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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON FRIDAY, 19 MARCH 2004, AT 10 AM

MR HINTON: Good morning, everybody. Welcome to the public hearings for the Productivity Commission's review of the gas access regime. My name is Tony Hinton, I'm the Presiding Commissioner for this inquiry, and my fellow Associate Commissioner on my right is Michael Folie. The inquiry terms of reference were received from the Treasurer in June 2003 and covers in brief terms the following six matters: first, the 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 finally, sixthly, the appropriateness of including in the gas code minimum requirements for access to users, such as price and non-price parameters.

This round of public hearings follows the release of the draft report by the Commission last December. The purpose of these hearings - this round of hearings - is to provide an opportunity for interested parties to discuss their submissions on our draft report. Participants are welcome of course to also comment on the views expressed in other submissions. This is the first hearing for the second round and further hearings will be held in Brisbane, Sydney, Adelaide and Perth. A final report will be submitted to the government in mid-June as scheduled.

As many of you here would know, we like to conduct all hearings in a reasonably informal manner but I remind participants that a full transcript is being taken. For this reason comments from the floor cannot be taken but at the end of the day's proceedings I will provide an opportunity for anyone who wishes to do so, to make a brief presentation. Participants are not required to take an oath but are required under the Productivity Commission Act to be truthful in their remarks. The transcript will be made available to participants and will be available from the Commission's web site following the hearings. Copies may also be purchased using an order form available from staff here today. Submissions - that I've already referred to - are also available on the web site.

To comply with requirements in the Australian government's occupational health and safety legislation, I draw your attention - that is, all those present today - to the exits at the back of the room and to the fire exits on this level opposite reception on the other side of the lift lobby. In the case of an emergency an alert and an evacuation alarm will sound. Please follow the instructions of fire wardens in the unlikely event that an event occurs.

I would now like to welcome our first attendees, presenters for this public hearing - that is Mr Geoff Towns and Mr Charles Crouch of Alinta Gas Networks

and Multinet Gas Distribution Partnership. Welcome to the public hearing.

MR TOWNS: Thank you.

MR HINTON: I invite you to make an introductory statement if you would like to do so - briefly - on your submission, after which we would then proceed to some sort of question and answer discussion session. Over to you, Geoff.

MR TOWNS: Okay. Broadly, we're very supportive of the Productivity Commission's draft report but to improve it we see the need for some further work on, say, four major areas; that is providing the NCC with better guidelines on their decisions about revocation and the level of regulation; developing guidelines for the operations of price monitoring; developing guidelines for the five-year review after the fixed period of price monitoring, and adoptions of changes to the decision on reference tariffs, taking into account the recent legal decisions that apply to those areas. I guess the fifth point we'd like to make is that we'd like the commission to make a fairly strong statement on this issue of full merit appeals because we note that the ministerial council is only proposing judicial review in their documentation and, as we all know, judicial review to the courts and appeal on the merits is quite a different kettle of fish. So basically that's all we'd like to say in brief.

MR HINTON: Thank you very much for that, Geoff, and also thank you for your written submission. It's much appreciated. It's also appreciated you being first cab off the rank here in Melbourne today. I'd like to, at the outset, take up this issue of a key part of the draft report that you also pick up in your written submission in relation to the proposed monitoring regime. As a more detailed question relating to it, I notice you refer to it as a price monitoring regime. We attempted to avoid that very precise reference to the nature of the monitoring regime and in fact sought to give the impression that it was wider than just price; in fact its activities of the service provider more generally and the relationships between the service provider with potential and actual access-seekers. So as a first minor detail point I'd like to - - -

MR TOWNS: I would certainly concede that point, Tony, because we do I think mention the need for monitoring of other things in our submission anyway. So in any further submissions I'll remove the price from the monitoring equation.

MR HINTON: So your endorsement of the monitoring option is in its broadest concept as described.

MR TOWNS: Yes. For instance, we say that we'd accept quality monitoring as well because of the need to ensure that the monitoring regime delivers the right outcomes for consumers and under monitoring, a service provider doesn't seek to run

down the infrastructure to increase their profitability.

MR HINTON: Presumably, inappropriate behaviour by the service provider can come in many forms.

MR TOWNS: True enough.

MR HINTON: In circumstances of a monitoring regulator, then the onus would be on the regulator to try and seek to identify all those forms of inappropriate behaviour.

MR TOWNS: Yes.

MR HINTON: A more substantive point, as opposed to definitional, was in relation to the sort of thresholds that we seek to apply with regard to the monitoring regime; the tests for when coverage applies and then the nature of the regulatory intervention that would flow from an infrastructure being covered, that is access is likely to lead to increased competition to a material effect and then substantial effect; the "material" being the threshold for monitoring and "substantial" being for cost based price regulation.

The question that came to my mind was this issue that you raised some concern about the practical definition of those terms and the delineation of them. Can you sort of elaborate a bit on your concerns here?

MR TOWNS: After the CEDA luncheon I could see all the legal advisers rubbing their hands with glee at this proposal, saying that this issue of the definition of a distinction between those two matters was likely to lead to quite a lot of legal contention and therefore we thought that it would be useful to provide some guidelines about how they should work or how they could work in practice and we put down some samples of that but only examples.

MR HINTON: But you're supportive of the concept that the threshold for monitoring would be higher in concept relative to the current threshold and the threshold for cost based price regulation would be higher again.

MR TOWNS: Well, aside from the point that we think that there are quite valid reasons to start all distributors off on the issue of price monitoring rather than reference tariff approval as we've argued in our case, but if that's not recommended then, yes, I think we need guidelines to that. But we certainly accept the two points though. We're trying to reduce any legal dispute about what material means against what - - -

MR HINTON: I think the Commission thoroughly endorses that objective as well

and we'd be seeking to draw on the expertise of interested parties on this issue in the public hearings in the period ahead. But having accepted or endorsed the concepts, do you have any problem with the words themselves "material" and "substantial"? You've clearly put emphasis on the need to have clarity and delineation.

MR TOWNS: Yes. No, I don't have any problems with the words. I mean, they're words that are well accepted in competition economics despite the problems with precise definitions of what they mean in different circumstances. So I think the approach should be, yes, that is the right approach to use those two words but try and provide them with some guidelines around them to make sure that the amount of legal contention is limited, because you don't want to face the example where the courts make a decision on it. One court makes a decision on it and gets it slightly wrong which leads to further contention and further legal issues over time.

MR HINTON: Let's move to one of the company's particular recommendations or expressions of view in your submission, and that's in relation to all distributors would not meet the higher threshold, the substantial test with regard to cost based price regulation. I think you used the term "utilities" on a number of occasions, but you're really saying that the gas distributors, those networks under your judgment would never meet the higher threshold of being required or subjected to cost based price regulation and therefore as a matter of course should be ruled out of that tier 1 - as some described - form of intervention. Have I misrepresented you?

MR TOWNS: I guess we state that there are a number of reasons why distributors should start off on, we'll call it, the monitoring regime because they were all automatically put on the schedule A of the National Gas Pipelines Act without any assessment of the market power or their individual circumstances. Secondly, most of the distributors have been through one or some price reviews and therefore their costs are likely to be efficient. Three, we reference an analysis from New Zealand undertaken by Kovac which looked at the unregulated gas industry in New Zealand and found that even with no regulation they were not abusing their market power because presumably of constraints that the commission has referred to in terms of their ability to do that, and also the commission's comments about the complexity and difficulty associated with reference tariff approval. All those reasons packaged up should imply that distributors should all start off on the price monitoring option.

MR HINTON: As a devil's advocate approach one might argue that what the Commission has put on the table, a revised gas access regime with new thresholds, new criteria and modified objectives and modified tests, that prima facie that would suggest that it's important that that would be seen to operate against - on a case-by-case basis, to have a specific rigorous application to it that would argue strongly against having a category of ruling that all distributors would be not subject to tier 1 and would therefore be put in the monitoring bucket only.

MR TOWNS: I appreciate this need to get this accepted by governments and therefore, yes, we would agree to not push that particular matter terribly hard, even though we think there are good arguments for it.

DR FOLIE: If I could just add into that - and this is the same sort of process - even though you may have gone through a cost review, a cost basis is set, if you then become non-regulated that's irrelevant because it's the nature of competition in the market that the argument would be better served if you then propose that distributors actually are facing a form of competition that may actually then never get them into, if you like, the substantial level because of being fuel of choice et cetera. But whether that's true in all cases or not, I don't know. The test is about competition and not the fact of actually being reviewed, because once you're reviewed you're suppressing the forces of competition and then the prices are being set. The test will always be the nature of competition, whether it's being realised and active in that particular market. Do you have a view then that really all the distributors are subject to sufficient competition it would then mean they're not in the substantial case?

MR TOWNS: Well, I suppose my concern is that it's going to be subject to decisions by the NCC, and the NCC has shown a pro-regulation approach in the past and without adequate guidelines I'm concerned, I guess, that the commission's intentions and the setting of that particular model may get distorted in the NCC without detailed guidelines to constrain them.

DR FOLIE: But if I may continue further down the route, the issue has got to be that the industry or the entity making its case has really got to focus on developing its evidence that there is competition and we've laid out a lot of rules, if you like, some insights, we're not entering the detail, but that's effectively got to be the driving force. That's part of where we're coming from. Now, do you believe in the end you can mount such an argument?

MR TOWNS: Yes, I think we can mount the arguments to make that change but I guess that my concern is the assessment of it and whether we'll get it through, whether the NCC will be able to deal with those competitive arguments when they have not dealt with those competitive arguments very well in the past.

MR HINTON: Well, on coverage decisions you put forward the view - and you alluded to it a moment ago - that there's a need for guidelines for NCC decisions, making decisions on coverage and the nature of the intervention that then would flow, whether it be monitoring or cost based price regulation. A couple of queries here - and the report does touch on some of these issues. Do you see that those would be explicitly included in the code themselves that then has the force of the code, or would you prefer - without being pejorative - a softer option of having

supporting material that would provide guidance or guidelines for the decision on coverage and form of intervention? There is a sort of a black letter law approach and an administrative guidance approach. Have you got a view on that?

MR TOWNS: I wouldn't necessarily describe the code as black letter law but - - -

MR HINTON: I was trying to make a distinction to help the discussion, okay.

MR TOWNS: Yes. But, no, I think we'd prefer to see them in the code mainly because it would have something of the force of law but not quite the black letter type I think you referred to as the codes being - well, the current code at least is definitely not black letter law.

MR HINTON: Sorry, I took you down a route there that I really didn't want to go. I'm trying to make a distinction between inclusion in the code - - -

MR TOWNS: Yes, I think I'd prefer to see it in the code because it's a fairly important area, one; and, two, it's better to have all the legal and guideline issues in one place because it's just more efficient to have those things in one place rather than separate documents which may not necessarily have a connection or whatever.

MR HINTON: The regulators might take a view or even public policy advisers might take the view that that particular approach carries with it all the nature of inflexibility that in fact good regulatory systems probably shouldn't have. It might purport to have precision but it may also in fact be quite excessively prescriptive, lead to inflexibility that makes it not a good regulatory structure.

MR TOWNS: Yes. I suppose we're talking in this case about fairly general guidelines about how market power can be assessed, about how competition can be assessed and setting out some of the things that are even in the commission's early chapters that could be pulled together for guidelines about competition and where you put the weight on various issues and things like that. So we're not talking about very strict instructions to the NCC but merely general guidelines about how to assess critical economic issues. I think generally the ones I've suggested are just pulled from the commission's draft report in any case and put in a different format, dot points, rather than text.

MR HINTON: Thank you.

DR FOLIE: Could I just have another one on that. I mean, one of the paradoxes of why this inquiry is there because in good faith or whatever a code was put together to try and undo all of these things, is it beyond human nature if you actually rewrite another one or change it substantially, is there not a fair chance you could end up in a

similar situation five years down the road; in other words, the more you put into a legal guideline document, because it then gets its own legal interpretation rather than being more flexible, or does the industry really want to have it laid out? It's quite an important - - -

MR TOWNS: Well, I suppose there's another issue here that where there have been legal decisions on the interpretation of the code in the last six or seven months, they should be incorporated in the new code because they are interpretations, legal interpretations, and that is a valuable method for updating and renewing codes, certainly. Secondly, even with some simple guidelines - three or four guidelines - for the NCC to take into account when assessing decisions on coverage or level of regulation is not - you know, tops half a page. We're talking about cutting out large sections of the code, so I don't think it would lead to a larger code. In terms of black letter law, well, it's not going to be black letter law, it's merely guidance of a type of how to go about assessing economic and competition issues and where to put the weights in those assessments. So for all those reasons I think the industry would still support having those in the code.

MR HINTON: On that point - and you actually pick this up directly in the latter part of your submission - this need for the Commission to draw on the outcomes of recent decisions that have come through, particularly from the tribunal.

MR TOWNS: Yes. I mean, the commission can hardly support the context of full merit appeals and not support those decisions that flow from full merit appeals being used to update the code when and where they're available.

MR HINTON: Let me explore that further with you, that logic. Could not an interested party argue that if a tribunal makes a decision that is directly adjusting, modifying, a decision by a regulator that the regulator in the future is almost obliged ipso facto to take that into account in future decision-making, or is that an untenable outcome conclusion?

