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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 FRIDAY, 19 SEPTEMBER 2003, AT 9.04 AM

Continued from 18/9/03

MR HINTON: Good morning, everybody. Welcome to this last day of the hearings in Sydney for the Productivity Commission's inquiry into the Gas Access Regime. My name is Tony Hinton and I am the presiding commissioner for this inquiry. My fellow associate commission to my right is Michael Folie.

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

We have already talked to a range of individuals, companies and organisations with an interest in these issues. In addition, submissions have been coming into the inquiry following the release of an issues paper in July this year. We are grateful to the various individuals, companies and organisations who have already participated in this inquiry. The purposes 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 also welcome to comment on the issues raised in other submissions.

Hearings have already been held in Perth, Adelaide, Melbourne and Brisbane and, following the completion of this round of hearings, we'll be working towards concluding a draft report for release in mid-December this year and, following that, we will invite participation in another round of public hearings in February-March next year to discuss that draft report. 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's proceedings I will provide an opportunity for anyone who wishes to do so to make a brief presentation.

Participants are not required to take an oath but under the Productivity Commission Act they are required to be truthful in their remarks. The transcript will be made available to participants and will be available from the Commission's web site following the hearings. Copies may also be purchased using an order form available from staff here this morning. Submissions to this inquiry, of course, as many of you would know, are also available from the Commission's web site.

To comply with requirements in the Commonwealth occupational health and safety legislation, I draw the attention of all present to the fire exits with regard to this room. Out the back door, turn left or right. It is a ground floor room so the matters are very simple here. I understand this building uses the well-known beep-beep whoop-whoop system for evacuation. That completes the outlining of the requirements of OH and S matters.

It also completes my introductory remarks for this morning's hearings so I'd now like to welcome our first group to this morning's session, the representatives of APIA, the Australian Pipeline Industry Association.. Welcome, it's a pleasure to have you here. For the purposes of the transcript and to ensure the sound system is working, I'd like you to identify yourselves by name and who you represent, please.

MR BEASLEY: Yes, Allen Beasley, executive director of Australian Pipeline Industry Association.

MR MORTON: Euan Morton. I'm a principal and executive director of the Network Economics Consulting Group.

MR MacGILLIVRAY: Ian MacGillivray from Epic Energy.

MS DILL: I'm Julie Dill. I'm the managing director for Duke Energy International.

MR HINTON: Thank you very much for that. I'd now like to invite you to make an introductory statement for this session, after which we can move to an informal discussion period.

MR BEASLEY: Thank you, Mr Chairman. APIA welcomes the opportunity to provide this evidence to the commission hearing. The background to our submission is that it does provide a transmission-specific view in relation to the pipeline industry. It has been prepared by APIA's governing regulatory affairs committee with the assistance of NECG and in fact represents the outcome of a two-day seminar that was held to discuss the key issues that our industry faces and to discuss plausible solutions that can be brought forward. The submission is supported by all the major transmission pipeline companies, APT, Duke Energy, GasNet Australia, Epic Energy, Enertrade and CMS Gas Transmission.

At an overarching level APIA asserts that Australia's Gas Access Regime requires a major overhaul to rectify a wide range of unintended negative consequences for our gas transmission sector. APIA believes that errors in the design of the gas access regime and in its application have made the system unworkable for Australia's gas transmission sector. Now I'd like to turn in a little more detail into our submission.

We have spent a reasonable amount of time in our submission focusing on the state of play of the industry and the fact that gas demand is expected to grow at around 3.7 per cent per annum over the period to 2020. There will be a need for major expansions and new development. We've certainly identified in our submission a four billion investment need for this industry in the medium term and, of course, that brings major environmental supply competition and supply security benefits.

As have been outlined in other studies, our industry remains relatively immature, certainly by comparison with other overseas industries. The private sector dominates the transmission industry and that is a fairly recent development given the privatisation that took place during the 1990s. It is acknowledged that there is too much uncertainty surrounding pipeline development and it's clear, and I'm sure you heard this very clearly over recent days, there are a range of views on regulation impact across the gas delivery chain. The fact is that the transmission industry is in serial litigation with its regulators.

I'm not going to go through the brief of the PC because you covered that in your introductory comments but I did want to comment on the importance of the PC role. From our perspective it brings a fresh independent view of the industry and the role of regulation and that is most welcome. It relates to a current policy debate on a single national energy regulator where APIA asserts that the governments have been taking a highly simplistic approach where the concept with a single national regulator will encourage new investment. We believe that to be very simplistic in its approach.

The real issue, and this is the issue in front of the commission, is not the identity of the regulator but the directions given to the regulator in terms of transparency, accountability, predictability, certainty, professionalism and pragmatism in its approach. At an overarching level we would say that the PC recommendations must be very clear. The recommendations, as we understand, go into the Ministerial Council for Energy for deliberation and perhaps elsewhere, and we simply make the point that the scope for reinterpretation of the recommendations of the commission could in fact lead to even higher regulatory uncertainty and investor uncertainty. So our major plea is to be very clear on the recommendations that are made at that draft report stage.

There's clearly a genuine desire by governments to address some problems that have emerged with the regime and it goes without saying from this industry that we must avoid abuse, and I emphasise abuse, of monopoly power. Quite clearly there's a need to rectify significant deficiencies in the National Access Regime, to address concerns that access regulation can deter investment - a chilling effect that's been referred to by previous Productivity Commission reports - the need to enhance prospects for negotiated outcomes, streamline and improve the quality of economic regulation and of course to further increase the penetration of natural gas into markets.

Looking at the gas transmission sector itself, the submission emphasises that our investments are generally very large and that new investment is based on long-term foundation contracts. Our industry is highly reliant on a very small number of customers throughout Australia and in fact we did a survey of our major pipeline membership that ascertained across the major delivery chain 88 per cent of the gas throughput in Australia for those particular markets related to the top three customers and we also analysed four and five customers. So there's a large degree of market concentration at the customer level.

We generally have very informed customers who have considerable countervailing market power and, in fact, in this industry negotiated outcomes have been very normal and have occurred quite regularly throughout the period that the code has been implemented, and I might say most of those negotiated outcomes have been outside the code.

Our industry faces significant reserve depletion and bypass risks and I want to emphasise the point that new development in our industry is highly contestable, and bring to bear the examples of the SEA Gas pipeline, Enertrade's pipeline, Gove and Telfer where it is within the capabilities of customers to seek the expertise from the industry and develop their own independent projects, and that has occurred on a regular basis. Again, we would argue in spite of the code.

There are strong incentives in our industry, we believe, to meet the legitimate needs of customers and we argue in the submission that there's a need to roll back price control, as has been applied through the code, for the transmission sector with a much stronger focus on negotiated outcomes, and our submission sets out an argument that asserts that gas transmission pipelines in fact have less market power than airports - lower barriers to entry, for example - and that in fact determines that the regulatory approach should be no more onerous than that applied to airports.

Turning to the adverse impact of the Gas Code - and we summarise that in a number of points and I'll just run through them - the initial code was based on an all-in coverage approach and we continue to see that as being contrary to the intent of Part IIIA of the Trade Practices Act. There was in fact, when the code was developed, a presumption of coverage and we argue that unnecessary coverage has negative impact and imposes unnecessary costs on the industry. In fact, 17 systems have been revoked. Now, in various presentations there's a perception that this highlights success of the current regime. In fact, we think the fact that those pipelines have been removed from the code, at considerable cost to themselves, actually highlights a deficiency in the way the regime was designed in the first place.

Against that background of inappropriate coverage under the code, I think it's understandable from APIA's perspective that the transmission sector cannot support these minimum mandatory standards for pipelines that do not actually meet the coverage test. Such an approach includes no assessment of costs versus the benefits, and our submission argues for a less intrusive approach based on a behavioural code of conduct developed and adopted by the industry.

The second key point on the adverse impact of the code is the reluctance to treat each case on its merits. The one-size-fits-all in the submission sets out some case studies that demonstrate that point, and I might add that the building block approach and the interpretation of the capping model is obviously contentious with a regulator saying returns are generous and the industry saying that they're at the low end of the range. We have no particular quantitative material to bring today but that's clearly an issue for the future that is very relevant to the whole issue of perceived monopoly profits.

There have been unreasonable delays and expense in the process. The process is very information-intrusive. There is a presumption of guilt in terms of the issues the industry brings forward in an access arrangement with a process that's driven by, you know, counter-reports from consultants and it's apparent to us that that's merely to prove, to attempt to prove, that the service provider was incorrect in the material it brought forward, and we reject that proposition.

It's been very costly. Our estimation for the transmission sector is, in the first round of access arrangements $14 million has been expended. In addition, there have been litigation costs of $13 million to address certain issues relating to implementation of the code and the regime generally and regulatory bodies, we estimate, incur a cost of four to five million dollars per annum and that gives a total cost by our estimate of 35 to 45 million dollars for implementation in the first round of access arrangements.

I'll take us back for a couple of minutes to the entire objectives of the code as set out in the explanatory memorandum of the gas pipelines access bill, and I quote:

> The alternative to the access arrangement model is the negotiate and arbitrate model. Comparatively, the approval of an access arrangement will tend to create greater certainty for all parties and reduce the scope for and the number of disputes.

We would argue with the nature of litigation in this industry. That objective has not been achieved. Adverse impact of the code is discussed further in terms of regulatory creep, and we cite a number of case studies in our submission. The fact that derogations agreed to as a fundamental part of the code arrangements back in 1997 have been undermined, and I'm referring - or are potentially undermined by an approach that declares the Queensland Gas Access Regime a non-effective regime. In West Australia a state agreement, which related to the Goldfields gas transmission pipeline, appears to have been undermined by potential regulatory actions and, more generally, we see a move from regulators for proposals for even more information-intensive requirements to further their particular goals, so it's prescriptive, resource-intensive and it appears to be going further as time progresses. Our regulators appear to be trying to extract ever more information and, in our view, inappropriately.

I would like to focus on some of the adverse impacts of the Gas Code in relation to unintended consequences because I think it's the unintended consequences that have a big impact on national performance in the medium to long term. The first element is the code, and the adoption and implementation of the code actually encourages a one-size-fits-all service and, at a time when we're seeing convergence of energy markets and a desire by customers to have flexibility in their transportation arrangements we believe that has a significant negative impact because the codes simply occur - encourages a one-size-fits-all approach.

As an industry I think there's a risk that we're going to focus on managing the regulator rather than innovation and meeting customer needs. I think that's a key point we want to make. Market participants appear to be gaining the regulator, or run the risk of gaining the regulator instead of operating commercially. The chilling effect on investment has been well discussed and we do set out some case studies there. A reduced productive efficiency is an issue. APIA has, for a number of years, managed a research program aimed at reducing pipeline costs.

That research is a potential risk because of the nature of regulation and what it does to the incentives to invest in whole-of-industry research aimed at reducing pipeline costs and I simply want to emphasise the point that for Australia, in particular, given the distance between gas and markets and the thin nature of our customers - we desperately need lower cost, thin wall, high pressure pipelines, and that's an area where Australia has made remarkable inroads over the last decade and one which APIA believes is challenged into the future. Within the code itself there is a unique focus on efficient cost removal of so-called monopoly profit, and we argue that this conflicts with the pursuit of longer term economic efficiency in terms of investment, new services and productivity - for example, the research issue that I mentioned earlier.

Turning now very quickly to APIA's remedies in relation to the deficiencies we see with the code, the first and overarching one is an objects clause to give clear direction on how regulatory discretion is to be exercised to enhance regulator accountability, ameliorate regulatory risk, and we make the point that that objects clause must have substantive status. We see a strong linkage under the current regulatory regime to the continued effective access to merit appeal rights, and we go into wording - and I'm not going to go through the actual wording of our recommendations; just the principles that are behind them.

Turning to coverage, we see this as another important area where there are strong arguments to improve the Gas Access Regime to strengthen the coverage criteria. At a time when competition is growing between pipelines - and our submission sets out some of the results of that in terms of the Eastern Gas Pipeline and its impact upon a competing pipeline in the Moomba to Sydney pipeline, where tariffs have been reduced - the price effect in the market is very apparent. We're seeing integration and convergence of some markets, and I think that is especially true in the south-east Australian market, where we're going to see a range of innovative services and requirements emerge over the next few years, and of course there are some user pipelines and other pipelines where commercial negotiation has been very effective in achieving outcomes.

Coverage needs to be considered in the context of an appropriate market test and we believe it should not be invoked where downstream benefits are doubtful or are indeed speculative. In that context we suggest that the NCC should be obliged in its reasons to outline the mechanism by which competition would actually be enhanced in another market. We have considered the issue of substantial versus material and simply make the point that "substantial" has a well-known meaning under Part IV of the Trade Practices Act and we believe that wording should be adopted because it reduces the scope of protracted litigation.

We believe - again in terms of this test - that it is desirable to replace "promote" by "achieve" or "be more likely than not to achieve" because "promote" could actually undermine the intent of "substantial". There has to be a demonstrated effect and it has to be stronger than mere facilitation in that market. On a general point, we believe NCC has misapplied Ordover and Mears work and we discuss that in the submission itself.

Section 19B, the uneconomic-to-develop test: we believe there are problems with that test, in practice, and that the substitution of the word "pipeline" for "facility" has led to unfortunate and, we believe, unintended consequences. In practice in the Australian market, a range of substitute services are available in competition with gas transmission services, electricity transmission, swap contracts and storage are options that are mentioned in our submission. The real test is whether the facilities are a bottleneck to competition - that's certainly our view - and in fact the current application of that test leads to a nonsensical result that two parallel competing pipelines would still leave criterion B being satisfied. We believe that was not the intent of Part IIIA, nor do we believe that it should be the intent of the Gas Access Regime, which is modelled on Part IIIA of the Trade Practices Act.

We believe that the national significance test should be reinstated in the Gas Access Regime and we have reached that conclusion because of the history of the code, including revocation applications that it would be appropriate to ensure that smaller pipelines - which are often single-customer pipelines - have access to efficient, first-class filters to avoid the costly regulatory processes being applied. Just to put that into some perspective, the Parmelia pipeline, which should never have been regulated, and the regulatory processes they went through cost $600,000 up to the point of revocation, a cost that should never have been imposed. We believe it would be a considerable improvement if only bona fide access seekers were to apply for coverage and that it should be limited to situations where access has been sought and not provided or has been unreasonably delayed.

I just want to emphasise the importance with the regime as it stands today where a regulator is effectively an arbitrator - the ongoing access to merits review - and we set out in our submission the benefits of that in terms of accuracy and adjudication, reducing regulatory risk, promotion of confidence in the regime and, indeed, consistency with Australian competition policy. I raise that point simply because during the development of the code jurisdictions remove that merit appeal right and industry service providers had to lobby extremely hard to have it reinstated because, at the end of the day, it was our only protection against inappropriate application of a regulatory regime which impacted on legitimate business rights. I just wanted to make that point and it's a point we will be making very strongly in the policy process relating to the Ministerial Council on Energy.

We set out in our submission arguments in favour of a voluntary industry code of conduct because we believe it's important to avoid regulation of transmission pipelines not meeting the coverage test. We will always relate this issue back to the coverage test because that is the appropriate criterion to apply and we believe it's important to facilitate commercially-negotiated outcomes and there is in fact growing experience with such principles - for example, in the case of Duke Energy International's non-discriminatory principles that have been in practice now for several years.

We believe the key requirements of such arrangements are a commitment to open access, ring fencing of operations and particularly in respect of confidential information; relevant information to be made available to the market and the offering of capacity trading. We have set out in our submission a number of principles for a draft voluntary code of conduct, which I am not going to go into in detail because they are in the submission. We have not taken that particular initiative any further, but if it's of interest it's an area we would look at in a little more detail over the coming months.

Turning now to covered pipelines, and I preface all these comments in the context of market power and the fact that our pipelines have only a very small number of customers, it's very important to recognise the primacy of commercial negotiation in securing outcomes. It's very important to recognise the importance of ring fencing. We argue very strongly in the submission that there is a need to move to a negotiate/arbitrate model and, relative to the current arrangements, we believe that will be achieved at a fraction of the time and a fraction of the cost if in fact the arbitration clause is necessary. As set out elsewhere in the submission we also argue that there are very strong incentives for pipeline customers to meet the legitimate access terms of their customers.

We believe there needs to be guidance to that arbitration process and in our submission we clearly argue for commercial arbitration as being the most efficient way forward, and that guidance includes the objects of the code, the fact that it not be below foundation customer price for the same service. It should pay reference to other negotiated contracts, incorporate the principle of financial capital maintenance, the concept of workably competitive markets in clause 64(1) of the Competition Principles Agreement. Such arrangements could encompass both current and developable capacity but, as with the co-principle, we would envisage that an asset owner cannot be forced to invest himself or herself in expanding capacity.

Finally I just want to touch very briefly on access holidays because it has been a very popular theme in a range of reports over the last couple of years. We think it's very important that access holidays does not mask the need for fundamental reform in the Gas Access Regime itself, point number 1. We think it needs to be implemented in a manner that does not undermine investment. It should not distort - and I think there is a real risk that it distorts - expansion of existing systems compared to building new pipelines and that is clearly an issue, and our submission discusses a relevant case study, albeit not in the transmission pipeline sector but, fundamentally, there's still the uncertainty of what happens after the holiday. Unless those parameters are set up-front there's considerable uncertainty after the holiday is over - sorry, "regulation pre-period" - I prefer that to "holiday". There is also, subsequent to the regulatory free period, the issue of how the earnings during that period will in fact be treated after the event.

On balance, our membership came to the view that there is some merit in the principle of regulation-free periods, but it is not a panacea. We believe it is a suboptimal solution compared to a robust objects clause, strength and coverage criteria and introduction of a true negotiated arbitrated framework. If it is applied we believe that the following features are essential and should be automatic for all new greenfield pipelines. We had a considerable discussion over the period of such arrangements and concluded that a fixed period of 20 years would be necessary. After 20 years the pipeline should remain unregulated, but subject to coverage applications and that fundamentally, the principle that future regulations in such situations, if they were to be applied, must not penalise the pipeline for profits earned if they do in fact emerge over the access holiday period. So with those comments, that's an overview of our submission and I'm quite happy to take questions.

MR HINTON: Thank you very much for those comments, Allen. Also, I'd like to record our appreciation for APIA's very substantive written submission. It's a very detailed document that goes to, at some length, the range of issues that's before the inquiry, so thank you very much for that. I also acknowledge the significant contributions, of course, from APIA's membership - some key market players whose views are very welcome to this inquiry. Thank you for that.

I've got a number of questions, of course, but where to start is always a challenge. Let me start off with the investment issue. It's been put to us from a number of sectors, or a number of interested parties is a better expression, that the code itself is not impacting upon investment adversely; that the numbers with regard to new investment, construction over the last seven years of the period of the code, prima facie suggest that investment continues to be quite healthy and that this regulatory environment that we're operating under in fact could even be facilitating investment, let alone inhibiting investment.

Secondly, those same parties are in a group that would express the view that when confronted with the view, or the question, show us where the code is actually - or the Gas Access Regime is inhibiting investment. They are of the view that responses to that question have been less than fulsome in response, the argument being "Put your money where your mouth is," so to speak, "show us substantiation of the view that the Gas Access Regime is inhibiting investment." In your introductory remarks, Allen, you referred to case studies, but I'd welcome for this morning some discussion of this debate about: what is the counterfactual here with regard to the investment performance for this sector?

MR BEASLEY: I think it's important to recognise - and we set this out very clearly in our submission - that the vast range of pipelines that regulators refer to as evidence of the success of the regime are not in fact regulated under the regime at all. However, experience has shown that certain of those pipelines have been threatened by regulation of the regime, so naturally that has been a key issue - the risk of regulation under the regime in the same way that at any time there's a risk of inappropriate application of pricing arrangements to pipelines through an act of - you know, change of policy for example.

We simply make the point that the - and we set this out very clearly - the investment that has taken place, whether we look at the eastern Gas Pipeline, the SEA Gas pipeline, major expansions of the Roma-Brisbane pipeline, have taken place totally outside the framework of the code. I think where this issue becomes a point of major contention is where regulators and others say that it has facilitated new investment. The fact is that that investment has taken place totally outside the framework of the code, but those same investments are still at risk under the code, if it were to be applied.

In fact, on this issue of "prove that a project hasn't gone ahead", I set out, in a response to the Energy Market Review last year, the fact that there is a range of parameters that clearly impact on whether or not projects go ahead - and a lot of them are commercial - but simply make the point that when you weigh up all those commercial risks and the development risks and superimpose a regulatory risk, there is a major - we believe - probability that it's the straw that breaks the camel's back in terms of bringing forward efficient pipeline development that meets those longer-term markets.

In our submission we do set out one circumstance that we believe is very clearly indicative of the fact that the regulatory risk has impacted on development, and that's the Dampier-Bunbury pipeline, where because of the application of a draft decision by the regulator and then the final decision by the regulator, the pipeline owner has been unable to expand capacity to meet the needs of prospective customers. We set that out in our submission.

MR HINTON: We will come back a step to your comment that the developments that have occurred have been outside the code. If they are occurring while the code has been in existence, the fact that it's outside the code could be seen as a plus for the regime, not a negative - that is, it means the design of the code is not inappropriate at least; that these investments have gone ahead because the code hasn't impeded it. So I am a little unclear as to your argument as to why that shows then therefore the code is appropriate in circumstances where these investments have gone ahead outside the code.

MR BEASLEY: I think the only - they are "what if" scenarios because you can never compare what would happen under an alternative scenario, but I think the evidence you take from that Energy Market Review were the very clear statements that CEOs made in relation to their intents had the code applied. I'm quite happy to provide those comments to you, if you haven't seen them. I haven't got them with me, but there was a very clear stated intention of the very developers of those major pipelines that they would not invest under the strictures of the code.

DR FOLIE: Yes, I think it's actually quite an important point - to labour it a bit - because it is the one that always comes up, so it's worth probably developing. The group that says the code is working really says these developments have been able to go ahead, even though you've got a code that you mightn't like - the code is still flexible enough at this stage to enable these other - in other words, the real regime doesn't enable other greenfields newer pipeline developments to have taken place, and yes, certainly I can imagine the people who are then developing - the corporation developing that would say, "We're nervous of the code. Basically we believe we have constructed an environment where we can build this pipeline. We meet all the strictures associated with the code environment, and the code - we can do it without having the code." This is where the argument goes backwards and forwards. I think it's more than just saying, "You know, we don't like the code." They have built, and they have been able to do it within the code regime.

MR BEASLEY: It is more than that - - -

DR FOLIE: I think we'd like a - - -

MR BEASLEY: Yes, there are also stated intentions of what those same players would or would not do if the code, as a matter of all-in coverage, had applied. Again, you can't prove one way or another that that would or would not go ahead. I think the point is, as we set out in the submission, at the very least the code creates an incentive to size pipelines to current markets.

MR HINTON: I would like to get on to that in a minute. But aren't we talking, in effect, that general issue that if you look at the ACCC's written submission to us, you will see a view expressed that there is no grounds to reach a conclusion that the Gas Access Regime is inhibiting investment; look at these numbers in aggregate that show how the size of the sector has expanded, and then others go on to say, when the industry has been asked to show examples where it hasn't inhibited investment, the industry has been unable to come up with any substantive response. That's the framework we're operating under.

MR BEASLEY: All I can say is that that development has taken place in response to commercial pressures and contracts, and that gets back to the key point I made about the performance of those negotiated arrangements in establishing pipelines. Of course, the industry will always seek to meet the needs of its particular potential customers.

MR HINTON: Julie, did you want to say something?

MS DILL: Since I am managing director for one of those pipelines that built - or one of the companies that has built one of the pipelines which was specifically referred to, I'd just like to give you my view on that. When Duke Energy came to Australia to invest, our initial investment was up in Queensland and we did purchase a pipeline that was covered, but it was a special tariff arrangement, so it's not under the code - the Gas Code wasn't in place at the time. But we came here with the idea and the understanding that there would be a light-handed regime, a light-handed regulatory regime. Consequently that gave us an incentive to continue to invest in Australia.

The Eastern Gas Pipeline was developed as part of a purchase of some BHP assets. We acquired the right to build the Eastern Gas Pipeline, and so that decision was made at the corporation level with the understanding of this light-handed regulation for market forces at work, and it is actually the first time that a competitive pipeline came into Australia. So that was the dynamic and that was the incentive for us - to introduce competition into the market that didn't previously have competition. The Gas Code was just coming into play at that time and so we were already well down the path of investing into that Eastern Gas Pipeline, so the point there being it's probably not a fair assertion to say that the code has encouraged investment. The code was just coming into place; the investment decision had already been made.

One of the points we've made in our submission is that we believe that the coverage test should be strengthened. Part of that means that if there is not a - to be able to lodge an application for coverage on any pipeline it should be a bona fide access seeker. That didn't happen for us. When we completed the Eastern Gas Pipeline, just someone that had no interest in the pipeline lodged an application that we were forced to defend against, and it cost us an awful lot of money. I've heard ranges of - it was before I arrived out here but I've heard ranges of anywhere from a million to $3 million that it cost us to defend the competitive nature of this pipeline which ultimately, going all the way through to the competition tribunal, we found that it was indeed a competitive pipeline.

The perverse logic here is now that the Moomba to Sydney pipeline has filed an application that says, "Well, the Eastern Gas Pipeline is not covered because it competes with the Moomba to Sydney pipeline, so we'd like to be uncovered as well." What has happened is that they've come back and told the Australian Pipeline Trust, "Well, while Eastern Gas Pipeline competes with you, you don't compete with them, so the coverage remains." Intuitively that makes no sense to me. Consequently what may happen is that if they do remain covered, their tariffs may actually be lowered further than they currently are, and the reality is when Eastern Gas Pipeline came in, even though the Australian Pipeline Trust had the ability to charge a higher tariff, they lowered their rates to be competitive with us, so the market dynamics were already working and in place.

If they don't have the option to become uncovered and their tariff will actually be reset and we understand it would be reset at a much lower rate - now, I'm going to be having to compete with a regulated tariff that makes absolutely no sense in the marketplace and I'll have a very uneconomical and potentially a stranded asset because it won't make any sense for us to run this. As a result of that, I made a statement last year at an ACCC conference that Duke Energy will not make any further pipeline investment in Australia until the code gets rectified, until these issues with the regulations get changed. I can tell you very specifically - unfortunately our colleagues at Epic are looking to have to divest because of the issue they have with the regulator and their parents, their shareholders, are not willing to necessarily continue in this environment.

While there are other pipeline companies that may be lining up to buy those assets, we will not. As strategic as some of those pipelines might be - maybe not out in the west for us, but up in the Queensland area - not a chance that Duke Energy is going to play in that field. There's a lot of investment going on in - looking at the growth in the gas business in the Northern Territory. APIA just had their conference there; lots of discussion, really excited about all the opportunity there. Duke Energy will not participate in that because I am unwilling to take to our shareholders an investment that could be potentially be impaired.

