INDEX

SPARK AND CANNON

Telephone:

Adelaide	(08) 8212 3699
Hobart	(03) 6224 2499
Melbourne	(03) 9670 6989
Perth	(08) 9325 4577
Sydney	(02) 9211 4077

TRANSCRIPT
OF PROCEEDINGS

PRODUCTIVITY COMMISSION

DRAFT REPORT INTO GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT BRISBANE ON WEDNESDAY, 24 MARCH 2004, AT 9 AM

Continued from 19/3/04 in Melbourne

MR HINTON: Thanks, good morning and welcome to the public hearings 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 Treasurer in June 2003 and covers, in brief terms, the following six matters: first, the benefit 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 finally the appropriateness of including in the gas code minimum requirements for access to users such as price and non-price requirements.

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

We like to conduct all hearings in a reasonably informal manner, but 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 the Commission staff here today. Submissions to the Commission for this inquiry are also available on our web site.

To comply with requirements of the Australian government's occupational health and safety legislation, I draw to the attention of all those attending here today the emergency procedures if the occasion arises. There is a standard alarm system and fire exits are located at both ends of the corridor, out through the door behind you. The assembly area for evacuation is on the footpath on Wickham Terrace between Twine and Lilley Streets.

I would now like to welcome our first presenters for these hearings here in Brisbane today. We've got Mr Michael Cavell, Mr Peter Clarke and Mr Max Kimber representing Enertrade. Welcome, and to set things in motion I'd be grateful if you could make an introductory statement before moving to question and discussion session.

MR CAVELL: I'll be brief but I'll do that. First, just to put in context who is here, Peter Clarke is the general manager of legal and external affairs for Enertrade and Max Kimber, who will be appearing on his own behalf soon, is a consultant to Enertrade in the development of third party access principles to be applied to the new pipeline that we are building in North Queensland. So Max is intimately familiar with the approach that we've taken to third party access.

I'd like to open by commending the commission and its draft report on what I think is a courageous but critical recognition which is that the existing Gas Access Regime with the full cost of service regulation force behind it has been a deterrence to investment and to activity in the gas pipeline sector. In our initial submission we suggested that there should be an approach to regulation that allows for a more light-handed approach and we commend the commission on its recommendation for a two-tiered approach. We may have some practical issues associated with that, but in concept we are absolutely 100 per cent convinced that there should be two tiers, there should be a light-handed approach and that in fact that light-handed approach is critical to the development of gas infrastructure going forward.

The niggling issues we have associated with it have to do with principally two areas - and I'll address those fairly quickly. The first is that the proposal from the commission has a distinction between the two approaches that we think will be difficult to administer, the distinction between a material effect on competition and a substantial effect is one that will be difficult to have clear standards about and as a result is likely to result in some confusion about when the two regimes should apply, and we would recommend that the distinction between the two be based more upon not so much the existence but the abuse of market power, that the light-handed approach should be the preferred approach, the approach that would be applied in almost all instances unless there's a demonstrable case where the service provider has abused whatever market power they may or may not have, associated with their asset.

This does two things: (1) it requires potential users of the system to spend the time to determine if they can get access on a negotiated basis and second, it focuses the heavy hand of the cost of service regulation only on those service providers who have demonstrated an unwillingness to provide third party access on a commercial and negotiated basis. The second niggling point that we have has to do with who makes that judgment. In our view, the monitoring of the light-handed regime should be performed by an independent party and not by the regulator himself. Our view is that the regulator will have a natural bias and not being critical with that, but a natural bias towards the more heavy-handed and the more control-focused cost of service approach, and that given any opportunity to exercise that, that they would have a natural tendency to do so. As a result, our view is that the preferred audit or monitoring of the light-handed performance of the service provider should be done by an independent auditor. That could be a KPMG, a PWC or just about anybody who has any experience at all associated with infrastructure assets.

Having said that, again I would like to commend the commission on the recognition of the need for the two-tiered approach. I'd like to make an offer. We at Enertrade, as I noted, are in the process of building a pipeline that goes from Moranbah to Townsville. It's a pipeline that we intend to have full third party access to and the reason s for that are because our commercial interest is supported by greater usage of the pipeline. The pipeline is being built with excess capacity. Some of the challenges associated with the current regime, as you know, are associated with the existence of excess capacity and assets. We're building one that has excess capacity.

We're offering third party access through published principles that we expect will be published by 1 April and the asset construction is just under way at this point. It's not yet published so it's not in a position where we could provide it in our submission, but if the commission is interested in our views on what third party access means from a commercial standpoint we would be happy to make those access principles available to the commission once we publish them on the web site in about 10 days. So with that, I'll open myself to questions.

MR HINTON: Thank you very much for those comments and thank you for your attendance today. But also, thank you for your further submission that directly points to our draft report. We appreciate that substantive participation in this process. Thank you for your offer regarding informing us of those access principles scheduled for release on 1 April. We'd like to take you up on that, thank you very much. We think that that sort of practical experience can have direct relevance to how a monitoring regime might be implemented where, as you know, in our draft report, the key characteristic is one of the service provider offering an access policy for third party access as a key condition of participation in that tier of monitoring and I think my team will be in contact with yours about the 1 April release, I hope.

MR CAVELL: Certainly.

MR HINTON: Naturally your submission raises a lot of issues and you've flagged a couple of them. I'd like to take up a number of questions that have some sort of structure to them, but they might be a little sporadic and move around a bit. So that's the nature of this exercise I suspect, Michael, so bear with me. My first question is in relation to a sort of a broad sector issue and it's in relation to transmission versus distribution. Enertrade has the approach that the new regime should have all covered transmission pipelines in the monitoring tier as a matter of course; that is, it's a default option, not the cost-based price regulation tier that exists in the current regime that would apply to all transmission, and you argue in your submission that this relates to market power and the sort of absence of significant market power associated with particularly the size of customers alone for transmission pipelines.

That is a very interesting juxtaposition with a submission in our hearing in Melbourne last Friday where a company involved in the distribution side of the sector argued the absolute reverse of that. They argued that distribution networks are the ones that definitely had no power and therefore they should be put in the monitoring basket as a matter of course as a default option. But those transmission pipelines, they're big and large and they have natural monopoly characteristics, and so they need not necessarily be put as a default option in monitoring. It was that juxtaposition between Friday and Wednesday that quite struck me. I'd welcome your comments on that, whether you can elaborate further as to your reasoning behind transmission as opposed to distribution.

MR CAVELL: I'm not surprised by the views that they would have. I'm a bit perplexed by the notion that somehow transmission pipelines, which are effectively a conduit between two different markets - the downstream user market and the upstream producer market - somehow has market power that exceeds that of anybody on either of those other marketplaces. In my view the market power that parties have is a function of the diversity of the market, not necessarily the location of the asset. I'm not surprised by the views that they would have. I am a bit perplexed by the notion that somehow transmission pipelines, which are effectively, a conduit between two different markets, the downstream user market and the upstream producer market, somehow has market power that exceeds that of anybody in either of those other marketplaces. In my view, the market power that the parties have is a function of the diversity of the market, not necessarily the location of the asset.

I would say this about distribution: this will sound perhaps crude, but the distribution assets are much closer to voters, if you will, or to end users, and the result of that is often that, regardless of the merits of the discussion about whether distribution assets should or should not be subjected to a heavy-handed regulation, the reality is that they serve consumers who are residential and small consumers in their nature, and we as a transmission pipeline, serve them as the distribution company and that connection or juxtaposition with the small user is probably what drives most of the interest in the more heavy-handed or cost of service approach to distribution assets.

In a theoretical sense, I don't think that's necessary. I think what we're trying to say in our submission is, if that in fact is the case and that the existence of smaller customers for distribution companies somehow imbues them with a greater degree of market leverage or market power, or however you want to look at that particular phrase, let's not drag the transmission sector down with it, because those same principles and issues do not apply in what, as I said, is a conduit asset between two different markets where there's quite a great deal of competition and there's quite a difference in the scale of the customers.

Our customers on the pipeline to Townsville are a power station, a large nickel refinery, a large zinc refinery, a fairly significant set of industrial customers and possibly a distribution company, which currently doesn't exist, and that distribution company, frankly, in the Townsville market, would be a tiny fraction of the size of the marketplace that existed from an industrial and a power generation standpoint. It would be, to me, incongruous to drive regulatory principles around the potential for a distribution asset being connected to it and having that, effectively, flow back upstream into a more heavy-handed approach to the transmission pipeline.

The other thing I would say, that as a general principle in our access principles, it precludes us from discriminating based upon volume. There is a natural tendency, if you will, to negotiate more effectively with larger customers than with smaller ones, but what we have done is we have said that those larger customers will in fact establish the market and that we will offer those same terms and conditions to any other customer, regardless of their size. The purpose of that is to ensure that the disparity in size between the transmission pipeline and the downstream user does not become a factor in the negotiation. So that, in reality, when we negotiate with the Mount Stuart Power Station for an outcome, that same outcome would be made available to the distribution company.

There are lots of nuances in the types of services that they require and the quality of the service and the load factors and things like that, but broadly the principle is that they would have the same market power because they could, if you will, piggy-back on the negotiating power of the larger customers. Whether that is crucial to an access regime is probably a matter of some debate, there would be those who would disagree with that, but, for my view, that is the one reason why I am convinced that customers on the transmission pipeline all get the benefit of the negotiating power of the larger customers, and that is fairly significant to what I would consider to be true non-discriminatory access to the pipeline.

MR HINTON: Thank you for that. There is a public policy aspect to this as well. You have been discussing the distinction between distribution and transmission, but if you're going to have a new regulatory regime - or at least, a modified regulatory regime, prima facie it would seem to be sensible to apply the new criteria on a case by case basis to bring rigour to the outcomes as opposed to generic category shifts , like putting all distribution - or for that matter, all transmission pipelines, into the monitoring bucket and/or tier.

Prima facie, it would seem sensible to test that new modified regime on a case by case basis such that each particular infrastructure is assessed against the criteria and then put in the tier appropriately, and that would bring transparency, accountability and rigour to the application of the new or modified regime. Does not that seem to have force, if we're going to move from where we are today to something that is different down the track?

MR CAVELL: I can't disagree with that. The only caution I would have is there's not a lot of experience upon which to base that judgment and that, as a result, when you enter into the discussion of "Well, which basket should this asset fit in?" if it's largely theoretical and it's largely based on notions of market power that are, "Well, this is a natural monopoly, therefore it must have market power" it's difficult to make that judgment in a real context unless there's some experience.

If the desire is to establish an experiential base, I would recommend that you start that with a light-handed approach and the presumption that there will be a set of behaviours that would be applied and monitor those behaviours as opposed to presuming that we have to start with the more heavy-handed. But I agree it would tend to be - it would almost have to be, a case by case judgment and I can't argue with the principle of that.

MR HINTON: Let's move to the monitoring system itself and its operational aspects. Your submission expresses concern that monitoring by its very nature virtually defaults to cost-based price judgments and therefore by definition becomes quite intrusive, resource-demanding, of the very sorts of things that the intent of having this option was to get away from - that style of regulation, intrusive costly regulation. I am a little unclear as to why you so quickly moved to a concern about monitoring by definition being intrusive and needing to be cost-based price evaluation an therefore intrusive.

MR CAVELL: I guess I am trying to be practical and recognise my experience with regulators. Probably - if I were a customer - I will try to put on a customer's hat, I'd say that "The biggest measure of whether or not you're exercising market power is what you charge me, therefore the measure of your abuse of your position will be in your tariff," and if in fact it will be in the tariff, how do you measure in the abstract whether a tariff is in fact a market price or something else.

Attempts at value based regulation, attempts to find different ways to get to a tariff, all lead you back, effectively, to the same place, which is, "Well, what is the cost of providing the service?" and there's, arguably, therefore the potential for excessive profit in that tariff. Any regime therefore that says you have to measure the difference between these two some way will migrate towards a price-monitoring regime by definition. What we're trying to encourage is an audit process based on performance. In other words, we state in our principles that we will behave in a certain way and we will keep records that we have behaved in that way.

So if, for example, we say we will have non-discriminatory pricing and when we complete a negotiation we will post that and we will actively offer that to other parties, we would propose that the performance of that behaviour is what should be monitored, not just price, and that any time you come back around to just price, what you're going to do is you're going to say, "Well, I have to know what your costs are because I can't tell if you're charging too much," and in that regime it's a slippery slope that quickly leads to a judgment of whether or not your tariff is realistic based on the same principles that apply in a more heavy-handed regime, and the end result is you end up back there because that's where it leads you.

The performance or the behaviour based regulation is probably more difficult because it is based on principles and principles of behaviour in the marketplace that say, "We will act in a way that is transparent, that is monitorable and that acts in a commercial way to offer services to the marketplace, and what we want you to do is monitor those behaviours and ensure that we are doing what we said." We offer then our monitoring regime - to have available, if you will, a financial statement that would be similar to the one that any listed company would file.

If you will, that is a check on, to use a crude term, excessive profit, because in that financial statement, using financial principles and using the actual financial position of the company, you have a means of monitoring, "Is this company doing either too well or not well enough?" and it's a marker, it's one marker amongst many, that takes you away from saying, "Is this tariff the right tariff that you should charge?" Any time you get down to, "Is that the right tariff?" - you are on the slope to cost of service because the is no place else to go with it.

DR FOLIE: If I could just on that, you just said that the classical, if you like, financial statements that you have to provide as a listed company - there is a lot of discretion in how you can actually determine what your cost base is going to be, in that you can revalue assets, you can depreciate them at different rates, et cetera, there's a flexibility. The regulator would say, "We really need to understand what," if you like, "the true economic costs are, so therefore we can't really go along with just taking the normal financial reporting," because the financial reporting could in fact indicate what they would say - the economic profits really could be quite high, but financial reporting can actually show the profits to be quite low. That is one of the debates that goes on, why you can't actually get to being accepted having financial reports the basis for monitoring regulation.

MR CAVELL: That is exactly the slippery slope. We have accounting standards and we have, if you will, reporting standards associated with financial statements, and what the regulator is saying, "Well, they're unreliable because they can be manipulated." Well, I would flip that around and say that the fact that the regulator makes a separate judgment about what is an appropriate depreciation rate is similarly an inappropriate and unreliable standard, and that if in fact what you are going to do is say, "Well, the existing accounting standards and the way companies have to report as listed companies is unreliable, then the conclusion is the only one that comes from that, and that is that I, the regulator, must specify what those standards are."

The result of that is what exists in the United States, which is a uniform system of accounts for regulated assets, that is about 700 pages thick, and that specifies exactly how you're supposed to account for your regulated assets. The end result of that is two sets of books within every company, because they keep one set for financial purposes and they keep a separate set that is designed for regulatory purposes. I have yet to understand why that's an appropriate thing to do and why that's an appropriate cost to impose on a company and why it's appropriate to have that separate set of standards.

So I guess what I would say is I disagree absolutely 100 per cent with the notion that a financial statement is inherently manipulable and therefore is unreliable, because they are not, they cannot be unless you attack the very foundation of the financial regulation that goes along with listed companies. There is always the opportunity for abuse, and in fact with a regulated asset there is always the opportunity for abuse.

If that's uncovered, it's not going to necessarily appear because of how they have reported their financials, it is going to come out in some other way, and that type of abuse is exactly what, in our view, leads to the imposition of a stronger regulatory regime. So I don't think you should make judgments at this stage based on potential for manipulation of financial statements that have a whole different set of regulations surrounding them. I think that's not the right approach to it.

DR FOLIE: It's interesting that your answer is that you're a bit of a lone voice amongst the industry. We don't seem to have had strong representations about financial reporting that could actually sort of be a guide for monitoring.

MR CAVELL: Well, I guess I'm strongly of the view that the financial reports that companies provide as listed companies should be transparent, should be honest, should be based upon the reality of the company's financial position. One of the things that's happening in the accounting standards area that in many ways is a mirror of this is, for example, in derivative trading in financial statements, as you know, the international accounting standards put requirements associated with how you reflect your position on your financial statements when what you've got is a futures position, and how you mark that to market and how does that marketing to market have an impact on your profit and loss and your balance sheet.

Those standards are coming into the electricity industry and at some point will come into the gas industry because there will at some point be a sufficient market for gas that makes it possible to have a futures market and to have some derivatives trading around both capacity and the asset itself. Those standards are going to be extremely rigid and they're all designed around the same thing, and that's transparency and accountability. That's what our access principles are devised around as transparency and accountability for our behaviour. In my view the financial statement the listed company provides is the best and first starting point for that, not a constructed set of accounts that may or may not reflect the actual financial position of the company.

MR HINTON: Could I explore further with you your concerns about the monitoring regime and suggest to you that the starting points are different from what is in the draft report and what you would like to see; that is the fact that you put all transmission pipeline into the monitoring tier means that your starting point is different to the draft report which says, "Let's do on a case-by-case basis with coverage tests applying." A certain test is met then you're in the tier for monitoring. I can understand with your framework, caution about how the monitoring regime might be regulated or might be operated by the regulator in that all the transmission pipelines are there being monitored. They would therefore be concerned about those that had significant market power and would therefore want to watch them in such a manner to ensure that price gouging whatever was not occurring.

But if the starting point is our draft report framework whereby you're only putting those in the monitoring regime that prima facie do not pass the coverage test for monitoring and therefore are unlikely to have much market power then the incentive for the regulator to be intrusive is much less powerful. I agree there's still a concern there could be regulatory creep. To address that we put forward the idea that we would prescribe, define and set down in some detail how the monitoring regime would operate. It would be trend information, it would not just be price, it would be behaviour. I was hoping that sort of framework and that sort of structure would ease your concerns about the tendency of the regulator to become, by default, quite intrusive.

MR CAVELL: It does. I guess my concern is based on two things. Let me pause just for a moment. What you're suggesting is not different from what the federal regulators in the United States did with their open access and their desire to encourage pipelines to move to open access. They published an order and it was order 436 initially that said, effectively, "If you do the following and you have open access, and these are the principles that that includes, then we'll provide certain other benefits." You'll have access to, for example, an opportunity to a transition mechanism to deal with the existing gas supply agreements that you have which may or may not have take or pay provisions in them. They try to use the carrot and stick to encourage pipelines to move.

If what's at the core of what you're talking about is something that says, for example, "This is what we think is the appropriate way - or a way - from a broad principle standpoint to have third party access - and if you voluntarily do that then we would have a tendency or we would look favourably upon that in terms of a more light-handed monitoring regime." I think there's real potential from that. If what it is is instead a bit more abstract, I think what's going to happen is the same thing that happened with section 8 of the existing access code. The original access code was supposed to be a negotiate-arbitrate model with last resort to cost of service regime, and within the first one or two opportunities it was a full-fledged, absolutely unequivocal cost of service regime.

About six months before that occurred I spent some time with Alan Asher and his staff trying to talk about different ways to impose, if you will, a regulatory oversight short of cost of service and I was flabbergasted to find that there really was not a receptive ear to that. I mean, the objective was, how fast can we get to a full cost of service control regulation. When I encountered that on the Eastern Gas Pipeline I was staggered to find the NCC taking the view - and with the support of the ACCC - that they thought that the Gas Access Code was supposed to be a universal application to pipelines. They were all supposed to be covered and the default was coverage.

They advocated that in proceedings that led to ultimately the decision by the Competition Tribunal. But the mindset was clear, despite the words of the National Access Code that said, "If you get into it you use section 8." Section 8 became the guiding light for regulation. So my experience here is that this particular group of regulators will seize whatever control they can and will do it aggressively unless there are clear boundaries that say you can't do that, and that those boundaries are clearly reviewable. If that's the case - and as I said, if there's a clear set of standards that says you can't just move there, and here are the kinds of things that will keep you away from that - and that's reviewable then it can work. But it's a risky game to place that decision in the hands of the people that want to impose the more heavy-handed cost of service control.

I don't know whether the culture there has changed much but I was very stunned to find the notion of universal application and universal cost of service - and that appears in user groups applications, that whole proceedings was stimulated by a party who had never sought access. I mean, the whole circumstances surrounding that said, "What we're trying to do is get the cost of service," and unless there's a clear boundary that says you can't do that and that that's reviewable I think we're on a slippery slope.

MR HINTON: Thanks for the elaboration. Still on monitoring, your submission expresses concern also about whether or not the monitoring process would have characteristics that would influence commercial behaviour in the sense of ensuring that specific needs of customers would be met by the service provider. You seem to suggest that monitoring itself might not be a framework that can ensure - appropriately cover behaviour of the service provider in the desired direction. That puzzled me a little. I would have thought that the threat of wrong behaviour leading to shifting after five years from the monitoring tier to the cost based price regulation tier, would be a powerful incentive, or at least a disincentive for inappropriate behaviour in that period of five years of monitoring. There is a trade-off here in terms of how intrusive the monitoring is in terms of how powerful it is, but I'd welcome your comments on this area.

MR CAVELL: I'm a bit confused because I agree with you that I think that is a powerful incentive for behaviour, so I'm not entirely sure what comment you're referring to in our submission. I'll see if I can find it.

MR HINTON: Page 6 was my reference. If you're not disagreeing with my formulation we can move on.

MR CAVELL: I think that the point we were making here had more to do with who does the monitoring, than the point you were making. I agree with your point, I think during that monitoring period the incentive is to stay in the monitoring period and that's pretty powerful. The fact that they're there indicates that's where they want to be. So I agree with your view on that.

MR HINTON: Let's pick up your point about who would be the entity, which entity would be the monitor. It could be argued that the last thing this sector needs is another regulator in either form it takes; that is, now we've got NCC coverage, ACCC or state based regulators with regard to the day-to-day regulation of the regime and then you've also got a whole range of tribunals and review processes. Now you're suggesting another body called "the monitor", whether it be an independent arbitrator or an independent monitor, whether it be commercial or whatever. Isn't this, prima facie, of concern that we're going to add another sort of structure institutionally to this system?

MR CAVELL: Actually, what we're suggesting is an independent auditor. The monitor of that report is likely to be the existing regulatory regime who reviews the report. It's more a matter of who actually does the audit of the behaviour and what are the standards under which they do that. That's no different than independent audit that you get of your financial records. In that case it's the shareholder who makes a judgment about whether or not the financial statements are appropriate, along with ASIC and others. But in this case the independence is that the company would procure an audit from an independent person and that audit would then be a publishable report that would be made available to the regulator to make their judgments from.

