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

INQUIRY INTO THE GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON FRIDAY, 12 SEPTEMBER 2003, AT 9.18 AM

Continued from 11/9/03

MR HINTON: Good morning, everybody. Welcome to the public hearings for the Productivity Commission's review of the Gas Access Regime. This is our second day of hearings in Melbourne. My name is Tony Hinton and I'm the presiding commissioner on this inquiry. My fellow associate commissioner on the inquiry, on my right, is Michael Folie.

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

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

We will then be working towards completing a draft report for release in mid-December, and we will invite participation at another round of hearings to discuss that draft report for hearings in early 2004. We like to conduct these 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 staff here today. As all participants probably know, submissions to this inquiry are also available on our web site.

To comply with requirements in the Commonwealth occupational health and safety legislation, I draw attention to those present to the exits at the back of the room and to my right in that corner, and to the fire exit stairs on this level opposite reception. That's on the other side of the lift lobby. In the case of an emergency, an alert system will be activated, a beep-beep, whoop-whoop system that we're all probably familiar with, and there will be fire wardens available if that circumstance were to arise. That completes my introductory remarks for this morning's hearings.

I therefore now would like to welcome our first attendees for this hearing, Mr Chris Welberry and Mr Nigel Collins from ExxonMobil. Welcome. What I'd like you to do at the outset is to identify yourself by name and organisation, by company, both for the purposes of the transcript but also to confirm that the sound system is operating properly, and then, if you would so wish, I invite you to make an introductory statement to facilitate proceedings this morning. Thank you very much.

MR COLLINS: I'm Nigel Collins from ExxonMobil. I'm with the gas and power marketing group in ExxonMobil, and my responsibilities are really regulatory affairs.

MR WELBERRY: I'm Chris Welberry, and I'm responsible for government affairs for ExxonMobil's upstream businesses in Australia and PNG. Nigel is going to do the introductory statement.

MR COLLINS: I guess just first to introduce ourselves as a company: we have interests in the gas industry in Australia and I'll obviously give you some summary of that. We hold 50 per cent and are operator of a Bass Strait joint venture with BHP Billiton. We supply gas into Victoria, New South Wales, Tasmania and soon South Australia. We hold 20 per cent in the Cooper Basin joint venture, which is operated by Santos, and that operation shifts gas into New South Wales, South Australia and Queensland. We hold around 40 per cent and are operator of the gas project in PNG, which is currently seeking markets in Australia, and we have equity and substantial interests in gas resources for Western Australia and again are working with joint ventures to commercialise those.

Just to give you a perspective I guess now on what we see as the state of the market in Australia, and then some specific comments on relevant terms I guess to this inquiry: since the early 1990s there's been significant development in the gas industry in Australia, both in terms of pipeline infrastructure and, most importantly, of upstream and downstream competition. We believe the key to that development has been the deregulation of the industry and particularly with the removal of barriers to interstate trade, the removal of the exclusive franchises to market access with AGL in New South Wales and Gas Corp in Victoria, breaking down and vertically separating ring fencing of the government-sponsored or owned transmission, distribution and retail monopolies, markets opening up with the foreseeable expiry of the long-term historic supply arrangements and negotiation of foundation shipper arrangements to underwrite new pipelines interconnecting markets.

We believe that these elements were key to the development of the competitive national market we see today. We believe that while the Gas Access Regime has supported the development of the market by facilitating third party access to some of the historically protected monopoly infrastructure, we don't believe that it was a fundamental factor in the market's development.

The further development of strong and deep competition in the gas industry, including upstream competition, will now directly depend, we believe, on the creation of new market opportunities and development of new upstream supplies from remote basins. We believe that critical to supplying those market opportunities and bringing those new resources to the market at competitive prices will be the efficient development of new gas transmission pipelines, as well as fair access to existing pipeline infrastructure.

The development of new upstream projects and new greenfield pipelines requires enormous capital investment, and key to the development is negotiated foundation shipper arrangements. It is vital that the regulatory environment aims to support the efficient development of such infrastructure and aims to minimise regulatory risk, both for the pipeline developer and the upstream developer and foundation shipper. ExxonMobil believes that the existing Gas Access Regime does not necessarily provide that balance.

We have some real concerns relating to the Gas Access Regime in relation to its support of greenfields projects. First, one must recognise that under the existing regime there is potential for a coverage determination after construction of a pipeline, and then, following from that, determination of a third party access tariff that may be lower than say a foundation shipper's tariff. This places significant risk on either the pipeline developer and/or the foundation shipper. To minimise the risk, the shipper can try to negotiate a matching clause say in his agreement, but obviously that places the full risk onto the pipeline developer, so the output from that may be that the pipeline developer won't develop the pipeline because their risk of a return may be lower than he's accepting, or that the tariff being lower for a further secondary shipper, if you like, may mean that the foundation shipper is no longer competitive in that market for growth volumes, so the pipeline may not proceed or the project may not proceed.

I guess we ask: is that the most efficient outcome for the market? And, further, I guess the consequence may be that the pipeline is built with no spare capacity and, again, is that the most efficient outcome for the market? From our understanding, an example may be the SEA Gas pipeline, although we're not directly involved in that pipeline, but we don't believe - or our understanding is that we don't believe there's a spare capacity within that pipeline.

Under the current gas access arrangement, the tender process is a regulatory mechanism that's intended to facilitate the market determining a competitive access arrangement prior to construction, and this process was utilised by Chevron in the case of PNG gas to Gladstone pipeline as part of that massive PNG project development. It's our experience, however, that since becoming project operator the tender process, while it is intended to provide some certainty, does not provide sufficient flexibility to assist the project as market opportunities firm and the pipeline routes need to be re-optimised to assist the project and extend it. We also believe the tender process is extremely slow and cumbersome, presenting its own difficulties to pipeline developments.

I do want to make it clear that we're not suggesting that the gas access arrangement has had a substantial impact on the ability to gain market commitments or has specifically at this time slowed the project or is hindering the project, but the ability to look at new pipeline routes as markets develop is a problem under the existing tender-type arrangement which the project has moved along on.

We believe that the nature of greenfield gas is such that it must be landed at a competitive price in the market, otherwise the project won't proceed and, further, there are strong commercial incentives for pipeline developers to fill their pipelines as rapidly as possible. Therefore with such strong competitive and commercial forces existing, we believe that development of greenfield upstream and pipeline projects would be greatly assisted by the adoption of a COAG recommendation to provide an initial regulation-free period for greenfield pipelines. We believe the length of that regulation-free period should be sufficient to provide certainty for the pipeline developer and foundation shippers, and a period of 20 years would seem perhaps appropriate. Following this regulation period, coverage should not be automatic and should be reviewed in terms of the competitive forces but protect against monopoly power at that time.

ExxonMobil recognises that there may be circumstances where existing pipelines and pipeline systems are subject to limited competition. An example may be the low pressure distribution pipeline systems, where duplication costs may be too high to ever represent a realistic competitive option, and where equitable and competitive access is vital for full retail competition.

While there may need to be regulated access, we believe it is important that it provide sufficient certainty to encourage ongoing efficient system augmentation, extension and expansion. In our submission we suggest the Commission review alternative European regulatory models that provide generic published rates of return that apply for a period, and some of those models include a higher rate of return for an initial period for new pipelines.

We also note in the Shell submission that in some of those jurisdictions they also allow a regulatory-free development of LNG facilities and we see that rather akin to long-distance greenfield pipelines in Australia which are bringing gas from distant sources to markets. ExxonMobil fundamentally believes that free commercially negotiated market outcomes between pipelines and users are the most efficient and effective approach to provide an environment for market growth, security of supply and infrastructure investment.

The Gas Access Regime in its current form is fairly heavy-handed regulation. We believe as the market develops and competitive forces strengthen, the aim should be for a movement to lighter-handed regulation. Further, we believe coverage of transmission pipelines should be restricted to pipelines where free and fair commercial negotiations have failed or are not possible due to the absence of competitive forces and presence of monopoly behaviour. ExxonMobil, however, believes that such moves to light-handed regulations are best supported in an environment of strong, demonstrated and enforced ring fencing of pipeline infrastructure from downstream marketing activities.

We also highlight in our submission that a further area for the Productivity Commission to address is the excessive time that it takes for coverage and access arrangement authorisation decisions. However, we believe that the adoption of some of the recommendations proposed in our submission, and particularly so the Parer recommendation for regulatory-free periods for greenfields pipeline, may address some of those time issues. I guess that really covers the key areas from our submission, so thank you for allowing us to come here today, and we look forward to being involved in the further review as it develops.

MR HINTON: Nigel, thank you very much for those comments and thank you also for ExxonMobil's written submission that you've also referred to, and thank you for ExxonMobil's participation in this inquiry more generally. A couple of matters I'd like to explore in the time this morning we have before us: the first one is in a broad area. You make comment about the Gas Access Regime as not being crucial behind the developments that have occurred in the gas system, gas sector more generally generically defined, and there are all sorts of factors at work there. I'm sure that you better than most appreciate.

But what really is before us is more of a reverse of that - that is, does the Gas Access Regime actually impede investment occurring, in a sense the counterfactual - what would have been the gas sector characteristics and growth in the absence of a Gas Access Regime? That's almost an impossible task to come to a conclusion on, but we would welcome your comments on that in a more specific concrete form, the sort of impact that the regime might or might not be having on investment in terms of impeding investment.

MR COLLINS: Yes. I guess we haven't seen specifically any pipelines not go ahead because of the Gas Access Regime. However - and I guess as we've said in our submission - we have concerns that it really encourages pipelines to be built fit for purpose, so to speak, without spare capacity, and again we ask is that really the most efficient development of a gas sector, in that the cost of augmentation of those pipelines later looping compression et cetera, we believe is typically quite - is higher than purely putting in a slightly larger diameter pipe in the first place.

That's speculative, I guess, for a pipeline developer, and not being pipeline developers it would be up to them if they see that as being beneficial to putting that speculative investment. However, a risk of having a regulated lower rate of return imposed after construction of a pipeline certainly seems to be encouraging this built-for-purpose development, and we don't really see that as being beneficial to the industry in the future.

