INDEX

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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT BRISBANE ON TUESDAY, 16 SEPTEMBER 2003, AT 9.10 AM

Continued from 12/9/03 in Melbourne

MR HINTON: Good morning, everybody. Welcome to these public hearings here in Brisbane for the Productivity Commission's 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 Michael Folie.

The inquiry terms of reference were received from the Commonwealth Treasurer in June 2003 and covers, in brief terms, the following six matters: first, the benefits, costs and effects of the Gas Access Regime, including its effect on investment; secondly, improvements to the Gas Access Regime, its objectives and its application to ensure uniform third party arrangements are applied on a consistent national basis; thirdly, how the Gas Access Regime might better facilitate a competitive market for energy services; fourthly, the appropriate consistency between the Gas Code, the National Access Regime and other access regimes; fifthly, the institutional and decision-making arrangements under the Gas Access Regime, and the last point that I flag is the appropriateness of including in the Gas Code minimum requirements - that is, price and non-price requirements - for access to users.

We have already talked to a range of organisations, companies and individuals with an interest in these issues, and submissions have been coming into the inquiry following the release of an issues paper in July. The Commission is grateful to the various organisations, companies and individuals in Queensland who have already participated in this inquiry. The purpose of these hearings is to provide an opportunity for interested parties to discuss their submissions and their views on the public record. Participants are welcome to comment also on the issues raised in other submissions. Hearings have already been held in Perth, Adelaide and Melbourne. Further hearings will be held in Sydney on Thursday and Friday of this week.

We will then be working towards completing a draft report for release in mid-December, and we will invite participation at another round of public hearings to discuss that draft report in February and March of next year. The Commission likes to conduct all hearings in a reasonably informed manner but I 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 for 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 staff here today. As all of you who are familiar with Productivity Commission inquiries - submissions to each inquiry are also available on our web site. To comply with requirements in the Commonwealth occupational health and safety legislation, I draw to the attention of those present the exits for this room. They're out to both the left and right through the door at the back of the room. The evacuation procedures, if they are needed, use a beep-beep, whoop-whoop system that I'm sure most of you are familiar with.

I'd now like to welcome our first attendees for today's hearing; that is, representatives of Enertrade. To facilitate our proceedings this morning, I invite you to, not only for the record, but also to confirm that the sound system is working, identify yourselves by name and company and then I would invite you to make an introductory statement to facilitate the discussion session that will then follow. Thank you very much.

MR CAVELL: Thank you. Michael Cavell, CEO of Enertrade.

MR KIMBER: I'm Max Kimber of M.J. Kimber Consultants, consultant to Enertrade on regulatory matters.

MR WOODROW: I'm Don Woodrow, manager of regulation for Enertrade.

MR HINTON: Thanks very much.

MR CAVELL: Thanks for the opportunity to come and make a presentation to the Commission. I've been involved in this business since 1978 when I briefly worked at the Federal Energy Regulatory Commission in Washington DC and then became an attorney in private practice representing natural gas pipeline companies before the FRC in tariff-setting matters. So I spent a considerable amount of the last 25 years struggling with the issues that the Commission is confronting, and they're not small; they're not easy; they're very technical, and in reality I don't envy you your task of trying to find, if you will, the right answer. What we are hoping to do today is present a bit of an alternative perspective on things.

When I came to Australia in 1996 the National Gas Access Regime was in its formative stages. It hadn't yet been adopted, and we had a debate at that time that quite honestly is extremely familiar, based on the submissions that I've seen today. You could conclude from that that we haven't gone very far because we're still debating the same issues eight years after the first time they were looked at, but I don't think that's the case. I think there has been a considerable amount of experience gained over the last, certainly, five years since 1998 when the Gas Access Regime was formally adopted.. It's that experience that I think is the reason for this inquiry.

I view it as an opportunity regained, because I believe at the time the code was first adopted, it was an opportunity lost, and I refer to that primarily because I think we lost sight of the first principles. The first principles that came from the Hilmer report and from the Industry Commission and the various inquiries that led to the adoption of a Gas Access Regime were focused on two basic approaches. One was light-handed regulation and the second was a preference for commercial negotiation and market outcomes. I think in both cases the Gas Access Regime has failed. It does not state a preference for commercial outcomes, and the outcome is far from light-handed in terms of how it's being applied.

What we advocated at the time was that there be an alternative structure. When I say "we" I should refer to the fact that I was with Pacific Gas and Electric at the time, which was a US based energy company, combined gas and electric utilities with the gas pipeline system, and we advocated not that cost-of-service and a heavy-handed regulation approach not be adopted, but rather that there be an alternative track, and that that alternative track should recognise the commercial realities of the marketplace and recognise that there is an incentive on the part of natural gas pipeline companies to, if you will, voluntarily comply with the broad principles of open access, and that the reason why there is that incentive is because it's in their commercial interests, and that that alternative track of a voluntary compliance option would be true to the spirit of both a light-handed regulatory approach and to the spirit of a preference for negotiated outcomes.

Unfortunately, that was not adopted at the time. What was adopted instead was an approach that has led to, from my perspective, a heavy-handed cost-of-service approach to regulation of the industry. I've been working in this industry, as I said, for 25 years, and a good part of that time has been spent on the vagaries of cost-of-service regulation, both from the standpoint of an advocate and then ultimately from the standpoint of an executive within a company that was subjected to it. I don't think I have ever seen more counterproductive activity than I have seen in the processes that are embodied in cost-of-service regulation. It's in many ways a jobs bill.

It creates an industry of its own. It creates an advocacy industry. It creates an advisory industry. It creates a consultant industry, and ultimately it does virtually nothing for the marketplace. It becomes a technical debate about technical issues having to do with costs and prudency of costs incurred and capital bases and references to capital markets, to capital as a pricing model, none of which has anything to do with the commercial marketplace in which these pipelines operate. I admit that the United States has a heavily cost-of-service focused regulatory regime, and I would estimate that within the companies I worked for, the amount of management, time and energy spent worrying about that and managing that, was probably in the order of 40 to 60 per cent of our time.

That is a staggering diversion of attention from the commercial marketplace to a regulatory marketplace that produced outcomes that had very little to do with the realities of customer requirements or supplier requirements. There is a superficial attractiveness to the arguments in favour of cost-of-service regulation, and that goes something like this: these are monopolies. They have market power. They will abuse it, and the only way to preclude that is to impose a cost-of-service price cap regulation. I would assert that none of those principles is proven. There is no evidence to support any of them, other than technical arguments, and there is absolutely no justification not to try a light-handed regulatory approach at least to give it an option of occurring.

The best example of that, in my view, is right here in Australia in the Eastern Gas Pipeline.. The Eastern Gas Pipeline was built after the code was adopted. It was started well before the code was adopted, and it was proceeded with on the basis that there was a promise of a light-handed regulatory regime. That promise was rapidly shattered on the Eastern Gas Pipeline by the regulators, with the end result that they were forced into a protracted and expensive litigation to demonstrate, if you will, that there was no need for regulation because the commercial interests of the company supported an open access regime and an aggressive marketing activity.

That's precisely what has been adopted on the Eastern Gas Pipeline. They have an open access regime that focuses on non-discrimination, market response of pricing, transparency, confidentiality of information and dispute resolution. All of the things that are at the core of the, if you will, first principles behind the access code are there in the Eastern Gas Pipeline access regime, and it's working, and they did it voluntarily, and they did it because it was in their commercial interests. The imposition of regulation on that system would only have imposed costs. It would have done nothing to facilitate market development. It would have done nothing to respond to the needs of the customers at both ends of that pipeline, and I think the Eastern Gas Pipeline is a testament to not only the reasons why the code should not be applied in a heavy-handed way, but really as a testament to a voluntary compliance approach or at least the option of a voluntary compliance approach.

We at Enertrade are in the process of building a pipeline from Moranbah to Townsville. We are already encountering the issues that arise when you have a heavy-handed cost-of-service regulatory regime in negotiations with potential customers, all of whom are clamouring for access principles, clamouring for tariffs and clamouring for a regulatory outcome that cannot be satisfactorily provided within the commercial time frame that they or we have to make decisions.

The end result of that is a skewing of the discussion between ourselves and that customer away from the value of the transaction, away from an assessment of the value of the service that we're providing towards a view that if the costs are not within a certain range, then the outcome is unsatisfactory regardless of the value delivered to the customer. This is not only unproductive, but in my view it distorts the whole intent behind the negotiated commercial outcome, because it's driven around using a regulatory cost-of-service outcome as a crutch to avoid engaging in direct commercial negotiations.

Most or many of the responses that I've read to this inquiry are by gas users. A headline one, I think, was developed by the Allen Consulting Group, which basically asserts that without cost of service regulation, you cannot resolve the tension between the need for markets and the need for the service. Again, that's a bald assertion. It's the same assertion that same consulting group made at the time when they drafted the code seven years ago. In my view, their objective today is simply to justify what they've already done and that theme runs through several of the gas user groups. There is not one shred of evidence that any of them have provided - not one example - of an abuse of market power by a pipeliner who is voluntarily providing open access. There is not one example of that. There are only bald assertions that there must be regulation to prevent an abuse that hasn't even occurred.

Our submission effectively says: give light-handed regulation a chance. Give it the opportunity; restore the opportunity that we lost seven years ago when we first adopted this regime by providing for the option of an asset owner to voluntarily comply with the principles of light-handed regulation and the principles of open access and let it work in a commercial marketplace. There is no need for heavy-handed regulatory intervention unless there is, in fact, an abuse of market power. Until that is demonstrated, there is no need to impose it. I won't go into the specific details. I'd like to offer it for discussion.

The people that I have with me - Max Kimber was present at the time I drafted the open access principles for the PG and E pipeline here in Queensland and was also a consultant to me when I was at Duke, and we developed the open access regime for the Eastern Gas Pipeline. He was also present when we made the same judgments regarding the Tasmania gas pipeline, that it was in our commercial interest to be an open access pipeline. Max is heavily familiar with the terms of that and he is here to answer questions about it, to the extent that he can. Don Woodrow is the head of our regulatory branch within Enertrade and he is hoping that he won't have to deal with a heavy-handed regulatory regime going forward. Thank you very much.

MR HINTON: Michael, thank you very much for those comments. Given your history and your past hats and involvement, I think you bring a particular perspective to the issues before the Commission. I would also like to thank you for your written submission - thank you very much - and also for Enertrade's involvement in our inquiry more generally. I note, from your written submission, that Enertrade also strongly endorses the submission coming from the Australian Pipeline Industry

Association.

MR CAVELL: That is correct.

MR HINTON: There is a link there. To get matters under way, I'd like to pick up on some of your earlier comments about the background to where we are today. You referred to the Hilmer report and the Industry Commission work back in the late 90s. You talked about an environment and a view that was pushing light-handed intervention with light-handed regulation, with commercially negotiated outcomes. You then went on to say that what we've got today is fundamentally different to that. Can you explore for us why this has occurred and what factors have been at work that have led to this sort of - in your perspective, from your judgment - disconnect between the origins of the Gas Access Regime of the 90s and where we are today.

MR CAVELL: I can speculate. I wasn't obviously in the room when the decisions were made, but I think it's driven out of two basic approaches: one is that there is a fear that if you allow industry to effectively look after itself with a light-handed oversight, that bad things will happen and you'll be blamed for that, so there is a fear that without a heavy-handed approach and without control, if you will, by Commonwealth bureaucracy, the outcomes won't be as positive. Secondly, I think there's a fundamental distrust of industry and there is a view that I think comes through in what I believe is the predicate for the heavy-handed approach, which is a series of presumptions about the behaviour of industry that suggest that they will behave to abuse market power, they will act in a way that is contrary to the views of the bureaucracy or of the regulator and that therefore we must prevent them from doing that by controlling their behaviour.