We've got over a billion dollars invested in pipeline assets in the country. Again that was all bought with the idea that it would be light-handed regulation and it hasn't, and so I'm not leaving - we continue to be able to operate with the code of conduct that Allen referred to - but even though I am currently able to run the Eastern Gas Pipeline as an unregulated asset, I still run the risk that someone else can come in and ask to have coverage applied again, and I would have to go through the same defence all over again. It is a deterrent to investment. I'm living proof.

MR HINTON: Thank you very much for those comments, Julie. But one of your comments I'm particularly interested in for the record: you said that at that ACCC conference you went on public record to say that in this regulatory environment Duke would not be investing. Can you send me the transcript of that, or the actual text of what you said, as part of a submission that goes on our web site?

MS DILL: Absolutely. I want to say that it was just a little over a year ago and I'm certain there was a transcript there, but I made a presentation.

MR BEASLEY: It may not have been that exact quote, but it was a very similar one - when I conveyed the letter to the Energy Market Review on the intention of pipelines company. That was a very clear intent I stated in that letter.

MS DILL: Yes.

MR BEASLEY: But there are a number of pipeline companies that - - -

MR HINTON: The reason we're putting so much weight on this is because it's an explicit part of our terms of reference, as I said in my introductory remarks, and secondly, significant interested parties are making statements in direct conflict with that view. We need, as an inquiry process, to come to grips with some sort of judgment assessment about those conflicting positions.

MS DILL: We'll be happy to find that transcript and I ask - - -

MR BEASLEY: In fact, I can read that quote into the record, because it was in the letter to Warwick Parer dated 26 September:

> Regulation of access to gas pipelines in Australia has been implemented in a manner inconsistent with the light-handed approach originally envisaged by policy-makers. This implementation potentially imposes significant costs for the economy in the form of lost investments. Duke Energy International will not invest in any further pipeline developments in Australia until regulatory certainty is achieved. Julie Dill, ACCC conference 26 July 2002.

MR HINTON: Perhaps the best way to proceed is to put that letter into a sort of addendum to your submission - - -

MR BEASLEY: An addendum to the submission.

MR HINTON: Thank you, Allen. Thank you, Julie.

MS DILL: You're very welcome.

MR BEASLEY: Can I just build on this point, because I think it's important, this progressive tightening of the regulatory regime. It's true a code of some form was mooted in the early 1990s, and in fact there was development of an industry code of practice agreed by APIA, APPEA, AGA and I believe the Commonwealth government was - well, I know the Commonwealth government was involved, because I was on that side of the table at that time. I think that was around early 1994, but I may have to revisit that. So that was the first step. The next step was actually a series of sale processes, and if you look at the sale bill and the explanatory memorandum for the sale of the Moomba-Adelaide pipeline, it was clearly articulated on the basis of a negotiate/arbitrate model and in fact said it had the concurrence of the Trade Practices Commission at the time.

Similarly, a little earlier, the Commonwealth sold the Moomba-Sydney pipeline, again on a negotiate/arbitrate model. It was really not until the mid-1990s that the intent of a code crystallised. Even then, it was promoted to the industry as something that was light-handed. In fact, when the legislation was introduced into South Australia in 1997 it indicated the clear intent to preserve, in a commercial negotiation, as a desirable outcome in that code. So I would like to set out, in addition to this material, the chronology of development of the code, simply to make the point that the investments that are made that are now referred to as success stories relating to the code, when you relate it back to the investment decision, it related to a very different operating framework. So I would certainly like to have the opportunity to set that out.

MR HINTON: Presumably lead times are an important factor here as well, as to when the investment decisions were being made.

MR BEASLEY: Yes.

MS DILL: Absolutely.

MR BEASLEY: It's the lead time that is the critical factor.

MR HINTON: Earlier in our discussion, I think I cut you off, Allen, about the implication or the possible adverse impact of the regime on expansion of existing pipeline capacity. It has also been put by some others to us that constructing to known demand as opposed to adding in some possible surplus capacity is a flow-on effect of the regulatory regime. So that the builder, the investor, seeks to avoid regulatory risk associated directly with the surplus capacity of the newly-constructed pipeline. Is that what you were going to say? Was that the comments I stopped?

MR BEASLEY: That was the next point, but before we go there were there any - because this point about the code and investment is such a critical one, clearly to your consideration, are there any other key points that any other - - -

MR MacGILLIVRAY: I'd like to make a couple of points in relation to at least Epic Energy as an investor in pipelines, and the owners of Epic Energy certainly share Julie's view of life at the moment, perhaps not as strong to the extent that they would be prepared to invest, but I know from immediate experience that the hurdle for investment, at least within my group, has increased. Regulatory risk is treated now as a new overlay on the risk regimes, which are faced within the company. Indeed, and I guess we are about to talk about that now, when we embark on a project and view a project we basically build that project, or seek to build that project, specifically to the foundation market.

At no stage now do we look to build in any additional capacity in any particular project for fear that particular capacity will become captive to the regulatory process and most-favoured nation clauses in the foundation contracts would drive down the overall investment. So both in terms of new investment, new greenfields investments and expansions, certainly Epic Energy would not now build a new pipeline or expand an existing pipeline for one jot more capacity than the market acquires at that immediate time. So while we don't have dead bodies in relation to investment projects that we can demonstrate are lying stranded in the outback somewhere, it is certainly true that in a practical sense investment is being hindered.

I guess the project that we have been watching closely over time, which is the SEA Gas pipeline, wasn't built by pipeline operators at all. It was built by a customer consortium who were unable to source gas from producers at an appropriate price and had no option other than to build a gas pipeline to deliver that gas to the market. It wasn't a matter associated with gas transmission tariffs. So yes, I think it's a difficult question for you to put to us, to show us projects that have failed, because there are a myriad of issues which would relate to whether a particular project is commercial or not, and the gas transportation element is only a relatively small element in some cases, but from practical experience the investment environment has deteriorated.

MR HINTON: Thanks, Ian.

DR FOLIE: I think though, the interesting element about capacity - in fact we were given an expose on this matter yesterday from the ACCC, and it went through actually using the example of the SEA Gas pipeline where it has been built to a certain capacity at this stage of the game. However, by adding more compressors, et cetera, that's lower, you can effectively almost double the capacity of that pipeline. So the notion about, in other words, initial fill capacity, yes, but at fairly low incremental costs you can, you know - 50 per cent will double the pipeline.

MR BEASLEY: I think the analysis we present in our submission is somewhat different, because it discusses the consequences of an approach that sizes the diameter to initial markets and then adds compression to a situation where you scale for your longer-term markets with the initial capacity of the pipeline, and you do get an answer that suggests that it's more efficient on a cost basis to scale that pipeline initially to meet those future demands. But the point on SEA Gas is probably irrelevant - - -

DR FOLIE: I was just using that as an example though - - -

MR BEASLEY: Simply because, you know, that is a project that was developed in full knowledge of a regulatory regime where a pipeline can - at the very least a pipeline competing into an existing market would be very, very unlikely to be covered.

MR MORTON: That is actually a very important point, because it seems a very odd justification for a regulatory apparatus. To suggest that it doesn't apply to anything new is a strength. When you think about the economic decisions it's affecting, which is new investments, the justification is - or the point you made that it's a strength that it doesn't apply to new investments seems very odd, when in fact its only application is to an existing stock of investment - an existing stock of sunken, irreversible investment. So simply put, the point that you made that it's a strength of the code that it doesn't apply to these new investments, when you think about the economics and the economic efficiency being driven by the fact that new investment is fundamental to the pursuit of economic efficiency in the long run. I mean, that is the most important issue of the lot, I would suggest, in terms of the dynamic efficiencies. Arguing that a strength of the code is that it doesn't apply to those new investments raises very, very fundamental issues about whether or not it should be applying at all to existing investments, when you think about the economic decisions it is affecting.

MR HINTON: Let's look at the term "efficient investment", because it gets bandied around a bit. I would be interested in your comments on whether there's an asymmetry between underinvestment and overinvestment in terms of which is the bigger cost to the welfare. If the code is discouraging investment the argument is that therefore we end up with a system with less investment than ideal. Others argue that in fact there is a risk that you can have overinvestment that also has costs in terms of the concept of efficient investment. Is there an asymmetry with regard to the costs of over and underinvestment? Is it more costly, welfarewise, to have underinvestment relative to overinvestment? Do you have a view on that?

MR MORTON: I think that's very straightforward actually, because if you think about the entirety of the social surplus that is in peril by underinvestment I think the decision is very straightforward, because we're not talking about a marginal issue. First of all, it is not at all clear to me that when people talk about overinvestment, what would be driving that overinvestment, because fundamentally we're talking about a contestable industry. The only issue would be that an investment would be brought forward in time. That would be the only issue. Because of the contestability of the environment the investment would be brought forward in time through that competitive process. Putting that to one side, I think it's very, very straightforward, and the point was made very well in your Part IIIA review, that the - - -

MR HINTON: It wasn't a Dorothy Dix question.

MR MORTON: The jeopardising of the entirety of the social surplus from natural gas that occurs through that process will easily overwhelm any costs associated with overinvestment, recognising that when you think about it in a contestable way that cost of overinvestment is bringing forward investment in time.

MR HINTON: Let's move on, but thank you for those substantive comments on the investment issue - - -

DR FOLIE: I've just got one that is related, if you like, philosophically, before we get into the other ones. It's something that doesn't seem to get addressed. It's, if you like, the operation of the existing network, framework that we've actually got. To what extent is the code, and of course the pipeline/distribution system is only one element. You've got then the end users, the retailers and you've got the upstream side. But effectively, looking at the network as it is, what impact does the code have on the ability then for, if you like, basically innovative trading, in other words capacity-swapping, being able to actually develop new financial contracts? You might be able to say to customers, "Swap out gas for electricity." In other words, a lot of the innovative things, which I believe most of the North American companies certainly came to Australia - if you like, I'll use the word, the Enron-type innovation. I know it has been discredited, what they did, but effectively there is a move in the energy markets in that direction. To what extent does the code and all the tariff regulation actually inhibit the development of that sort of a market? I would just like a general sort of feeling about that area.

MR BEASLEY: Let me make a general introductory statement. I mean, with the physical integration of, for example, the south-east Australian energy market, we believe there will be a need for a range of newer and innovative services to meet the needs of customers. In addition to the issue of capacity trading the principle that there will be a need for new services and new service offerings I think is probably the most fundamental need to kick start those sorts of arrangements. You already have evidence I believe, in the case of Duke, and Julie might want to add to this, of a pipeline that is not regulated under the Gas Access Code coming up with a whole suite - and I think we set it out in the submissions - a whole suite of new products and service offerings. We referenced I think seven in the submission, something of that order, and that sort of innovation is clearly going to be needed as we move ahead, including in relation to new product services, new customer requirements and some general convergence on gas and electricity issues for example.

At the same time, if you look at the code, it takes you down, philosophically, a very different path. It's a path that says, "We're essentially here to defend a plain vanilla service and that's what we're going to put our effort into." So actually, productively, it takes your eye off the ball in terms of - runs a major risk of taking your eye off the ball, in a responsive sense, to meet your customer needs, because you're always looking at, "What does this mean for my reference services and my relationship with the regulator?" as opposed to going out and being innovative in the market to actually meet the needs of customer services. I know, Duke, in your case you've got something like 15 contracts relating to a range of new product offerings.

DR FOLIE: But do they relate to the more innovative - in other words, rather than just the normal traditional sort of tariff sitting, are they actually related - I'm asking specifically, because you've got pure pipeliners on the panel, whereas a lot of other people are actually half-integrated and separated, so it's really trying to get to the role of pipeliners into this. To what extent would then those sorts of financial contracts - once they get going a lot of them will start moving around. Would the regulator be involved with that - having to go to the regulator and explain what you're doing with futures contracts, et cetera? I'm really trying to get a flavour as to - is the code in any way impeding this sort of development of the sort of operational markets - a broad, general question.

MS DILL: I guess speaking for our experience on the Eastern Gas Pipeline and with the new Vic hub facility that we've put in place that connects our system with the GasNet system, I have a group of folks that work in a gas supply area that continually come up with new products and services that they can offer into the marketplace - things like a park and lend, the back hauls from forward hauls; different ideas, different bundled services as well that we do not believe that we would even attempt in a regulated environment, because it would become increasingly onerous for us to have to try to explain what it is that we're trying to do, how does it fit in with the tariffs that have been established, and it doesn't ultimately help the customer or facilitate the flow of gas from market to market without the ability to be able to try to do something that's more innovative.

I'm a bit sensitive to the Enron relationship, but that falls within the legal, moral, ethical bounds that we abide by at all times. But we do have a focus on the customer, to try to figure out how can we best serve them and, at the same time, it's an absolute requirement for us to try to become as innovative as possible because we have to remain as competitive as possible. I have a pipeline that has spare capacity on it, so the market drivers for me are incredibly important. So I have to be able to be out there and entice new customers to come and move volumes on the pipeline because I have spare capacity. I have a sunk cost in a pipeline; I've got to earn a return for my shareholders.

As a greenfield pipeline you always know that your returns will ramp up over time, but it's incredibly important for us to continue to add volumes onto that pipeline. We do believe the code would be restrictive in those alternatives, to be able to provide those services to the customers we currently provide that to.

MR MacGILLIVRAY: The practical issue for a covered pipeline in relation to those innovative services is the operator party who has invested in the pipeline would be always anxious that any additional revenues, for instance, that came from that innovation weren't turned into the regulated revenues and therefore it has a negative impact on the overall investment. That might be where you're coming from.

MR BEASLEY: It seems to be an exercise where you'd put your focus on defending your reference services and there'd be that natural gravitation towards your reference service for those regulated pipes - - -

DR FOLIE: Ian's response, if I can understand it, is therefore the code as it's being regulated - not in this building block basis - if you're covered, would then actually stifle innovation of those.

MR MacGILLIVRAY: The cost of service approach which drives an allowable revenue notion is potentially inhibitive because any services, for instance, could either be captured as the reference service that would be obliged, and therefore those allowed revenues would be also capped and impacting on your original investment, or just generally the issue of, well, what is the allowable revenue and at the next reset will that be captured and taken from you?

MR HINTON: Let's move on to the area of coverage, and there's a whole range of questions that emerge here. It's a broad topic. First of all, I want to thank you for your comments on your proposed strengthening the coverage criteria, referring to substantial rather than material and also this question of national significance aspects. What I wanted to raise under coverage is the issue of on-off switch that operates under the Gas Access Regime at the moment - that is, you're either covered or you're not. If you're not covered, you then proceed in this generally unregulated environment. If you are covered, you're subject to the force of that regime that applies.

The question that has arisen in our inquiry so far is whether or not in fact that on-off switch is the right way to go, in the sense that the market is not black and white. There is a range of market performances with regard to market power. At one extreme end, you might have very significant market power, monopolistic positioning, that prima facie lends itself for direct regulation of the kind that's operating under the Gas Access Regime today. At the other extreme, you might have some market power that still puts you under the coverage criteria, so the switch is on, but you might argue that the regulatory framework should be nowhere near as heavy-handed as that which applies in the first case.

That takes you down the track of perhaps there is scope to have a better regulatory framework, a better regulatory model, that has tranches under regulation.

So you might have a lighter-handed intervention at one end, a heavier-handed intervention at the other, and something in between as well. So you have criteria for coverage, but different resulting regulatory systems that might operate, depending on which particular bucket you fall into. Do you have any reaction to this idea?

MR MacGILLIVRAY: Bit of a leading question, because you're almost asking us to sign off that somewhere there is a scope for heavy-handed - - -

MR HINTON: It was a bit pejorative, Ian. I use that in the sense that many in the sector describe the current regime as heavy-handed, and that in some circumstances that might be appropriate. But those that are subject to that today might be in fact better off, both in terms of them and the system, if they didn't get subject to that "heavy-handed" regulation, but something lighter-handed in different forms - that there are many options around. Any reaction to a model that has within it certain tranches rather than a single on-off switch for coverage?

MR MacGILLIVRAY: If I can just respond in a real vanilla term, in terms of what we're proposing, we're suggesting that more emphasis should be placed on the negotiate/arbitrate model. Almost that's a self-regulating mechanism, and if it's a small operation clearly the parties would be attempting to resolve that with a small-scale dispute resolution mechanism. If it's a large operation, then that arbitration may be more significant. I think the model that we're suggesting in some ways does go a little bit towards what you're suggesting.

MR HINTON: Except, Ian, a negotiate/arbitrate model singularly applied, similar to what comes out of Part IIIA of the Trade Practices Act, does not carry with it the option of the current building block approach that is inherent in the current structure of the regulatory framework for the Gas Access Regime. So yours would be a complete substitution. I was putting forward a variation of that, which had your model in addition to the current model, as refined, or even as a third model which might be just monitoring alone, which would even be lighter-handed than a negotiate/arbitrate model that you've put forward in your written submission.

MR BEASLEY: I just wanted to go back to the central tenets of our submission which relate to the issue that our customer numbers are very small, and that there are ways of managing smaller customers that wish to seek access. The real issue here is abuse of monopoly power, not the mere possession of monopoly power, and that we've put forward the negotiate/arbitrate model as a very clear alternative to reflect the circumstances faced by our industry now and in all prospect into the future. Even if you double the customer numbers on pipelines, there would still be significant countervailing market power.

I think we need to be careful about moving away from the Part IIIA test, as is shown under the Trade Practices Act, because those pipelines that are uncovered, that are not covered under the code at present, certainly are open to coverage declarations and there would be a range of circumstances where those sorts of declarations may emerge. I suppose under the model we've set forward - the negotiate/arbitrate model - if things aren't happening in the market, that is a reasonable test. If you're going through in a major dispute every time you need to bring another customer on board, then clearly there is an issue. But the whole negotiate/arbitrate model that we've set forward as the alternative we would see as a superior result to some sort of trigger coverage approach.

I'll always relate that issue back to the way the code was applied from day one by saying, "Everything's covered," and you don't know whether - just talking about the principles - exactly what is envisaged in its application.

MR HINTON: Allen, isn't that the problem with the negotiate/arbitrate model - it's case by case by case - that therefore becomes drawn out and quite lengthy for the service provider, yet in circumstances of the current regime the ACCC could very well argue that the benchmark is set, the standards are there, then it's in fact streamlined the process relative to Part IIIA negotiate/arbitrate?

MR BEASLEY: It depends very much on your view on the role that has been fulfilled by the access arrangement model. There are those that argue, well, it's near its completion; everything has been set. I simply make the point that there are still appeals under way, or recently completed.. Even in the second round access arrangements in relation to GasNet there was a second round appeal, and the same principle that the ACCC - if I recall - put forward a number of years ago - you know, once you've gone through the first round of access arrangements, everything is fine; everything just ticks along. Well, the way it has operated in practice, as we set out, is the access arrangement itself becomes a giant arbitration and is going to continue to be subject to considerable appeal and litigation..

DR FOLIE: One of the flaws of the negotiate/arbitrate appears to be that the ACCC normally has to review and sign-off most, if you like, authorisations. This is in general industries - in other words, if you want to do something somewhere, you go to the ACCC and there's an investigation and you get an authorisation. Would not then the negotiate/arbitrate model in each case then be treated similarly by the ACCC as an authorisation process, and hence their view is they would then need to go into: have you given sufficient information in the negotiations to the arbitrations? I think their view is you might have a more cumbersome process.

MR BEASLEY: Why go to the ACCC? The situation we set out is a process that's based on commercial arbitration.

DR FOLIE: But the ACCC does have under TPC some rights normally under - I mean, this is a general proposition.
The ACCC may well view that they need to make sure that this access has been given appropriate - - -

MR MORTON: Authorisations are for any competitive agreements. That's anything but what we're talking about here, isn't it? The example you are describing is an authorisation for a section 45 issue or a section 47 issue. They're fundamentally authorising any competitive activities. That's just completely foreign to the situation we have before us now.

DR FOLIE: Except I think the ACCC worry - I'm just putting a view - that effectively then the negotiate/arbitrate still may be unfair bargaining. They would like to just have an overview under their general sort of Part IIIA and other areas.

MS DILL: At a practical level, I could put up Duke Energy's non-discriminatory access principles that we apply on our Eastern Gas Pipeline again, for example, as a good model for how the negotiate/arbitrate would work. It is something that works very effectively for us. It does again allow us to provide additional services for our customers. We have a transparency through our principles in regard to - it's not volume-related, because you have our big foundation customers which you want to be able to provide the same types of services and pricing to anybody that comes in. So it's all out and available and very transparent on our web base.

If anybody believes that they have been unfairly disadvantaged to another customer, then they can come in and we can have an arbitration process. We have not found that we've had to do that yet because the principles themselves that we've put forward on how we operate this and how we negotiate with our customers work very effectively. I would just submit that as a model for how the negotiate/arbitrate model can actually work effectively in the marketplace.

MR HINTON: Let's come back to this so-called - I think the ACCC put it to us yesterday - transition aspect. It may have been that the Gas Access Regime as administered over the last X years has been intrusive, has been heavy-handed, but the hard yards have been covered and now you can look forward to using those sorts of benchmarks, those sorts of decisions and outcomes, to have more streamlined, efficient regulatory outcomes that in fact would lead to much more efficient regulation relative to say negotiate and arbitrate - that is, why throw away all that past investment of the last six years and change the system?

MR BEASLEY: Well, I simply make the point: has it been resolved? The case study we set out in respect of the Moomba Sydney pipeline - putting aside the issue of whether it should be covered in the first place, the case study we set out suggests that the ACCC is adopting very inconsistent internal approaches, even now, five years after implementation of the code, when it comes down to the treatment of the derivation of the depreciated optimised replacement costs from the optimised replacement costs, and in parallel is the treatment of depreciation, so I'd certainly encourage you to look carefully at that case study to ascertain the veracity of the ACCC's statements that, you k now, it's all over, or nearly all over, because I'd certainly argue that's not the case.

However, more generally, I'd simply want to make the point that the negotiate/arbitrate model has been put forward by us and has been supported by analysis of the market in which we actually operate, where you take the top five customers. That accounts for 94 per cent for the major pipelines in this country; 94 per cent of the gas throughput. These are informed customers who are well capable of negotiating outcomes. Who is the ACCC protecting here? And, I mean, if it's the small customers, that is derived quite logically by reference to the negotiations for those major customers, so if there are small market participants, small volumes of gas for the same service - and I make that point - then surely that reference is back to the outcomes negotiated with those major customers.

MR MORTON: Is it worth casting your mind back six years to the promise of light-handed regulation six years ago?

MR HINTON: The ACCC told us yesterday that what is operating today is light handed.

MR BEASLEY: But did they also give evidence that, yes, it's been prescriptive on the first run through?

DR FOLIE: I think we're trying to actually - we've read all the papers, we actually know the history. We're trying to understand how we can go forward.

MR MORTON: But it's a fairly important point. Six years ago there was the promise of light-handed regulation. We've seen anything but that, and so we're hearing now that following this intrusive first round it's going to become light handed this time. Well, history suggests that that's not the case. In fact history of regulatory environments internationally is that they become at least as heavy handed over time. There aren't many examples that I can think of where regulation becomes less prescriptive over time.

DR FOLIE: But that's not relevant. Our brief is actually taking us - basically we're reviewing the system so that's sort of a part of the debate that's - - -

MR HINTON: Picking up Allen's point a moment ago about the nature of customer, we have discussed with a number of interested parties, given segments of the sector: is the regime appropriately flexible or appropriately described to cover both transmission and distribution? Is there a distortion there in the regulatory framework that means that transmission is handled well but distribution badly or vice versa? Does it take you down the option of looking at different sort of regulatory frameworks for distribution relative to transmission? I'd welcome your comments on that debate.

MR BEASLEY: I believe I'd only want to comment on the arguments as they relate to transmission because that's the entire basis of our submission, and that simply sets out the basis for a genuine lighter-handed rolling back regime based on that negotiate/arbitrate model, and the submission itself sets out I think in some detail the rationale for that. I would not make any comment on what may or may not be appropriate for distribution. That is not APIA's focus.

MR HINTON: I understand.

MR BEASLEY: We don't represent the distribution sector.

MR HINTON: You're allowed to comment if you wish.

MR MacGILLIVRAY: We made certain comments in the paper about the unique risks that the transmission sector faces.

MR BEASLEY: Yes, I think the guidelines to that are set out in the covering letter that I sent, which talks about the characteristics of transmission, but that's a focus on the characteristics of the transmission industry. There's no analysis, nor will there be, from APIA on the characteristics of distribution.

MR MacGILLIVRAY: Coming back to your previous question about the ACCC suggesting, "Well, it's been a balls-up to this point but now we're right. We've got to the other end of this. Now we might - - -"

MR HINTON: I didn't quite use those words.

MR MacGILLIVRAY: "- - - but now we can go forward." We spent some time this morning talking about the issue which you quite correctly focus on, that new investment, both the enhancement of existing pipelines and the development of new pipelines. We certainly are of the view that the code in its current form, notwithstanding the efforts of the ACCC, does not do that, so that situation confronts us, no matter what. Even if you accepted the argument that the code could simply sit there and regulate the existing pipelines in their current capacity - which we don't accept - there's still that huge gap in terms of how the infrastructure of the country will be developed.

MR HINTON: Under the arbitrated model, if that's an inherent characteristic of Part IIIA, why don't we scrap the Gas Access Regime and just operate under the Part IIIA system?

MR MacGILLIVRAY: That's right.

MR HINTON: Is that an option? Is that what you're really saying, because in the absence of a gas access regime, the default option is Part IIIA.

MR MacGILLIVRAY: That's right. That's right.

MR BEASLEY: I think it's a case of treating each case on its merits, and I can't really take that any further than that. Yes, we've set out an alternative model. In this submission we're focusing on our preferred solution that fits within a certain framework. Inevitably, as we set out in our submission for covered pipelines, there are issues of ring fencing, for example, that are relevant to the circumstances faced by those covered pipelines, but I don't know that that's territory that - you know, that's a theoretical option. I don't know that that's territory that I can travel today.

MR HINTON: Okay. Let's move on. We're now sort of getting to lists of questions that are one-offs rather than a thematic approach to questioning. You've referred to the Parer report that has a number of proposals. Let's put greenfields issues to one side for a moment and look at the institutional aspects of Parer, and certainly COAG is still giving very serious consideration to some of those, and that to some extent represents shifting ground for us. We will have to take into account what comes out of Parer and COAG for how we approach our inquiry, and there is an intersection of interest and overlap there, and it's important we have to be aware of those steps, those outcomes. I'd be interested in your views, though, on the sort of institutional framework that might emerge from the Parer proposals in terms of a national energy regulator or the distinction between a regulator versus policy making, gas as part of the energy sector overall. Those sorts of factors emerge from Parer's proposals.

MR BEASLEY: They do, and you're asking me to speculate on things that I don't think any of us fully understand at present. The key points I wanted to make in terms of the single national regulator - that's not an issue. To all intents and effects we have a single national regulator in the ACCC and, yes, Ofgar in Western Australia. We still face issues. So we have a single national regulator, we still face issues. We're still in serious litigation, so the suggestion of a single national regulator, whilst it may create some efficiencies, it may well not create efficiencies and it's got a long road to travel, I suggest, in terms of - - -

MR HINTON: But it may be more important for distribution rather than transmission.