So how you would perceive the market would be: had the Gas Access Regime not been in place, from the point of view of the historical monopoly pipeline infrastructure, I guess it provided a framework for early access to that infrastructure and for developing access arrangements for that infrastructure, and may have assisted negotiated type arrangements from that point of view. Certainly from the development of a greenfields pipeline, I'm not sure that we would see that the market would be any different had it not been in place for those greenfield pipelines.

MR WELBERRY: Can I just add to that?

MR HINTON: Please, Chris.

MR WELBERRY: I suppose another way to look at it is, since deregulation of the market, the ability for interstate trade - there have been some major interstate pipelines been put in place. They have happened in isolation of each other, and they have all had different experiences in the market. I suppose pipeline developers will now be looking at the experience of those pipelines that have been put in place, in making decisions on the next phase of development. So while those initial investments may have taken place, if pipeline developers have the attitude today that problems have been put up as a result of those investments, that may affect future investment as they go forward. That's something we really don't know today, but it is an issue that needs to be taken into account.

DR FOLIE: I'd like to ask a related question to this, and you will probably want to take it on notice and you may be unable to answer it - issues about - you know, we talk about efficient markets and things, that also relates to investment efficiency. I want to know - Exxon has a major involvement in pipelines all around the world - probably of all the people appearing before us, it would be more likely to have this sort of information.

What would be insightful would be to get an idea of the different, if you like, weights on capital efficiency between building a pipeline initially fit for purpose, building it at 50 per cent capacity then and there; the next stage would then be, to meet that same capacity level, what it would cost to do it with compressors - in other words, if you start at the initial and expand it, and then the other one would then be to be able to do it through looping, to get an idea, if you like, of the inefficient allocation of capital involved in actually building a pipeline fit for purpose. I think it would just help clarify the numbers, because there is a loss of economic welfare if we actually under-invest into inefficient non-state of the - - -

MR WELBERRY: We can provide that.

MR COLLINS: We'll have to take that on notice.

DR FOLIE: I understand. But that would be very useful, to have some indicative idea of those relative weights.

MR HINTON: You've put a lot of weight on the regime encouraging building to known demand. Are there techniques that could be incorporated into the code that removed or reduced the regulatory uncertainty, that removed that negative impact of the code on design to capacity - construction to capacity - the capacity decision, feeding in some growth factor there? Isn't there a possibility that the code could be modified to have the regulator give signals?

MR WELBERRY: I think the regulation-free period is something that we think would be very simple - a simple way of doing that. It then becomes a question for the pipeline, whether they're prepared to take that risk in building over capacity at the time they make the investment, that they have some certainty that they're not going to be disadvantaged in doing that. But at the end of the day it is speculative on their part. They, at the point that a pipeline goes ahead, don't know whether they'll be able to fill that capacity.

MR HINTON: I was reading your comments about the greenfields approach and the regulatory holiday of 20 years as being directed at the issue of the Gas Access Regime being a threshold issue, blocking actual decisions to pursue commercial opportunities for constructing new pipeline, and I'd like to get onto that again as well - come back to that.

I was reading your comments about constructing to known demand as being a slightly different issue than the greenfields issue of a threshold question of whether you have it or not, and I was therefore putting to you the possibility that you could have regulatory involvement, but have it in a way that, if it is going ahead, you've passed the threshold test of greenfields being constructed; what sort of regulatory structure might apply that would ensure that it didn't impede commercial imperatives that took the constructor down the track of building beyond known capacity.

MR WELBERRY: Yes. I guess one of the other suggestions under the COAG was again up-front coverage, binding coverage decisions. I guess, depending on what type of pipeline you're talking, most of these I suppose are greenfields - I mean, the SEA Gas pipeline is essentially a greenfield pipeline development - so, as Chris says, really we see probably one of the strongest solutions is this unregulated period for a greenfield pipeline. If you have that, you don't really need a binding - or I guess maybe the binding coverage decision is that this is a greenfield pipeline and therefore fits into the 20 year. If a decision is made under the existing arrangements, but it's not covered, or it won't be a covered pipeline for competition reasons, and that's binding, then essentially that's a similar result, I guess.

DR FOLIE: Another way to look at it is that if - and again usually offshore developments, ExxonMobil, you've actually got a significant pipeline, usually going to shore - do you ever build those actually fit for purpose, in other words, without regulation there - you make your own commercial decision? Usually they are presumably over size to some degree. So there's an issue between what happens onshore in the regulated environment and the one where the commercial activity takes place.

MR WELBERRY: Yes. It's a little bit different with an upstream facility, because you're pretty much building a pipeline fit for the field development, that you fully plan before you go ahead with it. So it would be relatively rare that you would build over capacity in that system. For example, in Bass Strait we have a very significant pipeline network, some 900 kilometres of pipeline linking our offshore fields into our processing facilities, but in each specific field development that would all be planned and developed up-front and the pipeline infrastructure involved in it would be fit for purpose, and as you deplete the field you will get into a situation where natural field decline will mean that in fact you're probably not utilising the full capacity of that infrastructure. So it is a little difficult to compare those two.

MR HINTON: The 20-year regulatory holiday that you are strongly endorsing and others have raised with us - an alternative that has been put to us is where there is no regulatory holiday but the regulator is obliged to transparently recognise the truncation of profits that could flow from coverage and regulatory intervention and therefore the possibility of countering that would be for the regulator to be obliged to take into account the possibility of higher rates of return with even scope for some degree of blue sky return, if that's how the commercial outcome results. Would that not be another possible approach for the code - the Gas Access Regime - in terms of addressing the perceived greenfields issue?

MR WELBERRY: Just to give you a bit more of a rationale on why we think the regulation-free period is an appropriate way to go forward, we very much believe that with a greenfield project, before the project goes ahead you've got to have an arrangement in place between the user and the upstream developer, an agreement in place that delivers gas into the market at a price that is going to allow the buyer of that gas to be competitive in that market. We think that that foundation agreement, if it passes the test and meets everyone's objectives in getting the project up in the first place, then that foundation shipment agreement is something that has been based on competition. That, we think, is the best outcome for the market.

If somehow the Gas Access Regime undermines either the shipper's project or the pipeliner going forward then we just don't see that that's in the best interests of the market, and this regulation-free period just seems to be a very simple way of allowing that to occur. At the end of the day, if you can't get an agreement in place with a buyer that meets their financial objectives and meets ours in getting an upstream development up, and meets the pipeliner's requirements, then the project won't go ahead. It doesn't really answer your question on this alternative approach. We would favour this approach because it is light-handed and it reflects a competitive outcome that everybody in the market has been able to agree to.

MR COLLINS: And protects the foundation shipper to a certain extent. If the agreed rate of return is getting the project up, or a tariff system is getting the project up and allowing gas to be sold into the market at a competitive rate, to have so small a level of volume - the last increment of capacity on that pipeline able to be regulated to an extent but it might be a lower tariff - the pipeline may still go ahead, but as I say, the foundation shippers find themselves in quite a difficult position for, say, growth volumes or perhaps even meeting their target volumes.

MR HINTON: But wouldn't there be scope for the regulator to take into account the possibility down the track of MFN clauses coming into effect, without eroding the foundation customer's position?

MR COLLINS: There may be potential for that but again that would be the regulator getting very heavily into the negotiated contract - separately negotiated contracts - and whether that's an optimum solution would be questionable.

DR FOLIE: If we go right back to the beginning, this thing is actually to allow access to pipelines, and originally it was for very significant national access. It's a hypothetical question so it has got to be answered hypothetically. Let's assume that there was an agreement between PNG shippers and you've got customers in eastern Australia; there is suddenly a gas discovery and you've got your 20-year regulatory-free period on the pipeline, which you sort of have anyway through the bidding. Let's assume there is a big gas discovery in the Gulf of Carpentaria. They are a different group and they want to get access to that pipeline to be able to bring it down into eastern Australia. The regulatory-free periods may well inhibit that market getting the gas because it may well be the customer down there doesn't want another supply of cheaper gas coming down and competing in the electricity market. But if the broad national objective was to enable this field to get developed how would that regulatory-free period be addressed to enable something like that to occur?

MR WELBERRY: In the case of the PNG project the pipeliner - the owner and operator of the pipeline - would be a different entity from both the PNG producers and the customers at the other end. You would think that it would be in their commercial interests, if they have spare capacity, to fully utilise that capacity and that would be something that they would be able to negotiate.

MR COLLINS: I guess we made the comment about ring fencing as well, but we see that as a fairly important element, to ensure that there are those sorts of commercial incentives for a pipeliner who may also have an affiliate at the retail end of the business as well, so there should be the commercial incentives to fill a pipeline.

DR FOLIE: Part of the access regime was to sort of - as envisaged back in 94 - to put a little bit of, shall we say, stick - in other words, encourage - to try and accelerate that. Do you believe that would happen? It could be crafted, I mean.

MR WELBERRY: We very firmly believe that it is possible to negotiate an acceptable outcome and that's our preference in doing that everywhere that we operate; that it should be in the pipeliner's interests to see that capacity filled and you should be able to negotiate an outcome. We have seen very few instances, if any, where that has not been possible. I think in the early days of the code there was a situation where it was necessary but in recent years that really hasn't occurred. That was the point we made through our submission, that the environment that existed when the code was brought in - it's a very different environment today. The level of competition is such that there really is a commercial incentive on all parties to be able to negotiate deals.

DR FOLIE: You mentioned earlier in your paper that effectively the nature of how gas is going to be developed and sold in the future is somewhat different; the market is changing from how it was, traditionally. As I understand it, traditionally you had of the order of - let's say - 25 to 35-year block contracts. Do you envisage now going for shorter blocks? How do you see the market changing and what impact is that likely to have on understanding the distribution and transmission system?

MR WELBERRY: While there is certainly significantly more competition, both in the pipelines, in the downstream and in upstream production, the Australian gas market is still very liquid. There are relatively few buyers. It is still necessary, particularly for a greenfield project, for fairly significant 20 or 30-year contracts to be in place to be able to underwrite that initial investment. We don't see that changing in the near future. But what has changed is that those arrangements are all being negotiated in a very competitive environment where in all of the eastern seaboard markets now you have a very significant number of upstream producers competing for those contracts.