I think it's that lack of trust in the commercial incentives that drive the industry, that are really at the core of the inability to accept that they just might have a commercial interest in dong the right thing. I'll give you an example of that: when we built the Eastern Gas Pipeline, we negotiated a commercial outcome with an end user that provided the foundation customer basis for building the pipeline. We made the judgment that the promise of that pipeline and the commercial opportunity there had more to do with the development of a competitive market in Sydney, and the development of markets that would need gas from the Bass Strait. As a result, we built in 40 per cent extra capacity - 40 to 50 per cent - and we overbuilt, if you will.

We did that based on a forecast that we, through our commercial activity, could stimulate demand, could stimulate activity and would in fact develop customers for the pipeline that would, if you will, be in the interests not only of us, but of the Sydney marketplace. When those arguments were presented to the regulator, the first thing they said was, "Show me the cost of service derivation of your tariff?" Our response was that we did not do a cost of service determination; it was a negotiated outcome. The response was confusion - I think is the best way to put it. They couldn't grasp that we actually came up with a number through the give and take of negotiation. We ran that through economic models that assessed its ability to deliver an acceptable outcome from a commercial standpoint and didn't really focus too much on the derivation of a cost-of-service tariff - because it wasn't relevant to us at that point in time; we were engaged in a commercial process.

The second thing, of course, had to do with the extra capacity that we built into the pipeline. We attempted to do an undertaking with the commission, the ACCC under Part IIIA. The objective of that was to establish how that excess capacity would be dealt with, if you will, through a voluntary open access undertaking. The response to that was, "We can't tell you how, under the code, we will treat that extra capacity. We can't tell you that because we can't bind the commission and the commission can't make that judgment until they are actually presented with a hard and fast access regime with tariffs embedded in it and that, yes, the outcome of that may well be that we will strip the capital associated with that out of your capital base and impose a different tariff outcome."

We said, "But how can we proceed with that degree of uncertainty?" The answer was, "Well, that is just how the system works and you'll just have to wait and find out later." We thought by using Part IIIA that we could engage the regulator in a discussion that would lead effectively to a voluntary access regime that was embodied in an undertaking that had an auditing regulatory oversight and that our behaviour would effectively preclude the need for a heavy-handed cost of service response. The answer we got back was, "That's not acceptable to us. It has to be at its core built upon a heavy-handed cost of service approach." That's the reason why we ended up having to go to litigation.

To me, both of those responses were based upon fear and distrust, and distrust of us as a company and fear that we are somehow going to do the wrong thing and that they will get blamed for it, if the wrong thing were to happen. To me, that's no basis for a regulatory regime; that's not why you do things. You don't presume distrustful or dishonest behaviour; you presume the opposite and then you build in a defence to the extent that there is an abuse of that trust. That's the approach you would take - but that doesn't appear to be the case here.

MR HINTON: That example you give, you see that as a prime illustration of how regulatory uncertainty pushes construction of new pipelines to build to known demand.

MR CAVELL: Absolutely it does. If not for the promise that we had, that because we were in a competitive environment, we believes strongly that the competition tribunal would see the merit of the argument that there was no need for coverage. I would illustrate as well, from that, that the coverage application that was filed was filed by an individual, or a company that had never asked for access, never attempted to negotiate it; they just threw a vexatious claim in for coverage and triggered a regulatory process that ultimately cost us about a million and a half dollars to get resolution on. So I think it is, if you will, the poster boy for what is wrong with the existing system.

It was wrong in the onset of the coverage application; it was wrong in how it went about the process of determining if there should be coverage and the whole concept of open access got lost. It got completely lost in preference for a cost of service outcome. So, yes, I think it's a prime example of what is wrong with the existing system.

MR HINTON: I pick up on that million and a half dollars that you referred to. That's your compliance cost with that particular case. Is that - - -

MR CAVELL: That was our cost of lawyers and advisers to prosecute, if you will, the procedures before the competition tribunal.

MR HINTON: Resolution of that case.

MR CAVELL: Yes.

MR HINTON: Still on this point - not the compliance costs - but this point about building to known demand, some have put to us that the code is quite flexible; that there is scope within the access regime for enhanced expanded capacity to be delivered through compressors, loops, through negotiations between those seeking to get more gas and the actual owner of the pipeline. Have you got any comments on how well that has or hasn't been working - that particular characteristic of the Gas Access Regime?

MR CAVELL: I would agree that there is scope for a different outcome. Unfortunately, there is also scope for the outcome that I described, and that is that it gets stripped out. Because that's not resolvable in a vacuum, if you will, before the capacity is actually built, there is no avenue for determining which way that scope is going to go. It's not just the capital base; it comes down to what volume projections do you use, or quantity projections do you use for the tariff calculation.

If you presume a capacity basis for that, instead of a known customer basis for that, the outcome is a substantial dilution in the tariff and effectively a placing of the entire economic risk associated with that extra capacity on an existing marketplace, instead of forecasting "Here's what it is now and here's where it goes." Second, on looping and compression, I think the APIA submission provided an example of the different costs associated with initial capacity versus later expansion. What we were seeking to do on the Eastern Gas Pipeline was find an optimal outcome. We built an 18-inch pipeline but it could have been 20, it could have been 24, it could have been 16. The diameter that would have fit the marketplace at that time, which was one customer, was 14 inch. We could have built a 14-inch pipeline from Longford to the Port Kembla Steelworks and satisfied BHP and Sydney would have received nothing, because there were no customers there at the outset.

The decision to pick 18 inch was based upon a forecast of growth that suggested that the need for the first expansion would be approximately 10 years in the future. Therefore that was an acceptable period of operation before the pipeline became constrained and would give us the opportunity to grow the marketplace, if you will, and deliver returns to our shareholders without the need for additional capital. So it was a balanced judgment made that, at that point in time the 18-inch was optimal for our forecast of the market. I mean, we could have been wrong; it could have taken 20 years for the market to grow. That's the risk we were prepared to take; that we could do something about it. We could forecast that market and we would build, if you will, the optimal initial design.

I think the constraints that have occurred on SEA Gas, and when those projects were put together, are an example of the opposite. The two projects proposed there were intended for different markets. They were both too small, when you put them together, so they had to come up with a new design when they actually put together what the market was in Adelaide, and the two projects combined. They've actually got parallel pipelines for a portion, followed by a large pipeline for the end. Neither would have built a pipeline that was adequate for the marketplace, because they were both focusing on their own loads and their own needs. Now, they both could have expanded with compression - that is additional capital; they both could have looped the pipeline - that is highly expensive capital - it is much more expensive than compression.

Another example would be our Moranbah pipeline. It was originally intended to be a 10-inch and that would have been more than adequate for the current marketplace there. In negotiations with a second potential customer, it became obvious that if we built that 10-inch and their load materialised in the way they expected, we would be expanding that pipeline before we finished it; we would have to put compression in midstream, before we even finished the construction. That seemed like folly and it seemed like it was contrary to the interests of the marketplace. So we made the judgment to build a 12-inch pipeline. It doesn't sound like much, but two inches yields about 50 per cent additional initial capacity.

That decision was made without having the commitment from the marketplace, but with the perspective that the marketplace will require that capacity sooner rather than later, and it would be, if you will, inefficient to build a 10-inch pipeline and then immediately expand it. Those types of incremental expansions are unnecessary if the forecasting suggest that it is going to happen within the first 10 years of the operation of the pipeline.

MR HINTON: These sorts of factors that you well articulate have been put to us as being the origins of some more recent initiatives with regard to the policy framework for greenfields investment - that is, you have the draft guidelines from the ACCC that present certain options to the regulator as to how there might be a reduction in the sorts of regulatory risk associated with the decisions, commercial decisions to pursue construction of a greenfields pipeline. Similarly, there is the Parer report that has flagged the possibility of regulatory holidays of certain periods - 15 years or whatever. Do you have any views on those sorts of initiatives in the area of how the regulator might approach greenfields investment?

MR CAVELL: Maybe I'm not the right one to answer that, but to parrot something I said earlier, I don't trust them. Quite honestly, my experience with the Eastern Gas Pipeline confirmed to me that that was a response to the issues on the Eastern Gas Pipeline and it was an attempt by the ACCC to preserve the cost-of-service heavy-handed approach. The Central West Pipeline solution they came up with was negative depreciation on that extra capacity - "We'll just defer the cost out and future customers can pay it."

The problem with that is that it makes no reference to the marketplace at the time. It doesn't say the market can afford it. In fact, it's indifferent to whether the market can afford it. It sets those tariffs and all of those options - set the tariffs in a vacuum that make no reference to the marketplace. As a commercial developer of a pipeline I'm not prepared to take the risk that I won't have the ability to respond to the needs of the marketplace. That's what I'm trying to put in place. The greenfields proposals the ACCC put forward are all ways to get earlier views on a tariff that is based on cost, not on value and not on the market. To me that is pretty useless, because that's not what determines if I can develop that market. It's the wrong focus and it's designed, in my view, simply to preserve the regime.

Regulatory holidays - all that does is defer the risk. I mean, how long are you going to put off the regulatory risk? 15 years, 20 years, 10 years, five - what is an appropriate amount of time? Most investment decisions are made on probably 15 to 20-year time horizons. They are based on, if you will, blended internal rates of return that don't deliver results unless you allow the time to go all the way out, a holiday for 15 years would probably satisfy many investors because in that time frame they'll probably believe they've recovered the value of their investment and who cares? It's a risk they are willing to take. I think that's a bit of a head-in-the-sand approach to the issue. It doesn't come back to what I think is the core, which is we've got to find a way to stimulate market activity and negotiate a commercial outcome, as opposed to that.

DR FOLIE: But isn't Moranbah a greenfields project?

MR CAVELL: It sure is, yes.

DR FOLIE: So under what circumstances are you sort of not trapped under the guidelines that the ACCC have put out? In other words, you're trying to replicate the Duke type of model.

MR CAVELL: Yes.

DR FOLIE: But even then you've still got to presumably get some clearance from one of the regulators to do that.

MR CAVELL: I don't think we do. It's a new pipeline. It's not automatically subject to coverage. It would only be subject to coverage if our position were adopted; if there were an abuse of any kind of market power. It's to a market that doesn't have natural gas. The competition there is fairly intense in terms of the alternative fuels that we are trying to penetrate the market to replace and the types of new industries that we're trying to stimulate. Our view is that it's not covered until there is a coverage determination and the best way to avoid that is to be market responsive - and that's how we are approaching it.

DR FOLIE: But you're still subject to Freddo the Frog putting in an application for coverage - Freddo the Frog being the cane toad who lives in Ingham or something that doesn't exist.

MR CAVELL: Yes. And that's a risk, yes.

DR FOLIE: So you still face that risk. Yes. What about then going back to greenfields, some of the - so your solution is to try and actually mitigate it and you feel you can successfully do that; even the guidelines don't necessarily impact at this stage. They're not turned into something more tangible; they just remain guidelines.

MR CAVELL: That's correct, yes.

DR FOLIE: Right.