MR TOWNS: It's a higher cost outcome because it might lead to more legal disputes. If the regulator does make a decision that is in conflict with an Australian Competition or Supreme Court decision then you have to go back to court and have it confirmed in another jurisdiction. So if the regulator made a decision in Victoria you'd have to go to the Supreme Court in Victoria. It would be expensive going to the Supreme Court. Whereas if it's in the code then it's as close to black letter law as you can possibly get and that new decision is sitting there in the code and there will be less disputation about it because it has been updated as a result of those decisions.

I mean, the value of legal interpretations are that when it has come to review legislation like the Trade Practices Act, it's the legal cases that have been determined

that are inserted in that new Trade Practices Act because that's the dynamic nature of legislation codes.

MR HINTON: I'm just a little uncomfortable with a process of frequent amendments to a code.

MR TOWNS: Not frequent amendments; once-off amendments.

MR HINTON: When they're subject to reviews - - -

MR TOWNS: No, you've got the fortunate occurrence of a few recent decisions that go to important areas of the code which can be taken into account in the development of the new code. In terms of the new code there may be other decisions which will have to wait five years out. So I'm not talking about - - -

DR FOLIE: This is an important point that comes through a lot. There are a lot of disputes in this which is another reason for this inquiry. You can probably subset some of the disputes which are very specific to the circumstances, number 1, of what the code is but also the individual circumstances which then you get a judicial ruling on that per se.

MR TOWNS: Yes.

DR FOLIE: Then are you then saying they are lessons that should be put into the code or - and there are other decisions which are talking about the nature of competition et cetera which are a more higher level which then do impact. So would you say you need to look carefully rather than - some people say, "There's a lot of law now. All these judges' decisions should be brought into account," or should we only be looking at the very high level of important overall ones that are the real lessons for competition in the market?

MR TOWNS: Yes, because I think where you can draw out the general applicability from particular circumstances that's where you update the code.

DR FOLIE: Yes, thank you.

MR HINTON: We got into this discussion primarily driven by you submission's view about the need for guidelines for coverage decisions and form of intervention decisions but you also in your submission pushed for clear guidelines on the actual operation of the monitoring regime. I assume many of the points you've been making in that other discussion would similarly apply to the guidelines that you put forward as being needed for the operations of the monitoring regime. Have I put words in your mouth?

MR TOWNS: No. I'm sorry, what was the question?

MR HINTON: I wanted to get you to agree that point so I don't have to go through it all again. I didn't want to run through - - -

MR TOWNS: No, but I'd like you to say it again just to make sure.

MR HINTON: You seek guidelines for the monitoring regime operation, just as you sought guidelines - developing guidelines for coverage decisions. You said they should be in the code, not as just as administrative guidance, separated from the code.

MR TOWNS: Again we're talking about general principles, we're not talking about black letter law, you know, "This party shall do this, this and only this," we're talking about assessments based on sound economic criteria that should be taken into account.

MR HINTON: We do seek in our draft report reactions from interested parties on the nature of the monitoring regime. What information should be monitored, what reporting data should be reported annually, what comments might or might not be made by the regulator regarding the assessments of the monitoring process or the outcome of the monitoring process. So we're already getting some views on that point, in effect, many agreeing to your view about the need for guidelines for the operation of monitoring system.

MR TOWNS: Yes. Broadly speaking we didn't have any problems with the commission's approach, just the need to be more certain. We can handle that by some of the guidelines which even I think can be drawn out of the commission's own draft reports on their report on airports in particular.

DR FOLIE: I still think we probably would need more but we were hoping for a slightly more detailed response, particularly on the monitoring regime because as we say in the draft report, if not careful it could become nearly as bad as the heavy-handedness on the information requirements, but there needs to be fairly broad coverage about it so that people get a full picture of what's actually occurring. They can actually decide whether competition access has been given.

MR TOWNS: I noted that.

DR FOLIE: You'd probably look for a little bit more, a bit more help, because in the end where again the commission - even if they were to do what you're doing, is another entity that's actually trying to work out what ought to be done without the

industry actually providing that. I think there needs to be a bit more clarity in that area if that would be possible.

MR TOWNS: Yes, I noted that the ACCC monitoring report on airports went to 250 pages. I thought that was probably excessive but I'm not sure how you can limit regulators from making detailed comments upon only the basis of fact and it still runs to 250 pages.

MR HINTON: Then you get judicial review that generates a whole range of other sets of documentation that accumulate into very large amounts of paper, written words that need to be absorbed for future possible input. Is that efficient regulation?

MR TOWNS: Well, we'll come back to that.

MR HINTON: A detailed question regarding one of your proposals in your submission relating to revocation, when you're moving from, say, a cost-based price regulation to light-handed regulation or you are actually being monitored. That's locked in for five years.

MR TOWNS: Yes.

MR HINTON: You're also seeking that revocation, that is, moving from being covered to not being covered should also have a five-year period of non-review, that is, locked in. Can you elaborate a bit on your reasoning behind this?

MR TOWNS: I would think that if it doesn't have a five-year fixed period like the monitoring regime, there could be gaming and opportunistic behaviour by regulators to move it back to a system of coverage because they can appeal at any time about - - -

MR HINTON: But if a decision has been made, whatever the sources of the revocation decision, if a decision has been made by the regulator making coverage decisions, rules that against the coverage criteria that particular pipeline no longer needs to be covered, gaming a decision would seem to be fairly sort of - very surprising to see it occur in that how would you get a different result by the same regulator, not another body, in a reasonable period of time without significant events occurring? It would seem to be a rather waste of scare resources in pursuing that sort of gaming exercise prima facie.

MR TOWNS: I seem to remember there are quite a few decisions in all sorts of areas in our society that go to one court and go to another court and get a few different experts together. These are all contentious issues and I'm not sure that - certainly it reduces - - -

MR HINTON: No, we're talking here about the same regulators making the decision. We're not talking about a review process, appeal process, challenge process, which has other recommendations in a draft report and which you comment on. This is in terms of a decision by the regulator on coverage being reactivated and challenged by the same regulator making a judgment about the same case.

MR TOWNS: Well, again I guess it depends on the case. If you look at airports for instance, as an example, would the regulator have gone back to court when the airports increased prices by 100 per cent in some cases, even though they were not covering their costs at the lower level? But, you know, the ACCC was going around saying, "You know, this system is not working. Look, the airports have increased prices dramatically." You know, they didn't say but the airports were not covering costs at that level. But I'm not sure that there won't be pressure on regulators to come to apply again, whenever they can, and I thought, well, maybe you should expect some symmetrical issue between monitoring and revocation that should be for at least five years, just to ensure - - -

MR HINTON: To bring a certainty to - - -

MR TOWNS: Yes, I guess just to bring a certainty to it.

MR CROUCH: It's probably also worth noting of course that even an application that's ultimately unsuccessful does have costs and there has been some history in other access regimes of access seekers using the threat of declarations as a strategic tool to improve their bargaining positions. So if you made a decision that revocation is appropriate I think you probably then can make a case to actually rule out that possibility for a given period.

MR HINTON: Yes. It's a question of whether or not that undermines the flexibility of the system to handle significant events occurring post revocation.

MR TOWNS: I suppose that's true. I mean, they're still liable to the general trade practice laws against anti-competitive behaviour and monopoly restrictions, so - maybe not predatory pricing but that's another issue.

MR HINTON: That's another issue, yes.

MR TOWNS: But yes, in general - - -

MR HINTON: In terms of access regime, which is what we're talking about, it was a little unusual for me in that I don't think any other interested party to date has pursued this particular aspect with us.

MR TOWNS: Look, it's not one of our major points. It's just something, you know, we thought that was required. But it doesn't come to affect us because, well, I couldn't conceive of us not being covered at least, unless you bring back the national significance test in another place. But yes, so it's not a big issue for the industry. It's merely a comment I guess on the operation of the whole model and the thing we saw as being perhaps a better system.

DR FOLIE: I'd like to come back to the monitoring regime. One of the key things of our report to date has been that basically it's a common code for both distribution and transmission, and we would see no reason to have any difference there. Clearly there's a lot more argument about pipes and pipelines and expansions. But, you know, effectively, if you like, the economics of competition appear to be somewhat easier to understand than the distribution side of things. When it comes to monitoring, it has been fairly silent perhaps. If there is to be a monitoring regime do you believe then the parameters being monitored appropriately would be somewhat different for distribution than they are for transmissioned, and I don't recall anybody really emphasising that if there were to be monitoring it would need to take cognisance of - even though they're in the same industry, the structure and the important things to be looked at are somewhat different under these two - - -

MR TOWNS: I suppose I'd better be a bit careful how I answer this, given our recent purchases of transmission lines. No, I don't think there should be any differences between transmission and distribution lines. I mean, you're monitoring prices, quality, access and, you know, for both you've got the same issues about - well, you've probably got more access issues in transmission lines than you have in distribution networks. But the same prices and costs information would still apply. So there might be some differences in terms of the types of things you concentrate on. But broadly the same issues would be dealt with, with both sectors.

DR FOLIE: Distribution connections et cetera. In other words, your blue book might look different to another blue book, I would think.

MR TOWNS: Yes. They might have all the same headings but they might be monitored in different ways because of the different nature of the businesses.

MR HINTON: Expansion of existing pipelines, in your submission you seem to be objecting quite strongly to the idea that expansion of covered pipelines be automatically covered. That seems to be hard to be sustained - page 16, I think it is. If you've got a covered pipeline and you've expanded, prima face that seems to us, certainly in our draft report, that that should also meet the coverage test and if it doesn't then there could very well be implications for investment decisions on expansion.

MR TOWNS: Could you point to that particular argument?

MR HINTON: It's a good point.

MR TOWNS: I can't remember covering it.

MR HINTON: I can't find it on page 16 of your submission either.

MR TOWNS: I realise, you know, when you read a lot of submissions, Tony, that you may - - -

MR HINTON: That's a good point.

MR TOWNS: Let's pass on that one.

MR HINTON: I don't recall it in your submission either, but thank you for that. I won't go back to that issue. Assett management contracts, let's move on to that, and this is page 19. I think I'm on safer ground here.

MR TOWNS: Definitely.

MR HINTON: You seem to be uncomfortable with the regulator having powers or scope to examine the relationship between parties involved in asset management contracts. But those users of energy probably would be the first to say that that is a potential source of erosion of the intent of the gas access regime, particularly with regard to pricing and transfer pricing and profit sharing, and that if a service provider seeks to hide price gouging for example by having an asset management contract that is priced a little bit differently than might otherwise be the case and not subject to review, then you would seem to be potentially having the capacity to undermine the integrity of the access regime, the gas code. Now, that's an over-simplification and an overstatement I suspect, but I'd welcome your comments.

MR TOWNS: Because gas competes with electricity for customers we have to be quite competitive in our pricing when we go into estates and when we hook up new customers, because we can affect their choice of energy service. So if we want to expand gas then we have to be competitively priced and in a lot of cases we might put our infrastructure in at cost because we want to get gas into a particular new facility or new township. So this idea that we can easily profit shift and transfer price is just not generally the case at all. Also, if you want to build a good business up as an infrastructure business, the last thing you want to do is transfer price and subsidise the damn thing because you'll never build it up as a business. So we like to tender out, and our company tenders everything so our network business has got to

compete with all other network businesses, but we build infrastructure for heaps of telecommunications, and gas, and electricity, and other businesses and it has to be efficient, otherwise we wouldn't have a solid business.

MR CROUCH: Also, I'll probably just add a couple of points to that. Firstly, I think it's our relative is going wider than just the interpretation of the associate contracts provision of the code, but I think this is where this has originally came from, and we've got a very strong view that that's an incorrect interpretation of the associate contracts provision. That provision in our view is about ensuring that there is no ability by a vertical integrated service provider-retailer to favour its downstream operations. That I think is probably a legitimate function of the code, but to the extent that there was any evidence of asset management contracts being used in that way - and I don't think that anyone actually has been able to show that that's the case - that doesn't have the impact of directly impacting on competition in a way that the associate contracts provision is designed to - it's not designed to defeat. So probably I think it's just worth noting that, and again I'd reiterate Geoff's comments, that ultimately we are subject to a degree of competition that the Productivity Commission did refer to in its draft report, and ultimately there are quite strong incentives to make decisions that are commercial.

MR HINTON: Thank you, Charles. Can I move on to your recommendation 16, that the Commission recommends that, "The new Gas Code should allow all the actual costs of regulation by the regulator to be recovered from consumers." This is a cost of regulation issue, it's an equity issue and it's also an issue of making sure regulatory costs are as slim as possible but also does relate to questions of game playing and incentives and disincentives for inappropriate action as well. So it's a wide ranging set of issues here. But the prior question becomes - that suggests prima facie that the system at the moment does not allow the costs of regulation to be taken into account by the regulator when cost based price regulation is being applied.

MR TOWNS: I think it's different in different states. In Victoria we get the licences, the cost of the licences returned to us in our pricing. But in Western Australia it's quite a different thing where the regulator there has been quite difficult about recovering costs, which maybe Charles can speak about.

MR CROUCH: Yes, I might expand on that. As I understand, the situation in Victoria is that companies here pay a licence fee which represents their assigned proportion of the costs of the regulation. They know what that licence fee is, it's fixed in advance. If the regulator subsequently spends a different amount that's a problem for him. It can't be passed back to the companies. What happens in Western Australia is that we actually basically just get a bill for the actual costs of regulation. It's not correct to say the system doesn't allow cost recovery because you can build it into your regulated cost base. The situation we're at, at the moment with

our current access arrangement is, we've built in a forecast of regulatory costs, and for a variety of reasons the actual cost of regulation over the last five years has been significantly above that estimated cost.