So while you are still looking at a fairly substantial length of contract you are looking at them negotiated on a very competitive basis. Most of those contracts are also being negotiated with regular price review clauses in them. So prices are being readjusted through the life of those contracts. But the terms are still going to be, for the foreseeable future, the 20-year period to underwrite the initial investment in both the pipeline infrastructure but also the upstream developments.

DR FOLIE: As part of that, a number of submissions have stated to us that one of the problems in Australia is that there is insufficient upstream competition. In other words, the basin to basin and the ownership structure as well as the joint marketing arrangements are actually inhibiting upstream competition, which of course is the drive for downstream competition. How would you respond to that?

MR WELBERRY: I have seen the argument and I know there are a number of people putting that argument. I find the separate marketing thing very curious - the cross-ownership. The way that the upstream industry works with joint ventures is really a natural ring fencing arrangement. As Nigel mentioned, we are involved at the moment in all of the basins in the eastern seaboard, but we are involved in those ventures with different joint venturers in each of them. All of those operations are ring fenced from each other. There are very strong firewalls in place within our organisation between any of the commercial arrangements that go on between those joint ventures.

So you have that natural ring fencing, in the sense that you've got different joint venturers involved and it's totally unacceptable to those joint venturers that that cross-ownership has any relevance to what goes on within those joint ventures. I just find that separate marketing thing very curious. On the other side of that, if you were forced to separately market your gas, and say for ExxonMobil you were separately marketing but on a full basis across all of our interests, the implications of that on competition to me just seems that they would have more of a concern with that.

That aside, there is now a significant number of upstream ventures selling into all of the markets on the south-east. The number that we put in our submission was something like - in all of the major cities you are looking at between three and six producing basins or producing joint ventures selling into each market. On the other side of that there has been somewhat of a contraction in the number of gas buyers - and by buyers I mean aggregators and not big industrial users.

In terms of the buyers that are now in the market there are really three major retailers, AGL, TXU and Origin, and Origin very publicly say that they have got a very clear vertical integration strategy. So for an upstream producer to sell gas into south-eastern Australia you've really got to deal with either TXU or AGL. That's on the one side. On the other side you have now got between three and six upstream producing basins trying to sell into that market.

MR HINTON: If I interpret your words correctly you are saying that your push for lighter-handed regulation is crucially dependent upon, for its sustainability, having very clear requirements concerning ring fencing?

MR WELBERRY: Yes. In the upstream businesses there is a natural ring fencing there already, in the fact that all of these ventures are usually with different joint venturers. That works very well. There is very active competition.

MR HINTON: I understand how the commercial imperatives for different participants in joint ventures can separate decision making. What I was going to ask you was, when you do have a vertically integrated company and it's ring fenced through regulatory intervention, how sound is that ring fencing? Is it bullet proof? Is the ring fencing capable of delivering what it seeks to deliver?

MR WELBERRY: It should be.

MR HINTON: I know it should be, but some have cast doubt. The point of asking is that some have cast doubt on the capacity of a regulator to put in place a ring fencing requirement that is actually waterproof.

MR WELBERRY: In our experience, it's in the commercial interests of those involved that it does work. If you look at a company that's involved in both distribution and as a retailer and pipeline owner, by separating out that pipeline and running that as a commercially separate entity and fully utilising the capacity that they have in that pipeline - is in their commercial interest. The market is full of people that say those things don't work. I think they do work.

MR HINTON: Come back a step to - we were talking earlier about capacity. Under the code, proponents argue that there is flexibility in the regime that can in fact have expansion of capacity through decisions to augment to expand by the use of funding for loops, compressors, whatever, and that the code is designed in fact to facilitate that process of emerging demand being met through this capacity to enhance capacity, though we don't seem to have experienced that occurring very often. Why is that the case? Why isn't this part of the code not working?

MR WELBERRY: You mean, where capacity is full and no-one has gone out and required an expansion?

MR COLLINS: Presumably the market isn't there. I guess so much we would say, and commented in our submission that really we believe the development of systems and transmission pipelines et cetera have not really been as a result of the code. You can argue how much it may have hindered or worked for the efficiency of the development of those but have really been underwritten by the market opportunities opening up, potentially some new finds of gas in say the Otways and things like that and those finding a market. So much is really being developed as a result of the market actually, the position of the market now with new customers with historic agreements I guess winding down in the foreseeable future and a need for gas by the market. I would imagine that part of the reason why some of the augmentation and expansions may not be occurring may be because of the market itself not being there to underwrite.

MR HINTON: So you wouldn't look to the deficiencies in the code as being - rather than facilitating augmentation, it's not impeding augmentation?

MR COLLINS: We've not really any great experience I guess in that area.

MR WELBERRY: Yes. I mean, I'm not sure if there's an example at least in the transmission system that we're involved in where that has been an issue to this point.

DR FOLIE: I'd like to come back to the tender process. I think there are some interesting points you made about, if you like, the east coast pipeline, PNG down to Gladstone. I'd like to get a better understanding of the level of regulatory intervention that goes on actually as a result of feeding back to the ACCC - in other words, what is occurring. If you suddenly find you've got a customer somewhere that requires the pipeline to be slightly relocated, to what extent do you actually have to keep getting approval for things or do you have to wait until you've actually got a very clear idea and then put a proposal and then they may actually come back and say it no longer fulfils the tender conditions? Just elaborate a little bit more about, if you like, the interaction between the regulator and the marketing/the pipeliner.

MR COLLINS: I guess firstly we're not the pipeline developer.

DR FOLIE: I understand that, but you're the marketing.

MR COLLINS: That's AGL and Petronas. We can't really speak for them, obviously, and they've probably had far greater discussions with the regulators than we have. They're obviously in discussion - - -

DR FOLIE: Do you find a constraint in your marketing activity then as to - you've got to be cognisant of - - -

MR COLLINS: Certainly, from our experience, there is very much a process, and has been, I guess of keeping particularly the Queensland government, who are really overseeing the overall process, informed of where marketing opportunities are and the status of the marketing position. I guess really though it was the latter that you described, that it's really a case of firming up the market and then going with a different arrangement because it really can change dramatically, the pipeline route. To be continually going back and saying, you know, "Look, it may be here now, or it may be here or it may need to be this capacity or it may stop here or we may need an extension here," would be a nightmare to manage for both the regulator and I guess for APC and Petronas. So it's really been developing the market and then going back with potentially an alternate route but at the same time simply keeping some information flowing.

I think the experience has been that the regulators have certainly tried to do whatever they can and certainly have been very interested in how the project has been developing, so it hasn't been as if there have been any sort of blocks up, but it just highlights some of the problems with the current tender process, that it is very easy to find that, as you're developing, you do it very early in the process so that you do have, I guess, some certainty over returns and tariffs and things like that - arrangements that would be ongoing for the pipeline, but then there's a process where you're having to firm up markets, having to look at, you know, firm up customers and the actual capacity and size and route of the pipeline; so that process then starts taking place and there's not really the flexibility to be able to move a pipeline route to any great extent or to perhaps change capacities greatly or extend it greatly to new markets.

MR WELBERRY: I suppose, while I know this is a hard ask, the more generic that initial proposal could be and the more flexibility that could be in the initial proposal would facilitate that process going forward. You have to have a very specific proposal to start with and then every time it's changed - you know, it's an iterative thing, but if you could generically say, "Well, we're going to take gas from up here and sell it in this range of markets and there'll be a pipeline that facilitates that" - now, clearly there are issues in how you would actually do that but anything that could be done to make that more generic would be of assistance.

MR HINTON: You referred in your introductory remarks but also picked it up in your submission the issue of timeliness of regulatory outcome and the implication of your remarks is along the lines that lighter-handed regulation by its very nature would lead to more timely regulatory outcomes. I think a persuasive case could be presented that way by definition almost, but are there other aspects of the processes inherent in the Gas Access Regime today that lead to lack of timeliness or delays in decisions that you'd want to draw our attention to?

MR COLLINS: I guess no specifics, but I guess there's got - as soon as you have a regulatory process that requires - and I wouldn't advocate that there wouldn't be need for public submissions at all but as soon as you have that basis there is a very significant due diligence type process that needs to be gone through, of receiving public submissions, drafting, decisions, receiving comment again, so it's hard to see how that process perhaps could be improved and not actually having made submissions but not actually having been involved in developing a pipeline and seeing what - you know, there may be pipeliners who have better ideas on how that might be sped up.

MR HINTON: Is there anything else that you think that - Michael, go ahead.

DR FOLIE: I've got one last one which - effectively, everywhere you've light-handed regulation and you've reported in your paper the idea that effectively you should have published rates of return. I can understand that there is an issue in the industry about WACCs and the level and the arbitrariness about how they're selected. Putting that aside but just publishing a rate of return, you still end up with a heavy-handed building block process under that regime. It just removes - because you've still got to determine prices, revenues and the cost base, et cetera, so you've still got the same regulation, just that you might be able to get a better rate of return out of it. Is that what you're really proposing? In other words, still the heavy building block?

MR COLLINS: Where there needs to be regulation, where there's been a market failure, negotiations have not been able to be resolved where there are pipelines where there are clearly monopoly conditions that make negotiations very difficult. As we say, there may still need to be regulatory oversight. We don't necessarily advocate it. I guess what we have seen in Europe is that there has been - it seems most of the regimes are regulatory regimes - have up-front published tariffs which last for say the next five years. The rate of return will be you know 9 per cent, 8 per cent or something, and they typically recognise that a new pipeline - and sometimes they'll say, "If it's bringing competition" - I'm not quite sure how they judge whether it's bringing new competition to a market that has a higher rate of return, and it might be an additional 3-4 per cent, and as I say again in Shell's submission there's typically no - basically a free period for new LNG facilities.

I guess I put it to perhaps the Commission that in your review it might be worth looking at some of those regimes. Just simply that for pipelines where there is still required a regulatory oversight it may actually provide them with at least some knowledge of what the ongoing return is going to be for the next at least say five years, and perhaps if you are looking at trying to encourage some augmentation, extensions, expansions, to some of those systems, perhaps a slightly higher rate of return may encourage that, and I guess by having that published you would fairly quickly be able to see if it's actually working - if it really is encouraging - if it is the appropriate rate.

