INDEX

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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON THURSDAY, 18 SEPTEMBER 2003, AT 2 PM

Continued from 16/9/03 in Brisbane

MR HINTON: Good afternoon, and welcome to these public hearings for the Productivity Commission's review of the Gas Access Regime. My name is Tony Hinton and I'm the presiding commissioner for this inquiry. My fellow associate commissioner on my right is Michael Folie.

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

We have already talked to a range of companies, organisations and individuals with an interest in these issues, and submissions have been coming into the inquiry following the release of an issues paper in July. We are grateful to the various companies, organisations and individuals who have already participated in this inquiry.

The purpose of these hearings is to provide an opportunity for interested parties to discuss their submissions and their views on the public record. Participants are, of course, welcome to comment on the issues raised in other submissions. Hearings have already been held in Perth, Adelaide, Melbourne and Brisbane, and we will be working towards completing a draft report for release in mid-December and we will be inviting participation in another round of hearings from interested parties in February-March next year.

We like to conduct all our 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 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 ommission's web site following the hearings. Copies may also be purchased using an order form available from staff here today. For all those familiar with commission inquiries, submissions are also available from the commission's web site.

To comply with the requirements in the Commonwealth occupational health and safety legislation, I draw to the attention of those present the fire exits to the left

and right outside this room; through the back door, left or right. It's a ground floor room so it's fairly straightforward. I also advise that this building uses the well-known beep-beep whoop-whoop system for evacuation. That's the completion of my introductory remarks.

I'd now like to welcome our first attendees at these Sydney hearings, representatives of the ACCC. Welcome. What I'd like you to do at the start for the record, for the transcript, and to make sure the sound system is working, is state your name and identify who you represent and at the end of that I invite you to make an introductory statement, Ed, that I understand you're hoping to do.

MR WILLETT: Yes, thanks, Tony. My name is Ed Willett. I'm a commissioner with the Australian Competition and Consumer Commission. I'll ask my colleagues to my right to introduce themselves.

MR HATFIELD: My name is David Hatfield. I'm a director in the gas group for the Australian Competition and Consumer Commission.

MR ANDERSON: Warwick Anderson, director in the gas group at the ACCC.

MR BUCKLEY: Mike Buckley, general manager, gas group, ACCC.

MR WILLETT: I thought what I'd do, Tony, is just make a few brief introductory comments. I'm not going to summarise what we've put to you in our submission but draw out some salient points from that submission. I might start by saying just by way of background that I think we'd all be aware that national competition policy since 1995 has been something of a reform revolution in so many areas of Australian industry, and no less so than in the gas industry, and particularly so since the implementation of the Gas Code in 1998.

Like most reform revolutions, it has involved some transitional costs and caused some consternation, particularly from vested interests who may have some privileges peeled back from them in the interests of the broader community. That's not an uncommon phenomenon and would not be uncommon to the Productivity Commission. I'm sure perhaps no organisation in the world is more familiar with the sorts of difficulties and problems that can be associated with reform but, nonetheless, recognise that there are often areas for reform in the economy that are beneficial in the long run for Australian consumers and for Australians in general.

Despite the consternation and some of the transitional costs brought about by introduction of the Gas Code and gas reform more generally, we think that gas reform in Australia has been one of the success stories of the NCP reform program. We think that it holds out a great deal of promise for the development of the gas industry in Australia. There have been benefits to date, and I'll touch on those in a

moment. We think there are even greater benefits to come. An important point is that we're about five years down the track with the Gas Code, many of the transitional costs have been realised and we're still to realise most of the benefits of this reform program.

Gas reform was implemented in order to promote competition in gas industries, in gas supply, promote growth in gas supply and gas consumption, to efficiently use existing pipeline infrastructure and to facilitate the development of efficient pipeline infrastructure. By and large, the evidence so far is that those objectives are being attained. Investment in the industry has increased substantially. Gas consumption has grown at a higher rate than previously was the case. New pipelines are bringing alternative supplies to gas markets. Upstream and downstream competition is emerging, with some way to go. There has been a reduction in published pipeline tariffs and listed gas transmission businesses have met with investor acceptance. Again I simply reiterate, this is the early days in gas reform in Australia and we expect these benefits to increase and accelerate.

There have been criticisms of the Gas Code as chilling investment in gas pipelines. We think that that criticism, by and large, has focused on rhetoric. There has been very little evidence to date put forward to substantiate those claims and, indeed, we think the evidence is quite the opposite, that there is substantial evidence of increased investment in gas pipelines in Australia since the code was put in place and we don't think it's merely a coincidence. There can be a debate about the causal relationship between those two things but what is not in doubt is that that increase in investment in gas pipelines in Australia has occurred, as the Parer committee recognised has occurred, in the context of the Gas Code being in place.

I want to say something about why a specific regulatory regime in gas is appropriate rather than a generalist regime. The first point to make about that is that that's not necessarily a dichotomy. Part IIIA was introduced into the Trade Practices Act to effectively regulate natural monopolies. Part of Part IIIA recognised that there would be specific industry regimes designed according to criteria specified in clause 6 of the competition principles agreement, and the Gas Code has been designed to meet those criteria and designed as a regime within the umbrella of Part IIIA.

It's not a pure negotiate/arbitrate model, which is what declaration under Part IIIA is. We've had some experience with pure negotiate/arbitrate models and think that for many industries, particularly industries where you expect to encourage more players into the industry - in other words, it's not going to remain a concentrated industry - that a pure negotiate/arbitrate model is not an effective model, particularly in the early days of natural monopoly regulation. We've had some experience in the telecommunications sector where Part X1C began its life largely as a negotiate/arbitrate model. It involved enormously prolonged processes, a

large

number of disputes and, in the end, a process that did not facilitate effective regulation and has since been modified to build more of the more prescriptive elements into it, to make the regulatory regime more effective.

We think the gas industry, particularly in the early days, has similar characteristics, which suggests that more prescription built into the regulatory regime is desirable than a pure negotiate/arbitrate model. We can debate how much prescription is needed. I think that's an important focus of this inquiry. But we think that a pure negotiate/arbitrate model even now is not the way to go.

I'll say something now about the code's approach to regulation, and the first point to make about this is that it is not a rate of return or cost plus model of regulation. It's a price-capping approach using reference tariffs and using benchmarks for efficient costs in order to provide incentives for infrastructure owners to earn higher returns from conducting their busineses well. I'll say something more about the scope for reducing the level of prescription and increasing those incentives for businesses doing well, higher-powered incentives in the regime in a moment.

Before I leave the code's approach to regulation, I should stress the point that's made in the submission that we're now starting to see substantial certainty and confidence in the gas regime as it is today, particularly from the banking sector and funds involved in supporting gas pipeline infrastructure, and there is some evidence of that in the submission.

\While we think that the Gas Code and gas reform in Australia has been a very substantial success, that doesn't mean that there's not room for constructive development and it doesn't suggest that we think that nothing should be changed in terms of the Gas Code. In fact, we think there's scope for development within the existing rules through the exercise of discretion by regulators and we think there is scope for developing the rules to improve the quality of the regulation.

In terms of improving the regulatory approach within the code at the moment, because we have just about finished the first round of access arrangements for pipelines, there have been a lot of things done and achieved that don't need to be replicated. The clearest example is inserting the initial capital base for all pipelines. That doesn't need to be done again. As well as that, as we get more experienced with the Gas Code and as we have a set of prices for services based on efficient costs, the scope for the lightening of the regulatory load in terms of regulatory processes also increases.

There is scope to take an even greater benchmarking approach to determining reference tariffs going forward, to move more towards the CPI minus X approach where any consideration of costs is focused purely on the setting of the X, and

drawing in total factor productivity approaches or, rather, more high-powered benchmarking approaches. These are things that the commission is actively

considering at the moment and I think there is scope to move to more of those things in the future.

Some concerns have been expressed about the codes in a number of specific areas. I'll draw out a couple of those. One is in terms of greenfields investment. The first point to make about greenfields investment is that sometimes the code is criticised in terms of its approach to new investment in a way that suggests the whole approach in the code is flawed. There is an important distinction to be drawn with greenfields investment and existing investment, and that's because the risks associated with greenfields investment are of a different nature to existing pipelines, particularly existing pipelines that have a lot of utilisation currently.

The commission has recognised there are some issues in terms of greenfields investments and has developed a guideline on how the commission will approach regulation of greenfields investment in the future. There hasn't been a lot of utilisation of that guide. We hope it will be utilised more in the future, but we think that the code as it is at the moment can cope with the different issues associated with new investment.

We think there are some areas where the code could be improved. I'll just touch on a couple before we move to questions. We think there is scope to streamline the access approvals process. Some access approvals have taken far too long and we think there are areas that could be addressed to improve those processes. We think there is scope for ensuring access to the switching services provided by processing facilities. This is, in effect, a transmission service through a processing facility to enable trades of gas between two or more destination points. There has been some experience with that problem to date. We think the answers that have been developed to date haven't been ideal, and I can say some more about that. There is more said about that in the submission.

We think that the status of expansions of covered pipelines could be clarified under the code, although at the moment we do think we have authority under the code to deal with expansions of covered pipelines, and we can say more about that in response to questions. We think there is scope to simplify the competitive tender process under the code and also to develop other means of dealing with issues where people have tried to use the competitive tender process in the past, where there might be better approaches that could be utilised. I'll finish my opening statement there and we'll move to questions.

MR HINTON: Ed, thank you very much for those comments. I'd also like to record the Commission's appreciation of the ACCC's substantive participation in our inquiry. In that context also, thank you for your written submission that you've referred to. It's particularly important, for the Productivity Commission's to work, that we have input from the likes of the ACCC, given your statutory responsibilities

and

direct experience concerning the administration of regulations, et cetera. I have a whole range of questions, I'm sure - - -

MR WILLETT: I'd be disappointed if you didn't.

MR HINTON: I certainly don't wish to go through your submission paragraph by paragraph. I don't think that's a fruitful use of time, but your submission and your comments this afternoon do generate a couple of reactions from me, and I'm going to try and tranche them into some sort of sensible sections. Let's take investment first of all.

MR WILLETT: Sure.

MR HINTON: You make, in effect, a statement rejecting claims that the regulatory framework is, in fact, providing an adverse impact upon investment decision-making. It's not deterring efficient investment, I think is the formulation you use.

MR WILLETT: Yes.

MR HINTON: The first question that comes to mind relates to the word "efficient." In the context of efficient investment, inefficient investment could be something less than ideal or - as well as the second category - more than what is appropriate. Is there any asymmetry there with regard to the effects? Is it worse to have under-investment relative to over-investment or is it worse to have over-investment relative to under-investment?

MR WILLETT: I think it's important to get the right level of investment and to create the incentives for the right level of investment. Over-investment has a cost. Under-investment has a cost. I'm not sure that the cost of under-investment is substantially greater than the cost of over-investment.. I don't know that you can generalise like that, given that what we're talking about here is not necessarily whether a pipeline gets built or not, but the size of the pipeline that gets built.

I know there has been some criticism of the code on both counts; that it's deterring pipelines being constructed and it's causing pipelines to be built smaller than they otherwise would be. On the first point, we have seen no evidence of any pipeline that has not been built because the code has been in place. That point was explicitly addressed by the Parer committee. They went to some length to try to research that point, and they came to the same conclusion.