DR FOLIE: But doesn't than then lead to - we have all the problems around the corporations and the roles and duties and the discharge of the duties of auditors. There's a lot of debate that - even though a set of audited reports can't really get into the intrinsic detail of the management. In fact when they write their audit report they qualify it. We can only do this on the basis of the information given and detailed workings of management, et cetera, et cetera. It seems difficult to believe that, if you like, a highly political and complex regulatory process would hand itself over to monitoring the companies under that style of regime with a more detailed sort of - - -

MR CAVELL: I have to acknowledge that this isn't necessarily the best audit environment in which to make such a recommendation, given some of the events of the past. But if you start with a presumption that somebody is going to try and cheat and the auditors are going to have a hard time getting the information, then effectively you've conceded that this is not going to work because if that's the presumption that all these companies are going to try to find ways around this and they aren't going to seek to follow their commercial interest and get as open and efficient use of their assets as they can, and when they say they're going to be monitored - I mean, there has to be at its core some element that there's trust, that that's what they're going to try and do. Yes, an auditor only has access to the information that's provided to them but that's true in any environment where there's an audit.

If there's a desire for abuse, the auditor is not necessarily going to be able to uncover that. If the presumption is there will be abuse then probably the answer is "impose full cost to service regulation" because that's really - in your regime - the only reasonable answer to the presumption that there will be abuse. It's similar to the argument about the theory of market power versus the actuality of market power. The term "natural monopoly" is a dangerous term because the implication of the term "natural monopoly" is that there is market power that exists and it will be used, and there's a string of assumptions behind that about the behaviour of the individual or the company that happens to own that asset, that I think are an inappropriate set of assumptions. That's the reason why we we're suggesting that if abuse exists, that's when you take the next step. It's the abuse that triggers it, and that you have a presumption that there won't be abuse and you set up a system to monitor that to ensure that there isn't. That's similar to what happens with financial statements and you kind of, if you will, you trust that the companies will behave with integrity.

I don't have an answer beyond that and I agree that to suggest that auditors are somehow infallible - because they're not - and their accessed information is limited to a certain extent but if you specify what you want them to audit and you specify the kind of records that are required for that, if they're not getting it and their audit report says, "We're unable to get access to these things," I'd say there's grounds for further investigation. Further investigation could lead to uncovering an abuse that could lead to a change in the regime. I certainly wouldn't want to have a further investigation if it was my asset.

MR KIMBER: I think I could perhaps draw a parallel to the technical side of the pipeline industry. All pipeliners are governed by statute, such that they have to operate according to a particular Australian standard, and be built and operated and ultimately abandoned according to a particular set of rules. They've been accepted by governments, and governments also accept the reports of independent auditors to determine compliance with those particular set of well-known standards, and they are really quite complex and include lots of risk analysis, and in effect the technical side of pipelines is managed on a behaviour-monitoring process with annual reports from auditors who determine the quality or otherwise of the compliance of the pipeliner to a particular statute which calls up then an Australian standard. So we're really no different in this case. We're calling in an independent auditor to report to customers and governments that the company has performed according to a set of standards that have been agreed to.

MR HINTON: Actually you've diverted my attention to another submission that will be heard later in the week about the technical specifications. It's been put to us that while there is significant force for a national technical standard for pipelines, it's been put to us that that hasn't been delivered. I know this is a diversion a little from where we've been going with regard to monitoring regimes but - - -

MR KIMBER: It's certainly like the point that I make in my submissions.

MR HINTON: Let's come up - the next session will explore that further. You're put on notice for that topic.

MR KIMBER: I was simply drawing the parallel here that we have a technical audit. Companies have run with audit rules for many years, for centuries. Auditors have been known to be fallible, known to be able to be hoodwinked but is there any reason to throw out a tried and tested system or not adopt a tried and tested system simply because it has some shortcomings? I'd suggest that the shortcomings from the current model are much greater.

MR HINTON: Let's move on to another area. In fact I'm gong to pick up, Michael, your comment about the Moranbah to Townsville pipeline proposal you've got, and that you talked about non-differentiation of price, for example, to customers, irrespective of size. That raises questions that we've been looking at with regard to the role of foundation contracts in this area, and even constructing to known contractual demand. It's been put to us that a foundation customer by their very nature bears some of the risk of the investment and therefore it's not inappropriate that that risk have some return, and that might be a certain price with regard to the product being shipped; gas. Does that not lead to some erosion of the principle that the foundation price should be the basis price for all other customers, irrespective of size, if the foundation customers normally are large?

MR CAVELL: It could. I think for a foundation customer to argue that somehow they're taking the risk of the asset development because they're signing a contract that benefits them in a number of ways, that somehow they should get extra compensation for that risk, misunderstands a bit the negotiation that goes on. The presumption behind that statement is that the foundation customer somehow has a preferred position and that that preferred position should be memorialised and recognised forever, and I guess my view is that what the foundation customer is, is they're the market and they're the first market you encounter, and they're the ones that establish what the market is for the particular risk allocation that you're doing in your negotiation with them.

My experience with foundation customer negotiations is that they're very difficulty, they're very complex. There is not an existing asset there that you can make reference to for operational behaviour and for performance characteristics. In fact, you're not even sure what the diameter of the pipe necessarily might be. You're not sure how the line pack is going to work. You're not sure that other customers are going to be there. Often the foundation customer hasn't used gas before, so they're uncertain what the requirements are. They don't know what their load factor is going to look like. So the negotiation is varied, complex, difficult. But ultimately it comes down to an allocation of risks between the parties, and there is an asset developer who's going to take the risk of developing an asset and there is a customer who's going to take the risk associated with utilising a different energy source, and that allocation of risk leads to the determination of a value associated with the service that's being provided.

To me, that value is the market. That defines what the market is for that particular service because I, as a service provider, am willing to take the risks I am to provide that service at that price. The end user is willing to take the risks associated with using gas as long as it's at that price. What better definition of the market is there than that type of negotiated outcome? I think they're over-rated in terms of the regulatory context. It think foundation customer are the first customers. They happen to be there at the time the asset is being developed. I don't particularly see any reason why that puts them in a different position; if there's an alumina refinery there today and there's one being built in three years. The risk allocation that takes place in three years might be different but the starting point is the market, and the market was set by that foundation customer.

Now, there are probably those in this sector that would disagree quite vehemently but my view on that is that those perspectives on foundation customers come from a regime that says, "We're not going to build an asset based on a market, we're going to build an asset based on a customer," and that's what leads to under-sized assets, that's what leads to a lot of the presumptions associated with the development of the infrastructure that I think the existing regime is discouraging, and in part it's because they're freezing this notion of foundation customers as if there's some magic there. It's the definition of the market at the time the pipeline was being developed. That's what it is and it should be treated as such.

MR HINTON: Which leads presumably to MFN clauses if there is any excess capacity.

MR CAVELL: I don't think necessarily "most favoured nations" is necessarily the answer to that. I don't have "most favoured nations" clauses in contracts that I negotiate because I think they're fraught with difficulty. When I mentioned that a customer coming along in three years would be a different risk allocation, well, there's also going to be a different load factor, a different pattern of usage. There's going to be a whole series of different circumstances. There might be the different term for the service, a whole lot of different things different, that are sufficiently different to say, "Well, is that really a trigger for most favoured nations?" No. What I will do is, I'll say, "When I negotiate that agreement, I will post the provisions associated with it, I will post the material terms associated with it and if you want to do that, fine, you can have that but you've got to do the same deal at the same time. You can't piggyback your terms from your other deal and say, 'All I want is just the price, that's the only piece I want, just that tariff.'" That to me is inappropriate. That's how "most favoured nations" clauses work and my experience with them is that they don't, that they end up in litigation because there's always value factors in the equation that don't get reflected directly in the price and as a result you end up fighting about that. This is not a commodity on a shelf we're selling here. It's capacity in an asset. It's a lot different, more complicated.

MR HINTON: You mentioned the Townsville pipeline has excess capacity. There is some debate occurring with interested parties. Some take the view that it is good commercial practice to construct to more than known demand, by definition have some sort of surplus or excess capacity for emerging market growth or whatever. The alternative view is put that there are some commercial reasons why you'd want to construct only to known demand, contracted demand, even in circumstances of no regulatory risk, and that's an ACCC view that's been expressed in this later submission. Do you have any sort of insights on this particular debate? Are there any natural tendencies for commercial imperatives to construct only to known demand in an absence of regulatory risk?

MR CAVELL: I'll tell you what I think could be working there if somebody were to do it, that the load pattern of the market place is crucial to the design of the asset, and the asset size defines the line pack, if you will, it defines the operating flexibility, it defines the capability of the asset to respond to varying conditions. So if, for example, there is a customer out there who has just the most horrendous load factor in the world, "I want gas for an hour every day and no other time, but when I want it, I want it at a huge rate." An example of that would be a peaking power station.

MR HINTON: Yes.

MR CAVELL: It's difficult to come up with the design that meets that requirement, that also has the capability to serve other loads, unless they happen to be counter-cyclical to that particular demand. So you can, depending on what it is you're trying to do with the asset, you can talk yourself into a negotiating position or a structure or a design of the asset that is reasonably customer specific because you're trying to meet the particular requirements of a type of customer. If you're surveying, in contrast to that, a market and that market exists as an energy market in Townsville and it's not just the foundation customer, there is an energy market there, it's served by coal, it's served by bunker fuel, it's served by aviation fuel, it's served by propane.

There's a whole series of energy sources at work in the Townsville market, and what we try to do in doing the design work is anticipate, "Well, where might that market go with the introduction of gas?" There is a guess in that. There is a risk associated with that guess. You take your existing customers, "What's the best way to meet their requirements?" It might be to say, "Well, let's put an extra couple of inches in the pipeline. It gives me extra line pack flexibility that helps me with my existing customers, and by the way, what it also mean is I have some excess capacity so I can market more effectively the customers." Now, was that a system that was built for growth or was that a system that was built to provide line pack flexibility for the customers that were identified? I don't know. The end of result of it is, there's an asset that has capacity that can be sold to the market, and I would say even in fit-for-purpose pipelines, 90 per cent of the time there is excess capacity in some form that can be marketed to the market, even if they're billed the smallest feasible for a particular customer because that customer doesn't have a 100 per cent load factor requirement. Most of the time they don't.

MR HINTON: Let's pick up a couple of other topics. I certainly want to discuss coverage in a minute. But before we get onto coverage issues I'd like to raise a question about objectives. You recall in our draft report we've got a proposal to have an overarching objective, but also to tidy up references to objectives and some objectives that are scattered throughout the access regime's documentation. Your submission expresses a concern about the proposed overarching objective and in particular, worried about the formulation - I'll read it to you:

> We've got to promote the economically efficient use of and investment in the services of pipelines, thereby promoting upstream and downstream competition.

You express concern about the word "efficient" not being applied to investment, that you read it as being an objective that is one of promoting investment as opposed to promoting efficient investment, if I read your submission correctly - I hope I haven't verballed you - and that raised concerns for me because what your concern is, is in fact one that we thought we had matched precisely by the formulation we had, that is, we thought "economically efficient use of an investment in" means efficient investment, not just efficient use.

MR CAVELL: I guess what we're saying is that if that's what you meant, is that efficient is both, then it's fine. If for some reason somebody chooses to read it differently and says, "Economically efficient use, that's the emphasis, and yes, if we can get investment," the idea behind the efficient investment argument is a recognition that investment is a complex decision and that the efficiency is measured over an internal rate of return that might be measured on a 20-year time horizon, and that it's important to keep in mind that it is a complex decision involving the efficiency associated with it is not just, "What's the least cost asset I can build?"

So I think that was the only point we were trying to make, is that there's the potential there for a disconnect between the economic use and the economic investment and it should be the same standard, and if that's what you intended then we're there.

MR HINTON: Well, I had an ulterior motive in raising it, not only to put on the transcript what we intended but also to pick up the point that when we're going to pursue an overarching objective for the Gas Access Regime it's important prima facie, consistent with our terms of reference, that it be consistent with the objective of Part IIIA because of the intersection of the general access regime and the Gas Access Regime, and the government has now put out its final response to the Commission's review of Part IIIA. They have a formulation very similar to that which we have in the draft report, but also include the words "and operations of", which even makes it a more complex formulation to see where the word "efficient" might apply. It will be applying to use, operations and investment, and to write that in English that's read the same way by all readers is going to be a challenge for us. So I flag that for you in anticipation of your reaction to the final report perhaps.

MR CAVELL: It's a powerful word, "efficient", isn't it? It has about 6000 meanings, depending on how you apply it. I'll leave Max to address the issue of the perversity that occurs from an emphasis on efficient operation, because if "efficient" is read in an extremely narrow sense, the operation potentially becomes unsafe in an effort to be efficient, and you can get some rather perverse outcomes. But it's a powerful word, "efficient". I think the intent behind it, from what I've heard that you said, is to recognise that these are complicated questions and they're not just about cost, and as long as the intent is that "efficient" is designed to indicate a broader, more difficult question, then I think we can get around the fact that it gets applied to multiple areas because it will have different meanings in each area; it will mean something different.

MR HINTON: Thank you for that. Let's move on to coverage issues and I take you back to your introductory comments where you express some unease about our formulation of the thresholds for coverage tests, that is, access likely to lead to a material increase in competition, and then the higher threshold again with regard to the application of the tier associated with cost-based price regulation, the word "substantial", and there's this debate about material and substantial and the distinction between the two, the meaning of the two and the history of interpretation of words of this kind that have been scattered through public policy legislation over the years.

I've been a little puzzled by a number of interested parties expressing concern about lack of clarity as to the distinction between the two, in circumstances where I thought we had worked pretty hard in our draft report, with legal advice, to show that even the juxtaposition of the two words is quite substantive in saying material is less than significant. Material is certainly non-trivial but it is not as high as substantial. How could I address your concerns, is my question.

MR CAVELL: We took legal advice as well and I have to say I had trouble understanding the legal advice that came in, because what it suggested was, it depended on the context what the word meant. As an investor, when I set up a term that says "unless there is a material adverse change" the intent behind that is to say it's a change of considerable significance. It's an important change or else I wouldn't use the term "material" as opposed to immaterial, which doesn't mean anything.

Whether that's different than saying, for example, I'm looking for a substantial adverse change, probably I would view them differently and I would view them as in the same order of significance, as the draft suggests, and that material would be 10 to 15 per cent of the price and substantial might be 40 to 50 per cent of the price. Whether those loose terms - and whether they provide the kind of clarity to inform the regulator as to which to apply, I'm unsure of. I guess what we were suggesting is that the test to move beyond - what I really was focusing on is the test to move from the behaviour monitoring to the cost of service regulation should be driven more around events than around standards of potential effect on competition in undefined marketplace upstream or downstream, and that that test is the actual abuse of the position that the service provider is in, and if there's a mistake about the market power that they have and there is a mistake about, I guess you'd call it the theoretical circumstances that they find themselves in, if the test is driven around an actual abuse of behaviour, where they exercise excessive market power or they abuse the marketplace in some way, then you've got something that is a trigger for moving to the cost of service based regime that is palpable, and we were talking earlier about incentives.

That's the incentive that keeps them from abusing that power, because they know if they do they've moving. If the incentive is, "Well, the potential here is that this might move from material to substantial in this five-year period," that's difficult for a service provider to put his arms around and say, "Well, what would cause that to happen?" I don't know what might cause that to happen because it's a matter of degree and whenever it's a matter of degree it's a bit of a sliding scale. So I guess - and that's the concern that we were expressing.

MR HINTON: But this is the ex ante, ex post issue that under your construct, with everyone in the tier for monitoring the transmission and behaviour is monitored and when they behave badly they then shift, then it's post. But in the construct in the draft report it's one of ex ante where you're making judgments about the extent of the market power as currently prevailing that may or may not involve identified transparent examples of misbehaviour - shorthand, which is why we were seeking to flesh out, define, prescribe what the import of material and substantial really are. We thought the juxtaposition of the two alone was quite informative to any regulator. But clearly the message we've got is that we need to be much fuller in our explanations and definitions of those thresholds.

MR CAVELL: I guess I'm just trying to make sure I can get into that light-handed regime.

MR HINTON: Yes.

MR CAVELL: And it has to be clear enough that I know I can get into it, I guess. I mean, that's what defines for me the satisfaction of it, satisfactory nature of it. If it provides enough clarity that I know I can drive myself into the more light-handed regime then I'm okay. I wasn't sure from the way it was formulated how I was going to do that and part of that is, I have to admit, perhaps an unhealthy scepticism about the integrity in which the regulators would approach the question, because I think they would approach it with a view of trying to pull people out of that regime, not trying to find ways to put them in. What I'm suggesting is, well, let's make sure they can't do that. So there's a bit of bias in that.

MR HINTON: Perhaps that explains there reference on page 4, that you don't think raising the test for coverage will alter the NCC's recommendations on coverage. I assume that's a cultural issue.

MR CAVELL: I agree, that's right.

MR HINTON: And your reading of history and approaches that you've alluded to it on a number of occasions this morning.

MR CAVELL: Yes.

MR HINTON: But there is this question that we raise, that you pick up on, this idea of best endeavours as examples of access being sought, and questions of whether or not that can lead judgments about coverage and judgments about behaviour. Are you able to elaborate on how we could describe or list how best endeavours occurs for third parties seeking access, that show that they have made a serious attempt to seek access? What form does that take, that indicates substance of negotiation as opposed to a non-substantive exercise of negotiation? You alluded to that earlier, about a party without even entering into negotiations sought coverage for a particular infrastructure.

MR CAVELL: It's a difficult one to put your finger on. It's not unlike - this will sound like a silly comparison but the US Supreme Court has struggled over what is the definition of pornography and their basic answer is, "I know it when I see it," which is pretty crappy in terms of an actual definition. But they couldn't put their finger on it. What is a substantive negotiation? I don't know but I have a sense that you can tell from the exchange of correspondence whether or not there has been a legitimate effort to reach a negotiated outcome negotiation.

Now, one way to measure that - and I hesitate to even suggest this, but one way to measure that is the use of an independent expert to make a judgment about whether or not there was a subsequent discussion. I think we tend to overplay independent experts a bit and I'm not sure they necessarily are as expert as we like to think that they might be. But to me, if somebody legitimately and honestly is seeking access and for some reason is blocked, I think you can tell that from the way the correspondence and the negotiations have gone. I realise it doesn't exactly answer your question but that's my perspective on it.

MR HINTON: It gives comfort that your experience suggests that it's capable of judgment by the regulator that it has occurred. That's the message I'm getting from you.

MR CAVELL: Yes, I think it is. I mean, there are customers who will make unreasonable demands and there are service providers who will make unreasonable demands. They usually stand out like sore thumbs because there has been negotiation and discussion on a series of topics, and then for some reason on one particular topic there isn't any, and often there is an intransigence that becomes obvious. To me, that's where a substantive negotiation can break down, is where there is some intransigence. I think it is something that you can see and you can tell from the discussion about it. Certainly the regulator would probably interview both parties and, "What's the problem here?"

If the problem is substantive, and often the result of a misunderstanding, at least you know they have tried, and you can tell that. If he is asking for X, "Well, did you try to get a clarification of that?" of course not, and why should I put words in his mouth. You can quickly tell when the negotiation is not intended to produce an outcome. I don't know if that's satisfactory to you or not, but - - -

MR HINTON: No, it 's a very useful perspective.

MR FOLIE: Michael, you dealt with a couple of questions. One is, to your non-discriminatory price policy, does that - because you have said a couple of different things. I just want to be absolutely clear - does that mean then, if you have got a, say, 100 per cent load factor, you charge one price? If you have then got a very seasonal factor but the same volume, you would charge the same price, or would it be adjusted then for its call on capacity? Then if you're a very small volume user, would you also charge the same price? In other words, are you pricing differently for different terms and conditions? In other words, is the energy price going to be the same all the time or is it non-discriminatory in terms of one of a suite of perhaps 50 different contracts you might actually have?

MR CAVELL: The price for a reserved amount of capacity is the same regardless of the load factor or the customer. The judgment about what that reserved capacity should be is where it gets difficult. The over-run requirements or the opportunity for over-run is specified, it says you get X amount of overrun at an authorised tariff, which allows for flexibility around that MDQ. There are tariff differentials that are driven off the term of the contract, so if you sign up for five years you pay more than if you sign up for 15, those are reasonably defined. There would be a set of principles that would say when the usage of the pipe gets to a certain point, then the tariff for a firm forward haul goes down, and that would be the same for everybody, and that tariff will be a charge per gigajoule of reserved capacity. There is not a distinction in how we come up with that charge, other than based on the term of the contract that they sign up.

What happens in negotiations with customers is a lot of the negotiation is around, "Well, what about my over-run flexibility? What are the terms associated with make-up rights or imbalances? and things of that nature. Those are all specified in, if you will, the access principles and the general terms and conditions; say, "This is our starting point. If you want extra flexibility, we're going to have to talk about how we accommodate that, because it affects other customers." There is also a provision in our access principles that deals with the triggers for additional capacity and basically says that, if the increment of capacity that would otherwise trigger a tariff reduction simultaneously requires us to invest capital in additional compression, then the tariff reduction won't occur, but it is all spelt out, what those conditions are in the access principles.

MR FOLIE: The final question is one that is fairly easy. If there is an industry proposition - let's say, that the access regime has, effectively, deterred, distorted, impacted adversely on investment and the operation of the industry, ACCC would particularly if - and said, "Really if you look at the evidence, this isn't true. You have got charts that show the level of investment; you show people are still investing; you have had the sea gas pipeline." Why I'm asking it is, you yourselves are actually putting in place a pipeline now, despite the regime that is actually there and you feel you are going to achieve most of your objectives. What are your views?

MR CAVELL: Well, for the same reason that I invested in the Eastern and Tasmanian Gas Pipeline is it's my view that regulation won't apply. My strategy is to have a commercial operation that discourages applications for coverage because people are satisfied. So it's because I believe I can avoid the regime that I think I can invest in those assets. If I felt I was going to have to build strictly to the regulated regime, the assets I would have built would have been remarkably different than what actually was built.

So it was basically my view that the regime should not apply, for two reasons: one, in the Eastern Gas Pipeline, my view was they shouldn't apply because there's competition there and regulation offers nothing in a context where there's competition, except distortion; and the second was that I will behave in a way commercially that is responsive to the customers' requirements, therefore there's no need for anybody to seek coverage, because it will all be spelt out and they will be satisfied with the outcomes.

MR FOLIE: That is actually the further follow-up point, that, let's say, the regulators would say that this regime does permit situations like you're doing at the moment, so therefore it doesn't need to be changed?

MR CAVELL: Over their dead body - but yes, it does. It does permit it, but not by their - the regulator was not a willing participant in those judgments.