Now, I think there are some reasons why regulatory costs are probably unusually difficult to forecast accurately. In Western Australia some of the issues have been that, for instance, you've had a lot of costs associated with the regulator's costs in the Epic case which ultimately get passed back to regulated parties. I think the regulator probably has incurred more costs than he and anyone else had expected in the assessment of the access arrangements. There's also a risk factor which hasn't actually come up directly but could. In Western Australia there's an assignment of regulatory costs reporting to a formula depending on your share of the pipeline market there. If somebody is uncovered then basically all the other places who are left in the pool have to pick that amount up and that could occur in the middle of an access arrangement that significantly increases the amount you pay by possibly as much as 25 per cent.

So it was for those reasons that we felt that if you take the view that the most efficient way to cover regulated costs is by incurring a levy on the companies that would be on the basis that ultimately regulation benefits consumers and that you've got some expectation that ultimately they're the ones who bear the cost. I think you can actually make a case that it has general economic benefits, so it's appropriate to define that from consolidated revenue. I recognise that realistically, particularly state governments are not going to find that a particularly palatable view and our understanding of the finding for the economic regulation authority is that it is likely to be on a levy basis, the same way as Ofgar has been funded.

In those circumstances it does seem appropriate that whatever costs Ofgar and NERA thinks it appropriate to charge us for regulation, ultimately we get to pass those on because if we don't we're recovering less than what has been assessed as being the efficient costs of providing gas pipeline services.

MR HINTON: Thanks for that elaboration, Charles. Michael, how are you doing?

MR FOLIE: I'm right, thanks.

MR HINTON: Geoff, Charles, have you got anything else that you think we haven't focused on that we should have focused on this morning, in the last 50 minutes or so, that you'd like to draw to our attention?

MR TOWNS: No, I don't think there's anything more we need to say. You've got our submission and we don't need to elaborate any more than what's in that.

MR HINTON: Thank you again very much for your submission and for your attendance today. It's appreciated.

MR TOWNS: Thank you.

MR HINTON: That completes the first session for this morning's public hearing. We're scheduled to have the second at 11.30 with a break for morning tea, so I've been very generous and allowed more than the 15 minutes for morning tea than previously scheduled, so let's return back here at 11.30. Thank you very much.

MR HINTON: Welcome back to this second session of this first round of hearings in Melbourne on the Commission's inquiry into the gas access regime. I now have the pleasure of inviting Mr Greg Harvey to appear before the hearing. Greg, welcome. I invite you, as discussed a moment ago, to make a brief introductory statement to help things along for this particular hearing. Thank you very much.

MR HARVEY: Thank you, chairman. I repeat, as I did to your hearings late last year, that while I am motivated to come from my experiences - chair of the National Gas Pipelines Advisory Committee, and a lot of my views have been formed in undertaking that role - I emphasise that what I put in my note submitted before this meeting and what I have to say today are my own views and do not represent the views of NGPAC. There was some fairly inaccurate and offensive comment on that following my last appearance which I take strong objection to, but in all commonsense for any reasonable person, surely it's entirely appropriate for me to offer views as an individual on the basis that the committee which I have chaired has not considered these views and indeed I have not sought to consult with them on it. It's a huge committee representing all stakeholders with a variety of conflicts of interest, so I thought it was appropriate - without any further apology - to put my views from observations over six years as chairman of that committee and a few years before that as an active participant in the gas regime.

So on that basis, chairman - I mean, for those of you who didn't see it, I must say I took exception to being called the "Sir Les Patterson of the gas industry". I thought that was a bit much - anyway. You will have seen the note I submitted, the two pages, as my comments on the draft report and you, I'm sure, will have noted that I found the review - the draft report - very comprehensive. It seemed to address all of the principal, practical issues with a few exceptions which I'll come to in a minute. I note the difficulty of the commission in conducting this review presented by the fact that in parallel the Ministerial Council on Energy is considering another review which deals with the institutional arrangements, among other things, of the future of the gas regime and the electricity regime and others.

The burden of what I want to say today is very largely about urging the commission to be bold in its final report and be prepared to comment on some of the recommendations of the COAG - we all know it as the Parer review. It's called the Energy Market Review of COAG. That's the Parer review. That review of course is referred to in the communique of the Ministerial Council on Energy issued on 11 December. In the note I've just handed you which is in addition to the formal comments that I lodged the other day, I note that the communique almost foreshadows - well, it certainly foreshadows - some interaction between its deliberations on what the institutional arrangements for administration of a gas access regime and indeed the energy access regime would be, and any findings and recommendations you should make.

While I note that your draft report also acknowledges this parallel work it is in my view less than robust as it might be in commenting on the direction or some of the directions in which it goes. For example, in your formal recommendations you comment on the need for separate bodies to pronounce upon whether or not a regime should be covered and then the body which administers the rules that follow from that coverage. In the body of your report you refer, with approval - or at least you appear to endorse - the idea that, on page 382 of your review - that's really the last page of the formal review - that:

> The energy market review proposals in relation to some of the roles of the instrumentalities administering it could be perceived as an undesirable step away from the separation of regulation policy-making and administration.

But that isn't a finding of yours and indeed you haven't made a finding that would be a desirable feature of any regime that follows. I would urge you to sort of, in addition to your finding number 12, I think it is - not 12. Well, anyway where you find that coverage and regulations should be undertaken by separate entities, that - - -

MR HINTON: 12.1 draft recommendation.

MR HARVEY: Yes, I thought it was 12.1. I couldn't find it.

MR HINTON: It's a draft recommendation.

MR HARVEY: Yes. That's really constrained to the coverage question and I would like you to consider going a bit more formal on this, I think, very important issue of separation of policy from actual regulation. I've made a couple of other comments in my note. They're all pretty much along the same sort of lines. As I've tried to think over all the years I've been in the middle or in the muddle, if you like, why is it that we're having difficulty in achieving goals that every state and territory in the Commonwealth and all stakeholders agreed on at the outset. We seem to be not achieving that result. I said in my first submission that I thought the objectives were not being interpreted necessarily in the same way by all the stakeholders and that leads to some disconnects and I've sort of made that the emphasis of the paper I submitted a couple of days ago.

Indeed I note that there is some separation foreshadowed by the Ministerial Council of Energy communique in the code change process and the implementation of policy from the regulation. But then they sort of lose the plot a bit and somehow get the ACCC involved in approving code changes which seem to run counter to what a lot of the findings will have been and what a lot of the stakeholders have

referred to, that is, you know, it isn't right to have the gamekeeper setting the rules. The policymaker should do that. Interestingly, the MCE in its communique was extremely clear about that. In its appendix number 2 - when it looks at the regulatory procedures - the very first point it makes is:

> Ministers acting jointly will have power to issue binding policy directions on and commission inquiries by AEMC.

Point 2:

> AEMC will have no power to initiate amendments, regulations or rules.

So, you know, they're sort of reserving to themselves the policy issues and giving the AEMC quite a defined role.

Then of course you have under the MCE's proposed structure the Australian Energy Regulator which sets within the framework of the ACCC but separate from it. I don't have a problem with that. I mean, I think if the service providers - in all aspects of commerce you have sort of green fencing arrangements, I think that's probably quite efficient. You would certainly cut the costs of administration and you'd have access to administrative support that would be otherwise not available and, frankly, it probably also gives the AER - the Australian Energy Regulator - access to staffing, development and expertise which is very necessary.

One of my concerns was that the expertise of regulators, in the early days in particular, was spread too thin. We just didn't have enough experienced regulators. Certainly I've got no problem with the Australian Energy Regulator sitting under the ACCC. But I would like to see this commission's report emphasise more strongly, if it agrees, that the Australian Energy Regulator is that, particularly in relation to gas. Let's go back to fundamentals. What we're trying to do is to have a market which will deliver pretty much all of the outcomes. The regulatory system is to see fair play to ensure that the market is transparent. What I find really very worrying in the MCE's communique - and which I think is a perfectly legitimate aspect within your terms of reference to at least comment on - is the potential for confusion of role.

Even under the communique here they have all these separations and they set up little tribunals and rules and so on. But if you have a look at the writing instructions given to the various bodies under the MCE's proposed system, they're actually saying under the net benefit tests that the AEMC - this is the body which will recommend code changes and so on, or will deal with code change recommendation, not even recommend them - is suddenly given this enormous and very onerous task of taking into account long-term interests of consumers in a regime that is really - okay, of course we hope the long-term interests of consumers is

actually embedded in a really good market system. To confuse the issue by sort of saying, "By the way, you'd better take that into account," and the next one down - two points down:

> The AEMC is to assess competition, access and consumer impacts.

Well, are we going to now have amendments to the code or the regime that actually address consumer impacts?

I have been deliberately a bit naive in my note that I've just handed to you and I'm saying can't the states deal with the consumer matters below the line, as it were, ie, you have a market functioning as efficiently as it can, are giving all the proper feedback that markets give and that social engineers always seem to get wrong. I mean, the market says how the market works best. Then if the market is actually delivering outcomes which in the interests of their community quite outside the market - I mean, if little old ladies in Kellerberrin or Mukinbudin - I'm picking Western Australian places that don't have gas actually. But, you know, shouldn't they be dealing with those aspects if gas prices are interfering with regional development policy along the Murray. Surely that is not a market mechanism problem that should concern the AEMC.

So I'm suggesting actually that if it's amenable to the commission that they might look at some of these things, and I've even gone so far as to suggest that they should comment on the trigger price mechanisms which are foreshadowed on page 12 of the communique - sorry, the price capping. I think that could be the Achilles heel of the intentions of all this market reform. Here we have the MCE saying that it's going to great lengths to separate this and that function and to have an Australian Energy Regulator, and it says quite a lot of tremendous things about aiming at economic benefits and transparent markets and so on. Then it - I'm sure it's the political reality and that's why I admit I'm being naive - goes on to say:

> The MCE will take into account particularly the need to protect consumers.

It goes on and says:

> All jurisdictions where full retail competition is operating, retail price caps will be aligned with costs, and these will need to be reviewed periodically.

I'm not sure by whom, and I'm not sure who aligns the costs. The point I'm trying to make is that if you've got this margin column which is divided according to what we hope will be the markets, not only for gas from the wellhead but for pipeline

services, for distribution services, for gas marketing services related to the interaction of that particular stakeholder with the regimes we're talking about here in particular, but then at the end of the road there is this price cap, I mean, that's a bit of a worry, isn't it? Certainly the MCE and everybody says, "We're trying to form a platform for future investment of $37.7 billion worth of assets and to give certainty," and then in one line they say, "Well, actually, sorry, chaps, at the very end of it we'll have a price-capping arrangement." Obviously state governments and Territory governments in particular will want the ability to intervene to ensure that their community is not disadvantaged by some aberration or for any other social policy that they have legitimately custody of, but shouldn't they be approaching that as a separate exercise? Let the market reveal the true market forces and if there are sections of the community disadvantaged by that, then shouldn't that be dealt with as a community development, regional development, whatever you like to call it, but not try and flick it off to the AEMC - three persons, incidentally, not elected but appointed by the states and the Commonwealth, I think.

It just sort of worries me that we've gone through all of this problem and I think the commission would do a service to the stakeholders and to the Ministerial Council on Energy by just addressing that question. I think that's enough from me.

MR HINTON: Greg, thank you very much for those comments. Let me break down my questions and comments in several tranches. First of all, thank you for attending and your written submission, and we appreciate the capacity within which those are occurring, but it's also important that you put that on the public record. Also on the public record, I assume that when you talked about "offensive comments" there was no question of anything coming from the Commission in that regard.

MR HARVEY: None whatsoever.

MR HINTON: Thank you very much. It was a number of media releases and journals that touched on those things, as I recall. I also pick up on, as a second comment, your very important remark that our particular inquiry is running along at a very similar timetable or coincidence with work going on regarding the MCE and the responses to the Parer report. That is a challenge for us. Our report came out on 15 December, but pens down, in terms of when it was finalised, was well in advance of that. So taking account of events in late November early December were of course impossible for our draft report, but we are very conscious of our need and in fact obligation to substantively and seriously take into account those sorts of decisions by COAG and other government processes.

I congratulate you on your remarks this morning in the sense that you have in effect anticipated my first three questions and very successfully in fact, so I'm not

going to re-raise them. They did touch on issues to do with the objectives clause in particular, concerning efficiency relative to consumer interests. I don't think it would be helpful to revisit them because you've articulated your views very directly and succinctly on that. But I would like to explore with you a little further the institutional arrangements. One way to make a distinction between administration and policy is so that administration is left to officials and policies made by ministers, by governments. But the MCE in setting AEMC seems to erode the power of ministers in terms of approval of code changes. Is that your reading of the response of the MCE to the Parer report as well?

MR HARVEY: Well, I wasn't sure how much you wanted me to comment on the Parer report and - - -

MR HINTON: It's the response to it rather than the Parer report that's - - -

MR HARVEY: Quite. But I think there are a number of really good findings in the Parer report but I think when it comes to the detail of the administrative and policy framework, there's some sort of gaps between the boards. I'm not at all sure that I understand what was involved here. It seems from the instruction in the communique that the ministers can issue binding policy directions to the AEMC. So presumably that would include a direction to amend the code or to recommend an amendment to the code - - -

MR HINTON: Contrary to what AEMC does?