In terms of the more difficult point that pipelines are being built too small, again we can't find any evidence of that. One pipeline that is often used as an example is the SEA Gas pipeline that's currently under construction from Victoria to Adelaide. I find that a surprising claim, particularly when you look at the

characteristics of that pipeline as it is under construction. It's a bit of a funny pipeline, because of the way it's developed. It's built as a combination of twin 14-inch pipe and single 18-inch pipe, but just take it as an 18-inch or 450-mm pipeline. It will have a starting capacity of 88 petajoules and a developable capacity of 125 petajoules, recognising that typically the way a pipeline is built is to build it at a diameter that will, by and large, meet initial demand with very little compression and then capacity will be increased progressively with more compression. That strikes me as quite an efficient approach to building pipelines and it's generally the way it's done.

Let's compare that with, say, the Moomba to Adelaide pipeline that currently provides gas to Adelaide. It's a larger pipeline - 560 mm or thereabouts - but its current capacity is at developable capacity. In other words, to increase capacity it needs to be looped, so no more scope for increased compression. It has a total capacity of 118 petajoules. What does that mean? It means that the SEA Gas pipeline has the potential to more than double the gas being made available to Adelaide. When you compare it to the eastern gas pipeline built by Duke from Longford up to Sydney, it's about the same size as the SEA Gas pipeline at 457 mm. It had an initial capacity, I think, of 55 petajoules. Its had one compressor, I think, added to it and its current capacity is now 65 petajoules. As I understand it, it has a developable capacity with full compression of 110 petajoules.

The SEA Gas pipeline is significantly bigger than the new pipeline that's being built running from Longford, an important gas source, to Sydney, an important gas market. It seems to me, when you consider all those facts, it is extremely difficult to argue that the SEA Gas pipeline is underbuilt.

MR HINTON: A number of interested parties have put, you won't be surprised to learn, a very different perspective on how the market operates and, in particular, while there are great difficulties in assessing what the counterfactual ought to be in terms of investment outcomes and, in the absence of having a gas access regime, the starting point is one of regulatory risk but, if you have regulatory risk, that in itself has to be an impediment. A regulatory risk would particularly apply to that which is associated with a surplus capacity relative to known demand or even contracted demand and, therefore, the reasoned argument goes along the lines that that in itself is a strong incentive to construct only to known contracted demand.

It therefore follows that, while it is more efficient and cheaper to invest in a pipeline of larger capacity as opposed to using loops and compressors, the system that operates today pushes you away from that by being an impediment to that construction of a pipeline greater than known contracted demand. That's the reasoning behind the counterfactual to what actually exists today with regard to investment over the last seven years.

MR WILLETT: Sure. Let me address that question in two parts: first to address the question of regulatory risk associated with new pipelines in general and then to address the cost differentials of building a pipeline with a lot of spare capacity compared to building a pipeline with developable capacity through increased compression.

On the first point, we recognise that regulatory risk is an issue. That's an issue particularly for new pipelines, and part of our job is to ensure that that regulatory risk is minimised. That underlines the importance of the greenfields guideline and it also underlines the importance of the offer within the greenfields pipeline, which is to enter into a regulatory contract, in effect, with a pipeline proponent on the terms and conditions that will govern that pipeline for a substantial period of time.

That's the approach that's built into the competitive tender arrangements under the Gas Code. That will recognise that the competitive tender arrangements are not always going to suit pipeline proponents, so we offer an alternative, which is to enter a regulatory contract under the auspices of the greenfields guideline. We think the code is eminently suitable to taking that sort of approach. We haven't had a lot of interest, I've got to say, in that to date. The first question I'd ask people who argue that the Gas Code can't facilitate certainty in greenfields investment is, "What's the problem you've had with the ACCC so far?"

In terms of addressing this question of undersizing and it's more efficient to build larger pipelines, I don't think that's right. I don't think it's right for a number of reasons, the first being that oversizing a pipeline substantially beyond demand initially has a very substantial cost associated with it too which needs to be taken into account. That's the cost of bearing that higher construction cost - the capital cost over time - when a large part of that pipeline is empty. It also has a lot of risk associated with projecting demand for that pipeline.

Take the SEA Gas pipeline, for example. With the SEA Gas pipeline, we'll have two pipelines going into Adelaide. The suggestion is it's been underbuilt and there will be more demand for that pipeline in the future and it won't be able to meet that demand. There's already, as I mentioned, substantial developable capacity there to meet it, but who is to say that people will actually want a lot more gas in the future from Longford as opposed to coming down from Moomba? Who is to say that the more efficient approach might be actually to increase the capacity of the Moomba to Adelaide pipeline? I can't say that and I don't think there's anybody in this country who can say definitively that in 10 or 15 years' time, when more gas than can be provided currently by the SEA Gas pipeline or the Moomba to Adelaide pipeline is needed, that should come by increasing the capacity of the Moomba to Adelaide pipeline or increasing the capacity of the SEA Gas pipeline or building another pipeline from a new gas field that's been developed.

There seems to be a lot of risk associated with the assumption that a lot more capacity than is currently reflected in the SEA Gas pipeline is going to be needed, so let's save the cost of building the pipeline, wear the capital cost of that while the pipeline is under-utilised and then be at the risk of that capacity never being utilised, because it's made redundant by another development somewhere else. I find the argument that a pipeline like the SEA Gas pipeline has been underbuilt because of the code extremely problematic.

MR HINTON: Thanks very much. I was going to move onto another topic, but - - -

DR FOLIE: It's hard to pick up a very thorough review of everything. One of the issues that, if you like - the success of the ACCC in general has been really in the area of actually strengthening the market rules; in other words, establishing the rules of the game and a lot of markets - as they're changing in Australia - established we'd actually got competition rather than actually price setting. Price setting tends to always be more vexed and more complex. Certainly that needs to be done fairly effectively.

I really worry a little bit, I suppose, with the issue that we get to - the idea of monopoly power and rents. It permeates through the whole discussion. Effectively, in a lot of other sectors in the economy we do actually tolerate rents; they are in fact encouraged. We've got them in real estate, media, patent law, and even as a business idea. One of the interesting things about rents, particularly if they're in one of those open-access areas, as long as you've got barriers to entry - that's where the ACCC comes in - by writing the rules to be able to get access to the same level playing field, those rents usually disappear and you usually get a lot of investment flowing into that particular industry. So you get quite a dynamic change as people flow on.

We don't seem to have that in this particular industry. We've gone to a price-setting, building block; industries having tariffs set on the basis of a negotiated notion of what is an efficient industry, which no other sector has to really go through. In retailing, their logistics are to the best practice. In other words, it's the antithesis of what goes on in other parts of the economy. I think that's the reason why you get a lot of, "Why is it so intrusive?" Of course, the nature of that building block and trying to squeeze out the so-called last bit of rent creates an awful lot of time and effort. Would you like to comment on that juxtaposition of the two areas?

MR WILLETT: Yes. The important distinction is between contestable markets and natural monopoly markets. Contestable markets - as you say, rents are tolerated; in fact, there's no law, there's nothing in the Trade Practices Act, that inhibits the development or exploitation of a monopoly. The reason for that is that in contestable markets, provided they remain contestable, the expectation is that any exploitation of monopoly will be, over the long term, competed away and what Part IV of the Trade

Practices Act does is ensures that someone with market power can't entrench that market power and thus make that market less contestable through, for example, predating on new entrants or entering into collusive arrangements with competitors. That's why we openly tolerate rents in contestable markets. They're part of the process of competition.

Natural monopolies are very different. By definition, natural monopolies are not contestable. If a pipeline from Moomba to Sydney has a lot of market power, it's very unlikely that you're going to see someone come in and build a pipeline beside it to undermine any rent-seeking activity by that natural monopoly, because it's much cheaper, even when you get to looping, to keep developing the capacity of the existing pipeline. It's a decreasing cost activity that underlines its natural monopoly characteristics.

Because of that difference, natural monopolies aren't contestable. Therefore, any rent-seeking behaviour is not going to be competed away. It's because of that difference that we do have a regime - going back to the Hilmer report; in fact, going to the Government (Non-Tax) Charges Report, I recall, recognised this problem with natural monopolies and it said what we need was an area within the Trade Practices Act that focused on the problem of natural monopoly.

DR FOLIE: I think that leads then to the issue that comes back, if you like, to part of your course excess factor is crafting the rules under which that so-called theoretical natural monopoly is accessed. There are issues within it, getting into the tangible area of this, of who owns the gas, what are the rights to be able to trade the peak capacity - in other words, do you actually de facto enter a gas contract; have a share of that pipeline, in essence, and is it the right of the owner of the gas rather than the owner of the pipeline? We're not here to craft it, but has the commission thought about trying to have the access regime more structured around actually defining the property rights, the tradable rights, where if you get that right, you actually take away a lot of the monopoly? It is going to become important - and I'll come onto other issues where it is then - because this is only one segment in a chain. We've got to look at how the chain works, and it is this issue of property rights to the various aspects as you move through the chain.

MR WILLETT: Yes, I think that's a good question. There are two points about that: the first is the code was designed to recognise that pipelines are generally built through the use of foundation shipper contracts who take a large chunk of the initial capacity of the pipeline and, in effect, underwrite the initial investments. Those contracts associated with the foundation shippers have terms in them that help determine the tariffs, both initially and going forward. What the code is designed to do is to ensure fair access to what is left - the spare and developable capacity. So the code recognises that there might be that capacity sharing, if you like, initially through foundation shipper contracts, but it focuses on capacity that goes beyond that.

I think your question goes more to my second point which is about: can you, as an alternative to regulation, design arrangements whereby you actually have competition between owners of a share of the pipeline? You have perhaps a foundation shipper arrangement that divides up the capacity of the pipeline between three users, for example, who then compete with each other to sell that capacity. I think that sort of arrangement is feasible; I just haven't seen a good example of it, such that coverage of an existing covered pipeline would be rendered redundant. I don't know this in detail, but it may be that the SEA Gas pipeline actually has those elements built into it, but I'm not familiar with the detail of it.

DR FOLIE: We hear elements of it in WA. Because these are commercial, they trade peaks - in other words, between Alcoa and Western Power. They've mentioned it at the hearings we had, so it's not - the details of it. It is increasingly important. It appears to be becoming an issue because part of our reference is also the issue about tradable capacity, and that certainly permeates the whole discussion, and there's been a feeling that tradable capacity issues actually haven't emerged and presumably it must be something to do with the way the access rights are structured. I guess the point of the whole thing is that there's been so much focus on the price issue and these other issues then will help settle out some of the price.

MR WILLETT: This is really going to a coverage question more than a regulatory question, so it's more appropriately a question for the NCC, but I'll have a go at it since I can draw on some experience from that previous job. The question is whether the availability of that spare capacity and the tradability of that spare capacity is such that it undermines the market power exploitable by the owner of the infrastructure. That would be the question that would need to be addressed. I haven't looked at the coverage question of the Dampier to Bunbury pipeline, but no pipeline that I've been involved in looking at has had those sorts of characteristics, such that the market power of the pipeline is undermined.

DR FOLIE: In other words, the access arrangements that are currently in place leave the market power totally within the pipeline - - -

MR WILLETT: That's right.

MR HINTON: While you're trying your hand at matters of coverage - - -

MR WILLETT: I don't want to go too far down this route. It might be stepping on some toes.

MR HINTON: No. Feel free to shift to the next topic.

DR FOLIE: I'd like to continue on that same stream.