MR HINTON: My last question, Michael, is in relation to page 10 of your submissions with regard to ring fencing. You make quite strong statement that:

> It is almost impossible for adequate ring fencing to be applied in the light of demands by corporate regulators and good corporate governance and continuance disclosure by listed companies.

That is a pretty strong statement. Can you help me out and elaborate on that one?

MR CAVELL: I am of the broad view that ring fencing is much ado about nothing. The whole concept of ring fencing is that somehow within a corporate structure you can separate the decision about access to capacity from other judgments that corporation is making. Ultimately, that comes together at a decision-maker level at some point, and the concept that by keeping the negotiators separated has somehow accomplished something, is silly. To me, ring fencing is a euphemism for lack of transparency, and the way you deal with the notion that, "Well, I might be helping myself out here" is you make that a transparent transaction and you make it one in a context of non-discrimination where if you're going to do a deal for yourself, you've got to make it available to everybody else.

That's a pretty heavy discouragement to favouring yourself and it's a strong incentive to behave in a transparent way. That does more to discourage internal favouritism and transfer pricing and things like that than artificial constructs that break down when you get to the general manager or the manager, at some level they fall to pieces, sometimes it's at the CEO level, but it's kind of silly to impose rules that impose costs, from my view, that don't accomplish the objective. It's as simple as that.

MR HINTON: Is there anything you think that we haven't touched on this morning that you would want to particularly emphasise?

MR CAVELL: No, I actually think that - as I said, I have been encouraged by the process from the start. The openness of the commission to thinking about this has been obvious to me, and this just reinforced that. So as far as I'm concerned, keep going.

MR HINTON: Thank you very much again for your submission and your attendance today and ongoing input to this inquiry. It's appreciated.

MR CAVELL: I leave you with Max.

MR HINTON: Leave us with Max.

MR HINTON: This is the second session of this public hearing here in Brisbane. I now welcome to the microphone Mr Max Kimber of M.J. Kimber Consultants Pty Ltd. Welcome, Max. I'd invite you to make an introductory statement.

MR KIMBER: Thanks, Tony. Firstly, let me say that I'm making this presentation or submission on behalf of my own company M.J. Kimber Consultants Pty Ltd, Leigh Fletcher, who is a well-recognised metallurgist and pipeline welding expert in Australia and overseas, and Phil Venton who has probably designed more transmission pipelines in Australia than anybody else. The purpose of the submission is to develop a link between safety, quality of engineering and the current access regime.

But firstly, Tony and Michael, I'd like to make one statement, that subsequent to my submission to this Productivity Commission I've been appointed to a three-member gas review board in Western Australia, to opine on applications for changes to the regulator's decision in respect of the Dampier-Bunbury pipeline. As a result, I will not say anything associated with anything on that matter and confine myself entirely to the content of the submission. It was a juxtaposition of events; I didn't know it was going to turn out that way. So that's the situation and I wanted to make that clear to the commission.

There are three primary issues that I want to raise. The first is negative influences on engineering quality of high-pressure gas transmission pipelines and I think that's a very serious issue and we're beginning to see the effect of that now in the Australian environment. The other issue particularly promoted by my colleague Leigh Fletcher is the development of extensions to natural gas transmission systems into regional areas for regional development, and finally a comment about the way in which most state and territory jurisdictions have set aside a requirement under the competition policy agreement for a common standard for engineering within pipeline, and I feel that's relevant because it's associated with the administration of the competition policy agreement from which the current regulatory regime that we have in place now arose.

But firstly, the influence on engineering quality - and I speak from close involvement, both commercially and in an engineering sense with many of the pipeline companies throughout Australia, excluding Western Australia I might add - where we have noted that the companies' responses to the imposition of regulation has resulted in the firms endeavouring to cut costs because the regulator has in some way affected their expectations of cash flows from a particular project by setting a weighted average cost of capital that may be inappropriate and thereby reducing the revenue flow from the pipelines.

Most access arrangements are set to run for about five years and during that time the only ability for a pipeline company to reduce its costs or increase its revenue is to reduce operating costs - reduce its net revenue, I should say. Operating costs therefore are our target and that was portrayed in a little graph that I've provided in my submission by a Mr Harper who's the general manager operations of AGL and Agility. It portrays a series of regulatory tranches where an infrastructure company is forced to introduce a CPI minus X type of regime and he made the point in his presentation to APIA, from experience from his own company but I've observed it elsewhere, where a CPI minus X results in simply an attempt by that firm to reduce its operating costs, push its operating costs down.

Now, you know, that's all fine if there was some fat there to reduce them. But I'm suggesting in my submission that most of the fat has gone. Most of the companies who are regulated now were the outworking of previously government owned pipelines, some of which were operated in such a way that there was fat. In other cases they were operated as lean and mean organisations. So the progression of regulation using a CPI minus X approach, where operating costs normally rise at about CPI - because they include a lot of labour. Admittedly they are relatively small when measured against the cost of debt, for example, for a company. However, they are significant in the context of ensuring that the pipeline is operated safely and reliably.

The contention that we're making in our submission is that this progressive reduction in operating costs driven by a CPI minus X regime will ultimately result in the removal from an organisation of appropriately skilled staff. Now, I drew the commission's attention to a couple of instances of that in my submission. Longford and the Longford failure resulted in a royal commission that found that effectively the reduction in operating costs by the removal of skilled engineers from the plant site was one of the primary causes of the failure.

I also alluded to the most recent Santos incident where there was the failure of a cold part of the plant and again observation of some of the upstream producers, there are attempts there to reduce operating costs and the end result is often the failure of the plant, and I'm suggesting that we may be getting closer to a major pipeline failure as a result of the absence of appropriately skilled engineers to design in the first place and operate the pipeline subsequently.

Particularly I'd like to draw attention to the design side of pipelines. As I said in my submission, there seems to have been little concern among regulators about the initial capital value of a pipeline if it's a new pipeline. That is, they take the initial capital base as being equal to the cost of construction. Now, there's a suggestion among some who say, "Well, you can gold plate the pipeline as much as you like. You can design it such that it will be completely proof against any risk, any damage, any fault, any poor operating practice. Well, that's not the way it has turned out. The way in which it has turned out is that companies are now not wishing to put as much capital at risk, particularly if there's a risk of regulation subsequently.

So most pipelines therefore are designed on the bare bones basis, and I'd suggest many are designed without the appropriate attention to detail and quality. Now, again we have not had any failures. I'm suggesting that we need to be very cautious about this approach of minimising capital cost, minimising operating cost, and therefore removing that skills base on which the industry has so successfully operated for 30 years. 1969 was the first gas pipeline built in Australia and most of those pipelines were designed many years ago and are therefore, I think, well designed, high quality. They were designed by organisations who didn't gold plate but they made sure their assets were in good order and condition - and maybe we're living on that fat now and maybe that fat is running out.

So therefore, just going back to the regulatory model we've got, using this building-block approach of the cost of capital plus depreciation plus operating cost, firms look at operating costs within the access arrangement period and say, "We've got to reduce it. How do we reduce it? We reduce it by getting rid of our technical staff," and I want to avoid being accused of defamation so I won't name the companies. But there are a number of examples around where that's occurring and the safety of the pipeline and its reliability in supplying gas to large markets is being prejudiced.

The next issue I'd like to talk about is the way in which our current regulatory model stifles regional development. Regional development has been a bit of a buzzword around Australia and I don't wish to be painted as an agrarian socialist by the economic rationalists around. But there is still something to be gained for the good of Australia's GDP by developing regional areas with lower priced fuel sources, and natural gas is one of them. There is also a good case for network integrity to have distributed generation in a network, which means transmission pipelines into areas where generators can be installed for network support or to avoid costly and environmentally unfriendly high-voltage transmission lines.

So I think there is a case for regional development and in a way it's more social and economic in a generic sense than it is specifically to this regulatory regime. But the regulatory regime impinges on it by the very narrow view that regulators take on rolled-in pricing. That is, they look to extensions to a network and say, "Does that have system-wide benefits and therefore can it be rolled in?" In most cases the result is no. There have been some pipes that have been rolled in but they've been, for example, to the western underground storage into the GasNet network, and that was seen to enhance the system's integrity and therefore could be rolled in but an extension up to the Riverland may not provide any advantage to the system.

So what I'm suggesting is that one of the areas the productivity commission could look at reasonably closely are the rules associated with the implementation of system-wide benefits. Maybe the regulator should step a little further away from this and say, "Well, there are improvements to the public good. There are some public benefits by rolling this particular extension in," I'm suggesting that that process should be done, as Michael Cavell said in, a very transparent way so we know how much subsidy is going to that particular extension. There is a clear opportunity for those stakeholders in the main transmission system to make statements to the regulator that they don't want this small charge, and it will be a very small charge on their tariffs to support regional development. Alternatively, governments might say, "Well, as part of community service obligations we can fund that," but it's a transparent process. It's not done under the cover of a one-line budget item or something like that. So I'm saying the regulatory regime stifles regional development and the clear indication of that is the Victorian government at the moment putting a lot of its own money into calling tenders and endeavouring to get regional pipelines built. I think the regulatory system should accommodate that and provide incentives for network owners, for transmission pipeline owners to extend into those regions.

So I think those are the major issues. The other one that I wanted to cover is this COAG issue and common standards in Australia. COAG said quite piously at the Hobart conference in about 1995 that there should be a common standard for pipelines to be built and operated throughout Australia, and that was called AS2885. It's called the Australian Standard for Pipelines for Gas and Liquid Petroleum. Now, prior to the COAG making that pronouncement, we did have some six or seven national standards in that the AS2885 was there but the local regulator, technical regulators, wanted to apply their own spin to it and so we had six or seven technical regulations throughout Australia. Subsequent to the COAG determination, most jurisdictions altered their legislation to require pipelines to comply with AS2885 and that was fine for a few years but since that, in the last five years, each of the jurisdictions has said, "Oh, well, we don't quite accept AS2885. We think in Western Australia or in Victoria or in Queensland or somewhere the rules should be slightly different because things are different here in Western Australia or in South Australia or somewhere." The only jurisdiction that adopted the philosophy envisaged by COAG is South Australia where it says AS2885 is a single and sufficient standard.

So I'm suggesting that the Productivity Commission might consider making some reference to this aspect, that as part of the competition policy agreement on gas in 1997 states should be reminded of the need for compliance with that particular requirement, and maybe the NCC should look at it as one of the criteria that it uses for determining whether competition payments are made.

MR HINTON: Max, thank you very much for that and for your submission. I appreciate that quite detailed articulation of your submission and it's picking up the three key points that you wanted to flag. Also, congratulations on your appointment to the Western Australian Gas Review Board. Good luck with that, and I understand the need to particularly refer to that this morning, such as the capacity in which you're appearing today. I don't have too many questions emerging from your submission and your statement this morning because it's covered those three topics but let me raise a couple though.

The first one is in relation to your first issue. The negative influences on the engineering quality and safety. You refer to the source of this negative influence being the nature of the intrusive cost based price regulation itself and how it's administered. What's the solution? Do you want explicit recognition of the need for the regulator to recognise the importance of these costs being adequately funded but funding is fungible. What's your solution to this, this so-called perceived problem?

MR KIMBER: My solution is a recognition that in natural monopolies - and let's use the word precisely here, that is, high up-front cost, low incremental cost, low operating cost - CPI minus X is not appropriate. That is the expectation that the application of CPI minus X just doesn't work because those operating costs that are essential to keep the pipeline operating reliably and safely are mostly CPI or AWE, average weekly earnings-linked rather than linked to a CPI minus X. That's one issue. I think regulators err in applying CPI minus X for transmission pipelines, and I'm not endeavouring to represent the matter for distribution systems. So that's one issue.

The other issue is that the building-block approach adopted by regulators simply requires - almost requires - a responsible firm, who has to pay its dividends to its shareholders, look for cost-cutting. There is cost-cutting that is quite effective, that is, the trimming of fat but when it begins to impinge upon the long-term safety of an asset that has a life of 100 years or so, it is significant. The regulator should recognise that as one of the secondary effects of this very narrow view of efficient cost, and I draw the Productivity Commission's attention to the Competition Tribunal's decision on the Epic pipeline on the Moomba-Adelaide system whereby a very narrow view of the cost of steel was taken by the ACCC, and the Competition Tribunal found that that narrow view was hardly appropriate. If you then replicate that narrow view to the whole panoply of so-called efficient costing then it's likely that those sections that are important to the reliability are set aside and firms cut those costs in order to meet their expectations to their shareholders.

DR FOLIE: Could I just sort of - - -

MR HINTON: Sure, Michael.

DR FOLIE: - - - follow a bit onto that because, I mean, this so-called - this is current speak - efficient costs that the regulator talks about and this is really the most intrusive part of, if you like, the regulatory process we're now discussing. Effectively, understanding from both their written submissions and general comments, basically they spend a lot of time actually understanding what is best practice, what is the best way to do things - in a way, my understanding is, reasonably proscriptive as to what should be done because they then allow those costs then to be put into the cost base. Are you really implying that effectively they're not able to actually do this job effectively?

MR KIMBER: No, I don't think they're qualified to do that.

DR FOLIE: Because a major part of their work effort is the intrusive - - -

MR KIMBER: It is a major part but recognising again that operating costs when compared to the costs of capital, the financing costs, debt costs, are really very small.

DR FOLIE: I understand that. There's been a lot of submissions and discussion about, if you like, the WACC and all the issues there with the capital costs. We're now talking about the operating costs which are still in the thing there, and they do, as I understand, spend time and best practice. We've seen in various cases that they spend time looking at maintenance practices because in fact you can have old, sloppy and antiquated Australian practices which they - I don't know whether they do or they don't - pick up best practice American which may have some capital elements and things. So I mean, are you saying they're not in a position to be able to do this, or the dialogue, or they don't accept when the firms says that, 'The way we do it here is still as good or best practice"?

MR KIMBER: I don't think so, Michael. One can always learn from overseas, and I've learnt a great deal from overseas operations but again they have to be applied in specific circumstances, and I take issue with the way the regulator has used these key performance indicators in an attempt to benchmark pipeline against pipeline. Now, they all have differing characteristics. Some are high maintenance, some are low maintenance. Some are in remote areas, some are in built-up areas. All of which has a significant effect on the cost of operations. So, for example, there is no way that I would accept, as an experienced pipeline operations engineer, a benchmarking between the GasNet network in Victoria with the Moomba-Adelaide pipeline, for example. It's apples and oranges, and as a result, applying these principles of best practice in a generic sense is impossible.

So therefore one has to look in a great deal of detail to the way in which that pipeline operated, and sure, I can go to any pipeline and see good practices and bad practices but in general the pipeliners have been operating reasonably successfully and reasonably reliably and quite efficiently. However, because we're losing a great number of skilled people, then it's quite likely that the costs ultimately will rise because the lower-skilled group, the less engineering expertise that's put into the pipelines to optimise maintenance and operating costs will result ultimately in shorter lives and major pipeline failures. So I'm suggesting that the application of best practice and KPIs to pipelines is really not valid unless you look at a great deal of detail, and I'd suggest the pipeline operator is the best source of that. If indeed the regulator wants to get that far down into an organisation to look at how often they do a hot-end inspection of a gas generator for a particular compressor, well, good luck to them but I don't think they could judge it in the same way that the operator can.

DR FOLIE: But are they not doing that in some circumstances?

MR KIMBER: No, not in detail. They are thumbing through the costs and saying, "Well, that looks a bit high," you know, "This Moomba-Adelaide cost looks a bit higher than the South-West Queensland cost." Well, you've got to look at it in the context that one pipeline was built in 1969 and the other in 1999, just as a difference.

DR FOLIE: Now, the final part of this thread, taking a slightly different tack, I still don't understand - I'm now on the other side - I don't understand why incentives for a company to actually seriously curtail their maintenance procedures and schedules which would actually have them put at risk a major, massive capital asset which they could lose, it doesn't seem to me that the fact that they might cut - but all of this is an incentive to make sure the asset still remains whole, so that you're probably going towards an edge perhaps but - - -

MR KIMBER: Yes, well, I think you are and you need only look at some of the articles to which I referred in my submission where pipeline companies are supposed to be high-reliability organisations where there are good links between the workface and the senior executives. And Michael, you probably understand this better than most having been in the Shell company and seen the need for bad news to percolate through an organisation. Now, we've reached a stage where that bad news is not going through to the top echelons of the companies because we've got rid of senior engineers. We've got rid of the engineers in sort of general manager, senior positions and able to interact with the board.

So the end result is that costs are made arbitrarily and no bad news comes up from the workplace, and again you only need look at things like Piper Alpha, which you surely remember. Longford was another situation and the insurance register are littered with cases where the bad news didn't get to the top. Cost cutting at the bottom has ultimately caused a failure.

MR HINTON: Max, let me get you to explore further your tendencies towards agrarian socialism. In particular, it could be put to us quite a contrary view, that the last thing for the Gas Access Regime is another objective tacked onto it that would have all the potential to bring inconsistency and potential conflict in delivering this form of regulatory intervention and that in fact if you wanted to go down this track of pursuing regional development in whatever form that might take, the way to do that is to use the other mechanisms that are available at Australian government, state government levels, that can pursue those in a transparent - which you rightfully acknowledge is an appropriate objective - way, whether it be by subsidies or whatever. Is that not a ground of significant concern for the sorts of approach that you were suggesting?

MR KIMBER: Well, it may be, and this particular aspect doesn't sit comfortably with me, I must admit. But one of my colleagues is pretty keen on developing it. The background to it is that there is very little evidence since this regulatory regime has been put in place of regional development of natural gas pipelines. We had a pipeline built to Mildura which was carried out through the ACCC tender process and again coverage was ultimately revoked. So one wonders about whether indeed it should have been a regulated pipeline in the first place. But that's just about the only example of any regional development that has been done to the gas industry except where major pipelines just happen to pass the door of a regional centre.

So I'm saying that there is no incentive for any developer to put a spur on a major transmission line any more to serve a regional centre unless that regional centre is within a kilometre or so of the main line. The central west is one example of where, if that pipeline had been rolled into the total Moomba-Sydney system, ot would have affected the overall tariff by less than a cent a gigajoule, but would have provided regional development through Dubbo, Parkes, Forbes, right through to Tamworth.

In fact, when the regulatory regime came in, the developers of that pipeline stopped at Dubbo and said, "We're going no further because we're going to have this fight with the ACCC about what the tariffs are on it," and the tariffs turned out to be significantly different from what had already been agreed between the various parties. So I'm saying there has to be some recognition that the code and its implementation has affected regional development and that there should be, as I said earlier, some recognition that roll-in of extensions to the pipeline should be able to be allowed without taking a very narrow view of the overall system improvement policy that the ACCC has applied.

MR HINTON: Max, is there anything that you'd like to pick up again that we haven't picked up?

MR KIMBER: No, I don't think so. I think you've given me a good hearing, thank you.

MR HINTON: Well, thank you very much for your submission and your time today. We really appreciate it. We'll take a coffee break for those who haven't had coffee and return here at quarter past 11 by that clock up there, because it's running slow.

MR HINTON: Welcome back to this public hearing on the Productivity Commission's inquiry into the Gas Access Regime. I now invite to come to the microphone the representatives of Energy Networks Association, Mr Bill Nagle and Mr Garth Crawford. Welcome.

MR NAGLE: Thank you very much.

MR HINTON: I invite you to make the introductory comment or statement to lead us into discussion, please.

MR NAGLE: Thank you very much. My name is Bill Nagle. I'm the chief executive of the Energy Networks Association and with me is my associate Garth Crawford, the national director of government and regulatory affairs of the Energy Networks Association. Obviously we're very pleased to maintain our participation in these public hearings and the PC report, and particularly the opportunity to speak to the inquiry team here today. The last time we spoke to the Productivity Commission about the review was last September in Perth under the auspices of the Australian Gas Association. In December 2003 this new Energy Networks Association was formed by agreement of all gas and electricity distribution businesses including the previous AGA members. So we are essentially continuing on the involvement of the Australian Gas Association under this new banner, Energy Networks Association, in its review.

One of the recognised major priorities of the Energy Networks Association has been to continue this involvement in the review and the previous AGA made particular requirements and arrangements within the Energy Networks Association to ensure that has occurred. Like I mentioned, the Energy Networks Association is a national representative body for the owners and operators of electricity and gas distribution networks. So we're talking distribution here and not transmission, production or retail along the gas chain - distribution. These businesses deliver electricity and gas to over 12 million customer connections through approximately 800,000 kilometres of electricity lines and, more relevant to the inquiry here today, 75,000 kilometres of gas distribution pipelines. Although it's distribution, the term "pipeline" is still attached to the term.

The reforms to the industry representation arrangements in this area highlight one of the key themes of the early chapters of your draft report, which is the significant changes in the industry structures that we're seeing over the last five or 10 years following the national competition policy reforms and other reforms leading from the involvement of private sector businesses in the delivery of energy. While the ENA is a new organisation, its contribution to the inquiry is drawn from the same gas distribution businesses that were represented in the previous AGA and, in our submission, is very much a product of the cooperative work of the six gas distribution businesses involved in delivering gas here in Australia.

The gas distribution networks owned by these businesses represent the largest class of assets impacted by the Gas Access Regime, the largest class. The assets under the gas distribution businesses outweigh the assets covered by gas transmission pipelines. The commission's draft report has been a matter of obviously intense industry interest since last December and has been the subject of detailed discussions among ENA members over the past few months. Broadly, energy network businesses considered that the report has a number of very positive findings and recommendations that it makes regarding the Gas Access Regime. ENA members consider that the commission has identified most of the areas of improvement - and I say identified here - in the existing regime and set out a range of possible solutions to only some of these issues.

So we're going to come back to that, about - there was a series of identified improvements that should be made but recommendations didn't go to all of those. Obviously you've set out a range of possible solutions to some of those issues that have manifested themselves over the past few years of the regime. The ENA believes that the commission's review is the most independent, comprehensive and detailed stocktake of the regime to date and certainly long overdue. The most important message the ENA members want to give the commission here today, however, is that we have strong concerns that the report does not make detailed recommendations which will improve the impact of the regime to the largest proportion of assets under the regime issue the gas distribution networks, and to protect adequate investment in the existing networks, even after making findings that the cost-based regime is riddled with problems and inconsistencies.

Rather, the approach that the commission appears to have adopted in this draft report is to possibly narrow the range of assets potentially subject to the cost-based pricing approach and raise the test for coverage under any form of regulation. For a number of reasons, which we'll go to soon, the ENA considers that a final report, which does not go beyond these two elements, would not effectively improve the operation of the regime for most of its participants, and the largest proportion of assets covered by the regime, particularly after the Productivity Commission finishes its report and during the implementation phase of the report through, sort of, ministerial council and energy, sort of, processes and involvement of government agencies that we may see the coverage tests set out in the draft report narrowly applied by the regulatory community more generally so that very few assets will be subject to your perceived new regime. That's why the underlying cost base regime needs to have the Productivity Commission's closer attention and follow up some of the findings from the draft report into recommendations into the future.