Currently it would seem that you don't really know what rate of return you're going to get until you've gone through this very long process after potentially you have built it or you wanted to build it - you know, that could be a year or two down the track before you virtually know what sort of return you are going to have. It's not necessarily advocating the position, but simply it may well be something that provides some of that certainty for existing facilities.

MR HINTON: Anything else you would like to emphasise that we haven't covered in this discussion?

MR COLLINS: No, I don't think so. We've covered pretty well all of it.

MR HINTON: Thank you very much for your participation today and your written submission and we appreciate bringing your perspective to these issues. Thank you again.

MR COLLINS: Thank you.

MR WELBERRY: Thank you.

MR HINTON: We'll take a one-minute quick stop before we go to the next session.

MR HINTON: Good morning, everyone. Welcome to this second session of this morning's public hearings for the Commission's inquiry into the National Gas Access Regime. I now invite Mr Patrick Murphy of TXU to the table. Welcome, Patrick.

MR MURPHY: Thank you.

MR HINTON: It is a pleasure to have you here. In accordance with established practice I would be grateful if you could identify yourself and your company for the benefit of the transcript, but also to confirm the sound system is working okay.

MR MURPHY: Certainly. Patrick Murphy. I'm TXU on the network side of the business.

MR HINTON: Thank you for that. If you so wish I would invite you to make an introductory statement to help us progress these proceedings.

MR MURPHY: Certainly. It will be brief, to say the least. TXU welcomes the opportunity to meet with the Commission and make submissions and appreciates that opportunity. Given what I would paraphrase as a cut-down version of the AGA's positions, we support the AGA's views, but have chosen to highlight a couple of areas where I think it's fair to say the AGA have given a fairly wide-ranging submission, undoubtedly because they are seeking to reflect the views of quite a range of their members.. We have tried to emphasise a couple of points there.

The three areas we would be advocating focus on in particular are the coverage issue, governance of the regulated businesses and incentives to encourage investment. I can touch on each of those briefly and then handball back to you. TXU's fundamental position would be that where there is more than one transmission pipeline having the ability, the potential to service a market, coverage should only be required where there has been a clear and long-term benefit identified and, we would suggest, independently identified and quantified as being of significant value to offset the implications of coverage.

On the issue of governance we are very much aligned with the AGA's views that the current Objects clause in the gas access arrangements - Gas Access Code - is not sufficiently clear to give the appropriate guidance to regulators as they interpret the code. There have been a fair number of examples cited, I think, in the AGA's submission particularly - wide-ranging interpretations have occurred. We believe they can be improved with a better Objects clause.

There doesn't appear to be ready access to full merits appeal processes for the regulated businesses. There at least is some confusion or debate on the legal side of things as to whether we can, via various means, jump through the hoops and gain access to appeal processes. We would advocate that those hoops, if you like - those impediments to achieving a full merits review - should be significantly reduced. In part that flows back into the governance, and our regulator - who is applying the code - will be in effect looking to his or her accountabilities and understanding that, yes, if they're not applying the code in a reasonable and balanced fashion, as was intended, there will be some option for a review of that process. As it currently stands we are not at all clear that anybody has that ability to bring that accountability and would dare to suggest that some of the regulators don't feel there is an appeal process.

Some discussion a few moments ago - and again I'd like to note that we support very much the comments of ExxonMobil, Steven Littlechild's work - his brief but meaningful paper. Having had the pleasure of meeting Prof Littlechild, I wasn't surprised but, yes, a valuable contribution which, no doubt, you will find interesting. We're seeing that incentives to encourage investment - going back a little bit - the codes and the regulatory processes were put in place at a time when there was concern over over-investment, inefficient investment, and there are balances and controls on that side.

In my view there was a logic at the time that when these access arrangements and when the national codes for electricity were put in place that, if a fair return was allowed, investment would come forward and occur naturally. At the time, most of the major businesses were managed, run by people with an engineering background - talking about the generation transmission distribution businesses in particular. There may well have been a legitimate concern that some of those people's natural propensity and their training and such was to build big, strong transmission lines and pipes and such things.

Since then a lot of changes have occurred in the ownership, the management and the incentives on the businesses within, apart from the regulatory regime. Those incentives fundamentally mean that nothing is invested without careful thought as to, is it a good investment? Is it going to deliver long-term benefits to the shareholders, the owners of the business and into the public regime? And if there is any doubt, not only does it deliver benefits to the end users, but if there is doubt about the way it will make a return for the business it doesn't happen..

In that regard we can cite, I suppose, the struggle in Victoria to expand natural gas to small towns, rural towns, rural areas, that didn't get the gas on while Gas and Fuel was in place. There is a very clear public benefit for people to have access to natural gas, the heating side of things and such. Natural gas can be delivered to many additional towns across Victoria at a price that would be somewhere in the range of half or less than what people are paying for the equivalent bottled gas. It has convenience value and it's cheaper but, under the code, there are a lot of questions as to how a distribution business can make that investment earn a return and have some opportunity to get an apt performance, some additional return over and above the basic WACC provided by the regulators. In effect, after 20 years, if you are really lucky, you might have paid off a debt that you borrowed to do that - You may have a business - but that's a very hard sell to a shareholder.

We see that many of the comments made by the ACCC - when they have looked at greenfield gas transmission lines - about access holidays - I heard you speaking a few minutes ago - and those sort of arrangements have the potential to make those investments attractive to the businesses, to investors and such, and to deliver to potential customers a very good service, so while there's coverage an extended period of predetermined outcomes under the coverage regime - and 20 years is the sort of period we have looked at, where take-up rates, particularly where there is retrospective reticulation into a town, 20 years is required before you will get access, full take-up to 75-80 per cent of the population of the area to get a relatively mature investment. We would see that as a good way to go forward that will encourage investment and will deliver a good outcome to people who clearly want it.

As you are no doubt well aware there is an arrangement in Victoria that the government is funding the shortfall to encourage the investment. I'm not sure how often things will come together - that governments will find a fund to encourage investment in that way and whether that's truly a sustainable way, but that's almost a bandaid, trying to overcome some of the concerns investors have had about investing in some of these small towns and some not so small, but greenfield sites. They were the points we wished to emphasise out of the wide range of material you have already got before you.

MR HINTON: Patrick, thank you very much for those comments and thank you also for your written submission. I note your point that AGA is doing a more detailed submission and you, of course, align yourself to that submission as part of your participation in that association. We also see that TXU is on the front page of the Fin Review this morning, too, so you have got a busy time ahead on that basis of that report, at least, but I don't think we'll get into those matters here this morning.

MR MURPHY: Somebody else is doing that. Good luck to them.

MR HINTON: I have a number of questions that arise from your comments this morning and your submission, and let me take them sequentially out of your submission. You refer in the coverage issue - which is where I am going to first take us - about coverage of transmission pipelines, where more than one transmission pipeline has the ability to service the market should only occur - that is, coverage should only occur where a long-term public benefit has been independently identified as quantified as significant and clearly in excess of the public cost. The question which immediately arises in my mind is, what sort of criteria would emerge or would need to be applied in identifying long-term public benefit? It's a very broad expression, "the long-term public benefit". For an independent authority, regulator, to make that judgment it seems that some guidance would be necessary as to what sort of benefits are we looking at here.

MR MURPHY: Yes, agree. It is a matter of market power and whether there would be a view that the coverage will assist, but - removing the potential market power, or the abuse of the market power, that the transmission owners might have - open up the market, if you like, similar to the discussion a little while ago about the ring fencing - well, either there's some very irrational business managers around, or ring fencing in the Victorian - vertical integration, if you like, in the Victorian regime has for some been seen as not worth doing. A lot of the distribution businesses and such are no longer aligned with retail businesses.

MR HINTON: Yes. But on this transmission pipeline, if I read what TXU are saying here, you're almost saying that if there are two pipelines then virtually it's almost impossible to see how a regulator should be involved. If there's only one pipeline, then you might have a different set of criteria, but in circumstances where more than one transmission pipeline has ability to service the market, then it's pretty hard to see how you would want to have a regulator intervene, unless it is very transparently clear there would be a public benefit. Is that the emphasis that has been given here?

MR MURPHY: The view is that there would be natural competition there between two, and that's a market - let it work.

MR HINTON: Right. So you're giving a lot of weight to the point of market power criterion with regard to coverage, and prima facie market power would not exist in that scenario where more than one transmission pipeline has the ability to service the market. It's that emphasis that I was getting at.

MR MURPHY: Yes. We would say it would be limited market power, and no worse than the issue of being regulated and the danger that comes with that, for all concerned.

MR HINTON: It implies that you're happy to have regulation when there's not more than one service provider. Prima facie that means there is market power.

MR MURPHY: Yes, we accept there's the potential for it, and I think my comments on the greenfields - - -

MR HINTON: We're going to get onto that.

MR MURPHY: We would say we're not advocating that we would be allowed to reticulate regional Victoria without some form of regulation. We don't see that as something that people are going to agree to, and we could see good reason why they wouldn't at this time.

MR HINTON: I was going to move secondly to this question of investment, and here there is a TXU statement that TXU is not aware of any inefficient investment.

> There are strong incentives on transmission and distribution businesses in the Gas Access Regime to discourage any inefficient investment.

However, it has been put to us that - I think you were here in the discussion earlier this morning - that the regime seems to be providing, in the minds of some, a very strong disincentive to construct beyond known demand, and that prima facie could in fact mean that it is an inefficient investment.

MR MURPHY: I will put my hand up there and say I wrote that phrase, and my mind-set at that time was certainly, in my reading of the code and such, the over-investment issue.

MR HINTON: Okay.

MR MURPHY: My colleague, who was not here, perhaps would be better placed to talk to the particular issue of people building smaller pipes than they otherwise might do, and I'll leave others to comment on that one.

MR HINTON: Patrick, I appreciate the point that there's a nuance here that the definition of "inefficient investment" can vary from minds to minds; that is, some would say that excessive investment is inefficient and some might also argue that inappropriately sized investment being too small could be inefficient investment, and so it depends on how you write that sentence. But if that sentence is aimed at excessive investment as opposed to the different formulation I just gave you, then, yes, we have a different discussion.

