up and look at more the actual compilation of those costs to substantiate the statement or not?

MR HINTON: We think the costs of regulation - there are at least two components there: one is the sort of administrative costs, which is a small part of the overall cost of regulation, and we think we can get more precise information on that, but we don't think that would be working on the right side of the decimal place. The big costs of regulation are in circumstances where regulation is inappropriately applied and therefore has a direct effect, inappropriate effect on commercial activity. That's the impact of regulation we're more concerned about. It doesn't stop us wanting to have - in fact, we still would like to have refinements to the processes in the Gas Access Regime to make it an efficient administration, or more efficient. We've got a number of recommendations in that regard as well.

MR HEADBERRY: When you say the indirect costs, if those indirect costs are being picked up and paid by consumers, and consumers view that it's working well?

MR HINTON: No, the community as a whole - downstream, upstream - more generally - impact of inappropriate regulation.

MR HEADBERRY: So you'll be putting some quantification of what those are or - - -

MR HINTON: No, we might do some more on the direct costs of administration, but we're not going to be modelling the impact of adverse effect on investment, et cetera, with regard to economic activity upstream and downstream, from inappropriate regulation. We think that's an heroic exercise, excessively ambitious.

MR HEADBERRY: But at the same time you're saying in your report that investment is being stultified because of regulation, and yet the investment that we're having, the big chunk of investment - by saying that, you're saying it impacts on the pipeline investment, but in fact the investment that we've seen both upstream and downstream of that pipeline has been enhanced because of the controls that have

been put in place to ensure there hasn't been rent taking. That surely has to be an element of the analysis.

MR HINTON: We agree that its implications for upstream and downstream are an important part of the analysis of the Gas Access Regime. What we baulk at is a view that lower gas prices, by definition, mean that that is a good outcome.

MR HEADBERRY: No, we're talking about the potential of your recommendations to increase gas prices because we're removing the controls.

MR HINTON: To the extent that higher gas prices are warranted, then that would not be seen as a negative.

MR HEADBERRY: No, the thing is if the controls are removed then you can't - they're not warranted necessarily, it's because someone is able to rent take.

MR HINTON: No, in circumstances of where intervention occurs inappropriately and therefore the price that's proposed by the regulator is too low, we would say that is a cost, not a benefit.

MR HEADBERRY: If the cost of intervention is high and the reward is low, I agree with you - that's why quantification ends up with the - - -

MR HINTON: I'm trying to challenge the sort of presumption that if higher prices of gas flow from our recommendations, that is not necessarily a cost for economic activity - if the prices that would have been charged that were low, were inappropriately low, is the point. Regulators don't always get it right.

MR HEADBERRY: But then you need to examine, in that case, whether the regulators are being overly cautious or overly friendly in one or other direction. The quantitative analysis indicates that they are being friendly to the regulated industries, rather than the reverse.

MR HINTON: The jury is still out on that. If you were in Sydney for the appearance there at the public hearings of some other parties, they in fact were directly challenging the ACCC's examination of that issue, as to how generous they were actually not being with regard to WACC calculations, or WACC assumptions, WACC parameters relative to overseas regulators in particular. So I think that a spurious precision is a risk for all of us and those that seek to have quantification usually fall into that trap. Magic numbers do not exist. It doesn't stop the pursuit of analysis with robust process and rigorous analysis, but it's certainly important that you also don't give precision to a number simply because there's a number on the back of the fag packet.

MR HEADBERRY: The work that we actually provided to you was not done on the back of a fag packet. It was done as analysis over 10 years of analysis of 300 or 400 companies and the returns that they were getting on their assets to find out whether the parameters that the ACCC and other regulators have been using are inappropriate. Whether it's high or low is - we actually calculated and worked out that they were inappropriately high, but in fact that was not just done on the back of a fag packet; it was a sincere and longitudinal study into returns that have been earned by Australian businesses in Australia.