At this stage therefore I'd like to hand over to my colleague Garth Crawford who will make a more detailed analysis of some of the elements of the draft report and our submission in response to that, and particularly go into those issues where we would like to see some of the positive findings of the draft report transferred to specific recommendations. Thank you.

MR CRAWFORD: Thanks, Bill. I'm Garth Crawford, the national director of Government Regulatory Affairs of the Energy Networks Association. The first issue I'd like to speak briefly about is the series of judicial determinations and appeal outcomes that are relevant to the commission's recommendations and findings in its draft report. These include the Australian Competition Tribunal judgment in the GasNet matter, the tribunal's judgment in the Moomba-Adelaide pipeline system appeal which was mentioned, and the judgment of the WA Supreme Court in the Epic Energy appeal. The ENA strongly urges the commission to particularly examine the findings of the Australian Competition Tribunal in the recent GasNet and MAPS cases which were released in December 2003.

We consider that the outcomes of these judicial precedents are entirely consistent with the overall direction of the commission's draft report and that integrating the outcomes of these precedents into proposed refinements of the Gas Access Regime would bring significant benefits in terms of mitigating some of the adverse impacts and trends in the application of the existing regime. An example of this is the concept of workable competition set out in the judgment of the WA Supreme Court in the Epic Energy appeal. Ensuring that regulatory authorities clearly understand that the Gas Access Regime is intended to produce outcomes consistent with workable competition, observable in real markets rather than the theoretical concept of perfect competition, and that regulatory authorities are aware of the implications of this, is likely to produce enhanced regulatory outcomes and promote efficient ongoing investment.

Similarly, integrated in the outcomes of the Moomba-Adelaide pipeline system and the GasNet cases into the commission's final recommendations and findings has the potential to address two other ongoing issues in access pricing. First, the common tendency for regulatory authorities to substitute their own preferred values in access pricing matters where service providers have proposed values that fall within a commonly accepted range of uncertainty. Second, an approach which seeks to adopt assumptions in the regulatory pricing debate that leads to the lowest possible short-term pricing outcomes even where these assumptions do not reflect reasonable approaches adopted by other businesses in competitive markets, and we saw an example of that brought up regarding the line pipe costs in the Moomba-Adelaide pipeline system, which was mentioned by Max.

To turn to some of the first findings of the commission's draft report, the ENA supports the proposed insertion of a clear and binding objects clause into the Gas

Access Regime, which regulatory authorities would be required to consider when making decisions under the regime. In particular, we support the incorporation of the concept of economic efficiency into the proposed objects clause. This will better recognise the different types of efficiency, such as allocative, dynamic, and technical efficiency, which the regime should be concerned with, and also ensures clear linkage back to the original helm of reforms.

In addition, importantly in our view, the incorporation of the term "economic efficiency" also incorporates important elements of the judgment of the WA Supreme Court in the Epic Energy case. In particular, its finding that the Gas Access Regime should aim to replicate the outcomes of workably competitive markets. A caution that we would raise with the commission is that changing the regime's written objectives - or in this case actually creating them - would not necessarily result in a marked change in the execution of regulation. For this reason it's important that the commission addresses the weaknesses of the regime and its application in more detailed recommendations on substantive issues, such as the application of the cost-base tier of regulation in concert with improving the guidance provided by regime.

The ENA does not support the commission's proposal in draft recommendation 5.3 to remove consideration of the legitimate business interests of service providers as a factor to be considered in the assessment of an access arrangement and other key decisions under the code. We don't support this proposal for reasons of both principle and pragmatism. In terms of principle, it is the only section in the regime that specifically recognises the special property rights impacted by the regime reflecting that the overwhelming majority of assets covered under the regime are sunk capital assets owned by private owners who require incentives and minimum protections for ongoing investment. In terms of pragmatism, specific and useful judicial precedents referred to earlier have built up around this part of section 2.24, in the past two years in particular. These precedents and the guidance they offer which complement the broad directions of the commission's own proposed reforms could be unintentionally lost were that specific subclause of section 2.24A to be removed.

MR NAGLE: Just to stop you there. It would be worthwhile I think coming back and discussing that one in detail later, because there has been a build-up of quite a fair bit of case law in this area for a while and we're just wondering whether or not the Productivity Commission has had any advice on the impact of some of their recommendations on that case law.

MR CRAWFORD: To consider coverage issues briefly, the ENA supports the commission's recommendations for a higher minimum threshold for coverage and the addition of an overarching efficiency objective to assess whether coverage increases economic efficiency. While the ENA supports in principle the two-tiered model of regulation put forward by the commission, there are some concerns amongst industry that regulatory creep could undermine the commission's ultimate objective in improving operation of the regime. For this reason, the ENA has proposed removing the scope for regulatory authorities to act as sponsors for the application of more intrusive forms of regulation, an option left open in the draft report.

Our other major concern is that while it appears to be the commission's intention that fewer assets will be covered under a future gas access regime than are presently, there is the potential for institutional drivers on future coverage bodies and coverage decision-makers to lead to an actual expansion of the total scope of assets covered by the access regime. Further guidance and explicit statements about the total level of coverage expected under a future reformed regime would be one way to address this issue. One of the points of relevance in this regard is questions from some parties about how future judicial bodies and decision-makers could interpret the terms "material" and "substantial".

The ENA has not carried out specific work in this area, although we are aware other parties have. We simply urge the commission to ensure that the questions are answered as clearly and definitively as possible prior to the implementation stage. I now want to speak briefly to the issues raised by the commission in the chapter on access arrangements - in particular, issues relating to pricing principles, the deficiencies of the current cost based form of regulation and the issue of information collection. The ENA is broadly in agreement with the commission on the need for improved pricing principles under the Gas Access Regime and the general nature of what those improvements should be, but ENA members do seek some modifications to the commission's recommendations.

In particular, the ENA considers that a reformed section 8.1 of the National Gas Code should specify that reference tariffs should include a return on investment at least commensurate with the commercial and regulatory risks involved. This is consistent with the concept of the asymmetric risks and costs of regulatory error. We should also specifically require that in approving reference tariffs, or a reference tariff policy, the regulator be satisfied that the tariffs or policy are consistent with the objects clause of the regime and section 2.24. Thirdly, it should possibly retain the existing references replicating the outcomes of competitive markets, due to the significant weight of useful guidance for regulatory decision-making relating to this term which has arisen from recent judicial determinations.

As raised in our discussion on objects clauses, a point ENA wishes to stress to the commission is that improving and clarifying regulatory guidance in and of itself will not overcome many of the negative features of the regime. Additional specific recommendations to improve the actual operation and the application of the regime itself will also be necessary. An example of this is the fair sharing of efficiency gains made by service providers. The draft report usefully acknowledges the problems of the current arrangements which rely on regulators making forecasts of future possible efficiencies and lowering access prices to fully and immediately pass through 100 per cent of the benefit of these forecast gains to end users.

The ENA considers that a specific recommendation by the commission is required however for a specific provision to deal with this issue. A starting point for a fairer approach would be a requirement that service providers retain at least 50 per cent of actual achieved efficiency gains rather than the current arrangements. High level pricing principles and objects clauses alone won't address these types of detailed issues which bear critically on incentives for investment and efficiency. One of the most important elements of the ENA's response to the draft report is that we do not consider it sufficiently addresses the largest single impact of the regime, the adverse impact of the current cost based approach to ongoing investment in existing gas network assets.

In ENA's view, while making coverage arguably apply to a narrow range of assets and proposing new mechanisms to deal with particular issues surrounding new investments are important initiatives, they do not address the central deficiencies of the regime and a substantial proportion of its potential to harm the medium-term interests of the community. One of the ways which the commission could assist in addressing the adverse impact of the regime on investment in existing assets is re-emphasising in its final recommendations the need to re-balance access prices towards facilitating adequate medium-term investment, a key message from its past review of the National Access Regime.

Another practical way would be to give explicit guidance to regulatory authorities in the regime that where a service provider has proposed a parameter in the setting of access prices that fall within a reasonable range, regulatory authorities should not seek to substitute their precise preferred point estimate of that value which they consider most appropriate. This would reinforce the original operation of the unique model underlying the Gas Code which is based on the principle that it is for the service provider to propose reasonable terms and conditions and for the regulatory authorities to take that proposition and assess it against the principles of the code.

On the issue of information collection powers, the ENA is concerned that some of the commission's proposals on information collection powers could actually lead to higher costs than the existing regime and reinforce the heavy-handed application of cost based access pricing, which is at the heart of the regime's adverse impact on investment. The ENA rejects proposals supported by some regulatory authorities to introduce new information collection powers, especially where there has been no clear definition of specific deficiencies in the existing powers under the Gas Code and Gas Pipelines Access Law.

Proposals to allow new detailed information collection requirements to be imposed on service providers within access arrangement periods are particularly likely to increase regulatory intrusion and costs unnecessarily. To turn briefly to the commission's consideration of light-handed regulation, the ENA supports in principle the recommendation for price monitoring as an alternative light-handed approach to regulation. Our key concerns in this are that the tests for coverage operate as the commission intends them to operate so that a significant portion of assets actually benefit from the new, lighter-handed price monitoring option and also that the lighter-handed model does not evolve through its application by regulatory bodies into the type of intrusive regulation it was designed to help address.

Further to this point, the ENA considers that it is inappropriate for the National Competition Council to be given the task to develop information collection guidelines for the price monitoring option. The commission carefully considers the issue of new investment and access arrangements in its draft report. The ENA welcomes this consideration and would also emphasise that reinvestment and investment in existing networks are of central importance to the sustainable operation of the regime. Existing assets under the regime constitute around $8.6 billion of capital investment. New investment in transmission pipelines, by way of contrast, has averaged approximately $500 million per year over the last five years.

The ENA supports the measures proposed by the commission to address the potential impacts of the regime on new investment. In the case of proposed binding rulings of non-coverage, ENA members consider that a 20-year period for a binding ruling of non-coverage is the most appropriate, given common project financing timelines. A measure which provided a guarantee of non-coverage for the initial loss-making period of the Greenfields investment, for example for only 10 years, would have little impact on decisions to invest. One element of the position on binding rulings which is set out in the draft report which we have some concerns with is that the concept of an unsuccessful application for binding rulings of non-coverage should lead to automatic coverage under the regime.

We are a bit unclear about whether this is the deliberate intention of the commission. In our view, it should be a defining principle of the regime that coverage and coverage assessment can only ever be triggered by at least one genuine access seeker actually applying for access. On the issue of administrative arrangements and appeals, the ENA broadly supports the commission's findings and recommendations. One exception to this however is the issue of possible backdating of regulatory rulings. In ENA's members' views, this would lead to issues of complexity, inequity and unworkability in situations where networks and pipelines serve multiple tariff classes, sometimes under a mixture of varying terms and conditions. The ENA does not consider that the proposal is appropriate for these reasons.

Similarly, the proposed removal of the further final decision stage is not supported by the ENA. This approval stage is often required to enable a service provider to lodge a final access arrangement which flexibly meets the key requirements of the regulator for the access arrangement without necessitating that regulatory body to actually prescriptively impose the exact terms of a final approved access arrangement. In a number of cases as well, the further final decision stage has allowed the correction of manifest technical errors made by regulatory authorities, which, if left uncorrected, would have had serious unintended revenue consequence to distribution businesses or required more expensive and time-consuming methods of rectification.

In relation to appeal arrangements, the ENA supports the removal of restrictions on the grounds of merits appeal. We consider that one further improvement that could be made in the area of appeals is a formal recognition by the commission for a consolidation of the inconsistent range of local merit appeal bodies established across states and territories - an issue highlighted in table 2 in our submission. The commissioners recognise that having all merits reviews being heard by the Australian Competition Tribunal is cost-effective and more likely to produce consistent outcomes. The ENA urges the commission to go the next step and ensure this point is included as a formal recommendation in its final report.

Finally, on the issue of institutional arrangements, the ENA makes a number of recommendations to the commission. We strongly support the emphasis given by the commission to having separate bodies assessing coverage issues under the regime and then applying the regime in detail to gas infrastructure which is determined to be covered. This prevents regulatory overreach and the undesirable governance implications of any regulatory authority being placed in the position of determining the scope of its own jurisdiction. The commission has made the finding that the existing Gas Code change arrangements are deficient.

The ENA concurs, and considers that many of these deficiencies would be able to be overcome if representatives of service providers whose property rights were impacted by the regime were able to have a formal vote in the code change process. The ENA also considers, as a consequence of the deliberate division between independent economic regulation, on the one hand, and policy agencies of governments, that regulatory authorities should not be permitted to unilaterally initiate code changes that affect the policy framework of the access regulation regime. This concludes our formal presentation. Thank you. We are both keen to answer any questions you have or discuss issues further.

MR HINTON: Thank you very much, both Bill and Garth, for those comments, detailed comments, and thank you very much for your detailed submission. Input from ENA and therefore its membership is crucial for this inquiry, so we appreciate this substantive participation. I have got a number of questions. Interestingly, going through my list of questions - I think your detailed presentation touched on a lot of them, so I am maybe in fact seeking elaboration or clarification of some of the aspects already covered.

The first question I had is in relation to something Bill said, and that is "ENA of course is distribution, not transmission focused." One of our challenges was to come to grips with identifying the differences between distribution and transmission, from a regulatory intervention perspective, and to see whether or not a single regime was appropriate, whether the common characteristics were sufficient to underpin a common approach with regard to regulation. I would welcome your perspective on that issue. Have we addressed it sufficiently - adequately? Have we reached the right conclusion that a single gas access regime covering both transmission and distribution is appropriate while there is sufficient flexibility to take account of the differences between transmission and distribution?

MR NAGLE: We've always argued that there should be a single regime, in terms of the nature of the businesses and what the regime seeks to address. There isn't any reason to have separate regimes at all. In that regard I think report is setting down the right path. What worries us about the report though is that there's an implication there in the report that because of, I guess, the two major initiatives that you're looking at doing, which is creating a new tier of coverage called the price monitoring tier and changing the coverage test - and some of the commentary in the report implies that that's enough to correct the major problems in the regime.

We had the impression that that sort of targeted more to, say, some of the greenfields-type issues and problems which may therefore impact more beneficially on transmission. We don't have a problem about things being beneficial for transmission. There's no competition necessarily between the two sectors. But I think in the outworkings of your model, either accidentally or deliberately, there is an acceptance that there should be a single regime but the mechanisms you're proposing may only pick up transmission, and we think that's a major flaw.

MR HINTON: Let's move on to the area of objectives. You certainly in your submission support the concept of an overarching objectives clause and in many ways endorse the sort of formulation we put forward including implicitly the tidying up of other references to other objectives that are contained in the documentation. But you go on to elaborate and suggest that interpretation of this objective, it's important that concepts of dynamic efficiency and workable competition get somehow picked up. I wanted to explore this with you a bit further in the sense that the approach we've taken is that efficiency is the objective and competition is the mechanism by which you achieve that objective, and with the pressure of market failure then you have intervention.

So the prior question then becomes, given all this background of terminology of perfect competition, workable competition, efficient competition, effective competition, are we really shying at shadows here? Do we really need to get into putting an adjective in front of competition - whether it be workable or whatever - in circumstances where ACCC say they don't apply perfect competition concepts, so why do we need adjectives to say what they should be pursuing? It's how they go about it as prescribed by the regulatory mechanism. Can you give me a reaction to that inflammatory statement?

MR CRAWFORD: I think it's partially true and I guess that goes also to our point about not wanting to over-rely on the objects clause. I guess something I'd say to that was whether or not the ACCC says it applies to a perfect competition model, evidence form regulatory decisions are that they apply something very close to it. For example, in the recent Victorian gas access arrangement review decision, the ESC offered a suggestion that revenue had to be just sufficient to ensure ongoing service provision which gets you something pretty close to marginal cost pricing which is an underlying assumption of perfect competition, for example. So I would just, I guess, caution that you need to look to actions rather than what the words of regulatory authorities are about what model they apply.

But, look, I have some sympathy for your view that you don't want to overload the objects clause with too much specific economic jargon, as it were. But I guess what we're seeking is a confirmation that the commission is not seeking to exclude all of these findings and judicial precedents which are gradually building up a body of work as to how regulators can appropriately apply the Gas Access Regime by drafting a new objects clause.

MR HINTON: Thanks. In fact I'm a little remiss in not thanking you also for your specifically highlighting recent decisions that have direct impact on the sort of conclusions we will be reaching in the final report, such as the Epic, such as Moomba, such as GasNet. So we appreciate your submission and to some others as well, picking up the importance of those decisions.

MR NAGLE: Can I just make a couple of comments further to what Garth has said. The legal cases are quite interesting in that irrespective of whether or not we struggle with terminology as a perfect competition and/or a workable competition here, when these issues go to court that's essentially the debate that seems to be had in front of the courts. The courts do buy into the arguments about differences between perfect competition and workable competition because they throw up different results. The perfect point estimate approach of some of the regulatory bodies compared to the range of acceptable values against the objectives of the regime, for instance, is sort of a classic case there.

What we're trying to say is that there is a real world operating out there and the regulators need to understand that a concept that they might have to have in their head of that perfect competition does not transfer easily to this market where they can actually highlight exact points of values in the regulatory formulas and that in doing so they actually err in their responsibilities. They also are inconsistent with the fundamental model that there's a series of principles that the access arrangements should be consistent with, and that the access arrangements are proposed by the service provider, ie, the distribution or transmission businesses, and that the imposition on them is to be consistent with the principles of the code; not single point estimates worked out through some sort of economic model predicated on perfect competition.

So I don't think it's really just a rhetorical debate, I think it's a legal issue and it's a practical issue. So we're looking at an objects clause and pricing principles that actually say to the regulatory authorities and to our businesses that will live into the future that those objectives have to be met pragmatically and met against the pricing principles rather than sort of a formulaic solution.

MR HINTON: Thanks for that, Bill. I'd like to come back to something you said in your introductory comments, explicitly flagging you wanted a further exchange of views on it regarding our proposed deletion of 2.24, that is the service providers' legitimate business interests to be of consideration. The origins of that proposed deletion essentially were driven by where those particular property rights should be recognised as being important for regulatory intervention. In terms of a coverage decision we didn't think it was pertinent whether or not a particular infrastructure should be covered, but when it comes to setting a price for a tariff then it was a direct, deliberate, appropriate relevance to a regulatory intervention.

So the new pricing principles in fact includes, under our draft report, tariffs which generate expected revenue at least sufficient to meet efficient long-run costs. There is a property right there inherent in that sort of pricing principle and one that I would have thought adequately addressed what I saw as your concern about our proposed deletion of legitimate business interests from 2.24.

MR CRAWFORD: That's true, although I guess I'd reference the fact that section 2.24 is of relevance to wider issues than just pricing principles. It's a benchmark set of objectives and set of guidance to regulators for a number of decision points under the - - -

MR HINTON: Including coverage. That's important because intervention by its very nature erodes property rights of some sort, otherwise it wouldn't be achieving anything. It certainly changes commercial behaviour. But there is another wider reason why we sought to address the formulations of 2.24 and that is a listing of a range of interests that prima facie are potentially in conflict, does not provide guidance for regulatory intervention when we're talking about broad guidance, for example, an objects clause in particular, or the objectives of the intervention. It may be useful to have those sorts of interests flagged at the more detailed level of intervention and how the intervention is actually implemented.

But in terms of the raison d'etre for the actual intervention itself, we saw it important to be broad brush for the focus on an overarching clause without having a listing of potentially conflicting interests. For example, we're also proposing the exclusion of, deletion of, the interests of users and prospective users. As soon as you put in the legitimate business interests of investors in the covered pipeline as service providers, there's always pressure then to put in the counterpoint for users. We found in our judgment that the administration of the regime was complicated by having those very things; a listing of interested parties' interests at this broad level of description as to why we have the Gas Access Regime. That's the origins of it; not seeking in any way to challenge that there are legitimate business interests and service providers' legitimate interests overall, including property rights, but how you take that into account would be done at the more detailed level such as tariffs.

MR CRAWFORD: I understand. I guess my comment would be that some of the concern I think is raised because section 2.24A is the only section of the existing regime that specifically lists out those sort of elements of legitimate business interests that incorporates private property rights in the existing code. So service providers are seeing a proposal to remove that, albeit with the objective of clarifying the overall objectives of the code and better, sort of, devolving out the considerations to the relevant sections. We didn't see that second element of that. I guess the other thing which would be useful to us would be the commission's more explicit statement in its final report that the overarching objectives clause proposed by the commission actually already incorporates some elements of that, section 2.24A, the legitimate business interests because there's a reference to investment at the moment but investment can be read in a number of different ways.

MR HINTON: Let's move on to monitoring. You've expressed on a number of occasions, both in the submission and also this morning, among other things, the risk of regulatory creep, that if you've got a monitoring regime in place there's always the potential for the regulator to get over-enthusiastic - my words, not yours. We recognise that in the draft report and we therefore seek to have a prescription and description of the sorts of operations that would be inherent in the monitoring tier. Why would not that sort of approach provide sufficient comfort to counter the risk of regulatory creep?

MR CRAWFORD: We support that approach and we understand the commission was trying to do that and says that quite explicitly in the draft report. I guess what causes some concern was some residual elements, such as the case I highlighted where there's the potential for a regulatory authority to actually sponsor a gas network or pipeline to move from a price monitoring tier to the cost based tier which would essentially - some regulators essentially creating work for themselves by arguing that, no, this network or pipeline - coverage of it would substantially increase economic efficiency, therefore it should be covered under the cost based tier. We would see that as an undesirable element. We would see the access regime is supposed to provide open access for genuine access seekers. It's not appropriate for regulatory authorities to essentially be arguing one way or the other that you should go up the tiers of coverage or down them.

I guess another element was the commission's model, as I understand it - and I could be wrong in this - was if you're under a cost based tier of regulation and you applied to have non-coverage, there's nothing in the commission's model to prevent a potential party advocating coverage the day after you get non-regulation which then essentially takes you back to the bottom tier of regulation and we start all over again.

MR HINTON: You've anticipated three more questions but let's stay with that for the moment, Garth. When revocation occurs that's where the coverage decision-maker has made a judgment that the threshold was not reached, therefore it's not subject to the cost based price intervention. Has ENA got experience that suggests that revocation has the potential threat for reversal so quickly? I thought that that was not a message that we had received to date, that revocation has occurred, and revocation has never been really challenged.