MR BEASLEY: In terms of implementing it, yes, so we're nearly there as a transmission sector, and we still have problems.. I think the important principles are to ensure a very clear separation of the policy role and the regulatory implementation role, and you'll see in our covering letter we do set out the importance of effective separation and the code change and regulatory functions because we see the code change process as being essentially a policy process and the regulatory function being a pure implementation process.

MR HINTON: You've anticipated my question about NGPAC.

MR BEASLEY: NGPAC? Well, I simply make the point that as an effective means for changing the code - we're still trying to implement the code. So that's the first point. There are still issues of interpretation of the code as it exists that have created a lot of uncertainty and a lot of - lack of clarity. There have been legal appeals and the result of one of those legal appeals - we argue actually it reinforces the need for that objects clause. That's set out in our submission. NGPAC has focused primarily on what we see as pretty minor code changes. Where major issues come forward there's been a tendency for it to go round in a circle.

What has concerned us with the role of regulators on that particular committee is that it's become a trade-off between service providers and regulators with jurisdiction sitting in the middle doing nothing, so we see that code change process as being a policy function and the regulatory function as a regulatory implementation function, and have basically said in our submissions that there shouldn't be direct regulatory participation or involvement in that code change process.

That's only part of a much bigger picture because of course the Parer report is also considering a range of other mechanisms that relate to this market management company et cetera. I don't know that I really need to go into that here today. Suffice to say it is an issue of importance to us that we're seeking to take forward through the Ministerial Council on Energy because that's probably our main focus on that particular set of issues. Is there anything anyone else wanted to add to that? I think that's all I wanted to say.

MR HINTON: Allen, what about the issue of a distinction or separation of decisions on coverage relative to actually regulating - - -

MR BEASLEY: Absolutely. Take it as read. Take it as read that it is totally untenable to suggest that the regulator can make decisions on coverage, and that remains our position.

MR HINTON: Can you elaborate the reasoning behind that important separation?

MR BEASLEY: I think in terms of the principles of separation of powers of avoiding conflicts of interest between a regulatory function and a decision on whether or not to regulate, that is to us and remains an important distinction that was set out in Part III of the Trade Practices Act, and should continue to be maintained.

MR HINTON: There's a potential for the regulator to be captured by that regulatory process to colour decisions on coverage? That's what you're saying in shorthand?

MR BEASLEY: Yes, I think that pretty well says it.

MR MORTON: I guess we're really saying that the fundamental points made in the Hilmer report are still totally appropriate now.

MR HINTON: Thanks, Euan.

DR FOLIE: Just coming a bit to greenfields, there are a lot of different areas on it, but you seem to be flexible about actually saying you don't necessarily in a 15, 20-year access holiday; that you view that as a lesser priority.

MR BEASLEY: That's very clear in our submission, but having analysed the risks and opportunities, it arises because of course over the life of a pipeline the truncation issue is unlikely to be apparent until some considerable time into the project, and we set out some parameters and simply say, "Well, if you are considering this approach, here are some issues to consider, some of which have been discussed but just to reinforce the nature of the issues that we think are important and that if it were to apply, let's get it clear that this shouldn't be a case-by-case approach because that just creates more uncertainty in terms of what may or may not apply." We've reached the landing, I suppose, an unofficial landing, on 20 years as representing something that was simple and yet reasonable in the context of the sorts of pipelines that have been considered around this country over the years.

I can't really take that any further. It's not a science. I think it's a judgment issue. The problem with 15 years as set out in Parer, however, is it takes you to a period when you look at the ramp-up for volumes. You know, you're far more likely to be in the process where you are just getting out of the red.

DR FOLIE: If you've got your national development hat on, which is moving about three levels above where we all are at the moment - is you build a pipeline somewhere in a remote part of Australia from a gas source to a market and effectively want to ensure then there's another major gas discovery, significant gas discovery, shall we say, somewhere within reach within the catchment area of that pipeline, that that could actually could get access into that pipeline before the 20 years. In other words, that would be a major - because a major part of it goes back pre-Hilmer flaws actually to ensure national developments. I mean, that's one of the big policy drivers of having access.

MR BEASLEY: I mean, why wouldn't participants seek to negotiate an outcome under those circumstances, if there's spare capacity?

DR FOLIE: Except there's been a history in the west and of course that was under government though where effectively you couldn't actually get into pipelines.

MR BEASLEY: You see, I think this is one of the issues. There's a lot of history in the transmission sector. I'd simply make the point that in the move to a privatised sector, the presumption of guilt was applied very early in that process rather than giving the industry the opportunity to demonstrate its credentials and I think that's again a central thing of what we set out in our submission, The ability to demonstrate our credentials is a very important one nationally in terms of long-term development and gas growth.

MR MacGILLIVRAY: Which pipeline were you referring to, Michael?

DR FOLIE: I think on the early days of - this was owned by SECWA, basically the one going from Karratha - - -

MR MacGILLIVRAY: This is the gas specification issue?

DR FOLIE: It's the gas specification issue and then there are other ones but the offshore - the smaller groups offshore which eventually now are taking it down through the - - -

MR MacGILLIVRAY: Take or pay issues.

DR FOLIE: - - - the Goldfields and take or pay. Not so much the take or pay issues, just access into that additional transport system.

MR MacGILLIVRAY: Again, I think it's a bit rough to bring that into the current environment that was, you know, a government-owned enterprise. The government are also operating a bundled gas service. It's tough to relate that.

DR FOLIE: But I think national gas - it is several levels above where we are but it is a thing that drives the national access - is actually that if gas is just - in other words, they do want to be able to make sure, if pipelines are built - that lies behind it - they can actually get access to those new discoveries that weren't foreseen at the time that the pipeline was signed up, and I just wanted to have on the record just the views, if you like, of the newer industry.

MR BEASLEY: I think the whole premise we've set out is there are very strong incentives for this industry to negotiate outcomes. Number 1, with our existing customer base, losing a customer or a significant decline in volumes by a customer would be a pretty significant impact on the pipeline company and, similarly, bringing new volumes on would create opportunities. So why wouldn't the parties negotiate an outcome and, in fact, if you look at the history of pipeline development since introduction of the code, there are lots of examples where those negotiated outcomes have worked in practice.

I mean, where are the examples where it hasn't because, for example, Roma Brisbane looping was on the basis of commercial negotiation, commercial arrangement, to expand the capacity of the pipeline. The construction of a whole suite of pipelines has been based on negotiated outcomes, so why would anyone wish to question the veracity and intent of an industry in terms of negotiated outcomes with customers.

MR MORTON: Yes, there is a very substantial opportunity cost for a pipeline owner not to attract volumes given the relationship between average and marginal cost because marginal costs are so low relative to average cost. There's a very substantial incentive to - profitability is very closely linked to throughput - simply put.

MR MacGILLIVRAY: That was the old model.. Again, I say in Epic's case that's not the situation. We would build a pipeline now and I think the producers, the gas producers, are quite worried about the very point you are making that a pipeline now will be sized in a fashion where the incremental cost of expansion may well be greater than the average cost of capacity. I think in the past when pipeliners were building pipelines, they actually had an eye to that future development, built in another inch on the diameter because the marginal cost of that investment at that time provided potential significant upside in the future. That's not the situation now and I think producers are being turned around. They are concerned that pipeliners - and they do want pipeliners to invest in new pipelines - will build in such a way that that new entrant who is seeking additional marketplace will not get into that pipe.

MR HINTON: We've almost done a complete circle back to where we started.

MR MacGILLIVRAY: Exactly.

MR HINTON: One last question: MFN clauses, conditions. Is it now standard market practice? Is it an emerging standard practice? Where are we in that continuum of this MFN?

MR BEASLEY: I've got to say from an industry view I have to take that question on notice because certainly I haven't done any research. It is clearly an issue and all I can say is if I was a customer today contemplating a pipeline, I'd know what I'd want in terms of foundation arrangements.

MR MacGILLIVRAY: Indeed, the fact that there is a code and the pipelines are either covered or could be covered, if you were a foundation customer now facing the prospect of that pipeline being covered and any spare capacity, should it become available, being caught by a regulation and being made available at a lower tariff than the foundation customer is paying, you'd be a mug not to seek it.

MR HINTON: Is there any matter that you think you would like to emphasise that we haven't covered over the last hour and a half?

MR BEASLEY: It's probably a point that I touched on and that's simply the issue of how the code is actually applied in terms of it being used by regulators to demonstrate that there's monopoly rent-taking because they apply a methodology that says, "Okay, we come out with this answer having applied the capping model," that that demonstrates that there is in fact a monopoly profit within the industry, whereas the reality of those parameters, as I understand it, is that there's always a range and that if it's the fact that the regulator is coming down towards the bottom of that range, of course you're going to prove that point but it has no particular substance.

I don't really need to elaborate on that. I suspect that there may well be research that may become available on that but it's clearly a factor in terms of the way a regulator justifies their market to major customers the role they're adopting under the code.

MR HINTON: Yesterday afternoon ACCC expressed the view that their decisions in fact have tended to give the benefit of the doubt to the service provider and - - -

MR BEASLEY: Yes, I just wanted to touch on it because it was a point I made in passing in my introduction that there's a gap between the generosity model that the ACCC promotes and what we've been saying as an industry but there has been no real analysis on that. There have been assertions and counter-assertions and there's probably a gap and something may or may not come out during the course of this investigation that may be relevant.

MR HINTON: I know work is going on.

DR FOLIE: As time is running out a bit I don't want too long an answer but I'm puzzled as to what goes on in this measurement about so-called efficient costs and it's particularly pertinent within a pipeline. I would be interested if you could elaborate a little bit about when you actually go and you're dealing with the regulator. He's requiring information every five years as to, "What is the best practice benchmark most efficient way to run your pipeline?" Now, if you look at a pipeline it's got pumps and compressors and about three people running it, so I'm just curious as to actually what is the nature of the dialogue between the pipeliners and the regulator to determine the so-called efficient - new efficient cost.

MS DILL: It's not applicable to - - -

MR BEASLEY: I was going to say it's not an issue I can really comment on because - - -

DR FOLIE: But it's a puzzle in the process because they are continuing to actually re-estimate, if you like, in some sense the cost under which the system has been put down in its 30-year, 40-year life, and one that really - you know, the size and shapes, the people that I think might be a bit smarter, and flow - I just would like an elaboration and particularly for transmission.

MR MacGILLIVRAY: Well, in relation - if you're going to the point of operating a maintenance cost and the regulator then looking at whether those costs are appropriate, I think at this point the industry has seen that as a second-tier issue because pipelines are so capital-intensive the battle was being fought at the capital.

DR FOLIE: So it's a WACC fight rather than actually - - -

MR MacGILLIVRAY: At this moment - - -

MR BEASLEY: WACC - that's a valuation fight.

MR MacGILLIVRAY: Correct - and it goes to the point - - -

MR BEASLEY: ICB - yes.

MR MacGILLIVRAY: It goes to the point that Allen made before. It was certainly in the case of a number of the pipelines. We really haven't got to the point where that first review has looked back on whether the operating costs have been appropriate. In the case of the Epic pipelines we've been in a four-year period attempting to get an access arrangement in place for a number of our pipes. We haven't had - and I guess it will happen shortly where the regulator does in fact look back on actual costs and start to make a rule as to whether they're appropriate.

MR BEASLEY: Yes, just to make a point we set down in our submission that putting aside fuel costs you are talking about the order of about 8 per cent.

DR FOLIE: I know all that but I just wanted really to effectively find out about the capital base and the WACC and this - because they make a lot about estimating the efficiency and it goes on and on and on, so I'm just curious.

MR MacGILLIVRAY: Well, the main game is in the capital at the moment and then I guess the future game will be in the - - -

DR FOLIE: In a different - - -

MR MORTON: If we could draw your attention to case study 2 that looks at some of the assumptions that underpin the Moomba to Sydney draft decision and the extreme sensitivity of revenue outcomes to those assumptions, revenue outcomes and probability outcomes varying 20 to 25 per cent based on a - almost akin to depreciation schedule - and the point I make is the extreme sensitivity of cash flows to regulatory assumptions and the risk that places upon industry and the implications ultimately that has for investment to the extent the pipelines are covered.

MR HINTON: Well, thank you again for your participation today and your submission and both APIA and Epic and Duke. Thank you very much. Your inputs are very valuable for us.

MR HINTON: Good morning again. This is the second session of this public hearing on Friday, 19 September here in Sydney. I now invite to the microphone a representative of Newmont Mining company, Rhonda Smith. Welcome, Rhonda.

MS SMITH: Thank you.

MR HINTON: For the purposes of the transcript and to make sure the sound system is working, I would be grateful if you could identify yourself and the capacity in which you are attending and then I would like to invite you to make an introductory statement that might facilitate subsequent discussion. Thank you.

MS SMITH: Thank you for that. I am Rhonda Smith and I have acted as a consultant to Newmont Mining. I will make some brief comments in relation to the Newmont submission although, I assume, people have it and maybe have read it. I think the general comment I would make is that Newmont has some experience as a gas user with the code and that it generally supports the code, but in fact thinks that there are some areas in which perhaps some improvements could be made.

Newmont's interest in the Gas Code really relates to five different issues: (1), its historical involvement as one of the parties that was responsible for the gasfields pipeline. It has one of the largest transport contracts. It has supplies to its operations at Junee and Wiluna. It's likely to need supplies in future to new mines and it's interested in contractual arrangements with third parties, so essentially its interest is that of a shipper of gas.

The key areas which Newmont is interested in is the consequences of the code for upstream and downstream industries and whether or not a code and coverage under the code will promote competition. I would refer you to the submission that was made by Newmont to the National Competition Council in relation to the application for revocation of coverage of the Goldfields pipeline and there's a fairly detailed discussion in that about the competition aspects of the code.

The particular areas that Newmont believes it gets advantage from the code in relation to are, first of all, certainty. It's particularly important where you have long-term investment in infrastructure to have as much certainty as possible - and that recognises of course that complete certainty is never possible - within which to make planning decisions and to get appropriate levels of investment. The cost of gas-fired electricity depends on the delivered price of gas purchased as fuel and the heat efficiency factor of the generating plant and that, in turn, depends on the age and the size of the generating plant and, of those two factors, the one that can be affected independently is the heat efficiency factor, although once certain decisions are made of course there are limits to how much change can be implemented there.

The point about this is that the transmission costs involved in the transportation of gas are not insignificant in terms of the operations of electricity plants and it is in that context that there is a particular concern of Newmont as to coverage of the code and the certainty that that code provides. Not only does the code provide certainty but it also provides a consistent Australia-wide basis, which Newmont considers to be important for attracting investment, including foreign investment and for avoiding regional distortions.

Secondly, Newmont is particularly concerned with efficient pricing. It needs prices that reflect costs and provide a satisfactory return on capital, taking account of the risks involved. Efficient pricing provides a price-discovery mechanism and that price-discovery mechanism is particularly important in the context of negotiating around that price, so although the operator of the Goldfields gas pipeline has no approved access undertaking, coverage has actually influenced the price-discovery process, and that's discussed in paragraphs 23 and 24 of the submission.

The pipeline tariff is mainly determined by the capital cost of construction and the volume of usage and those two factors become fairly significant in terms of what the incentives are for the players in the marketplace. Newmont is also concerned with the implications of the code for investment and recognises that there is a balancing required between the interests of various parties, the owners or the investors in the pipeline, the users of the pipeline and the public in general, and it's particularly concerned that you have an environment that promotes competition and results in efficient outcomes.

Of particular interest here is the ability of the gas-fired generators to act as a competitive constraint within the electricity industry and, again, their ability to do this depends very much on the price that's paid for the transportation of gas. One of the things that becomes quite important in this context is the ability of gas-fired electricity generation to locate closer to the marketplace and therefore to avoid the losses that are involved in lengthy transmission of electricity, and that of course has been part of Newmont's experience in terms of its activities in Kalgoorlie.

I won't go through all of the other questions and the answers to those questions, but perhaps just summarise a few of them. A question in relation to compliance costs under the code and the representation of those costs: in fact what Newmont argue is that the costs are quite reasonable, given the benefits that are conferred in terms of development, transparency and so on, and also that the compliance costs associated with the code are not significant relative to the other sorts of costs that are incurred in providing gas.

Newmont's experience has mainly been in relation to the code and the operation of the code in terms of the application by Goldfields for a revocation of their coverage and, as I suggested, there is information in the submissions of the NCC in relation to that. It does suggest that in thinking about revocation perhaps there should be some consideration of the test that's used, such that you introduce an allowance for the prejudice to third parties. Third parties having made their decisions on the basis of existing arrangements may then be quite significantly disadvantaged as a consequence of a change in those arrangements.

In relation to the disputes resolution procedures the experience in Western Australia of course has been somewhat unfortunate and it suggests that maybe there should be some consideration to what sorts of things can be dealt with by a disputes mechanism; what avenues should be open, and that perhaps it should be restricted somewhat to avoid regulatory gaming and deliberate delays, which are really just exploiting the system, but it is conscious of the natural rights of people and therefore their need to have access to an appeal mechanism.

In terms of investment Newmont's view is that there should be adequate allowance for the risk involved, but once that risk has been dealt with, once the costs invested have been recovered, then in fact there should be a reconsideration of the tariff level and in fact the same sort of risk allowance should not be available to people who come in and subsequently purchase, so there is a recognition that in actually building the pipeline, not knowing what the exact volume of demand is going to be, that should be recognised and allowed for, but that at some point in time that should cease or at least be modified. It opposes the suggestion of a 15-year access holiday, again because if the tariffs are set appropriately there really is no need for this and it doesn't think that there needs to be a modification.

It does have some views in terms of the obligation to develop capacity and it suggests that the cost of providing new capacity perhaps ought not to lie solely with the party requiring the new capacity and suggests that there are in fact opportunities for free riding in several places where that is the case, so free riding on the part of other users of the pipeline, because they get the benefit of additional access as well, and free riding on the part of the owner because the owner actually gets reduced overall unit costs as a consequence of the expansion, so it would like some consideration given to the arrangements for financing expansions. I think probably that is sufficient at this point. Thanks.

MR HINTON: Rhonda, thank you for those comments, and also thanks to Newmont for their submission, which I am sure you were fully involved in. We appreciate the participation by Newmont in this inquiry. I note your comment that Newmont made a substantive submission to the NCC on the revocation issue regarding the Goldfields pipeline, so there's significant information in that submission as well. Thank you.

There are a number of points I would like to take up with you in the available time. The first one is in regard to certainty. In making the comment that the access regime is endorsed - notwithstanding some suggestions for some refinements - you particularly put weight on the fact that it delivers a degree of certainty to the sector. I'm a little puzzled by that comment in circumstances where a number of players who are significant market participants have expressed the view that regulatory uncertainty is a crucial aspect of the access regime itself; that is, the discretion of the regulator, the uncertain objects clause with regard to what it is seeking to do through the access regime; therefore the degree of uncertainty as to what the regulatory outcome might be generates itself uncertainty in addition to the usual commercial imperatives. Can you react to that sort of different view?

MS SMITH: I can react to that personally by saying, yes, I suspect that that's exactly the case. However, Newmont apparently have not been troubled by that particular set of outcomes and have found it helpful to have the regulatory environment that they operate under there and maybe they would get more benefit if there was less uncertainty, but they seem to be satisfied with the degree of certainty that they have at this point.

MR HINTON: Are you suggesting that perhaps Newmont as a major user accessing available gas through a major pipeline has benefited directly from their regime, therefore their experience is one of endorsement of its nature?

MS SMITH: I think that's right and in fact what the regime has done is it has put information into the marketplace that actually enables them to then negotiate, so it's not so much what the reference tariff itself is - although I am sure that's relevant - but it is in fact just the fact that there is information there and therefore that reduces the negotiating uncertainties that they would otherwise face, so it's a comment about certainty in the context of negotiating rather than more generally in the operation of the system.

MR HINTON: I appreciate your circumstances constrain you a little as to how much you can express a view in representing Newmont, but let me try my hand at some questions. In particular, is there market power, or countervailing power, in the hands of large users of gas relative to the service provider - such as the transmission company - there seems to be a range of views out there. Some say this is a captured customer and has no market power whatsoever; others say large demand means some market power and negotiating circumstances can prevail. Can you throw any light on this debate as to the nature of large industrial users versus transmission companies?

MS SMITH: History of course plays a role here and, that is, that Newmont was one of the three foundation customers in relation to the Goldfields pipeline and in fact was involved in the construction of the pipeline and then sold its interest and negotiated a long-term supply agreement at the time that it sold it, but of course the question you are asking really relates to the sorts of issues that were looked at in relation to the NCC submission for revocation, and so one of the things that Newmont was particularly interested in there was to establish, first of all, that the pipeline itself was unlikely to be duplicated, and that involved looking at not only the capacity of the pipeline itself but also the options that were available and the likely demand in the future.

Then having established that the issue which the NCC looks at in relation to the Gas Code is whether coverage actually promotes competition or conversely in relation to revocation, and so the issue became, to what extent were there constraints imposed upon the pipeline operator that would then constrain the prices back towards competitive levels. A fairly obvious possibility for somebody who just looks at a map is that there are two pipelines that come down from the north and so you look to see, okay, what's the relationship between those two pipelines. The first thing seemed to be that there was not much unused capacity, if any, on the Dampier-Bunbury pipeline and so in that sense it wasn't going to be a constraint. The other issue was whether you could - if there were capacity available - put laterals in to supply some of the intermediate area between the two pipelines and therefore offset the demand for the - or at least use it as a bargaining chip, I suppose. Again that didn't seem to be a particularly viable operation given the likely length of life of the mines and the capital costs involved.

The more interesting one, I think, was in fact the prospect of electricity as the constraining influence. So you ship your gas down the Dampier-Bunbury pipeline and turn it into electricity and then ship your electricity across to Kalgoorlie, and that's in competition with what comes down the Goldfields pipeline. So if the Goldfields transmission costs are too high then in fact it will lose the business because the electricity will come across the high-voltage lines. Again that was a problem in this particular circumstance because of the distance between wherever it is that the transmission line starts which is - - -

MR HINTON: North.

MS SMITH: - - - east of - sorry, west of Kalgoorlie, and comes across to Kalgoorlie. Is it 1200 kilometres? It's a very long distance anyway. So the transmission losses on that line are actually very significant. The other aspect that affects the losses and the costs is the usage of the line, and the line was very highly used. So in fact the sort of constraint that was being imposed there was a minimal constraint. So given those sorts of comments what was being said here was that, no, there weren't significant constraints upon the Goldfields pipeline operator and therefore there was concern as to what would happen to tariffs if there were not some coverage involved. I hope that answers the question.

MR HINTON: Yes.

DR FOLIE: I've got one. One could actually calculate it quite easily by looking at quarterly gold production. So effectively Newmont take from four mines.

MS SMITH: That's right.

DR FOLIE: So supplying four mines - but I think Junee and Bronzewing are in some sort of difficulties - I don't quite know what, but are probably not at their normal production levels, and Wiluna, a similar sort of area. So the background of that is to what extent are the offtakes varied from Newmont over the period of time? Presumably it's not underlifting from what it has had in the past.

MS SMITH: To be honest, I don't know the answer to that question. I can take it on notice and provide you with information if you would like that.

DR FOLIE: Because it is actually a point put to us by the pipeline owners and operators. It is effectively one of the issues they face in running a pipeline down through this area; they have very large lumpy customers and basically they do sort of - and sometimes their mine lives aren't quite as long as in good faith everybody enters into. So they are facing effectively a much riskier load profile than most other pipelines in the rest of Australia. It's a higher risk pipeline, ergo they need better rewards for it, et cetera. I'm just trying to clarify factually as to whether in fact you do actually have offtake that is jumping around a little bit.

MS SMITH: I don't know but I can take that on notice and get you the information. The other thing, of course, is that the suppliers normally undertake all paid contracts, so it's not so much the fact that you don't get revenue for the load but rather the implications of variable load in terms of your operation of the pipeline - - -

DR FOLIE: It's not much good if you're still - whether you are still paying or not as well. In other words are they true take or pays or not? There may be more flexibility on load variation, et cetera. So it's getting some idea of the two different turning points.

MS SMITH: We can certainly find out the answers to some of those sorts of questions. There certainly was discussion within the NCC's submissions about if you weren't fully utilising the amount of capacity that you had available to you, whether you could actually then effectively sublet that to somebody else and the answer was, yes, you could, but it was likely to be fairly short term. It was likely to be, "We'll give you 12 months' notice or we could give you three years' certainty," but other than that pretty uncertain.

DR FOLIE: Because my other - it's a bit of a nonsense question because effectively to what extent, because you may be well over-committed, have you actually tried to do shorter-term contracts - in other words there can be occasionally a minor expansion of opportunities and they can come along and you might have just a two or three-year mine life and you might actually want to undertake that particular facility, and to what extent those sort of contracts are negotiable within this.

MS SMITH: Historically I don't know. Again I could make inquiries. When we were putting the submission for the NCC together there was no discussion of any particular examples of where that had occurred. Short-term mine lives seem to be a problem, depending on where they are located because often the capital costs involved in putting in a line to supply them far outweigh the benefits that they are going to get, so they are often done with diesel rather than with gas.

DR FOLIE: But there are ones along that line that you can actually - - -

MS SMITH: New ones and particularly ones with longer life.

DR FOLIE: I'm not trying to look at new ones. I'm talking about ones that could be within the catchment of the pipeline within the power network, that you may need additional - a specific company.

MS SMITH: Yes.

DR FOLIE: It's an idea again, and the basis of the question is that - again it's put to us, it's a pipeline that really is facing quite a different customer profile to the rest of Australia, ergo they need to operate somewhat differently and therefore just trying to get an idea of what happens and as Newmont - goldmines are the ones that tend to have the shorter mine life.

MS SMITH: I think there is also potentially the issue that unlike other areas where there is a reasonable prospect of growth the forecasts that I've seen don't seem to suggest any significant growth. It's really - things that drop out are replaced or the assumption is that they will be more or less replaced so that there is within a fluctuating area a fairly steady growth into the future, but certainly not - sorry, steady demand, but not really growth into the future, so that also affects their - I mean, there is still capacity to expand the capacity - sorry. There is ability to expand the capacity of the pipeline. It's subject to six compressor stations and I don't think they have all been put in. You've also got the possibility of looping - that there really doesn't seem to be much justification given the likely demand, and you're right. I think it often tends to be fairly short term. Pops up, gets dealt with, mine's finished, move on.

MR HINTON: I would like to seek your elaboration of something in your written submission. It's on page 16, para 47. This is the area in relation to pipeline expansions; extension of existing capacity. You go on to say that any expansion to a pipeline is an asset which benefits the pipeline owner and such expansions also benefit other shippers by enabling increased throughput in common sections of the pipeline. You then say that there should not be a prohibition - the prohibition on funding should be reconsidered. I am little puzzled by that position in the sense that I didn't think there was an actual prohibition on funding. It was a non-requirement that they had to fund and that's a slightly different flavour to what is inherent in the regime.