MR HINTON: Michael, you've put forward your desired outcome, which is a sort of voluntary participation light-handed regulatory regime. Can you elaborate a little about how you see that working. I have in mind at least two questions here: firstly, is this the only regime, or would this be a tranche of the regulatory structure? I will elaborate on that if you wish, but the second aspect is: what sort of enforcement options would exist in the hands of the regulator if things did go wrong? I would welcome your comments on what sort of shape you see that regulatory framework performing.

MR CAVELL: We see it as a tranche. We see it as an option. Not everybody wants to do this perhaps; maybe there are those who would prefer to have regulation. There are some people who find comfort in the certainty that may ultimately arise from somebody else setting their tariffs. So we see it as a tranche. We see it as an option that occurs early in the piece at the coverage point, where if in fact there is a determination that there is coverage, the pipeline has the option of voluntary compliance.

The oversight that goes along with that is (1) the establishment of a set of principles on how you're going to operate. Those principles include non-discriminatory tariff setting, non-discriminatory access, transparency, posting of transactions, posting of all transactions with affiliates or related companies, and essentially a regime that says, "We will be non-discriminatory and open in how we go about our business." The regulatory oversight is, in the first instance, an audit of that compliance with those principles, so that each year, if you will, we would file a report with the regulator that says, "Here's our compliance."

It becomes an audit responsibility, as opposed to an interference responsibility. That auditing would include "Did you do what you said you were going to do? Did you post things appropriately? Were you non-discriminatory?" It could involve discussions with customers; it could involve lots of audit, even at the pipeline operation side, if they would like, to confirm that we have in fact complied with our undertaking to comply with open access.

If, for some reason, there is a finding that we have not complied, I think then the regulator has the option to move us, if you will, into a cost of service based tariff calculation. I would urge that that decision be reviewable and not be an unreviewed determination by the regulator, and frankly, I'm prepared to take the risk that I will comply adequately and that I'll survive the audits that occur every year. Now, there is a cost associated with that. It's far less than the cost of regular tariff resets and the determination of a separate set, if you will, of cost-of-service regulatory financial books which are what result from cost-of-service oversight. But those costs would be reasonably minimal and, in fact, would be costs - if in fact our commercial interest is in compliance, then audit of that compliance is no different than auditing our financial statements and we'd be prepared to do that.

MR HINTON: A rather more specific and quite narrow question in response to some of those comments, Michael: you talked about a non-discriminatory tariff.

MR CAVELL: Yes.

MR HINTON: Can you perhaps elaborate for me as to the full meaning of that - that is, is it non-discriminatory in a very simple sense, that everyone gets the same price no matter what? Or, is there scope to have same price for same product - that is, are there volume factors at work, are there queuing factors, are there priority factors, are there trading opportunities for secondary market activity? On your non-discriminatory tariff point - I'd like to hear your comments.

MR CAVELL: Absolutely there is. To address the last point: part of the principles include capacity brokering which basically says, any customer who buys capacity can resell it. That only applies obviously to firm capacity because as available capacity they only pay for it when they use. But the principle of non-discrimination is that at the time you do a negotiation, you do a risk allocation of the various critical elements in that negotiation. You define, if you will, a product that the customer needs. It's rarely a firm forward haul on a plain, straightforward basis. There is always some nuance in that, be it occurrency nuance, be it a term nuance - something that drives the risk allocation in the process of the negotiation.

What we do is we identify those critical terms and then we post those critical terms on a web site and say, "Anybody who desires to do that same risk allocation, and do that same service, can have it for the same price." Now, we make it a point in our principles of saying that volume is not relevant. One of the key issues that underscores this lack of trust, if you will, is that the little guy gets crushed and the big guy can negotiate what he wants. Our principles say that if it's only volume that's different, then there is no basis for discrimination. So if BHP comes in and negotiates an 80-cent tariff, and then John at the local restaurant says, "I want that same tariff," it doesn't matter that his load is a fraction of BHP's, if he is willing to do the same principal terms, he gets the same deal.

So the non-discrimination says it's not volume based; it's based upon, if you will, the realities of the commercial negotiation. We would post that for a period of time and offer it to the marketplace and say, "Here's a deal that's been done." Wouldn't identify who the counterparty was, but we'd identify all the key terms. I'll give you an example of one of those. In the initial discussions on the Queensland gas pipeline with QAL, because they were in a marketplace that had US dollar revenues, they wanted to hedge their upstream cost to US dollar principles. We offered to them a US dollar tariff that was, if you will, discounted from the Australian dollar tariff. The purpose behind that was because they are mitigating some of our currency risk as well. So we offered that tariff. They accepted it.

We then took that US dollar tariff and posted it and said, for example, to

QMAG - who was another customer in Gladstone - "If you want to do the same thing and hedge your currency position, you can have this tariff" - it was about a 10 per cent discount to the tariff - "and we'll give you the exact same deal we gave to QAL." QMAG, for its own reasons, chose not to do that, but that was their choice. But the principle was that discount and that negotiation yielded an outcome around currency exchange that we were prepared to offer to anybody else. That offer was extended for a six-month period. We sat down with all of the other customers - none of them took it up - but I don't think that defeats the principle of non-discrimination, that none of them took it up.

DR FOLIE: Can I pick up another greenfields type of issue, because it probably is - - -

MR HINTON: Sorry, there was a follow-up on the volume point. I thought you were going to say it. Is this non-application of the volume factor reasonably acceptable across the sector? Or is it much more prevalent in the sector with regard to volume being an important component of pricing?

MR CAVELL: I think there are those that would say that the volume gives people leverage and that therefore they should get the better deals. I happen to think that the whole reason why we end up in cost of service is because the big guys get taken care of and the little guys don't. So I'm not sure that there would be universal agreement. That's the principles on EGP, Queensland gas pipeline, Tasmanian gas pipeline, and will be the principles on the Moranbah to Townsville pipeline.

DR FOLIE: Just picking up again, because you've been involved in two greenfields-type experiences, one of the areas of discussion in the greenfields area appears to presume that there may well be a pipeline that has sort of done an abstract and other people don't get a chance to buy into it. In other words, when the pipeline has been laid down, or not been laid down, but effectively the negotiations are taking place, there needs to be more public process. In other words, "A pipeline is under way and there may be principal negotiations, but anybody who wants to join into it, please do now, because otherwise you then find that the foundation shipper actually gets an advantage." Other people have said, "Well, if I had realised I could have got X and Y, I would have then become a foundation shipper." To what extent do you think the process is sort of reasonably public now that people can actually get a chance to then join in when a pipeline is in its very preliminary planning stages?

MR CAVELL: There's no way to be - - -

DR FOLIE: As far as voting in other people's commercial negotiations.

MR CAVELL: There's no way to be sure, but one way to deal with that is to have a principle that the pipeline would have to, if you will, conduct an open season on capacity, which is basically an invitation to the marketplace. We did that in Townsville in that we put ads in newspapers. We indicated we were planning on building a pipeline and we invited the marketplace, if you will, to respond. I would say in Townsville that was difficult because there was no gas service there so the marketplace was trying to come to grips with, "What does this mean? We've got natural gas service. We don't really know what the potential of that is."

We then went and had discussions with the Chamber of Commerce. We had discussions with the Enterprise Board and tried to stimulate an education process that would support that open season. All this was taking place 12 months before we made the final decision about what size. If you will, it was commensurate with the land access negotiations, the native title negotiations, all the other preliminary things that have to be done, and I think it's reasonable to require an open season, and that that be conducted in an auditable way, if you will - in other words, that it be properly posted and that the responses be effectively responded to when they come in.

On the Eastern Gas Pipeline, that project actually existed five or six years before I got involved with it the first time, but there had been extensive open seasons in the Sydney marketplace. Obviously, existing customers there were contractually committed so a lot of the inquiries had to do with a time frame that might have been five or six years in the future. All of that was factored into, if you will, the market assessment that led us to decide to build an 18-inch pipeline, because the view we had was, that changeover time period, which was around 2005, 2006, was an opportunity point that could stimulate more expansion or more expansion of the marketplace. So again an open-season process publicly advertising and newspapers. You can specify how you do that, and we would put that in the undertaking; that this is how we're going to do it.

I would also suggest you should do that every time you consider an expansion. That's pretty commonplace in the United States. If somebody is thinking about an expansion, the first thing they'll do is they'll do an open season and see who's out there. Obviously, it's in their commercial interest to do that. You get lots of responses that don't materialise, but in the process you learn the market and you can focus your expansion more effectively on what the market potential is. So that's as public as I think you can get. We would have it posted on a web site, and we would advertise, "If you want to learn more go to the web site." It would all be there for them to consider.

MR HINTON: Coming back to your lighter handed regulatory framework, you referred to that option of light-handed regulation being a tranche of a range of possible regulatory involvement. Does your model have your lighter handed approach applying to everybody and then they are tested by the regulator as to how they perform against promises - that is, the regulator trusts the performance of the company, and if they don't perform they then get put into a different bucket of regulation, a different category of regulation, or does your model in fact initially at the outset put different companies, difference activities, into different forms of regulation at the outset depending upon certain criteria?

MR CAVELL: I would actually make it a voluntary tranche. I would make it up to the pipeline, and do you want to do this, because not all - as I said, not all pipelines necessarily want to do it, in which case they can opt to go down a different regime and use the ACCC greenfields approach if they're building a pipeline. There are lots of ways to do it. All I'm asking for is the option to voluntarily comply down this other tranche. So I would make it a choice of the pipeline.

MR HINTON: So it's not the choice of the regulator and that removes the need for criteria to make a judgment about which particular form of regulation you might be subject to initially. That would seem to be prima facie - require the regulator and policy-maker to have significant confidence and trust in the sector, but your description of lack of trust in either direction doesn't seem to fit comfortably with that formulation.

MR CAVELL: I would say that voluntary doesn't mean, "Trust us; we'll do it." It means, here are the principles under which we will behave, and here are the access principles, if you will, that support that. So it's an undertaking. It's effectively a movement of an undertaking process into the regulatory regime with constraints on the regulator's behaviour, if you will. When we went down the Part IIIA process on EGP, the response we got was, "Well, we're just going to apply the code." We said, "But that's not what Part IIIA is about," and they said, "Too bad. That's what we're going to do." I think what this becomes is, it's more than just, "Don't worry; we'll behave properly." You have to define what that means, and that's why we put in our submission a series of, if you will, principles that underscore that voluntary compliance, and then it becomes auditing your behaviour against those principles.

MR KIMBER: Since I prepared the undertaking you've had the negotiations with the ACCC during that process that Michael described. If the commission is interested, those undertakings that were prepared by Duke Energy are still on the ACCC's web site, and maybe would give the commission an example of what Michael is describing, because effectively what we did was to encapsulate all the criteria, all the modes of behaviour that Duke Energy was voluntarily wishing to do within that access arrangement; within that undertaking.

It was an undertaking under 44ZZA of the Trade Practices Act and complied with its requirements, and also enunciated very clearly the behaviour criteria, the auditing criteria, and the penalties that would result from a failure of an audit process by the ACCC. It also included how each of the access arrangements, each of the contracts that would be put in place with potential shippers, would be managed and the safeguards for the shippers that were within those contracts. So it was a complete package that said, "This is the way we'll behave. These are the contracts we'll have with our shippers. These are the prices we'll charge. These are the services we'll offer and if we don't comply with any of that, then the regulator can step in and penalise us."

MR WOODROW: Just building on that, our submission states that there will be fines attached to noncompliance. So it's not just voluntary misbehave; switchover cost of service. There would actually be some other penalties attached, perhaps in a graduated form, depending on the breach to apply to the pipeline as well if they didn't comply with the voluntary regime.