MR CRAWFORD: Revocation has been granted on, I guess, a limited number of assets so far, and we would have to see how it was applied in the commission's new proposed arrangements, but even the threat of coverage, again for example, could be used as a strategic gaining opportunity from potential users.

MR NAGLE: One of the problems that we have with the proposal is not so much the words you're using - I mean, there is no hint in the report here about what the starting position is of all the businesses. If this whole regime was accepted and implemented by governance tomorrow, where do all the businesses sit? So if all the gas distribution businesses are put into the price monitoring regime or are uncovered subject to whatever forces on them then occurs or does it assume that wherever you are at the moment that's where you're going to be in the new regime?

This is one of the reasons why we have asked you to actually say something on this, about what your expectations are of the three-tier regime. On day one where are all the businesses? So if all the businesses, gas distribution businesses, are in the price monitoring regime, if they so wish, or the uncovered regime, then our concerns would be, well, what stops an immediate attack upon them, in terms of trying to push them back into the cost based regime by the regulators, which will in fact happen, undoubtedly. The reversal of revocation that we have at the moment is not a problem because in fact the ones which have been revoked are absolute gimmes - I mean, they're very, very clear.

We would like to see some of our gas distribution businesses - the core gas distribution businesses' coverage revoked as well, even under the current regime. So what happens if that begins to happen under your regime? What is to stop the push-back occurring? I think the push-back effort would be much greater if the assumption is that we all start uncovered or in the price monitoring regime. So that is why we have this sort of problem with this reversal possibility.

MR HINTON: Let's take up that point then. At page 15 you say that all existing covered pipelines should be in the monitoring regime. I am reading that as all distribution covered pipelines from your view. Though I have, as an aside, mentioned that a representative of the transmission sector has also said that given their nature of lack of market power in that sector of the gas sector also warrants, prima facie, inclusion in the monitoring regime if they're covered rather than in the cost based price regulation. So we have got both claims before us that the starting point from day one should be monitoring rather than cost based.

That raises a real question of whether or not that is rigorous. If they are subject today to cost based price regulation with that threshold, doesn't that suggest that, prima facie, they should be subject on a case by case basis to a valuation against the new thresholds to see whether they should continue to be cost based price regulation or subject to monitoring - or for that matter, there is always scope of course to move to uncovered in circumstances where the coverage threshold is probably higher under our proposal relative to what is applied today, or we state it is. That suggests, even on that basis, some covered today would not be covered in the new proposed regime. Doesn't that case by case formulation have rigour, have accountability and have transparency, rather than saying, "Day one, everything should be in a certain category"?

MR CRAWFORD: I guess, to start off, we put that position for its administrative simplicity and also to avoid the potential costs of a case by case assessment. I can see merit in a case-by-case assessment. What we're trying to avoid is the situation which arose in 1997 where the Gas Pipeline Access Law was passed and by virtue of schedule A of that law all assets were covered, and that has been at immense cost for gas distribution networks and gas pipelines that subsequently had to apply for coverage under quite extensive and expensive processes.

Our other point in terms of the starting off point would be that most gas distribution networks have gone through at least two cost based reviews and have had, essentially, the regulator's careful eye over its costs and operating structures and so forth twice and that, given that, there is argument that you could have a presumption of a price monitoring approach, for example, for five years, similar to the Productivity Commission's own recommendations in the airports review, for example.

MR NAGLE: But we are having the exact debate that we wanted to have actually about, in the PC's mind, what is the starting point. If your regime is adopted, what happens on day one? Because that wasn't clear, we would like to see it clear, because, if it's clear, from what you are now saying, the assumption is that wherever you are at the moment you will be in the new regime, and then you graduate, if that's it right term, to one of the higher tiers, then that is really the debate that we have.

That brings us back to, I guess, our fundamental concern with the report, that if the PC perceives and accepts a number of problems with the current regime but then says they are solved by the price monitoring tier and the changes to the coverage test, which to me is a contradiction in the position. If you actually say that the cost based system has all these sorts of problems, why isn't there sort of more recommended surgery on the cost based, which is what a lot of submission and our presentation here this morning here is about.

MR HINTON: I understand the point. But certainly the approach in the draft report is one of having a higher threshold for the test for applying cost based price regulation. It therefore follows that the potential for some pipelines currently subject to that would not be under the new regime which requires an assessment to substantiate that.

MR NAGLE: If the PC panel was given the job to make that decision by governments when they adopt or not adopt your recommendations, well, we might be a little bit more relaxed about it, but I suspect the NCC or something else like that might be the people who are going to make these recommendations, and they have never made a recommendation yet of a substantial asset being uncovered.

MR HINTON: Well, we certainly propose in the draft report that the entity responsible for coverage decisions - and currently that is the NCC - would make not only the coverage decision but also the level of regulation intervention as to whether it be in tier 1 or tier 2.

MR NAGLE: Because, you know, the issue is that we had an agreement back in

95, 96, 97 about the nature of the regulation, and on paper it looks good. But the designers of the model didn't implement it, somebody else implemented it. The implementation of it was very much predicated on you're guilty until you're proved guilty rather than you're innocent until you're proved guilty. So what we had was a writing down of every single element of what we perceived to be protections of property rights and flexibility in the current regime to, essentially, asymptotically approach a cost of service regime.

If that happens again, we will have a very high level report which has all the rights words and everything, governments can even adopt it for political reasons, say, "This is fantastic, " but of course then they hand it over to a series of other players in the market whose approach is, "Let's just read down every single one of these flexible clauses." So we really would like to see the PC do two things - make some judgment or comment about where they perceive all the assets are going to fall, on day one; and if a lot of them still seem to be falling where they currently are, ie in the cost based regime, to say something about the cost based regime along the lines that we have recommended in our more detailed recommendations about those bundle of assets which are still there.

MR HINTON: What if the final report sought to elaborate on the application of the thresholds certain examples, case studies, that might illustrate where the threshold for coverage applies, and then the higher threshold again for cost based price regulation would apply, would that be helpful? Not necessarily putting it into the code but illustrating what was behind our intent of the levels of thresholds?

MR CRAWFORD: Yes, we consider that would be very useful, and I guess in that regard as well we would consider any further work on the differences between substantial and material in the coverage clauses - any further work in that area would also assist our members.

MR HINTON: That is exactly what I am referring to, giving concrete examples where material gets activated and when substantial gets activated.

MR FOLIE: I will just ask them a question on that as well. One of the judicial precedents that have come out is interesting, that they have actually found the, if you like, structure conduct performance model - they're rejecting it, rather - in other words, quantitative indices about the level of competition. The judges seem to be more persuaded by looking at actually what is occurring in the market per se, which I think is interesting. Would you therefore expect the commission in its final report to be going more in the direction of actually giving - again quantitative, there are so many competitors in the market - in other words, quantitative measures of it or really to stay more with the trend of actual market performance, which is still a bit loose because it can't be prescriptive, you have actually got to look at how the market is actually performing. That is one of the problems with giving clear guidance on these things. What are your views about that dichotomy?

MR CRAWFORD: I think real world examples and real world application rather than use of indices and theoretical measures of competition would be more useful in this case, given that each set of assets under the gas regime is in a very different position and, for example, it's not really conducive to measure an issue of coverage or non-coverage in the same mathematical theorem as, for example, the ACCC uses in applying whether a particular merger should go through or not. They are not very flexible in that regard.

MR NAGLE: I think the recent Loy Yang decision by the Federal Court sort of goes to that issue as well, where the Federal Court rejected - I mean, Garth can talk about the details of the court case better than I can, but they seemed to have rejected a theoretical formula of what competition impacts might flow from AGL's purchase or part-purchase of that power station and sought to have more real world likelihood discussions about that impact on competition, and in that way the ACCC's case was not upheld, competition was not - - -

MR FOLIE: Because, effectively, policy has got to be fairly consistent across all different arms. You know, gas can't be totally unique to all the other areas, and part of where we took it in the report was guidance on - effectively, there are tests for competition and things. But with the mergers and acquisitions criteria which the ACCC - so you feel that may not be appropriate for the gas industry? We tried to approach through that area.

MR CRAWFORD: I feel like the methodologies of analysis applied in those mergers cases isn't particularly appropriate. I think the overall guidance probably has some relevance, but the actual measures, quantification and measures of it, aren't, and I think that is reflected in some of the commission's draft recommendations in any case. For example, the commission asked for information about ensuring that an access seeker has actually tried with best endeavours to get access to a pipeline or network before it has applied for coverage, and that is an example of taking a real world practical approach as opposed to measuring something in abstract.

MR HINTON: Let's move to this issue - and you have touched on it in your introductory comments as well as your submission - of expansion of existing pipelines. In draft recommendation 7.4 we, in effect, say that if a pipeline is covered, then the expansion of that pipeline would also be covered. I can't see how that could not be sustained - that is, if market power is the criterion by which judgments are going to be made about coverage, it is difficult to see how an expansion of an existing pipeline that is covered should not also be covered, in that it's hard to see how that would reduce its market power. In fact, if anything, expansion would lead to increase, if not sustain or maintain, that market power.

MR CRAWFORD: I guess I disagree, and I would refer you closely to the judgment of the Moomba-Adelaide Pipeline system. For example, if you have a pipeline which has 100 terajoules a day maximum capacity, and you expand that pipeline to 150, essentially you have got to fill that with customers. There may only be 101 terajoules of demand out there, so you have a very different competitive environment for that additional 50 terajoules a day than you do for the original 100 capacity constrained configuration of the pipeline. So to me, it essentially creates a new service, a new market, and that needs to be assessed on that basis.

MR HINTON: The idea behind the recommendation is to remove that process, administrative burden, on everybody, to go through a process of case by case assessment, when in fact, prima facie, it's hard to see how you could reach a different conclusion if that owner of that pipeline has market power.

MR CRAWFORD: If the owner of the pipeline has market power for the existing configuration of the asset, which was what led it to be covered. But our argument is that the expansion of a pipeline, for example, can create significant spare capacity, a different competitive environment between users and the owners of the pipeline which may not evidence market power.

MR NAGLE: Yes. I think a fully committed pipeline delivers a very different series of power, you know, market power levers to the owner of that asset than one that's two-thirds full, and the expansion of that pipeline and the desire to attract new customers to take up that capacity is a completely different ballgame than sort of providing a market with a pipeline that's fully committed. I mean, it's similar in a way that if you're talking about the distribution business and you're expanding into a new regional area and it's built off the edge of a gas distribution system around a major city, the market power issues are very, very different.

I mean, if you're going into marginal distribution country you're up against a whole range of incumbent fuels. You don't have any guarantee that you're going to have an uptake of customers. You might be building it on the basis of maybe a bakery or a glassworks or a hospital or whatever being sort of a fairly major base-load customer that might take 20, 25 per cent of the capacity. But everything else, all the other small businesses and residences, you still have an incumbency fuel, incumbent fuels that you have to challenge. So you have diesel, electricity, LPG, wood in some cases, and it's a very, very different situation than, say, the rest of your distribution system. So we really do think that there are very different competition pressures on expansions to the parent asset wherever that sits, either a pipeline or distribution business.

MR HINTON: This takes us to one of your other concerns and that's the draft report's approach on new investment doesn't give adequate focus on brownfield issues as opposed to greenfield. That is the topic we were just talking about, expansion of existing assets. We felt that there were some aspects of this covered through the discussion on the scope for binding rulings or truncation premium sharing, or even the setting the sort of premium on expansions and how a truncation might or might not occur. You don't think that there is some scope here for the brownfields issue to be addressed?

MR NAGLE: I guess in terms of brownfields expansions - and this is linked to the last issue we discussed where you may have a network augmentation to a new area, where a binding ruling of non-coverage may not be the most appropriate mechanism to do that. A regulatory truncation premium, if the commission made clear that that was to be applied in that new augmentation, would be of assistance I think and I think the Productivity Commission actually recommended that in its review of the national access regime, specifically saying that not just new investment but augmentation of existing facilities should be covered by those sort of new mechanisms.

MR HINTON: I'm not so sure it was quite as precise as that, but - - -

MR NAGLE: It may not have been a recommendation but it was in the text.

MR HINTON: But our draft report wasn't quite as precise as that.

MR NAGLE: No.

MR HINTON: It explored truncation premium and sought views on it, and that's really why I was raising it with you this morning. But that does touch on another issue that was raised earlier this morning, this so-called regional objective. Our terms of reference in fact invite us to look at some regional aspects or regional perspectives. But not too many have taken up this issue at all. It's a question of whether the gas code and the gas access regime is appropriately or inappropriately looking at regional objectives. Do you have any views as a distribution focus regarding this?

MR NAGLE: We haven't gone through it in this submission, but I recall in Perth we had a bit of lengthy discussion about this and I can only concur with what Max Kimber said in the previous submission, that we have an arrangement in Victoria and in Tasmania where there's large amounts of public money on the table to get some expansions done into regional Victoria and Tasmania, which we've never asked for. I mean, normally if you lobby government to spend $70 million you would be reasonably happy, but they're spending $70 million without being asked to. You know, we've actually said, "Why don't you actually change the code to make some of these riskier marginal projects more attractive to our members?" you know, by responding to some of those comments I made before about allowing the businesses to be uncovered and more flexible in the way they price and the way they do deals, given you've got all of these incumbency fuels.

Because the pressure on our businesses in regional areas is that for some reason the next town out is being ignored by the gas distribution business which is now owned by a private company, and in the old days they would have built it here because they would have been told by government. Our businesses would like to go to those towns. They have to attract a couple of foundation businesses, but then they need the flexibility to price for the other businesses to make the whole deal worthwhile, and the code prevents them from doing that.

So I mean, we didn't make a big plan of it but we noted that rather than looking at the regulatory regime per se through this review, to deal with some of those regional expansions governments have decided, for whatever reasons, they want to put public money in line to resolve that issue and we just don't see the logic of that.

MR HINTON: Isn't that an issue of who should pay? As alluded to by Mr Kimber earlier this morning, that if it's done by pricing across the network then that means other gas users pay. If it's supported by public revenue, taxpayers more generally, then there's a very different burden as to how that is funded. Isn't that behind the sort of different policy approach here?

MR CRAWFORD: I guess, as Bill said, we don't have a problem with Victorian and other governments saying that public moneys will be spent on gas distribution systems in regional areas. Our concern is to make sure that the regime is effectively integrated with that, so that we don't get a process, as has happened in Victoria, where you've had competitive tender processes under the gas code for about seven projects and they've all fallen over, and subsequent to that, after a year, two years of delay, you then get a separate process undertaken by the Victorian government which is then operating what is essentially an unapproved and competitive tender process for projects.

Why not just bring together those processes and allow the gas code to recognise that in some instances governments may make public policy decisions that regional networks in locations X, Y and Z should be built, and allow the regulatory system to recognise that better, rather than insist on a competitive tender process which is focused on the lowest possible price, have those fail and then have government step in afterwards.

MR HINTON: Thanks. I've got several more detailed questions unrelated to the sort of more thematic approach we've been discussing so far. So they will be a bit sporadic in their coverage and their focus. So let me try some of them with you. You expressed concern about harmonisation of information requirements across jurisdictions. We were a little puzzled as to why you didn't think it was a good thing. At the moment you've got quite varying information requirements emerging from different regulators in different jurisdictions. Would there not be some benefit in benchmarking some of this and bringing some sort of more harmonised approach?

MR CRAWFORD: I guess our concern would be if regulatory authorities themselves worked hard for the process of harmonising information requirement then a maximum of information collection approach would be adopted rather than a minimum approach and that some - part of the issue of the information collection code changes which have happened and representations made to the commission that you should be increasing information collection powers is an outworking of the fact that regulators have actually disagreed amongst themselves for years and been unable to put forward a set of consistent, clearly defined information requirements that they are not currently able to collect under the code.

MR NAGLE: The whole issue of that information collection goes back a long way and there's always been strong disagreements between the regulators and the regulator businesses over this. It goes back to the original agreement back in 97 about a deliberate policy decision to constrain the ability of regulators to require, demand information of the businesses. The deal back then was that the businesses will give up a large amount of their property right by going into an access regime. But that had to be constrained in a way that wasn't open-ended and a chap getting racheted up. There was a carefully balanced agreement struck back in 97 about the interests of the investors in the asset and the national interest in terms of the coverage regime.

The point at which that erodes is at this information - one of the points that actually erodes. One of the other points is that issue about point estimates rather than sort of a range of values for WACCs and DORCs and a whole range of other sorts of things. But the issue of that information flow - and there's always sort of - like, you know, Bruce says, "Well, public policy says that, you know, perfect information is the way to go and why don't we just have this sort of national system of information flows?" We don't consider that it's anywhere as simple as that. Every time through the National Gas Pipeline Access Code, which we sit on, when our businesses are asked to produce more information it's almost always inconsistent with the original 97 agreement about what the information is going to be used for.

The fundamental model is that the businesses propose access regimes consistent with the principles of the gas access code and law and the regulators make judgments about that. There is a fundamental difference between that and handing over the reins of your business to a regulator to run your business for you. If they wanted that, they shouldn't have sold the gas business as a private sector in the first place.

MR HINTON: You strongly oppose backdating reference tariffs - ignore that remark, but I did pause. There's a proposal in the draft report about the regulator in setting reference tariffs to have a date of effect different to that which is the date of decision and this was driven primarily by concern about the lack of timeliness in some cases for outcomes, regulatory outcomes for this gas access regime, that the system was generating quite extensive delays which were certainly inhibiting and deferring commercial activity, which was unhealthy for everybody. One way to perhaps remove some of the incentives that might encourage game playing, particularly with regard to timetable, was to provide scope, flexibility for the regulator to set a date for the reference tariff earlier than that which applied for the decision itself. Now, you've strongly opposed this. Is this concern about the difficulty of giving flexibility to the regulator or what's underpinning your concern?

MR NAGLE: Well, I think a couple of things. The assumption is that the gas businesses are responsible for the delay. I mean, that's the only way you can read that particular recommendation, that the gas business is blamed for the delay and therefore the regulator will punish them by backdating the decision for where the regulator reset starts.

MR HINTON: What if it's a higher price? Maybe the consumers are the source of the delay.

MR NAGLE: That certainly hasn't been our experience to date. But that's why I was raising the point, that it's about getting the incentives right or removing appropriate incentives. Now, you're suggesting that the source of delay is not service providers and therefore to have potential to backdate would not address the problem.

MR CRAWFORD: Yes, and could I just add regulators in the past have actually clearly acknowledged - because the AGA, one of its central concerns was these delays and the finalisation of access arrangements, and regulators consistently said when you raised these issues of delays on time lines that, "Look, we're all in a learning process here. We're going through the first round of access arrangements. We acknowledge that we don't have some of the skills and resources at the moment necessary to do this in a timely fashion. We're hoping to address this," and it was a constructive discussion between parties about why there was a delay. I don't think you can look at the delays and simply conclude that it's a process of gaming, strategic gaming or otherwise, by service providers. To us it's a remedy that doesn't fit the problem.

MR NAGLE: The pragmatic issue then becomes, well, if you don't backdate how do you compensate or claw back? I mean, if it's the other way around the price is different. How do you compensate? Who do you compensate to, to your retailer? Well, it could be maybe an unrelated retailer - to current users or users at the time. There's a whole range of practical issues that we just thought - well, we really didn't think the issue was a big enough problem to actually impose, first of all, the pejoratives of implications that it was our fault and second of all, you know, that there was going to be massively complex compensation and clawback arrangements for something that ain't really broke.

Now, it may have been in the first round of access arrangements because it was a learn-by-doing exercise. But I don't really see that as a current issue, that we don't see a lot of flak coming our way on that issue and through the NGPAC process those sorts of delays haven't been an issue on our agenda for some couple of years.

MR HINTON: What sort of administration - there's been proposals around to remove the further final decision. That has emerged from a number of interested parties who feel it's unnecessary including ACCC I think, if I recall correctly. But you've come out of left field at me and said that you don't like this. In fact it's an important sort of back-up to remove errors that might have occurred in the final decision. Is this direct experience or are you just being cautious here?

MR CRAWFORD: Yes, it's direct experience. In fact, it's experience very relevant because it's actually a Queensland network that's an example, Envestra Ltd's Brisbane network, where the QCA made a completely technical error relating to the number of net connections and gross connections and the change of this over the regulatory period, and that would actually have significant revenue implications for Envestra were that technical error carried through simply by the QCA being able to essentially ride that component of the access arrangement. But as it was, the further final approval and further final decision allowed that technical error to be addressed in a pretty cost-effective way and for the access arrangement to be finalised.

MR HINTON: So maybe you'd like another round.

DR FOLIE: Why wasn't that picked up in the draft stage? I just don't quite - I mean, part of this was to try and contract all these delays, which everybody was saying the more review periods you've got, the more delays. Why wouldn't a fundamental error like that be actually picked up because you've got a preliminary finding earlier?

MR NAGLE: My particular understanding in that particular case, that was a calculation that had to be done at a late stage anyway.

MR CRAWFORD: That's right, yes.

MR NAGLE: I mean, whilst these access arrangements are going on, the businesses are still operating, there's expansions, there's changes going on and I think that metric was one of those things that you did towards the end of the process. So if you got it wrong then basically you either live with it for five years or went through some sort of lengthy court case to resolve it.

MR HINTON: In our report we talk about the binding ruling of 15 years and you suggest 15 is too short, it should be 20 but we in fact in the draft report seek views on this issue. Certainly in that earlier hearing we did not get much elucidation as to the reasoning why 15 was not as good as 20 or 20 was better than 15 or 15 was appropriate. We'd welcome your perspective on this. Why should it be 20 and not 15?

MR CRAWFORD: I guess it's just anecdotal experience from the industry about what the project financing guidelines for these sorts of new projects and augmentations actually are, and as a period we want to err on the side of having this as an effective mechanism rather than, for example, if the commission was to declare that there should be a 10-year binding ruling of non-coverage. That would essentially have no effect on investment because these are long-lived investments where it's only in the out years that a blue sky profit is made.

MR NAGLE: Yes, I think we made some comments at one stage, possibly in Perth, that the commission may want to look at the funding arrangements and maybe get some separate advice on that from the institutions who fund these sorts of up-front, heavy, capital-intensive infrastructure projects, and to get some feel for the pay-back periods.