MS SMITH: I think you're right. I don't think it is an absolute prohibition on funding and I think what Newmont are really wanting to sort of put into the public domain there is that they would like the pipeline owner to be more willing to consider adopting those costs rather than fairly - you know, the first step usually being to see if you can get someone else to pay for it. It's a fairly common approach.

MR HINTON: There's usually - commercial imperatives can come to the fore; that is, for a price something will be constructed.

MS SMITH: That's right.

MR HINTON: Something will be expanded and how that's funded will depend upon the return from the use of the expanded facility.

MS SMITH: Yes. I think what they are looking for is just some recognition that there are these other benefits that don't go specifically to the party seeking the expansion and that they would like recognition of that in terms of the way in which the expansion is going to be funded.

MR HINTON: Thank you for that elaboration. Also in relation to your submission at page 14, paragraph 43 - and you referred to this in your introductory comments too, Rhonda - about the proposals around that there can be say a 15-year or 20-year period for which a greenfields investment would not be subject to regulatory oversight, a so-called "regulatory holiday". Newmont seems to be saying that that's not supported by Newmont. I would welcome your comments as to why Newmont might have that view.

MS SMITH: I think the basis for what Newmont is saying there is that if in fact the projects are properly costed so that the risk involved is actually factored into the costings and a reasonable rate of return is also factored in, then there ought to be no need to allow anything which is effectively another form of risk allowance and so, given that, they don't see the need for this kind of regulatory holiday.

MR HINTON: Do you see a tension in having a reasonable return and the possibility that that sort of regulatory oversight leads to truncation and in fact the removal of options and blue skies return for risky projects? Isn't that a potential impediment to new investment?

MS SMITH: Yes. I must say I was thinking about this yesterday and I was thinking about it not so much from Newmont's point of view necessarily but just as an economist, and wondering in fact what's going on here. It seems to me that there is a bit of a mix of accounting costs and economic costs and it seems to me that if you take a strictly economic approach to the costs involved then in fact the blue skies part of it really doesn't come into it. If you take an accounting approach then I think that's where the blue skies comes in, so I'll say that Newmont doesn't think it's appropriate and that I, as an economist, would like to know just exactly how the costs are being determined.

MR HINTON: I think perhaps there is an issue of ex ante and ex post return.

MS SMITH: Yes.

MR HINTON: Rhonda, is there anything that we - Michael, please. Sorry. Excuse me.

DR FOLIE: I am just interested a little bit - we have had put to us that the state regime is actually superior - in other words, as a model is superior to the code, and they believe effectively all the agreements - provides access, provides the tariff review process, and it's pretty clear from the submission that Newmont actually want the state agreement to be scrapped and effective - as far as this goes - and the code to rule.

MS SMITH: I think the appropriate thing for me to suggest would be that you have a look at a fairly detailed discussion that Newmont included in their submission to the NCC on the role of the code and effectively explaining why they thought it wouldn't be an effective code.

DR FOLIE: Okay.

MR HINTON: Rhonda, is there anything that you would like to particularly emphasise that we haven't covered so far?

MS SMITH: There is just one point that I missed when I was going through the earlier comments and, that is, in paragraph 52, where the submission states that Newmont thinks it would be appropriate to have a better objectives clause, one which requires good consumer and public policy outcomes and the control of market power by monopolies and oligopolies rather than the weak promotion of competition. I would have to say that the view Newmont takes is, I think, the view that the term "promotion of competition" is not particularly well understood except by perhaps economists and people who are heavily involved in the competition area. I mean, my understanding of the term "promotion of competition" is that we're looking to see whether the arrangement actually improves the environment for competition, so does it bring down barriers to entry, et cetera, and Newmont would certainly be supportive of that but what they're saying is that it's not a well-understood concept and perhaps it would be useful to expand it so that people would actually understand what the meaning of it was.

MR HINTON: Interestingly, a lot of interested parties have put the view that the objects clause should be strengthened with regard to its focus on investment rather than consumer interests and Newmont seems to be bringing a slightly different perspective to that.

MS SMITH: I think Newmont is saying that it doesn't see that the code, as such, is a problem from the point of view of investment and therefore it wants to put a different slant on the objects clause.

MR HINTON: Some could also argue that there is a clear intersection overlap of common interests between consumers and investors as well.

MS SMITH: Of course there is.

MR HINTON: Thank you again for your participation and the submission. We appreciate your participation in the Commission's inquiry into the Gas Access Regime.

MS SMITH: Thank you.

MR HINTON: I now invite representatives of EMRF, Energy Markets Reform Forum, to the microphone. Welcome. It's a pleasure to have you here this morning. What I'd like you to do is to identify yourself by name and what hat you're wearing for the purpose of this transcript and to confirm that the sound system is working. Then following that I invite you to make an introductory statement to facilitate our subsequent discussion session.

MR LIM: Thanks, Tony. My name is Bob Lim. I'm an adviser to the Energy Markets Reform Forum, otherwise known as the EMRF. I'm accompanied by George Leong, who is the contracts manager for Orica Explosives. Orica Explosives is a member of the EMRF. The EMRF represents major gas and gas infrastructure users in this country and members come from the following major industrial users: OneSteel, BHP Billiton, Amcor, Hydro Aluminium Kurri Kurri, Tomago Aluminium, BHP Steel, Orica, Visy Paper and Boral.

Mr Chairman, the EMRF obviously welcomes the review and certainly welcomes the opportunity to provide its views and appear before the commission. Do you want me to make some general comments and deal with some specific issues that we are interested in pursuing with the review, and then perhaps offer ourselves for any comments or questions or challenges from the commission?

MR HINTON: Thank you for those remarks, Bob, and also your offer to make an introductory statement. We have two submissions from EMRF and thank your for those but, yes, I think to facilitate our discussion this morning we'd welcome you making some comments on matters that you'd particularly like to draw to our attention on transcript this morning.

MR LIM: Thank you very much. I think I'd like to make a number of general comments and then follow up with some specific suggestions as to how the code can be amended with the view to improving the operations of the access regime. I think the first general comment I'd like to make is that we believe that the facts and analyses need to be produced in this review for public scrutiny to sustain the assertions that we've heard to date and certainly heard over the last few years of regulatory intrusion, regulatory uncertainty, inadequate returns and regulation deterring investments. So we are asking that all the facts and analyses to be made available for public scrutiny so as to sustain those sort of assertions.

The second general comment we wish to make is that the facts and the analyses also need to be produced for public scrutiny to support proposals for light-handed regulation because we hear a lot of commentary about the need for light-handed regulation but we don't exactly understand what light-handed regulation means and whether light-handed regulation actually can produce results quite different from what the results have been in the operation of the regime to date.

Thirdly, we think that the facts and analyses need to be produced for public scrutiny to support assertions of regulatory failure and that, therefore, because of regulatory failure, the Australian economy has not sufficiently benefited from the implementation of the Gas Access Regime. The fourth point is much more positive, Mr Chairman. The fourth point is as follows. As major users of gas and gas infrastructure, and I might emphasise here that Orica Explosives is a major user in a sense that I think it takes about 10 per cent of the New South Wales load - represents 10 per cent of the gas market in New South Wales - as major users of gas and gas infrastructure, EMRF companies consider that there have been substantial benefits from the operation of the Gas Access Regime.

Our experience is that transportation tariffs have declined. There has been a commencement of gas retail competition. There's also been inter-basin gas on gas competition. There have been new infrastructure investments. There has been more gas consumption and more new consumers have come onto the market; for example, gas turbines - rural and regional customers have got access to gas. There has been more flexibility, albeit some flexibility rather than much, in non-price transportation issues, and there have been major new upstream gas developments with more new players coming onto the upstream markets.

We also, finally, see the beginnings of a gas grid operating or starting in south-eastern Australia. So, chairman, we believe there have been pretty substantial benefits from the operation of the Gas Access Regime. Against that general background and perspective from where we come from, we would like to make a number of specific suggestions for improvements. The first one concerns the objects clause and we have covered that in our submission, but more specifically we have no difficulties with an economic efficiency objective in the objects clause. In fact, we have suggested that the economic efficiency objectives could be combined with the current preamble to the existing code.

We consider that the current preamble currently accesses a fair distribution of consideration to all stakeholders in the marketplace, and that it should be retained for that reason. But we also have a very strong view that the retention of the words "prevents abuse of monopoly power" should be in there and it will become clear, chairman, at a later stage why we believe that the abuse of monopoly power should be retained in the objects clause.

We finally believe that combining the two objectives of economic efficiency objectives with the current preamble to the Gas Code is not inconsistent with the Commonwealth government's response to the PC's Part IIIA review and certainly not inconsistent with the ACT's guidance to regulators about the objectives of competitive market outcomes, efficiency of cost and the delivery of price and non-price attributes to customers

The second specific suggestion, Mr Chairman, concerns pricing principles. We agree with the need for pricing principles to be clearly inserted in the code. We're happy to see economic efficiency based on efficient costs as the key principle. We don't believe that that means that it is inconsistent with the so-called building block approach of knowing the capital base - what are the efficient costs - and the ability to derive efficient prices based on the maximum rate of return. It's not inconsistent, too, with the current regime of having efficiency incentives for performance.

We'd also like to see clearly in the pricing principles additional consideration to be given, and a key aspect is to prevent predatory pricing. A key aspect is to prevent reloading - the ability to reload tariffs - and those are the key areas we'd like to see in the pricing principles area. The next specific amendment or suggestion we have concerns information disclosures and information collection powers. The experience to date of the EMRF with access regimes has been unfavourable from a process point of view.

It had taken at least 22 months in New South Wales between the commencement of the access review and the final determination being issued by the regulator - this was the last access review done in New South Wales on gas pipelines - simply because of what we considered to be very extensive regulatory gaming. Certainly in the case of South Australia I think an all-Australian record has been set, which is a four-year period in which an access regime or access review had been completed. Again, in that particular review, regulatory gaming was a big issue, with information gaming a major issue.

Chairman, we believe that transparency is critical to rebalance the information and resource asymmetry problems that regulators have, and users as well, so as to balance that problem. We certainly believe that under the present Gas Code there is a need to clarify the information collection powers that regulators currently have. We believe that the corporate restructuring going on that we see in the gas pipeline industry with new corporate structures, establishment of pipeline trusts, private commercial contractor arrangements between related or non-related parties - all require that information collection powers should be given to regulators to ensure that they can establish that the costs are robust and that all the costs are at arm's length.

There is currently a deficiency or an alleged deficiency in the current code where there is a need, we believe, to clarify and remove any ambiguity in terms of information collection powers being make available to regulators to enable them to access that information, so as to enable them to do their jobs properly. We also need to ensure that all users can and are allowed under the current code to be able to derive all the elements of cost relating to the tariffs that they have to pay, so as to establish that they are efficient, reasonable and fair.

Mr Chairman, I should just bring up for your attention that in the recent ACCC review of the GasNet access arrangements application, the ACCC stated that they had legal advice that GasNet need not provide all the elements that should be made public to enable users to be able to derive all the elements of their tariff. I should mention, too, that the ACCC had never provided that legal advice that they claim that they had. So we would like to draw to your attention that users are unhappy about being unable to have access to all the information necessary to enable them to derive the elements of their tariffs and to establish that those tariffs are fair and reasonable.

The next specific issue concerns the single regulator and resourcing. The EMRF has been a very strong supporter for a single national regulator for a long, long time and we say that also in the context of a single national regulator for electricity as well. We believe that single national regulator should be properly resourced. Experience to date shows that with the regime we have of separation of the regulatory bodies, in terms of the ACCC being responsible for transmission and the state regulators being responsible for the distribution networks - although in the case of New South Wales the state regulator is responsible for at least two trunk lines.

Experience to date shows that there's been inconsistency. There have been differences in the application of rigour in terms of how each and every regulator approaches his or her job, and there have been differences in resourcing and expertise. So a single national regulator that is properly resourced would be a major forward step.

Chairman, another specific issue we'd like to bring up concerns ring fencing. We had an experience in New South Wales a few years ago whereby certain associate contracts involving politically integrated business were written and only approval sought after the regulator had completed his access review. We believe that that situation was not satisfactory and that that situation had foreclosed retail competition in New South Wales for quite some deal of time. In that context, chairman, we believe that the code needs some improvements, to certainly look at the issue of penalties, and certainly to look at the issue of incentives for regulators to act upon receipt of advice of the potential code infringements. We think there is some grey area over there which needs to be dealt with.

Gentlemen, the next specific issue concerns appeal rights. Currently users have very limited appeals access to the Gas Access Regime. They are generally limited to administrative appeals. The regulators know that and have therefore, on occasion, failed to act on issues that could uphold users' rights. In New South Wales for example, again, harking back to the last New South Wales access review, the regulator did not recognise that past - that users had made - past users' contribution, capital contributions to the network system. As a result, of course, users were being asked to pay for the privilege of having built the capital, and put in the capital contribution in an earlier stage.

Unfortunately, chairman, although users at that stage - and I represent a number of major companies that were very unhappy about that particular situation - legal advice was that the code only confines appeal rights in that particular case of past capital contribution by users to potential users, as opposed to existing users. So it basically cut off any appeal rights by current users, as opposed to potential users. So I guess our bottom line is that we would like to see access by users to appeal - an ability to appeal on past capital contributions or, in a broader case, an ability to appeal against the finer decisions of a regulator - in addition to the existing ability to make administrative appeals.

Chairman, the next specific suggestion concerns NGPAC, the National Gas Pipeline Advisory Committee. EMRF has been - and the Energy Users Association of Australia - have been represented by me on the NGPAC since its formation. I was a wearing a Business Council of Australia hat in an earlier situation, but subsequently I was wearing the EMRF/EUAA hat - representative, if you like - on the NGPAC. We support the continuation of NGPAC. We believe that it has done reasonable work to date. What we suggest is that governments really need to commit to its successful operation and, by doing so, they need to adequately resource the operations of NGPAC and, very importantly, to ensure that end user representation continues in - and that end user representatives also have voting rights. Under the current arrangements it's only the jurisdictions that have voting rights and, as a result, jurisdictions have not been able to move as quickly as one would hope that they are capable of moving when the need is there.

Chairman, on the issue of access holidays, we have presented some views in our submission - on access holidays. All I just want to make is that we believe that there is no arbitrary time period which would be correct in any given case, in terms of a fixed access holiday, other than by accident. We can come to that in the discussions in a few minutes' time. Gentlemen, I might pause for a short, little while because we would like to - I'd like to pass on to my colleague, George Leong, who has a few comments to make on non-price factors and certainly to give some examples of whether a large user, such as Orica, has countervailing power or not. That was, I thought, an interesting issue you raised earlier about countervailing powers and a suggestion by some participants that the users do have countervailing power. Perhaps George Leong.

MR LEONG: Mr Chairman, I represent Orica Explosives. We operate an ammonia plant in the Hunter Valley and Bob has correctly stated that we use nominally 10 per cent of New South Wales gas supply, so we are a very large user of gas. We are a constant user of gas. Our gas consumption doesn't change. We use gas 24 hours a day, seven days a week, every day of the year, so you would think that we are a large, significant user to any service provider. We have a very limited negotiating position in terms of the transport of gas. Specifically I'd like to point you to the Sydney-Newcastle trug where basically from a price point of view we pay what's in the access regime and - - -

MR LIM: A reference tariff.

MR LEONG: - - - a reference tariff. But further to that, the normal terms and conditions which are specified by reference tariffs - we don't have the ability to negotiate on that. We've been negotiating with the service provider for over three or four years and we haven't really come to a resolution. We basically have very minor changes - well, minimal changes to the standard terms and conditions. One of the things that - in the standard terms and conditions in the reference tariffs, the service provider has the ability - or has the right to vary the specification of gas to us without any notice. We don't believe that he should have that right, but it says so in the reference tariff. Because we're an industrial user of the gas, a small difference in a chemical composition or the calorific value of the gas makes a significant impact on our process, so we just wanted to bring that to your attention.

There's a second item which is of interest, in that we always pay our bills on time, but if we didn't pay our bill on time, as part of the reference tariff we have to pay interest on anything which is overdue within 14 days. Normally in a commercial negotiating position, that position would be negotiated - we would agree on what the terms would be for that, but I haven't got a choice here. I basically have to accept what is there. Another thing is that the service provider requires security from us and normally that's - in a competitive situation that also should be negotiated. So with just those couple of examples, I just wanted to point out that really we had no real ability to negotiate on the standard terms and conditions, as defined in the access arrangement. If we don't have that ability I don't believe anyone else has in New South Wales.

One other point I'd like to make is that Bob said that gas is a very significant input to our process. We use gas not as a fuel but as a raw material, where we break down the components of the gas to make ammonia. There is no substitute for that gas. We can't use any other form of energy. We must use natural gas and we have nowhere else to go really, other than to use that product. So I give you those examples.

MR LIM: Chairman, the import of all that is that is to try to half-answer, if you like

- and we can build on that later - any suggestion that users, singly or collectively, have substantial or significant or large countervailing power when negotiating with a monopoly, and the experience here has been that - on non-price issues the experience has not been positive. On price issue, any attempt to negotiate below the reference tariff has not been positive, and this is coming from a company that has 10 per cent of the load gas market in New South Wales.

Chairman, just to finish off very quickly, we have made quite a number of submissions to the NCC on the coverage issues, involving the Eastern Australian Pipeline Ltd application for revocation of coverage. We were not quite sure whether those submissions ought to be brought before the commission at all, but we were a major player in supporting the requirement for the revocation of - the revocation application to be dismissed. So if the commission finds it of use, we would be happy to add to your collection of documentation on that issue, because we believe that the coverage issue is a very important one.

But certainly just for the present purpose, we would just support the need for time lines to be strictly adhered to. For example, the NCC's consideration of the equal access exercise has taken at least two or three years. The minister has been given final recommendations, about - at last nine months ago - and it is still unclear when the decision is coming forward. So there needs to be certainly for the present some recommendation that strict time lines need to be introduced, so as to enable some discipline into the whole process.

Chairman, that completes our opening remarks and we are happy to answer questions. If we are unable to answer them, or we don't think we can adequately answer them, we will come back and give you a written submission.

MR HINTON: Thank you, Bob, and thank you, George, for those comments. Thank you also for your submissions, which I've already referred to. Not only do you address what you consider assessments as to the Gas Access Regime but you've also put forward some refinements or proposed refinements, so thank you for that. There are a number of matters I'd like to follow up, though you have correctly anticipated some of my areas of inquiry, which is not surprising.

Let's start off with the broad issue of coverage, and here there are a number of issues that I wanted to look at. The first one is when the Commission reviewed Part IIIA of the Trade Practices Act, we came up with the view that with regard to coverage, that having regulatory intervention that produced a substantial effect on competition was preferred over, say, a wider coverage such as subsequently reacted to by the government and interim response, to use the word "material" effect - "material" then being much smaller than "substantial," therefore led to a much wider coverage that would flow from the government's interim response to Part IIIA. That same issue is being addressed by this inquiry with regard to the Gas Access Regime. Do you have any views on that broad issue of the actual scope of coverage that might be driven by the use of the word "material" as opposed to "substantial"?

MR LIM: Yes, Chairman. We have in fact - may have covered that in our submission or perhaps in our earlier informal discussions with yourselves. We certainly support a much wider definition of competition simply because we think there are important upstream and downstream issues involved that narrow that definition - might exclude the coverage of some of those issues. Our simple approach is to have a wider substantial definition.

MR HINTON: Does that not, prima facie, raise questions of regulatory risk in circumstances that if you were covering an activity that might not have significant benefits through intervention, because of the nature of not leading to a substantial increase in competition - does that not, itself, prima facie suggest that it's hard to sustain as a basis for intervention?

MR LIM: If you include a wider definition, I would have thought that intuitively the key issues would be covered anyway, and that is the impact on, for example, gas users or users of gas pipelines. But I can pick that one up a little bit more, because we hadn't covered those issues substantially in our submission and, given the commission's interest in that, we can give you a written piece.

MR HINTON: Sure. I have a reason for asking it, because it has taken us to a discussion of options for the nature of regulatory intervention in the sense that if you do have a wider coverage using, say, "material effect" rather than "substantial effect" that could lead you down a track of saying, "Okay, let's have different tranches of intervention.." You might have heavier-handed at one extreme and light-handed intervention at the other end of those segments of the sectors subject to coverage. That then raises the possibility of different categories of regulatory intervention across different segments of the sector, depending upon the nature of the level of monopoly market power judgments. Do you have any view on that particular option?

MR LIM: The only comment I would like to make there is that that is a hypothetical question. I think I would like to see some evidence that that has been the case before I'll give you a comment on what our options and preferences might be, because unfortunately in this debate, in this review and in the debate that we've been having with other players in the industry for several years now, there are a lot of hypothetical questions and statements made and our response has always been to ask for the relevant facts and the proof and evidence to support those statements. Chairman, I'm happy to provide answers on options if that has been the case in terms of regulatory experience.

MR HINTON: It's a possibility that you might wish to wait for the draft report as well on that issue - it has arisen in a number of our public hearings, it has arisen in a number of submissions, but mainly the public hearings - and let's see how we handle it as a Commission in our draft report, then you might have something more substantive to look at. I would dare not foreshadow what the draft report might say at this stage. Michael, please go ahead.

DR FOLIE: It's a fairly higher-level point, and I'm here effectively really saying you need the code and concern about actually monopoly power, et cetera. One of your remedies though is really a requirement for quite detailed rights for the regulator to be able to then have access to information. Incredibly intrusive, in other words, to be able to go in in between regulatory periods, to be able to really go further and deeper into the corporation. Through your basic submission you've actually got very strong on the building block to be able to actually access how the cost profile is changing over time. I just wonder, as your members are all fairly strong sort of free enterprise type of groups, as to whether they would actually subscribe to this, because you could start building an area in business precedent that really in Australia corporations need to be far more detailed, far more pulled apart. Do your people really follow that?

MR LIM: The simple answer to your question, Dr Folie, is that my members operate in competitive markets. The market sets the price and they have to drive the efficiencies, they have to drive the costs down. That's the difference. What we are talking about are national monopolies, monopoly networks, where there is little transparency, where there is no competition and the market does not set the price. So that's the difference.

The other issue I want to make is that on information collection powers we are not talking about an ability to give regulators powers to trawl for everything under the sun. Perhaps we didn't make it very clear, but we are actually saying, "Let's draw up some parameters if the network service providers are concerned about trawling exercises, and just narrow down the parameters to constrain, if you like, the powers of regulators."

The other point I would make too is that some of the examples you've given about regulators being able to get in between regulatory periods are actually quite reasonable for a number of reasons. One is that unless regulators can get in before the commencement of an access review to discuss and negotiate the types of information that the regulators need to be presented in the AA or the AAI on 1 January 2005, it may well be near impossible for the regulator to finish access review within six months or within 12 months. The experience has been that because of information regulatory gaming we have had 22 months' access review periods and four years' access review periods in South Australia, and in the first case in New South Wales. I hope that answers your question that I'm not asking for carte blanche trawling exercise powers to be given to regulators. Parameters are to be drawn, and I hope I've convinced you that there are good reasons why those additional powers are to be given.

I will also mention that if you were to go to the NCC's final recommendations on the coverage issue for people you will see the very complex corporate structures involved in a vertically integrated business and related parties, and you will see that some of the corporate arrangements are simply not likely to be made public under normal gas access regimes. It may well be necessary to have to ask those questions by the regulator, given that some of those transactions may have a bearing on the cost.

MR HINTON: Bob, in your introductory remarks you talked about EMRF's concerns with the possibility of handling greenfield issues, the possibility of regulatory holidays, and it's at page 10 and 11 of your second submission, supplementary submission as well, where you run through some reasons as to why you don't like these. That seems to be a case of the only one in step. The old joke goes that little Johnny marching in the platoon - that he was the only one in step. There seems to be widespread support, or at least recognition, that there is a potential for greenfield investments to be impeded by the regime, and that therefore one way to address that is to look at one option of having regulatory holidays. Another option, and a mixture of both, is the possibility of having scope for rates of return cognisant of the risks inherent in greenfields, but you seem to be taking a different view. What is your concern with that particular policy option regarding greenfield investments?

MR LIM: First of all, chairman, just a bit of correction on your comments. I don't think we are the only parties saying that we don't like access holidays. I think, if I'm not wrong, Newmont Mining, who was - the representative from Newmont was also espousing similar views. We believe that properly run access review by a regulator can do the job without necessarily deterring their investment of the greenfields pipeline. We have set out about four reasons in our submission. We also set out in our submission that there has been an overemphasis on the risk that the pipeliners are exposed to in terms of greenfield pipelines. We would argue, and we have argued in a separate forum to the ACCC when they were looking at the greenfields guidelines, that in fact the foundation customers actually wear most of the risk. So there needs to be some realistic understanding of where the risks lie before one takes the next step to say, "Because of the high risk" - and that's a hypothetical statement - "then there is a need for access holidays."

I should also say too that if you extend the argument a little bit more, and say that if you give an access holiday to a company for the first 10 years and beyond that there is blue skies, I should also say that it's very easy to build, incrementally, additional capacity to cope for the blue sky spirit, and you will find that the marginal revenue would be much, much greater than the marginal costs of building that additional capacity. I think that was one of the implications that Rhonda Smith was trying to make. We share those views as well.

MR HINTON: Thanks for those comments. Can we pick up George's examples with Orica Explosives. We appreciate those particular coalface experience comments, George. One concern I had with your description is that in focusing on non-tariff components of service, it seemed to ignore completely that there was a tariff component and maybe the regulatory intervention had priced it at that set of characteristics of service delivery, in that at the end of the day the price of service delivery reflects the nature of the service and if you want certain bells and whistles then you might have to pay more. Can you really look at non-tariff components of service in isolation of looking at the total cost?

MR LEONG: I was replying - one of your question in the issues paper was, "Does the access regime restrict negotiations between a service provider and a customer?" My answer was, "Yes, I believe it does." It's still a monopoly power from the service provider. Why should the service provider negotiate with the customer? He has got no incentive to negotiate whatsoever. There is a reference tariff and there is a reference set of terms and conditions. We try to negotiate both those with the service provider and we don't have any success.

MR HINTON: Is there any way the code could be refined to try and better meet one of its objectives, which is to encourage commercially-negotiated outcomes? Your experience, and the experience of some others, suggests that the code hasn't been delivering commercially-negotiated outcomes as much as they should have been. What refinements might be possible that would free up those sorts of options?

MR LEONG: There is one place where the commercial conditions can be negotiated. That is in the prudent discount when there is an economic justification for that, but that's an entirely separate matter. But if I was in the service provider's position, and I have a reference tariff and a reference set of conditions, we have to make some incentives for the person to negotiate. I'm not sure how you would do that. There is no incentive for him to negotiate down from where he is. The reference tariffs basically set a maximum cost to provide service and there's very little time - there's hardly any opportunity for them to charge less, or any incentive for them to charge less.