MR HINTON: So regulatory risks exist.

MR WOODROW: (Indistinct) behaviour there.

MR HINTON: So the risk of regulation is there in that framework but against the basic characteristics of the undertakings that are transparent and given up-front. Do you see then the regulator reinforcing noncompliance with the undertakings and imposing fines if that occurs? You seem to be also saying not only does that occur, then that particular company then gets subject to a more heavy-handed form of regulation as well.

MR WOODROW: At some point I imagine you would have to design a system for a minor breach - suddenly end up under cost of service, but there might be some other financial penalty attached to it. I don't know. There's a range of incentives.

MR HINTON: Thank you. Michael?

DR FOLIE: I'd like to come to basically the issue about - actually negotiate and arbitrate point. Effectively, number 1 is a lot of project managements - tragically, a lot of them end up in basically "negotiate-arbitrate" towards the end. That's nothing to do with this area, and some of these cases can take years to actually settle. How would you actually envisage this taking place, because otherwise you end up with another regulatory regime at the back end, and you've also got, saying in the end, you want it ratified by a court? So if it really goes bad it can take perhaps nearly as long as the cost of service.

Would you envisage both parties having to actually stipulate exactly what they had agreed and what they had not disagreed? In other words, go to the arbitration in a fairly sort of formal manner - in other words, really having a significant trail of where you had got to so you can actually see there are probably three or four points which you just couldn't agree on. You get agreement on all the other ones. Can you see a process of trying to simplify that, because it could end up being just as intrusive with the arbitrator wanting to try and sort of replicate all the detailed information again?

MR CAVELL: It could be. I would view arbitration as a failure of the process. A couple of things, to put that in a context, is there will in fact be posted reference services and reference tariffs. These generally are services that are generic and are unsatisfactory to most sophisticated end-use customers because they don't define enough. So there is in fact a reference point in the information that is available which is a reference service. The negotiate-arbitrate that I'm contemplating here, if you will, is more of a commercial arbitration process where in fact, yes, the process of getting to the dispute has to be documented. The issues that are remaining in dispute have to be documented and, if you will, they get submitted to a commercial arbitration that resolves them.

As I understand arbitration, it's binding. It's an outcome that's binding in terms of the result. The customer at that point can say, "Well, that may be a fair result but I'm not interested," and go his separate way. It doesn't bind him to buy the service but it determines an outcome that is commercial based upon the positions of the parties that enables you to look at both sides of it. I will give you an example of the nuances that arise in negotiation. One of the things that's true of almost all commercial loads is that they're not steady load factors. They have peaks and valleys. They have periods of high demand followed by periods of virtually none.

Operating a pipeline and maintaining the safety of that operation when the demand is fluctuating wildly is fairly difficult and it essentially involves line pack management. You manage the pressure in the pipeline from through how much line pack you have in it. Most industrial customers will come and say, "I need some flexibility in my take pattern," and that becomes the key to the negotiation - that flexibility.

That's a function of the pipeline's physical capability to manage it, as well as, "Well, what are the commercial implications of that?" If you sign up for 10 terajoules a day, but sometimes you want 16 or 18 terajoules a day, that has commercial consequences to other customers on the pipeline. So there has to be a system negotiated around, "Well, maybe some of that's as available." "Well, I don't want it to be as available. I want it firm." "Then maybe you need to buy 18 terajoules." "Well, can't I buy 14 instead of 18 and get some authorised overrun capability?" Then the answer to that might well be, "Yes, we can work around that, but there is a ramp-up requirement. There is a minimum take requirement during the day." As you work through all these things, effectively what you're doing is trying to establish a commercial basis for them to purchase your service, that works for their operation and enables you to efficiently operate your pipeline.

In the process of doing that, there are often difficult points where you say, "I just can't afford to pay that extra amount for that firm service, and I don't have enough of a marketplace out there to broker that capacity when I don't need it, or I don't have a counter-cyclical load available to me. It's just not going to work. I think you're being unfair." I think that's a question that can be presented to a competent commercial arbitrator to make a judgment about whether or not the outcome is appropriate. They have to be able to consider the operating requirements. There is always an overriding safety requirement that says if the pressure drops too low everybody is off, because the pipeline can't safely operate then. I think those are the kinds of things that can be resolved through arbitration.

My experience is that they don't end up there because there is a desire on both sides to achieve an outcome that works. Those are the kinds of things that happen in the commercial discussion. It's rarely, "Your tariff is 85 cents; I need it to be 80," and the parties stare each other down. It rarely comes down to something as simple as price. Price is often the last thing that gets considered, because price is a function of load factor and everything else. The ultimate cost to the customer depends on what their take pattern is and everything else.

It is an emphasis on a commercial outcome. It is intended to be a binding outcome, so that you don't end up with protracted litigation and it is intended to not be the regulator. It is intended to be a commercial arbitration, because that is what the emphasis is.

DR FOLIE: This point is the point that is often used by customers from time to time saying pipeliners are impossible to deal with because they always pull these endless technical rabbits out of the hat and they're using that as a commercial excuse to gouge me on price. Regulators are sympathetic to that and I think clearly governments, from a policy point of view, are clear to that. Perhaps I could retease back the answer. What you're really saying - that the sophisticated response to that particular set of allegations - whether it be true or not - or perceptions, you can actually resolve this debate about actually how to get access to pipeline is through fairly straightforward, albeit technical, analysis which can actually be fairly objectively drawn down and one can actually then see the realities about whether then it does start to impinge commercially. In other words, what you have to pay to be able to go outside those limits or not, because - that it is amenable to a technical analysis, which is probably a lot easier than a cost-of-service analysis.

MR CAVELL: I think the technical analysis is about the only way to do it, if it comes down to that issue of what is the pipeline capable of doing. Theoretical capacity, which is usually the basis for regulatory outcomes, is precisely that - it is theoretical. It requires that practical assessment, that I think is technical and can be resolved by a competent arbitrator in evaluating it. That's not to say it's easy, but it can be done.

MR HINTON: Your model has a particular element of transparency, particularly throughout your contracts. Do you see any tension here with regard to commercial-in-confidence material and commercial-in-confidence information? Isn't, by definition, a contract often commercial-in-confidence?

MR CAVELL: It is, and there is a natural tension. I guess part of the price of purchasing the service from a transparently operated pipeline is that there is some transparency. The provisions that get posted are the principal material provisions. There are not parties identified. That could be viewed as a furphy, given that there is only likely to be one or two customers on occasion and it's pretty obvious who is who. But the idea is that we, as a pipeliner, are not seeking to hide the principal commercial terms, and we're seeking to make them transparent. There are areas where there will be sensitivity, and those will have to be handled in a sensitive way and that may even be part of the negotiation, as to what gets disclosed and what doesn't.

My experience with it, at both the Queensland pipeline and at the Eastern Gas Pipeline, is that it works. The Queensland gas pipeline is probably the most transparent in that there are only four or five customers, so it's pretty obvious who is who. It was accommodated reasonably effectively. The web site that we had access to - they had access to, had limitations about what they could get to. You couldn't observe daily takes, you couldn't observe patterns and behaviour that the customer needed to know, but you could observe the principal economic terms under which the contract was entered.

MR HINTON: This brings me to this issue of ring fencing in terms of vertically integrated companies; that is a key part of their regulatory regime operating at present. Can you give us some comments on your perspective as to the need for ring fencing and also how well it has or has not been working so far?

MR CAVELL: I am a bit of an advocate of the view that ring fencing is the wrong approach to the issue; that transparency is the way that you ensure that there is not favouritism or fun and games going on. I've not been involved in any company in the US or here where ring fencing has been meaningful. I say that because ultimately ring fencing occurs at an operational level but does not occur at the senior management level. The only way to effectively ring-fence is to require a complete disaggregation of the industry and I don't think that delivers, necessarily, an efficient outcome.

Affiliate transactions have always been an issue and I think ring fencing is principally focused on affiliate relationships. My view on the better way to respond to those is to have the affiliate transaction fully transparent, fully postable and auditable in terms of the information upon which the transaction was done. But that's where you get the openness in behaviour. Ring fencing leads to perverse things like putting doors between operating and marketing people, that are open and walk-through all the time. But the door is there - because the image of ring fencing is there it is putting marketing on a different floor and ultimately they both report to me.

We have to market and we have to be doing these other things to serve our commercial interests. Ring fencing at that level may serve a purpose in that a regulator might say, "I feel more comfortable with that," but in reality it does very little to meaningfully address the issue. Transparency, in my view, is the key to affiliate oversight and that's where you get meaningful curbs on behaviour, because they have to post it. They have to show everybody what it is. The regime also currently includes a provision for prior approval of affiliate transactions. I think that's folly.

To suggest that a regulator is competent to make judgments about the commercial marketplace in an affiliate context - and that the commercial marketplace can wait - is basically to say, "Don't do affiliate transactions." That's not the answer either. The answer is transparency with an audit oversight. That is how I approached the issue of ring fencing in the submission that we made.

MR HINTON: Thank you. We are running out of time, but I wanted to get on to the objects clause that is also another important part of your submission. You put particular weight on the view that the objects clause, the objectives of the regulatory regime, should be in relation to encouraging investment. Some have put to us that an objects clause that doesn't have any reference to consumer interests, doesn't do justice to the nature of regulation. Do you have any reaction to that sort of mind-set?

MR CAVELL: In other words, that the objects clause, because it doesn't say the interests of the consumer should be balanced against the interest of investors? As long as it states that there is an interest in investors I don't have a problem with that. I'm flabbergasted that somebody would suggest the interest of consumers aren't somehow embodied in what's going on in the cost-of-service regulation, but if there is a need to state that that is part of the objective, that's fine. I would caution, at the time the Gas Act was adopted in the United States, it was done in a context where the pipeline system was severely underdeveloped and the objective of the Gas Act was actually to establish a basis upon which investment could occur.

In reality it was designed to stimulate financial interest in loaning money and making equity capital investments in the pipeline industry. As the system became fully developed, the focus on consumer interest emerged because the system was effectively built. Australia is at the stage where it is underbuilt severely - it's underdeveloped. Imposing too heavy a commercial interest early in that only ensures that it will stay that way.

MR HINTON: Consumer interest.

MR CAVELL: Yes. I'm sorry if I didn't say that. There has to be that balance and there has to be a recognition that we need to stimulate investment. That is what is needed at this stage; is to stimulate that investment. It may be that the balance will shift and the objects clause could have both elements within it, but I think there needs to be a renewed emphasis on the importance of investment.

MR HINTON: Thank you very much for those comments, Michael and Max and Don. Are there any points that we haven't covered that you would like to particularly emphasise this morning?

MR CAVELL: No, I think we have covered them in our submission. Obviously we have been at this for a long time. Opportunity regained - go for it.

MR HINTON: Thank you again for your attendance this morning and your submission and your participation more generally. It is appreciated. The Commission's processes are very importantly dependent upon this sort of involvement, so thank you very much for your time and resources and your participation.

MR CAVELL: Thank you for your time.

MR HINTON: We will take a short break for morning tea and return here in the order of 10.30, 10.35. Thank you very much.

MR HINTON: Good morning again. We'll now commence the second session of our public hearings here in Brisbane, and I now invite the representatives of Allgas Energy and Energex to the microphones. In accordance with established practice, I'd be grateful if you would, for the benefit of the transcript and to check that the sound system is working, identify yourselves by name and company and then I invite you - as I understand it, you're going to make an introductory statement - to make your presentation to facilitate the discussion session that would then follow. Welcome to this morning's hearings.