MR HINTON: Go ahead, Mike.

DR FOLIE: It's reiterating what you said in your introductory remarks: that industry claim that - in other words, in their submissions - the arbitrate/negotiate has never really been given a fair chance - I'm stylising there - and certainly within this round of material we're given, there's quite a detailed play by APIA - the pipeline group, and supported by most of their members, with a fairly spelt out negotiate/arbitrate - which they feel would work, would be able to deliver the attributes. What are your comments?

MR WILLETT: I think the fundamental problem is that there is a difference of view between us on what an appropriate tariff is. We're going to strike that issue and the issue will be just as contentious in the context of an arbitration as it will be in the context of an access arrangement concerning reference tariffs. I don't know that that alleviates the difficulty that we've had in sorting out the right arrangements for these pipelines in the past. It seems to me it just increases the transaction costs of that process because you need to go through those arbitrations with a number of users; one arbitration doesn't create rights for subsequent players. That's the difference with an access arrangement. You have one determination that's applicable to all-comers.

The process of an arbitration would be little different. Because we're starting this reform program, this regulatory program, we don't have good benchmarks to apply, in part because these are natural monopolies so they don't have competitive benchmarks but also because no-one has gone through the process of identifying what the efficient costs of these pipelines are. There are two approaches here: either you can identify competitive benchmarks or as a surrogate for that you develop a model that tells you something about the efficient costs of that pipeline. Inevitably, we're going to have to go through developing that efficient benchmark through the building block approach as an initial first step in regulation, regardless of what regulatory model you apply.

That's always going to be difficult and it's always going to be contentious because these pipelines, by definition, because they're covered, have had market power, they've had a profit-maximising incentive, and so as a consequence they've charged profit-maximising prices. It's almost inevitable that a regulated tariff is going to be somewhat lower than the current tariff and it's almost inevitable that the pipeline is going to want to stay as close to the existing tariffs as they possibly can.

DR FOLIE: What about the notion of the pipelines where they've had - and this is part of their model; you have foundation shippers in there. They've got tariffs associated with that. They offer the same tariff to all other comers.

MR WILLETT: Yes. There is a question in my mind about whether that's appropriate for all levels of utilisation, or is there and should there be some scope for sharing efficiencies gained by increased utilisation? I'm familiar with the problem of most favoured nation clauses that are generally in foundation shipper contracts. I'm sensitive to those, but I'm not sure that that means that whatever the initial price negotiated as part of the foundation shipper contract should be the price for all time. If it was, that would be an easy approach to take, but it's not the approach that's adopted in the competitive tender arrangements under the code. The additional thing that they prescribe is that if you're going to have some approach up-front that identifies tariffs going forward, then you need people tendering on the basis of what price they're going to charge to all-comers. If you don't have that competitive process, then it's a bit difficult to say, "Well, the initial foundation shipper contract is the right price for all time." It might be too high a price in the end, it might be too low a price in the end. Long-term contracts generally provide certainty for both sides of the negotiations, so they provide benefits, and you would expect that both are benefiting from that certainty associated with long-term tariffs.

MR HINTON: I've got a couple of questions about market power that flow from some of that discussion, Ed. The first one relates to what a number of interested parties have said to us: that the basic approach - using their shorthand, not necessarily mine - the basic approach of the Gas Access Regime is one of being found guilty before being tried. That is, they have market power; they will use that market power; therefore they will be regulated as opposed to an alternative mind-set which would be, "You might have market power; see how you behave and if you behave badly then we'll regulate you." That's consistent, I think, with a point in your submission about, in these circumstances, mature gas pipeline systems: unless individual circumstances indicate otherwise, there is a significant level of market power - reverse onus of being guilty, in effect. Do you have any reaction to that accusation; that that is the outcome of the current regulatory framework?

MR WILLETT: The coverage process, at the start, says these pipelines have substantial market power, therefore they have the ability to price substantially above efficient costs. We know there's a problem with natural monopoly in that that sort of profit maximising behaviour, rent seeking behaviour, isn't going to be contested away, competed away, and it has the potential to substantially distort competition in dependent markets. There's nothing new in all that; it goes back to a lot of literature in the Hilmer report and whatever.

So to the extent all we're saying is - and all the process is saying is, "Well, if an entity has substantial market power, and therefore have the ability to profit maximise by charging high prices, then they will have a responsibility to their shareholders to do exactly that." It's not so much saying they're guilty, it's just saying, "Well, these are the incentives that face any business." That's the natural monopoly problem.

MR HINTON: Yes, I did say they were their words, not mine. Yes.

MR WILLETT: As I said, that's different to contestable markets where it's not an offence, it's not contrary to the act in any way to charge high prices and no more than that.

MR HINTON: A related question is - it's still a coverage related one and that's a bit related to what came out of the Part IIIA review in terms of intervention that seeks to have an impact on the competitive environment; whether the effects are material or substantial. You recall the Productivity Commission's recommendation of applying the substantial test, and the government's interim response to that, referring or preferring a materiality test. Do you have any particular view on that area of debate that's germane to Park IIIA review, that flows through to this inquiry?

MR WILLETT: There was a view that the airports decision under declaration set a low hurdle for the promotion of competition. I was never an advocate of that view because I thought that that decision just focused on whether barriers to entry were lowered or not, which is essentially the important question. If you reduce barriers to entry to a downstream market, then by definition you promote competition and in a not insignificant way, unless the barriers to entry that you're addressing are trivial.

The Duke decision, I think, could not be said to have set a low hurdle for the promotion of competition. It has identified the important question of whether the pipeline has market power or not, or substantial market power, is the right question to ask. In a different way that focuses on the same question: does it have the ability to distort competition upstream or downstream and thereby increase barriers to entry to those markets? So I find those two decisions entirely consistent and focus on the right things.

The trouble with amending the coverage criteria at the moment is that you would be inevitably, as a matter of law, sending a signal that something different is intended. If those questions that I've just outlined aren't the right questions, what questions do you intend? As an economist I have some difficulty suggesting that those questions that I've just outlined aren't the right questions to be asking.

MR HINTON: That brings me back to almost a prior question that I've asked some others, but also has arisen in a number of submissions as well, and that's the perception around, in some parts of the sector, that what we have today in terms of the regulatory regime operating is significantly different to that which was perceived or envisaged post Hilmer exercises, such that we've moved away from an essential infrastructure focus with a view to increasing competition, to a focus on consumer interests, however defined. Some interested parties perceive that as a very different regulatory framework operating today, relative to that history. Can you comment on that sort of perspective or perception?

MR WILLETT: Yes. I think it's nonsense. I can't see where it comes from in terms of either the coverage processes that the NCC conducts, or the regulatory processes that we conduct. Everything in terms of my work and I think the work of the commission has focused on promoting competition and getting competition in dependent markets, ensuring that natural monopoly infrastructure with market power doesn't have the ability to charge prices that are substantially above efficient costs.

I think implicit in the criticism that you cite there, is a view that the commission pushes the reference tariff down as low as it possibly can within its discretion under the code. Can I say that that is absolute nonsense. If anything, we bias the outcome in favour of the infrastructure owner. Let me give you two examples: we have a discretion under the code to set the initial capital base of a pipeline as somewhere between depreciated actual cost and depreciated optimised replacement cost: DAC and DORC. The Epic decision has clouded that somewhat, but I won't go into that at the moment. We've got an appendix on that and I don't think it needs a big change, but there are some subtleties there that I'm not going to go into right now.

We have consistently taken the approach that the ICB should be set at the upper range, or close to it, at around DORC, because that reflects - better reflects the objective that we have, which is trying to do what we can to replicate the sort of outcomes that a competitive market would deliver. Book value doesn't mean much for the way markets generally work, so depreciated actual cost is often a fairly meaningless concept in terms of benchmarking efficient costs. It can mean something to the particular business concerned, but not to the sort of benchmarking approach that we take under the code. So that's one example where - and that is a very significant example because that makes a big difference. I think if you look at the Moomba to Sydney pipeline, I think the book value is around 100 million; depreciated actual cost would be around 100 million and DORC valuation would be around several multitudes - - -

MR FOLIE: Enormous difference.

MR WILLETT: Yes, around the 600 million mark. An enormous difference; enormous difference. We're up towards the top end.

The second example: equity betas - again, it's a very significant parameter under the code. An equity beta is a measure of how risky the pipeline business is compared to other businesses who use the stock market as the general benchmark there. It's basically a measure of the volatility of revenues associated with the pipeline business compared to the volatility of other businesses listed on the stock market. You would expect - and there is some evidence to say that pipelines - there is some considerable evidence to say that pipelines should have a relatively stable

income flow and therefore a lower equity beta. But generally we have adopted an equity beta of around one, usually a little bit more than one, which is to say that they have an average level of volatility, compared to the stock market.

Again, adopting that approach makes a big difference in terms of reference tariff outcomes, and yet there is ample discretion for us to go much lower than that. In fact, in a current tribunal matter - the GasNet decision - we have a party to that matter representing users who are arguing for an equity beta of 0.35. We've got some material provided by the Allen Consulting Group suggesting that the beta measure, based on market evidence, is around the 0.7 or 0.75 mark. There's good evidence for us to rely on, if we wanted to go there, but we take a cautious approach and we've adopted an average equity beta.

It's interesting that in the two current matters before the tribunal - the GasNet matter and the Moomba to Adelaide matter - both pipelines initially put our outcome on equity betas at issue, saying that we should give them higher equity betas than the average - the stock market or thereabouts. As soon as we put in our submission that, "Well, we were generous and it is open to the tribunal to come to a lower view if it chooses to," both parties withdrew that issue from their statement of claim. So I think there's a statement there that maybe they really know that we're not being very hard on them; at least on that issue, in fact, we're being quite generous.

MR HINTON: Let's move on to the objects clause, or objectives of the regulatory regime. I suppose it starts off with the view that generally speaking an efficient regulatory structure would prima facie best have some clarity to its objective, and that can lead to second order regulatory parameters that then leads to a framework for administration. Many interested parties have expressed the view, with case examples - including Epic - that the objectives of the regime are not only lacking clarity, but they also have a number of conflicting - potentially conflicting objectives and tensions and that then leads to the need for judgments about how you balance those tensions; that leads to a view that that has regulatory uncertainty to it, that leads to the view that that in itself means it's inefficient, inappropriate regulation.

That then takes you further down the track - the way to address that is to bring clarity to the objectives of the regime. There is a supplementary point about the hierarchal structure with objectives scattered throughout the code in different places, with questions of primacy. Now, a deal of submissions have flagged that issue with us and some, in fact, have proposed very specific explicit word changes in this area. I note that your submission itself doesn't address that generic issue, either explicitly or implicitly, but I'd welcome the commission's views on this issue.

MR WILLETT: Okay. We haven't addressed it because we don't think it is all that unclear. Certainly we have a fairly clear view and it's not much different to the view that fell out of the Part IIIA review and that the objective of the Gas Code is the

promotion of competition in gas markets through efficient investment and utilisation of gas pipelines. I think that's pretty close to where the Part IIIA - or at least the government response to the Part IIIA review came out.

I take the point that some of the things that are called objectives in the Gas Code could be more accurately described as descriptors, rather than objectives, and that generally one clear objective is preferable for a piece of regulation like the Gas Code. If one was going to be put up - and I am not concerned by the prospect at all - I just don't think it would make a big difference, or make any difference at all to what we do or the processes that we are responsible for.