DR FOLIE: Is it not the way the reference tariff works, that if he charges less for you as a customer, then effectively he has lowered the reference tariff and all the others get access to the less?

MR LEONG: No, the reference tariff is the maximum price he can charge you. He can charge you less if he wants to. There's nothing stopping him charging less. He can't charge more.

DR FOLIE: But the view of the pipeliners, as I understand it, is that the reference tariff actually then ends up as being the minimum. It depends on which side of the fence you're on.

MR LEONG: Yes.

DR FOLIE: But basically that sets the lowest price and you will find it very difficult to charge above that. Of course, you can always deliver for nothing - - -

MR LIM: Or you charge by way of - - -

DR FOLIE: Therefore you've taken the incentive away from him to - - -

MR LEONG: But if we didn't have the access arrangement there I believe that we would, as a customer, pay more than the reference tariffs, because it's a monopoly supply situation.

MR HINTON: But I was getting at the flexibility of a price, a benchmark price, relative to the service. Presumably if you wanted bells and whistles you would be willing to pay more, and they would be willing to charge you more too, but also provide the service. Doesn't the access arrangement have flexibility as to the nature of the service, and the price can be varied by variation of service delivery?

MR LEONG: Yes, that's correct, what you said is correct. We are talking about the standard terms and conditions. The standard terms and conditions really - they are the things you go to when you have a contractual argument with a service provider. They don't materially change the price of your transport arrangements. You know, the price you pay is going to be X, and the terms and conditions may give you a longer period before you pay the money, or bits and pieces, but it doesn't materially change it.

MR HINTON: Could you negotiate with the service provider along the lines of, "I want guaranteed gas quality of these characteristics all the time, seven days a week, every day of the year and I want to pay X per cent above that benchmark tariff structure"? Isn't that a negotiation option?

MR LEONG: Yes, that's a negotiated option in theory but, in practice, that doesn't happen. The gas quality is whatever the producers put in at the end of the pipeline.

DR FOLIE: But they have got to narrow the spectrums, haven't they?

MR LEONG: They have got to narrow the - yes.

MR LIM: Spectrum.

DR FOLIE: When you sign the contract he has got to deliver within that band, doesn't he, because there can be different fields upstream - have got slightly different CVs on them.

MR LEONG: That's correct, but in the actual contractual terms, if they're outside that I've got no recourse. There's nothing that says there has to be - you know I still take the gas. I still pay the same amount of money for the gas. It doesn't change. It had caloric value and I pay by caloric value - you know, would I be charged a lesser price?

DR FOLIE: But you do pay on CV, though, don't you?

MR LEONG: Yes, we do.

DR FOLIE: But the way the tariff is actually set by the regulator does actually recognise that you only pay for the calories you actually get - - -

MR LEONG: That's correct.

DR FOLIE: - - - though I can understand it's inconvenient in a feedstock plant - you're not giving the crop the right chemical mixes and there's a technical issue you've got compared to a heating issue.

MR LEONG: Yes, that's correct.

DR FOLIE: But if I come back to the other one, which is the credit terms you mention, we get away from the specific, but normally in a commercial thing you've got a set of terms and conditions, which are a standard slate and you're paying $100 for 14 days' credit and you want to go to 90 days, the commercial negotiation often can take place where you then, the buyer, can say, "Well, I'll pay you $105 and be able to get 90 days' credit" and, I mean - you can't have that sort of dialogue with them?

MR LEONG: I can't get the commercial terms increased - - -

DR FOLIE: Is that because of the regulator or is that then a violation of his terms and the - - -

MR LEONG: The minimum conditions are set out in the access arrangement, so you can't charge me more than this price and the terms are these number of days.

DR FOLIE: So it comes back to the way the regulation has been set - that there's no reason he'll give you 90 days because he's going to bear a cost on that, so it's the way the regulator - it's a code implementation problem, not so much the service provider.

MR HINTON: Even under the access arrangement you could pay more for a better service?

MR LEONG: I can pay more, yes.

DR FOLIE: That's why you can't disentangle - - -

MR LEONG: I can negotiate - - -

DR FOLIE: - - - a whole lot of tariff against service characteristics.

MR LEONG: I have the ability to pay more for better conditions, but we don't really want to pay - - -

MR HINTON: You're not going to win the negotiations.

MR LEONG: No.

DR FOLIE: But that's different - I mean, I think it's pretty important just for - - -

MR LEONG: But the concept is yes, I can pay more.

DR FOLIE: Right, okay, but that's a normal commercial - - -

MR HINTON: But you are arguing that the market power of the service provider is such that negotiating that, you aren't necessarily going to get a good deal.

MR LEONG: All I'm saying is that, as one of the largest users in New South Wales, negotiating with a monopolistic supplier, I've got no negotiating position in terms of the terms and conditions.

MR HINTON: This may be too hard a question, but is this specifically the characteristic of the New South Wales market that you are putting up with here or do you see this as a generic gas issue?

MR LEONG: I can only speak for the New South Wales market and specifically for they Sydney-Newcastle pipeline.

MR HINTON: Yes, I understand.

DR FOLIE: As a hypothetical, as there are access arrangements around is it theoretically possible for you to then source from another supplier?

MR LEONG: No, because it still has got to travel from the Newcastle to Sydney pipeline.

DR FOLIE: So you still have to access - - -

MR LEONG: Yes. I can buy gas to Wilton or Horsley Park without any problems, but to get into Newcastle I've got to travel via that Newcastle-Sydney pipeline. I've got no option whatsoever.

DR FOLIE: Right, so it's that tariff you've got to pay.

MR LEONG: Yes. It's a catch-22. I can negotiate as to Sydney. I can't get into Newcastle unless I use this monopoly supplier.

MR LIM: And yes, you can negotiate, but how long is a piece of string?

MR HINTON: Is there anything else you particularly want to emphasise that we haven't touched on?

MR LIM: Just a couple of comments, Tony. I think in our submission we refer to the cost of regulation and in particular we refer to some work that BHP Billiton had done a few years ago in trying to build up the cost of gas regulation in New South Wales and they came up with a figure of $2.5 million for an estimate of what might be the cost of regulation, which equates to 3 cents per gigajoule and, even if they were 100 per cent wrong and let's say it's $5 million as opposed to $2.5 million, it's important to contrast those sorts of figures to the $28 million worth of duplicated pipeline between Wilton and Horsley Park from ineffective regulation, so it's important to try to - that we want to point to the fact that poor regulation or ineffective regulation can add a lot more cost to the national welfare.

The second point - and that's running along the lines of ineffective regulation - is that we think ineffective regulation - and by that we mean any so-called "light-handed regulation" or regulation that doesn't have a cost-base approach - we believe that sort of regulation will encourage inefficient and duplicated investments, which we have seen through the Wilton-Horsley Park exercise. We think it will lead to a lot of cost padding, a lot of gold-plating, labour cost-padding, and so on, and we think it's socially undesirable as a country. That's the second point about ineffective regulation that we wanted to make.

MR HINTON: Thank you very much. I thank EMRF and you both for your participation in this inquiry. We appreciate that it's not resource-free in participation, so thank you. We will now break for sustenance and return here as scheduled at 1.15 for the first of the afternoon session.

MR HINTON: Welcome back to this start of the afternoon session, Friday, 19 September, to the Productivity Commission's inquiry into the gas access regime. I now invite to the microphones the representatives of AGL. Welcome. It's a pleasure to have you here and, for the purposes of the transcript and to make sure the sound system is working, I'd be grateful if you could identify yourselves by name and who you represent, following which I'd also invite you to make an introductory statement that might facilitate our discussion this afternoon. Thanks.

MR WILES: Thank you. Well, let me kick off. My name is Robert Wiles. I'm the general manager regulation and policy for the Australian Gas Light Co.

MR PRINGLE: David Pringle, manager regulatory affairs gas networks for the Australian Gas Light Co.

MR WILES: So let's move ahead.

MR HINTON: Please.

MR WILES: Tony and Michael, thank you for providing us the opportunity to contribute to this important process. My intention today is to talk to the presentation you've got in front of you. It follows pretty much the same format as the written submission that AGL has made to the commission. I'm assuming that you have either read or been well briefed on our submission and my intention today is really just to touch on the highlights and to develop the key themes from that presentation. I will be happy to take questions on the way through but, as you indicated, Tony, it may work better if I give the presentation and we discuss the issues afterwards. It's up to you entirely.

The review that the commission is undertaking here is very much a key part of a bigger process. It's obviously not occurring in isolation. There are some very significant policy developments that have been driven by governments over a number of years. It's notable that out of the Ministerial Council on Energy there are a number of statements about energy policy in which there are some quite significant statements about the government's intention for the role of gas in the energy balance in Australia going forward. I think in particular most recently from the Ministerial Council meeting on 1 August it's notable that ministers then reinforced the policy direction to improve the climate for new investment in the energy sector. They noted the importance of gas supply in the national energy framework and committed to further increase in the penetration of natural gas lower energy costs and improving energy services.

The current review has the opportunity to build upon the findings and the recommendations that the commission itself developed in its review of the National

Access Regime and, indeed, the Commonwealth government's interim response to those and to the Parer committee's review - the energy markets review. This review offers the opportunity to ensure that the Gas Access Regime can deliver on the policy objectives agreed by government. The regulatory regime should be delivering outcomes that promote efficient investment in and the use of infrastructure. Where regulators retain discretion, and this becomes a fairly significant theme through the presentation, it needs to be exercised with certainty and predictability.

A few comments about the current regime, if I may: it is our view that the current regime and the broader reforms of which it forms a part have delivered quite significant benefits to the economy and society generally. Reforms over the last decade have created some significant benefits for customers but it is our fairly strong view that the access regime is flawed. There is an absence of clear and specific rules and investors face many degrees of regulatory risk. Regulatory risk is an unnecessary risk. There are many risks facing business and business accepts those and that's what our job is, to manage them, but to create unnecessary risks is quite unproductive.

The current regime is not delivering on the stated policy direction and, importantly, it is not capable of delivering on the policy direction going forward. It points regulators towards a focus on ever-reducing tariffs when industry refers to the WACC limbo which appears to be a process where regulators compete to see who can come up with the harshest decision. That leads to a lack of incentive for new investment and it takes the focus away from innovation in service provision. We believe that these themes are consistent with the commission's review of Part IIIA and those of the Parer review.

We believe that carefully focused changes to the regime can improve economic efficiency over time and reduce some of the larger risks of making regulatory errors. We believe the changes are needed both to the legislation and to the code. We believe that those changes are eminently achievable within the current framework. We are certainly not advocating wholesale change or throwing the current arrangements out but the changes that are needed are important. The rest of the presentation speaks to the five key themes which were contained in our written submission and which we believe helps to present a framework for our messages.

The first of those key themes, and I may say by far the most important, revolves around improving access regulation, improving the process for determining the price and other terms and conditions of regulation. This theme talks to the need for clearly defined objectives that align the code with the policy direction, to the guidance of the exercise of regulatory discretion, to providing investors and service providers confidence about regulatory outcomes and clarifying objectives and pricing principles. So we will talk about both the objectives and the pricing principles that we think are necessary in order to take the code - the access regime - into an appropriate shape for delivering on policy objectives going forward. We also believe that attention needs to be given to appeal rights to ensure transparency and accountability on the part of regulators.

Our second theme addresses what's commonly referred to as greenfields projects and the strong need for incentives for investment in new developments. The third theme is the test for coverage under the code to ensure that pipelines are only regulated where it leads to a substantial increase in competition. Fourthly, we believe that modifications are needed to streamline the code change process and, in the fifth category, there are a number of issues where we suggest relatively small changes to the code and we refer particularly to ring fencing, associate contract provisions and provisions which are appropriate to transmission but not to distribution. Through all of this there's a general comment that we need consistency between the generic Part IIIA framework and the Gas Access Regime and the rest of the presentation now involves going into each of those five things in a little more detail.

So we talk first about the need for clear and appropriate objectives in the access regime. The current regime gives quite wide discretion to regulators. It was always intended to do so. It was a deliberate feature of the code when it was originally designed. Our assertion is that that discretion has led to outcomes that the industry never envisaged when the code was originally developed. The factors that regulators are directed to take into account often conflict. There is a lack of clear guidance on the exercise of that discretion and on how to resolve those conflicts and this results in significant uncertainty about the regulatory outcomes.

The uncertainty has reduced expected returns on investment and created unnecessary obstacles for investors. Owners, and we're speaking here as a significant owner of infrastructure in the industry, are increasingly reluctant to invest in regulated assets. We're looking to alternative investment opportunities and looking quite significantly at the balance between regulated returns and unregulated returns.

A second effect of the way the current regime is designed has been a very strong focus by regulators on information and creates a significant cost of administration. Regulators appear to have been driven to focus on short-term benefits for existing customers to driving down tariffs almost for its own sake. It has removed strong incentives for service providers to seek innovative ways to improve the service provision to customers and of operating and maintaining the infrastructure.

A recommendation is for an overarching objects clause in the code along the lines of that recommended by the commission for the National Access Regime with a particular reference to promotion of economically efficient use of and investment in gas infrastructure. We believe it important in this process that prominent reference be given to the standard of workable competition. Closely related to the question of overall objectives of the code is the question of pricing principles. They're almost inextricably linked and so many of the comments here are similar to the comments about the overall objects; that is, there is a great deal of discretion that regulators have in the way that they apply the code and many of those guiding factors involve the exercise of discretion in balancing what, in some cases, are competing objectives.

The current regime doesn't give any clear guidance to the regulators about what the regime is meant to achieve. It doesn't provide an overarching philosophy and it doesn't underscore the fact that regulation is but a means to an end.

On the other hand, there is explicit requirement for a building blocks methodology and for a choice of cost of service, IRR or NPV approach. Somewhat perversely then, in the midst of a code that appears to give a great deal of discretion to regulators, on this aspect it avoids a great deal of flexibility that might be quite beneficial. Then again, within those fairly prescriptive approaches, there is broad discretion as to the development of the particular parameters, such as asset valuation, WACC components and the like.

What we've seen in the absence of a direction to regulators as to how this discretion should be exercised has been a strong drive - as I mentioned before - simply to reducing tariffs. There has been a forensic examination of asset values, rates of return and operating costs. There appears to be an objective of reducing tariffs for its own sake. There is a strong pursuit of notional efficient costs. It is certainly true that this has delivered very significant benefits to customers, the customers of today, but at the possible cost of infrastructure in future which will be insufficient to meet the needs of a growing economy.

I particularly draw from the apparent trend of regulators to date to reduce tariffs to suggest that even if it is believed that that was appropriate in the past, it is simply incorrect to assume that tariff reductions leading to benefits means that more tariff reductions means it leads to more benefits. There is clearly a point beyond which tariff reductions are counterproductive and lead to inefficiencies in the economy as a whole, and it is our assertion that we are at that point now.

The effect of the current regime on investors has been increased wariness of further investments in regulated assets, and it has a second effect: management is focused on cost cutting. Necessarily when the regulators require costs to be cut management has to focus on delivering those cost cuts. That distracts management from the far more productive pursuit of developing innovative ways of managing the business more efficiently going forward. I emphasise the point here that even if it has been the case in the past, equating cost cuts to efficiencies is incorrect.

We endorse the pricing principles recommended by the Productivity Commission for Part IIIA in the broad, and we believe that, to the extent that they're compatible with the Gas Code, similar pricing principles would be appropriate in the Gas Code. We have, in our written submission, identified a number of specific pricing principles which we suggest would complement those as recommended by the commission for Part IIIA. We particularly promote the concept of an earnings sharing model in which the business is given a direct incentive to drive for efficiencies by sharing over a period of time the benefits that derive from those efficiencies. The code should open up alternative pricing methodologies. We believe that there is a place going forward for price monitoring and we particularly believe that specific guidelines are needed to ensure predictable and consistent outcomes.

I talked about appeals before and it is worth noting that regulatory decisions can have a very significant impact on the property rights of infrastructure owners, the balance to which is that regulators need to be accountable for their decisions. In a broader sense, appeal rights would be expected when key decisions are made. Normally there would be a review of the process, the procedure and the merits of the decision, but under the Gas Access Regime parties have limited rights. Parties can't seek merits review until conclusion of the process and the significant discretion given to the regulators, particularly in terms of pricing principles, limits the value of the appeal rights that exist. The appeal body is explicitly limited to considerations of matters as set out in the schedule to the Gas Pipelines Access Law.

Guidance about policy objectives and pricing principles that we've talked about previously will assist in resolving those concerns, but we assert that there should be provision for merits review of the regulator's final decision. At the moment merits review has to wait for a regulator to reject an access arrangement in its final decision and impose its own access arrangements, and amendments are required to remove limitations on the grounds of appeal.

Turning to greenfields pipelines, and the issue here is facilitating efficient new investment, a matter that has been stressed in importance, both by the commission in its review of the National Access Regime and by the Parer committee. It's an issue that features prominently in policy statements from governments, it is clearly an issue that is of importance to governments to ensure that there is sufficient infrastructure to deliver the growth objectives that governments foresee for the gas industry.

The issue is exemplified most obviously in greenfields projects, such as major new transmission pipelines, but it's also an issue in respect to the expansion of the distribution networks. Again, on this point, the recommendations from the commission on the Part IIIA review and the Parer committee are welcomed, but we believe more needs to be done to support the agreed policy direction. We draw particular reference to our own experience with the extension of the gas distribution network into regional areas of New South Wales, where we have had significant success in generating viable extensions into areas, in particular like the Riverina, in times gone by, in times where there was a joint approach between the retailer and the networker.

We contrast that with our more recent experience in the central west and the current difficulties with the Central Tablelands Project, and we would liken the situation to the moving of the goalposts that has resulted in the separation of retail from networks. The separation is something that has obviously delivered very significant benefits elsewhere and this is not to argue against the concept of the separation of the two parts of the business, it is simply to observe that a collateral damage, if you like, from that has been that the development of regional networks is now - projects which were previously marginal are now not viable, and previously projects which might have been viable are now marginal.

The solution to that would be the provision of long-term exclusive franchises, ideally for a retailer associated with a network company, but alternatively, for a stapled franchise between an independent retailer and the network, and we believe that that could help to make some regional networks viable. We understand that this may be more of an issue in Victoria than it is in New South Wales but it has the potential to have some broader impact.

Back to the more general comments about greenfields pipelines: we welcome the recognition being given to access holidays. We think that's a worthwhile avenue to pursue, but we suggest that it is not a panacea; it needs to be - access holidays - and we've talked about 15 to 20-year holidays - need to be looked at in a context that the assets we're talking about here are very long lived, and I mean, 15 to 20 years being a lot less than the lives of these assets. Postponing the application of uncertain regulation for 20 years is obviously a step forward, but what it does is raise questions about what will actually happen after the holiday. We believe that the package needs to be complete, including addressing what rules will apply after the access holiday and what will be the transitional arrangements to bring a pipeline in 20 years back into the access regime and the regulated environment.

We have suggested previously - and again in our written submission to this review - an NPV benefit sharing model in which the benefits that a project generates - and necessarily in an NPV sense, these are later on in the life of an asset - where the project is successful ought to be shared between the investors and the users of the system. We accept that it requires an information gathering regime, but we assert that it would be no more intrusive than the current regime and ought to be eminently workable. We believe that such a model is very much worthy of consideration.

Let me just talk briefly about coverage. Regulation is not a costless exercise. Regulation is not the end in itself. It's a means to an end and is about applying an economic regime where it can generate the benefits in terms of competition in other markets that are clearly ahead of the costs of the regulation. But the emphasis here needs to be on a clear net benefit for the delivery of economic efficiencies. Regulation, for its own sake, is counterproductive and costly. We refer to the commission's recommendation, again in the Part IIIA review, for a criterion that includes the substantial increase in competition test. We strongly support that approach.

We acknowledge that in effectively asserting that more infrastructure ought to operate outside the code that there are valid concerns about how those pipelines themselves operate. We believe that an industry code is the appropriate way to proceed, just as it is in terms of access to upstream facilities. We note, however, that a code is probably not appropriate for those pipelines and networks where coverage doesn't apply simply because of the size of the operation. The history of revocation from the existing code includes a number of networks and smaller pipelines where it is recognised that the cost of regulation outweighs whatever benefit could flow from the effect of the regulation. It's difficult to see that a code of conduct is applicable in such circumstances, but we accept that there are a number of circumstances where a code of conduct is applicable.

The concept of multiple tiers of coverage has been raised. We don't believe that that is appropriate. We believe that it creates unnecessary complexity in terms of the assessment of who is in and who is out, who would be covered under what tier and what rules would apply under different tiers. We believe that with the appropriate guidelines to regulators, where the code applies, a single in or out test is appropriate. Again, we assert that the substantial increase in competition test is the one that should be applied.

Code change process: we share some fairly widespread concerns that the current code change process is a bit cumbersome. We note, however, that as part of the current policy direction there is to be created a new body, the Australian Energy Markets Commission, whose initial task will be rule-making and market development in the electricity market. I don't believe it's been explicitly stated anywhere but we believe that an appropriate development would be for that body to take over the rule-making and market development function in gas, and we note that that body and the Australian energy regulator have been slated to take over responsibility for gas transmission in 2005.

That being the case, our recommendation is not in terms of how the future regime should apply but simply to suggest that a transition path needs to be defined to take us from the current NGPAC regime to the new regime envisaged by the Commonwealth and state governments.

There are just a few other - relatively minor but nonetheless important in the scheme of things - factors that I'd like to touch on. Ring fencing arrangements have been raised in this discussion, and we wish to record our view that ring fencing arrangements under the current code are effective. We believe that they have operated effectively. We believe that there is a danger if they are strengthened that they go beyond the simple ring fencing of regulated and unregulated businesses, the infrastructure from the retail, which was their original intention. There are significant benefits to be gained in the service provision part of the industry from sharing resources and we believe it important that ring fencing rules not be applied to stifle those efficiencies.

Associate contract provisions in the code have been unnecessarily onerous. They have imposed very significant administrative burdens on regulated service providers and associated retailers and have adversely impacted on customers - we believe an entirely inappropriate outcome. We believe that the rules should be relaxed so that approval is not required, only notification, where associate contracts relate to reference services as opposed to negotiated service different from the reference services, or where the service provider is prepared to make a general offer of the service to be available through any retailer and to make it clear to the customer that that is the situation.

We note that there are also a number of smaller provisions in the code which are factors relevant to transmission pipelines but not relevant to distribution pipelines. They relate principally to matters such as the trading and public register of spare capacity. That has caused some concern to the operators of distribution networks and we believe it needs to be clarified that such provisions are not applicable to distribution.

Just to summarise, we've identified the five themes that we believe are appropriate and in which changes are needed to both the legislation and to the code, changes eminently achievable within the current framework of the code, not wholesale changes to the code but nonetheless important. At that point I'll draw to a close and invite your questions.

MR HINTON: Robert, thank you very much for that substantive presentation and very useful presentation. Also I thank AGL for their written submission which also is a substantive and very useful document. The Commission appreciates the participation of AGL in this inquiry, particularly given the significant role that AGL has in the sector. I have a couple of questions and though in fact your presentation has anticipated some of them - - -

MR WILES: I'm very pleased to hear that.

MR HINTON: - - - and that's a good thing, but let me start off with the greenfields issues. You talked about the truncation problem associated with regulatory intervention with regard to greenfields and you therefore, in effect, endorsed the concept of regulatory holidays that's been picked up by the Parer report and others. However, it's been put to us that there may be a potential for a regulatory holiday for a greenfields transmission set of proposals, it may in fact distort investment decision-making relative to say brownfields - that is, the expansion of existing infrastructure - and I think a hypothetical here is a construction of a competing pipeline as opposed to expanding the existing pipeline option. Do you have any reactions to that sort of tension that might be inherent in the idea of regulatory holidays?

MR WILES: I would support the assertion that there is a tension there between the treatment of different projects differently but I'd make the observation that that's probably a reflection of life, that there are many different projects that exist in many different circumstances and some projects don't get regulated at all. I think what the industry is asserting is that there are probably more distortions under the current circumstances than there would be by offering regulatory holidays, at least for some class of new projects.

It's a matter of concern to us, which I hope I've reinforced in the presentation today and certainly in the written submission, that previous recommendations have focused the idea of a regulatory holiday purely on transmission pipelines. I accept that that deals with the fact that transmission pipelines are much more discrete projects and more easily defined as being greenfields, brownfields, or whatever, but the fact remains that there are significant distribution projects that require very significant investment in essentially new territory and then there are equally significant investments that are probably not quite so clearly new territory. I would love for there to be a means whereby we could facilitate and encourage the investment in them all but I think where there are appropriate means of dealing with particular types of projects, let's do that and let's not avoid that simply because it doesn't include something else.

MR HINTON: Do you have any views on the sort of alternative approaches as opposed to a regulatory holiday that the regulator be given guidelines that would require him to place greater weight on the truncation effects of returns of regulatory risks such that he would seek to, or have scope to approve much higher rates of return for greenfield investments that might otherwise be the case? Are there better alternatives or - - -

MR WILES: There is no doubt that if the changes that we and others in the industry are promoting in terms of objectives in the code and the law and pricing principles are put into effect, then the concerns that have been expressed in the context of greenfields pipelines are, to some extent, ameliorated and I think that probably deals with the question you're talking about because what we are really saying is that there would need to be a greater recognition of the risks associated in projects and an acceptance that those projects that turn out to be successful need to be allowed to earn a return above their WACC to offset the suboptimal returns on projects which do not come good.

A key point to be made I think is that, in order for that regime to operate effectively, there needs to be a process whereby such outcomes can be locked in sufficiently early in the process and I guess I draw the contrast there with the greenfields guideline that the ACCC published some time ago which essentially was an invitation to discuss the possibility of rates of return that reflect different levels of risk but without any degree of confidence on the part of an investor that that would actually be delivered. Very large amounts of money need to be committed to these projects very early on in the piece and that's the time when confidence needs to be gained about the regulatory regime that's going to apply to these pipelines.

MR HINTON: Back to your objectives of certainty and predictability.

MR WILES: Absolutely.

MR HINTON: Well, let's move on to coverage. You anticipated my questions and cut me off at the pass, so to speak, of the possibility of a tranched approach or tiered approach to different sorts of regulatory regimes. Let me try a hypothetical on you and, really, in raising this question I have in mind your rejection of a number of regulatory models being applied was based on the conclusion of being too complex, overly complex I think were your words, but I read your comments to be importantly dependent upon the coverage criterion associated with a substantial increase in competition being the regulatory intervention outcome.

What if we didn't have substantial increase in competition from a regulatory intervention but rather we used the much wider coverage criterion of material effect on competition such that the activities being subject to coverage would be much wider but also much more diverse. Would that not want you to re-examine your position with regard to the option of having a tiered tranched regulatory model?

MR WILES: The phrase "Sophie's choice" comes to mind.

MR HINTON: Thank you for that analogy. You could call it a cheap-shot question, if you like.

MR WILES: No, absolutely not. I think though that I do sustain the point that you're offering two suboptimal alternatives and ones that I don't feel I'm in a position to offer extensive comment on at the moment. We would push for the substantial coverage criterion and support that by saying that those pipelines, those pieces of infrastructure that are covered, ought to have a clear and predictable regime and those that don't meet the criterion ought not to be covered.