MR HARVEY: Yes. I mean, as I understand the system, the AEMC cannot initiate amendments but must receive all proposals to amend the code from any stakeholder. Then it is obliged to consider all of those things and hold hearings and consult, then I understand that it advises the ACCC on whether the code should be amended, and the ACCC at the end of the day actually amends the code or decides not to or decides to hold its own inquiries. I might be wrong there but I found it a bit confusing. Then I wasn't too sure what happens after that. I think the ACCC says, "Okay, this is the amendment," and that's it. So the ministers somehow are then out of the loop, unless they choose to intervene by directing the AEMC at the outset.

MR HINTON: That makes the AEMC subsidiary to the ACCC under that formulation as described.

MR HARVEY: That's my understanding of it and I'm sure it's true. I have lots of problems with that. See, one of the strengths of the present arrangement - and you point out that it hasn't worked and that's quite right. I mean, you can own a beautiful Mercedes-Benz car and if you simply don't put petrol in it then it won't work. I think there are some very good features of the present system. I'm not trying to defend the

NGPAC or anything but there are opportunities within the present framework for stakeholders to make recommendations for code changes, for those code changes to be sorted and prioritised and analysed across all markets. That's a very important part of this whole thing of having a national scheme because we've got one code for all markets and the markets are very, very different, as I said in my earlier stage.

So it is important that you've got a body not just saying, "Yes, this code change is a very sensible idea for that market but how does it impact on other markets also covered by the code?" It's important that whoever receives the submission for a code change has access to a wide range of views. These three members of the AEMC are obliged to conduct inquiries and so on and so forth and that's very good. They are obliged to consult all the major stakeholders, including the regulators, and that's very good too. But then it seems that they sort of somehow or another summarise the code change and presumably offer their advice to the ACCC on whether or not a code change and what sort of code change should be put into it. Then it goes to the ACCC and then it becomes a code change. Somehow or another, unless ministers are brought into the loop through the consultation process with government departments, I'm not sure that they have then the final say.

I sort of guess what in fact they said - the Parer report said - it is really looking to cut down the length of time and the complexity and the cost of making code changes.

MR HINTON: Another way of looking at the MCE response is in terms of the energy market's two key tranches in terms of electricity and gas and some interested parties have expressed a view that electricity is driving that agenda, driving that reform and driving those outcomes, but that the sectors are still very different; that is, the two subsectors of energy are quite different. The detail of the response to Parer in fact is primarily based upon electricity issues and that there may be wrinkles that either tranche out or treat differently or separates slightly in certain circumstances the gas sector. Have you seen it that way?

MR HARVEY: Absolutely. In fact I thought that you were absolutely spot on when you said that you felt there was a need to have - I think you've said that in here. I'm beginning to forget where I read everything now. I believe you identified the need for a separate approach to gas. I note that even the MCE, looking for uniformity and unity and so on, has said that gas would follow. But it does seem to me that we're looking at an approach which is absolutely dominated by electricity and I can fully understand that. But let's not lose the good things that were present in the gas regime.

I think the objectives clause, however that can be introduced - and if its linkage with the administration of the rules, ie, to the regulators writing instructions is going

to be absolutely key - I think it's going to be extremely difficult for this commission review or indeed any sort of formalised inquiry to determine all the things that could crop up when you actually get down to the nitty-gritty of writing these detailed sets of instructions to the various instrumentalities being set up. But I think the biggest contribution can be in identifying the pitfalls of confusing policy and making sure the objectives are clearly understood by all levels of the process.

MR HINTON: We certainly appreciated your focusing on the objectives issue in parts of the report in circumstances where we thought it, as put in the draft report, quite important to have an overarching objective and that the documentation not contain conflicting objectives that by definition leads to bad regulation and certainly costly regulation. We appreciated your focusing on that efficiency focus and also with the issue of consumer protection being mechanisms separate to the objective of the gas access regime pursuing them, other than the long-term, long-run interests of consumers which are driven by having an efficient gas system. So we appreciate that. Let me move on.

On page 2 of your written submission you pick up this idea that we should rank our recommendations and topics according to priority action at the political level. Thank you for that. You're right in a sense that there are different degrees of detail and significance with regard to the recommendations. At the moment they're tranched by chapter which is tranched by topic rather than significance, though some are precursors to the next steps as well, so there's a temporal aspect to some of these things as well. So I wanted to raise with you whether you can elaborate on your point, your suggestion, that we do it by priority for action because priority for action can be by way of time but also can be by way of substance or significance. I'm a bit uncomfortable with your suggestion, in other words.

MR HARVEY: I think it's an uncomfortable problem. I think it's uncomfortable for the ministerial advisers and departmental officers who are expected to come up with quite a lot of the detail of how the thing will work when it could be influenced. For example, if the policy level people - the minister - said, "No, this is rubbish. We are going to inextricably link consumer protection with this process, so just forget it," then you're going to have to write that into the procedures and the membership of these various bodies, I would have thought.

On the other hand, if the minister says, "Yes, look, what we're on about here is investing $37 billion over the next 10 years and encouraging market forces to give us the feel for how these things are developing because we acknowledge that regulatory engineering doesn't always hit the right mark," then that would have an impact on how the departmental and ministerial advisers would recommend the framework. So I suppose if I had my choice in the matter, I would see such an emphasis on the importance and timeliness of a policy decision along broad principle lines sufficient

to sort of enlighten and direct those who are then fleshing out how it will all be done.

MR HINTON: I think I have a better understanding now of what you had in mind. You're really looking at those recommendations that are broad brush, such as having a monitoring regime; clearly a very significant change would be a significant change to the gas access regime. That's one broad level. At a second level is the sort of recommendations relating to the guidelines and how that regime might operate. You wouldn't look at that second level if you didn't accept the broad level.

MR HARVEY: Well, it would make a huge difference, wouldn't it? You wouldn't even go to that step. But my difficulty of doing it by significance is that both are important. You can't have the first without the second, and the second is irrelevant without the first.

MR HINTON: We might look at it in fact in terms of presentation for absorption into the final report, looking at listing perhaps some of the broader directional type fundamental changes we're recommending that are then fleshed out in more second order but still important recommendations. Thank you for that.

MR HARVEY: I mean, if I can just offer you some of my experience when this whole regime was set up. Everybody was sort of driving somewhat blind and certainly through a fog and hours, days, weeks were wasted on sort of bicycle shed issues; things that people would get their heads around, particularly at departmental level, and they would sort of tease away at all the details and miss something as important as a right of review on the basis of merit and they're going to try and cure that by having this perfect system of detailed regulation. So that's what I think - if I understand you correctly - would be a huge contribution you could make; decisions on the broad principles at an early date, adhering to - if that's the ministerial intention, as it appears to be stated - the underlying principles of economic development and investment and fair markets and have the rest of it follow that, rather than some confusing issue about price capping at state level by we don't know who.

DR FOLIE: You've said it within your verbals but part of our findings were that NGPAC for a variety of reasons actually wasn't very effective and, if you like, it's the sense about separating policy from detailed implementation. Do you in some ways support the recommendation we came down with which was very much putting much more back into it? I mean, it's flawed because of ministerial members, and if it's going to be important, governments in reality are actually going to make the changes. Do you at least sort of come along with what we thought or do you think there are some criticisms of that?

MR HARVEY: I think it's quite proper for the ministers to retain the policy

decision-making power. I suppose my only discomfort with the pretty bald statement that NGPAC wasn't working was that you might have found why it didn't work a bit because its membership may have been slightly dysfunctional in terms of built-in conflicts and having regulators actually on board with the policy-making process. You have commented on that. But I also think it might be worth - and by implication I think you've even picked up this other point. But certainly it's an unfair criticism of the NGPAC framework and regime to say that it just doesn't work and it couldn't work, it's sort of inevitably flawed, because in my earlier submission I think I have gone back to a hobbyhorse I've been riding for a number of years which I mentioned earlier: you can have a Mercedes-Benz but if you don't fill it with petrol, it's just not going to go anywhere, or if you put - no, we won't go into the drivers because I'm the chair of NGPAC.

That process - the process, by the way, which still exists and will be the only way to change the code until some new regime emerges - could have worked very much better if those responsible for advising the real policy-makers, the ministers, had put the effort into ensuring that what we had was working as well as it could work. I don't think that happened. I think the large part of the answer as to why that occurred is that everybody was suffering slightly from reform fatigue and, secondly, the gas regime was actually working reasonably well. We've had really strident voices saying, "It could work so much better if we did this, that and the other thing," but I'm here to tell you that for 12 months, there hasn't been the slightest indication from any of the major stakeholders that they've got a problem, other than it takes too long.

The problems have been that some of the original stakeholders in the assets have paid too much and they would like a much more comfortable tariff regime to help them over those problems and various things of that kind. But we haven't had one recommendation for at least a year on what could be done to amend the code as it is. You know, you have to say that all of them have said that even if they had an idea, it would take so long to get it through - well, I haven't had one even as we speak today.

MR HINTON: Wasn't there another matter of holding fire pending the Commission's inquiry?

MR HARVEY: There was certainly an element of that in terms of the major stand-off, and the major stand-off between the stakeholders in the present set-up are between service providers and the regulators-consumer representatives in terms of information that the regulator should be given and should be made public. I think your report goes a long way to de-complicating that. My own recommendations about linking the objectives, right through to the role of the instrumentalities that administer the regime, will also help clarify that. At the moment there is an

absolutely unshakeable assumption on the part of the regulators - for very good, sufficient reasons of context and circumstance and history - that there will be regulation. It's taken a long time for the industry to get up and say, "Look, we want withdrawal of coverage."

MR HINTON: Revocation.

MR HARVEY: Revocation, thank you. It's taken a long time for it to get to that point because it was just sort of assumed that everybody would have to put in an access arrangement and it would be crawled all over and regulators would feel they weren't doing their job if they not only assessed the access arrangement proposed but also thought about what would be better than that and so on. Pretty soon you've got a very complex arrangement. I actually find your approach a very good one: intervene if there is cause to intervene and feel entirely comfortable about not intervening if the market seems to be sorting it out.

I put in my paper that as long as you've got in there a very practical and workable right to put your hand up and say, "Hey, I'm a stakeholder and I'm getting a rough deal out of all this," so provided that's there, I really do like the approach where if everybody says they want investment and markets to operate and light-handed regulation and so on, well, let's do something about it. Pick up some of these ideas you've got.

MR HINTON: Anything else, Greg, that you'd like to emphasise that we haven't picked up in the last 40 minutes or so?

MR HARVEY: Only I emphasise this other comment that if your report is going to come out in final form in relatively - when is it due, by the way?

MR HINTON: It's due 12 months from receipt of the terms of reference. So it's due to go to government by 13 June which means we have pens down late May - the latest, late May, mid-May.

MR HARVEY: Even in that time frame, we're going to have a big lag between your recommendations and the picking up by the MCE of all these other things. I still think it would be useful for you to give some guidance from your perspective as to how to make the present system work in the meantime. I've gone on about that a bit, and you were kind enough to pick up some of those ideas and anything else you may have; far be it for me to say what they should be in detail, but if things occur to you, I think it would be very useful in the report to actually put them in.

MR HINTON: Okay. Greg, thank you again very much for your attendance and your submission and we appreciate the time and energy you put into it.

MR HARVEY: Thank you.

MR HINTON: That completes this morning's session. We're now going to break for lunch and return at 1.30 here in this room to have the afternoon session. Thank you very much.

(Luncheon adjournment)

MR HINTON: Welcome back, everybody. Good afternoon. This is the first session of the afternoon session of the Productivity Commission's public hearings in relation to the inquiry into the review of the Gas Access Regime, and the first interested party attending this afternoon is Alan Moran of IPA. Welcome, Alan.

MR MORAN: Thank you.

MR HINTON: What I'd like to do at the outset is invite you to make an introductory statement that might highlight some of the points you want to flag for us and then we'll proceed.

MR MORAN: Fine. Thanks, Tony. As was said in the very short piece that we put to you, we think the report is a pretty good report actually, and analytically it's very sound, and as an ex-member of the commission I would have been very pleased to have been part of it. I think just a couple of the issues that I've highlighted, there is the translation of the ideas into policy and into law that just give me a little bit of unease knowing, as I do and as you do, chairman, as well, how things do get translated from various outside bodies into policies and into dictums for the administering bodies, and I think it's very important for it to be crystal clear, and overkill, if anything. So that really is the heart of the submission to say that there's a few things in there which I think, if left as they are, would be ambiguous and might be taken by some people out of context, possibly purposefully or whatever.

In this respect I think one of the matters I point to is the notion of "economically efficient" which means something to some people and means something very different to other people. You know, to a free market economist, it means lack of monopoly and lots and lots of players; to a Soviet economist, it would have meant something totally different; the wise bureaucrats, coming up with the best idea, and if not careful, that's what we might well end up with.

Other aspects - I'm not too sure why that notion of promoting competition in upstream or downstream markets is left in. I don't even know why it was in in the first instance, but it seems to me to be redundant, and that's also a possible way - and it has been used in the past - by regulatory agencies to say, "Well, this isn't promoting competition," or, "This pipeline" - or whatever - "isn't promoting competition in the Moomba. Therefore we'll continue regulating," it even though the key thing is promoting competition in the downstream market, if anything. So if we're not careful, that, even though it's a well-meaning phrase, can be used to arm intervention-minded regulators.