MR MURPHY: Yes, and I suppose that's my baggage of spending time - yes, with the, "How much is going in? What are these customers going to pay? What's the shortfall?" That was the context in which I read it. Apologies for the confusion I've created there.

MR HINTON: No, it's important to clarify that, what TXU are really saying. We won't misquote you, is the point.

MR MURPHY: I think I've probably misquoted myself.

DR FOLIE: On page 3 of your submission, I was a little curious about - in the second paragraph, which is:

> The most fundamental changes occurred in Victoria with the development of the VENCorp operated Victorian gas market in the late 1990s. This was brought about by a reregulation of the gas transmission infrastructure -

and then you go on to say -

> and created the only transparent market for incremental gas supply in Australia.

There are a lot of thoughts in there which I don't really quite understand. Perhaps you could pull that apart.. There are some inconsistencies within it - reregulation and transparency and a good market. Are you saying that therefore a highly regulated market is a good market? Is that the TXU position?

MR MURPHY: I will have to take that one on board and get my colleague to expand that point and clarify his intent in what he's written there.

DR FOLIE: Including the role of VENCorp. All right then. It would be just useful to clarify that, because it's a little unclear.

MR MURPHY: Yes.

MR HINTON: As foreshadowed, and you've also touched on it in your comments this morning about the greenfields issue, that's exercising the minds of a lot of interested parties. You come up with a whole range of mechanisms that should be available to address the adverse effect that regulation might have on greenfield projects, and thank you for your submission in listing those five possible mechanisms for addressing greenfields issues - that's on pages 9 and 10. You then go on to say in the text you would envisage that these mechanisms be almost at the choosing of the service provider; that they could seek to be treated under each of these or one of those, at their choice, from that menu, one of these five. Is that a realistic option, for a regulatory structure to have those sorts of choices available to a participant in a regulated sector?

MR MURPHY: I think - well, perhaps it's the wording again. The thoughts were that there would be a range of options available, that people could advocate one or the other of, go to the regulator and such and seek agreement that, yes, they're in accordance with the code and that the code is fairly broad in that sense that they operate. Maybe it's a step too far at this time. We have, as is mentioned, been hearing in discussions with the ACCC about their thoughts on greenfields transmission lines, and they have advocated many similar points and discussed many similar points - yes, draft guidelines and such things, and they haven't sought to put them in the codes and such.

MR HINTON: I think, Patrick, it might be useful for readers of the transcript if I just flag what the five are, because I found the listing quite informative. The first one - and it's one we discussed earlier this morning - "Economic regulation-free periods" or "access holidays". The second one was voluntary non-discrimination open access agreements. The third one was ex ante regulatory compacts; the fourth was price monitoring and the fifth was, "Make provision for binding pre-investment rulings on proposed expenditure." Now, when I look at those, I see some of them not as alternatives but in fact potentially in combination.

MR MURPHY: Yes.

MR HINTON: You could have, for example, an economic regulation-free period with a price monitoring approach.

MR MURPHY: Yes, and you could have ex ante sign-off on the investment and then a price review holiday period for 20 years, so that you know the initial investment will be valued in such a way. People talk about the airports and the price monitoring type arrangements.

MR HINTON: In that context then, the question then arises would there be criteria - would it be appropriate to have criteria by which the regulator would want to apply some or one or all of those particular mechanisms - that is, in which circumstances would they be most pertinent, or don't you see the regulatory regime needing to have that sort of precision to it?

MR MURPHY: I think the regulator needs some direction as to, yes - is the test - is this meeting the objects, is this achieving the outcome, is there a public benefit, and again I accept the challenges in framing the assessment of that public benefit, but don't quite say, "Well, because it's hard we shouldn't try and do it."

MR HINTON: But your starting point is, the National Gas Access Regime today, in TXU's mind, is impeding greenfields investment, otherwise you would not be putting forward these mechanisms.

MR MURPHY: That's certainly our experience, our view. I think the people at

Bairnsdale, who have a gas pipe right outside - on the edge of town, a major pipe - I think it has already got a city gate built, a take-off point - they haven't been able to get gas reticulated to a town.

MR HINTON: So you particularly point to distribution network greenfields that are being impeded by the code?

MR MURPHY: Yes. They're the immediate examples I focus on.

MR HINTON: What we have a difficulty with is disentangling other effects or other factors at work that might be stopping a greenfields project proceed - disentangling those factors away from the effect of the code as such, the role of the regulator - the regulatory risk or the uncertainty associated with regulatory intervention. Can you give me a better feel for the sort of - take the Bairnsdale case if you wish - the sort of forces at work that impede that greenfields going ahead? Presumably there are some commercial imperatives, presumably there are some demand judgments, revenue returns, that also impact on outcomes, not just the regime itself.

MR MURPHY: Yes, absolutely. Bairnsdale - TXU spent probably 18 months, nearly two years, working on going through the whole process, the whole regulatory process and the political process and the internal judgments and assessments of take-up rates, costs to build, how it could be done, marketing, how it was going to work between distribution, retail activities, how they were going to buy the gas - all those issues. Quite a few people - quite a deal of money was spent.

At the end of the day, yes, a successful tender process was run. TXU had a five-year set price arrangement. Changing business conditions and circumstances meant that when it came to the point to invest, alternative investments were available and TXU's judgment was that some of those were more attractive and TXU, having gone to all this trouble and expense, had an access arrangement there. TXU onsold it to Great Southern, New South Wales - they were interested.

By the time they got themselves lined up and ready to start to dig, they had been reorganised in New South Wales into Country Energy. They have then sought to on-sell this access arrangement and run a tender process, and they have come around and marketed this thing. Time has gone past and the period that all this was to apply for, the five years, is nearly up, and nobody has put a shovel in the ground; the people of Bairnsdale are still sitting there without access to the gas pipeline that runs past their town.

Investra now have had requests in with the EFC for some clarification on the way the investment would be treated if they were to reticulate Bairnsdale, and no doubt they're better placed to describe what they're actually seeking from the EFC. Months and months have gone past and they haven't been able to get clarification, so another year, another winter, will go past without the people at Bairnsdale getting access to the gas. Yes, there are businesses making commercial decisions and, as time goes past, different alternatives pop up. People will one day pick up the paper - and, "Yes, we're going to an IPO," or another day some other form of investment is available.

The regulatory process is not helping, I suppose, is the message we'd like to leave. There are a lot of impediments, a lot of challenges. We'd like to see the regulatory process helping on these matters. It's protecting customers from getting access to a cheap and reliable energy supply. Something has gone skew-whiff here. We started out trying to make sure people are not ripped off, for want of a better set of words. They're missing out, so we say, yes, there have got to be some changes. There's somewhat of a list there, but at least some of those options would assist in encouraging some of these investments. There still will be the challenges internally of competing options and all those sorts of things, and commercial imperatives, but this is one area that we think can be improved and can help.

MR HINTON: Thank you for that elaboration. I was going to move on to the objects clause, unless Michael wanted to pursue any of that.

DR FOLIE: No, that's fine.

MR HINTON: There's certainly been a lot of comment given to us on lack of clarity in the objects clause of the regime and it certainly was an issue that was addressed in the Part IIIA review that the Commission undertook that you have referred to. TXU have come up with a formulation of a possible revised objective of the National Gas Code, and thank you for that. I was wondering whether you could elaborate on why you would want to have a negative in the objects clause; that is, item C has something it's not. Is there a particular reason? There are a lot of things the Gas Access Regime shouldn't be pursuing but you've particularly chosen to flag that it should not seek to replicate outcomes which would occur in a perfectly competitive market. I assume there's some history here that you'd like to alert us to that underpins the inclusion of that particular negative item C.

MR MURPHY: Yes, I can speak to that. It is a belts and braces exercise and it does duplicate what is in Part A, as you suggest, in many ways, where it's already talking about a workably competitive market. There was a concern - and this is consistent with the AGA position and, as mentioned earlier, that is a group of contributors to this process. There was a concern that that still - that Part A was not necessarily strong enough, particularly those who were reviewing the outcomes of the Epic appeals and such, and the agreed position was, to put the belts and braces, "Let's highlight this particular issue, that it isn't perfect competition we want here." There's the measure. It's a workable - well, what's an example of perfect competition? Nobody seemed able to come with such a thing, so to that extent we recognise it is a duplication and in some ways addressing more a current type of issue of how will the decisions out of the Epic arrangement flow through into the regulatory regime as we know it?

MR HINTON: Under Part A of your suggested revised objective for the National Gas Code, you explicitly include investment in essential infrastructure services. You see that as an important inclusion, relative to what we've got today? Is there a particular reason for that reference? Do you think that the absence of that in the current documentation is a problem or it just brings clarity?

MR MURPHY: I think it brings clarity to what we're talking about here. I believe that to be the main point of that.

MR HINTON: We might explore those specific words further with the AGA as well, thanks, Patrick.

MR MURPHY: I'm sure they'd be far more articulate than I am.

MR HINTON: What I'd like to do is move on to the last part of your introductory comments but also the last part of your written submission, which is access to effective appeal mechanisms. It's a very difficult area here in terms of how to resolve the inherent tension between the need for timely regulatory outcomes and ensure that natural justice in its most wide definition is appropriately applied. But what I'd like to explore with you this morning is why you are concerned about the current regime of appeal mechanisms. Is it lacking specificity? Are there inconsistencies across jurisdictions? Are there too many of them such that it leads to untimely outcomes? I would welcome your comments on why you think the current system is deficient.

MR MURPHY: Whilst we wouldn't describe the current system as fast, a slow, balanced, reasonable outcome is better than a fast, unbalanced one. Speeding up for the sake of speeding up is not something we're greatly advocating. There is a lot of money invested already in these networks. The regulators have a very challenging task. At the end of the day they are trying to manage competing objectives. As such, without some form of balancing process, some opportunity to be heard by somebody else, investors and businesses feel very vulnerable.

We have found it difficult to get review processes through the courts on the electricity side of things, to get a view, and then at the end of the day the judge said, "Well, gee, regulators have got very wide discretion here. It's very hard to prove they've done anything wrong. No, thanks very much for coming. See you later." That is not encouraging people to invest, those sorts of outcomes. It almost becomes personality driven and, as such, not helpful.

MR HINTON: It's the discretion that's the problem or the way courts interpret the discretion?