MR LEE: Thank you, Tony. Trevor Lee, group manager of regulatory affairs from Energex Ltd.

MR WHISH-WILSON: Patrick Whish-Wilson, regulatory manager at Energex.

MR BLOXSOM: Tom Bloxsom, CEO, Allgas Energy Ltd.

MR LEE: Thank you, commissioners, for this opportunity to give you some comments on this very important review. It's a review that we've taken very seriously. We have worked with the AGA for quite a period now to come to a common view amongst the AGA members, and really in a sense, the AGA submission represents Energex's view. What we've tried to do is just support that general view of the AGA with some specific matters and, with respect to that, we gave you a direct submission from us with some contributions by Prof Littlechild and Prof Round. We also funded Prof Littlechild to take a few days off and write you a very short submission to give his own personal independent views, which he has sent to you.

We have also helped to fund the Network Economics Consulting Group to look at some ACCC claims about the relative generosity of rates of return in Australia for regulated industries against other countries. We have the first preliminary results of that study. It has taken - it must be about eight months now to do, but the NECG will be submitting to you in due course - in a week or two, we hope - the results of that analysis which includes the analysis of gas transmission and gas networks. I invite you to turn to the first slide which lists five key messages. The title of this is Time to Move on.

By moving on, we mean to change the regulatory regime, and we're talking about, from our view, very fundamental change, not tinkering around the edges. We don't think any tinkering can save the present regime. It has got to be a fundamental change. We believe that fundamental change has been recognised by governments. They're going through what they call the second phase of energy reforms and they have certainly shown in recent months that they mean business. The first phase of energy reforms I think they're referring to is what happened in 95 with the whole

Hilmer changes that broke up the vertically integrated industries. So now we have the second phase of industry reforms and I'll talk a bit more about that later.

The second message we want to give is that we think the direction for change is now becoming much clearer than it has been in the past. The ministers themselves have talked in their deliberations about shifting the focus of regulation from the short term to the long term, including industry development and industry investment. There's also mixed up, I think, with this from private ministerial statements that there's a feeling - an unease that the infrastructure of gas and electricity and maybe other essential services is not up to what it could have been. Ministers are going that way, and we think the Epic case and some of the general principles that came out of the Epic case also helped to point the way towards regulatory change.

The third message we want to give is that we believe there's a whole array of regulatory reforms out there that are fit for this new direction we are suggesting to you. Their variety and diversity is such that we think that there could be a horses for courses approach here rather than the present system that we have at the moment, which is a one size fits all - no matter what industry you're in; what regulator type of company you are, you get one type of regulation and that's it.

The fourth message we want to deliver is about the way determinations are arrived at. Again, this comes out of Epic but it's also, in a sense, embodied in the original code that has never been put into practice - that is, it shouldn't be a question of regulators making precise determinations, but rather of companies proposing arrangements that are judged against the general principles of the code and either accepted or rejected by the regulator and then the proposer can go away if the thing is rejected and have another go at it, or eventually it might end up with a merits review.

The fifth message is on coverage. Essentially, we think there are a lot of gas networks out there that just simply don't need to be covered. There are a lot of substitutes and there is a lot of competition going on. We'll talk more about that later. Basically, there should be a break point where people aren't covered. The bottom of that slide just says, "The way forward; accept all the AGA recommendations." Just to emphasise that point that we're here to support what they've said. Turning to the next slide - there's a whole series of slides here which I'll just flick over. It was just to remind people about the energy reforms that are taking place and some of the milestones in that reform, and it explains a bit more about this second phase ministers are talking about.

I suppose the reform process kicked off with the Productivity Commission's own review of the National Access Regime. That has been followed - in a sense, a lot of water has gone under the bridge since then. We've had the Epic case. We've had Duke. We've had the power review of energy markets to twenty-twenty. We've had the formation of this Ministerial Council of Energy and its relationship with COAG, and that's all putting in regime change over the period of 2004 to 2006. A couple of other things have come in from left field.. I'll talk a bit more a bit later about the debate on CAPM, which really started about 1997. It has come into some sort of fruition in recent times.

The next slide is just a quick summary of the first element of that, which was the Productivity Commission Review into the National Access Regime. A couple of simple messages out of that review were that the present regime has a chilling effect on investment; secondly, the cost of overinvestment is far, far less than the social cost of underinvestment, and I think that's a very fundamental message the original Productivity Commission found. It has been lost, I think, on regulators but that's very important. It's much better to overinvest, even gold plate a little bit than have that horror of no investment or underinvestment.

Just the line at the bottom of that slide really says to regulators, "Don't be too intrusive. Don't be too imprecise. Just try and improve on unregulated outcomes." That, I think, has also been lost by regulators. The slide after that just talks about the federal government's response to the Productivity Commission's review. Again, as the AFI noted at that time, there's an uneasy sense that infrastructure was not up to standard and that the regional regime had been at least partly responsible for that.

The next slide talks about Epic Energy - in fact, the next two slides. I just want to emphasise here, we're not talking about the particularities of the Epic Pipeline case. That is quite separate from the point I want to make here. The relative merits of their case and whether it wins or loses has got nothing to do with what we're saying here. What we're talking about here is a question of general principle that the justices came to as guiding regulators under the law. The justices were clearly writing the history in this judgment. You only have to look at the 100-odd pages where 70 per cent of it is talking about general principle. These guys are writing the history. They refer back to cases in America 50 years ago. They refer back to key elements of trade practices legislation and key cases in Australia. What they're doing is building up general principles that should be applied by all regulators forever.

Attachment 1 to our submission puts Energex's views on what those conclusions were, and we also had Prof Round and Prof Littlechild go over the Epic decision, and they largely agreed. So I would just like to make the point, this is not about the Epic Pipeline. This is about general principles.

The next slide really just summarises, in our view, what the Epic decision was all about in terms of general principle, the first point saying that the origin of law - that's the Hilmer reforms and the Gas Code in particular - are not about applying a perfectly competitive model to regulation. Secondly, what those things are talking about is something entirely different, and that's the Worker be Competitive model. Indeed, the modern interpretation of workable competition should be applied. The second major thing that they're talking about in our view is that they're supporting this proposed accept to project model. In other words, regulatory decisions shouldn't be a deductive approach where you build up to some price but it should be an inductive approach, which is to take a proposal and compare it against overriding objectives.

The next slide talks about the COAG power review. I won't go into that in too much detail. The problem a bit with that was we're suppose to panel members individually and Epic came along a bit too late for them to consider properly. The other problem they had is that the regional regime is such a complex matter and they had so many other issues to deal with that their solution to the whole matter was really just to say was, "Well, what we'll do, we'll propose a single national regulator. He'll sort all these problems out when it gets started and we'll leave all the details of the regulatory debates for him to fix." That's really where that thing concluded.

As the next slide shows, that idea of the single national regulator has been taken up by the Ministerial Council of Energy and they've come a long way, especially in the last few months. What they're about is two things: one is structure and one is process. On the structure side, they've already sort of finalised a lot of those arrangements. What they've done is establish a national energy regulator, the AER, which is to operate from 1 July 2004 and it is to absorb responsibility for regulation for electricity and gas transmission, distribution and retail by 2006, but not retail pricing.

The second bit is the process which they're just about starting on, and that is to get new energy laws to govern regulation. As we understand it, this Gas Code review is the fundamental foundation for that new energy law. Whether it's going to be a unified one law or two separate laws for gas and electricity I'm not quite sure yet, but certainly they see this as the foundation of that new approach and you'll note of course that the terms of reference include Duke and Epic for the Productivity Commission to consider.

The next slide really starts to come back to what the AGA have said. On the objects clause, the AGA has made two points. The first thing is that the objects clause should say there should not be a regulatory regime which emulates perfect competition. The second bit they say is mirroring Epic. What it should be about is mirroring workable competition. These two slides - this one and the next one really talk about why we're saying it should not be perfect competition.

There are three or four basic arguments. The first one is just economic theory.

If you're emulating perfect competition, then by definition you're not getting innovation; you're not getting dynamic efficiency, and you're not getting all the goodies that real markets in the world produce, like diversity of products and customer choice. You're getting none of that.

The second argument is a legal one and it comes back to Epic, which basically says by law the Gas Code means you do not have perfect competition. The third argument is based on financial theory. The capital asset pricing model underlies what regulators apply today, which is - to summarise it - called a building block/WACC approach. I think everyone in this room is familiar with that. But it's the cause, the foundation of that WACC approach. We had Prof Stephen Gray advising us in detail on this matter. As we understand it - and a lot of this has only come to us in the last few weeks - this debate was started by two of the foundation fathers of financial theory - that is, Farmer and French. It has now come to the position where the results of the CAPM approach, as you can see from the words there, are distressingly imprecise, beset with massive uncertainty. In fact, the whole thing is what they call a dead horse.

What we've got in this country is regulators applying this model to massive industries - such as gas, electricity, telecommunications, rail and all the rest - based on a model that gives you no better answers than a wing and a prayer, or serendipity. That's what these theorists, the foundation farmers [sic] of this approach, are now saying. As Prof Gray there says, when you start to apply the limits of where this model can lie, it's vast.

If you just turn over to the next line, it gives you some idea of what we're talking about. Regulators, when they make a determination, come out with a very precise WACC. It's usually down to two decimal places, like 5.93 or something like that. But what the financial theorists are saying is that in fact regulators have simply no idea where the true cost of capital lies within a very wide margin. According to US data, that's at least - in this example we give here - you know, a couple of per cent either side of that precise definition.

Regulators have no idea where the true cost of capital lies with the regulator company. The only thing certain is that anything to the left of that middle point means that the regulator company is not going to recover its true cost of capital. There is a 50 per cent chance - that's what we're talking about. You don't even recover the true cost of your capital.

If you turn over to the next line, that's called "not perfect competition under two" - in addition to this fundamental theoretical problem in the CAPM what we have also is regulators cherry picking the parameters that go into the WACC calculation. I can talk about this in the question and answer period afterwards, but every regulator company knows that. If there is a plausible range, regulators pick something in the middle or the lower part of that range, never the top part of the range. So what we end up with is something less than a fifty-fifty chance of recovering the true cost of capital.

Also, you see some reference there to NECG. If you just turn over the page we've got some preliminary results from that analysis. People may not be aware of the debate, but the ACCC came out and basically said, "Look, don't worry about regulation in Australia.. We're more generous here than other countries overseas." Well, we didn't believe it, nor did a lot of other regulator companies. We funded NECG to do the analysis and the gas distribution - as that shows and this is only preliminary stuff - that in fact the Australian margin in either risk-free rate is lower than it is in those countries over to the right - that's mainly the US so far. But the preliminary results we've seen in a whole raft of other industries show the same sort of result. We are at the lower end of generosity - if that's the word for it - than other countries. I put a question in a box there and I have to say, you know: what have regulator companies done to deserve the solution that is currently applied in terms of regulation? How bad can we be to have to suffer this sort of regulation?

If you could just turn over to the page after the bar chart, there is a slide there that talks about the objects clause. Again, here we are talking about the second part of AGA's recommendation; that we have a clause within the objects clause that says you should regulate and you should replicate workable competition. Well, the question posed there is: what is it?