MR HINTON: I've got one more question and it's to do with the institutional arrangements. It's particularly pertinent to you in the sense that it's relating to the sort of national energy regulator proposals that have come out of a number of COAG processes and other sources, including the Parer report, and it's not a static process. There is a process, it's continuing, and we could expect to see more emerging from that before we finalise our report but as you have electricity and gas hats on together, you bring a particular perspective that might be useful for us in circumstances where some are saying that a national energy regulator issue is being driven primarily by electricity rather than gas, and that has the potential to not do justice to the gas sector. Is that an overstatement or does it have substance or - - -

MR NAGLE: I think there's every possibility. Our position is at the moment supportive of a single national regulator and the other institutions that we're looking at but they're talking about rolling in gas and electricity distribution two or three years down the track. I'm glad you raised this because it was one of those issues I implied in my opening comments that we have a - one of the reasons why we would like to see the commission dot some i's and cross some t's is because I think your report is going to be used as a fundamental source document for a process that a lot of people don't quite appreciate, that after establishing these Australian energy market commission bodies and the Australian energy regulator, et cetera, there is a much bigger and more fraught process coming down the track at us which is to develop a national energy regulatory framework, one part of which is converging the way gas sectors and the electricity sectors are regulated.

The gas sectors are bigger than the electricity sectors. Most of the political focus is on electricity. We believe that the most generic thorough-going debate on the nature of regulation of energy assets going on in the country at the moment is this one and that we're very keen for government to actually pick up some of the debate that's been had through the Productivity Commission review of the Gas Access Regime. That's why some of these sorts of issues about coverage and the nature of the cost base system, et cetera, I think are very important to us. We don't really know how that's going to play out, about whether or not electricity is going to wipe out anything that we actually agree on here in only six months' time or whether or not governments will consider that this is, you know, quite a useful process to inform electricity regulation as well. I mean, obviously that's our view but we are going to have a debate about objects clauses, pricing principles, nature of the coverage tests, appeals arrangements, the allocation of efficiency gains over an access period, on electricity and gas in that generic debate we're just about to have. We're treating this one as in fact a precursor to that debate.

Now, it would be greatly disappointing to us if we end up with a Productivity Commission report that says some fundamentally useful things but leaves a few, sort of, outs in it and therefore governments reject it as a model going forward for electricity and gas in the future. So that's why we're sort of being cautious about some of the matters that we've been talking about here today. I don't know how that debate is going to go in the future but that debate is just about to be had, and one of the things that we have been toying with, asking you here, is whether or not you want to say something in your final report about the usefulness of your final report to that more general policy debate about regulation of energy assets per se. I think it would be very useful if you did because policy-makers in government would be then more aware, I think, of the linkages between debates we've been having here and the debates that we're just about to have over there.

Being closely involved in that debate and coming from debates on this very thing yesterday with the ministerial council on energy people, the penny hasn't quite dropped for all of them yet that this debate we're having through the Productivity Commission review is essentially the same debate we're going to have through that process. So I keep telling them that they have to draw linkages between what they want to do and this review. It would be great if this review can actually make those comments as well. Now, I know that's sort of straying into some sort of policy areas but I think from a more pragmatic point of view you can say there are a number of generic points we're making here. It's not just about gas distribution or gas transmission. It's about the regulation of monopoly assets per se, be they energy or telecommunications or whatever.

MR HINTON: Thanks. Michael?

DR FOLIE: I've just a question about judicial review. The case being made by yourselves and many other industry representatives is that we've got to take careful note of the large growing body of case law that we have in this area. You could argue that a lot of the case law has been developed specific to the existing Gas Access Regime, which in fact a part of that case law is indicating that the legislation may be a cause of some of the problems, and the cause of why the regulation is as it is. For instance, you know, the regulator, it's been found in court, must take all factors into account, et cetera, et cetera. My question is that really there will be some elements of judicial law that's around - that's been findings that are relevant but another significant proportion of it will be related to the existing regime. If the then legislation were to be altered then that's not important, and should one be bound by a whole lot of second-order points that may have been made in law on the existing regime rather than have a newer regime?

MR CRAWFORD: I guess what we'd have to say is that separating out from some of those judicial determinations there are some second-order points but there are also some first-order points, such as what sort of competition are you trying to replicate in the Gas Access Regime? And we would see strongly those judicial determinations and the guidance they provide the regulators, we would see it strongly as useful that that guidance continue into the new regime and not be diluted accidentally, as it were, through changes - for example, the removal of the replicating competitive markets clause of the gas code pricing principles. So it is about separating out those second-order points about the application of an existing regime but also those useful points about how do you appropriately apply any access regime? We've tried to separate out some of those points in the front of our submission in that section.

MR NAGLE: Yes, I mean, the Productivity Commission's general position in the more generic access regime in their draft report on this one even, going down the same directions as some of those precedences in those court cases. So, from the Productivity Commission's point of view, you might be concerned that, in terms of your own words, wiping out some of those case law precedences which are actually quite useful in terms of the direction that you seem to be heading in. So I think it's just not our concern. I mean, obviously we have a concern about that, given that we started with a system that was a bit broke and the courts have actually made a number of decisions which are correcting in a way that we think goes back to its original intent. It strikes me that your recommendations in the draft report are also heading back to the original intent of the deal back in November 97, and it would be a shame if accidentally in pursuing some of those objectives, that we actually remove some of the precedences of some of the court cases, which are actually delivering the same result.

Now, I mean, I'm not a lawyer and I'm not quite sure what the final debate is on precedence based on one code to a slightly amended code in the future. I don't know if you've taken any advice on that one yourself but it's an issue that we've been discussing internally and our current view is that those precedences are very, very important because they are consistent with the original intent of the Gas Code.

DR FOLIE: Now, do you consider that some of these judicial results that have come out have been due to actually looking at the original intent of where the code was meant to be drafted and that's been a part of these long, drawn-out judicial cases? They have gone back and drawn on original intent rather than actually drafted legislation.

MR NAGLE: And it also went back to the Hilmer statements back in the early 90's about national competition policy and its objectives as well.

DR FOLIE: So would that give you faith that the way that we've actually - the material is substantial and some of these sorts of issues, that that's a part of - it's laid out by defining and giving indications of what the intent is and therefore they could be made workable?

MR NAGLE: That is one thing that - - -

DR FOLIE: Following the same - maybe a tortuous couple of jumps in the way but effectively what you said, it worked in the past with less structure going in the drafting that take account of intent. If more focus was put on intent, if there was a change, then these sorts of recommendations may be able to be made workable through the judicial system because some people believe they are probably difficult material substantially to be able to define the difference, and even yourself have raised concerns. Do you have some faith that it's defined more carefully, that again we could actually relive history and start getting some sense, perhaps a bit faster than it took last time?

MR CRAWFORD: Yes, the coverage example is a good one that if the Productivity Commission clearly says that it intends to raise the bar for the material, the price-monitoring tier, let alone for the substantial cost-base tier, then that would give us some comfort that courts and future tribunals could clearly see the police intent behind that and we wouldn't get into a situation where the application got out of whack with the policy intention. So, yes.

MR HINTON: Thank you. Bill and Garth, anything you'd like to particularly emphasise that we've overlooked so far?

MR NAGLE: No, I don't think so.

MR HINTON: Okay. Thank you very much again for your participation today and also your submission. That's very important for us. So that's appreciated. We'll now break for lunch and return to this room at 1.30 for two more sessions this afternoon. Thank you very much.

(Luncheon adjournment)

MR HINTON: Let's start the afternoon session of these Brisbane hearings. The first appearance for this afternoon session is Mr Mark Christenson from In Tempore Advisory. I'd invite Mark up to the microphones. Welcome, Mark.

MR CHRISTENSON: Thank you, Tony.

MR HINTON: I'd invite you to begin the proceedings by inviting you to make an opening statement or introductory statement, that you might pick up on some points you would like to emphasise.

MR CHRISTENSON: Yes. First of all, thanks for the opportunity to make a submission and to discuss it at the hearing. My background is in economics and I've worked many years ago with the commission in Canberra. Subsequent to that, I was with Queensland Treasury and I now have my own consulting firm which deals a fair bit with rail and electricity. As someone who has personally, I suppose, had to wrestle with the issue of access and infrastructure over my professional life I've developed some views on it and I've tried to represent them in this submission. I suppose that the starting point for me was that, the microeconomic reform agenda having progressed over the last 10, 20 years and achieved a lot, I think that there's a sense - and certainly in the area of infrastructure access - that, if you like, we've hit the wall or run into a situation of, in economic terms, diminishing marginal gains from the access regime, and I believe that to take the next step, if you like, we need to step back and look at it a little bit differently.

In the submission I've tried to draw some references to sort of more artistic representations, I suppose, of the issue as I see it and, if you like, the core of it is that I think we have got bogged down in, if you like, the obsession of this "what is the counter-factual situation" for with or without a regulatory regime. Again, in the submission I've tried to use an example of where that question in itself could be presented as part of the problem, if you like, given that if we stop and reflect the ability to, you know, present or to demonstrate what a counter factual is, is a fairly - well, that was one of the points I made in the submission.

At certain points in time we presented as something which is difficult, whereas at other points in time I think there's an inclination to think it's not possible at all and, you know, they're the sort of outcomes that you get without recognising - I suppose, again, what I've tried to demonstrate in the submission is some of the fundamental paradoxes around access regimes and, more importantly, the sort of underlying theory, if you like, upon which they're based and as I see it, it comes down to a sort of marrying of what we would call maybe self-interest or the incentive of the individual to become involved with business and to pursue their self-interest and the broader social outcomes that we desire, and I think that if you have a close look at that relationship and even relate it back to a lot of the things Adam Smith said a couple of hundred years ago, you can start to see or start to appreciate the fundamental paradox with that, inasmuch as if you do constrain self-interest then you actually end up compromising the desired outcomes in a broader sense.

I think that part of the problem is that that relationship is not one that we can actually prove or demonstrate in an analytical way and as such, it really involves a leap of faith or a gut feel that that is at the core of what we're about when you talk about, you know, a free market philosophy. To the extent that that gut feel has been lost then I think we're starting to struggle in a mire of arguments and counter arguments about what may be or what could be, when if we relate it back to the core theory, you know, we can see that that's a dangerous path to go down. So yes, that's basically the crux of it.

MR HINTON: Thanks for that, Mark, and also thank you for your submission. We're always pleased to receive submissions that attempt to stand back and look at things afresh. It's something the Commission tries to do as well. But at the outset let me try and reformulate one of your propositions and see if I've understood you correctly. You were expressing a view that if by regulation you constrain self-interest then ipso facto you lead to eroding the broader outcome, achieving the broader outcome. Another way of looking at that is to say that the onus should be on those wanting regulation to show that the benefits of regulation are greater than the costs, and that is, we have to accept right at the outset that intervention is not the first option. It may not even be second, may not be third.

But the onus should be on those pro-regulation, pro-intervention, to show benefits exceed costs, as opposed to the reverse onus where those seeking to remove regulation can show that the benefits of removing regulation will be greater than the costs of removing regulation. Now, am I putting words in your mouth or is that - - -

MR CHRISTENSON: Well, I don't think that's how I would put it because I think that part of, if you like, the opposing views, the one battling against the other, is actually part of the problem because it is, if you like, a leap of faith to believe that an utter pursuit of self-interest is obviously going to be in the best interests in a broader sense I think you can't demonstrate that in any sort of cost benefit analysis, if you like, because the whole belief is a gut feel, if you like, or something which you relate to at a level which is not going to be quantifiable, which is not going to be expressed simply in words and numbers.

MR HINTON: But the inevitable conclusion from your formulation would be that, "Let's get out of here. Let's dump the Gas Access Regime, in circumstances where economic policy or theory has moved on from the invisible hand. It has moved to - there are market imperfections that do not deliver preferred outcomes, best outcome, and therefore that there are circumstances where intervention is warranted. Now, if you accept that, then it becomes almost essential that judgments be made about net benefits. Is the intervention going to be efficient? Are the benefits going to exceed the costs? I thought the whole construct of that development of economic theory warrants some sort of analysis of efficiency: benefits exceeding costs.

MR CHRISTENSON: Yes. But if you ask yourself - I mean, can you tell me what efficiency is? Can you tell me what that is?

MR HINTON: In that formulation as I put it then, as opposed to efficient market, efficiency of intervention is where the benefits exceed costs - and more broadly defined, that is, all benefits, all costs.

MR CHRISTENSON: Yes, but you're defining a process for getting somewhere. But can you articulate what that point is, and I would suggest that you can't, and therefore the starting point should be that, that you cannot analytically agree on what efficiency is, and indeed the whole theory actually argues that and that's the reason why we've moved away from an essentially planned type of approach to business and infrastructure in particular. There was a recognition that the government could not - or an agent indeed could not - come up with what those efficient parameters were for the relationship between a buyer and a seller. Therefore we don't recognise the fundamental contradiction when we go into regulation which says that we are really pursuing a pseudo essentially planned approach. I mean, it's not that but it is something of the same principle because it says that the QCA or Gary Samuel or someone of that nature can actually second-guess what we've already said they can't second-guess.

MR HINTON: What I'm really trying to draw out from you is whether or not in that position that you propound does that lead you to the view that the Gas Access Regime should be scrapped, because that's where it takes you?

MR CHRISTENSON: Yes. Well, I would argue that - - -

MR HINTON: And the intervention should be scrapped.

MR CHRISTENSON: I think all that question does is demonstrate that you've already fallen into part of the trap that I'm trying to demonstrate in the submission, which is: you are asking a question which I can't answer satisfactorily because it's of the same ilk as the one I'm trying to express about the whole thing. So therefore it is, of asking the question that you need to ask yourself, because if it's not self-apparent, if it's not self-evident what efficiency is, then there's no point arguing about it.

MR HINTON: So where does that take us? What question would you like me to ask? If that's the question I'm not allowed to ask, do you have a question?

MR CHRISTENSON: Well, it's not so much you're not allowed. I would say the question we need to be asking ourselves is: why are we obsessing over this question when our theory tells us that the agreement is not going to be demonstrable. It can't demonstrate what that is. So you're going to have situations like you have with this inquiry, where BHP is saying, "Well, this is our view on account of factual. Here's your view on account of factual." You can't resolve that. The question that needs to be asked is why we have established - or what are we going to get out of a process, which has achieved a lot on that level but is not going to take us to the next step, because it's just going to put us into a loop of arguing which I would think is not going to be productive in the long term.

Indeed it only tends towards a heavy-handed approach because the frustration that inevitably arises with that circularity takes us into a more heavy-handed approach. I mean, the response is always go into it further rather than come back, because coming back leads you to the question that you've just put to me, which is: would you suggest scrapping the access regime? I would not suggest that, because the mere argument of it demonstrates the problem.

MR HINTON: But if you have a gas access regime it follows that there may or may not be scope to improve it.

MR CHRISTENSON: Absolutely.

MR HINTON: In those circumstances judgments need to be made about, first of all, is there a rationale for having intervention, that is, a gas access regime, and if the answer is yes, market failure: then is the solution as currently designed the best way to achieve a redressing of that market failure? If the answer is, "Well, we're not sure," that leads you to make judgments about what is your best estimate, using as rigorous analysis as you possibly can bring to bear to the blank bit of paper. Now, isn't that a construct that's defensible, sustainable and in fact almost crucial?

MR CHRISTENSON: I think it's crucial up to a point but I just don't believe that it is going to take us the next step, which I believe that there is a sense growing that there needs to be a different step taken or a different approach. The argy-bargy of the process we have now has been very productive but I just don't think it's going to go that next step.

MR HINTON: It's not going to bring a conclusion.

MR CHRISTENSON: No, because you're looking for a conclusion, if you like. It's a process and I think, as I've tried to put in the submission, you've got a process of liberating business or the individual, such that they can pursue their self-interest in an unencumbered fashion and that is the process that we've agreed fundamentally that is about the market. But then over the top of that we bring in constraints and requirements which are then designed to try and achieve a public interest outcome, okay, and it doesn't work because it contradicts itself, because it's saying, "You have to pursue your own interests but at the same time be mindful of the public interest as we've specified with A, B and C."

But if you go back to Adam Smith in the theory he observed that there was no link between the two. He said that it was a natural consequence of individuals and business pursuing their self-interest that led to the positive outcomes associated with the market. So we mix them up whereas really the only way to achieve that is to apply the process as an end in itself, knowing without getting caught up in it, that that's going to achieve the right outcome that you want.

MR HINTON: Would you support intervention where it's clear-cut that there is market failure, that there is capacity for natural monopoly characteristics to provide market power that could lead to rent seeking contrary to the wider good?

MR CHRISTENSON: Well, again I think the question needs to be framed in the sense if you're going to get the right answer then you need to deal with it on a case-by-case basis but having regard for this more fundamental paradox that sits in the background which you can lose sight of and then get into the - I suppose that contradiction then manifests itself in the process, which then becomes unproductive.

DR FOLIE: Could we move from the metaphysical? Have you got a few more concrete examples about where you see these problems and it may be in other areas because you've worked in a variety of access areas?

MR CHRISTENSON: Yes.

DR FOLIE: Where do you actually tangibly see this paradox?

MR CHRISTENSON: Well, I've done work with Queensland Rail, for example, and in their access taking there was a situation where - I suppose they were offering reference tariffs, similar to the gas situation, I suppose, and they were leaving certain discretionary items in that, or interpretations or flexibility for them to charge their customers, and the QCA was putting it back on to them to say, "Well, we want you to clarify this ambiguity that exists in how you're going to come up with these charges." Now, I would have thought that that is an example of missing the point because the discretion is actually needed to come up with the correct charge, because the opposite of that would suggest there is a formula for it, and if we suggest there's a formula for it then why do we need a market? I mean, the concrete example is again part of the problem because it is a metaphysical view of things, and I think that's part of the problem.

Again, the fundamentals about the theory, I would argue, have a metaphysical component which has never been adequately addressed or acknowledged in the economics fraternity, which is now leading us to these problems where we're trying to say, "We can pin down what an efficient price is, we can determine what an efficient access tariff for gas is," but then we say we can't, because if we could, we would contradict everything that we're about.

DR FOLIE: I think the objective is to have that rather than actually saying that you actually have achieved an objective to move to a desired state.

MR CHRISTENSON: Well, again, I think - - -

DR FOLIE: Rather than actually saying you will actually achieve that state, and there may be some - what I think you're saying is that the regulatory process is actually believing you can actually achieve that state and that's actually - - -

MR CHRISTENSON: Yes, it does. It does, but what I'm saying is if you relate it back to the base theory it says, and Smith was saying, "Look, intuitively this is what we want. We achieve a better world for everyone on a social level." But forget that for a moment, because if you try and approach business on that level then you're going to come undone because he observed that the best outcomes were about the individual and the business focusing entirely on their self-interest and promoting that, and a consequence, an unintended consequence of that, was the social outcomes that we try and achieve in a policy sense and ultimately become hung up on and obsessed by, and in the process compromise the thing that we set out to do.

DR FOLIE: So part of - if you like, a concrete part - of what you're saying, am I correct, is that a lot of the regulatory environment is replicating the market outcome. By calculation they can actually achieve what, if you like, Adam Smith was doing through basically seeking their own self-interest.

MR CHRISTENSON: Yes.

DR FOLIE: But once you start to try and plan it there's a subset within the economy, "This is a flawed process." Is that - - -

MR CHRISTENSON: Yes. Well, I think it's not a flawed process inasmuch as I think we have to go down that path. What I'm suggesting is, having gone down that path there needs to be a fundamental turn in a different direction because I just don't think that it's going to sustain the sort of outcomes or achieve the outcomes that we want, because we have to move away from that outcomes fixation, if you like because that's ultimately what we end up arguing about and really it should be about the process of liberating the thing that free market economics is about.

DR FOLIE: So from a policy point of view we can't necessarily - certainly I can speak for myself - imagine how we can quite get there. But a part of the draft report is effectively, one could interpret what you're saying, winding back on that detailed replication, leaving a bit of it but trying to move away from that. So in that sense do you think the direction that is laid out in the draft report sort of is moving in the right direction?

MR CHRISTENSON: It's definitely moving in the right direction. But again I've tried to explore this in my submission, which is to say, well, again we're reacting to a situation where the public interest perspective was very strong when these regimes were initially established, and indeed the NCP agenda. But we're now seeing that regulators have, if you like, an inherent bias against monopoly providers because they're established to address that. I mean, they exist because there is an implied problem and the problem is a monopoly. If there was no problem they wouldn't exist so that, if you like, they're assumed to be guilty of overcharging or restricting supply and so forth. So they've already come into existence to address a problem which I then believe becomes, you know, if you like, the problem in itself.

MR HINTON: In your submission you say that, "Policy design to promote market-based outcomes can be seen as both as a means and an end in themselves." What sort of policies do you have in mind there, other than deregulation? Can you give me examples of any policies that can be designed to achieve market-based outcomes that are not deregulation?

MR CHRISTENSON: No, I don't think there is. I think fundamentally the process is a removal of the constrictions that are faced by the individual and by business. I think, as I was just saying, the perception of a problem to start with then leads us to be non-trusting of that sort of process, to the point that we try and say, "Well, we've got to continue on with that philosophy of free market being a good thing, but on the other hand we're going to come over the top with a whole range of regulations and a whole range of controls, because we don't really trust QR. We don't really trust a gas pipeline owner because they are in a monopolistic position." That starting point then, I believe, actually then precludes you from actually seeing the problem or that the process that you get caught up in is the wrong one.

MR HINTON: Explored enough, Mark? Any other point you wanted to sort of emphasise? We've got your written submission. Thank you very much for that, we appreciate it.

MR CHRISTENSON: No, that's fine. Thanks for your time.

DR FOLIE: Thanks, Mark.

MR HINTON: This brings us to the last session for the hearing here in Brisbane. So I now invite the representatives of Allgas Energy Ltd, a wholly owned subsidiary of Energex Ltd, to come to the microphones, please. What I might do is get you to introduce yourselves and that will help the transcript preparation as well, as she identifies who people are.

MR LEE: There's the four of us - Trevor Lee, group manager of regulatory affairs and Jennifer Hocking, regulatory affairs manager distribution, Patrick Whish-Wilson, regional manager, and Prof David Round who's representing himself.

MR HINTON: Welcome to this hearing and I invite you to make an introductory statement to get things under way.

MR LEE: Thank you, commissioner. I'd like to thank the commissioners for the opportunity to make remarks on the draft report. As the introduction said, we're representing both Energex and Allgas here, and Prof Round is representing himself, and we'll be talking to his paper on Workable Competition. Allgas has made three submissions to this review. We've also funded several papers by Prof Littlechild and by Prof Round, and we also funded analysis of the technical problems in the CAPM methodology by Prof Grey. That was attached to one of our earlier submissions. We've also contributed to a comparison of international rates of return, WACC, by the NECG, and we've also funded a market analysis of asymmetric risk by KPNG. That last paper has not been submitted to this review just yet; it's being finalised at the moment.