MR MURPHY: The courts interpret that the regulators have a very wide discretion and the regulators have already applied very wide discretion, so the two together agreeing, where the regime is structured that the discretion appeared to investors initially, when they've bought in and they operate these business, that it will work this way, and decisions are made that, "Yes, we'll put the money in and we'll hope to earn our returns and have our money working away there for the next 20 or 30 years," and it turns out, whoops, no, that's not the way somebody who's sitting in judgment in the sense of a regulator has interpreted it. Even to get a second opinion on that is very difficult if the discretion is so wide or the view is that the regulator has unlimited discretion, almost.

MR HINTON: But one way to address that is to tighten up the guidelines in the code for the regulator; that is, to give more precision to the matters that they are obliged and should only look at, as opposed to going down, giving precision to the appeals mechanisms.

MR MURPHY: We'd suggest that perhaps both will help the regulator, (1) if it's clear, yes, there's some clear guidance, and then here, if you don't follow the clear guidance there's another form of review process - merit review.

MR HINTON: Thank you for that clarification - elaboration.

DR FOLIE: I've got one that goes back, unless you want to finish on the line of the appeals.

MR HINTON: No, that's fine.

DR FOLIE: Going back to your suggestions about the improvements, you have price monitoring which has come up as light-handed regulation. One of the state regulators - and I believe a lot of them are actually saying in order to have price monitoring we need to have standardised regulatory accounts, we need to have more information to be able to do that. What are your views that, in other words, it may not be as light-handed as it looks to begin with?

MR MURPHY: The information to understand the price - well, are they monitoring the prices or are they monitoring what the business is earning? I think if they're monitoring the prices, and that is an international comparison, like for like, some form of price benchmarking and such, perhaps it can be light-handed. If it is monitoring the earnings of the business, yes, then you'll need regulatory accounts and proper ring fencing and those sorts of things.

I could perhaps point to the Commerce Commission in New Zealand's recent draft decision over the last few days on the way that they're looking at their distribution businesses and setting a price path going forward with a B and C element, one based around productivity achievements for those businesses over the last 10 years, I think it is, and then a second element which is to say, "Yes, we've gathered the information from you. We know you're outperforming financially above what we believe to be a reasonable outcome, so we're going to put you on a factor of 1 per cent greater price reduction. We've looked at some of these other businesses and they aren't earning as much, and we take it that they're doing as well as they can, so we'll put them on a negative 1 per cent against the productivity factor." So in the sense that they're having both a look at what the businesses are earning and what they're charging relative to other people and trying to set a price path going forward, in such circumstances certainly they need to access the information sufficient to assess what the businesses are earning.

If we went way out there and said, okay, airports - and this is a reasonable landing charge at an airport on an international comparison, then what the business is actually earning is somewhat irrelevant. Does that take you anywhere?

DR FOLIE: Yes, of course.

MR MURPHY: I take it that the people who are saying they need the accounts are really saying, "We need to monitor what the businesses are earning."

DR FOLIE: I don't think it's been clear in some of the industry, if you like, the debates - as to what you mean by price monitoring because, depending on where you sit in this argument, people have got different views about how they would then monitor the price and what that then means as to what they're monitoring.

MR MURPHY: I've asked similar questions as you have. People are suggesting this to me and saying, "Can you advise me that I'm better off under this price monitoring?" "Yes, trust us.." "Hang on. You're supposed to be on my side. I'm not trusting you at all." I think a lot of work would need to be done before too many people would be advocating price monitoring, moving from the current regimes. That would be my view.

MR HINTON: Patrick, is there anything we've left out that you'd like to emphasise particularly in terms of your actual participation in the public hearing?

MR MURPHY: No, thank you. Thank you for the opportunity. I'll undertake to get back to you with some clarifying comments on particularly that section on VENCorp and such.

MR HINTON: Thank you very much again for your attendance today and your written submission and TXU's involvement in this inquiry. We appreciate it.

MR MURPHY: Thank you.

MR HINTON: We now have a scheduled coffee and tea break and we're due to come back here at 11.45 for the appearance of the representatives of the Energy Users Association, so till 11.45, thank you very much.

MR HINTON: Welcome again. This is the last session of the Commission's public hearings here in Melbourne, for our review of the National Gas Access Regime. We have appearing in this session Mr Roman Domanski of the Energy Users Association. Welcome, Roman.

MR DOMANSKI: Thank you.

MR HINTON: In accordance with established practice I would be grateful if you could identify yourself by name and organisation, for the benefit of the transcript but also to ensure that the sound system is working. Then I would invite you to make an introductory statement, if you so wish, to facilitate subsequent discussion. Over to you.

MR DOMANSKI: Thank you, Tony. My name is Roman Domanski. I am the executive director of the Energy Users Association of Australia. I was intending to make some introductory comments and also speak a little bit to the submission that we've put to you in preliminary form. First of all, we welcome the opportunity to take part and to make a presentation to your inquiry into the National Gas Access Regime. We particularly welcome and value the opportunity that presenting at your public hearings provides to us, to put to the Commission our views, and we strongly support the Commission's transparent and public inquiry process. We believe the Commission must use this process to ensure that all interested parties justify their positions, including the factual evidence, if it is to get to the bottom of what represents a useful and effective access regime for Australia.

Our comments will, of course, focus on end user views, as we are a national association representing energy customers. We note that the predecessor of the Productivity Commission estimated that substantial benefits would flow from competition reform, including access, and that one-quarter of those benefits would relate to energy issues. Many of our comments are based on our substantial experience in dealing with access and monopoly regulation issues across Australia in all jurisdictions, and involving both gas and electricity as well as our substantial work on gas issues in other areas.

The National Gas Access Regime in our view has brought benefits to energy users and to the Australian economy. The international competitiveness of the economy has improved and consumer welfare has been enhanced. It's important to remember that the Hilmer review foresaw the need for such a regime for this very reason, because they recognised the problems that monopoly provision of access to essential facilities can entail. We also participated in the Commission's previous inquiry on the National Access Regime and we welcomed your basic support for that regime and some of your specific conclusions and recommendations.

I did just want to say that we found some of the recommendations to be a bit questionable, and in our view they were based probably too much on a fairly simplistic model of how infrastructure fits into the economy and we are not sufficiently cognisant of the economic costs of monopolies. We also have some trouble trying to work out and determine how some of those recommendations were supported by empirical or factual evidence that was presented to that inquiry. We will do our best, in this inquiry, to inform the Commission of the user position in relation to gas access and hopefully to convince you that some of your recommendations need a bit of a rethink in terms of what was proposed in that previous inquiry.

I just wanted to make the point that as an organisation we are pretty resource constrained and our opportunities to participate as effectively as we would like in reviews such as this are therefore somewhat limited. We can only call on a fraction - in terms of resources - of what can be mustered by the industry regulated by the gas code. That situation is made worse by an absence of support for users to participate on gas issues. We hope that you will take this into account in your deliberations and we will put forward some recommendations to improve the situation in the future. You should be made aware that the NEM now has an end-user advocacy funding scheme that gives us and others access to some resources to overcome that imbalance. We are seeking, and have sought for a while now, to have a similar arrangement provided for gas.

The submission which we have provided today and that I will talk to now is a preliminary one and it covers only some of the key economic issues for this review, from the standpoint of gas end users. We apologise for the lateness of the submission and for the partial nature of it, but at this stage we are probably covering what we think are the main issues, at least in the economic sense. We hope to finalise that submission in the next week to a fortnight, if we can prevail upon you to grant us a little bit of extra time to do so. We are also intending to extend it into other areas that are covered by the terms of reference and the issues paper.

We are a national organisation representing the interests of energy users and gas is a major input to our members. High gas prices, at all levels of the chain - production, transmission, distribution and retail - adversely affect the efficiency of companies such as those that are our members, as well as impacting on their investment decisions. We think that point needs to be drawn to the attention of the Commission.

The implementation of the Gas Access Regime, since the mid-1990s, has brought benefits to major gas users. Transmission and distribution network prices have been reduced, reflecting regulatory determinations, and that has reduced monopoly rents. The advent of third party access has also promoted inter-basin gas-on-gas competition, and there is potential for gas retail competition to also develop in future. Also more consumers, including those in regional centres, now have access to gas supply. The development of a national gas grid in south-eastern Australia has also commenced and these are dynamic results in a hitherto underdeveloped and pretty immature gas market and they stem, at least partly, in our view, from the existence and implementation of a Gas Access Regime.

We have heard and we continue to hear a pretty loud and enduring chorus of complaints from pipeline owners and related interests that the implementation of the regulatory framework for gas pipelines has been adverse, in terms of its impact on investment in the pipeline industry. There are some quotes in our submission from a recent article in BOW, penned by Henry Ergas, who claims in that article that:

> The consequences of prices being too high is that users of infrastructure assets pay too much for this service yet rarely or never do without it altogether. In contrast, if prices are persistently set below cost, even if only by a small amount, long-term investment in maintaining, replacing and renewing the infrastructure will be compromised.

There is, however, no general view that the Gas Access Regime has deterred investment per se. Pipeline interests, including the Australian Pipeline Industry Association, put arguments to that effect to the Parer report. The review panel had the good sense to challenge the industry to provide evidence that showed this, and the Parer report notes that:

> The panel wrote to APIA, asking for evidence of prospective pipelines not proceeding solely because of the operation and application of the gas code. In reply, APIA did not identify any such pipelines and acknowledged that there were a sweep of barriers to new transmission pipeline development.

It's highly relevant, in our view, that when challenged it do so, the major industry body making these complaints about the code could not provide any evidence to sustain its assertions. We believe that PC needs to similarly challenge these assertions, if they are - and I've no doubt they will be - made to this review. The EUA would note that ineffective regulation - and we include light-handed regulation of monopolies in that - may also encourage inefficient new or duplicated investments, for example, if it perpetuated monopoly rents and/or resulted in a less than optimal level of supply of gas for transportation. This would be socially undesirable, as the national competition policy was not intended to promote inefficient incentives and create a nation of monopolists and rentiers.