Now, Energex has put five criteria for fulfilling workable competition there. We derive those from a very close reading of the Epic decision and what the justices were saying. Attached to our submission are also comments by Littlechild and Round. They have slightly different criteria. I think Littlechild was coming down with maybe having only three criteria rather than the five. David Round had some different views, but in essence, I think what all of us are saying is that there are certain principles that should be applied under workable competition. If that's put into the new code, then the arguments over precisely the wording can be sorted out during the drafting process. That is the essence of the principles we're trying to get to.

Now, just referring back to what was spoken about this morning before we came in, where the discussion arose about balance - how we balance conflicting objectives. Our view is that if you put these sorts of criteria in for workable competition, then the long-term interests of consumers and the long-term interests of producers are constant. There is no need for balance. There are no conflicting objectives. You take all that's in the current electricity code out and you put this in. There's no battle between different interests. Every interest is served in the long term by those sort of criteria.

The next two slides just give some quotes from Littlechild and Round about what workable competition is, which I'll leave for you to read. If you could now turn to the evolution of regulation and the slide after those, what we are really talking about here are three different generations of regulation. The first generation of regulation, which is that heavy-handed cost-of-service stuff you see on the left-hand side - what we are supporting the AGA in is by saying all those forms of regulation should be prohibited; no more cost-of-service regulation. Instead of that, what we should have is either the true incentive regulation you see as a block on that right-hand side, or underneath, what we call hands-off regulation, which really comes down to a monitoring or a surveillance approach with an underlying threat that if you don't do your job you go back to something much tougher.

Just to go across to those yellow boxes across the top there under "true incentive regulation" there are various forms there which we believe correctly applied would mirror the outcomes of a workable competitive market. If you like to just turn over the page, I'll say a few more words about what price service offerings is, because we don't believe that probably many have heard of that. In essence, it's a very complicated approach, but what it does is describes a situation where a regulator company, in conjunction with its customers, develops options that customers choose - at the end of the day - which one they prefer to apply to them.

In this case we've done it by three different types of cars. You know, you can have the basic line that gets you from A to B, up to the Mercedes-Benz with all the modern, sophisticated trickery and luxury that you want. But basically it comes down to, "You tell us what you want; you pay the price for the option that you select." We asked Profs Littlechild and Round to assess price service offerings, and we gave them a lot of detail of how the thing worked, and they came back in those two attachments to our submission - attachments 2 and 3 - giving their views. We've done some quotes here that you can read at your leisure, but basically both professors are saying, "Yes, it's credible, it's feasible and it's robust. It meets all the criteria of workable competition," and we should try it.

If you like to turn to the slide that shows a lot of traffic lights, what we've done here is to say, "Well, looking at this array of possible regulatory forms, how do they compare against these workable competition criteria?" - which is listed on the left-hand side there. Really, any form that has green lights on it is okay; anything with the red is out. As you can see from the left there, the building blocks/WACC type of approach just fails to pass those criteria for workable competition. So does the total factor productivity approach, where it is based on building blocks, which is what the regulatory forum is suggesting as an outcome. That also has red in it, so it's out under workable competitive criteria.

I'd like to just go to the next slide on the coverage test. Maybe we will answer some questions on it later, but basically we just feel that the Allgas network is one example. It's just simply working in a competitive market. Why we need to be regulated, quite frankly, is beyond us. We feel that there are quite a few other networks that are in the same boat. On the next slide we just review our arguments here and really just emphasise the point that the way forward is the structure of recommendations that the AGA has made. The final slide - before you turn over, I just have to say if we don't get radical change, if we are going to get tinkering, we're not going to get choice of you-beaut types of cars. What we are going to get - please turn over - is a continuation of really what we've got now. It's a model T Ford. There is no choice. It is always black. It is not very reliable. It is not cheap and it's only good for the era in which it was designed. I'd like to finish there. Thank you.

MR HINTON: Thank you very much, Trevor, for those comments and the presentation. We would like to put those charts, tables and slides on our web site, so we would be grateful if you could send them to us electronically, such that the readers of this transcript can usefully cross-reference your comments to the actual slides to which you were talking, if that's possible. Thank you also for your detailed submission; it was much appreciated. We appreciate Energex's and Allgas's participation more generally in the inquiry. I note that you've promised us shortly some results of the analysis of rates of return comparisons. We look forward to that, thank you. I also note that Allgas supports and endorses the AGA submission, which covers a whole range of matters, so thank you for all that background and linkage.

My first question really comes out of your written submission, not touched on in your comments this morning, and that is you see - and this is in fact in the executive summary at page 3. You describe other new regulatory forms which could be applied in a transition from current regulation. Can you elaborate on that: are you looking to a transition period towards a new environment, or are we looking at a discrete shift to the new world?

MR LEE: It's a bit of both. I think the discrete shift is to eliminate cost-of-service regulation. That must be done. We feel that is a very difficult thing to achieve because the way we view it, there is a very strong vested interest in a cost-of-service approach at the moment. When you look at the regulators, there is a whole career structure based on cost of service. If you understand the WACC you're up for promotion. The whole culture within the regulators is about cost of service and the building blocks/WACC type of model.

There is a whole raft of consultants who have made their money - and make their living - out of advising on WACCS and the building-blocks approach. To overturn that inherent vested interest is a major problem, I think, because regulators really have to change the way they think. The only way to solve that problem, we think, is with that discrete shift. But once you've made that - that is, the not having the perfect competition bit of the objects clause - when you shift to the positive bit, rather than the negative, on the positive side I think there's a whole array of different forms of regulation that fit this horses for courses type of approach.

In some cases where you've got networks or pipelines that are obviously in a very substantial market power situation, then I think you need some of that top line of yellow boxes type of approach which might be a true price cap, it might be a price service offering approach, it might be something about nature, where the regulator is very much involved and indeed, where he might well take into account a cost-of-service analysis in coming to a decision about their proposals. But the determination would not be based on costs of service; it would be based on, as we explained, proposals from them viewed against the objects clause.

Further down towards those sort of hands-off type regulation, I think there is a whole array there that you can progress companies, depending on their market circumstances. In some cases it might be a formal monitoring approach, as used to be applied under the Prices Surveillance Act, where the regulator would do a formal report on its progress against criteria such as efficiency, satisfying customers, not charging too much for prices, its profitability is not too high - all those sorts of things.

At a lighter hand beyond that, you might have just information disclosure, where the company just voluntarily offers the information trends on its output, its costs, its prices, its profits, so that it is like a public - what's the word for it? - a public assessment of whether this company is doing the right thing or whether it isn't. In all those cases the thing that hovers is the threat that if you're not doing the right thing, then you go back to some form of greater intervention. You would have that lighter form coming right up to the point where you become uncovered. In some cases, as indeed with the Allgas network, we think it's at that point of being uncovered. Smaller networks than us - we think, well, they should be free - they are already past that threshold.

So to answer your question as succinctly as I can, I think you need that discrete leap and, after that, you have a horses for courses approach, depending on the market circumstances of each regulator company.

MR HINTON: But under your model the choice of which particular regulatory regime would operate would be at the choice of the company.

MR LEE: It does, to a large extent, but I think at the end of the day the regulator has to okay that against the objects clause. Clearly, in some cases, where a network has substantial market power that it can't decide to be uncovered, or it can't decide just to have information disclosure, there has to be something more intrusive - they have more control in it than that.

MR HINTON: But that requires, therefore, a judgment by somebody that market power exists against criteria that leads to a decision for coverage.

MR LEE: That's right.

MR HINTON: And that would be at the discretion and judgment of the regulator - a regulator - - -

MR LEE: That's right.

MR HINTON: - - - not the company.

MR LEE: Yes, I think that's right.

MR HINTON: So your model has options for lighter-handed intervention - and even heavier-handed intervention - but the decision as to which one would apply would rest with the regulator in the first instance.

MR LEE: That's right. So we propose - - -

MR HINTON: And the criteria would be market power for whether or not you'd fall into column 1, 2, 3 or 4 - whatever - for the shape of regulation that would apply.

MR LEE: I think that's the starting point, but next time around, in the next review - let's say that the regulator decided that where some large network has proposed a very light-handed form and he'd rejected it and made a decision that it had to have some sort of intervention - let's say a price service offering as a sort of baseline - something like that. Next time around, if the company has performed well, it has shown that it hasn't abused its position in any way, the customers are getting a good deal and all those sorts of trends are going all in the right directions, then next time around the company can suggest, "Well, maybe just formal monitoring would be sufficient, or just information disclosure."

Again, it would propose that and the regulator would then again investigate it to see, against the objects clause, whether that was allowable. So there would be a transition over time. But the ultimate decision would have to stay with the regulator, or a merits review on appeal.

MR HINTON: And a merits review based on not the process criteria, but in fact against the objects clause.

MR LEE: The merits of the proposal against the objects clause. Yes, something like the Australian Competition Tribunal would make that judgment.

MR HINTON: Do you see a distinction here between - any differentiation that is with regard to transmission versus distribution networks, or do you just see the nature of the sector itself; the nature of whether market power exists?

MR LEE: No, I don't see any difference in approach between either transmission or distribution, or, I have to say, any other industry either. We think it would apply equally to electricity or indeed almost anything I can think of. The same general principles apply in Epic. Epic wasn't talking about the Gas Code. The justices were talking about the Hilmer reforms and the principles underlying those reforms in a general sense.

MR HINTON: So in what circumstances do you think that the regulator might get into a system of the building-blocks approach that you characterise as existing today?

MR LEE: He would be barred from applying that in any determination. However, if he wanted to do that, under workable competition, if he wanted to do it to help make a judgment against performance, against the objects clause, that would be within his discretion. But he would not have the power to impose a separate determination based on that. He only has the power to accept or reject the proposal.

MR HINTON: Not impose?

MR LEE: Not impose, no.

MR HINTON: So can you run through for me how it might work for a greenfields proposal; there would be a price service offering associated with a new proposed transmission pipeline?

MR LEE: It would depend on the circumstances, but in that case the price service offering approach might not be the most appropriate way. There might be some other form that the company preferred, but basically, in principle, the company would go out to its customers and, as was described earlier this morning, it would talk through with a range of its customers, its main users, the sorts of conditions that they wanted from their pipeline service. It might well be that there would be a whole raft of things other than price that would form difference packages to be offered by the service provider for people to choose between, "You can have this," plus whatever other things pipeliners can supply. It might be all sorts of things: environmental matters, there might be development in rural areas on some other matter. It doesn't have to be confined to the pipeline. It can be a whole vast range of commercial outcomes that can be negotiated. These come down to options and then, at the end of the day, the customer decides which of those options and price he prefers. It's a price service offering.

MR HINTON: Would the option of regulatory holidays fit within that model for a greenfield, let's say?

MR LEE: In a sense, with those sort of options you're putting up there is no regulation for a prolonged period. It would depend on the market circumstances of the pipeline, but I think that would apply. In some cases the decision could be, "Well, let's have this arrangement for 15 years," where the regulator just doesn't have any influence on how this matter is worked out over those 15 years, but he comes back at that period and, you know, you might be in trouble then if you don't do the right thing. So I can see the 15-year thing operating.

MR HINTON: But it would be proposed by the company and agreed to by the regulator?

MR LEE: That's right, yes. The options are designed between the producer and the user.

MR HINTON: Right.