That said, a lot of the things in the report are I think excellent. I think it's quite appropriate that we set the prices at long-run efficient costs and things, and that's made clear there. I don't recall you saying anything about revenue capping. There is

a revenue-capping approach in some places used which I think is not a good idea. It should be price capping rather than revenue capping because the revenue capping starts forcing firms along a particular path; a misplaced path often in my view.

Again, I spent little time talking about the efficient tariff thing because the crux of our view is there should be as little of it as possible; the tariffs ought to be set by the market, and we're seeing these market-type situations evolve throughout Australia and it, it seems to me, would provide a great service if the commission could give some guidelines to the policy-makers as to when they ought to step back, and maybe some concrete guidelines - and the guideline might be when there are two firms and one of the firms has got at least a quarter of the market or something of that nature which would then - and clothe the regulator's decisions to basically have a go at something because they basically want to stay in the business of setting prices, and often they feel that the prices aren't coming out the way they should come out. So I think that would be very useful.

One final thing - yes, a couple of things as well - another one where there's an ambiguity or possible ambiguity if you're not careful, and that is this issue of the access holiday which you support strongly and I agree with that, and then there's also the monitoring and I think if you're not careful, the mixture of the monitoring with a five-year time span and the access holiday beginning with a 15-year time span can get mixed up and the monitoring can, if you don't word it correctly - and maybe you have got it there, but I think you should look at it again. If you don't word it correctly, it can compress that access holiday to essentially a five-year access holiday.

Just one other aspect which hasn't been addressed are the market carriers in Victoria, and that was a point that we made in our first submission. Of course VENCorp took a contrary view. We think the market carriers is a prescription for inefficiency, that if you can't have property rights to this carriage there to gas, then you will find that a bureaucratic organisation is running it and even one which is quite well running - in our view VENCorp is - will not do it as well as a market and therefore this notion of market carriage which was an innovation and maybe sounded a good idea at the time I think needs to be rejected and replaced by a contract carriage regime which is the same regime that operates in gas throughout the world. So basically that's all. Essentially our comments are kind of tidying up ones and basically really urging you to stick with what you've got and clarifying some areas.

MR HINTON: Alan, thank you very much for those comments and your attendance today, but also thank you for your written submission. It's appreciated. What I'd like to do is take up some of those points you've just raised, but also first of all, one that you didn't, but is on the third page of your submission in relation to our thresholds in the draft report. You might recall - I'm sure you do recall - that we seek

a higher threshold than currently prevails for coverage for the monitoring regime, namely, access is likely to lead to an increase in competition to a material degree, and then go on to talk about a higher threshold again for cost based price regulation, like access is likely to lead to an increase in competition to a substantial degree. We therefore put some weight on the two aspects of that; the probability aspect, the likelihood, but also the degree of effect; that is material versus substantial.

It's a very lengthy question, I'm sorry, but it's the preamble. You, on the third page, talk about it's not clear that the difference of the definitions of "material" and "substantial" is as clear as it should be in a way that produces the desired effect. So my question really is one of three aspects: first of all, do you agree with the concept that having these levels of threshold are appropriate; secondly, if that's appropriate, do you think the words "material" and "substantial" are okay in their own right; but thirdly, aren't there ways to make sure the intent of those words as used in that formulation can be made clear in the structure of the documentation of the gas access regime? I can elaborate on that if you wish, but they're three aspects of the issue you raise about the delineation of difference. I welcome your comments.

MR MORAN: It's a bit of a throwaway line and it's an easy line for me to say, "I don't know what the difference is," because I think a lot of people wouldn't be quite clear what it was, and I didn't have a difference of view from the report in terms of what you were trying to do. I think it's a good idea - it just wasn't clear to me that "material" and "substantial", after the effluxion of time, and now different people are looking at it, would have the same effect as your intent was there.

So I think your third point there may well be overcome if you do clothe it a bit more in some further - amplify precisely what you mean, and I think it's important - as I said in my opening, overkill is better than underkill in this because people will define these in ways that they want to define them down the line.

MR HINTON: It's been put to us that in isolation, judicial process - looking at in isolation the words "material" and "substantial" might struggle with delineation. But if they look at it in terms of a wider context with a description of intent, that "material" is not as large as "substantial", and an elaboration of those concepts, then that would then guide a judicial or semi-judicial process for decision-making as to the application of the concepts. That's what's behind your point of elaboration.

MR MORAN: Yes, I think quite a detailed purposeful drafting is necessary there to give effect to what you intend then by those words, and I notice somebody else in evidence already has also questioned the "material" and "substantial". But it makes a lot of sense what your intent is there, and you ought to just carry it through, in my view.

MR HINTON: We note your message. My second question goes back to one of the points you made in your remarks in relation to objectives - economically efficient use of, in the objectives. I think it's recommendation 5.1, "To promote the economically efficient use of … the services of transmission ..". You're expressing concern that that might give the wrong signals regarding - is it marginal pricing for example, margin cost pricing? It also has economically efficient investment in - we're also looking at the possibility of including economically efficient operations of - reinserting that particular phrase as well, consistent with the government's recently released Part IIIA review, the final response to the Part IIIA review.

I put to you that that conjunction of those three aspects could seem to overcome your concern or at least address your concern about the impact of economic efficient use of leading to marginal cost pricing.

MR MORAN: I think it probably would, but I'd still be inclined to spell it out a bit more - even to the degree you just have then I think would be helpful. The final government response wasn't out at the time, but I think just to spell out that "economically efficient" does not mean marginal costing; in hardly any circumstances would it mean that. You might even spell out what circumstances it might mean that, and leave it at that, to ensure that people are basically talking about full-cost competitive-like markets. Again it's not a difference I've got; it's just that I think that, to avoid a misconstruction.

DR FOLIE: I've got one just in the interim. You do point out about the market carriage process. What if VENCorp - this is a pure hypothetical - but let's assume if it was privately owned, do you believe that you'd have the same level - in other words, the incentive structures, a little bit of difference and the accountability a bit different, because there are some very interesting differences the way the two processes are conducted.

MR MORAN: Yes. I think the difficulty with VENCorp as it is, is that it isn't the owner, but is the controller, and they can't write contracts because it's not the owner, it doesn't have the same incentives; probably maximising incentives to find new ways and little caveats in the pipeline that could be used more efficiently et cetera. I think all of those things tend to make it less efficient than it should be. If VENCorp was privately owned, then it could write contracts and it probably wouldn't matter whether - you probably could carry a market carriage system in those ways, although in my view it would evolve to be a contract carrier; that the owner would start passing them out or signing long-term leases, if you like, with various people who would want the certainty.

DR FOLIE: I think that's part of what I'm - because it's not a discussion about one particular entity. So for the record, I don't want to get it wrong, but it is an

interesting, different innovation for actually how market transactions could be conducted.

MR MORAN: Yes.

DR FOLIE: But you believe it would probably end up defaulting towards the ordinary method that we've got.

MR MORAN: I think so, Mike. One of the interesting things - I noted that VENCorp put a submission in countering my views for the first time round on that, but VENCorp have since commissioned a great deal of research, some of which is published or all of which is tending to the view of saying, "How can we create property rights here?" So VENCorp, having quite vociferously opposed my notion that the fact that property rights aren't there is a deficiency, now seem to be moving towards saying how they can correct them of their own volition in some ways, and they've brought in ICF and some other consultants to offer them advice on that.

MR HINTON: A related point, Alan, some have expressed the view that the Victorian market has significant meshed network with significant scope for bidirectional flows, and a market with those characteristics raises practical issues associated with how you define capacity, surplus capacity, and if you can't define that, then it's pretty hard to have a market in it. I was wondering whether that might be a more fundamental problem in moving the Victorian system back to contract as opposed to - - -

MR MORAN: I think it's sand in the eyes basically. There's some very long pipelines in the United States with lots and lots of outlets, lots and lots of inlet points. I don't really see that the pipeline we have here as being unique from American pipelines.

MR HINTON: Thanks. You raise in the last page of your submission an issue that has got some currency, particularly more recently, and that's questions of institutional arrangements, and pushes for a national energy regulator is around, the government's response or the Ministerial Council of Energy minister's response to the Parer report, the Parer recommendations, and that's certainly an area we have to revisit in the light of more recent developments in moving from a draft report to a final report. But I would welcome your perspective on these issues about a national energy regulator being driven by, say, an electricity sector that may subsume a gas sector. Do you have any problems here or cautions for us?

MR MORAN: No, I don't. I try to avoid getting too heavily involved in it. I mean, my own view is much more of an anarchist, if you like, or cataplexy - you know, whatever we economists call it - in the sense that you don't so much need a regulator,

national or otherwise. You just need law and people's rights and the normal law, people having rights and responsibilities that go with them and contracting with each other. You do need a regulator of course in electricity to actually schedule; you need a scheduler. There's no question about that, and you probably need that in gas too.

But when people are talking about a national regulator, they seem to be talking about a planner and somebody who is specifying why the pipelines or the electricity lines ought to go and who ought to build what power stations et cetera and I think that's a bit of a dangerous development and one which probably is not warranted. That isn't to say that you don't need - there are things more particularly in electricity than gas. For instance, ancillary services have got to be found just to keep the electricity running around and somebody has got to charge for that, and there may well be issues of connection and the various rights of parties.

So to me, the best aspect, the best regulator, is a very thin regulator and it's one involving himself in the specifics, the operational specifics, which are necessary as in a traffic policeman, traffic lights sort of job, unless in terms of planning, because I think in planning these things, as we've seen in electricity, certainly in my view, planning these things will tend to over-plan in many cases and occasionally under-plan when they've got no money.

MR HINTON: I've got one more question for you and that's the terminology that has sort of been in the lexicon of gas access regimes and elsewhere, certainly in competition policy more generally, and that's this concept of "workable" or "workably" - competition - and the objective of workable as opposed to perfect markets or perfect competition, and there's no shortage of views around from interested parties on this issue. I'd welcome what sort of comment you could make on our handling of that issue in our draft report, if you've focused on that issue, but also more widely, particularly the concept of "workable".

MR MORAN: I think, yes, that's basically what I was referring to in my own remarks. You know, "workable competition" is a term which people will make of it what they want. I think that it would be very useful if you were to spell out what you meant by workable competition. To me, workable competition is you've got two firms certainly of comparable size fighting it out for a market. That is workable competition as long as they don't collude. I mean, all of this is basically to avoid the excesses of monopoly, one way or another, and if you've got two firms that are going to fight it out in the market and if they don't collude, then the answer will be workable competition.

I think it would be useful for the commission - and this might be breaking new ground - but it would be useful if the competition were to specify what they meant by two firms there. I mean, it certainly is the case - and courts have agreed that it is the

case - like the two pipelines in the Moomba-Sydney pipeline are of comparable sorts of size. One is larger than the other but they're still both large pipelines feeding the one market. That is workable competition, and I think it would be very useful if you were to tease out some ideas and offer advice as to where the boundaries lie. I mean, if it's like only 5 per cent of the market and 95 per cent of the market, you will almost certainly say, "No, it's not workable competition." At 25 per cent, would you say it is workable? I don't know. These sorts of issues I think would be useful for the commission to offer advice to regulators in the future.

MR HINTON: How about the prior question though, Alan, and that's maybe there's no need to even have the term "workable competition" in the documentation if the objective is efficiency and that if you have then intervention to replace or address market deficiencies, then you don't even get into the sort of realm of saying whether or not you're achieving workable competition or perfect competition or competition of any order. You're seeking to address market failure by intervention to try and bring some sort of pressure, regulatory pressure, on delivering of service. That's not duplicating competition because you can't do that. Why do you need a concept of workable competition in any case?

MR MORAN: I guess you may not need one. I'm not suggesting you do necessarily need one. I think that it's useful here though to provide guidance to the regulatory authorities - more than guidance, dictates if you like, to the regulatory authorities about when they may or may not move into an area. You know, there are clear areas where competition is in place that almost everybody would agree it would be inappropriate. It's basically useful for the commission to make these points to extend no-go areas to the regulator authorities, to say when there are two pipelines serving a particular market, there is no need for regulation. We've got regulation; it's called competition. But then when there are three, it's even better. When there are four that's better still et cetera. So I think I'm not fixed to the idea that you need to use the term "workable competition" which has emerged more - it has always been around in the literature but it has emerged more popularly since I think the Epic pipeline case in Western Australia. The courts have started using the term and if everyone understands it, it's great. But I think it would be very useful if you are going to use it, whether or not you use it, that you do spell out what you mean by "workable competition", basically to create this no-go area for the regulatory intervention.

MR HINTON: Some interested parties might say though that if you take what you're saying to an application degree, that a prescription of formula, an application of formula for judgments about market power, might have the benefit of precision but could have the significant difficulties of inflexibility such that you could have regulation where it is not really warranted or you might not have regulation where it should be warranted. That sort of formula approach sounds neat and tidy to many

regulators but delivering it in a complex commercial world usually is very difficult. That trade-off seems to be a very, very significant one and one that at least makes you cautious about formula driven approaches.

MR MORAN: I think that's a good point. It is a good point. It seems to me though that the regulatory agencies have in the recent past in Australia tried to usurp ground where regulation isn't necessary, instead of backing off where it should be undertaken, and I think even if it's only as an example, it needn't be limited. Behind your question there may be cases where you have a monopoly pipeline but it can't exercise market power because electricity or various other things are already in place and that's great, that's fine, but it would be, I think, useful to leave that open. I mean, you're not here to actually dictate all the areas where they may or may not go. But to cut some off I think would be quite useful, would be very useful if the commission were able to do that, to clarify the law and prevent the sort of situation - and very, very wasteful case law we've had with the Duke and Moomba-Sydney pipelines and Dallas - we've had with others as well.