MR HINTON: Do you think there might be a spin-off with regard to bringing greater certainty to the minds of industry participants, or at least bring greater clarity as to where the regulatory outcome might be if there was greater clarity? That in itself might bring benefits in terms of timeliness - although I want to get on to timeliness down the track a bit.

MR WILLETT: Yes, indeed. Possibly, although I must say in my dealings with gas people I haven't found that there is a lot of confusion about what we're trying to do and what they're trying to do, and what the code is trying to do. I think people are actually pretty clear on that; we just disagree on where the results should come out.

MR HINTON: In that context, some have proposed word changes that pick up the nature of what should be duplicated by the regulator: as opposed to "perfect competition" it should be "workable competition". There is a raft of literature on those terms - - -

MR WILLETT: Yes, and we've added to it in our appendix.

MR HINTON: Yes, we add to it daily. I certainly don't want to review the literature here this afternoon, but do you have any reaction to that idea; that the clarity for the objectives would be more noticeable, apparent and valid if this term "workable competition" were included as opposed to the concept of "perfect competition"?

MR WILLETT: I find this argument a rather nonsensical argument. It would stop us saying that we did - we have provided - - -

MR HINTON: I'm glad you give clear answers.

MR WILLETT: No, I don't want to leave you in any doubt. I don't know how you apply the notion of perfect competition to a natural monopoly. If anybody can enlighten me on that - but I would think to any economist that notion is just nonsensical. Nothing that I have done in the years that I've been working in this area

has approached anything like that because, to my mind, it is nonsense.

Workable competition is the notion that recognises that perfect competition is an ideal that is rarely achieved. It has assumptions underpinning it that are, by and large if not inevitably, unrealistic. What the literature generally does though is it relaxes individual assumptions under the perfectly competitive model to benchmark or test different policy approaches and so some of the elements of perfect competition are still useful in that sort of analysis, but that forms no part of the regulatory approach under the code. In fact the regulatory approach under the code recognises that pipeline owners will be able to earn returns that are in excess of costs from time to time.

They will be able to retain the fruits of improving efficiency and productivity and it simply tries to - the Gas Code and its processes simply try to replicate the sort of results you get in a competitive market by dragging the natural monopoly owner back to costs every so often before setting them off on another opportunity to improve their productivity and efficiency and earn higher returns. All that recognises is the points that I was making earlier that, left to the devices of the market, natural monopolies don't have a natural mechanism to compete away monopoly profits. They can earn monopoly profits for a very long period of time absent regulation and that's the regulatory problem of natural monopoly.

So there has been a lot of work under the Gas Code and other areas of access regulation in Australia about appropriate mechanisms to provide incentives on infrastructure owners to improve their business and earn higher returns. That's a workable competition model.

MR HINTON: Thanks. I've been sort of - or we've been exploring more thematic issues and approaches related to structures in the shape of regulatory frameworks and in particular with regard to what we have today but I also had half a dozen or so questions on much more specific, perhaps more obscure, matters but certainly still not unimportant in their own right. So I was going to take them almost at random so there mightn't be any sort of commonsense linkage to some of these questions but I'll just take them in turn and I'm sure Michael will have a few as well.

Let's take distribution and transmission issues that it has been put to us that the origins of the code primarily were driven by views about market power with regard to transmission pipelines and that the regulatory regime was expanded in its scope to pick up the distribution network rather late in the piece. There's also a view around that these are different issues - distribution versus transmission - but on the other hand it has been put to us that the flexibility within the gas access regime is such that it can handle both transmission and distribution with the regulator taking out the various factors that may differ for those two segments of the sector. Do you have any views about this, ie that maybe we need two explicit tranches of the regime for

distribution and transmission or is the current framework all right or do we come up with something else?

MR WILLETT: I think using a common framework for both is appropriate but it's important to have enough flexibility within that common framework to adapt to the circumstances of the different pipelines and some distribution pipelines do differ from some transmission pipelines. Some transmission pipelines differ from other transmission pipelines and some distribution pipelines differ from other distribution pipelines.

I don't think it's possible to say that all distribution pipelines look like this and should be regulated like this and all transmission pipelines look like this and can be regulated like this because there is as much variability between transmission pipelines and between distribution pipelines as there is between transmission and distribution pipelines, so I don't see a strong case for taking a different approach to those different pipeline businesses. I think there's some benefits in actually having the common set of rules, common set of frameworks, applied to the different pipeline businesses.

I don't think the way you've depicted the development of the code is quite accurate. I'm going to defer to David, I think, who has had much more experience in the development of the code.

MR HATFIELD: Yes, I was interested reading the transcript, that description, because having anticipated in the process on the gas reform task force and then on the gas reform implementation group, the way it actually worked - initially three working groups were set up: an upstream working group; a distribution working group and a transmission working group, and each would look at what needed to come out of the COAG commitments to gas reform for those respective areas. In transmission and distribution it was expected that separate codes would be required and so separate working groups were established to go and start preparing those separate codes.

Very quickly in that process within a couple of months of a sort of two or three-year process, people realised that the issues that were being discussed in the transmission working group and issues being discussed in the distribution working group were identical, or virtually identical, and that in terms of how to develop an access regime and what needed to be in an access regime for both of those, that it would be much more constructive to have one working group develop one code and, at the end of that process, given that almost everything would apply - whether at the end of that process there needed to be some variations along the way.

So very quickly, very early on in the process, not right at the end of the process, the two working groups were brought together and one code was developed

for both transmission and distribution. There were at the end of that process some subtle changes, say for example queuing policies and the definition of capacity and the requirement to post-capacity. It's very different in a distribution network to what it is in a transmission pipeline and the code reflects on those small changes but the way the process worked through was in fact in recognition early on that the two had many more similarities than they had differences.

MR HINTON: Thanks, David. It's not quite related but some have also said to us that the regulators tend to focus on gas only when in fact the sector is interlinked dramatically with energy sources more generally and that that narrower focus by regulators is leading to perhaps inadequate appreciation of wider factors at work if you looked at these issues from an energy perspective, particularly with regard to a market power, particularly with regard to capacity to rent-seek and therefore the coverage or the regulatory outcome is inappropriately restrictive in circumstances relative to what would have been the case if it looked more widely from an energy sector's perspective. Do you have any reaction to that sort of comment to us?

MR WILLETT: Well, it's a relevant question - it's more a relevant question for the coverage process than it is for the regulatory process because our job is simply to vet access arrangements for covered pipelines but I'll say a couple of things about it. Yes, the markets are - the sectors are integrating and converging. Gas is an important, and probably growing in importance, feedstock to electricity generation, so it's becoming more and more a part of the electricity industry as an input. That doesn't mean it's a substitute for electricity. It means that it's more like coal in some uses as a feedstock for electricity generation.

Of course there are other uses for gas which electricity or other feedstock to electricity can't act as a substitute - the fertiliser industry is a good example - and then there's the household sector and, while there's some substitution between gas and electricity for energy use for the household sector, there are also uses where the two products aren't good substitutes. If you do the cross-elasticities as demand you find that, by and large, on the demand side there's some substitution but not substitution such that it would reflect effective competition between gas and electricity at the user end and I think, while I haven't done the work, you'll find the same as an input to electricity generation between gas and coal.

It's interesting, in the tribunal decision on the Eastern Gas Pipeline - and might I begin by saying that the tribunal on a couple of occasions has addressed this question and found that there are separate markets for gas - but in the Eastern Gas Pipeline decision they said, interestingly, look, along its path the Eastern Gas Pipeline will be trying to sell gas in the regional areas and there are no markets for gas or distribution systems for gas along that route and the pipeline owner will have to work very hard to get gas penetration into those greenfield areas. Because gas isn't a good substitute for electricity they'll have to work extra hard to get that gas

penetration.

So they are in effect looking at it from the other side of the coin saying, "Look, there's a market-making need along the route of the gas pipeline and, until that market is made, the Eastern Gas Pipeline is not going to have market power even though they're the sole source of gas to those regions because there is this market-making need and that's because gas wouldn't be entering an existing market for energy. It would have to make its own market, in effect.

MR HINTON: Yes, electricity is locked in but gas is an option.

MR WILLETT: That's right. Yes, gas is an option and it has different uses and it's within its own market, so you have got to make that market and that constrains the exercise of market power for that market-making period.

MR HINTON: I'm running down my list. The next one I had was ring fencing and associated contracts seen as a very important part of bringing integrity and transparency to the regulated outcome market. To date I think there's only one complaint how ring fencing has been operating. There seems to be reasonable acceptance that it's appropriate to have ring fencing in this regime and there seems to be a widespread view that it seems to be working okay. Maybe that's because it's not working - to be a cynic. That's my first comment.

MR WILLETT: Cynicism is always good in this process, Tony, I've found.

MR HINTON: And the second comment is, well, (a) can you give any comments on its appropriateness and (b) whether or not it's working?

MR BUCKLEY: There's not much we can say on that, Tony.

MR HATFIELD: Our approach would be it's necessary, it's important and, by and large, we believe it's been working.

MR HINTON: Well, the complaint that arose was sort of along the lines that it was once again reverse onus. The complaint was that practices differ across jurisdictions, which doesn't necessarily touch your desks, and in one particular jurisdiction the regulator was taking a view that it was reverse onus. The company had to show that ring fencing was working, that they were meeting all requirements as opposed to the alleged approach by some other regulators that took at face value a statement from the company that, "We are complying with the ring-fencing requirements." The first we've seen is very intrusive and burdensome and the second we've seen is appropriate. Do you have any perspectives on that balance?

MR HATFIELD: From the regulator's perspective you're at a significant

information, asymmetric disadvantage and the way the ring-fencing provisions of the code are structured they're really around a set of requirements within a reporting obligation by the companies, so the companies are really under obligation to confess if they've breached anything and then that can be addressed, fixed if it needs to be, and provide effectively annual reports of compliance. Given that the regulator really doesn't understand what's happening and knows what's happening within the industry and within that company, it's really relying upon the company to describe what it has done and to develop a compliance program, if you like, or set up systems that demonstrate that it will meet the ring-fencing requirements.

The regulator really then relies upon aggrieved parties complaining to it before it can really understand or know. The alternative would be an incredibly intrusive approach for the regulator to effectively step in and either second-guess or even micro-manage the actual structure of the company, which doesn't seem to be the intention of the code and hasn't been the way certainly the ACCC has approached ring fencing.

DR FOLIE: I think that's what appears to be happening because it has occurred in a few areas that's it's I believe emanating out of - the Queensland regulator has put a proposal which I think has been discussed at the regulator's forum but not on regulatory accounts and they're quite detailed and a number of some of the groups are quite - you know, if you're a fairly small distributor you've got to produce all of these across the thing and they view this as an enormous burden and again it's not perceived to be the original intention of the code but it sort of grows and I guess it's one of the areas these things - sort of saying it grows all the time.

MR WILLETT: Perhaps we might take that question on notice and see if we can provide a full answer and we do plan to provide some supplementary material, so if we have anything to add on that we'll include it in that submission.

MR HINTON: Thank you very much for that offer and picking up associate contracts - because there is a relationship there.

MR WILLETT: Yes.