MR LEE: It's a joint effort to come up with options. So if you're a pipeliner and you've got three or four customers they would have different needs and you might come up with two or three options that suit the biggest or the most persuasive, then everyone chooses, in a sense they vote for what you actually produce down that pipeline. The thickness of it, pressures - - -

MR HINTON: That's why I was exploring the greenfields aspect with you, Trevor, in the sense that if the approach of a regulatory holiday were to apply, which has been flagged by some, that almost by definition doesn't involve any price service offering characteristic. It just says, "Give me a holiday, mate," and then down the track, 15 or 20 years later, I may or may not say, "Now, I would like to go to some sort of price service offering for non-foundation customers." I was really trying to explore with you whether that is part of your model's characteristic.

MR LEE: In essence we're talking about two difference circumstances, because price service offerings is most amenable to a situation where there is more market power or a network rather than a pipeline, where you've got a whole range of customers.

MR HINTON: Yes.

MR LEE: You know, if you're getting down to the point where it's just a regulatory holiday for 15 years then presumably this pipeline is either not that important in the national sense, has got competitors or there are substitutes available in terms of electricity or something else, and you're just saying, "Well, there is no real market power problem here. We'll just take our hands off for the 15 years."

MR BLOXSOM: Can I back that up? As far as a greenfields transmission pipeline - and we listened to Michael this morning talk about the greenfields ones that went in - the actual price service offering is what Michael described as well. In the offering for the price you may get some sort of MDQ levels, you may get late pass to MDQ on certain days, you might get firm offerings, you might get non-firm offerings. It's all part of the offering, which you will pay a price for. What Michael was talking about was no different to what Trevor is talking about, except: what form is he offering? The offering is what the customer requires, for which he is willing to negotiate a price. So it can work down to a small offering, or it can work out on a raft of offerings. Some of those offerings are specific to an individual, to a customer, to an end user. Some of them are specific to a band of customers, or a band of end users.

DR FOLIE: So in essence the PSO is somewhat the equivalent of what the telecommunications industry have had to go through effectively with broadband, mobile phones, these type of things. In other words, there are a variety of options to industrial customers to domestic ones. There are then wholesale resellers, et cetera. Is this the sort of model, that style of model, where there is a service and all sorts of other sub-tariffs, the sort of options you might select?

MR LEE: The Australian Communications Authority are very interested in this price service offering approach.

DR FOLIE: So this is more innovative, if you like, than is done at the moment in telecommunications, for want of a better - - -

MR LEE: Yes, when they became aware that we were interested in this and have been developing over the years, they saw us in May and basically said, "This is the sort of thing that we're trying to develop more in our industry." Quite frankly, I know nothing about telecommunications, but the guy came and said, "This is really what we're trying to do there," and he wanted all the details of how the whole structure of price service offerings is constructed, and we showed him.

DR FOLIE: So presumably some of - reading in your paper that the idea that you then have consumer groups or where you have - - -

MR LEE: Absolutely.

DR FOLIE: - - - in other words bands of groups, and you're consulting with them and trying to put all of that together. That's a very challenging ask.

MR LEE: That's exactly right. Prof Littlechild is something of an expert in that. He has been advising groups in a number of American states and Canadian provinces on precisely that. His only problem with price service offerings was how you form these groups and how you decide which option is going to be preferred over some other option when you can't discriminate in terms of your service delivery. You can often discriminate in terms of service delivery by saying, "You will get a Mercedes-Benz, you'll get a Holden Commodore, you'll get something else." You can do that with a whole raft of things and, as technology improves, you can discriminate more and more and more, because you just understand your network more and technological developments allow you to do that sort of thing.

But at some point there will be losers as well as winners, as in any market I have to say. We all go and buy things. We're all getting a bit older, and I know a lot of the things that I like are no longer made, so everyone loses in markets. But also it's true, for having those community groups - how do you balance the different interests between them? That's what Littlechild was interested in. How to sort out a democratic highest indifference curve on the consumer, if you want to talk in those terms, to make sure that you were maximising the benefit to consumers.

DR FOLIE: That's what struck me. It's pretty avant-garde and may be difficult with - - -

MR LEE: It's certainly avant-garde. It's what markets do. It's avant-garde to regulators, but not to markets.

DR FOLIE: Anyway, it's just worth teasing out that it is a fairly innovative way of actually trying to overcome the issues that we're dealing with.

MR LEE: That's all it's doing; is trying to replicate a real-world market. That's all it's trying to do.

MR HINTON: I would like to take up the Queensland circumstances that you've picked up at - I think it's about page 13 - of the nature of the sector in this state. Certainly Australia has a mixture of experiences in terms of the nature of the sector across different states, but for Queensland you note that a significant part of the gas demand comes from very large industrial users, and reference to the sort of market power, or even countervailing power that those users might have, in terms of negotiations with the provider of the gas and the transmission system associated with that gas. However, an alternate view could be put, and the mind of a regulator could argue that large industrial users dependent upon gas coming down a pipeline are in fact captive customers, and countervailing market power might be less than real. Do you have any reaction to that sort of mind-set? They can't go anywhere else.

MR BLOXSOM: They can go other places. You know, at the moment you would say the majority of them can use electricity, they can use coal, butane, depending on what level of industrial customers you're talking about. So if you're talking about a power station, you're talking about a refinery or you're talking about an industrial customer that wants heat to run a boiler to generate steam, they've got the options there now. The distribution gas network in Queensland is probably less than one-tenth the size of the electricity distribution network.

The gas customers in Queensland, and I'm talking about the majority of gas customers, not the large-end ones, are probably, again, far less than one-tenth of electricity consumers. The laws governing the installation of networks for gas, as compared to electricity, are different. Gas is still a fuel of choice, and very much a fuel of choice, in Queensland. There is not a major driver for customers to use gas - the majority of customers.

MR HINTON: But if you're a large industrial user, let's take an electricity generator, wouldn't the cost of converting from gas to coal be prohibitive?

MR BLOXSOM: It's normally the other way around. It's a cost of converting from coal to gas.

MR HINTON: I'm talking about if you're an existing customer, taking out gas, then the power that you might have, because you're a large industrial user, would seem to be constrained significantly by the available alternative options of that energy. That was the hypothetical I was discussing.

MR BLOXSOM: And there's not many alternative options as far as where they get the gas from because 60 per cent of the gas sold into Queensland is sold by producers, and sold by one producer in particular.

MR WHISH-WILSON: I think the large customers on our network are of the size that they can move plants, so they are not the large electricity generators or things like that which are going to be there for 20 years. We've actually had a lot of customers close down plants and amalgamate in the last couple of years just because of that - they are all that medium size. They are still on our load, but we're talking 50-terajoule customers, 100-terajoule customers maximum.

That's very small for a southern state but it's big for us up here. Also we have a transmission pipeline running through the middle of our network, so you actually find that's another countervailing power with our large customers because they can just go, "Oh, we'll just build our own pipes and transmission; it's just one kilometre down there." So that's another force that means we always have to be supplying them at the best price we can give them. With other fuels, we have had examples in the last 12 months where a customer has actually said, "Is there any opportunity of giving us a lower network charge, because we're considering butane as a long-term alternative?" Things like that - there have been examples.

MR HINTON: These are the issues that touch on market power.

MR WHISH-WILSON: Yes.

MR HINTON: That's why I'm exploring them with you, so thank you for that elaboration. I'd like to move on to an area you put some weight on in your written submission. We're looking at pages 14 and 15 with regard to ring fencing. I'd welcome your comments at the hearing this morning on your experiences with the ring fencing requirements, because you certainly make some strong statements in your written submission.

MR WHISH-WILSON: We have no problems with ring fencing in itself. We just find, being a small network - and you'll see from our examples, the code is not clear with the treatment of ring fencing. It has allowed regulators to vary their approach and we just - you'll probably hear from investors similar to us up here in Queensland, we feel that for the size of our network the ring fencing obligations are quite onerous. I think our point was that other jurisdictions have just required notification that ring fencing has been complied with, things like that, while up in Queensland the regulator has taken the opportunity under the code to ask for further guidelines and things like this.

MR HINTON: Reverse the onus, so the onus is on you to show that you are complying as opposed to saying that you're complying and for the regulator to check whether you are complying?

MR WHISH-WILSON: Yes, and it's - considering the level, I think we have to do an audit, et cetera - - -

MR LEE: I think it's got to be understood in the context of what happens in electricity because the ring fencing requirements there are extreme and in a sense Energex has reorganised its whole internal structure to comply with ring fencing. So our holding company, a lot of companies lying off the bottom of that, coming back to the holding company, they're all severely ring fenced. Those rules and the requirements for us to comply with them are extremely strong in electricity. The problem we have in gas is that immense burden of administration and compliance is now being shifted from electricity - which you can argue is fine - to gas, which is for us a very minor matter, or relatively minor matter.

So the cost to the gas part of the company of having to comply, the same way as we comply in electricity, becomes a big burden. We have to do big ring fencing reports. The intrusion gets more and more. We have intrusion into the regulatory accounts into the gas part of the business, which is extraordinary. You have to say, well, where are the costs and benefits of all this? It's costing Allgas a tremendous amount of money to comply with ring fencing and other requirements but, given the size of the business, it's just nonsensical. It's really a problem.

MR HINTON: So if I hear you correctly, you don't disagree with the need for a ring fencing system, but you question the forensic nature of the way the Queensland regulator seems to be pursuing it under the Gas Access Regime.

MR LEE: That's right.

MR HINTON: That is, costs relative to the benefits associated with that sort of forensic approach. You particularly refer that experience, relative to the experience in some other states?

MR LEE: Exactly right.

MR HINTON: Well, a related point, and I think your written submission goes on to pick it up, is this question of associate contracts. You think the same culture there is occurring with regard to the attitude of the regulator and your relationship between Allgas and Energex Ltd, your asset management agreement. You refer to that. Can you elaborate on that?

MR WHISH-WILSON: The issue here is, because of our structure, we're trying to do an asset management as an owner structure in Energex. The contract to be put in place is simply for Energex to manage the network for Allgas and Allgas to be the owner. Because Allgas is a fully-owned subsidiary, it's an associate. The regulator under the code has asked to see this contract and to - whether to approve it. The issue for us is, for us not to do that - we do not think it's appropriate and for us to actually avoid going through this process for approval of this contact, we'd actually have to change our structure, which is nonsensical. If we just absorbed Allgas back into Energex, of which it is a fully-owned subsidiary, this would not be an issue. It's simply an interpretation of the code and that's what we just want clarified.

MR HINTON: Isn't it germane to the issue of vertical integration, though - that is, an asset management contract can be very wide-ranging in its application I would have thought. I'm being a devil's advocate here. In terms of the approach the regulator might take, if the regulator has an obligation to ensure that there are properly in place ring fencing arrangements, prima facie it would suggest that they would need to look at Energex' contract with Allgas on asset management.

MR BLOXSOM: I think you've touched on it, because in the code it falls back into the ring fencing provisions and really the ring fencing provisions there are to make sure that you've got a competitive market. That's to do with the delivery of gas so that you're not giving a benefit to another portion of your business - eg, a retailer over another retailer. In setting up an asset management contract, it's not part of a competitive market. It's not going to have any impact on whether one retailer gets a better deal than another retailer.

What we're trying to do out of it is to get the synergies from having electricity and gas people working together and for one owner, just like Agility does, just like Origin Energy asset management does, we're trying to get the benefit of that. At the moment it doesn't stop a competitive market or it doesn't limit a competitive market and it doesn't fall within - it shouldn't fall within the ring fencing provisions.

MR HINTON: Thanks. You've taken that up with the regulator?