MR HINTON: Michael?

DR FOLIE: Just one on monitoring in your submission; effectively summarising, you somewhat sceptically point out some of the dangers of monitoring. Would you like to elaborate a bit more or do you have a positive element about what should be done in a monitoring regime?

MR MORAN: I think that the monitoring - and you're using that term to say, "Look, we've got to move to something a bit more lighter handed than we've had in the past," and you don't buy too many debates about that, in principle at least. My issue with the monitoring was a specific issue, that it was the juxtaposition of monitoring and the access, the 15-year access holiday could distort - the monitoring could actually distort that notion that you've got in place there by making it a five-year access holiday. The more general issue about monitoring is whether or not we ought to look more loosely rather than the very stylised price-setting system which is currently in place and I think - well, the jury is still out on that, but I think that probably is worthwhile saying anyway - that a monitoring system might well be better than the rigid system we have at the present time. But my concern is that this ought not to be in place in those greenfield pipelines that we're talking about, the 15-year holiday, because otherwise we've just converted it into a five-year access holiday which would be much less supportive of the investment.

DR FOLIE: I'd suggest the parameters for judgments about coverage need to be well guided.

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

DR FOLIE: So that the regulator making the coverage decision doesn't default to the monitoring option for the greenfields as opposed to - - -

MR MORAN: Precisely, yes, and it might well be well enough covered there, but I'd just ask you to look at it again because it struck me as possible.

MR HINTON: We flagged the issue of tendency to go to the third umpire and go monitoring rather than - - -

MR MORAN: Yes.

MR HINTON: A related point which I've briefly overlooked - yes, your submission addressed some concern, on the third page, that you're worried about the five-year ruling for monitoring being locked in for five years unless the information is proven to be false or intentionally misleading. So there's an out - in our formulation the decision to monitor the pipeline, the network, applies to five years but there is always the issue that the information that the regulator made the decision on was based on fundamentally flawed data and that's not a matter of getting a forecast wrong. That's a matter of the interested parties concerned deliberately, intentionally misled the regulator's mindset by providing information that was false.

MR MORAN: Yes.

MR HINTON: Now, maybe we need to look at the formulation. It's not there to generate uncertainty in the mind of interested parties. It's meant there to be an escape route for something that could be directly related to inappropriate behaviour such as intentionally misleading the regulator.

MR MORAN: Yes, I appreciate that and I agree with your point. But it is again one of these areas where somebody who wanted to interpret it in a different way could do so and say, "Well, this was predicated on the market growth of 4 per cent a year. The market has grown at 20 per cent a year. Therefore we're going to change all the pricing mechanisms in there." Now, that's something that you would be cutting out the upside benefit from a firm. It may have been even misleading, I suppose, of the firm to say that, "We think that the market is going to grow by so much," but it grows much faster than it expressed. Should you then overturn it? I don't know. I would have thought not.

If this is going to be a regulated case, it's quite up to the regulator to inquire himself into what is likely to occur and if it's massively different from what the firm is saying, then he can stipulate a different sort of price at the outset. Certainly if somebody has been deliberately misleading, then clearly that is a case where you

would unravel it. But I think you want to make that a fairly narrow window.

MR HINTON: Thank you. Michael?

DR FOLIE: No.

MR HINTON: Alan, is there anything we've left out you want to particularly focus on?

MR MORAN: No. As I say, I think the report is very much on the right lines and I think even though we've had a tortuous process of these reports in the last few years, I mean, at least we are edging towards the right sort of area I think in them and this report is just - well, it's another one there and I hope it does get adopted and accepted, and I hope it gets accepted in the way that you intend it to and not the way that some people might interpret it if they wanted to be mischievous about it.

MR HINTON: Thank you again for your appearance today and your comments, plus your submission. We welcome your participation.

MR MORAN: Thanks very much.

MR HINTON: We've got one more session this afternoon and it's with the next interested party, being BHP Billiton. What I'm going to do, if you bear with me, give me three minutes to get my papers together before we restart. We can turn off the transcript and I'll call up BHP Billiton at quarter past.

MR HINTON: Welcome back. We now commence the last session for this first day of hearings in Melbourne on the Commission's Inquiry into the Gas Access Regime. I welcome to the microphone David Biggs and Colin Martin. Thank you very much for your attendance today. As discussed, I'd be very grateful if you could now make a brief statement to sort of set proceedings under way. We might then proceed to a normal question and answer discussion.

MR MARTIN: Thank you, Tony and Michael. BHP Billiton would like to thank the PC for the opportunity to make a submission to their draft report and for the opportunity to appear here today. BHP Billiton does support public and open processes such as those adopted by the Productivity Commission. Our presentation today won't be very long. It's just a short outline of our submission and then we welcome your questions.

Even though our submission was close to 50 pages, we have tried to be selective in our response to the 450-page Productivity Commission draft report and focus on what we see are the key policy-altering recommendations. Our overarching issue with the draft report is a suggested change to the current regime. In short we see it as a move from a balanced approach across all segments of the supply chain to an approach that appears to promote the interest of pipeline owners above the interests of others in the chain. We do not believe that the report has proved the case for this change. In fact, in our initial submission we went to great lengths to point out how robust and healthy the entire gas industry has been under the code. If this approach is adopted, we believe that the owners with bottleneck infrastructure, ie the pipelines, will exploit their market power to increase price above efficient costs, and that this could cause distortions at both ends of the pipe, ie in upstream and downstream industries.

In keeping with trying to focus on the key issues, our submission focuses on the PC's proposed changes to the coverage test, the objects clause and the relaxation of pricing principles under clause 8.1 of the code. On coverage, our position is that the current coverage test works. A pipeline either has market power or it does not, and if it does have market power or monopoly power, it should be subject to the obligation to offer two things; non-discriminatory access and cost based pricing. To try and - I mean, this is old news from BHP. So to try and move the debate forward, we actually in this submission went and looked to the US.

The US has a very well developed healthy and growing pipeline market and instances of pipeline competition. In fact we did find there that the regulator does have a monitoring option, but it is only available to pipelines that pass an objective market power test, being the Herfindahl Index. On our calculation, none of the major pipelines in Australia would come anywhere close to meeting Furkes market power requirements to be monitored. Since 2000, only four US pipelines have actually

applied to be monitored out of the hundreds that there actually are; that the regulator realises that in order to monitor in a competent manner, that it must have access to significant amounts of cost and other information. So it's not less information it's more information.

So that's where we are on the coverage test. On the objects clause, I state in our initial submission, we support an objects clause to be inserted into the code. It's just that we don't support the clause recommended in the draft report. I think there's two key differences here: one is that the draft report refers specifically to investment in pipelines, and the second is that it recommends the dropping of some additional protections that we think are in the code, and I'll cover each in turn.

On the investment issue, we all believe that efficient investment in all sectors of the chain is covered by our suggested objects clause and that a regime should not be trying to promote investment in one segment of the chain over other segments of the chain, but rather facilitating investment throughout the chain. We also see that the proposed dropping of the protections - like preventing the abuse of market power and providing the right of access on fair and reasonable terms, is simply part of the overall step to strip the balance of interests out of the code and to promote pipeline owners' interests over other participants.

Finally when we come to the proposed new clause 8.1 of the code, the first thing we note about this is that under the PC's draft report, that the code would only apply to pipelines - to many fewer pipelines than it applies to today; only those with very extreme amounts of market power. Quite frankly we believe that changes to clause 8.1 are simply inviting the vertically integrated players to make it virtually impossible for other players to compete to supply end customers on a competitive basis. I guess our other concern with 8.1 is simply that, on our read of it, it didn't show how it was related to other parts of the code, and particularly other parts of section 8, and how you would change other parts of section 8 is not addressed in the draft report and we would strongly disagree with any changes to the rest of section 8 of the code to retrofit the new principles in the new section 8.1. Tony, that concludes our opening remarks. As I said, they'd be brief and we welcome your questions.

MR HINTON: Colin, thank you very much for those remarks. They're very useful in sort of succinctly picking out some of the key points of your very substantive submission, and we appreciate your written submission as well. BHP Billiton is a key interested party of many interested parties so we're grateful for you participation in this exercise right from day one. What I'd like to do is pick up some of the points which not surprisingly you've already flagged in your introductory comments - pick up some of the points out of your submission on our draft report.

The first one is really in relation to one that I've explored with some other

interested parties, and that's how trying to establish a tiered structure to the regime by adding a monitoring process in addition to the cost based price regulation, and we seek to do this through a mechanism of different coverage criteria - and I'm not really telling you anything you don't already know - but that's by way of introduction to say that this has led to a significant focus on the words "material and substantial" and I won't reiterate the threshold description because I know you know them both well. But one area of concern for some interested parties including yourselves, is there a sufficient delineation of the meaning of "material and substantial" to the extent that if it was not there, then that could lead to greater uncertainty in the regulatory structure. My question then becomes cannot we, in a process of defining, designing a regulatory structure, actually set down what "material" and "substantial" do mean, such that delineation does exist.

The key point being the juxtaposition of the two words in itself means they are different. If you in isolation put to a court or a judicial process or pseudo judicial process, "What do you mean by - how would you interpret 'substantial and material'?" I can well understanding uncertainty, but the system doesn't operate in a vacuum. I'd welcome your comments on that sort of response to this area of concern.

MR MARTIN: As I understand the question, it's that alone the words "substantial and material" may have very similar meanings, but the fact that they're in the same piece of - in the same instrument, they're obviously meant to have a different meaning. Let me first start by saying I'm not a lawyer.

MR HINTON: Neither am I.

MR MARTIN: So I won't get into the meanings of substantial versus material, but I guess one of the points in our submission on this was that in fact even if they were defined differently, you're still I guess putting in two layers for regulatory error. So as opposed to the current test where there's one opportunity for regulatory error on the coverage test, now there's two opportunities for regulatory error. There's coverage versus monitoring - sorry, there's no coverage versus monitoring, monitoring versus a more fulsome coverage. So just simply by bringing in two tests you are increasing the regulatory error chance.

Secondly I guess - and maybe I can take it a little bit further on just the monitoring option. On the monitoring option, the way it's proposed by the PC in the draft report, we see that it wouldn't do anything to prevent the abuse of market power by a party that's being monitored. Quite simply I think it's an invitation to just gain the regulator that's doing the monitoring, and that is because your proposed monitoring option is linked with a sort of information-light-type regime, as opposed to an information-heavy regime. So how does the regulator know that the pipeline is acting in an inefficient manner if he doesn't have the information to asses that. So I

think that's our main problem with the monitoring regime.

MR HINTON: On regulatory error which you flag, there is a concern being put by some interested parties that the current system, by being covered or uncovered, in fact has a bigger regulatory error in the sense that if you're worried you'd put it into coverage as a regulator rather than uncovered, such that marginal ones - judgments about marginal ones - would tend to fall into coverage rather than uncovered in circumstances where the intervention is quite intrusive. That means that you're more likely to experience regulatory intervention with high costs with the possibility of very few benefits. It's that mind-set that can sort of support a view that having the option of a monitoring option can help remove or at least reduce the risk of high cost regulation with very few benefits occurring.

It doesn't dispute the fact that the regulation with a two-tiered system - that is, with monitoring as well cost based price regulation - does have regulation decision-making with risks, but the costs of making an error under my first scenario would seem to be much larger than the costs of making an error in the monitoring option scheme.

MR MARTIN: Yes, and I guess our response to that would be that there is an opportunity for a pipeline whether - if it's covered now, to seek to have coverage revoked, or if it's not covered someone has to apply to have coverage applied to it. In our view - and I guess we've observed a few coverage processes by the NCC - it's a fairly exhaustive process. Just look at the Moomba-Sydney pipeline which is maybe the most exhaustive of all, and that moving through those extensive processes and the extensive opportunities for input by all parties, that the opportunity to get the error that big at the end of the process is probably pretty small on the basis of the current coverage test.

So I guess what I'm saying is that if there is a current - the opportunity for regulatory error, while it might be increased between the current way the code works or the current way the coverage works in your proposal or the PC's draft proposals, that the error might be increased, but if there's still a very strict process for moving through, deciding which bucket you fell into, well then that might be a manageable outcome. But we just don't think that monitoring as proposed by the draft report is the right type of monitoring quite frankly, because it's effectively no monitoring. It's effectively no ability to understand anything that the monopoly in terms of infrastructure is doing.

MR BIGGS: But the issue really I suppose is around our view of what is effective monitoring. I suppose if one could get comfortable that the monitoring was in fact effective, then one perhaps could get more comfortable with it, but as Colin has indicated, that then takes you down the path of probably a fair amount of information

disclosure at least.

MR FOLIE: Which has its own costs.

MR BIGGS: Which has its own costs anyway. So I mean we could probably debate for a long time as to what you need for monitoring to be effective, but I guess our level of discomfort about monitoring largely comes from that concern, plus, as we've mentioned, the fact that we do think that while the process of being covered or uncovered is lengthy and potentially expensive for all involved, including in some cases ourselves, it is at least exhaustive, and therefore one would assume that its thoroughness would, as Colin says, minimise the chances of grave error. It's not to say it's error free.