MR HINTON: Our terms of reference require us to consider, assess, examine the consistency of the sector-specific regulatory regime with the broader Part IIIA access arrangements and any other, for that matter, access arrangement. We certainly appreciated your comments regarding why there is a need for a gas specific - the timeliness of speedier outcomes that flow from that that might not necessarily operate under a Part IIIA system. So the question that first arises in my mind is one you've already answered. The second one is: are they consistent? While it might be needed to have it, there's still a question of consistency. It's not good regulation to have a generic structure under, say, the Trade Practices Act and then a separate Gas

Code that has inconsistencies. Do you have any views on that relationship issue?

MR WILLETT: I guess what I might add to earlier comments is that I see that question going to the scope for negotiation and commercial resolution of disputes, and I know there have been some comments that suggest that the Gas Code doesn't facilitate commercial negotiation. I must say that hasn't been our experience. We haven't had any access disputes notified to us under the Gas Code. All of the settlement of tariffs under the code to date has been through commercial negotiation.

Yes, that commercial negotiation has been in the context of where we've completed access arrangements, a reference tariff for a reference service, and the knowledge that if a dispute over a reference service goes to arbitration, then the code obliges the arbitrator to determine the reference tariff, so there's a bit of certainty and therefore inflexibility associated with that element of the code. But there are opportunities for negotiation around those reference tariffs and for services other than reference services. That is a notion that is consistent with Part IIIA and consistent with the declaration process. The question is whether the prescription in the code is the right level of prescription to facilitate that commercial negotiation, but the end objective is the same. It's to ensure that there's enough certainty and enough clarity to facilitate commercial negotiation by access seekers and infrastructure owners.

MR HINTON: Thanks. There is a number of suggestions around about comments on light handed versus heavy handed, lighter handed, heavier handed and whatever in between. You implied in your earlier comments today - I think they were Ed's comments - about the sort of building block approach is the inherent nature of what we've got today. The statements to us are that that in itself leads to, by definition, a heavy-handed, intrusive regulatory outcome or regulatory process, though your submission implied that it wasn't heavy handed; it was quite light handed.

So we do have a different perspective and a different perception regarding that. I raise the question as to whether or not the sector lends itself - whether efficient regulation could be achieved if we had different tranches of the sector being subject to different nature of regulation; that is, one segment being subject to light handed - such as monitoring, in that extreme - just only monitoring, out to say the sort of building block approach at the other end of the extreme, where a segment of the sector was subject to say the existing regime appropriately modified as found to be appropriate. Do you think that sort of model is one that is potentially appropriate, potentially rich in good outcome, or do you think it would be overly complex or - - -

MR WILLETT: I think it could be potentially very costly. I guess the comment I'd make is that if we want to benchmark different approaches to regulation, we have enough variation through different regulatory approaches around the world to draw those comparisons. I've got to say that while the code is described as heavy handed

and interventionist, by international standards and international quarters that's not the case. In fact, the Gas Code is regarded as relatively light handed regulation of the gas sector in Australia. That was confirmed by Janusz Ordover in his work for the NCC in the Moomba to Sydney revocation recommendation, where he points to aspects of the code that were indicators of a relatively light-handed approach, and those indicators that he identified were that it used a benchmarking approach rather than say, "These are the prices," and it provided for commercial negotiation of prices.

The problem is - and I've referred to this earlier - that you've got to have a starting point for any access regulation. Your starting point can be existing prices but, as I think I described earlier, the risk with that is that some of those prices at least will reflect exercise of market power and prices well above costs and will be inappropriate. You could say, "For those ones that are high, we'll just glide them down," but without a benchmark what's the appropriate glide path? We don't have competitive benchmarks. That's the nature of natural monopoly.

I know there's references to, say, competition between pipelines. I think that's a simplistic notion and it simply recognises that where you have two sources of gas to a downstream market, then there is competition between the different sources of gas in delivered prices, but that doesn't mean that the prices of the two pipelines provide competitive benchmarks. They do nothing of the sort. Compare current prices on the Moomba to Sydney pipeline, for example, of I think 65 cents without GST with current prices on the Eastern Gas Pipeline of somewhere in the 90s - I think it's 92 or 96, depending on when their last inflation factor was applied.

We know from the tribunal's decision that the Eastern Gas Pipeline price is a price that reflects cost because that's, by definition, the price set by a pipeline that doesn't have market power. The NCC in its recommendation on the Moomba to Sydney Pipeline said the Moomba to Sydney pipeline does have market power and certainly the work of the commission says that 65 cents is way above efficient costs. But the price on the Eastern Gas Pipeline tells you nothing about what the price in the Moomba to Sydney pipeline should be. It's not an appropriate benchmark.

MR HINTON: Well, let's look at it a slightly different way. The coverage and application of regulation is an on-off switch. That is, you're either covered or not covered; you're in the bucket or outside the bucket. The regulator then has a mind-set normally seen as one of saying, "If you're going to be covered or subject to my authority, I will make sure I don't make a mistake. I will therefore subject you to the full force of that regulation," even though the one that just falls into the coverage bucket might only need lighter-handed regulation compared to the other extreme, so my point of raising this stepped approach or tranched approach was whether or not in fact, instead of having an on-off switch or two buckets, you might have four buckets, so the one that just falls into coverage might be subject to a separate set of force of

regulatory intervention that is lighter handed by definition than the full force of the current regime, such that it's horses for courses, and that's the sort of origins of this question I asked a moment ago about whether there was capacity to have a fruitful regulatory arrangement different to that which applies today.

MR WILLETT: I think there's possibly some scope to do something like that. I think the Parer report suggested something along those lines by suggesting that there should be a minimum level of requirements for all pipelines. One of your intermediate steps might be a pure negotiate/arbitrate, so there is just an arbitration process available for the middle category of pipelines, if you like, and there's full-blown coverage for pipelines with serious market power, whatever that means.

Alternatively, you could say exempt certain parts of the code in application to certain pipelines. There are opportunities to do that, and that might lead to high quality regulation and better adapted regulation. The preferable approach, I think - and this is where I was heading before - would be to try and develop the code and lighten the regulatory load in relation to all pipelines covered under the code, although these aren't mutually exclusive processes and they might be all part of the one process.

But the point I made in my introduction is that it's always difficult to start applying access regulation like the Gas Code and you do need to start somewhere and you do need some benchmark prices to start from. Once you've established those, and that can be quite an intrusive process, inevitably the regulatory process going forward is going to work more effectively and be less intrusive and more light handed. Combine that with the fact that we are actively looking as a regulatory agency, and I'm sure you will be actively looking at ways in which the code can be further developed, moving from say benchmarking through the building block approach to benchmarking using a total factor productivity approach for example. I must say that process would be helped substantially by the fact that the building block approach has already been applied and set those initial reference tariffs, and then all you need going forward is to set the X factor in CPI minus X regulation. That could be a very light-handed form of regulation going forward and that can be facilitated by relatively small, perhaps no changes to the existing Gas Code. So I think there are all those sorts of possibilities.

MR HINTON: I did note with interest your comments about this transitional aspect, so thank you for those comments. Related to that transitional concept, is there another factor at work; that is, that the sector today has developed significantly since the mid-90s, therefore what is being regulated today is different to that which was first regulated? Is that an element behind your transition issue as well?

MR WILLETT: Inevitably, as the sector develops, not only in terms of the pipeline business but also in terms of the gas business, then the need and the design

of regulation will change as well. It's a different process involved in promoting effective competition in gas markets than it is to protect that competition once it's established. We're at the stage I think in Australia at the moment - and I think this is confirmed by the Parer report - that we are on the cusp of getting effective competition in gas markets but not quite there yet. Some very encouraging developments are leading in that direction. We have massive new investment in gas production and new sources of gas coming onstream. That should make for a more vibrant gas industry. We haven't got there just yet.

Once that process is fully in place, once we have the loop of gas pipelines around the eastern seaboard and perhaps more development through Queensland, with a more vibrant gas supply sector and a more developed infrastructure sector, the task of promoting, to the extent it needs promotion, or protecting competition in the gas industry will be much easier and, because that process will be much easier, then the regulatory requirements will be much lower. How we get from here to there and what the timing of that is will depend on the opportunities for the exploitation of market power in the future by gas pipelines and to what extent they are conditioned by the development of competition in the gas industry.

One of the very important processes under the Gas Code is of course the coverage process which will - is already reducing the coverage of the Gas Code to pipelines progressively as it becomes apparent that they don't have any market power.

MR HINTON: Revocation?

MR WILLETT: Yes, that's right.

MR HINTON: I'm glad you mentioned the Parer report. I won't touch on greenfields, we've sort of touched on that already, but there are a number of institutional suggestions within that report which COAG are struggling with. That's perhaps the wrong verb - seriously considering. Can you give any comments on those sorts of recommendations or views, proposals in relation to institutional structure that might then underpin, overarch, the Gas Access Regime?

MR WILLETT: Yes. I'll be a bit careful here because there are current processes going on within governments, within COAG, on this very question. This question is a matter for governments appropriately but what we said in our submission is that we think there is a case for generalist regulators as opposed to industry-specific regulators. We think that case is made out by experience around the world and in Australia. There is clearly scope for rationalisation of regulators at the state and the Commonwealth level and that rationalisation is part and parcel of the process that's currently being undertaken by governments in considering their response to Parer and other aspects of reform in energy markets.

Already there are steps that we've taken and have been taken elsewhere to try to reduce or eliminate problems associated with the different regulators at the state level and the commission and the differences between - any differences there might be between transmission pipeline regulation and distribution pipeline regulation. We have the utility regulators forum that meets on a regular basis to try and harmonise approaches to common regulatory issues and we have, as part of the commission, the energy committee which is made of commissioners from the ACCC and the heads of the relevant state regulators to provide input on regulatory decisions by the commission to ensure that we have as consistent approach as possible in at least the commission's approach to regulation.

Those existing processes could be built on. Alternatively as a result of decisions by government, we can move to somewhat different arrangements, perhaps more consolidated arrangements, but I think whatever arrangements are put in place, then the important parameter, the important need, is to be able to take advantage of the synergies between regulation of different infrastructure because, in the commission's experience, there are very substantial synergies. It's very hard to get the expertise together to perform effectively in this area. It's a very specialised area and there are very common skills required in telecommunications regulation, in rail regulation in cases of electricity, et cetera.

So it's very hard, I think - it would be very hard to get an essential critical mass within a regulatory institution therefore, just focusing on, for example, regulation of gas transmission or regulation of electricity transmission because we know we take advantage of the synergies between regulation. We have committees that cross those different industries and they ensure that there is a consistent approach.

MR HINTON: To follow up on that regarding the role and operation of NGPAC, there have been some comments from some interested parties that its composition is right and some say it's not right. Some say it's not achieving anything, it can only do the easy stuff, the hard stuff's too hard by definition. Do you have any comment you can make on NGPAC?

MR WILLETT: I must say I've not had a lot to do with NGPAC. You're on it, aren't you, David?

MR HATFIELD: I've participated on it on occasions.

MR WILLETT: Anyone else wants to - no. Look, can we take that one on notice again and think about that?

MR HINTON: Sure.

MR WILLETT: I think we'd like to take it away and think about it for a bit. There are clearly some common issues with consideration of a new rule-making body in the electricity sector as well and some thought has been given to that. We just haven't thought about what that means for NGPAC or rule-making bodies in the gas sector.

MR HINTON: And appeal forums as well. There's an issue of whether the regulator is the appeal body, which brings me to my next question; that is many in the industry argue very strongly for having a merits based review option inherent in any regulatory structure and it might apply to the gas sector. Do you have any reactions to that?