MR HINTON: There is no question that the submission with its attachments is a very substantive document with a lot of substantive input and we appreciate that. Others are also doing extensive attachments to submissions as well, that we're still absorbing in full, but all I was commenting on was not in any way casting aspersions on the particular product that you've provided, but rather to say that there is a risk here that conclusions can be reached as if that is the only view around. There are a number of views and analyses and works out there that touch on this issue of comparing the performance of different regulators across countries and across sectors with regard to the return on investment.

MR HEADBERRY: I've run out of questions for the time.

MR HINTON: That brings me to record our appreciation again for your coalitions' input today to the inquiry - in fact, the Energy Market Reform forum more widely. It's appreciated and certainly it's valuable input for us. I know that certainly appearing today before us is not costless as well, so thank you for that. It's been a robust exchange and that's helpful; we like that. Once again, thank you.

That does conclude today's scheduled proceedings. As foreshadowed, and in accordance with the Commission's established procedures, I now offer an opportunity for anyone else present to make a statement if they so wish, the requirement being that you come to a microphone and identify yourself for the purposes of the transcript. No-one is offering?

MR MIGNONE: Statements or additional comments?

MR HINTON: It's open for anyone to speak who is present. Ralph, you're most welcome to. It's an open transparent forum that we encourage. Ralph, for the purposes of the transcript, if you identify yourself - welcome back, I say, because we know who you are. Thank you.

MR MIGNONE: Ralph Mignone from Envestra. I just want to clarify two points, and one which was touched upon earlier in regard to the Moomba incident. Just to

make it clear that from my understanding of the situation there was an increase in the price of gas and what we need to do is differentiate the price of gas against the regulator - one regulator service of gas transportation. My understanding is that the price of gas was increased because the product that was being sourced for that incident was LNG injection gas which was of a higher cost, so I just wanted to clarify that and make that clear.

Another point was in relation to consumers actually ending up paying for the administrative cost of regulation, and there was very little complaint by consumers of that cost. I think everyone is aware of the story of the frog - if you put a frog in a pan of water and increase the temperature gradually, you'll finally kill the frog. Consumers, I would say by and large, aren't aware of the cost of regulation as part of the cost for gas they pay overall. However, a good example of where it is transparent is in the recent introduction of full retail contestability, whereby in South Australia the cost of power did go up by about 20 per cent or 30 per cent, purely as a result of the mandate or regulated introduction of FRC.

In that case there was quite a bit of feedback from customers and you may have noted in the press recently in SA, the introduction of FRC for gas similarly would have increased gas prices quite significantly and in order to, you could say, stop the frog from jumping out of the pan the SA government has volunteered to inject about $60 million into the industry to prevent that price of gas rising due to that sudden impact of regulation, you might say. That's all I had to add, thank you.

MR HINTON: Thank you very much for those remarks and it will be on the transcript accordingly. Thank you all again for your participation and your attendance today. Excuse me - David?

MR HEADBERRY: I just thought that was interesting, particularly about the gas price and electricity price to consumers. Sorry, David Headberry again.

MR HINTON: Thank you.

MR HEADBERRY: We need to really look at the causes of those increases rather than assume that it was purely related to regulated industries. We're talking about the regulation of the energy transport, gas transport in this instance. In the case of electricity and why South Australian electricity prices have gone up from a consumers' viewpoint is not related so much to the regulated cost of transport on the network systems - although they are contributors - but a lot of that has got to do with how risk is managed and how that has been allowed for by the regulator in the price cap for domestic users.

The implication of the comment that was made from Envestra was that we've

got to be careful about regulation. I happen to agree that the regulator got it wrong on electricity in South Australia for domestic consumers, but the big area of price hike that occurred was directly related to the allowances made for risk management processes that are needed by a retailer, which his all part of the competitive element of the build-up of both gas and electricity supplies.

MR HINTON: Thank you, David. Does anyone else wish to take the floor? As no-one is coming forward, I therefore adjourn these proceedings. The next hearings are in Perth tomorrow, Thursday, 1 April. Thank you very much.

AT 12.53 PM THE INQUIRY WAS ADJOURNED UNTIL
THURSDAY, 1 APRIL 2004