MR BLOXSOM: It's just another cost. At the moment, the need in Queensland is to extend the gas network so that people have the benefit going forward on choice of electricity, gas or a combination of both. It also allows for the future. Where is the future going? We're looking already at microturbines. We're already looking at ceramic fuel cells, of hydrogen fuels, which is going to bring the two networks together sometime in the future, or it will change the structure of the networks. What we need to be able to do now is to understand that something like that is going to happen and look at: how do we grow the network in Queensland, considering the difference in climate? The networks in the south have grown, and the same in America and those places; they've grown on the basis of heating. So how do we grow that network - eg, investment. At the moment, all we seem to be doing is spending money as a result of trying to comply with the access regime - eg, the Gas Code. There's no benefit. The customer doesn't get any benefit and eg, the communities don't get the benefit, because we need to grow that network. That's what the community needs.

MR HINTON: Related to that is almost a prior question - that is, the sector today, the gas sector broadly defined, is in some minds quite different to that which applied back in 96-97, when the Gas Access Regime was being designed and implemented. Two questions then become: do you agree that the sector has developed, and secondly whether or not that change in fact does represent another reason why the

Gas Access Regime does need to be modified to reflect those developments, or is that particular market development irrelevant to the question of the provisions of the Gas Code?

MR LEE: I think what's got to be understood is that Energex as a company is a very different animal to the one that existed back in the mid-1990s. You know, in some respects I think the criticism that there's a sort of Fortress Queensland attitude probably has some foundation. Probably the criticism that all we get is "You are supposedly a Queensland icon and the only interest you take in consumers is, you know, in the sense of, you will take what we deliver. That might have been true up to the mid-1990s and, to some extent, I think that's the way things operated before that first phase of reforms. The Gas Code was designed to deal with that situation.

But things have changed. Energex at least is a totally different animal. We've changed in internal structure. We operate nationally now. We're competing with other companies, the whole range of energy markets right across Australia. It's not defending Fortress Queensland. It's out there competing across all those different markets nationally and, indeed, we even do a little bit on the international side, too. There's another bit which is, you know, the internal structure of Energex has changed and the internal culture has changed. A lot of the old school have gone, quite frankly, and there are a new breed of people have come over in the last eight years. The focus is on customers, what we can deliver to you, the best possible way, exactly what you want.

Our problem is that the regulatory regime stops us doing all those things. It stops us competing nationally. We would have moved in Victoria in a much bigger way if it wasn't for Victorian regulations and price controls down there. We'd have done many things but for the regulatory regime. Electricity, we put up a price service offering to the regulator here, a price service offering that was agreed by our customers, had supporting letters from community groups and all the rest of it and it was rejected. We can't do the things that our customers want because of the regulatory regime.

As I said before, you link that with the determinations that come to a WACC to two decimal places, when regulators who have got no idea where the true cost of capital is, and we're expected to invest an awful lot of money to satisfy our customers on the basis where we might not recover the true cost of our capital, even, and we can't do the things that we want. So we think the code was designed for a situation that may well have existed up to 10 years ago or eight years ago, but things have moved on. Energex is certainly a totally different animal from those days.

DR FOLIE: I'd like to go back to - it's mentioned in your presentation but I don't remember seeing it actually in your submission - one of the alternatives to positive service regulation - which is effectively what we've got at the moment - is total factor productivity. What are your views if that got currency and that was replaced with the cost of service?

MR LEE: We fully supported total factor productivity up till about 18 months ago as an option; not as the best one, but as an option. But internally, in the industry - I'm talking about gas and electricity - we had internal seminars on that. At the end of the day, frankly, it was only CitiPower that preferred it out of all the companies at that stage, both gas and electricity. Others thought there were just better ways of doing things. What we didn't realise up to that point is that there's another way to interpret total factor productivity. The pure form as applied overseas is basically where you just have the industry average productivity of the last three years, say, driving forward, being the driver on companies to perform against in future. In other words, what's already been achieved by the industry average is your X going forward. There's a total disconnection between costs and prices. So once you start off and prices where they are, you have the TFP driving you forward.

CitiPower wanted that. Most other companies just thought, "Well, it's just too narrow." It's not getting into all those other goodies I've talked about. But then 18 months ago we had the utility regulators forum have a particular consultant, which I won't name, doing an analysis of total factor productivity. What they've actually come out with is a building-blocks version of total factor productivity. In other words, what we have is no disconnection between prices and costs and no other goodies; but what we have is building blocks to start with and building blocks every three or four years to come back to.

When you start to analyse that, there are a couple of things, quite apart from the very narrow limit of the regime. What it in fact does is penalise the efficient, both at the start and during the period. If you're an efficient company, relative to others, then you start off at a lower price. Why is that? That wouldn't happen in a market, if you started off at a lower price. Then you are driven by an industry TFP, where the poor performing companies will obviously get a benefit. They start off with a higher price and they can drive that TFP down faster than you can; you're already on your production possibility funding, or close to it.

You, the efficient company, are getting screwed by a TFP that's determined on average. So you lose both ways. So why would you want a regime that penalises the efficient? As soon as that utility regulators forum idea came up we went from an ambiguous attitude to TFP to one violently opposed. The industry will not wear a TFP approach of that sort, I can tell you.

DR FOLIE: This is on the same line of forms of regulation - I have some difficulty in understanding if you did basically the PSO you still may be subject to some, because that doesn't actually overcome the regulatory issue. It would then presumably be subject to price monitoring, or some such level or general monitoring. As you show in your chart - they are two separate entities.

MR LEE: No, no, no.

DR FOLIE: Which effectively under that, because how do you - how does one then sort of know whether the competitive sort of overall environment - - -

MR LEE: It is very hard to describe PSO in detail, because it's a very complex thing.

DR FOLIE: Yes, I don't want to go back over all that again.

MR LEE: But be assured - - -

DR FOLIE: In trying to differentiate between the two - - -

MR LEE: Absolutely.

DR FOLIE: Just to be clear at least on that.

MR LEE: Absolutely. Please be assured that on each of those three cars, if you like, embedded into that delivery is benchmarking, where you are delivering the Holden Commodore - if that's what you picked - at the most efficient way and price. The Holden Commodores will be delivered anywhere in the world.

DR FOLIE: Right.

MR LEE: There is a benchmarking part of the option that says there can't be any abuse of market power, there can't be any inefficiency. This is the best way of doing it. You do that by benchmarking. It's not a question of the regulator monitoring things, because what would happen would be a regulatory contract between - a tripartite contract between a regulator, the customer and us, the service deliverer that says, "We will deliver this Holden Commodore with these improvements over the next four years to you." It's a contract, like the undertaking that the gentleman spoke about this morning; we can even put it in to the Federal Court as an undertaking - that we will deliver these improvements at these prices, all benchmarked, as the most efficient there is over this period. If we fail, we pay a penalty.

DR FOLIE: Is the regulator then a part of the negotiating process.

MR LEE: Absolutely.

DR FOLIE: So it's a bit like the South Australian regulator - said they would like to actually work as they go through in any sort of tariff setting, if you like, or price-setting thing they like, at an early stage to be involved and they are - if you like, they are a player as well.

MR LEE: Absolutely.

DR FOLIE: So you say you'd actually capture the regulator and you'd all be in there separately moving along together.

MR LEE: Absolutely. The regulator, when he's going through that process, has all those objects clauses in his mind, about perfect competition - sorry, about work competitions - those criteria. He says, "Right, is this thing efficient?" - because that's one of the criteria I put up. "Does it satisfy customers?" That's another one. "Yes, they're satisfied. That's what they want." Right - he ticks that one off. "(2) is it innovative?" "Yes, this is the best bloody Holden Commodore I've ever seen anywhere in the world; it's got all sorts of things that customers want. In fact, it goes beyond what they even expected." Technological change - tick that one. Efficiency and all those other things I've mentioned - right, that's what he goes through in his mind saying, "This ticks off against my workable competition criteria." It's replicating a real world market.

What he does is look at the benchmarking, because the benchmarking reflects what rivals do. Rivals will beat you sometimes. This is always designed to be benchmarked, so you are better than your rivals, but after three or four years there might be a breakthrough in America or somewhere else has got some better idea of the Holden Commodore. So then he says to himself, "Ah, I know about that. That's what a rival would have done in this period. You've got to put that into our option next time around." So you are always on the frontier - you're always pushing the frontier.

DR FOLIE: He is an insider on all these and basically then he is using his inside knowledge to push.

MR LEE: That is why the regulator has got to get out of his mind this cost-of-service WACC stuff and get on to emulating what a real world market does - different skills, far more interesting than WACC stuff.

MR HINTON: But the model this morning, in the first session, had a transparency to it as well; that was a full disclosure of contracts and - as I asked them, I'll ask you: does this not raise a tension with regard to commercial-in-confidence considerations? Not at all?

MR LEE: The tripartite contract that we've signed - the three parties would agree to - would be open to anyone to look at.

MR HINTON: Let me ask you about NGPAC. The new institutional framework we might have down the track, of course, may be a little different to what we have got today, and you alluded to that with regard to other work that is going on in other fora, but have you had direct involvement with NGPAC and, if so, can you give any comments on it?

MR LEE: This is the method, you're saying, on deciding on co-changes?

MR HINTON: Yes, that's correct.

MR LEE: Is this the matter that you - - -

MR HINTON: Yes, the consultative body that has both regulators, industry and officials involved in an advisory body that seeks to look at possible refinements to the code. The existing Gas Access Regime does have machinery designed to facilitate refinements.

MR BLOXSOM: To me, it's just like if I run a company I would want the right number of directors with the right experience. To me, NGPAC should be run exactly the same, and today it's not, so it will never come to any decisions of any materiality, because there are too many people involved and they all have differing opinions of what should happen. So maybe a single regulator and a new structure associated with a new regulator would help NGPAC, but I think it needs restructuring altogether.

MR HINTON: Thanks for those comments. We're running out of time, but is there any item or issue that we haven't touched on that you'd like to particularly emphasise in this morning's presentation?

MR BLOXSOM: Just the size of the network that we have here in Queensland, relative to electricity, and because of the geographic location up here, we don't have the drivers that belong to networks in the south. Also, the cost of gas up here compared to the alternative forms of energy - electricity - it needs a stimulus to be able to grow the network here. I don't think that stimulus is coming out of the existing Gas Code.

MR WHISH-WILSON: I think, following on from that, you could probably ask why we haven't applied for revocation - because of the situation - well, we have considered it, but I suppose what has been holding us back is the issue on whether the NCC considers energy competition - that seems to have been a stopping point for us, and we thought now, with the review of the Gas Code we'll put this off until we see what comes out of this.

MR HINTON: You think the NCC should be making judgments about the energy sector as a whole with regard to competition policy and market power? Is that right?

MR WHISH-WILSON: I think they seem to have disregarded those arguments in every revocation decision I've looked at. Yes, it is - plus it's vital, as Tom said. Costs up here - we are really much higher priced than a lot of the energy substitutes, so it is very competitive.

MR HINTON: Thank you very much again for your presence today, your participation in the inquiry and your written submission. We look forward to further contact down the track. Your input is appreciated.

MR LEE: Thank you.

MR HINTON: .... name and representation. This is an established process for the Commission. It doesn't always get accepted and as no-one is jumping up with enthusiasm I will now adjourn these proceedings with the note that we will resume on 18 September in Sydney. Thank you very much.

AT 11.56 AM THE INQUIRY WAS ADJOURNED UNTIL
THURSDAY, 18 SEPTEMBER 2003