We've taken a strong interest in this review for the simple reason we believe the current regulatory regime is choking off the development of the gas industry. We think the situation in electricity is almost identical and we see the outcomes of this gas review being very relevant for the reform of the electricity regulatory regime down the track, as was discussed earlier with Bill Nagle. In the comments I'd like to make today I'd just deal with two matters. First is, I'd just like to summarise the key messages from our third submission to you.

MR HINTON: Please.

MR LEE: Where we dealt with the legal implications, as we see them, of some recent judgments for the draft report's proposals. Then secondly, I'd just like to get down to the real world of the network and give an example of how cost of service, frankly, stuffs us up when we try and deal with extraordinary events such as technical problems or rolling storms or something like that. I'll just give you an example of one here recently.

Returning to the first matter is our third submission to you, which was made in February 2004, in our third submission what we suggested is that the final report should take very full account of a number of recent judgments. I know some came after the draft report and some came at just about the same time as the draft report came out. Nonetheless one is obviously the Western Australian Epic case. The second was the decision by the federal minister on the Moomba-Sydney pipeline and the upholding of that decision by the Australian Competition Tribunal - that was also in February - the Federal Court's decision on Loy Yang and the tribunal's judgments on GasNet and on Epic south Australia.

Some of the comments made earlier this morning were relevant. We don't believe that this review is starting with a blank sheet. Our belief is that the proposals that have to come out from the draft report must conform with the judgments that are being arrived at through legal processes and those four or five cases in particular. If it was a case of the government taking away the Hilmer reforms and starting afresh, well, fair enough - you can say what you like. But in our view, the Hilmer reforms are there. The Gas Code and other codes fall off it and the courts are interpreting the intent and meaning of the law and the meaning of certain concepts such as efficiency and competition.

It's our contention that unless the proposals in the final report conform with those judgments then the problems are going to be ever increasing litigation. I think that's starting to occur now. Companies will take regulators to court if their decisions do not fulfil the intent and meaning of the law and I think the draft proposals are deficient in that respect, that they're unsustainable going forward because it would just lead to a lot of litigation and increasing acrimony. So I don't think that would help the development of the gas industry.

In our first submission, going back to August 2003, to this review, I'll just mention the fact that we said that a lot of this debate is really about battle between two economic models and a lot of what's been going on is superficial to that battle. We looked at an empirical record on investment relative to WACC internationally and all those sorts of things. But the essence of the thing is a battle about two models. One is the perfect competition model on that; the other one is the workable competition model. Now, regulators have not addressed that, which is pretty disappointing, given that the meritorious Prof Brian Johns who was an ex-deputy chair of the Trade Practices Commission brought this to the attention of regulators back in 98, and indeed the Victorian distribution business has brought people like Dr Dan Fessler, who is an ex-commissioner of the California Regulatory Commission, to Victoria to explain this, as well as Profs Littlechild and Beasley, and they've all made very much the same remarks.

So a lot of the debate has been superficial. It has been talking about empirical things; it has been talking really about that fundamental difference in modelling. Now, it's our view that the judgment in Epic and so on have settled that matter. We no longer have to debate the empirical record. We no longer have to argue about economic theory. It's the law. The law is the law. They have come out and they have said that is the intent of the law, and that the law means regulators should be replicating workable competition and not perfect competition. Also, the idea of efficiency is not some theoretical ideal but it's the process of workable competition.

This is quite clear, I think, from the Western Australian case where the justices said, "Well, there might be some ideal down the end - a bit like Keynes - but we're all dead in the long run. What matters is the process of competition, and that process of workable competition should be regarded as being economically efficient." That is our first message, our first submission. Our second message is that we believe there are a number of good reasons why the regime should start off with the monitoring tier two. Again, this was discussed this morning.

One is an argument really about natural justice and also a circuitory argument that indeed the minister's decision on Moomba-Sydney refers to. It's complicated argument. I won't go into it here, it's in the submission. But there is that natural justice principle. Another thing that came out of the minister's Moomba-Sydney decision we believe is again mentioned this morning, about what regulation is about. Now, the minister talked about reversing the onus of proof. He also made the point in the Moomba-Sydney decision that regulation should not be regarded as a precautionary measure. That is the last resort.

It is not there because people fear we might be doing something bad. It's only really as the last resort in the sense of intervening when necessary and I think the fact - as somebody else said this morning, that most businesses have been through at least one or two cost of services reviews already, that there's very little monopoly went sloshing around this industry in any shape or form. So I would come back to what the minister said, you know, only as a last resort and if there's not much of a problem here, why worry?

The third message that came out of our third submission, and the final one, I think is, notwithstanding whatever the judgments say and what the law may or may not say, we believe that the cost of service approach and the CAPM methodology in particular is just inherently dangerous. We provided papers by Profs Farmer and French and Prof Grey to the commission already and I think, you know, a very careful reading of the technical difficulties of CAPM would lead you to the conclusion that no-one knows what the cost of capital is, the true cost of capital, within a very wide range. They do not know.

The economists have also - I quote the example, one of the submissions said that, "It's the end of CAPM, you should never use it." They were thinking of course of just making ordinary investment decisions, but here we are in Australia using it as the whole basis of the viability of a major industry. If there's so much uncertainty in a methodology, how in God's name can we determine the fortunes of those critical companies in that critical industry, based on that unknown, that great unknown, the great uncertainty? You just can't do that. Anyway I'll leave that thought with you. We believe that CAPM is dead, not just for legal reasons but for the fact that it's inherently uncertain.

Now, I'd just like to say a few words about what happens in the real world out there in network land under this cost of service regime. I think Bill has touched on the problems of actually running networks and not enough attention has been paid to that. In late January we have five rolling storms in South-East Queensland. They're probably the worst sequence of storms ever. The storm on the night of the Friday, 30 January was certainly the worst ever. To give you some idea of the severity, we had 1400 major lines down just on the Friday alone. The highest ever in our 80-year history was about 300 down. I won't go on about all the statistics but just to give you an idea that it was extremely bad, we had something like about 1.2 million customers without power at various times over that seven days.

How does the regulatory regime affect us in how we deal with matters like that? The government here has started a review into our performance and there has been a lot of talk in the media about the fact that we hadn't maintained the equipment well enough in the previous period, didn't have enough resources on hand to cope with the trouble when it hit, and the regulator came out publicly and said at this time, "Well, Energex had always spent more money." Now, I know this is electricity, not gas, but the regime and the problems are identical; there's no difference. Well, we're lucky in a sense. There's another review that has just been conducted in that sense of the UK blackouts, and the House of Commons came out last week with its findings from the London blackout of August 2003 and the blackout of the West Midlands of September 2003. I must say there was another big blackout over there in the west country in October which is not taken into account here, but as I understand it, the reasons are similar.

Of course between that period of August and September in the UK there were blackouts right across North America, Canada, Italy, Sweden, Denmark and the rest. We have a major problem. Now, the UK House of Commons has identified the reasons for those blackouts, as we have identified the reasons for the problems we had here and they're all identical. The essence of that is the regulatory regime and the attitude of regulators.

So what we're saying is, no matter what the technical trigger was originally, whether it was a storm, whether it was a switch gear in the London Underground or whatever, what the House of Commons and others are saying is that it's only symptomatic of the root cause. The root cause is the form of regulation and the attitude of regulators.

The sort of thing that came out of our analysis and that House of Commons review, I'll just mention five of them: the focus on never ending cost-cutting - again something that was mentioned this morning - the micro-management of the regulator companies, inflexibility to change circumstances, (4) the inducement to short-termism in decision-making, and fifthly, the provision of insufficient resources to develop the infrastructure. Those are the five things that the British found. Those are the things that we found.

The UK review concluded - and I just mention these, paraphrase their conclusions:

> (1) the regulators' policy to date of both limiting capex and continuing the pressure on reducing opex is incompatible with the long-term stability of the electricity network in Britain. Ofgen -

that's the UK regulator:

> Ofgen's hierarchy of priorities, these are to promote cost-cutting to the detriment of the condition of the network and induces regulated companies to postpone major investment programs.

They conclude:

> The regulator's concern to reduce cost to consumers should now be tempered by a greater emphasis on assuring that network owners have the financial resources necessary to secure a viable long-term electricity supply.

Let's just come back to Energex's case here and what we're dealing with here. Now, we know Energex is the most efficient distribution company in Australia. We know that because the regulator told us so. We did a national and international consultancy work and that was the answer that we came out with. Even though we're the most efficient, that is against cost, what we have do under a regulatory regime - in essence the regulator is saying, "Well, you might be the most efficient in Australia but you're not the most efficient in the world. The latest cost distributors" - and he happened to mention the - well, the econometric analysis picked the American utilities and said, "Well, they're below you." Now, you compare the two. You do the OEC type purchasing power parity stuff. You do your transcendental logarithmic production functions and all that, and what you do is come up and say, "Well, Energex, not up with these US utilities. What you have to do is catch up with them and of course they're moving forward too, so we want you to catch up with where they're going to be in the future."

So there's a mechanism to drive you down to this so-called ideal, least cost-efficient level. They go further than that and they say, "Well, there's an incentive mechanism here. You can get a bit more profit if you're good," In other words, ,"If you can beat this ever screwing down of costs level by a certain amount you can keep that bit of money for a little while, you know, for four or five years, and then we'll pass it away back to consumers." So I don't believe that that so-called ideal efficiency has any legal status. It's not intended under the law, under the Hilmer reforms or under the gas code or anything else, nor has it any economic credibility.

I can go on about that for a long time, but I don't think there is any economic theory that requires you to reduce your costs down to an absolute worldwide advantage. That's mercantilism of 200 years ago. This is the whole point of comparative advantage theory. There's no credibility to it whatsoever. I know that you raised the question this morning about the Productivity Commission does not replicate perfect competition. It does replicate perfect competition. We've given evidence - - -

MR HINTON: Who does?

MR LEE: You raised the question that the ACCC says, "We do not replicate perfect competition."

MR HINTON: It's an important clarification because you said, "The Productivity Commission does not replicate - - -"

MR LEE: It's all these commissions. All these commissions are going to my head.

MR HINTON: I apologise for interrupting you - please.

MR LEE: But they do precisely that. That was what the CAPM does and I just make that point. I'll expand it later if you like, but that's precisely what they do do. Now, things are a little more complex than that. What we've had in our regulatory decision and what has happened in New South Wales recently too is a so-called smoothing exercise where the regulator says - I think that's what they say because it's not clear from the one or two sentences in our determination precisely what they do mean. But they remove an amount of money from us, a smoothing. I think smoothing means to deliver an early price drop to consumers. You see from the recent IPART decision that that took quite a bit of money off the businesses down in New South Wales, In our case it took 35 million off.

There's another matter here which is a bit different from gas, because we're under a revenue cap and not a price cap, that shows you the strictures that we're under. We're under a revenue cap which fixes a total bucket of money every year based on forecast demand. Forecast demand was 4.2 per cent a year. We were under that for four years. Last year growth expanded by 8.1 per cent. That's double, that's peak demand that was double 4.2. This year it's 14 per cent. Next year, with the uptake of airconditioning in Queensland - God knows, right? But we have a fixed bucket of money and we have burgeoning demand. There's no money for it.

DR FOLIE: Sorry, is that electricity?

MR LEE: This is electricity. This is the regime that we're talking about.

DR FOLIE: I just wanted to clarify those numbers, which regime you're talking about, for the record.

MR LEE: That's it, Michael. We are as much at fault as anyone else in failing to forecast how this demand was going to burgeon here over the last couple of years. but this is the real point. There's no flexibility in the regime. It's fixed for four or five years. So things change, like massive increases in demand for energy. But the regime says you can't have any more money to cope with it. What do you do? Well, I could go on, but let's just come back to the sort of problems we have in dealing with storms like this.

We had 10,000 field jobs to do in that week of the storms. The normal rate that we deal with those sort of problems is 600 a week. That's 14 weeks' work in one week. Where are the resources? Remember we've been cut, cut, cut. That's the incentive of the regime: cut your opex down to nothing. Now, the House of Commons review said, "Look, this can't go on. What you need is a totally new approach to regulation," and they suggested, to start with, a doubling of the capex spend over the next 10 to 20 years, to raise their system from what they call M minus 1 to M minus 2. I will just take a second to explain that. M minus 1 means one thing can go wrong on your system and you can cover it. M minus 2 means two things can go wrong and you can cover it. M minus 3, three things. M, one bit of trouble, the system is out. That's the essence of it. The British were talking about going from M minus 1 to M minus 2, said, "That's what the system needs especially in areas susceptible to bad storms such as Scotland, but M minus 3, that's too much, that's excessive, let's move the system back to M minus 2."

Energex is probably somewhere between M and M minus 1. In other words, one things goes wrong we're in trouble, one thing. If you've got one transformer out and you've got a hell of a job covering it. Because a bucket of money isn't enough, what we're having to do is sweat the assets. During January and early February we had hot weather, we had a cyclone, we had these rolling storms. At one stage we were running 70 transforms that were ageing at 150 times their standard rate. We had hoses all over them because the oil is boiling. This is burgeoning demand in hot conditions and we're sweating the assets; that's what we're doing. One transformer goes out, you're in trouble.

In Britain, "Well, double your capex expenditure over 10 to 20 years to get us back up to M minus 2." We need a massive change in the way regulatory regimes operate and the attitude of regulators. We estimate just to get back of this M, back up towards M minus 1, we're going to have to spend - currently we're allowed 250 million a year capex, we estimate 650 million a year capex minimum going forward. We're talking about getting on for three times the capital spent, that's what we need. This review had an earlier discussion about lack of investment, well, that's where the investment should be. That's what we should be doing.

Anyway, I will just sum up. We don't believe any of real world consequences were the intent of the legislation, the Hilmer reforms or anything else. We cannot see any legal or economic reason for the way the regulatory regime operates here. We fully support what the NA said this morning and its basic recommendations that you start us off on monitoring. We will show what the good outcomes of workable competition will be in that monitoring regime and if we're naughty boys, then hang us, send us back to tier 1. But under tier 1 I would say you still cannot have a perfect competitive cost of service outcome. Under law it has to be workable competition, but in that it's imposed by the regulator and not by the company. I have finished, sir.

MR HINTON: Thank you, Trevor, for those comments and thank you for your several submissions. But I also thank you for that various research work that you referred to that supplemented those submissions. We also appreciate you focusing, along with a couple of others, on some recent decisions that perceive to have direct impact on our move from a draft report to a final report and we endorse the need to do that. The intersection of pens down for the draft report and some decisions were not ideal from our perspective.

It's picking up something that Michael - body language - reacted to and that's some of your more concrete illustrations and reference to the House of Commons' views fundamentally related to electricity and I know you said that they're the same systems, but I'm not so sure that's the case for a couple of reasons. I think the two sectors are different, that is electricity to gas, particularly with regard to networks, interconnectivity; stages of development, electricity being an energy source given, gas often being an energy source of choice, not always but often, and the regimes themselves, that is the regulatory regimes themselves have quite significant differences. Therefore I was a little uncomfortable in taking at face value your very powerful point with regard to handling challenges in the electricity sector and how that derives from fundamentally inappropriate level of intrusive intervention and regulation with regard to the electricity sector.

So my first question really was, can you put the two together? Can you take your experiences with electricity and put it into the gas sector with some persuasion for us?

MR LEE: I think the similarities between gas and electricity and distribution are much greater than possibly between transmission and distribution in each of those separate energy sectors. The reason comes back to competition because, in essence, in distribution what we're trying to do is to get out and focus on customers and what they want and supply greater security, that's in the system itself, greater reliability, regional development was suggested this morning. In electricity, and as we would in gas - it's just a question of timing differences - what we would do is offer, and in fact we've made this offer to the regulator here, and it's happened in United Energy in Victoria. You offer what we call price service offerings which goes out, asks customers what they want and we can supply.

We think that works equally for gas or for electricity and distribution. It might not be quite as relevant in transmission. So all I'm saying is that if you're going to include transmission in one regime, along with distribution, I don't see any problem in mixing gas and electricity. Sure, there will be some technical differences, but I think the core of the regime would be identical but I can't see any problem with that. Before I go on, Prof Round was going to talk to his paper on workable competition as well, as long as you're aware of that. But basically I don't see any problem mixing those two regimes together.

MR HINTON: I thought I would just pursue that before we hear Prof Round's particular focus because I've got some questions on that topic as well, but thank you. Is Prof Round going to speak.

PROF ROUND: Thank you for giving me the opportunity to address the commission today. For the record I'm here as a professor of economics and director of the Centre for Regulation and Market Analysis at the University of South Australia and not representing any of the other hats that I aware around the traps. So anything I say today is purely in a private capacity and not to be taken as involving anyone else.

I would like to say that basically I support the thrust of the recommendations in the draft report. I don't have any major problem with them in the broad - the devil is in detail, of course. The only thing I would remark on here is that the phrase "material degree" I predict will be a boon for lawyers and sellers and dictionaries because I think it will cause the same problems we have had in Australia as to what substantially means in "substantially lessened competition" and I would urge you if you're going to stick with that phrase - I don't disagree with the sentiment, but the phrase "material degree" has no accepted meaning. If you can give it some specificity I think it would be very helpful, but at this stage I think it's a boon for other professionals to work through. You only have to go back and look at all the angst over what substantially means in the courts and in the commission to try and work out what substantially lessened competition might mean.

As Michael reminded me at lunchtime, I've been writing about workable competition for a long time and it twigged my memory that my very first paper in 1973 was called Workable Competition in Australia - I had forgotten all about that. But let's not live in the past, let's look at now. The wheel has certainly turned with respect to workable competition. It was a buzz word in the 60s, gradually fell into disfavour in the late 60s and 70s with the Chicago school and the mathematically-minded economists took over to drive models of markets. But dissatisfaction with those has gradually seen, not just in Australia but elsewhere, a swing back to a more broadly evaluative, but nevertheless useful model, more like workable competition.

There is an increasing realisation that structure really isn't as important as the traditional paradigm has said. The structure conduct performance model has pretty much, I think, run its day now. I don't believe structure in any modern market where firms are encouraged to act independently with true rivalry and being constrained and responding has much impact any more. I think what you have to look at is what motivates firms and I certainly believe that one firm can give you just as good a market outcome as a number of firms, so long as the carrots and sticks are there to make it behave. So long as its regulatory environment is there to let it see that if it doesn't behave in a socially appropriate manner it will be jumped on and that's certainly appropriate.

But I think that we need to recognise that competition, the goal that we all subscribe to, is now much better looked at as a process, as a process of interactive rivalry, as a process where firms strive to get ahead of their rivals and by all means earn short-run monopoly rents, I don't have a problem with that so long as they're not permanent, so long as they can be competed away, and so long as the consumers are being taken into account and consumers are being satisfied as well. One of the problems I have with a lot of traditional regulatory regimes is that they're very supply site focused. They're concerned with making sure that the access conditions on the one hand and price on the other hand is tightly controlled without looking at what other things consumers might like.

I get back then to what the Trade Practices Tribunal, as it was then, said way back in the late 70s in the QCMA case about competition being very much a process and was very much a matter of offering the consumers choice in all aspects of the price product service package that could be delivered to them. It has been a concern of mine for some time that a lot of the regulatory environments that we have in Australia, not just gas, right throughout, including regular competition assessments, tend to focus too heavily on price when there are other things that drive consumers.

In saying that, and as you can see from my presentations, I do think price product service packages are an integral part of regulation and should be a part of how a company is assessed by regulators. In saying that, I'm not saying there shouldn't be some supply side consideration of cost. Obviously cost has to be considered whenever you're talking about price. But I think there's a wider regime that has to be considered and a focus on competition as a process and workable competition in particular does give you that focus as distinct from the purely price-focused approached of a perfectly competitive benchmark.

Having said that, if you're going to - and I believe and I entirely support what the commissioner said in the draft, that you do need a carefully specified overarching objects clause. But the question then is how do you encapsulate this very broad notion of competition as a process in such an objects clause. The New Zealand government did this with its Commerce Act in the 80s and said that the goal of the act - I forget the section it was, section 2 or section 4, something like that - was workable competition. So they've said it, but of course - and I was one of the ones who criticised them at the time - that's not good enough because workable competition is a concept, it's very flexible. Perhaps you need to give a bit more guidance as to what it really is that you expect, because many have fought with the concept of workable competition and, you know, the list is five or six dozen characteristics that people have identified over the years as constituting something that you might expect to see in a workably competitive market.

Of course the problem is in any given market you mightn't expect to see all of these at the same time, or they mightn't be given the same weight, because the market itself is quite different. So you need to look at the markets in their own institutional setting in deciding what aspects of the competition you really want to emphasise and what the end result of the regulatory process should be. So I'm not saying it's easy. I don't think it's a matter of simply saying workable competition is the goal. But in respect of some guidance needs to be given as to the fact that it's the end result of the process that's important rather than an equilibrium type significant that's never going to be achieved anyhow, because we all know that a perfectly competitive long-run equilibrium is never reached, even as a theoretical construct, because there's always shocks coming into the system, exogenous ones or endogenous ones, or whatever.

So I think that we do need to specify a more practical goal. I think the perfectly competitive model - I know some regulators say they don't follow it, but if you really look at what drives them that's certainly the origin of their benchmarks and that's certainly coupled with what I think is now a pretty much discredited CAPM model - means that we do need to come up with a new model, a new enforcement model, a new goal for competition and general regulatory policy, one that won't create sunk, dead-weight losses. Because there's no doubt about it: if you get regulation wrong you can't retrieve those dead-weight losses. They're sunk, they're gone forever, and you want to make sure that whatever the goal is that you specify creates the right signals for dynamic market performance.

But, you know, I want there to be sticks as well as carrots. I mean, there has got to be those beating bushes on the edge of the track, that if you stray beyond the track you get beaten back in. So I'm not saying that firms will always perform in the right way and that's why of course we need regulation. We just want to make sure that the regulation that we have follows the right goals and is able to minimise the errors of regulation that we all know can take place. Now, what I'm saying is not new. I mean, other people have said it and I do refer in this paper to a special issue of the International Journal of Industrial Organisation that presented a whole series of papers back in 2001 about the need for more flexible and realistic models, and that's just one example of a whole new learning, if you like.