MR WILLETT: Look, I can understand the wish for a merits review. I've had some experience of a merits review in coverage matters naturally enough in my former position. I think that process is very different from what it would be in a full merits review - a full reconsideration of the matter by say the tribunal of an access arrangement. We've already discussed how technical and how detailed this process is and to then go to a quasi-judicial body and start from scratch and put on evidence in the way that is commonly done before the tribunal and to seek to find the right answer through that sort of process would be extraordinarily cumbersome, take a very long period of time, consume a very large level of resources. So I think the position for a full merits review and full reconsideration by the tribunal for access arrangements is a different question to the question of full merit review and reconsideration of coverage decisions by the tribunal, which I think is a quite manageable process and I think the EGP decision demonstrated that.

The current process is very close to a merits review. It's qualified to some extent but not in a way that I think would constrain people greatly in the issues they wanted to put before the tribunal. The important constraint that is there, however, is that it's a review on the papers that were before the commission and there is not the opportunity to put new evidence to the tribunal and that performs a very important role, I think, that restriction, in limiting the formality and the cost of the deliberation process by the tribunal. Some of the big costs of quasi-judicial hearings is putting material before the body in a way that is acceptable as evidence, whereas the processes of administrative bodies like the commission are very different. It's not so much formal evidence as information that parties put before the body in a way that is much less costly to produce.

Some of the material that we put together or some of the consultancies we commission are very costly but it's nothing compared to what you go through when you start putting on affidavits before the tribunal. So I don't think there would be a significant change in moving the current review process of the tribunal from its existing constraints to a merit review but I think there would be very big problems associated with moving to a total reconsideration of the matter.

We've had some experience with the tribunal and this process so far; one matter concluded and two currently before the tribunal. I think you will be in a better position to make a judgment about this when we get the results of those two outstanding matters.

MR HINTON: When are they due?

MR WILLETT: The hearings for both have been concluded. It's really a matter for the tribunal when they're going to hand down their decision but it should be within the time frame of your deliberations. It's a bit hard for me to go into all the reasons for this because some of them are confidential but we think that the current process perhaps is not that constructive in that it probably isn't very satisfactory to infrastructure owners seeking review because inevitably the tribunal, I think, is fairly heavily dependent on the commission process because of the nature of the process the commission has gone through.

We suggest in our submission that maybe - well, we think that the cost of that process probably exceeds the benefits. As I say, you'll be in a better position to form a view on that when you see the results of the matters. Our expectation is that both those access arrangements won't be subject to substantial changes as a consequence. If our understanding the tribunal processes were wrong on that, then we might be wrong in our opinion that the review process doesn't serve much of a role but that's the current view that we have on the basis of that experience that there's not much efficacy in that process.

MR HINTON: Perhaps widespread is too strong but certainly a number if not a very clear majority of submissions to us expressed concern about the lack of timeliness of regulatory outcomes and I note from your submission you've made a specific suggestion that might facilitate an improvement in that area, so thank you for that. Michael, do you want to pursue anything else?

DR FOLIE: Yes, I've got an easy one to begin with. On the tender process for greenfields, is it possible to be able to allow non-conforming bids? This has been done quite a bit for Queensland coal tenders to power stations back in the early 90s and quite often the non-conforming bid would win. It gives a bit of market innovation to the thing. Could that be incorporated into the process?

MR WILLETT: I think we've suggested that.

MR HATFIELD: We've suggested that condition bids could be submitted. One of the difficulties I guess in a competitive tender process is that you are relying on the process to deliver the competition that delivers an accessible outcome and so I guess, in constructing it, there was a need to ensure that - I mean, the regulator's role in a competitive tender process is to ensure that the process is a competitive one and, as

long as that is the case, then the regulator is happy to be bound by the outcome and,

because the regulator is not running the tender process, the code is structured in a way to try and ensure that the party running a tender process is making a fair comparison of the various bids.

I guess to that extent there are requirements in that that bid be conforming and all the parameters be set so that the tender process - all parties can participate in the process, have understood the basis upon which their bids would be considered, what the criteria were really for selecting the winning bids, and I think that's what's driven the conforming nature of that. It's really to say it's only fair for the parties participating to know on what basis their bids will be assessed and that if bids don't conform to those parameters, then they should be - - -

DR FOLIE: You usually put in two bids. You put in a conforming bid and then you put in your non-conforming bid so you could always benchmark effectively, if you were to go ahead, and then you could actually see the variations you're offering in your non-conforming. So you did always have in Queensland a measure that must be actually apples and apples.

Okay, thank you. The other one - part of the issue is to actually get competition between the gas sources and the markets and it's the network - but even just going around already there are interconnectivity problems, pressure differences, and you've mentioned - actually I've noted the first person to mention actually in a paper specifically. Thank you very much. There are issues. You can build hubs, small loops or you can actually move to processing plants, which is a no-go zone at this stage I think. Again, could you perhaps elaborate a little bit more about it? Does it make sense to pursue access into the processing plant for pressure movement, not necessarily basic processing, or to persist with actually building loops and hubs?

MR WILLETT: Well, we've suggested that recognising that processing facilities in effect provide a transportation service on occasion might be more efficient than requiring people to build pipelines to facilitate that trade. We have had some experience in Australia of those links being built. We also understand that the lack of that sort of transport service, has also impeded trades in gas to date. So we think there is a bit of an issue there. I would expect that eventually it would be resolved by building infrastructure even if that was inefficient but we're suggesting, well, perhaps a better approach would be to recognise that the processing facility provides transportation services and require them to switch if the consumer of the gas actually wants that switch to be made.

DR FOLIE: Do you envisage having separate, if you like, quasi-access arrangements for those loops because they have become actually critical parts - as the network gets more dense they'll become actually critical parts of the system enabling. back flows and reverse flows and all the other games that can be played.

MR WILLETT: I don't think we've got into that so much. We've just identified a bit of an issue that could be resolved very easily simply by requiring processing facilities to permit gas to flow down one pipeline when it's contracted to flow down another. That would seem to be easily done. It doesn't require an access regime. It's just a very specific obligation. It wouldn't seem to be associated with any costs unless there are particular constraints on the receiving pipeline but - - -

MR FOLIE: Okay, thanks.

MR HINTON: Is there anything else that you think you would like to emphasise, that we haven't covered this afternoon?

MR ANDERSON: One issue, if I may.

MR HINTON: Please.

MR ANDERSON: On a couple of occasions you mentioned the question of clarity and whether the current regime is providing clarity. I think it's a case that there are a couple of examples which are suggesting that the current regime is delivering a substantial degree of clarity. Firstly, in the construction of new pipelines it seems to us that the new developers have taken a fairly comfortable view of the coverage criteria and how coverage will apply to those pipelines in the future and, as a result, what we're seeing is pipelines being developed and the owners presumably taking a view that they can achieve a sufficient return of capital under the existing coverage criteria.

The second example, I guess, relates to the access arrangement process itself and, in looking at the reaction of the financial sector to the way the access arrangement process is working out, particularly looking at the ratings agencies and the work that Moody's has done recently, looking at transmission and distribution systems, it seems to us that the financial sector has taken a fair degree of comfort with the outcomes that are being achieved under the regulatory arrangement and which are expected going forward into the future.

MR HINTON: Warwick, thank you for those comments.

MR BUCKLEY: I think, Tony, we've agreed to take a number of things on notice and we'll prepare that additional information for you. I think we've covered a wide range of the issues and elaborated on the submission and certainly extended what I thought was going to be our allotted time, but I think that probably exhausts it.

MR WILLETT: I hope so. I apologise if I've been too long-winded, taking up too much time, but I certainly appreciate the opportunity to come along and explore these issues with you, and we'll provide that further information.

MR HINTON: Thank you again for your participation, for the last hour and a half or so has been very valuable for us - and your written submission as well - and your offer to follow up those other matters. We look forward to further contact with you. Thanks again.

MR WILLETT: Thank you.

MR HINTON: We'll take an afternoon break.

MR HINTON: Welcome back to this second session of our first session of public hearings in Sydney. I invite to the microphones the representatives of APPEA and, in accordance with established practice, I request you to identify yourselves, where you're from, for the purposes of the transcript, and to confirm that the sound system is working properly.

MR JONES: Chairman, I'm Barry Jones. I'm the executive director of the Australian Petroleum Production and Exploration Association, APPEA.

MR HAYDOCK: I'm Tony Haydock, director, energy policy and access to resources at APPEA.

MR MARTIN: I'm Colin Martin. I am APPEA's NG-PAC representative.

MR HINTON: Thank you very much for that. I now invite you to make an introductory statement that I understand you would like to do.

MR JONES: Thanks, Tony. APPEA represents the upstream gas producing industry, for this purpose, anyhow. One of the key elements of our industry is that we don't have a development, we don't have a project, we don't have a production unless we have a sales contract with customers, and having a sales contract with customers means that we do need a transmission system to get our gas from our production point to those customers. Access, therefore, to the transmission system is a fundamental issue to us, even though transmission pipelines and the distribution system is not part of our core business.

All of the upstream industry agree that there's a need for an effective and efficient access regime where there is a capacity for monopoly power to exist, and the stress is on the words "effective and efficient", "where there is monopoly power". Therefore we argue we want to retain the regime. We don't want to abolish it. The proposals that we and our members in their individual submissions are making to you focus on those words, enhancing the effectiveness and efficiency of the system. We don't necessarily want to see a wholesale rewriting of it.

We're also all agreed that an investment decision rarely gets made on a one-on-one basis. It's not very often that you can say an investment decision was caused by factor X and nothing else. Usually there's a whole range of factors which come into play in deciding what the final outcome of a decision would be. We would therefore urge you in your deliberations to look very carefully and very thoughtfully at any assertions that are made to you that the code was the sole factor for a particular outcome occurring in the system. In our view that is likely to be the very remote and unusual exception rather than the general rule.

That said, we believe that it is demonstrable that the whole process of gas

market reform, including the code, has led to a more dynamic and competitive upstream and downstream gas industry. We believe that it has led to greater diversification of supply sources and to greater consumer choice. Certainly a significant number of pipelines have been built with the code in place. We believe it's difficult, if not impossible, to demonstrate that the code has prevented any economic pipeline from being built. Where contracts have been signed with a critical mass of customers, construction has occurred.

However, we think that there are a number of cases where there is at least a prima facie set of evidence that can be made that monopoly power may at times have been used to deny access and, as such, we think a code is needed. When we say that we think there need to be a few changes made to improve the effectiveness and efficiency of the system, I repeat, we don't think a wholesale rewrite. We do think that some things need to be done to give more certainty to greenfield pipeline developers and their foundation customers and we see a degree of attraction in the recommendations which the Parer review has made in this regard.

We do think that some changes need to be made to entitle regulators to prescribe what information a pipeliner is to gather and to provide as part of an access arrangement. We do think that you should contemplate the idea of appeals rights against regulators' decision for users, as well as the service providers. We think there is a case for clarifying, simplifying, focusing the objectives of the code. We believe that the coverage test under the code is appropriate and we do believe that there are some improvements that can be made in the operation of NGA. Thank you.

MR HINTON: Barry, thank you very much for those comments and thank you for your participation today in this public hearing and for APPEA's involvement more generally. I also note your point that your members also are of course individually making submissions and of course there's a synergy there, and a link. I also note your comments that you're not pushing for wholesale changes to the Gas Access Regime. I also note that you nevertheless think that some improvements are possible but you also think you need a Gas Access Regime. So thank you for those broad-based directional type comments.