The COAG energy market review report did not form a view that supported the position that the access regimes have a detrimental impact on investments. It did, however, recommend several changes for the regulation of pipeline infrastructure that it felt was necessary to improve the existing regime and ensure that it did not become an impediment to investment in the future. We do not disagree with the panel's desire to ensure that access regulation, even if not currently an impediment, should not become one in the future and that it cannot be improved to ensure that it does not become one. We also support several of the review's recommendations, although I'd have to say not all of them, in this area. It's also relevant that:

> The COAG review noted that there have been significant additions to the nation's pipeline infrastructure over the last 10 years and even APIA's submission to the review acknowledged that some 7000 kilometres of new pipelines had been built in recent years, thus stimulating the gas market.

We would strongly caution against attributing too much to the general acceptance of the "deter investment" assertion, which remains unproven and these comments, I think, do underline the need for the PC to separate the facts from the assertions. I'd like to say a few words about effective regulation and the promotion of upstream and downstream investment, which is one of the important criteria specified in the terms of reference.

The claims of those seeking to protect the interests of pipeline owners should be carefully examined to ensure that they are not clouding commercial self-interest and preferably should be backed by empirical evidence, as I have said. Economically efficient regulatory outcomes should drive out monopoly rents. Inefficient investments and duplicated investments - as that's the essence of economic efficiency - is an approach that is well used and understood by the PC in relation to other sectors of the economy that are protected from import competition, for example. Network businesses will be more efficient if there's an absence of monopoly rents. That is what is good and effective regulation and that's what good and effective regulation is all about. Removing monopoly rents promotes upstream and downstream investment. The dynamic effects of such competition would increase national welfare, investment and employment.

I'd also like to say something about light-handed regulation and regulatory gaining. A solution presented by infrastructure owners, for the replacement of cost of service regulatory framework is light-handed regulation. Whilst that is superficially attractive, infrastructure owners have largely failed to define what is meant by light-handed regulation, and I guess we are still waiting to see what they mean by it. If it's akin to the light-handed regulation of the RPI minus X kind applied to British gas in the 1990s, the EUA will not be able to support that. That regulation, by virtue of its application, was shown to accentuate the asymmetry problems for regulators and other stakeholders and also to incentify as regulatory gaming. We have a quote in our submission from a learned article which examined light-handed regulation and the British gas experience, which demonstrates what we are saying. It's also noteworthy that the PC, in its review of the National Gas Access Regime, commented that:

> The Commission remains unconvinced that prices can be fully decoupled from the costs.

A fair bit has been said about regulatory rates of return being too low for pipelines. We ask the question of whether maybe they're too high in fact. Owners of energy infrastructure including gas pipelines have long claimed that the rates of return they're permitted to earn under existing regulation are being set too low and that this threatens investment in new pipelines and makes ownership unattractive. The operation of the Gas Code is relevant here as regulators use that code in making regulatory determinations including on rates of return.

We believe that the existing approach to setting pipeline rates of return, whilst not ideal, is adequate. We hold that view formed by years of experience in dealing with regulatory reviews and we believe that rates of return set for mature energy networks in Australia are not too low and we think that the judgment of the financial markets responding to regulatory determinations on that actually is consistent with our position. In fact, our concern is that they're being set too high and that that cannot be justified. We'd therefore like to draw the Commission's attention to the results of empirical work that has been undertaken on our behalf in this area.

That work substantiates our claims and it does so by examining a substantial body of regulatory decisions in Australia, in the United Kingdom and in the United States. It covers hundreds of regulatory decisions across several infrastructure industries including energy. The results of that work, which are summarised in the two charts that are provided on page 8 of our preliminary submission, show that Australian regulators have approved regulated rates of return that are well above those set by their overseas counterparts in the UK where they use a very similar approach to regulation and the US where they use a cost-of-service model in the main.

The EUAA is highly critical of this outcome which means that rates of return in terms of real post-tax vanilla WACCs are being set at levels that are some 200 to 250 bases points higher than in the UK where they use a similar regulatory approach. Now, coming out of that, there's several points that I just wanted to make.. That in fact means that Australian regulators have endorsed outcomes that ensure Australia's energy networks will be less efficient, that is more costly to end users, than in either the UK or the US.

There is nothing in the decisions of any Australian regulator to explain why return on equity and WACC must be higher for Australian utilities than for utilities in the UK and the US and there is a real possibility that regulators are contributing to a reduction in the competitiveness of the Australian economy which the EUAA considers is a critical issue for Australian's energy-using and world-competitive industries. With that, I'll conclude my remarks, Mr Chairman, thank you.

MR HINTON: Thanks very much, Roman, for those comments and, as you describe, a preliminary submission and thanks for your participation at this busy time for the EUAA, and I note that you foreshadowed that you will be making a submission containing specific amendments to the gas access regime as well. This is more a thought piece of a broad overview with some economic principles. I appreciate the distinction.

I also note your comment about Part IIIA findings - the Commission's review of Part IIIA and the government's interim response and that you noted views that challenge some of those findings. We welcome hearing those views. Our nature of this evaluation does require us to revisit some of those bigger issues and so we look forward to hearing from you on those specific aspects as well of Part IIIA.

Given the nature of your submission and your comments this morning, we probably won't go, in the time available, down tracks of looking at detailed changes to the gas access regime. What I'd like to do is try and focus on some of the issues you flagged this morning of the broader kind and even perhaps the broadest of all in the nature of intervention. What seems to run through your written preliminary submission is putting the onus virtually on those who have challenged regulation as opposed to the onus being on those who want regulation.

A lot of the flavour of the comments that you are making don't go to the prior question of whether intervention is appropriate, the nature of the sector. In this regard I flag in particular the question of the degree of market power, the degree of misuse of market power and whether that prima facie provides a basis for a gas access regime. My first question then becomes am I doing you a disservice or an injustice with that sort of flavoured comment?

MR DOMANSKI: Probably slightly, if I might say so, Mr Chairman. Perhaps I'll clarify - - -

MR HINTON: Perhaps I'm being deliberately inflammatory, Roman.

MR DOMANSKI: That's fine. I don't mind that but perhaps I'll just clarify. We are certainly saying that there is an existing regime there and that certainly the owners should be on parties that are seeking to change that to kind of put up or shut up, if you want to put it that way. But in saying that, we're not saying that you shouldn't challenge us and others who support the regime to also put up arguments for why we do support it.

I think I've certainly attempted to do that this morning in terms of highlighting some of the benefits that we think have come from the existing access regime and, in particular, our interest is in benefits to end users which we think should be the ultimate test anyway because why would you bother doing anything in an infrastructure industry that provides kind of an intermediate input to production of goods and services that are exported or compete against inputs unless it actually had some benefit to the people that use that service that's provided or the good that's transported through that service.

So we are quite willing and encourage you to ask us questions about why this regime is actually beneficial at the moment and we think there's a sound body of evidence there to show that it is beneficial in terms of the impact on the prices that end users pay for their delivered cost of gas, for example. I think in our earlier discussion, informal discussion, Mr Chairman, I referred to the fact that some of our members were now beginning to see a little bit of price competition in transportation charges in New South Wales.

So I think that's one example but you can look through the regulatory decisions, and I'd encourage you to do this as part of this review because there's a substantial body of evidence there now and most of them run into hundreds of pages, but those regulatory decisions identify significant price reductions that flow from the decisions that are being made by regulators. They also, as it happens, identify billions of dollars worth of investment in the revenue requirement that the regulators have set for gas network businesses as well. So I hope that sort of starts to clarify it a little bit anyway.

MR HINTON: Well, sort of a supplementary question to that broader topic becomes one of whether or not circumstances today are different to seven, eight years ago, that is, when the gas access regime was designed, the gas sector, the energy sector, had particular characteristics and, as you've alluded to in your preliminary submission and as quite a number of others have also flagged for us, the sector today is significantly different. There has been a range of investments both in transmission and distribution, a range of expansion of end users both in terms of households but also some major industrial users. There has been an expanding interconnectivity across at least the east and south-east. The question then arises, what might have been appropriate eight years ago, seven years ago, might no longer be relevant today and is that not in itself prima facie a suggestion that we'd want to challenge the gas access regime?

MR DOMANSKI: I wouldn't quite see it like that. Perhaps I'll make a few points in response to that which might illustrate where I'm coming from but, look, I certainly agree there have been changes. I'd describe them as being significant and useful. I wouldn't describe them as being sort of world shattering or something like that. I think the gas market in Australia today has developed relative to say five or 10 years ago but it has still got a long way to go in my view and I think part of that development has been due to the existence of the access regime and the pipeline investments which have taken place.

I would think that the access regime has had something to do with those investments and it would be interesting though to test whether, in the absence of the regime, they would have taken place or we would have got more. It's always a sort of a question that you could toss up, I guess, but I think my view would be that, you know, the regime is not perfect but it has contributed to that situation. If I'm right in that, then I think you would want to be pretty careful about getting rid of it now or even making major changes to it now because you might find that that actually has some negative impacts in terms of where the gas market goes in future. Certainly, from our point of view, we wouldn't want to see the baby thrown out with the bath water, as it were.

MR HINTON: Well, I'm going to hit you with about four questions on investment in a minute but, Michael, did you want to - - -

DR FOLIE: I'd like to pick up the market development one as you represent end users. I mean, implication of your statement is that if prices sort of are a bit lower there would be an enormous development in the gas market. We don't sort of seem to hear that from other people and, looking at the gas stats, they seem to have been flat since about 2000. So as a representative of a user group where do you see this big improvement in demand about to take off if the price were even a little bit lower - because that's the magic wand that you hold out for us all?

MR DOMANSKI: Well, I think the issues here are that just pipeline development, pipeline charges, of their own can only have a limited contribution to that. You need to see the gas market in broader terms, I think, and I would certainly point to other areas that need to be considered, including I guess the one that a lot of people identify which is the need for more upstream competition. Again, pipelines can contribute to that but there is a group of other impediments that are sort of stymieing that at the moment. Some of them are to do with state regulations, some of them are to do with ACCC authorisations of the past, some of them are to do with pipelines, as I've said.

So just pipelines in themselves I think will only have a fairly limited contribution but still a contribution anyway and I think, in terms of where that growth might come from, one area that I don't think has been - I mean, there's obviously industrial users and people like that that would be stimulated and we've certainly seen, amongst our members of the last few years, a couple of fairly significant investment proposals go down the tube partly because of issues related to gas contracts and gas prices. I don't think that can be divorced completely from transportation arrangements or transportation charges.