We had the new learning in the 80s and industrial organisation is perhaps a new learning now about what should be appropriate regulatory goals. Regulation has to be flexible. It has to be built on a flexible framework that can adapt and if there is going to be one big regulatory model then it has got to be even more flexible, I suggest, to take into account the large range of institutional environments in wouldn't it must operate. So my argument is that a workably competitive model forces regulators to look at both the supply side of the market and the demand side of the market, and the consumers, rather than just saying, "We'll act in, if you like, in loco parentis for the consumers by imposing certain conditions on firms.

I'd like to see consumers be given recognition of what their demands are and to see if firms will willingly try and produce those sorts of price-product-service packages that consumers might want, rather than regulating a firm to a price for a particular lowest common denominator type service. So I think there's more room to look at the wider range of regulated firm outputs than perhaps has been done to date. I think the Western Australian Supreme Court - I mean, it was a full bench so it carries some fair weight in terms of precedence and it's the only full bench decision on this issue to date - does have some weight. I think it needs to be carefully considered. It certainly emphasises that there's no one size fits all approach to regulation. I agree with that.

It emphasises that it's not a matter of achieving what it calls "theoretically ideal efficiency", whatever that might mean. I suspect that means efficiency as dictated by the perfectly competitive model, but efficiency is a moving target, we know that, both static as well as dynamic efficiency. They're moving targets but what we do need, I think, is to allow the ideals of dynamic efficiency to be more readily factored into regulatory decisions to avoid the sort of problem that Trevor is talking about, where there's just not enough money coming in to invest in the right level of assets, not just the right level privately but the right social level of assets as well.

Now, it's easy to say, "Well, there's plenty of investment going on in the regulated industries anyhow," but we don't really know what the optimum level is. I mean, the counter factual is difficult to specify there, as we all know. But I think it's something that needs to be carefully kept in mind. Regulation has to be market specific. You can't afford to be too prescriptive in general. There has got to be flexibility I think for the regulators to take each case on its own merits. This means that the regulator's comfort zone is pushed. I think if you have to consider a wider range of issues, all aspects of price-product-service, both allocative as well as dynamic efficiency, then the comfort zone of the regulator is challenged.

I think they have to think more carefully about what it is they're regulating and why, and what the appropriate benchmarks might be, and that makes life more difficult - so be it. I think if we're going to entrust society with regulation we've got to make sure that they do the job fully and comprehensively, taking into account the individual circumstances of those whom they're regulating. Now, because of that, and as I say in this more recent paper, I support draft recommendation 5.1:

> To promote the economically efficient use of an investment in the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets.

Of course it depends on how you interpret economically efficient use, okay? But I think the flavour needs to be given that that includes both allocative and dynamic efficiency. I don't know how you can do it without actually adding those words in there. Otherwise people will take that to read whatever they see in it and then of course, if you have a regulator doing that, the regulated company that believes its requirements for dynamic efficiency are not being looked at, will end up appealing. The whole regulatory process then becomes a drag on society's gas resources and I think it's best if you can try and circumvent that by giving very clear signals, both to regulated firms as well as to the regulators, exactly what it is they should be considering.

Of course there will always be debate and dispute as to whether this is allocatively efficient or not, as to whether that's dynamic efficient or not. But let's get it sorted out at the first stage, rather than going through to later stages of the review and regulatory process. So I think that's okay but I'd like to see it expanded perhaps to identify a bit more carefully what economically efficient is, and thereby promoting competition. Well, you do say "economically efficient use of an investment in", so you may well say back to me, "Well, we've got dynamic efficiency covered there because we do say investment," and I think that's arguable. But, you know, I'd rather see it explicitly spelled out and there are other aspects of dynamic efficiency, especially in choice and changing what you offer to customers, that I think are part of dynamic efficiency, once again the demand side that is not covered by that.

So I know the more broadly you word overarching objects clauses, the more difficult it is for everyone. But, you know, I think there are these three things in this statement that - even though I entirely support the philosophy behind this - I think perhaps could be augmented in some way, and promoting competition is open to debate as to how people see competition. If you said promoting the competitive process I might be happy with that, because that does then indicate that competition is a process, it's a dynamic phenomenon, rather than suggesting a particular competitive outcome. But this is my own personal crusade that I've always been on about, competitive process rather than competition, and you may put this down to the rantings of an academic with nothing much better to do with his time. Anyhow I'd urge you to think about that.

Providing the operational benchmark, as I've said, is difficult. There's no one unique set of parameters that you can observe in a workably competitive market and there's no one unique objective system of weights, as I said before. But that behoves regulators therefore to spell out clearly what characteristics they're measuring and the weights they're giving to it. You know, I don't believe that has been done consistently in Australia today by regulators generally. Now, switch to a workably competitive framework will of course cause problems in the short run. There will be less regulatory certainty. It's a bit like a change in president. When a court comes up with a new way of looking at things you simply have to adapt.

I mean, if there's a change in what's in an objects clause then there will be problems both within and between various regulatory authorities as they come to grips with this. There will be problems for firms to adjust to it as well. But I suggest that the long-run benefits of some grater specificity in what the objects are, are certainly worth it. But, you know, there is a learning curve and it's a matter of how long that learning curve will be and what the costs of that learning might be in terms of both society's resources and also private resources.

But I think, and the main point that I'd really like to make, is that under a workably competitive objected model of regulation the outcome does lie rather more proactively in the hands of the regulated firms. It's up to them to say, "Here's what we propose to do and here's why it's consistent with the competitive process," rather than it being the other way with the regulatory body saying, "Here's the price I'm going to let you charge for this minimum standard of service." I think consumers are better served by the other way. Of course there still has to be a monitoring approach or some other light-handed regulatory approach to make sure that the regulated firm is living up to its implicit social contract with buyers. But I think it's one that serves to enhance welfare rather more than we have at the moment.

I'd just like to say one other thing - the discussion this morning about the legitimate interests of business being dropped and you said, "Tony, well, yes, but we've taken out consumers and quantum interests of users as well." I think there's a danger there. I think if you take them both out then it's in the hands of a regulator to impose its own standard of what the overall object should be, and some Australian regulators certainly appear to be working purely to a consumer welfare standard, rather than an overall welfare standard, and I think if you leave both of them out you may get an undue focus just on consumer welfare.

If you leave them both in, at least they are reminded that the long-term interests of producers have to be considered as well. Now, that doesn't mean of course that they will do it. But I'd prefer, I think, until we get some clear articulation, either by the Federal Court in Australia or by some other body, as to what the appropriate standard is for welfare or public interest, whether it is just a consumer welfare standard or whether it's a wider welfare standard, as has been found in other jurisdictions, I'd be uncomfortable with leaving both those two conditions out. I think there's a danger that the regulators may then only look one way. If they only look one way there are all the dangers of ignoring the pressures for dynamic efficiency that might be lost. So I think that pretty much summarises what I'd like to say. There are a few other points in the paper but they're basically variations on the theme.

MR HINTON: Thank you very much for that, David. In fact that very clear articulation of the key points of your paper has already anticipated in many ways some of the questions I was going to get you to discuss, so thank you for that, and you've very usefully addressed some of the points I was going to seek clarification or elaboration on. But what I'd like to do is pick up on a couple of aspects and explore them in the available time before airports summon us. The first one is in relation to your picking up of our recommendation in regard to the overarching objects clause and thank you for your nuances of how you interpret it.

But we have another challenge and that is, in the meantime the government has put out its final response to the Commission's evaluation of Part IIIA, the general access regime. You will probably recall that that process also had a proposed overarching clause, objectives clause, and now the government has responded as a policy position that's a fairly powerful message to us as we move from draft report to final report. We would need to take into account substantively that government position. It's not just a luxury of ignoring it and saying they've got it wrong.

PROF ROUND: No.

MR HINTON: It's the government's position and our terms of reference require us to look at the intersection of access regimes. There are two words or two aspects that they've added that are different to our draft report and one is adding in not just "the efficient use and investment in," but also is "the efficient operation of and use". So there's another clause there, "operation". Secondly, they've added the word before the "competition in upstream and downstream markets," the word "effective", or at least they've retained it in one way or the other. But it's there in the final response. Do you think that either of those two additional aspects of an overarching objects clause changes the nature of your reading of having a sensible overarching objects clause?

PROF ROUND: No. Promoting effective competition is of course another word for workable competition. I mean, it was called effective competition by some, but workable competition was the term that became in more common use. The word "effective" suggests to me in some way that there is some - - -

MR HINTON: Ineffective competition.

PROF ROUND: Yes, and also that there's some specific end goal. "Effective" suggests to me a greater degree of specificity than workable, and so I think if it's effective competition people may be expecting that there is something written in stone of some sort as to what's being achieved. Whereas workable competition - this is why it's criticised of course - gives you a bit more flexibility in terms of what it implies. So that would be my only response. I mean I think putting "effective" in there is better than saying, "promoting competition".

MR HINTON: Because it rules out the pursuit of perfect.

PROF ROUND: Exactly, yes. But having said that I don't believe in policy sense there's any difference between saying, "effective competition", properly understood, and the competitive process.

MR HINTON: I think that "process" is the word.

PROF ROUND: "The economically efficient operation and use of", I don't see that that adds much unless it's intended to suggest supply side and use of more demand side. I mean, I don't see in itself it adds a great deal but I haven't given it a great deal of thought. But looking for why they have distinguished the words, the only thing I can think of is they're perhaps trying to emphasise a supply side and a demand side or a physical dimension of facilities rather than a more competitive dimension of the use of facilities or services, I'm not sure.

MR HINTON: My thinking was that the word "use" probably did encapsulate operation therefore if you can delete a word and make it shorter without changing the meaning then that has to be a plus. But now it's been seen as saying, "Well, why did we leave it out?" and therefore the omission is noticed as opposed to the inclusion and that's why I wanted to raise it this afternoon. We have his bit of paper that says that as opposed to a blank bit of paper.

PROF ROUND: That's right, but unless there has been some clear statement by the government as to the difference in the words I would think it's still open to the commission to use other words with footnote reference. This is not inconsistent with - but, you know, I'm not writing the final report.

MR HINTON: There is another way to write it of course and that's to say, "We have put particular weight on words that came out of the government's final response," but I won't draft yet. What I'd like to explore with you is this - and I think it will get a sharper focus in Sydney tomorrow when the ACCC are kindly appearing - it seems to be a rather unproductive debate that's going on in a vacuum in some ways whether or not the ACCC is or is not pursuing perfect competition with its building block approach, CAPM approach, or cost based price regulation, however you formulate it, as opposed to workable competition or effective competition or something short of perfect outcome.

Is it a substantive issue here in terms of what the code says, or is it the way the regulator interpreted it? Is it an application issue or is it a regime issue? If you look at the draft report a reasonable read would suggest that we seem to take the latter view rather than the former but I'm open to interpretation as well.

PROF ROUND: It's a difficult one to form any concluded view. The commission says, "Of course it's not the perfectly competitive model that we follow. We're concerned with competition." But they have to come back to a benchmark to come up with their various pricing and other parameters. It does appear to be based pretty much on the key outcomes of a perfectly competitive market structure in terms of price close to marginal cost, but with allowance to retrieve other things that won't be achieved in that pricing regime in a natural monopoly with a continually downward sloping long run average cost curves.

They appear to pay lip service to the competitive process but I come back to my original comment that it's the dynamic efficiencies and it's the demand side that appears not to have been as closely looked at as I would have thought. Because in any competitive market there are buyers as well as sellers. I think buyers need to be taken into account. I understand the need to get an objective benchmark. Yes, of course you've got to try and have one and that's one thing that the perfectly competitive model does give you.

But the question is whether the assumptions that drive that are good enough to replicate what's driving the very institution that you're regulating or the market that you're regulating. I think that's at times the problem that what is undoubtedly appropriate in a theoretical sense may not match up with the market that's before the regulator. But having said that, I believe the commission needs to spell out more clearly what it's doing in terms of assessing competition rather than tending to focus just on pricing type issues and pure price cost issues.

MR HINTON: You mean the ACCC?

PROF ROUND: Sorry, the regulator I have been referring to that's, yes, the regulator. That's something that I think is not the fault of the code but of the approach that the regulator has taken. But the code at the moment doesn't have that clear articulation of what the base model should be and perhaps we shouldn't blame the regulator for following its own interpretation.

MR HINTON: That's exactly where you're taking me and it's to do with, you've flagged the importance of not ignoring the Epic decision for example, it's a question of how to implement that and take it into account. That's why I asked this question: is it the regulator or is it the code?

PROF ROUND: I think it's probably a bit of both.

MR HINTON: Yes. That suggests that it needs explicit reference that it's not pursuit of perfect, it's the concept similar to workable without writing "workable" or "effective" into it.

PROF ROUND: Process of interactive rivalry or something like that.

MR HINTON: As an explanator to the overarching objects clause.

PROF ROUND: Yes.

MR HINTON: Or the pricing principle with regard to setting their reference tariff. You'll have all sorts of levels of footnotes to guidance. I thought it would be uncomfortable to have an access regime explicitly go down the detail right up front with regard to a term like "workable competition". That's my starting point.

PROF ROUND: I agree with that. I think it's a bit unfortunate that the Epic case - that's the Western Australia Federal Court case - hasn't had enough chance to be used to see whether regulators really are going to take that on board and by regulators I'm not just including the ACCC but all the state based regulators as well. So in a sense the productivity commission's review is a bit early. But having had that decision it does have some authority.

MR HINTON: So doesn't it therefore flow through to how the administrators administer it?

PROF ROUND: Yes, but a lot of these decisions take time and they're perhaps being worked through now. I mean I have no information as to how any of the regulators are reacting to that. In a sense the ACCC's final response to you - which I haven't seen - I mean it must have been snuck in yesterday or the day before so I haven't seen that. I presume it's on their web site so I'll have to go and check that out now.

DR FOLIE: It's on their web site. It was loaded on ours, yes.

PROF ROUND: I presume they're taking that into account. They may choose to ignore it. They may think it's wrong. They may think it doesn't have the authority of the Federal Court but as far as I can see it's a Full Court but I'm not a lawyer. But I would have thought there's some strong precedent.

MR HINTON: We might ask them tomorrow.

PROF ROUND: I think you should.

DR FOLIE: One of the conceptual problems is let's say we now are into a workable competition sort of regulation. Part of your thesis is to have price product service offerings which are then given but on the other side - and we touched around this a little earlier - they still will need to want to then assess what the supply side is going to be. What methodology are they going to actually use? I mean it always ends up as a mechanical process in some sort of a way.

PROF ROUND: Yes, I agree.

DR FOLIE: So we throw CAPM out but what - how do they then - what sort of methodology - or are they back into another complex - I mean this is a thing we may actually throw out, we've got workable competition that's got a lot of factors so they've even got more factors to take into account than they actually had before so it may be worse off.

PROF ROUND: As I said, it's not going to make the regulatory task any easier.

DR FOLIE: That flows back onto the companies.

PROF ROUND: Yes, it will go back onto the companies. The companies will have to produce better arguments as to what they want and perhaps justification as to what they deserve as well as what they want. But that's not necessarily, I suspect, a bad thing to put some of the onus back on the companies, because after all they're asking for in a sense a dispensation from the competitive process. But the regulator will have to be prepared to give and take as well.

If what the company is arguing is within the range of what might be deemed to be acceptable by those in a position to judge then I think that's probably appropriate. But someone obviously has to make the decision that what company A is arguing for is "reasonable". We couldn't necessarily see why it's outside the range of what might be regarded as normal or acceptable or whatever. But, yes, I agree with you, Michael, that there is no magic formula here.

DR FOLIE: The regulatory processes are intervention and therefore they're going to upset people; that's the nature of them. The solution in the United States is have incredibly prescriptive detailed sort of 700-page book that you fill out and you get every line to remove the fight that normally takes place with unhappy people at the end because someone hasn't got it right. So it tends to be, once you regulate, to drive itself to a very mechanicalistic sort of process. We have one that's being used a bit here. The paradox with the workable competition, it may be it's so loose that you've got even more variables that you may then be in court.

Because that's the other problem of the justices are that we've got too much discretion for the regulator. Have you already through that this is really what they believe, this is the right way to go?

PROF ROUND: It's a trade-off between flexibility on the one hand and this other result that you've just characterised on the other, and the inevitable cost in terms of resources of having to go down and check off every one of these 600 or 700 conditions. On the other hand, flexibility gives the regulator the chance to assess whatever is put up by the regulated firms and a chance reasonably efficiently to come up with a sensible conclusion but on pain of being challenged in the court.

I guess the only way you can really do that is over a long enough period of time evaluate the decisions, the cost of coming to them, and what the outcomes have been. I mean that is a massive research question and a big research project. But I don't think there is a simple answer other than to say it's a balancing question.

MR LEE: I was just going to say that I was the head of Office of the Prices Surveillance Authority for a number of years and certainly companies would come to us regularly for price increases, not based on any analysis of their costs or capital rate of returns or anything else, but just to justify it against a number of ministerial criteria, although one was related to costs which was unit costs. But nonetheless they were granted price increases on the basis of the validity of their arguments about, is it improving jobs, is it innovative, is it a real new investment that helps customers - those sorts of directions, and that's how the authority made their judgment, on the basis of the strength of those arguments.

I would see this operating in a similar way, although David said there's a whole range of characteristics of workable competition. I think you can reduce a lot of them down to about five or six. In fact if we go to one of my submissions, they're the main ones that they would focus on. Really the proposal to a regulator then will be along the lines of, not as it is now, about what is some perfect level of optex efficiency that Americans might or might not achieve, but rather, what do customers want in terms of the improved security of the system or reliability for our street or undergrounding for our suburb or reasonable development, or whatever, then to show the costs of those changes and get the regulator to judge whether they were good value for money on behalf of consumers.

That's what they ought to be judging, in the same way that the PSA operated. Now, it's not specific. It doesn't come out to two decimal places of rates of return or anything else. But hell, that's the competitive market. There's a bit of fluff on it.

MR HINTON: Can I, on reference tariffs - we've got about seven minutes left. On reference tariffs your submission picks up or expresses the view that the regime doesn't require the building-block approach to be applied. But others have argued to us that in fact section whatever it is, 8(4), 8(5), the total revenue target must be set by one of three ways. Isn't there an inconsistency here between that view and that view?

MR LEE: Yes. I think the code is a dog's breakfast.

MR HINTON: We got that message.

MR LEE: You know, you've got this legal view of what the law is about, what this act is about. Then you've got - well, we know the people involved who actually devised this code, so there's no surprise to us that it was a dog's breakfast where you ask one party what they want, another party what they want, and you come to some sort of, you know, line in the middle. But anyway that aside, then you've also got the stuff that was added on. I have to say, Tony, because of the influence of the Federal

Treasury and no doubt the Department of Finance in the early 1990s and certain people there that wrote pages about this sort of stuff, that it all sort of fell into these codes in an ad hoc manner, and I think regulators can take some comfort from some of the detailed statements in the Gas Code that what they're doing is what the act requires. Well, okay, they can take some comfort that the justices have said - but no matter what you do in the detail, you've got to come up with result that says something different and that difference is, it's got to be workable competition.

MR HINTON: So this is unnecessary detail, this debate, in circumstances where your basic concern would be met if you had moved to the pursuit of workable competition in applying that building-block approach.

MR LEE: Yes, that's right. I mean, I'd like to see all that stuff about NPV and all that taken out because I think it just confuses what the law was about.

MR HINTON: One more question and that's in relation to - I think David might have referred to it in his remarks as well. It's this idea that the starting point should be that all existing covered distributors under the current regime should move to this monitoring regime, monitoring tier, and of course with a binding of five years. You might have heard me raise this question this morning. Does that not lend itself for challenges of lack of rigour, lack of robustness, in terms of - rather than case by case determination with regard to the thresholds that we're seeking to put on the table?

MR LEE: When, again, I was with the Prices Surveillance Authority we undertook the first formal monitoring reports under the act. Monitoring had always been part of the Prices Surveillance Authority before 95. In fact it goes right back to the Prices Justification Tribunal. There have been various forms of informal monitoring conducted by that body. Now, in 95 the first formal monitoring exercise was taking - ACI was the first one. Now, ACI is a stone-cold, hit-you-between-the-eyes monopolist. It was at that stage, no question of that, and it's declared under formal monitoring. In other words, the government thought it was efficient and they no longer needed a price control; the formal monitoring would be sufficient.

There's no doubt that the formal monitoring process worked because in essence, what those reports are saying is, "You, ACI" - I shouldn't have mentioned names but anyway that's who it was - "you start being a lot nicer to your customers. You start updating your 1920 means of production into something a bit modern so the quality goes up. You do all these other sorts of things and we might take our controls off one day." Well, wonder of wonders, one year later, after this first message has been delivered to them they start to do all of those things.

MR HINTON: Let me be a devil's advocate - - -

MR LEE: So it's quite a strong - now, this public revelation of what companies do is quite powerful.

MR HINTON: I'm not suggesting that monitoring doesn't have a very persuasive force for good behaviour. I mean, that was discussed this morning as well. But rather, I'm raising the question that if you move to a starting point of all in the tier of monitoring, that in itself will be a strong inducement for more intrusive monitoring and that would be the sort of thing that I would have thought that Allgas or Energex or ENA more generally would be quite uncomfortable about. In fact you've already expressed concerns about regulatory creed.

But if you had a case by case judgment about whether you're in the cost-based price regulation or the monitoring tier, then that would in fact give you more comfort that the monitoring is then being appropriately applied to the appropriate set of infrastructure as opposed to this more intrusive process that would really start to be cost based. That's what I wanted to test you on.

MR LEE: I would agree with that basically. But I mean, the thought that runs through my head is, I don't think the costs - there could be any more intrusion than exists at the moment on any regulatory system.

MR HINTON: Michael, how are you going, all right?

DR FOLIE: I think I have the last bit. No, I'm right.

MR HINTON: Trevor, David, Jennifer, Patrick, anything else that you'd like to flag that we haven't focused on, at 10 past 3?

MR LEE: Thank you for the time.

MR HINTON: Okay. Well, thank you again for your submission and your participation and your involvement. It's important and we know it's not costless, so thank you.

MR LEE: Thank you.

MR HINTON: That concludes today's scheduled proceedings. As foreshadowed though, and in accordance with the Commission's established procedures, I now offer the opportunity for anyone else present to make a statement if they so wish, though of course it goes with the usual rider: if you wish to speak then you come to the microphone for the transcript and you identify who you are. It's called accountability and transparency, and I can see no-one rushing up to take up my generous offer. So I will adjourn these proceedings, thank everyone again for their participation and attendance, and note that the next hearings are in Sydney tomorrow, Thursday, 25 March. Thank you very much.

AT 3.15 PM THE INQUIRY WAS ADJOURNED UNTIL
THURSDAY, 25 MARCH 2004