MR HINTON: Thanks, David. Perhaps this is a sort of a free kick for you or a Dorothy Dix question in parliamentary terms. Does that lack of confidence regarding the monitoring regime as put forward in the draft report lead you to the view that the threat of shifting from monitoring to cross-based price regulation is not a substantive threat with regard to curtailing inappropriate behaviour in this monitoring bucket?

MR MARTIN: I think it is a substantive threat. But the question is how would the regulator know that the pipeline was abusing its monitoring status unless the regulator had the information - extensive amounts of information to assess that outcome. That's our problem with it; is that it is a threat to be moved to a cost based regulation. But I guess that we've been playing this game in Australia since the mid-90s, and we've come across no end of inventiveness of the owners of infrastructure in working within the system, and I guess that we think that without information, the owners of infrastructure will be very inventive in feeding information to the regulator to show that they're not exercising excessive market power when maybe they are.

MR HINTON: That seems to be putting very little weight on the likes of the voice that BHP Billiton could be expressing with some force if they found that pipeline or infrastructure owner or service provider was not delivering in a monitored environment. Would not BHP Billiton be banging the drum pretty loud and with articulation and force to express a view that it was not delivering - the service provider was not delivering properly based access or whatever form that takes.

MR MARTIN: That's a worthwhile comment to make, Tony. I guess that we would note - (1) we'd hope that our - we have shouted pretty long and hard over the years. So our position is pretty well-known, but one of the issues that this comes to is the excess - if one party shipping on the pipe, it might not be worth their while to spend the millions of dollars to have to fight, and BHP Billiton while we ship on

some pipes, there is few pipes where we sort of have most of the capacity. So it comes to the point - I think we sort of spoke about this at the initial public hearings, that as a single party, you might - being exploited might be the only best outcome to you because you just can't muster - justify internally spending the money to have the fight to get the coverage to occur on the pipeline. But for all users as a whole, then it might be much more efficient to have cost based regulation and users getting cost based pricing.

MR BIGGS: I suppose the point we're trying to make is that there are very few large industrial users such that they would necessarily invest the money to do the sort of thing you're suggesting, and I think as we said in our original submission, who was it left with then to raise the issue for example in the tariff, the retail, the commercial and the small industrial market. At the end of the day it goes back to the retailers and I guess we haven't seen much evidence that they've had problems with the sorts of things that some of their customers may have problems with in terms of tariffs on transmission pipelines.

MR MARTIN: And as we noted, part of that is related to the vertical integration of the pipeline owning companies and retails.

MR BIGGS: There's very few large customers. Western Australia is probably the exception. But in eastern Australia there's relatively few single large users, it would seem to me, that would be willing to fund this sort of activity. We might be one, but there aren't that many others.

DR FOLIE: Just on - part of the nature of your feeling about competition, it appears to be focused a lot on - there aren't parallel pipelines and certainly a part of what we've had evidence about is actually the increasing interconnectiveness, and you seem to - if I can read it correctly, sort of discount that as a source of competition you really want to focus on, unless there's an actual duplicate pipeline, but the network effect appears to be one that's fairly strong in most industries for the telephones, mobile phones, airlines et cetera.

MR MARTIN: Yes. I guess you might be referring particularly here - the minister uncovered the Moomba-Sydney pipeline on the basis of the network effect. A number of parties have appealed that decision. I guess time will tell as to what the competition tribunal believes about the network effect. Our observation is that when you dig into the network effect on that specific pipeline is that in theory it might be possible; practically it is impossible today.

DR FOLIE: That is to move gas from Moomba - - -

MR MARTIN: To move gas from Moomba to Sydney via the Moomba-Adelaide

pipeline, back all the costs to SEA Gas, costs to Victorian system and up the EGP is physically impossible today. Even if it was physically possible, the quality of service across the network solution as opposed to straight down the Moomba-Sydney pipeline is a very different product that you're buying. So we do not - as the system is currently structured today, we do not buy into the network competition suggestion.

MR BIGGS: I mean, you can't make a judgment on whether or not the network effectively gives options until it seems to me you've looked at what spare capacity there is in the various pipelines and what the relative cost of the options are, and the work we've done would suggest that - we can't think of any situations at the moment where you have a viable network option for example, even from Longford into New South Wales; realistically none.

MR HINTON: But in principle you'd endorse greater connectivity to provide wider options down the track.

MR BIGGS: We do. I think that's right, but I think just having lots of lines on a map doesn't actually mean it can practically happen or that it is in fact an economic proposition to go route A, and the same cost to go route B. No, not at all.

DR FOLIE: This is if you like a point in time problem. I'm just trying to understand; but it is actually a source of these point to point that can be - investment hypothetically could actually remove some of the bottlenecks and there's no investment; there may not be enough gas in certain areas et cetera, but effectively a network that starts to work effectively, the price signals were there would engender it, but clearly at any point in time though you may actually not be able to do it. What you're saying is this point in time you believe that it's not effective, but - five years down the road, as people believe they can make a dollar out of it, then it may emerge.

MR MARTIN: Yes, and we would suggest the current coverage test would deal with that situation because then you could apply to have all the pipelines that make up the network uncovered for example. But today we do not think that - at this point in time, Michael, we just don't think it's doable.

DR FOLIE: It's a technical investment feature of what's on the ground rather than actually an economic feature.

MR MARTIN: And it's a price feature, but it's technically today. Then there's a question as to how pricing would occur across the networks for firm - because remember we're comparing firm service here with firm service in this instance or that's the service we believe most people would wish to compare. If those networks have to have the capital sunk into them to expand them - so offer firm service

equivalent to the MSP in this example - then there has to be recovery of that capital, and when we sit down and do the numbers, the cost of shipping round the network is significantly more than the cost of shipping down the Moomba-Sydney pipeline. So would it in fact apply competitive constraints on the Moomba-Sydney pipeline in this instance.

MR HINTON: But in terms of a public policy environment, wouldn't the issue be one of whether that outcome is more likely to be achieved by regulatory intervention with cost based price regulation that has all its risks of regulatory risk in costs relative to a lighter-handed process with an option for monitoring as opposed to cost based regulation which would be a more conducive environment for that sort of innovation that generates greater connectivity.

MR MARTIN: I think as we said, if you had a monitoring option that was a true monitoring option so that people could actually understand what was going on, then that might work with the threat of Austral cost based pricing, but the monitoring option put up in the draft report is, in our view, a very light option.

MR HINTON: So would you be supportive of the monitoring option if we made it more intrusive, more information - do you think that's - - -

MR BIGGS: I don't think "intrusive" is the right word. I mean, at the end of the day what you're trying to deal with is essentially an effective monitoring option where you have to deal with information asymmetry, and that's not dissimilar to the problem you have with regulating pipelines as well.

MR HINTON: But at the end of the day, the effectiveness of the monitoring option is whether or not it provides a substantive threat that the default or result of, leading to cost based price regulation in circumstances of inappropriate use of market power. If it doesn't provide that threat, then why are you monitoring, otherwise you're not going to impinge upon commercial practice.

MR BIGGS: I quite agree with that, but I think what we're saying is we accept the value of the threat. We're just struggling with how one gets to the point of being comfortable via monitoring that in fact that misbehaviour is happening.

MR HINTON: The information asymmetry.

MR BIGGS: Yes.

MR HINTON: Let's move on to objectives. Your submission makes a number of comments in this area, and there's some useful explorations of variations of what the objective should be. I'm a little bit - well, as a precursor, let me say that we will have

a requirement to try and examine consistency between what might emerge from the Part IIIA review and the objective clause there that the government has put out a final response on, and what we might come forward in our final report regarding the objectives clause in the gas access regime. So we will have some further work to do there, irrespective of this cycle of hearings

But one of your suggestions is that you don't like the inclusion of the promotion of economically efficient investment in the services of pipelines. I'm a little bit concerned why or can't see why you would want to have that removed in terms of how the sector might operate longer term as to the basis of intervention.

MR MARTIN: I guess that we thought firstly that our clause was a bit simpler than the proposed clause in the draft report. If you had an overall efficiency objective that efficient investment would flow from efficiency, I guess that our point was that the investment - it was linked to investment in pipelines, not promoting economically efficient investment across the chain. That was I guess the main point, and our second point was that we - yes, and that that could distort decisions across the chain by just promoting investment in pipelines over promoting investment in upstream or investment in downstream.

MR HINTON: Can you elaborate for me or clarify for me how the objective of promoting economically efficient investment in pipelines can be to the detriment of economically efficient in upstream and downstream activities?

MR MARTIN: You mean do I have a specific example?

MR HINTON: A specific example might help me.

MR MARTIN: I don't have a specific example but I guess our concern - and maybe I'm not going to answer the question fully here, Tony - is that it puts primacy on investment in pipelines to the exclusion of including investment in upstream and downstream industries. Now, if we entered a course and said something about promoting investment in the supply chain, well, then that would probably address our concerns. The fact that the investment is purely to the pipelines - and again cutting to our balance issue, the code is a balance between the interests of the owners of pipelines and the users of pipelines. This seems to tip the balance further towards the pipeline owners without discussing the interest of the users.

MR HINTON: But some would argue that what we have here is government intervention in an area of national monopoly with potential for misuse of market power which is in relation to the infrastructure transmission and distribution networks. It's not intervening with regard to upstream and downstream activities because there's a market deficiency or a need for a rationale for intervention, what

we're describing here is an intervention by government to address some sort of characteristic of this infrastructure sector. Why would you want to expand the objective to go beyond the area of intervention?

MR BIGGS: I suppose the point is that the reason we're looking to intervene in the monopoly situation, such as pipelines, is that the objective at the end of the day is to ensure that the delivered cost of gas to customers is as low as it can reasonably be. Our guess our concern is that by focusing simply on pipelines to the exclusion of other parts of the chain, you may end up with a distortion. At the end of the day the whole purpose of regulating pipelines is to ensure that customers pay no more than they have to and get as low a cost of gas as they reasonably can. That's the whole point of it, it seems to me. It's also in part designed to make sure that as many people as possible can ship on that pipeline so as to provide competition to the end customers.

Pipelines of themselves, I mean, they don't exist for themselves, they exist to move gas from point A to point B. I guess what we're concerned about is that maybe in that sort of definition we're perhaps ignoring A and B which is where the gas comes from and where it actually goes to. I mean, if they could be addressed I guess we could get more comfortable with it.

MR HINTON: But, David, isn't there a temporal issue here? The price for gas for current users may be pursued at the best possible price for that set of consumers but longer term that price might need to be higher if you're going to have longer-term investment in this sector; that is, it's not a single shot, single time, examination of what is the best price.

MR BIGGS: It's not but equally there is no point in pricing pipelines efficiently if the end result is that you essentially make it uneconomic to explore for and produce gas. What have you achieved?

MR HINTON: Which is why the objective talks about "thereby promoting competition in upstream and downstream markets".

MR BIGGS: Well, I think at the end of the day we're looking for efficiency right across the market.

MR HINTON: Okay. Let's pick up something else with regard to objectives, and that is this question of "prevents abuse of market power". There was an explicit inclusion in the current formulation that flags that as an objective, as a supplementary objective. You're expressing concern as BHP Billiton that you're not sure that you would want to have that; in fact you don't want to have that particular supplementary objective removed.

MR MARTIN: Correct.

MR HINTON: Doesn't the efficiency objective in itself address that objective?

MR MARTIN: I guess, once again, having been around this for a while is that we think that's a very valuable supplementary objective to have. Some may interpret to be included in the efficiency objective. That would be of course, maybe in the future, subject to judicial review. We were suggesting putting it beyond doubt and just simply including it as a supplementary objective.

MR BIGGS: If it's intended to be covered by the efficiency definition I don't see the harm of including it as well.

DR FOLIE: Part of what we've been trying to do is to simplify, because the more criteria you put into the code the more it leads to interpretation and, if you like, gaming through - then the appeal processes et cetera.

MR BIGGS: I understand that but equally the broader the definitions are, the more open to interpretation they are as well.

MR HINTON: Let's pick up another aspect of your comments on the objective. You'd like to have explicit coverage of fair and reasonable; that is, "provides for rights of access that are fair and reasonable as a supplementary objective". This is not a new concept but it's not one that has too much clarity either. The point that I raise with you is whether or not - and I think some others will see this - that in fact could conflict with efficiency objective by having something that is fair and reasonable.

MR MARTIN: "Fair" is a difficult word, I agree with you, and that was the wording that I think was inherent in the current wording in 2 point whatever it is in the code. Look, if wording could be developed to say "providing a right of access on a non-discriminatory basis" which we believe is key, and on reasonable cost based terms, well, we'd be happy with that, Tony. But I agree, the word "fair" is a difficult word for interpretation. We were just simply restating the current words that were in the code.

MR HINTON: As you might imagine we've agonised over the formulation of the objective. It's not an easily reached single sentence that picks up all these - - -

MR MARTIN: It's not. It's a difficult task.

MR BIGGS: I suppose it's worth restating that our primary concern here is to

ensure that we do end up with a non-discriminatory access and we do end up with cost based pricing. If those are the outcomes I don't really mind how the objectives are cast, provided those two criteria are clear.

MR HINTON: But you see, David, both those criteria run up against significant challenges. Let's take non-discriminatory: how do you define non-discrimination; that is someone who wants access that is 24/7 and somebody who wants access when they really only need it as a back-up for some other source. There may be different pricing arrangements that people are willing to pay and probably there are. Now, is that non-discriminatory?