I have a couple of questions that I'd like to explore with you that come out of your comments this afternoon, as well as your submission. The first one is in relation to your reference to the Parer report and the references in that report to options, how better to handle greenfield investments and the suggestion of a regulatory holiday for 15 years, and that's shorthand that's in the document. You have expressed some unease with that formulation and think that that's too prescriptive. I'm a little puzzled by that in the sense that if that is too prescriptive, how would you change it? I think you refer to the possibility of a case-by-case approach. Can you give us some elaboration on what criteria might apply under that case-by-case approach, otherwise you'd end up with regulatory uncertainty in the

absence of criteria. That's behind my question. Can you give us a better feel for your thinking behind that statement about the 15-year period?

MR MARTIN: I guess our first statement in our submission was that in fact we endorsed the whole of regulatory adjustments or holidays for the whole - if all the criteria in recommendation 7.2 are picked up. Our concern is that picking an arbitrary number like 15 years is that it may not address all circumstances. For some pipelines, marketing development issues might be more appropriate for 10 years, other pipelines' marketing development may be 20 years or 25 years, and the statement was more to suggest that the pipeline developer gets a degree of flexibility of what to recommend about the regulatory holiday as opposed to and obviously entering into negotiations with the appropriate body as to why that's the appropriate holiday period. But certainly at the time the development decision was made, the holiday period would be agreed, so there's no uncertainty in making the development decision. It was more to give more flexibility to a pipeline developer to suggest an appropriate number of years as to which they would get a regulatory holiday from.

MR HINTON: So two points there, if I hear you correctly: (1) the period that would be applied would essentially be in the hands of the developer, not the regulator, and that the judgment about what period would be appropriate would be essentially one of getting appropriate return on the capital expended.

MR MARTIN: I think I said the period to be opposed would be in the hands of the developer and, whatever the regulatory body was that granted the holiday, there would be agreement between that body and the developer as to what the appropriate period was.

MR HINTON: The agreement between the developer and?

MR MARTIN: Whoever grants - whichever regulatory body grants a holiday.

MR HINTON: Okay.

DR FOLIE: I'm a bit puzzled. So effectively what you're saying is that it's up to the pipeline builder to propose. If he wants to have no holiday, he can have no holiday; if he wants 20 years, he puts his case and should get 20 years?

MR MARTIN: Correct.

DR FOLIE: It's not that the regulator should stop the pipeline if he wants 20 years and he should say, "No, I think it should be five years"?

MR MARTIN: Yes, correct, unless the 20 years was demonstrably unreasonable.

DR FOLIE: Okay. So it's clearly the right - just give that extra flexibility to the builder of the pipeline - the builder-owner, the source provider.

MR MARTIN: Correct.

MR HINTON: Thanks for that elaboration. My second area of questioning relates to the sort of coverage issues. If you were here earlier today with the discussion with the ACCC, there was a model put forward that had more than one category or type of regulatory structure. Instead of an on-off switch, you were covered and would be subject to a gas access regime. An alternative model is to have different regulatory frameworks for different segments of the sector. Some may be subject to monitoring, very light-handed supervision. Some of the other extreme might be subject to the sort of exercise we have today that applies once a pipeline gets covered. Do you think that that sort of model of differentiation across the sector as to the nature of regulatory intervention is viable, is worthwhile pursuing?

MR MARTIN: I guess, Tony, one of the issues is that there's already a great deal of debate around just the simple on-off switch coverage test, so either you are covered or you're not covered - - -

MR HINTON: Yes.

MR MARTIN: - - - and that's been fairly contentious and there's been a number of revocations to date and there's been some other revocations progressing and some attempted coverage which has not been covered. To move to a series - I think you described it with the ACCC, there's two buckets but what happens if you had four buckets or something like that. I guess the issue would be how practically would that process work and what criteria would apply to bucket 1 through to bucket 4. There's already a lot of debate around the existing four criteria and I guess conceptually I have difficulty understanding as to the differing criteria for differing buckets. That would be my first comment.

MR HINTON: If you have lack of clarity now, then having four buckets you might get even less clarity.

MR MARTIN: It would get more complex, for sure.

MR HINTON: I had in mind in raising it - this issue of the prime criterion being applied in this area is one of the presence of market power, and that presence can vary significantly from circumstance to circumstance, from company to company, and therefore if the criterion of coverage is based upon market power, then prima facie if that differs then maybe you'd want to have different intervention by differing degrees of market power. That's the logic behind the concept.

MR JONES: The logic, yes, I follow you, but basically you're making a judgment about the progress towards maturity of the market at any time. If we were sitting at one of the hubs of the United States with large numbers of buyers, sellers, massed pipeline networks, huge numbers of customers, you might have one set of criteria; if you're sitting as a customer at the end of the Amadeus Basin to Darwin pipeline, you may be in another circumstance.

Our argument to you would be that the Australian market is still relatively immature, that that degree of immaturity is going to change over time as we get more players at both ends of the system - well, we get more players at all three stages of the system - as we get more producers, we get more basin-on-basin competition, we get more networking of the transmission system and we get more customers at the distribution end of the chain, things are going to change, so your buckets would have to change over time as well, I think, to make sense.

I can appreciate the flexibility part of the argument but I think you would need to be, as Colin said, exceedingly clear as to what the rules were for each bucket and you'd have to have a mechanism in place for changing the buckets over time. We wouldn't want a set of rules to be put in place and then, as the maturity of the market progressed, the rules became inconsistent with the way the game was being played.

MR HINTON: The concept has with it a coverage judgment that puts you in a bucket. Instead of an on-off switch, there would be a four-bucket switch, but that decision once made, the regime applying to those in each bucket would be differentiated but would be known. For example, the softest end would be - they would be monitored as to their behaviour, for example, hypothetically. That would be a quite clear regulatory environment, as opposed to the last bucket, which would be the regime we have today, suitably modified in the light of these sorts of exchanges. That was behind my exploration, and it really touched on your comment about market power.

Your submission also refers to ring fencing and endorses the need for ring fencing to bring integrity to the nature of regulation. That implies that ring fencing provisions of the code are working. Is that reading too much into what you're saying?

MR MARTIN: I think that our position is that the ring fencing provisions of the code, yes, generally are working or have the - yes, are working, basically. There have been some complaints in various jurisdictions but in general, yes, the ring fencing provisions appear to be working..

MR HINTON: Is there any force to the argument that ring fencing by regulation in effect is reducing commercial options for how a company would structure its activities and that in itself, prima facie, could be closing off profitable activity. Isn't

that prima facie a criticism of ring fencing?

MR MARTIN: I guess it's a value judgment though: is the ring fencing needed to separate the monopoly elements of a business first as the contestable elements of a business and to allow greater competition to flourish than the risk that ring fencing may constrain the incumbent from doing something more profitably. So it's a balancing argument, I agree with you.

MR HINTON: So in effect you're saying that in circumstances where a certain activity is subject to regulation, that in itself could be a very powerful argument in the interests of the company to have ring fencing so that it can separate its activities away from that which is regulated and that which is not. Was that the argument?

MR MARTIN: It could be an advantage for the contestable elements of that business, yes.

DR FOLIE: A number of the end users in the submissions have put in their ideas about the nature of increased competition, but they put in the one they want: reform of the upstream gas market, and in fact I think even in Parer there's a response to that, but the point they make is that basin-to-basin competition that effectively we have at the moment is not as effective as if they could have separate marketing from each of those basins as well. What is the view on that?

MR JONES: I'll start and you can follow on. Our first observation on Parer would be that Parer wasn't charged to look at the upstream industry.

DR FOLIE: Nor are we.

MR JONES: It was a matter of some frustration to us in appearing before Warwick and his members because we could have meaningful discussions which couldn't appear in the end result. I think there were a lot of misconceptions about the upstream gas industry. I think there were a lot of policy positions which are formulated on the basis of where the industry may have been three, four, five or 10 years ago and which don't reflect what's happened in the intervening period or what's happening in the immediate past. One way of looking at the last 12 months we have watched, at least on the eastern seaboard, a rather scrappy, ungainly but entertaining market brawl between four basins about supplying gas to the eastern seaboard. If anyone thinks that wasn't competitive, I don't know what their definition of competition is.

Equally as much in Queensland, for example, we're watching now a quite competitive game going on between the prospect of importing gas, the role of the coal seam gas industry and the development options in Cooper Basin, and again if anyone thinks that that's not a competitive game, then I have a misapprehension of

what that word means. New players have come into the market, new producers have come into the market, new projects are under development, Minerva, Yolla, Casino, Thylocene, Geographe. Bass Strait is not a single producer situation any more. The dynamics of ownership in the Cooper Basin are fluid, as we speak. The OCA Origin Santos relationship has just changed.

The Delhi ownership is on the market. That whole relationship is in a dynamic stage. New pipelines have been built, new interlinkages have been made. It's no longer one pipeline into Sydney. For example, it's no longer one pipeline into Melbourne. It will, in the very short term, no longer be one pipeline into Adelaide. I think the whole nature of the eastern seaboard market has changed quite dramatically.

The second observation I'd make to you is that everyone who makes these assertions of course just assumes that Western Australia is sitting there on the other side of the continent and doesn't very much discuss the Western Australian market and the various nodes that exist there, be they the Woodside-led node, Rankine to Burrup at the top of the pipeline, BHP coming in at Griffin, the multiple producers that are feeding into the Varanus Hub and then into the pipeline, the entry of new producers into the Perth basin market and the possibility now of Gorgon Gas coming to shore. Again, anyone who thinks that there's no upstream competition - I don't understand what their definition of competition is. Admittedly, the Northern Territory is one supplier, one pipeline, but it's also largely one user, and even that may change as the dynamics of the Timor Sea develop over time.

MR HAYDOCK: I think, just to add to what Barry said, we don't want to be too critical of Parer in that a lot of contracts that relate to all these new developments were signed in the closing stages of his inquiry, which he wasn't to know about. There are something like 16 major new contracts with different gas ventures. There's a multiplicity of upstream players but essentially only three major downstream retailers in the market, so it's rather the other way around, shall I say.

DR FOLIE: I'd like to follow up on a more tangible one that is traditionally in the gas business, in both the west and the east coast. It's been 20 and 30-year blocks of gas that have effectively been sold into the marketplace with their annual off-take agreements. Do you see evolving, as exploration comes from those existing areas, coming up as five-year blocks - in other words, on top of those opportunistically as they get them, rather than actually characterised by always having the larger, longer-term ones, which would change the dynamics in the marketplace?

MR JONES: I think we're already seeing that. These 16 contracts which Mr Haydock referred to out of the 20, 25-year nature - some of the original contracts were the sorts of contracts which are being talked about for the Yolla development, for the Minerva development and Thylocene - again aren't of that sort of nature, so I

think already that degree of change is happening, and the next part is speculation, but we all do know that the longest contract does expire in the not too distant future, and the nature of the parties to that have all changed quite dramatically over time. Originally it was a very small, immature steel company that knew nothing about the oil and gas market, partnered with a very large multinational selling to a Victorian government - or to a government statutory corporation. When that contract changes or when that contract finally comes up, it's going to be an entirely different set of arrangements which are applying at both ends of the system.

MR HAYDOCK: I think, too, we could add to that that it should be noted that customers too have wanted long-term contracts to give them certainty.