We find the prospect of there being first division, second division, third division layers of coverage quite a daunting prospect because not only do you have the question of which pipeline to be in which division, but what are the levels of complexity that apply to pipelines and to infrastructure in each division? What are the processes for a piece of infrastructure to move from one to the other? The more levels you have, the more you open up the prospect that assets can move from one to the other during the course of their life.

Our concept is that infrastructure moving into or out of coverage would, if you get the rules right, and you get the pipelines in on the right side of the fence to start with - it would be a very rare occurrence that you would have pipelines seeking to be excluded from coverage once they were under it, or to be brought into coverage if they started off outside. All of the problems we've got at the moment are because of an inappropriate decision as to who would be included up-front and a lot of people seeking to get out from a set of coverage that turns out to be inappropriate.

MR HINTON: Yes, I suspect my question really was one of seeking elaboration from you of your thinking behind the criterion of substantial and you've done that appropriately.

DR FOLIE: One of the things that - this is a broader question, but the two industry bodies certainly basically said they want change for the code, and been through the various arguments, and when asked certainly the Gas Association, NGA, very strongly said, "'No, we'd like to keep distribution and transmission in the same code." We then asked, "Would you like to have branch separation? "No." But increasingly as we go around we find the discussion, depending on who is sitting at the table - you move down the general principles of the code and then you start getting some of the specifics of the regulatory environment, but there does seem to me, by and large, to be quite a difference between the issues and the way you talk abut distribution and the way you talk about transmission. I can understand people would rather have macro-reform rather than fit in this second order one, but I think it is fairly important to hear some views about whether these two need perhaps a branch in the code or to be recognised that there are structural differences. Could you - - -

MR WILES: It’s a good question and one tends to try to be pragmatic in offering comment on these things. I think up-front I’d declare that I don’t believe that there is a right answer. There is not a clear right answer. It is a question of balance between what I suspect would be significant administrative costs of having two separate codes for two groups of assets versus the fact that they could then be tailored to the specific needs of the different classes of asset. There is no doubt that there are features of the two classes that separate them. I talked before about the concept of trading and spare capacity. They deal with different types of customers in the main. The distribution networks tend to deal with retailers who are serving a broader market, while the long-distance pipelines tend to deal with major shippers.

There’s clearly a lot of commonality between the two groups, but the service they offer is different in that, on the one hand, you’ve got point to point service; on the other hand, you’ve got - how to describe it? - mix across a very disparate network. The experience to date, though - I’d tend to favour a single code and I guess I’ve got a bit of a bias there in having been involved in the development of the code up-front. It was an issue that we addressed in some detail, but there are a number of common features. The need to provide access, the need to have the regulation of prices, the need for those prices to reflect the requirement to curtail monopoly behaviour, to provide incentives to invest - all fairly high level stuff, but they are all common to both. The concept of a single code in which there may be a lot of common features and a specific transmission section and a specific distribution section seems to me to be a worthwhile compromise and believe that that would be workable.

DR FOLIE: That hasn’t been put to us; it’s normally to try and keep it all as one and - - -

MR WILES: I think the consequence of the recommendation that I mentioned in the presentation - that there are some provisions that need to be clarified as being applicable to transmission but not distribution - actually gets you there, because whether you have it as a section that’s headed Transmission Only, or a section of distribution only, or the proviso that "This section and this clause only applies to transmission" really is just a matter of presentation.

DR FOLIE: Yes, thanks very much.

MR HINTON: Let’s move on to ring fencing. Your presentation and your submission reach a conclusion that ring fencing provisions have been effective, but there’s a prior question: do you think they’re appropriate - that is, should they be there?

MR WILES: Not a question that I've actually given a lot of specific thought to. We've sort of accepted them as part of the furniture since the code has been developed and perhaps - - -

MR HINTON: I hasten to add my question doesn't actually mean I have a view on it one way or the other.

MR WILES: No. There is part of me that says they make life difficult, and therefore one would prefer they are not there, but on the whole, one accepts that given the general thrust of industry reform that we've had over the past 10 years, and the fact that there are many organisations that have historically been the bundle service provider covering what is now both the asset and the transaction in the transported product, that separation of those two businesses - because one is competitive and one is basically not - is necessary. So I think - although I perhaps hesitated a little bit initially with the question; I was rather surprised to hear you ask it - it would be fair to say that we accept that ring fencing is necessary.

MR HINTON: Do you see any tension of any substance between ring fencing associated with the regulatory objectives and the sort of commercial imperatives that underpin commercial activity? Are they in conflict, or can they sit happily side by side?

MR WILES: They require an internal discipline but then so does regulatory compliance generally and indeed, legal compliance generally. In our case we have a ring fencing compliance manual and ring fencing management and auditing processes, just as we have a trade practices compliance - manual and audit processes and management training exercises. It's part of the environment that we operate in. It creates tensions, it causes some problems, but not insuperable problems by any means.

MR HINTON: Related to this is, of course, issues associated with associate contract provisions. You've described them as - if I recall your words correctly - unnecessarily onerous. Was that the term?

MR WILES: Yes.

MR HINTON: I was wondering whether you could elaborate on that in terms of - is it because the regulator is interpreting the provisions a certain way? Is it the scope or coverage of what is defined as an associate contract? Can you give me a better feel for the origins and source of your concerns here?

MR WILES: We have got a particular example recently. I think - do you want to talk about that?

MR PRINGLE: Yes, I can speak to that because the AGL gas network probably has more associate contract dealings with IPART than most, if not any of the regulated business in the gas industry in Australia. Our associate contract is with our associated retailers. Because we're a distribution network they are all for provision of services to a particular end use customer and we have a clause in our contracts that we will not make an offer to any retailer without making that offer known to the end use - end consumer. So the end consumer is told that and he also has the ability to go and contact any other retailer with that same offer. So that's part of our ring fencing and trade practices type of practices - we will have that built into the contract.. So from our point of view, none of our associate contracts are by nature favourable to any one retailer over any other retailer.

So despite that, we need to go through the associate contract review process where it has 49 days' worth of approval. Typically even before that 49 days of approval process starts, we have quite a lengthy - what can be quite a lengthy period of discussion with the regulator that this is going to happen. So we inform the regulator prior to the start of the date that we have this associate contract coming along and the background of the contract and why. One of the examples that we quoted in our submission was a contract for a reasonably small customer; one small customer. That customer wanted supply of gas and it took almost five months, from the date when we began the negotiations, to when it was finally approved, and it wasn't approved until two months after the date when the customer initially told - he wanted the gas connected to that site. It was a new site.

The customer wasn't inconvenienced that whole two-month period because, as it turned out, there were other things that delayed it for a part of that time, but he wasn't able to get gas until five months after we started negotiating for this associate contract. That customer was aware - if it was any other retailer, it would have just gone straight through automatically.

MR HINTON: But in terms of associate contracts, you'd accept that to have integrity to the regulated system that it's crucial they be covered by the purview of the regulator's responsibilities?

MR PRINGLE: Our view is - our recommendation is that that should be notified to the regulator, that we have the associate contracts and the conditions of them, so that they are available. We don't want to try and do them in secret, but we will notify the regulator rather than have to go through the drawn out process.

MR HINTON: So it would be an advice only. But would they be available publicly to other customers? Is there a commercial-in-confidence consideration - - -

MR PRINGLE: I don't see an issue, why they shouldn't be made public.

MR HINTON: Thank you.

MR PRINGLE: There may be some - - -

MR WILES: A contract that may be commercial to the customer - you would want to protect the customer's interests in that respect.

MR HINTON: Yes.

MR WILES: I think the point that I'd emphasise there is again coming back to the question of why you've got the regulation - because the associate contract provisions per se don't achieve anything. What they do, though, is exert a discipline on the ring fencing between the regulated and the unregulated entity. In the case where the regulated entity is making it clear that this is a service that is equally available to unconnected retailers as it is to the associate retailer, then by entering into this contract there is no skewing to the level playing field, and in particular where it's on a reference service, there is no advantage offered to the associated retailer in entering into this contract, therefore seeking regulatory approval isn't offering any greater protection to the independent retailers.

Our assertion is that registering those contracts with the regulator so that there is a record of the transaction having been done, and if there are later proved to be problems, then the regulator has got all the information to act on, ought to be adequate protection, but where there are unique custom-built transactions that, by their nature, are specific to a particular retailer - and if that's the associated retailer - accept that that requires the regulatory scrutiny - but only in those circumstances.

MR PRINGLE: In that case you could argue that that should be open to scrutiny whether they are an associated retailer or not.

MR HINTON: There is a concern that's been put to us that one particular regulator is interpreting that provision - that is associate contracts provision - much more widely than other jurisdictions' regulators. It's picking up, among other things, asset management contracts that go way beyond what could be seen by some as being the appropriate scope of this provision. Has AGL got any direct experience or concerns in this area?

MR PRINGLE: We don't have any direct experience within New South Wales of that, but we are aware of the situation you're talking about, and we share that concern. In our submission we actually stated that there should be a provision in the code to prevent regulators taking that extra step and trying to extend the social provisions of the code.

MR WILES: We believe that circumstance you're referring to is interpreting the code in a way that it was not intended to be interpreted, and trying to use that provision to catch - - -

MR HINTON: Other activities.

MR WILES: - - - other activities that are quite different.

DR FOLIE: I have a quick question which is about appeal rights - and it's quite a common thread, so you're all on the same song sheet - wanting a full merit review. The first point is that - and it was made by the ACCC also yesterday - is that really normally you appeal on the facts that were actually put in the case, and that's fairly common on most sort of legal cases, so full merit review is really reopening the whole case again, which therefore could be more intrusive. The second part of the question is that if then the industry wanted the right to reopen, there are also the user groups, and no doubt there's a chance then the right of full merit review could actually be called by user groups as well. What do you think about - in other words, a double-edged sword?

MR WILES: Yes, it is. I don't have any further comment. That's a statement of fact.

DR FOLIE: So effectively a full merit review, you want it to come anyway, but there is also an element that users are wanting the right to be able to then call a full merit review under any terms.

MR WILES: Yes.

MR HINTON: One last question, Robert. Subject to any matter that you want to particularly emphasise that we haven't covered already this afternoon, my last question is in relation to a view that's been put to us about where we are today relative to when the codes were first implemented; that is, you've described the current regime as flawed, generating unnecessary uncertainty and therefore subject to significant criticism, leading to refinements.

An alternative view has been put that the first years of the access regime have been tough, but hard yards have now been done and that this transition period has now been achieved, so the administration of the Gas Access Regime as currently constructed should be less intrusive, less heavy-handed and even more efficient than what we've had to date; that is, why throw out the system we've got today, having gone through the pain of the last several years. Any reaction?

MR WILES: Quite a strong reaction. I understand that certain people may wish to promote that view of a fairly benign code that's been rigorously or variously benignly applied. Our response is that it's been applied the way it is because of the way it is, and without a change to the code we may find that it is applied to less rigorous effect because there is less blood to be squeezed from the stone, if you excuse the metaphor. But there is no confidence within the industry that the regulators will suddenly change their spot, and that's entirely what is driving the push to seek a change in the code.

MR PRINGLE: I don't believe there's any real experience of regulators ceasing to reduce the allowed rate of return and/or the forecast level of efficiency savings that they're imposing on regulated business.

MR WILES: No.

MR HINTON: Thank you for those comments. Is there anything we have not covered that you want to particularly emphasise?

MR WILES: No.

MR HINTON: Well, thank you again for AGL's submission and participation more generally in the inquiry, and thank you very much to you both for your appearance today. It's appreciated.

MR WILES: Thank you.

MR HINTON: We'll take a 30-second break while I get papers in order up this end, before calling the next to appear.

MR HINTON: We now move to the next session of the Sydney hearings of the Commission's inquiry into the Gas Access Regime. I now invite to the microphones, representatives of Hunter Gas Users Group. Welcome. It's a pleasure to have you here. For the purposes of the transcript, I'd be grateful if you could identify yourself and who you represent, at the conclusion of which I'd also invite you make a brief opening statement that might help us or facilitate the ensuing discussion.

MR SIMONIAN: Thank you very much. Firstly, I'd like to thank the Commission for allowing us and giving us the opportunity to appear today. My name is Garbis Simonian. I'm the managing director of Western Aluminium. I'm also the chairman of the Hunter Gas Users Group. Bob Lim has assisted me, as a consultant, because this area is quite new to me and I find it rather complex, but I'm slowly finding my way through. I'd like at the beginning just to ask that you be patient with me at times if I don't quite grasp some of the technical terms and some of the concepts, but I'll get to them.

The Hunter Gas Users Group consists of medium to large industrial gas users. Our membership consists of my company, which is a medium-sized company, with 45 full-time employees and 15 contractors. Others in the group consist of larger companies, such as OneSteel, Hydro Aluminium, Tomago Aluminium, Orica - and there are medium-sized companies such as my company, with companies such as Industrial Galvanisers, Milltech, Lovell Springs, et cetera. The position we take is quite opposite to the last speaker. I'm speaking as a gas user and we find that the current Gas Code, although effective, not effective enough.

We believe that currently the Hunter Gas Users Group pays some of the highest gas rates in the Hunter and there are a number of reasons for that. It is, of course, our geographic position - being at the end of the line - but we believe that some of the reasons we're paying these high prices are because of certain inadequacies in the Gas Code which we would like to see improved and tightened. We believe that certain aspects will improve competition and transparency.

Firstly, the gas market in New South Wales is unique. There is vertical ownership and contractual arrangements across the whole gas supply chain. Essentially there's one dominant gas retailer with a vertically integrated party who owns the distribution network. We really don't have much choice in the Hunter. We have a choice as to who we buy the gas from, the actual supplier, but when it comes to how we get it there, then we have no choice. In many cases the actual transport cost is higher than the cost of the gas itself, so in many cases we're paying $4 for the gas, or in that vicinity, but it's costing us 4, 5, 6, 7 dollars and in some cases more, to transport it.

What is this doing? What effect is it having? The effect is very practical and dramatic. To give you an example in the case of our company, we are currently paying $6 per gigajoule at the gate. That is after negotiating vigorously with AGL networks, because we threatened them with building a pipeline for 150 metres across a railway line, where the gas was considerably cheaper. After threatening and protracted negotiations, they reduced the price by 50 cents. You may say, "That's a pretty good outcome." Well, we don't think so. I have competitors in Victoria - my main competitor - who pays in the vicinity of $3.50. You must agree that is a huge competitive advantage, when gas is your highest input. We melt aluminium, and we use a lot of gas.

Now, why is this so? Well, we believe that there is more competition in Victoria. That's part of the reason. We also believe that competition is being retarded by the existing Gas Code in New South Wales. The effect it's having on our business is not just on our bottom line, our existing profitability or, in some cases, the actual viability of some of our members, but even when you are viable it retards your expansion. We are in a very, very competitive business. It is not only retarding expansion, but I know of cases where it is actually driving off potential investment in the Hunter Valley.

We are in an area of Kurri Cessnock local government area and Maitland, where we have one of the highest youth unemployments in Australia, around 35 per cent. We also have the highest unemployment in New South Wales. We need jobs, and I've seen cases where people have come and want to locate, they have a look and say, "No, your gas price is too high. We're going somewhere else." I know of one particular case where that's exactly what happened. It was to employ 300 people - 300 jobs which we sorely need. It was a company to supply products for the aluminium industry. We have two smelters in the area and they wanted to locate in the area, but they wanted to use two gigajoules of gas which is quite substantial, and that was a huge input from them, a very large input, and they just couldn't afford it so they've gone somewhere else.

From a practical point of view we really can't afford to continue with the existing regime. We need to do something, spur on competition, improve competition - and I don't believe what the previous submission presented - to spur competition is the way to go. We believe there are other ways and better ways. Secondly, what we would like to see is more transparency, because we believe that is the best defence against monopolies and what we call gaming. We need information, disclosure provisions in the Gas Code, not only to be maintained, but to be strengthened. We also want timely and robust information. We want the information not to come piecemeal, but we want it to come in full, on time, without us always continually trying to claw it out of the regulators - not the regulators, sorry, the actual works. Regulators must have reasonable powers and resources in order to carry out their job.

Thirdly, users must be able to understand the derivation of their tariffs. At the moment it's quite complex and someone like me really struggles, you know, reading through it. We believe that it can be simplified. There is no need for it to be so complex. Also we want, related to what I said previously, checks on the gaming and the information disclosures. We want time limits put on so that - and enough time for us to come back. We want a cap on the time frame for access reviews.

Another area where we believe it will spur on competition and bring in new players is we want clarity on the bypass pipeline provisions. In the past, when Duke Energy wanted to come into New South Wales, they were denied - or it was made very difficult for them to sort of tap into the existing pipelines, so they were forced to build another pipeline. So that showed a deficiency in the code. At the moment, although there are provisions, they are not clear. What we want is the code to make it easier and clearer for pipelines to be put in and distance pricing again to be clarified and also dispute resolution provisions to be simplified.

What we're trying to avoid is a long-drawn-out game with the existing network owner. We want to build a pipeline - well, we should be able to do that and tap in simply, clearly, without having to go through all the regulatory or legal hassles of appeals, et cetera. We also request the Commission to review the need to clarify positions in the code regarding tariff reloading, negotiating tariffs and other tariffs - other than reference tariffs - and dispute settlement mechanisms, which is what I've just said.

Another issue that has come in and we want to raise - although we didn't raise it in our written submission - which we believe will help competition and reduce prices, is the issue of backhauling of gas. In the Hunter there is a real possibility that coalseam methane will be found, because we're sitting on a coalfield. A number of companies are vigorously exploring for gas. If gas is found and we want to use the existing pipelines to tap in to haul back and sell in the Sydney market, for example, we want to be able to do that. The problem is the current provision is at the same price charge, which we believe is unfair, because you're just doing a gas swap. The gas doesn't physically move through the pipeline.

In the United States, I'm told - and in Canada - the backhaul fee is a lot less than the normal transport fee, but at the moment we'll be forced to pay the same even though the gas doesn't move. Again, I'm not sure but I'm told that it's substantially less, in the order of 10 or 20 per cent. Yet, as it stands now, we'll be forced to pay 10 per cent. Again, if there is a dispute resolution - we need a dispute resolution mechanism for this as well. We don't want to go through the courts. On this issue we will make a detailed submission later, because it is a very important issue, we believe.

The other concerns we have are of course - as I've mentioned - the gaming, the example of the associate contracts approval, sought after contracts were completed. My friend earlier said they want to simplify the regulations in regard to associate contracts. Well, there have been cases where they have been ignored. Why don't we have some provisions about penalties, or some sort of - you know, people don't comply with them, what happens? What's the use of having the regulations when people just ignore them?

Past treatment of capital contributions: a very good example of that is that one of our members, Hydro Aluminium, whose previous name was at the time, Alcan, when they built the smelter in I think 68, but the gas came later, in the early 80s - they paid more than half, or 60 per cent of the pipeline from Hexham to their smelter. They paid most of the cost and yet they get nothing for that and they're paying millions of dollars now, again. Past treatment of capital costs should be taken into account. You know, some of my members are very upset about things like this. It's just unfair. The other point that we want to raise is users can't appeal regulatory decisions.

So finally just to conclude, our members are remote gas users and are in a unique market, New South Wales gas market, with its dominant retailer and vertical ownership and contractual arrangements. Our members have had some benefit from the Gas Access Regime but they've had to fight for it and we believe that a lot more can be done and a lot more benefits can be - a lot of deficiencies can be rectified.

My members are concerned that a continuous campaign over the years by the pipeline industry quoting things like inadequate returns, investment deterrents, regulatory intrusion, require the Productivity Commission to establish the facts and to provide the analysis for public scrutiny. Now, these cliches, these terms I hear, "regulatory intrusion" and "investment deterrents" - it's funny, I'm reading a book currently by Sharon Bader called Power Play. It's actually on the electricity industry and the regulatory history of the electricity industry in the world and these same terms were used 80 years ago in the United States by the power companies before Roosevelt finally moved against them - the very same terms - and I see it again and again.

I think people should read this book just to get an idea how these guys operate because the bottom line is they want a monopoly and they want the maximum profit but at what cost? The community's cost, our cost and jobs in my area and the people that work for my company. They're exactly the same terms that they used again and again. Simple notions of light-handed regulation and non-intrusive regulation need to be carefully thought through because what these terms mean is, "Well, go easy on me and I'll do whatever I like." We believe that such forms of regulation of natural monopolies will compromise users' interests and make downstream industry such as ours in the Hunter less viable, less competitive and also retard development, which is my main concern. And now I am happy to answer any questions.

MR HINTON: Garbis, thank you very much for those comments and thank you also for your submission. You bring a particular perspective to the issues before the Commission, so thank you for that.

I'd like to start off and explore with you a broad issue of your relationship with the regulator. He has a group of users and, as you describe them, some are quite small and some are medium sized but it's regionally focused, end-of-the-line characteristics. The first question that comes to my mind then is how does the regulatory structure, the regulatory regime, let you down in that particular category of user and so the question then becomes what is your relationship with the regulator? How do you deal with these issues from the Hunter?

MR SIMONIAN: My relationship with the regulator is pretty one way, pretty much described as one way. When we negotiate we don't have, you know, much leverage really. The only occasion where we've had some success has been when we've threatened to put a pipeline in and we meant it, we would have. My members - the only way we see us getting a fair sort of price or competitive price is to increase competition and that means either competing pipelines or competing suppliers but those suppliers will again need pipelines.

MR HINTON: That's why I came back to your relationship with the regulator in circumstances where you seem to be constrained with your market power to negotiate acceptable outcomes with the service provider that their market power position puts you at a disadvantage.

MR SIMONIAN: Correct.

MR HINTON: Prima facie that suggests there is a role, a valid role, for the regulator - - -

MR SIMONIAN: Yes.

MR HINTON: - - - to intervene and set up a system that imposes certain constraints on the service provider and usually that carries with it an obligation for the service provider to agree an access regime with the service provider. The service provider has an access regime approved by the regulator. Your interests should be taken into account by the regulator in improving that particular access regime. Now, if it's not, that raises the question of what is your relationship with the regulator? Something seems to disconnects there somewhere. That's my question.

MR SIMONIAN: Perhaps Bob can assist me.

MR LIM: I think in Garbis's preliminary comments earlier I could see at least three areas in which that relationship with the regulator or the regime has not been satisfactory and in particular not satisfactory in terms of willingness on the part of the regulator to act and to act promptly. I think one example that Garbis used was the treatment of vast capital contributions by users; the fact that it was basically ignored by the regulator.

He also mentioned in his presentation the issue of associated contracts issue and, again, that was a view that the regulator did not act promptly or at the right time. So there's a third example which is the issue of gaming - gaming of information - and the extensiveness of the excess review, 22 months, or, as I said earlier, a four-year excess review is not an efficient review. So that relationship or those people in the Hunter, vis-a-vis the New South Wales regulator, that relationship has been based on those, at least, three or four major examples - - -

MR HINTON: Thank you for those comments.

MR LIM: - - - of regulatory failure, if you like.

MR HINTON: And Garbis did usefully make some suggestions about where the regulator's role could be refined - would improve the service delivery to the likes of the group that Garbis represents. But I have a problem in that if the regulator has approved an access regime with an essential benchmark tariff, then I'm a little puzzled why that leads to a pricing of that transmission service significantly above what you describe as your competitors in Victoria. Where's the disconnect there? How did the regulator reach the value, the pricing, the benchmark pricing of that tariff, that's so out of line with say your key competitors?

MR SIMONIAN: Well, a number of areas. I think that the returns that the regulators get is too high. Their internal rate of return of 12 per cent - that's pretty good money with no risk. I wish I could get my business model set up like that. Secondly, the valuation of assets, the way they're valued, I think that has many many question marks as to how they value it. We don't accept. The other thing is their costings, the costs. It's not transparent the way the management costs or ongoing costs, et cetera, are not transparent. This is why we are saying we want more transparency. The whole structure is too high.

I've done a little bit of homework on pipelines and what it costs to build them and, frankly, the costing on the whole structure is too high and, not only that, they want, I believe, too high a return for the risks associated with the investment. Now, we've prepared a chart of the return of other carriers in the UK and the US and the return in Australia that AGL gets is much much higher and yet they want more and they're not happy. That's why we're paying too much.

The other thing is I believe there's also a little bit of cross-subsidisation may be going on. Again, I can't tell - I'm not an expert - but this may well be happening. We're paying very high prices. Now, ever since the line was built from Wilton and they have competition with another line to Sydney, all of a sudden the rates drop there and, "Who are we going to put the extra cost on? Let's put them on the guys in the Hunter because they have no choice." There's no competition there and there's a bit of shifting going on. The other aspect we're very concerned about is, well, what happens when BHP closed in Newcastle, you know, the amount of gas going through, consumption dropped significantly, and when Pasminco closes or it's closing this month, I believe, again there will be another drop, substantial drop, and, you know, what will AGL try to do?

They will try to get the same income from less consumers, which means we will end up paying a higher gas fee which means our costs go up which means more people go out of business and the whole cake is shrinking and gradually that's what will happen unless some action is taken to do this. That's what we don't want. We'd want to pay a reasonable price and take into factor all these points that I've raised about past contributions, et cetera, et cetera, and let's get the cost down to a reasonable level to encourage some more players to come into the Hunter, otherwise it's just a spiral down. That's really what we don't want because it's going to lead to more job losses and more unemployment.

MR HINTON: Let's shift the discussion to the area of compliance costs. I'd welcome your comments, particularly given the shape of your membership. The sorts of costs incurred in dealing with the regulator, dealing with a regulated environment in terms of ensuring that you deliver proper documentation, make your case substantively and persuasively, relationships with the service provider as well, all carry with it certain operating costs of some substance. Can you give us some comments on that area?

MR SIMONIAN: Yes, it's a very complex area. It's an area that I don't believe any person in business can easily master. You need experts. You need consultants. It's a very complex area and you need time and certainly I can speak for the mid-sized members that we have, companies such as ourselves. We just don't have the resources to be able to tackle this problem on our own and I think one of the reasons we all got together and formed the Hunter Gas Users Group was for this very reason. It takes a lot of resources and we just don't have it to be able to fight effectively. You have a very large organisation with, I believe, 30 full-time people looking after this area against a company, such as me. We can't even spare one person so you have an adversarial sort of system where 30 against one and, also in terms of resources, we just don't have the money.

That's why we say let's take the gaming out of it, let's simplify it in that - not simplify it in terms of regulation but not let people drag it out and make it legalistic and complicated; so that we can understand it and we can sort of, I guess, present our case more easily.

MR HINTON: So you would be willing to wear the burden of administering appeals if they were extended to users' option?

MR SIMONIAN: Well, we would, but again it depends. That's why we said dispute resolutions are better; we'd prefer those than going to court. As you know, going to court is a very very expensive exercise, and wherever possible we would like the actual code to have the mechanism to take away - or even appointing an independent referee or some sort of judge, but not the full legal process. That would help enormously. A mediator, perhaps.