MR BIGGS: I mean, I think we're talking about the same class. If I take a very simple example, one of which we've had some experience with, one would regard as discriminatory a situation where, for example, an incumbent owner who gives his gas a different set of rights and terms of priority than anybody else. That's clearly discriminatory.

MR MARTIN: If we can just back up to an example here, it's a bit of an old example but it's on the public record if you look close enough. On the Moomba-Sydney pipeline AGL used to have an absolute first right in priority in perpetuity. That's the wording in the deeds between the Commonwealth and AGL. That therefore meant that every other shipper - if there was to be one on the Moomba-Sydney pipeline - was a second-class citizen. Now, for firm service we would like equal treatment of people that are in the firm service class, I guess, and not, for example, this form of discrimination. If there's two levels of firm services absolute, like last-off firm service, and there's other second-tier firm service, that's just an example of what we're talking about.

MR HINTON: But this is an area, Colin, where we can all point to examples where discrimination occurs. What we don't have is the reverse of that; that is, set up a system where it is not discrimination even though it's differentiation. You've put on the table several examples over the various discussions we've had where different pricing occurs, different access occurs, differentiation occurs. On some of those occasions eg. AGL case - discrimination occurs. Setting up a regime that delivers the word "non-discrimination" seems to me to be an administrative nightmare.

MR BIGGS: At the end of the day though I would assume the test would simply be, if that service has been offered to one, it's available to others, on the same terms.

MR HINTON: Let's take foundation contracts. There's a category - - -

MR BIGGS: We're perfectly happy for those to be available to everybody.

MR HINTON: That's the point. Maybe that's not a good outcome for efficient use of the resource in terms of investment longer term. If new customers, by a non-discrimination clause, gets exactly the same terms and conditions as foundation contracts then that might be a very strong incentive to construct and invest only to known demand and have no surplus capacity built into this new product line. That is a distortion to investment and one that really needs to be looked at if you apply the non-discrimination clause.

MR BIGGS: But perversely you can have a situation - and one which I'm aware of - where subsequent shippers have got better deals than the foundation customers.

MR HINTON: Which the foundation customers don't like if they're competing with a new customer.

MR BIGGS: Correct, but all I'm getting at is that it's not all one way either. At the end of the day though it seems to me that if you're shipping gas and you want to end up with your gas being competitive, for example, with your competitor's gas - let's assume you're both putting it in at the same point and it's exiting at the same point - you really want to be comfortable that you are going to be competing on even terms at least as far as the exit of pipeline. That's exacerbated further, of course, when you do have a degree of vertical integration, as we do, in many pipelines in eastern Australia.

MR HINTON: Let's come back to your second point - cost based price determination. Some would put to us that that's pretty hard to do anyway and the regulator will always get it wrong notwithstanding their best efforts. That's another argument. A perhaps more powerful argument is that that can be a disincentive for efficiencies of operation. If it's cost-driven it's not conducive to sound commercial practices if they're always going to have their price determined by cost based. What is the incentive for the reduction in cost?

MR MARTIN: I think the terminology currently in the code is "efficient cost based pricing" or something like that. So it's not just pure whatever costs you choose to have. It's true that there should be an incentive for some form of productivity gains or whatever but I think the current code can provide that. It has in various excess arrangements provided the service-provider with the opportunity to keep some productivity gains for a period of time, not - - -

MR HINTON: Incentive regulation, okay.

MR MARTIN: Yes.

MR HINTON: I baulked at David's characterisation of criteria that were musts; that even interpretation of those two have their own resources, is how we got down this - - -

MR MARTIN: No, no, no.

MR BIGGS: But you understand what our concern is. Our concern is that if two people are inputting gas into a pipe at point A and it's exiting at point B, then all things being equal that you would want to be comfortable that you're competing - exit the pipe on the same terms. That's the issue.

MR MARTIN: Yes, and I think we also want to be clear on this cost point. We're not and never have advocated a sort of Foukes style down to counting pencil sharpeners in the office of the pipeline type examination of costs of the pipeline. We're about making sure that the current costs - an examination of costs and not have to say that at the current level, generally, the regulators are probably at the right level of examination of costs. We're not suggesting - we never have - going right down to the smallest cost item in the accounts of the pipeline company.

MR HINTON: Still on objectives because your submission does pick up on a lot of that and it's not unimportant to the shape of our recommendations, you flag this need for the objective to refer to providing resolution of disputes - a dispute resolution mechanism as an objective in itself. This is not quite the same order of an issue as what we've just been discussing but you flag it as one of your preferences. My immediate reaction would be, why would you want to complicate an overarching objective with something that would seem to be a procedural issue and a rights issue - natural justice objective - as opposed to the basic reason for intervening; that is, it shouldn't be a raison d'etre for why the government would say, "We're now going to intervene through the gas code in that commercial activity." However, if you do intervene then, sure, no-one would dispute the need to have within that structure some sort of dispute resolution process.

MR MARTIN: Look, Tony, I can't disagree with you there. We liked the resolution of disputes policy in there originally but if it was put into a different clause in the code to say that basically, "If you are covered this is the mechanism for resolving disputes," that would suffice for us.

MR HINTON: And I hasten to add, Colin, that in fact our draft report goes on to describe what we consider to be very important review processes that are efficient, timely, that do not deny natural justice, but stop forum shopping and stop - - -

MR MARTIN: I think we've supported some of those recommendations.

MR BIGGS: I think that's right, yes.

MR HINTON: While we're on objectives I thought I'd raise it. We could get into a lot of detail on pricing principles, and your written submission does cover that, and I don't propose to go down all those details today in terms of this hearing. But one that struck me was that you objected to the deletion in the pricing principles of safe and reliable operation of the pipeline. This is a bit like dispute resolution. No-one is saying that the pipeline shouldn't operate safety and reliable characteristics and have those features that we all want in operation of commercial industrial activity. I think the question is whether or not it should be really a principle for pricing.

MR MARTIN: We actually thought it was a valuable principle for the service provider to have there because this is all about pricing - another reinforcement of pricing around efficient costs for example. So that we're not in a situation here of starving the pipeline of capital or opex so that it can't operate in a safe manner. So we thought it was actually quite a valuable guide to have in there that you are not about running to short-run marginal costs for want of a better term.

MR HINTON: This is probably why I've raised it this afternoon in that this raises the sort of broader issue: what is a valid expense to be taken account of in the regulator's judgments about cost based price regulation, and prima facie it seems sensible that you would not wish to have cost based price regulation exclude those costs associated with maintenance essential for safe operation.

MR MARTIN: We'd agree with you.

MR HINTON: So why pick on that one? Another one would be - which is more open to debate perhaps is the question of how the regulatory framework can extract appropriate sharing of costs of regulation, and I think Western Australia does it differently to some of the other jurisdictions in terms of levies, surcharges and automatic pass-through. So I think there is a debate with regard to what is included in a valid cost for cost based price regulation. The question that struck me is that we can have that debate, but putting it into pricing principles seems to me to be undue focused on detail that clutters what I consider to be good regulatory code.

MR MARTIN: Yes, and I guess that - as you said at the start of your sort of discussion here, we could argue for hours about the principles, and maybe in a more detailed forum we look forward to those arguments. But it's just we didn't think it did any harm. In fact we thought it was quite valuable in that instance. You obviously have a different opinion that it's a degree of detail which is not required in an overarching principle. But we both agree that it's a good idea to have a costing that includes safe operation of the pipeline.

MR HINTON: I appreciate that this point of course is a second order compared to some of the more fundamental - - -

MR MARTIN: Correct, yes.

MR HINTON: - - - issues you take with our draft report.

MR MARTIN: Yes.

MR HINTON: This may be too detailed, too; the Herfindahl Hershman Index, are you comfortable with its relevance for Australia? Are you comfortable with it as having robust rigorously based usefulness for determining judgments about market power?

MR MARTIN: We saw it as an objective measure of market power that has been developed. The Herfindahl Index has been used by BHP Billiton in a number of forums to assess different industries. So it's not just picked up straight out for this submission. We have used it in other forums when we assess industries. I'm not going to pretend I'm an expert on the Herfindahl Index. But we thought it was a relevant objective measure at least to kick the debate off on trying to come to an objective measure of market power that could be used.

MR HINTON: Yes. A number of interested parties have put to us that it would be very useful for the final report to elaborate in more detail the sorts of parameters, indicators, criteria the NCC would make on coverage decisions, and therefore decisions with regard to the nature of - whether it be monitoring or cost based price regulation. Some would really like a formula approach and some shy away from it, but we won't go into that.

Still on the two-tiered test potentially costly and unworkable statement of yours, you mention you've got legal opinion.

MR MARTIN: I think we said it was on the public record legal advice from Allens Arthur Rob.

MR HINTON: Yes. You go on to say that:

> Allens Arthur Robinson on the public record predicted that uncertainty created by the new test has the potential to lock up NCC in the series of appeals and reviews.

Can you point me to the right direction of that - - -

MR MARTIN: Is this is a footnote there, Tony? If it's not, I'm happy to send it to you.

MR HINTON: Maybe it's a footnote in the back.

MR MARTIN: If it's not, we'll get that to you.

MR HINTON: Thank you very much.

DR FOLIE: I think the question associated with it, did it take into account - I mean, on literal basis, this "material and substantial" can be a lawyer's funfest, but if you do what we've done here and elaborated earlier, actually lay out - in other words, measures that go with - in other words the background that there was an intent, so although the words are round, does the legal advice actually address that issue as well?

MR MARTIN: I wouldn't call it advice, I'd call it an article written by a lawyer as opposed to a specific piece of legal advice. BHP did not commission - - -

DR FOLIE: It's fairly important because it is actually being tendered. In other words you're tendering it as - - -

MR MARTIN: We did. No, we - - -

DR FOLIE: A large law firm - - -

MR MARTIN: Well, it is. I assume that they applied a degree of diligence in writing the article.

MR BIGGS: The footnote is on page 36 that refers to the article.

MR HINTON: Thank you, David.

DR FOLIE: But does it cover that - does it actually embrace that particular issue though?

MR MARTIN: I can't recall, Michael. I'd have to go back and refresh my memory on the article.

DR FOLIE: This is actually an important part of even a general article to actually really know what are the assumptions under which that opinion is actually given, and we've been very cognisant of the issue of trying to give guidance in the way, and then the concern is how much guidance do you need to give? So we're really seeking

feedback under that area.

MR MARTIN: Yes, and I guess that that article was just suggesting - and I can't remember the exact composition of the article; I'll guess you'll go and read it yourselves now - that, yes, this whole material and substantial issue is an opportunity for further judicial confusion.

DR FOLIE: Trying to do it not in a vacuum.

MR BIGGS: I think looking at it, my recollection is the article is addressing the draft report. So to that extent I don't think it's in a vacuum.

MR HINTON: I think if I recall, it was a sort of a summary of our draft report with some commentary for their clients.

MR BIGGS: Correct.

MR HINTON: But I'd need to go back and read it again as to the context with which that was specifically meant. Michael, how are we going?

DR FOLIE: I've just got one which goes right back to the beginning about the chain. We have - we didn't address it in our report because it was somewhat out of the terms of reference but people had put to us in the first round that they wanted more competition in the upstream business because this was more important than the other areas et cetera et cetera. Basically in your report you're actually, you know, sort of indicating that the whole chain ought to be done and you need more competition and there are basically low barriers to entry. It was put to us that the exploration leases and the production leases are very tightly held, and the most - if you like, the easy-to-go basins are now known and they're only held by a small number of players. Would you counter the competition issue?

MR MARTIN: Sure. In our initial submission we spent a lot of time on this. We pointed out that there were 16 new supply sources to feed eastern Australia, expected on line by 2008. We pointed out the massive contracting activity that has occurred in the market between different supply sources, and we also did a bit of work I think on the number of parties holding exploration leases in eastern Australia. That's all in our initial submission - pointing out that there is growing diversity in the upstream, and so, yes, we tried to address that point in our initial submission.

MR HINTON: Colin, David, anything more that you'd like to flag for us that we haven't done justice to in the last hour?

MR BIGGS: No. I'd just like to add, Michael, if there's any more information

you'd like on that upstream competition industry, if you could let us know, we'd be happy to help if possible.

DR FOLIE: You did raise it here, so I just wanted you to in fact draw forth a bit more on it.

MR BIGGS: Sure. Thank you.

MR MARTIN: Thank you for the opportunity.

MR HINTON: No, thank you. We appreciate that, particularly your substantive submission. That's on the public record for others to react to as well, but the written word is quite powerful, but also your elaboration this afternoon. It's appreciated.

MR MARTIN: Thank you.

MR BIGGS: Thanks for your time.

MR HINTON: That session now concludes today's scheduled proceedings, and as foreshadowed in my introductory remarks this morning, I now provide an opportunity for anyone else in the room who is present who would like to make a statement today before the Commission. It follows of course that it would be on transcript with a record, and if you wish to speak you need to identify yourself in advance as well. I now provide that opportunity for anyone else in this public hearing to speak up. There's no rush from the floor. So I will now adjourn these proceedings for today's session and note that the next hearings for this inquiry by the Commission will be held in Brisbane on Wednesday, 24 March. Thank you very much.

AT 3.14 PM THE INQUIRY WAS ADJOURNED UNTIL
WEDNESDAY, 24 MARCH 2004