The other area that I'd mention where there is significant potential for growth is in the area of electricity generation and a price change there in terms of gas prices can make a difference to projects that are proposed, either by way of peaking plant, for example - and you probably know that the electricity load in the NEM is growing very significantly, particularly for the summer peak end of the market, and that's the end of the market that gas-fired generation probably fits most conveniently in.

But also I think cogeneration is also worth mentioning. It's an area that really hasn't gone anywhere to speak of, and gas prices, gas access are an important issue - not the only one again, but they are an important issue in terms of cogeneration opportunities and improving the general sort of environment for cogeneration.

DR FOLIE: You stated in your introduction and also in the thing that basically really there have been 7000 kilometres of new pipelines built. We've had other submissions put to us where really since the code has occurred there has been really nothing of significance because effectively a lot of that pipeline development was actually set in trade almost pre-code, and since the code has been around there hasn't been very much. Would you like to elaborate? We're sitting here, we're hearing different stories.

MR DOMANSKI: Well, the 7000 kilometre number was from APIA, actually from their submission to the Parer review.

DR FOLIE: If I can just interrupt, I'm trying to get a very fine line between when things could have been built on time, but there's a difference between the decision to commit and then the understanding that actually the environment you've committed to might not have been the environment if you had realised what the implications of the code were going to be, or perhaps it's irrelevant - I don't know.

MR DOMANSKI: I think I can certainly nominate a couple of pipelines just off the top of my head that have been built under the code. Planning for those things, I don't think - I'm pretty certain I'm right in saying wasn't even thought of or under way - certainly not under way before the code was introduced. Just two that come immediately to mind are the SEA Gas pipeline and also the Bass gas pipeline. The code doesn't seem to have been a particular impediment to those.

MR HINTON: Let's stay on investment. One issue put to us is that greenfields investments that are subject to regulatory risk have a real challenge to proceed in circumstances of regulatory intervention removing scope for blue skies return, or the truncation of high returns in circumstances a high return is commensurate - or potential high return is commensurate with the associated risks, and that there's a real issue of regulatory intervention in effect by blocking potential for blue sky returns, in effect will block greenfields investment almost ipso facto; the truncation effect of regulatory intervention. That's another way of looking at it as opposed to saying you've got X thousands of kilometres of transmission or distribution pipelines produced over the last seven years. Any reaction to that point of view?

MR DOMANSKI: Yes. As an association, we have a pretty strong view that we want to see pipelines develop. It's not in our interests or in the interests of our members to have a gas market which is not being developed sufficiently because of some sort of impediments, whether they be regulatory or otherwise. We regularly get involved in those sorts of issues.

As far as greenfields pipelines go, we understand and we recognise the particular economic and commercial circumstances, risks that those sorts of pipelines can face, and we're actually somewhat sympathetic to the view that the current regime, if applied, applies well to mature pipelines, but issues like greenfields pipelines may require some modification. I guess what we would be encouraging you to do is to have a pretty hard look at that issue as part of this review. There are a number of options that have been floated for dealing with that, some in your previous report, some in the Parer report, some in the ACCC's issues paper, I think they call it, on greenfields pipelines.

MR HINTON: Draft guidelines.

MR DOMANSKI: Draft guidelines, that's it, yes. The ACCC I think has also recognised that, and been prepared to provide a higher risk-adjusted rate of return to the owners of some of those pipelines. The Central West pipeline in New South Wales I think is the one that is often mentioned in that regard. Whether a higher WACC or rate of return is the best way of dealing with that issue, I'm not so sure. We'll certainly give consideration to those options in terms of finalising our submission, because I believe this is a significant issue, and I don't think we've seen what we consider to be a perfect or ideal solution to it thrown up.

MR HINTON: But I particularly raise it in circumstances of your preliminary submission and your comments earlier this morning, flagging to think that rates of return are too high, not too low. That juxtaposition of that against the greenfields debate made me a little concerned that you might be misrepresented on what you're really saying about greenfields.

MR DOMANSKI: Well, the bulk of the pipelines and other infrastructure that are dealt with by Australian regulators in setting those rates of return are not greenfields pipelines. In fact, there's only a very small proportion of them that would be greenfields pipelines; the bulk of them are mature or relatively mature pipelines.

MR HINTON: A related point is to do with issues associated with capacity of pipelines. It's been put to us that the risk of regulation is a very strong disincentive for those constructing new pipelines to construct beyond known demand; that is, to build in surplus capacity at the initial time of construction, such that they build to known demand and then don't face regulatory risk for anything above that, because the demand is there and it's all fixed under long-term contract.

That has been put to us as a basis to argue that the regulatory regime in effect is incentive for inefficient investment, given that the alternative outcome of having construction of a larger pipeline with surplus capacity to known demand prima facie would be normally a more appropriate commercial imperative to pursue. That therefore lends an argument to the view that the regime is impacting on investment. Any reactions to that sort of line of thought?

MR DOMANSKI: I'm not certain that that's actually the outcome. People may be making that comment, but I guess I'd ask you whether they've actually given you any evidence that that has happened or is happening. Alternatively, I could make the comment that without that regime the incentive would be to - as is the case often with monopolies - to limit capacity, and in fact - it's not exactly related to the gas market, but in the electricity market we've actually seen that happen.

I think it's fairly commonly understood that the regime that's provided there for what are called market network service providers, the sort of people who take advantage of that regime, probably limit the size of the links, interconnectors that they build in that situation, because they're essentially leveraging off price differences between different regions and it's in their interests to see those price differences maximised, and limiting capacity is one way they can do that - classic, I guess, monopoly behaviour.

So those claims might well be made. Alternatively, I'd put a different view that you I think should look at as well, and I've given you a little bit of evidence, albeit not from gas but from electricity, to substantiate my claim. I guess I'd ask you whether other people that are saying the opposite have given you any evidence to show that their claims can be substantiated.

MR HINTON: Thanks for that. Let's go back to another broader question. It's to do with a bit of history, and given your background we'd welcome your comments. Some have put to us that the origins of the access regime in part depend significantly on Hilmer reforms, competition policy, public infrastructure, public policy intervention in these areas of these sorts of services, but that somewhere between the origins of the access regime and what is being delivered today there seems to be some sort of dysfunction or disconnect that has led to rather than Hilmer-focused regulation, we've now got consumer-based or consumer objectives, consumer interests regulation, and that is distorting the commercial operations and activities of delivering gas across Australia. Any reaction to that sort of description?

MR DOMANSKI: Yes, I have actually. Look, I've heard those claims too, strange as it might seem. Again, I don't see the substantiation for them, and again I've presented you with some evidence to suggest that, at least as far as rates of return go, regulators have erred on the side of providing higher rates of return for these industries than is justified just on the basis of what overseas regulators operating similar regimes do, what is justified in terms of a risk-adjusted rate of return.

I think if you go through regulatory decisions on gas or on electricity - very similar procedure and methodologies are used - you will see that whenever there's any doubt, the regulators always err on the side of the regulated business. For example, the parameters that go together in determining a WACC, wherever there's any doubt they always err on the side of the regulated business, most graphically illustrated, I think, by the market risk premium and the debate around that, where the science behind estimating a market risk premium remains quite under-developed and because of that you get a fairly big range - usually somewhere between 3 and 6 per cent, that people say is an appropriate market risk premium.

In those UK decisions that were analysed as part of that work that I referred to, typically the UK regulators are sitting somewhere around about the middle of that range, whereas the Australian regulators are sitting at the top of it, at 6 per cent. That has a demonstrable impact on the WACC. That 200 to 250 basis points that I referred to - a significant part of that is due to the market risk premium and the way it's set by Australian regulators. So I don't see a lot of evidence that those sorts of claims can be substantiated.

DR FOLIE: I've just got a related question to that. There is just a proposition - in the equity markets there's, if you like, in my understanding a broad belief that effectively in Australia you need a higher return on equity; in other words, a higher WACC than you do when - if we just take the US and even the UK, we see that a long-term trend on interest rates was needed to be able to maintain a reasonably stable exchange rate, and an analysis of a number of the targets that people require if they invest into Australia. Do you believe this could be an explanation as to why we actually see a higher WACC, translating that?

MR DOMANSKI: I know that claim has often been made. Again, regulators have analysed that question significantly and comprehensively, and I think on the whole they're pretty sceptical that it is in fact the case. You could maybe argue that because we're a sort of a mining-based economy or something, that that would have an impact, but on the other hand I think the Australian economy over the last 10, maybe 20 years has diversified away from that sort of situation anyway, so that I assume would have some sort of dampening effect on that. I'm not saying that there isn't any truth in it, but I'm just saying be a bit careful about those sort of claims being exaggerated too.

MR HINTON: Roman, is there anything else you think you'd want to emphasise that we haven't covered appropriately as yet this morning?

MR DOMANSKI: Just maybe one comment I'll make in closing, and that's to just highlight to you that we're hoping that in our final submission to you we'll be able to cover off on a lot of the other areas in the issues paper in particular, and we do have a pretty strong interest in several other areas that are highlighted in that issues paper. So we think there are some pretty significant issues there from a user point of view, and we'd be seeking to outline our position on those to you. We'll try as much as we can to provide you with information that backs up what we say.

MR HINTON: Thank you for that, and that's why the discussion today has focused on some of these broader issues that are in your preliminary submission and in your remarks earlier today, and your introductory remarks. Thank you very much for your participation today and your foreshadowed further participation, and we look forward to further contact. Thanks very much.

MR DOMANSKI: Thank you for the opportunity.

MR HINTON: That concludes today's scheduled proceedings. However, as foreshadowed and in accordance with the Commission's established procedures, I now invite from the floor interventions or comments, if there is anyone there wishing to do so, the only constraint being that they would come to the microphone for the purposes of the transcript and identify who they are. No-one is seeking to take up this invitation, so I therefore will adjourn these proceedings and note that the Commission's public hearings will resume on Tuesday, 16 September in Brisbane. Thank you all very much.

AT 12.38 PM THE INQUIRY WAS ADJOURNED UNTIL
TUESDAY, 16 SEPTEMBER 2003