MR HINTON: Yes. Michael? I covered the - - -

DR FOLIE: I think the main ones. Just a minor one, which is to do with if you take coalseam methane, the specifications could be quite different to that in the gas, and we had from a group today that are in the Hunter and want a very specific type of specification for their gas. Do you see any - there are some complications in this backhauling, particularly if the gas that's going in is quite different to the gas that's actually already in the system.

MR SIMONIAN: I don't have specific information on that issue, but in the United States apparently it's very common, in Canada. So certainly I'll have to look into it, but certainly for our use it wouldn't matter, but for some customers that may well be an issue.

MR HINTON: In fact it was one of your members, I think - - -

MR SIMONIAN: Yes.

MR HINTON: - - - who is in the room here.

DR FOLIE: But not wanting to go into that.

MR SIMONIAN: No.

DR FOLIE: How far is that - is that discussions about actually - because it is actually an important part of the code, to facilitate access of additional sources of gas around the country, not just focus on the end-user, but also to enable people who might get gas fields to be able to get into the system. I'm just interested to what extent there's been any sort of discussion between those producers into it - it's obviously fairly interim at this stage, but how far those discussions have got, and whether they're also going to bog down into complex negotiation, do you think.

MR SIMONIAN: Well, they haven't gone far, because this issue of backhaul, as I said, has come up recently, because this coalseam methane is moving very quickly and I believe there's a good possibility that there will be gas found. The only question is what quantities, and now the issue of what quality or what chemical specification or analysis. So I don't know. We'll certainly look into it, but that may be an issue.

DR FOLIE: Okay. Thank you.

MR SIMONIAN: But we have to be careful again not to use small technical differences in order to hinder real competition, which has also happened in other areas of business I've come across, where small specifications - the Japanese are very good at it. For years they kept a lot of Australian beef out of the market - or Australian produce - or the EEC does, using health or other reasons to keep out products.

DR FOLIE: So you'd like to widen our terms of reference, would you?

MR SIMONIAN: Well, perhaps. If it increases competition and reduces, I guess, prices to the user, sure. That's the aim.

DR FOLIE: For the Hunter, is there any scope for an alternative spur-line coming down from somewhere else

MR SIMONIAN: I hope so. For our members' sake we would like to see - as I said, we're very keen to see more players.

DR FOLIE: But presumably if the price of gas is significantly above that which is generally prevailing, as delivered, then that prima facie is a commercial incentive for others to look at that opportunity, subject to demand being sufficient.

MR SIMONIAN: Yes. I agree. That's a fair call, and that's why - what we would like is to remove some of the barriers that we see, such as distance pricing or this backhauling, having access to tap into the line, without being bogged down. I mean, these are the practical sort of barriers that we see, we want removed. I think the existing code can be improved, and more transparency. These will all help - all they do, these barriers, is just reduce the opportunity for competition and just put up the cost of coming into the market.

DR FOLIE: Yes. Is there anything else you want to particularly emphasise that we haven't covered either in your comments or our questions?

MR SIMONIAN: All I want to say is, the Commission is welcome to the Hunter. We have some great wines, it's a great place to come.

MR HINTON: Perhaps we should be meeting up there.

MR SIMONIAN: Yes. We should have the next meeting up there.

MR HINTON: Thank you again very much for your submission, your presentation and your participation in this inquiry. It's appreciated.

MR SIMONIAN: Thank you very much.

MR HINTON: We will now take a short break for afternoon tea, coffee, water, and return here at 3.15. Thank you very much.

MR HINTON: Welcome back to this afternoon session of the Productivity Commission's inquiry into the Gas Access Regime. I now invite the next attendees at this public hearing, that is the representatives of BHP Billiton. Welcome, it's a pleasure to have you here and, consistent with past practice and established procedures, I would be grateful if you could, for the purposes of the transcript, identify yourselves by name and who you represent, after which I would then invite you to make a presentation that would facilitate the ensuing discussion. Thank you very much.

MR MARTIN: I'm Colin Martin, from BHP Billiton Petroleum.

MR MURPHY: David Murphy, from BHP Billiton Petroleum.

MR BIGGS: David Biggs, from BHP Billiton Petroleum.

MR BALCHIN: Jeff Balchin from the Allen Consulting Group.

MR HINTON: Thank you very much. Over to you, Colin.

MR MARTIN: We thank the Commission for allowing us to present today, and for in fact receiving our quite lengthy submission. I guess, just to start off with, BHP have approached this review from a number of aspects. We are a significant gas supplier, we are a very significant gas user in the context of Australia. I think we consume somewhere in the region of 85 pedajoules per annum if you include our subsidiary companies, and in the past we have developed and owned transmission pipelines. So we have been interested, throughout the chain, over many years. I guess BHP Billiton, the name will not be unfamiliar to people that have followed the regulatory process as well over the last decade. We have been around for a long time, we have participated in many reviews, both major reviews such as this and reviews of access arrangements.

The BHP position is that the current regulatory regime for gas is working effectively to maintain the misuse of monopoly power. It has promoted competition and growth in both upstream and downstream markets and it is supporting new investment in pipeline projects where those projects are economically justified. Our submission goes into a fair bit of detail citing evidence of this, but just briefly for this public hearing, and I think the evidence is clear, thousands and thousands of kilometres of pipeline have been put in the ground over the 90s. There are lots of players interested in purchasing gas assets, as we have seen and will come on to further in this submission. Upstream activity has increased, reserves have increased and new sales contracts have been entered into from both existing and new producers and players. There is also a clear trend of gas increasing as a fuel type in virtually every sector. Just to top it off I guess, and the voters haven't missed out as well, 1 million extra households had gas connected over the 90s.

So I guess our view of that is that we don't see an industry in crisis. That is the upshot. There have been a lot of statements over the last couple of years that the regulatory regime, as it has been implemented, has in fact crimped returns, chilled investment and caused a flight of capital. Quite frankly, the empirical evidence does not show that returns have been stunted at all. Of the transactions of infrastructure assets or energy infrastructure assets that have been sold, it has been shown that they are selling at about 1.4 to 1.6 times their regulatory asset value. So it's a very substantial premium on their regulatory asset value. We suggest that there is a strong investment for utilities to invest.

Just over the page, we now come on to some evidence here as to really what has happened since I guess the 1998 Victorian regulatory decisions, which were broadly seen in the industry as I guess being a bit of a watershed as to how regulators would interpret the code. I mean, there had been regulatory decisions as far back as 96, but I think the 98 decisions in Victoria were seen as a bit of a watershed. I guess our view is that since that time there has been vigorous activity in the sector, both in the sale of existing assets and in the development of new assets. You will see that over the last four years some $11.3 billion of existing assets have been transacted. We don't view that as a flight of capital.

Now, we come on to greenfield developments and I guess the assertion by some that there has been a chilling of investment in greenfields activity. We have selected two particular pipelines to have a bit of a further look at, one of them being the Tasmanian gas pipeline and the other one being the SEA Gas pipeline. We have selected these, because some sectors of the pipeline industry have asserted that pipeline development was well under way before the application of the code became obvious, and they wouldn't have done what they've done if they knew how the code was going to turn out. Both of these developments were progressed or started within the environment of when regulatory decisions were well known.

Just to take the Tasmanian gas pipeline developed by Duke, it was in May 1998 that the Tasmanian government selected Duke to conduct a feasibility study on gas supply in Tasmania. In May 1999 Duke announced that gas supply to Tasmania was viable, well after regulatory decisions had been made. It took them a further - over a year, and in November 2000 Duke announced that it had board approval for the Tasmanian gas pipeline investment. In 2002 gas commenced flowing. So that entire Tasmanian process was conducted after the Victorian regulatory decisions came down and the implementation of the code was known.

If we move to the SEA Gas pipeline, it was in June 2000 that the South Australian government launched its new gas initiative. That was basically a beauty parade to encourage developers who want to build a pipeline. Contrary to what was said this morning, the pipeline industry did participate in that beauty parade. For a fact I know that GasNet are on the record, and Duke are on the record, of having participated in that parade. The South Australian government in March 2001 selected the SEA Gas consortium, which at that time comprised Origin and International Power.

In May 2002 the project reached financial close and it was announced to be a $300 million project. I think if you go back to press releases and the like between May 2002 and September 2002, TXU suggested they would build their own pipeline in South Australia. In September 2002 TXU joined the SEA Gas consortium. The project was expanded to a $500 million project and the fully-compressed capacity of that line was announced as being 125 pedajoules per annum into a market which currently consumes 120 pedajoules per annum. So once again the assertion of only building pipelines to size is clearly not demonstrated here.

If we move on to the coverage test, we believe that the current coverage test is appropriate and effective. In our view the test rightly sets a high hurdle for coverage. Covered pipelines that are found to possess substantial market power, in the absence of regulatory intervention, are likely to set inefficiently high prices. We think that the revocation process should reflect the importance of these monopoly assets and, in our view, the NCC has been very pragmatic in progressing revocations for smaller pipelines and smaller distribution systems that were covered at the start of the code, and for substantial assets, such as the Moomba-Sydney pipeline, it is our view that the process should be fully investigated and rigorously tested. If that takes a few years it's better to have due process than to have the incorrect outcome.

There has been some suggestion that somehow costs shouldn't be considered in regulatory coverage. It is our view that a cost based approach to pricing of regulated downstream monopoly assets is essential. Why? Because it maximises upstream and downstream activity, and it does provide sufficient incentive for continued investment over the long term in the regulated assets. We also note that the Productivity Commission has, in its Part IIIA review, noted that there should be a link between cost and prices. We think the debate is more how to measure costs and how to provide incentives, than whether there should be cost based pricing or not.

Another suggestion that has been made by the pipeline industry is that we should move to a negotiate/arbitrate model for transmission pipelines. I guess at the start of it we would note that for uncovered pipelines we currently do have a negotiate model, because there is no recourse, and that for covered pipelines, by definition, we are talking about pipelines with very substantial market power. In our view, and we will come to some examples here, the negotiate/arbitrate model just does not work for access seekers. There are a number of issues at play here. I guess the first statement that is obvious is that a monopolist has market power, which it can use to increase prices or reduce services. Without access to information the access seeker is in a position of information asymmetry and at a major disadvantage in any negotiations, but more importantly it comes on - it's great in theory.

Negotiate/arbitrate may sound good in theory, but in the practice of the market there are some issues here. The first one is that the monopolist pipeline in our view has no pressure to complete the negotiations within a reasonable time frame. In contrast, the access seeker will likely require certainty over both the availability of capacity and price within a set time frame. This is because, for example, an access seeker that ran a large industrial plant isn't going to turn their plant off to go to arbitration for six months. They are going to be forced to settle with the price that is being offered by the monopoly pipeline. I guess that also in our view a dominant retailer in a market - and there are dominant retailers in our view in the New South Wales market, the ACT market, the South Australian market and the Western Australian market - would have no incentive to negotiate on behalf of the end users of supplies. It's a straight cost-plus pass through to the end users.

This issue would be made worse where there is a vertical integration issue between a retailer and, for example, a pipeline owner. We would also suggest that, and this is our experience, arbitrations are expensive, time-consuming and have uncertain outcomes. So if the pipeline industry is after certainty they are unlikely to get it by the arbitration process. Just to come to some examples here, I guess that particularly on this time pressure issue, when the Eastern Gas Pipeline was being built, and BHP and Esso were foundation shippers on that pipeline, we signed a transportation agreement with Duke and the transportation agreement specified delivery point being Horsley Park in New South Wales.

Now, Duke could have built the pipeline to Wilton and then negotiated access on AGL's system to Horsley Park, and BHP Esso was not against that, or they could have - and what happened is, they developed a parallel pipeline. That was because they had a time pressure to meet the delivery date for BHP Esso, and the negotiations within that time period failed because the monopolist, in Duke's view, at that time would not strike a reasonable price. That is a clear example of where negotiate failed. There was no arbitrate test. They went and built the pipe instead. It's an example of the difficulty of negotiating with monopolists. If we move onto greenfields pipelines, I think our view on greenfields is that there is just no evidence that the code has constrained the development of greenfields pipelines. In our submission we show that the kilometres of pipe just keeps growing every year.

We also note that the coverage test ensures that the code is only a backstop and used when there is monopoly power. It has been mentioned today that a number of the new pipelines built are not currently covered by the code. We think that shows that there's certainties in investors' minds about the coverage test, for example.

We think that the regulatory decisions that have been taken on greenfields investments do show the code's flexibility. We particularly draw your attention here to the Central West pipeline which, from memory, is the only greenfields pipeline covered by the code. The ACCC's decision at that time was commented upon by the CEO of APT as showing the flexibility of the code, and there were a number of places where the ACCC used the flexibility within the code to meet the service providers' needs.

Our submission also goes on to comment about two very high profile proposed pipelines, being the Darwin to Moomba pipeline and the PNG pipeline. In our view, I hope we demonstrate that the code was not a material instrument in the current failure of those pipelines to move ahead. It was, in fact, competitive market conditions that meant that those pipelines had not moved ahead to date rather than any failure of the code, as has been asserted by some.

If the Commission does consider that any incentives are required for greenfield pipelines, I think it needs to consider a number of factors. (1) the code does not operate as a barrier to efficient greenfields projects. In fact, we believe that it supports efficient levels of investment in the industry. (2) - and this hasn't got much of a run to date, in my listening to the hearings and the submissions - is that, in our experience, the overwhelming majority of greenfields projects are underwritten by foundation contracts with shippers, so there has already been a very significant risk allocation go on between the pipeline developer and a set of shippers. In fact, it is the shippers that are taking the volume risk as opposed to the pipeline developer.

We note that the code does provide for competitive tendering. We agree that the provisions are cumbersome and they could be streamlined and fixed up, but I think that we also note in our submission that the PNG pipeline moved forward under the competitive tendering provisions and that there was no complaint by the pipeline industry as to how that worked.

We also believe that both producers and users have incentives to construct optimally sized pipes. I mean, it's not in the producer's interest to have a hose pipe built from their processing plant to the market. It's in the producer's interest to have an appropriately sized pipe built from their processing plant to the market, but that doesn't mean that the producer - an optimally sized pipe would not be a smaller pipe with developable capacity to follow in the event the growth of the market was unsure or being able to capture a market that was unsure.

I guess, in short, we don't have any magic fixes for greenfields pipelines and the question whether they're required, but we think that if the Commission does believe that something for greenfields pipelines is required they must be specific to greenfields developments and not affect existing pipelines under the code. Two, they must clearly deal with what happens at the end of the special period if, in fact, the pipeline did meet the coverage test at that time, whatever the coverage test was. Thank you for listening to our opening presentation.

MR HINTON: Colin, thank you very much for those comments.

MR MARTIN: Sorry, I left out a major page here - two pages. Sorry for that. I got a bit ahead of myself. It's actually a very important issue and I shouldn't have got ahead of myself.

MR HINTON: I'm happy for you to continue. That's fine.

MR MARTIN: Thank you. It's the issue to do with vertical integration in the downstream industry and how that flows into ring fencing within the code. I mean, in BHP's view, it's a fact of life that vertical integration in the downstream industry will exist in the Australian market. It's just too small not to have it. We think, though, that the vertical linkages between a monopoly and potentially contestable parts of the gas business can hinder the development of effective competition.

Vertically linked entities have incentives to act in ways that undermine the objectives of the gas reform process - that is, to preclude or delay the introduction of competition into a market and to allocate costs from the contestable business to the regulated business - and the implications of this unchecked behaviour can lead to higher prices and associated loss of efficiency benefits and the potential exclusion of new entrants from a market. Just a comment on this here is that new entrants, particularly if they're small - I mean, competition is fragile and you don't have to deter the new entrant too many times before the new entrant packs up and goes home somewhere else. We also think that a reduced level of competition and associated loss of industry innovation is likely as well.

What's the implication for the Gas Code of vertical integration? We think the ring fencing provisions should be maintained. They are there and intended to counter the negative effects of vertical integration. We think that the regulatory framework must be able to pierce the corporate veil, for want of a better word, and regulators should be able to look at any non-transportation associated contracts, such as contracts between a regulated entity and their affiliated service provider that provides and operates the pipeline for them. For example, Origin Energy asset management manages the Envestra system for Envestra. That's an example of what we're talking about here.

There is a potential for the shifting of costs between regulated and non-regulated entities. The ring fencing provisions must be effectively and efficiently used to counter the potential impacts of increasing vertical integration. In our view, we think the code actually is quite good in the ring fencing provisions. One of the problems we've noted is a lack of regulatory courage to use those provisions against service providers. It's more the implementation of those provisions within the code as opposed to, in our view, a problem with the code itself. That does conclude my presentation, thank you.

MR BIGGS: Excuse me, Tony. We did discuss this before, but would it make sense to get Jeff to say his small piece now, given that you may not have any questions of him, or would you prefer to deal with our section first?

MR HINTON: Let's stay with our schedule for the moment, if that's all right, Jeff, and take what we've got so far. We'll move on to Jeff's presentation shortly and follow-up questions that might arise. Let me record, first of all, our appreciation of Colin's presentation - thank you - and BHP Billiton's substantive submission. It is a substantive document that addresses a whole range of issues. It's important that the Commission has input from a significant player like BHP Billiton in this particular sector, so thank you for that.

In many ways, your submission and your presentation has anticipated some of our questions and that's not surprising, given that this is the last session of hearings having been held in Perth, Adelaide, Brisbane, Melbourne and now Sydney. Let me seek elaboration or clarification in a couple of areas. Let's take coverage, first of all. You put particular weight on the criterion of substantial competition, but some have interpreted the code, as currently structured, as much wider than that - coverage going beyond that.

Our Part IIIA review did refer to this issue and recommended that intervention be based upon the pursuit of a substantial change in competition as opposed to the government's interim response that referred to material effect, the latter, of course, producing a much wider coverage than the further. I assume that you were, in effect, endorsing what came out of the Commission's review of Part IIIA. Is that - - -

MR MARTIN: No, I think what we're saying - and, if we weren't clear on this, I'd like to make it clear - is that we support the current coverage test, as written.

MR BALDWIN: I'll make a few comments. What we actually said in the report was that we supported the coverage tests regulating assets that have substantial market power.

MR HINTON: Okay.

MR BALDWIN: At the moment, the way the coverage test is, you have to go through a few steps or hurdles to get to that end point, but as we see it the current coverage test, as it is, actually defines those assets that have substantial market power. I understand the NCC's view is that there's not a lot of difference between the use of material or substantial because, in effect, they still look at the end of the day as to whether or not the facility in question has substantial market power. In fact, there may be advantages in simplifying the whole structure of the test rather than trying to look at promotion of competition in a market, actually looking directly at just asking the question directly about whether something does have substantial market power. In fact, that's how the test works at present.

MR HINTON: The word "substantial" in this case - this formulation - is in relation to market power, not the effect on competition.

MR BALDWIN: That's right, yes.

MR HINTON: I apologise for the confusion that I've now caused. Thank you for that clarification. You're, in effect, endorsing the current regime's coverage outcomes. We can argue or discuss how you describe it, but certainly - - -

MR BALDWIN: That's right.

MR HINTON: - - - the basic message is, as you've just said, continuation of the current coverage outcomes. That took away the next two questions.

DR FOLIE: Just one which is worth throwing in, which is still on coverage: although you support the current regime, do you also support removing the right for any person to be able to then ask for coverage or should they actually have a material interest in the project?

MR MARTIN: I think that vexatious applications for coverage should be able to be dealt with in some way without having to go through the entire coverage process, yes.

MR BALDWIN: If you want my view, I think the NCC currently is required to assess any coverage application under the - - -

DR FOLIE: There have been cases where people allegedly have never asked for coverage and that's then triggered off a process.

MR BALDWIN: Yes. I mean, it brings the whole system into a bit of disrepute if anyone can just lodge a massive regulatory process.

DR FOLIE: That's allowed under the current system, so you - - -

MR BALDWIN: So it makes sense to prevent trivial or vexatious - - -

MR HINTON: But, in some ways, to assess whether it's vexatious is a judgment in itself.

MR BALDWIN: I think actually Mr Folie's suggestion where, rather than vexatious, a material interest is probably a better test.

MR HINTON: Yes, thank you. Let's move to investment. You've presented a case that fitted into that category of interested parties that argue that the gas access regime is not acting as a deterrent to investment activity in this sector, and you point to a whole range of investments that have taken place. The counterfactual area is very difficult, and so we do appreciate having your input on that issue, because it's an issue that we're going to have to come to some judgment on. Clearly there is a range of views. The more elaboration we can get in this area as to the impact or otherwise on investment - it's a tough one but an important one for us.

One narrow aspect I'd like to explore with you is this issue of expansion of existing assets. A number of interested parties presented quite persuasive reasoning, without necessarily specific case examples though some are probably around that suggested construction is to known demand, such that any expansion, subsequent expansion, is dependent upon compressors and loops. Because of the regulatory risk inherent in any expansion of existing capacity beyond known demands whereby there is surplus capacity would therefore be a greater risk than otherwise would be the case. Is there not some sort of reason, view, that can lead to that conclusion - that the regime in itself, with regulatory risk, does impede investment in size beyond known demand?

MR BIGGS: I guess we can only speak from our direct experience and we are - or have been - involved in discussions around three major greenfields pipelines; one is the Eastern Gas Pipeline, the other one is the Tasmanian pipeline, and the third one is the SEA Gas pipeline. The Eastern Gas Pipeline, which is currently not covered, was built ab initio with a fair degree of surplus capacity. Beyond a certain point any pipeline will need compression to increase its capacity in any event. It's just a question ultimately of what its free-flow size is.

The Tasmanian gas pipeline is in the same position. It has, to my knowledge, a degree of excess free-flow capacity and that was built after the regulatory code was well known, and the SEA Gas pipeline, based on my knowledge, was built with its current parameters due to a variety of factors, not the least of which - it has ended up being the product of an amalgamation of two separate pipeline projects which came into one and the pipe was ordered for both before the parties managed to negotiate their way to an agreement, so it ends up being in a somewhat curious position. I think, as we said, its compressible capacity is up to about 125 kilojoules a year, fully compressed, and I put it to you that it surprises me, based on the work we have done, that there is some reluctance to add an inch or two to the size of a pipeline as it goes into the ground, because the numbers we've seen would suggest in the overall cost of a pipeline project that adds something like 5 per cent or so to the cost. It's actually a very small increment and it surprised - - -

MR HINTON: An opposed to extension by compressor - - -

MR BIGGS: Compressing later.

MR HINTON: Yes.

MR BIGGS: So it does surprise me that the pipeliners believe that things are so finely balanced that they're down to those sorts of numbers, particularly as I suspect in those pipeline projects the contingency would be larger than 5 per cent anyway. I guess we're a bit puzzled by this and I guess in some cases where there have been perhaps reasons to build pipelines with a specific capacity related to size my guess is there may be extraneous reasons for some of that, not necessarily directly linked to the code. Certainly that would be the case on one pipeline that I'm aware of.

DR FOLIE: The implication is that they build to, if you like, free-flow size - for want of a better word - to then sort of mitigate the chance of then having to actually sort of have any capacity available for somebody to then ask for a coverage proposal. It always comes back to this coverage, as it has been put to us.

MR BIGGS: The only one I am aware of directly that it has been said that of is the SEA Gas pipeline. There may be other examples but I don't know enough about them but, to my knowledge, the SEA Gas pipeline was sized for, as far as I am aware, reasons unrelated to the code actually.

DR FOLIE: That's what you said in your other question.

MR BIGGS: That's my understanding.

MR HINTON: You refer to the importance of foundation contracts being a key, if not a crucial part of greenfield development, and that is very important as to who bears the risk. That raises questions of the market practice or otherwise emerging or common with regard to MFN clauses and whether or not you have some comments for us on the implications of MFN clauses that can in fact significantly shift again the risk-bearing of greenfields projects based upon foundation customers that might have a very different outcome for prices once you get new customers.

MR BIGGS: I think MFN clauses are more likely than not in transportation arrangements, particularly for greenfields pipelines - they're certainly common in the US and overseas in my experience - and, as a producer, we probably, as a foundation shipper - I'll be absolutely blunt - we would probably want to see some form of MFN clause. I put it to you that they are not always straightforward MFN clauses. Some of them do allow you to trigger that provision only in very limited circumstances, so pipeliners do have the ability to protect themselves to a degree - to the fact that any subsequent deal they do may have the potential to bring down tariffs across the whole pipeline, so it isn't as black and white as some people may think. Certainly that's our experience of Australia.

There are limits in terms of how some of those MFN clauses will work. I guess the other comment I would make is, look, it's simply a matter of negotiation at the time. When greenfields pipelines are built that is when the risks are allocated and the pipeliners go into those projects knowing full well precisely what risks they are entering into and it seems to me that they don't have to do the business if they're not comfortable with the risk. They go in with their eyes open.

MR HINTON: Thank you for those comments. Can I seek from you some clarification as to your position on the possible options for handling greenfield projects. You've presented in your introductory remarks up-front the view that there is flexibility in the code to handle greenfields and, not only that, the experience over the last X years is supportive of the view that the regime is not impeding greenfields investment.

Where does that take you with regard to your views on the ACCC's draft guidelines that has put forward certain flexibility for handling greenfields? Is that included in your judgment as to the code today? Secondly - a related point - what your attitude is to the Parer report options or suggestions or proposals in some ways regarding greenfields - to get me a better understanding of where you really stand on this issue of how to best handle greenfields issues.

MR BIGGS: To answer your first question, I think we are on record as supporting the ACCC's draft greenfields guidelines, so I mean our contrary - in our submission assumes that those, or something like them, may well come into effect and we have no problems with what was suggested by the ACCC. In practical terms our view is that the code, as we see it, does provide sufficient flexibility to deal with most options around greenfields pipelines. We have no problems for example with arrangements that seek to provide certainty over the longer term - that perhaps lock in an initial decision for a period and that is not capable of being reopened - if that is required to get a pipeline up.

I think we think that the regulatory holiday proposition out of the Parer review while attractive in some circumstances, once you get into the detail of thinking around how that would work, it strikes me that you potentially get into some real problems, not to say they couldn't be worked through, but my suggestion is that some of what seems conceptually attractive may get itself into difficulties once you get into the detail, but that's not to say these things couldn't be worked through in another forum to try and come up with some sort of workable solution that everybody can buy into, where necessary. I mean, I don't think every greenfield pipeline necessarily needs the same sort of prescriptive flexibility. I think the issue here is providing some sort of overall flexibility that essentially addresses certainty for a period, if necessary. That's the plea I'm hearing, I think, from the pipeliners.

MR HINTON: Does the same sort of reasoning apply to the investment environment for expansion of existing capacity; that is, brownfields, that someone has coined - - -

MR BIGGS: The answer is, potentially. My experience is that you're unlikely to see any sort of brownfields expansion unless it's effectively underwritten in any event to a substantial degree. That's typically the case.

MR HINTON: I had in mind whether or not if you gave pure greenfields that particular regulatory holiday that could distort investment decision-making relative to the alternative expanding existing?