DR FOLIE: It was really the nature of the market that's changing. In the United States you have one-year contracts, and it's really a part of the brief going back to Hilmer. It is actually a dynamic competitive gas market and you do need a number of shorter-term contracts that are likely to come in, so when prices are high - in other words, when there's shortages et cetera et cetera - it's a part of the evolution rather than actually the - the final one, which was touched on in the ACCC paper - there's an element of sensitivity - so it's probably easier to ask APPEA this question.

There can be some improved competition between flows between basins at this stage by using processing plants as a pressure hub, in other words, for redirecting flows rather than actually building around, but it's effectively a no-go zone at this stage. Is there an endemic attitude to this or is it effectively commercial negotiation - issues in the Cooper Basin could actually count flow in both directions - may be more efficient to use the processing plant as a redirector hub. At Longford they built a bypass around it. We have been asked the question and of course we're not covering processing plants but we've been asked that by an upstream - - -

MR HAYDOCK: So it's not a reference to access to processing plants per se?

DR FOLIE: No.

MR HAYDOCK: It's about directing the flows. I'm aware that the ACCC made this point in their submission but I'm afraid I haven't read it or grasped it as yet.

DR FOLIE: But it's come up to us when we've spoken to either pipeline owners - it floats around as an issue.

MR MARTIN: I think one of the issues to bear in mind here is that if gas - gas can either be sold on a delivered basis or on an ex-plant basis. If gas is sold ex-plant it may have one delivery point, it may have a number of delivery points. If there's for example two pipelines running away from a gas plant, it may have alternative delivery points or the commercial negotiation between the buyer and seller of the gas

at the time they wish to purchase the gas was they were happy to agree on one delivery point. I'm aware that of course Duke Hub has been built down in Gippsland, and there was the Origin bypass I think up in the Cooper. I would suggest that possibly - and I've got to say I'm not aware of the details - commercial negotiations failed to move delivery points and that that was, for the purchasers of the gas, a more economic solution to move gas to a different market than they could possibly negotiate, but I'm not aware of the details, so I guess we can't really comment on the appropriateness of the processing plants.

DR FOLIE: It was a broad position, not sort of in detail. Thanks.

MR HINTON: Your submission puts forward the view that the appeals process can be changed or should be changed to give equal opportunity to the user as well as the service provider, and you suggest that we should be looking at this. Can you elaborate on your thinking behind that idea? Where is the tension here in terms of the administration of the Gas Access Regime?

MR MARTIN: I guess one of the problems with the appeal process is that a user doesn't get the opportunity - on a regulatory decision, a user doesn't get the opportunity to actually become involved in an appeal or join an appeal until after the service provider has appealed, and I think it's constrained to only getting involved on the issues that the service provider actually appealed on. So if the users have a concern or a gripe, they are left out in the cold until such time as the service provider appealed. I guess in our view that's a bit asymmetrical and that we should be getting a situation where the regulator is trying not to - is encouraged to come up with a regulatory decision that meets the needs of both the service provider and the users, and if he does not, that either the service provider or the users have an appropriate appeal mechanism.. For the present time, users don't. It just seems asymmetrical to us.

MR HINTON: Can't the consultative process prior to a decision by the regulator address the interests of the user?

MR MARTIN: It allows the user to make representations, same as it allows the service provider to make representations, but that doesn't mean those representations will be taken on board.

MR HINTON: Yes, but there is an asymmetry there to start with, in that the service provider is a group of one and the user is one of either many potential or one of one action with potential.

MR MARTIN: Yes.

MR HINTON: So that the user is not representing anybody other than themselves.

MR MARTIN: Aren't the service providers only representing themselves? Tony, just to think about this, I think that for a user to appeal the regulatory decision, they would have to be - feel very aggrieved by the regulatory decision, because it's a purchasing gas - transporting gas may be part of their business, whereas - so it would have to, I think, be what they regarded as a very big problem in the decision to bother appealing it. But it's having that symmetry of appeal rights in the event it was what they viewed as a massive problem in the decision. So it's - - -

MR HINTON: What if there's circumstances where a delay is in the user's interest; doesn't that then lead to gaming of the regulator?

MR MARTIN: You could have a mechanism where the decision was implemented and with retrospective adjustment.

MR HINTON: Yes. Thanks. NGPAC, an important part of the Gas Code's superstructure and its administrative arrangements and institutional arrangements - I'd welcome your comments on how it's been operating and if possible its structure and its membership and whether you've got any views on possible refinements, though bearing in mind that Parer itself has also made suggestions about institutional changes in the overall area of regulations.

MR MARTIN: I think the first thing is that we have come out very much in support of the conceptual basis of NGPAC in that it gets the jurisdictions and stakeholders together in a formal process and formally discusses code changes and when a suggested code change goes to ministers, stakeholders' views are formally noted. So I think that it's a very good formal process; both service providers and users at both ends of the pipe get to be represented, and that's a very positive process within NGPAC.

It's true, it does make the meetings fairly unwieldy at times, because there are many people that turn up to the meetings, or I think there's 20-odd that is a full complement of NGPAC, which makes it a very complex meeting. I have to say the NGPAC has shown that it can progress code changes provided those code changes are not too controversial.. It has progressed a number of code changes very rapidly. In fact, I think Western Australia raised one early this year and it was progressed in a matter of two or three weeks. I mean, other code changes that I'd say are more of a policy nature have tended to stall with NGPAC.

I think that's for possibly a couple of reasons. One is that NGPAC is run on a shoestring. I think its budget is about $400,000 a year. So the secretariat does not have many resources available to them to actually almost develop recommendations or advice to the jurisdictions and for the jurisdictions to respond to and progress. It seems to be that the secretariat just isn't very well resourced to progress something as

significant as the regulation of billions of dollars' worth of gas infrastructure.

I guess my personal observation is that a lot of the time it really appears to be the stakeholders that are making the representations and having and pushing - having the debate without the jurisdictions really joining in.

MR JONES: Mr Chairman, I might take it from there. A consultative process of that nature works if all of the parties come to the table as equal in terms of their capacity to make decisions, to make input and to bind each other. What we're finding in NGPAC is that the industry representatives come along and they have already negotiated and got their mandate. They know what degree of flexibility they've got. They can actually, meaningfully negotiate and they can bind and make a decision. They don't have to then go back and go through another round of appeal.

All too often the jurisdictions send relatively junior officers who have got a written mandate on what they may do, with no degree of flexibility in it whatsoever, no capacity to negotiate, no knowledge to negotiate. I think those two things are separate. They're given written instructions, "You will stay on this," but even if they have flexibility, they really don't have the know-how of the industry and the subject that is being debated around the table to be able to make a meaningful input into the process. I guess what I'm saying to you is that over and above the secretariat not being appropriately financed and capable of making meaningful recommendations, the jurisdictions are not sending people who have a meaningful level of knowledge and the capacity to make a decision.

You need a relatively senior officer who has enough confidence to know that if he says yes, he can go back and his minister will be supportive of the decisions. A junior officer invariably is not in that situation, and that's a problem, because you have a negotiation of unequal parties: the industry half of the game is prepared to negotiate and come to a conclusion and the other half of the game says, "That's all very well, but we've got to go away and discuss," and then industry is not party to that discussion. You don't know whether your views are being accurately represented, or whether the understanding of what was on the table is actually being appropriately communicated.

I would make the other observation that we basically have three jurisdictions in this country who have a reasonable degree of knowledge of how the industry operates, and then we have a number of other jurisdictions in the country who know not very much at all. That doesn't help the process, either, when they all think that they are equal parties at the table.

MR HINTON: Thank you. Please go ahead.

MR HAYDOCK: You mentioned Parer's recommendations for successes to

NGPAC. I think APPEA would like to make the point that we see it a bit differently from Parer. He recommended that there be a body to recommend on code changes and it would be staffed by experts. We would make the case very strongly that if there is such a body there needs to be direct industry representation to provide the direct industry knowledge and expertise in code change proposals.

MR HINTON: Thanks for those comments, Tony - and yours, Barry - as well, further to Colin's. These issues have emerged in some other discussions with interested parties, but that has taken down a track normally of a push for not an absence of consultation with industry - on the contrary, all have endorsed that - it's a question of where the policy views get some sort of sharper focus and that by having a regulatory industry and a policy representation, you end up with nothing going forward, but if you had just a policy group that consulted regulators and consulted industry, that at least would provide a forum that might progress reform. Do you have any reactions to that formulation?

MR JONES: Policy made on the basis of ignorance is bad policy.

MR HINTON: But it was not in the absence of consultation - that is, there would be input from the regulator and industry in this formulation. I'm not putting it forward on the table as my proposal, I add, but that has come out of some of the other discussions with interested parties.

MR JONES: On the basis of past experience, Tony, bearing in mind that I didn't spend all of my life in an industry association, but in government, unless the nature of your consultation is dynamic and ongoing up until the moment when it goes into the minister - and, of course, at the end of the day the government sets the policy - we have always taken the view we will fight anything right up to that moment when it goes into the cabinet room, but when the government comes out and says, "This is the policy of the day, and we've decided - and we've heard your views and we've decided," then we get on with business and do our best with what we're left with.

My experience is that if you don't - particularly on technically complex subjects - have an ongoing dialogue that runs all the way through, that it's very easy for the policy-makers to mentally switch off - "Because we don't understand this, so if we don't understand it, well, we listen and click off." It's a problem, for example, which we have with safety administration all the time. Dealing with the safety regulators, we deal as equals. Once you progress one stage beyond those to the people who think they are the policy-makers, you get a glazed look because the intricacies of a safety case are way, way, way down the technical path.

To a large extent the code is in the same capacity. There are broad national policy objectives: you know, you want competitiveness, you want monopoly power constrained by social interests and things like that. They're broad national interests

and it's easy for a policy-maker relatively uninformed but with a good economics degree, like most of them think they have these days, to make those sorts of decisions. But when you come down to one stage below that: now, what does all of this mean? How am I going to make it work? You actually need people who understand the market, who can explain the market to the policy-maker and say, "Look, you know, that was a really courageous decision, but do you know it really means this?" "No, that's a really sensible decision." "Hey, listen, and can we do it this way instead?"

So I think we would be arguing for a much more dynamic - the more interface, the more players, the regulator, the industry and the decision-makers, right up to that last moment when it goes into the ministerial council or the single minister, the better. You get a better outcome.

MR HINTON: Thank you for those further comments. Michael?

MR FOLIE: No, I'm right, thanks.

MR HINTON: Is there anything that you would like to emphasise that we haven't covered in the public hearing this afternoon, that you'd like to particularly pick up?

MR JONES: No, thank you.

MR HINTON: Let me thank you again for your appearance today and your involvement in this inquiry - including your written submission - is appreciated. You bring a particular upstream perspective that's important, so thank you for that. That brings us to the conclusion of today's scheduled proceedings. However, as foreshadowed and in accordance with the Commission's established procedures, I now invite anyone else in the room, who would like to appear before the Commission to make a statement - they are now invited to do so, the only condition being that they come to a microphone and identify themselves for the formal transcript. But if there is no-one in the room who wishes to take up this wonderful invitation, I will adjourn proceedings and note that we will resume tomorrow here in this same location at 9 am. Thank you very much.

AT 4.47 PM THE INQUIRY WAS ADJOURNED UNTIL
FRIDAY, 19 SEPTEMBER 2003