MR BIGGS: It might, and I wouldn't rule out its application to enhancements, loopings and compression and so on, but I think it would - like in all these things we would argue that it would need to be on a case-by-case basis and fully justified and, as I said before, while we note the Parer committee's review and recommendations around regulatory holidays, we're not altogether sure that's necessarily the right direction to head it. It might be better to give regulatory certainty rather than - - -

MR HINTON: Rate-of-return concept?

MR BIGGS: For example - - -

MR HINTON: Yes, for example.

MR BIGGS: - - - or an agreement - enter into agreement with the regulator and the pipeline developer ab initio that is not capable of being reopened in any respect for a certain period, so the pipeliner knows where he is for 10 years or whatever is appropriate.

MR MARTIN: Tony, can I add to that?

DR FOLIE: Sorry. Can I just get to the - I mean, basically where it would seem that the greenfield pipeliners are really saying, "If we're prepared to put down the money we can negotiate with effectively an upstream and a downstream set of customers. We can put in place a set of relationships. They'll no doubt be signed for 15 to 20 years anyway" - that's the life of these large - we're talking about large transmission projects.

MR BIGGS: That's right.

DR FOLIE: "We, and our bankers, don't actually want to sign up to this unless we've got certainty.. What we're signing today will then not come under the regulator at a later stage because somebody else wants access and we're at risk of all the tariffs being dropped." I mean, that's the bottom line.

MR BIGGS: I think that's the bottom line to some - - -

DR FOLIE: You appear to be saying something different - that you feel that's not - that you would rather have the regulator at the beginning set the whole thing, which could actually take longer.

MR BIGGS: I guess what I'm saying is that certainty can be addressed in a number of ways.

DR FOLIE: Yes.

MR BIGGS: I would have thought that if the pipeliner and the users agreed a particular regime, what happens if two years later after the pipeline is built somebody else wishes to join the arrangements? It would concern me if that number 2 user came on two years later, was charged the higher tariff than, for example, the foundation users potentially, because that could end up essentially limiting competition.

DR FOLIE: So your concern is as much either the existing upstream producer actually finds a lot more gas - three years on - but then sees an opportunity that he can sell it, and then he wouldn't be able to have access into that pipeline arrangement - - -

MR BIGGS: Not at the same price.

DR FOLIE: Not at the same price.

MR BIGGS: Take a very simple situation - I'll pluck one out of an area that I know reasonably well. Let's assume we have a pipeline from Longford to Sydney. Let's assume the foundation loader is sourced from Bass Strait. Let's assume that three or four years after the pipeline is built new fields are found owned by other producers in Bass Strait and the only way they can get their gas to market is to hook into this pipeline. It would concern me if that pipeliner was in a position to charge them a tariff substantially higher than the tariff he was charging his foundation shippers, simply because you have a complete asymmetry or negotiation power at that point. I think that issue would need to be addressed.

DR FOLIE: Yes. I was trying to flesh the whole issue out.

MR BIGGS: It seems to me in that scenario you end up actually reducing the amount of competition in the market because you would end up with fewer producers, potentially, so I think that issue would need to be addressed somehow, which is why I personally favour some sort of established regulatory regime, which actually is in play for a period but does provide maybe some sort of an agreed or a regulated reference tariff and a regulatory standard set of (indistinct)

DR FOLIE: In other words, additional access must be granted the same broad terms as the foundation; not necessarily - - -

MR BIGGS: That would be another way of doing it, but that's the danger I see in having pipelines essentially unregulated for a period, even though they are greenfields pipelines - they will be looking for extra load - and they're still only going to be - likely in a position of market power. May not always be in that position, but those that are will have that power.

DR FOLIE: Thank you.

MR HINTON: Colin, did you want to - - -

MR MARTIN: It's okay.

MR HINTON: Let's move on to ring fencing. You made it very clear that you not only think that ring fencing provisions are appropriate, but that they are actually working as well, though you went on to push for some enforcement provisions - even the possibility of penalties, I think, if I recall correctly. That leads me to ask, why would you think that these provisions need strengthening along that way if you think they are working okay at the moment?

MR MARTIN: If I wasn't clear I apologise, but I think what we said is that the code does have some quite good ring fencing positions at the present time; that there are penalty provisions within the law, I think, as opposed to within the code, but in our view there appears to have been a lack of regulatory courage, for want of a better word, to actually enforce or take action when provisions appear to have been breached, or investigate when they have been alleged to be breached. That's our concern. The regulator has the power; it's that to date we haven't seen much evidence of the regulator actually choosing to use that power. So, yes, we think the code actually does cover the issues. It hasn't been implemented yet.

MR BIGGS: Can I suggest also that the reason we all stress this issue is that in the last few years we've seen a fairly dramatic consolidation in the industry in the east coast, both gas and electricity, and the net effect of that is the number of buyers of gas capable of taking substantial quantities has reduced considerably, to the point that there are arguably only three, and I think most of those have direct or indirect linkages with either distribution or transmission pipeline owners. So it concerns us that there are few substantial retailers that don't have linkages with infrastructure owners, and we would suggest that that puts ring fencing in a far starker light perhaps than when the code was written.

MR HINTON: Let me seek you to be a bit speculative here. There doesn't seem to be much complaint out there from sector participants about the ring fencing provisions, in terms of they're not onerous, they're not causing problems for those who are being subjected to them - that's the point. There has been one complaint out of Queensland, but that's in regard to how the regulator has been administering them.

If one was a cynic, one could argue one of two things - (1) they're not complaining because they don't work, that is, there's no impact, or (2) there is a useful synergy or intersection with commercial imperatives such that the ring fencing provisions mesh in with sensible corporate structure for this sector. Is neither formulation correct, or is there a third way?

MR BIGGS: A third way could be a bit of both, I suppose. I think it's going to be very specific, depending on the circumstances. I mean, I don't want to go into it here, but we have had problems in some markets with ring fencing issues, when we have tried to sell gas into some markets.

MR HINTON: That is, provisions being imposed upon you?

MR BIGGS: No. That is, the fact that in our view ring fencing has been, shall we say - - -

MR HINTON: I was being deliberately provocative, David. Excuse me. Sorry.

MR BIGGS: I was concerned I wasn't making myself clear.

MR HINTON: Yes. I understand.

MR BIGGS: We have had situations where we believe the ring fencing provisions have not been operating effectively in some markets.

MR HINTON: Yes.

MR BIGGS: That's clearly a concern. It's particularly a concern to us as a producer, because clearly we want to see more retailers in the market rather than fewer, and it seems to me that if you end up with fewer retailers, then there will be less growth in the market, probably, and certainly less ability for new producers to get their gas into market.

DR FOLIE: I've got one point on producers, that a number of the user representations have actually made - they want to see far more competition upstream. They'd like to break out, if you like, joint marketing efforts, and I believe in the Parer report there's even an idea in the future that upstream - a condition of them should be to take into account future marketing arrangements. What are your views about that?

MR BIGGS: My view is the Trade Practices Act already deals quite adequately with issues around joint marketing and separate marketing, and that authorisations are required unless exempted by state regulation. My suspicion is that I would think you would be very unlikely to see state exemptions beyond those currently in place, in which case the matter will fall to be dealt with under the Trade Practices Act, if you wish to jointly market.

DR FOLIE: Then I have another one which is related to hubs and processing plants. You're in a good position to be able to answer that, as you're involved in it. What's your version of the appropriateness - in other words, is it more efficient to have access to the processing plant, mainly for pressure differences, and be able to manage flows and backflows, or is it better to actually build the hubs, even though there's investment costs on the hubs?

MR BIGGS: I take it you're talking about things like change in delivery points?

DR FOLIE: Change in delivery points, very much - not about getting delivery point - - -

MR BIGGS: But we are talking - - -

DR FOLIE: Change in delivery points and therefore backhauls as well.

MR BIGGS: Yes. Let me say, I'm not an engineer, but I would venture to say that some plants may need some reconfiguration to change delivery points. Whether it's cheaper to do that in every case rather than build a pipeline, I don't know. I can only speak for BHP. We do not have a problem with offering a delivery point service - change service, if the market wants it, and I can only suggest that in our experience we have found other stakeholders - and let me hasten to add, not necessarily our joint venture partners - who do have a problem with delivery point changes, and they may be people that you'd least expect to have a problem with it, ironically.

DR FOLIE: Thanks.

MR HINTON: Let me ask sort of a system question. Your assessment in your presentation is that the regime is working reasonably effectively, notwithstanding some suggested refinements, improvements. That prima facie suggests to me that you are supporting a sector-specific access regime. What I'd like to explore with you is whether or not that conclusion is particularly dependent upon the nature of the sector, or is it because you have significant difficulties with the negotiate and arbitrate model of the default option, that is, Part IIIA of the Trade Practices Act?

MR MARTIN: I'll go first and then maybe Jeff might like to add some special economic comments. I think it's a bit of both actually. We think that an industry-specific regime can deal with the specific issues of the industry, and we think the code has been satisfactory. Let's not forget, the code was negotiated with industry representation over a number of years, so it was a code for industry basically by industry, and that seems to have been forgotten by some other sectors of the industry. As we describe, we don't think negotiate/arbitrate works and yes, so that's basically it. Jeff?

MR BALCHIN: No, not much more than that really. I mean, the origins of the code itself came out of, I suppose, a lack of confidence from all players in the industry, just being left to the vagaries of just the Part III regime - there was a lack of confidence. So that would create most certainly outcomes, and what we've certainly known is it would take quite a while to introduce the reforms that everyone wanted to introduce to the gas industry.

Access regimes, or the terms and conditions and the conditions of access, would have only been worked over a series of arbitrations over time, and having been involved in this I actually took some convincing myself that that was the case, and I eventually got talked around to it by the industry, most notably by the pipeliners, who at the time actually didn't want a bar of it, just the straight negotiate and arbitrate regime, which is all rather interesting now that their views seem to have changed in a short period of time.

But I think there are also some other problems with a purely negotiate/arbitrate regime. One is that the lack of certainty in how prices are set and reset makes it very hard to put in place any sort of decent incentive-type regulations. You could easily imagine something falling into a sort of regime that provides very little incentive for companies to minimise costs or keep control on costs, because there's always a threat that arbitrations can be remounted at any time and access prices reset if cost savings are found.

MR MARTIN: Achieved.

MR BALCHIN: Achieved, yes. One of the other key concerns of industry at the time, as I recall, was that when new pipelines get developed it's often quite efficient to push off the recovery of capital - a lot of the recovery of the capital costs into the future. Rather than to set very high prices in the short term, as you might under a straight-line depreciation-type tariff park where you start with high prices and they go down over time, you can achieve far faster growth of the market and a far more efficient outcome by deferring capital into the future.

Now, that sort of tariff structure only works if you've got actual certainty about how a regulator is going to treat the value of your asset over the life of it, and that's something again that's hard to provide that sort of certainty, without those sorts of rules being written down, and that's exactly what the pricing principle in the code became; the sorts of rules that people wanted to make sure would be applied over the life of assets. So, yes, that's the origins of the code, and I think many of those concerns which are set out in some detail in the BHP submission probably still hold today.

MR HINTON: Thanks for those comments. I wanted to ask you about the efficiency of regulation. A number of interested parties have put the view to us that the regime falls well short of delivery of timeliness with regard to regulatory outcomes. Have you got any views on this particular area?

MR MARTIN: I think there's two issues here. One is that the first round was setting the initial capital base for each system, and that was an extremely involved process and an extremely contentious process. One of the benefits of the code is that that only has to be done once on gas, unlike electricity where it's reset every time, and so that process is behind us.

The other, I guess, issue is that there were assertions made that regulators were extremely slow in coming to their decisions. BHP's observation, having been involved in many of these initial access regimes, was that it was a two-way street and that information the regulator believed they required appeared to be slow in coming from the service providers, and there were months wasted in certain access arrangements, in seeking information from the service provider - the regulator seeking information from the service provider. That's our understanding.

MR HINTON: Before we move to Jeff's comments, I wanted to seek your brief comments on the institutional aspects of the Parer report that touches on national energy regulator, different institutional arrangements that perhaps might reduce the number of jurisdictional regulators. Does BHP Billiton have views on those sorts of ideas that are floating around?

MR BIGGS: We do. We support a single energy regulator, provided that person is appropriately and fully resourced in terms of both people and money to do the job properly; we would certainly support that as an outcome, recognising that if it's to occur at all it will probably happen gradually.

MR HINTON: Well, let's see what comes up. Certainly it's something we will have to watch carefully in the months ahead so that we can take account of whatever decisions emerge from COAG that might touch on the different environment for us in terms of our recommendations. Unless there's any other matter you want to particularly focus that we haven't covered, I was going to suggest we move to the second half of this session, as we discussed prior to commencement.

MR MARTIN: Yes. I've got one matter I'd like to put on the record.

MR HINTON: Certainly, Colin.

MR MARTIN: It came up this morning. This was the question I think you asked of Michael about covered pipelines offering innovative services, and I think the assertion was that in fact if you're covered you're stifled in offering any innovative service. Unfortunately I can't mention the covered pipeline here because of confidentiality provisions in contracts that we have. Two BHP entities do have contracts that cover a covered pipeline, and we believe they have offered us innovative services.

They have offered us blending services, they have offered us borrow and loan services, they have made commitments to us that they will work with existing shippers to move delivery points on those pipelines so that they can buy their gas from our delivery point, and we have agreed payment mechanisms for accepting different specification gas. So I guess from the customer's perspective we have been able to negotiate innovative services with a covered pipeline. I just wanted to put that on the record. Thank you.

DR FOLIE: Part of the whole process is to actually generate more innovation and more dynamics in the market rather than just point-to-point sale.

MR MARTIN: The services, they are services we as a customer sought to negotiate with the pipeline so they met our needs, basically, and the pipeline came to the party.

MR HINTON: Thanks for that, Colin. I now invite Jeff - are you going to make a brief introductory statement, Jeff?

MR BALCHIN: Yes, I'll make a brief statement. We've written so much, I'll keep the comments fairly short. There are just three - - -

MR HINTON: We may have reached close to overload as well. Excuse me for interrupting.

MR BALCHIN: I'll just touch briefly on three issues which we covered in our paper, which was a form of regulation; the objectives of the Gas Code; and the third issue that I want to draw your attention to is some of the empirical work we did that Colin referred to in his presentation.

MR HINTON: Yes.

MR BALCHIN: First, about the form of regulation - as Colin said in his presentation, and it's my view, too - that regard to cost when setting regulator charges is inevitable. The reason for this is basically because investors are worried about cost. They want to make sure that they can earn a return on their investment, at least commensurate with the risk return for a project. All of that means cost. In fact, the role of cost is acknowledged in most of the submissions to the Commission's current inquiry. For example, APIA's submission, where it talks about the instructions to arbitrators, talks about the preservation of the opportunity for financial maintenance - "financial maintenance" is jargon for cost. The debate really then is how cost is measured and translated into prices and, in particular, the incentive properties of different forms of regulation.

In the Allen Consulting group's paper, we have tried to draw attention to what we think is quite a lot of commonality between people who advise regulators - which I do, quite a lot - as well as some regulators and many of the regulator companies themselves. In fact, there was a submission to the Commission's Part IIIA inquiry that included a whole lot of - many views on the appropriate form of regulation, many with which I agree. To draw out some of these, many regulated entities seem to be concerned by regulators' attempts to second-guess efficient cost and they have a preference for providing incentives for companies to reveal efficient cost and then to use that information when setting charges. That's something with which I entirely agree and it's something that I advise to my regulator clients.

Many regulated entities are also concerned about regulators stranding assets, which means removing investments from the asset base if, with the benefit of hindsight, they turn out to be duds. That's again something I entirely agree with. It creates a lot of risk for very dubious benefit. Many companies are also worried about regulators conducting detailed tests of whether expenditure incurred has been prudent. Subject to some caveats, it's something you wouldn't want to rule out for some special situations but, again, if you're providing incentives for companies to be efficient, then it's probably a good idea to rely on those incentives to actually make full use of those incentives, which is to actually rely on their expenditure as being efficient. That's what incentive regulation is all about.

Also, a number of companies endorse or argue that regulators should provide them more flexibility over how they set tariffs and, again, when I advise regulators, in all the advice I provide, it is consistent with what I think is best practice regulation today. Companies should have - I think it's a very good practice to provide companies with flexibility over setting charges and to focus on designing the price control, so that they have an incentive to set efficient charges. There is one big caveat I would make to this, though: that where you have vertical integration the incentives of the parties can be quite distorted and so there can be no option but for regulators to become more heavily involved in those situations.

It's true that Australian regulators haven't endorsed all of these principles for simplifying regulation, but it's also true that they really haven't much of a run on the ball to date either. Most regulators have - there have really only been three or four first, second-round reviews of access arrangements, and that's really the Victorian companies. Even here in New South Wales there have really been two first-round reviews of the AGL system. In the first-round reviews the setting of the initial capital base and other precedents were for future regulatory decisions, intended to be far too all-consuming for regulators to think about things like the role of incentives for making regulation more effective in the future. But at least one regulator - and that's the Victorian EEC - has accepted most of these comments, most of these propositions, and that's reflected in their most recent decision on the access arrangements of the Victorian gas companies.

When we talk about this sort of regulation, what we're talking about is price cap regulation. I suppose in my submission we wrote a lot trying to isolate exactly what it is we're talking about: what are the decisions you need to make in applying price caps, when you're applying price cap regulation, because we had a concern that some of the Commission's discussion in the Part IIIA report probably didn't quite hit the mark. When you apply price cap regulation there are really two decisions you need to make. If we're not going to try to set prices with reference to predicted efficient cost - which most participants disagree with as well - price is the way to start, at cost - at actual cost.

The questions then are: how do you set the rate of change of prices over the regulatory period and what is the term of the regulatory period you set? The first of those - the rate of change in prices over the period, or the X factor - there are really two methodologies for doing that which exist now. One is try the forecast expenditure and demand over the period, and then to backwards induce the X factor - the thing that solves the net present value calculation. That is really the building-block approach. The alternative approach is to try to arrive at the X exogenously through, say, a measure of long-term TFP. That is the productivity index approach that is referred to in a number of submissions.

The differences, or the costs and benefits of both of those are quite hard to separate in practice. In particular, the incentive properties are fairly hard to separate and the reason is because the incentive properties come from divorcing price and cost over a period, rather than where the X came from. Once the price is set it actually doesn't matter where you got the price cap from; it's just the fact that price and cost are divorced that matters. It's also difficult to be conclusive about how information intensive both approaches are. You know with TFP there is quite a lot of information you need to gather anyway and it's not an easy process. For using the building-block approach all you really need are five years of forecasts, of aggregate operating expenditure and aggregate capital expenditure and demand over the period.

What is difficult is that what is the unknown is how much information a regulator may require to support those forecasts. All it really needs is a story, but the critical issue is how much information is required to support those forecasts. There are different approaches the regulators adopt. Some do this well, some do it quite badly, I think, and there are probably ways that exist - certainly there are ways that regulators can improve their practice. But where the two approaches do differ, in my opinion, is the information asymmetry in both the approaches. Where you try to look at forecasts of costs and demand over a period inevitably the regulator is up against it. Inevitably the regulator doesn't know as much as the regulated companies about what may be spent over the period and in that way, if the TFP approach could be implemented it would arguably be an improvement, but you'd have to say that it's not a quantum leap in regulation from where we are now.

As I said, the main benefit of the TFP approach is reducing the information asymmetry, but for many assets that really doesn't - there's not much of an asymmetry about future changes of expenditure anyway: the transmission pipelines, operating expenditure hardly moves; demand is fairly constant if it's all tied up in the long-term contracts, and capital expenditure - you're talking about lumpy things that don't change, that may happen or may not happen.

So in conclusion, in my view, there's been a lot said about the building-block approach and it's been criticised quite heavily and I think a lot of those criticisms actually - many of the criticisms, when you analyse them, don't actually pertain to the building-block approach per se; they pertain to other forms of regulation. Many forms of regulation involve stacking up costs but the building-block approach, used properly as an input into price cap regulation, certainly has a lot going for it. Until the TFP approach, I think, can be developed - and it probably won't even be right for all assets - the building-block approach remains a robust way of setting price caps.

Some of the comments that were made about the pricing principles and the code - I must say I was a little bit surprised in some of the submissions to the current review, that there was a need - that the current pricing principles in the code are quite vague and that further principles, like those discussed in the Commission's Part IIIA report, are required to provide further certainty. These were the principles that revenue from all the services should recover costs, including a reasonable rate of return, upper and lower bounds on prices as well as an emphasis on non-linear pricing, where that improves efficiency.

I think what you need to understand is that section 8 of the Gas Code really isn't a set of principles on pricing; it's actually a methodology to implement those very principles. For the most part the principles in section 8 of the Gas Code are actually quite consistent with the principles that the Commission espoused in the Part IIIA review. Not only that, the methodology of the Gas Code actually provides far greater certainty about how you may apply those principles in practice. For example, the first of the principles - and probably the most important to any service provider - is that revenue recover costs of providing the service including a reasonable rate of return.

Costs with any capital intensive facility is very hard to define. The Gas Code has a process for defining some of the major features of that cost over time and providing certainty. In particular I'm talking about the methodology for updating the regulatory value over time. As I see it, that's probably the main - the most important feature of the Gas Code, the certainty provided to investors over how assets are revalued over time and certainly it's a substantial improvement over the electricity regime.

It's quite clear that section 8 of the Gas Code contains far too many words. It would be a substantial improvement if the vast bulk of that were reduced down to a few pages of what are the most important principles. But I also think that, as is implied by some of the submissions, it actually ought to be tossed out and replaced by just a few sort of undefined - a few guiding principles would actually be a rather large step back for everyone - investors alike.

On to the objectives of the Gas Code. I think in my view the Gas Code can certainly still be administered as it is now, even after the Epic decision, and there can still be results, but I certainly think that the Epic decision has shown that the guidance provided to regulators in the Gas Code currently is not as clear as it could be and in particular the Epic case has diminished the relevance of efficiency and it has introduced a whole lot of other factors that regulators have to weigh up alongside efficiency that inevitably will mean that regulators are less open in how they've made decisions. It may well be that the decisions - they may be caused to make decisions they otherwise wouldn't, if they had more clear guidance.

All submissions or many submissions to the Commission's current process have variously endorsed economic efficiency as being an overriding objective for all aspects of the code. I'd like to add our voice to that fury. Obviously, as a piece of economic regulation, economic efficiency is the appropriate criterion. A number of submissions have also suggested that the references to efficiency be further modified by talking about the outcomes of workably competitive markets and there's also been a suggestion in one submission that the outcomes of perfectly competitive market be banned, as that the regulators not be allowed to target those outcomes. I think both of these modifications are going to reduce rather than enhance the level of guidance provided to regulators.

With workably competitive markets, just the pages already devoted to discussing the many and various outcomes of this market to the Commission's current inquiry testify how ill-defined and vague and open for dispute this sort of concept will be in the future. Clearly notions of workable competition are relevant for anti-trust type matters, when you are assessing whether or not to regulate, for example, but that's not the role of the words as an objective over the regime. As stated, the role is to have regulators target - the intention is to have regulators target an objective, to target outcomes of something and if those outcomes are vague, then they just shouldn't be in the law.

If there are specific outcomes that people want, that they think come from workably competitive markets, like the regulators use incentives where possible, it would be far more appropriate for those things to be debated directly and added transparently to the law, rather than have them stuck in someone's mind as to what a set of words might mean.

Now, as to the second proposed modification, banning the outcomes of a perfectly competitive market, I think that's probably even more dangerous. Certainly when I was in I think probably first year or maybe second year of university you learn the first theorem of warfare economics which is that the outcome of a perfectly competitive market is economic efficiency. It's sort of an objective that said that the regulator must take the outcome of objective - of economic efficiency - but not take the outcome of a perfectly competitive market. It means you effectively can't do anything. So I think in the interests of trying to give regulators clear guidance in the future it would probably be in everyone's interest for criteria like targeting the outcomes of any sort of market not to be a feature of any objectives.

The last matter I wish to make a few comments on is something that Colin referred to in his presentation which is some of the empirical work we did about trying to test the proposition of whether or not regulators have actually been overaggressive, overzealous or short-sighted, surgical or forensic, in dealing with access arrangements today. In all of my advice to regulators, I always encourage them to face decisions as carefully as possible on objective evidence. Now, the main reason for that is not because it's a useful tool for bashing regulated companies but because it's a very important constraint against arbitrary decision-making and that's certainly the way of objective evidence that experts use in other countries. It's a very good constraint against bad decision-making, particularly where there are effective appeals in place. I should also say that consistent and careful application of any relevant economic theory is also a very good constraint against arbitrary decision-making.

Now, the empirical test we undertook was to compare the value of the various regulated companies in Australia in the eyes of the market, or the market value of the companies - it is their value in the eyes of investors - for the value assigned to those assets for regulatory purposes. The expected link between these values is clear. If the price is set by a regulator or approved by a regulator actually provides a revenue stream that's the same as the cost of providing the services or the expected revenues are the same as the expected cost of providing the services, then these two values should be identical. That's actually not a proof; it's a definition of cost based regulation. We provided references to material in our submission that shows that this relationship is quite widely accepted.. I should point out that it actually doesn't matter in this how investors value the regulated assets. It doesn't matter whether they think the CAPM is rubbish and some other method should be used for deriving the discount rate. All that matters is that all - the only assumption is that the market has valued the asset correctly.

Australia has had a number of sales of regulated entities over the last five or so years and so there are a large number of sale transactions that you can use to derive a market value for a company. We've also looked at a number of listed numbers as well where it's practicable to separate out the market value of the regulated element from any other activities but we've limited all the transactions. We've looked at only to where there has been a regulatory value set prior to the transaction or the date at which we've sampled the share price and the rest. So it's only where there's a transparent regulatory value for the asset and also where the rules for updating that value over time are also known in advance.

The results - and again in our paper there are a number of caveats. One caveat that we have for this which is all of the businesses we've looked at serve mature markets and so we don't hold this out as a test. There's no greenfield problem or anything like that. All it is is a test of whether the regulators thought most of the assets - or the main assets that regulated the code - whether they'd been too tough or otherwise for these assets. Now, the results are set out in a detailed report but the key theme is that the market values of these regulated assets in Australia are a multiple and what you would probably call a healthy multiple of their regulatory values.

The more early transactions, many of the market values, were approximately double the regulatory value and that included all of the gas distribution businesses in Victoria that were sold in 1999, all of which was done after the regulator approved the first access arrangement for those companies. So there was nothing unknown at the time of that privatisation and, in fact, there are a number of statements in that 1998 decision by the regulator that suggested a far more interventionalist and, dare I say, heavy-handed approach to regulation than has actually emerged. More recently, the ratio applied by transactions as well as listed companies suggest that their market values are around 1.4 to 1.6 times the regulatory values.

It is important to understand what this means. It means that, if this ratio is applied consistently across the business, then a dollar invested translates into between $1.40 and $1.60. Under those conditions it's inconceivable that a rational investor should not want to invest or what I should say in the positive is that there is adequate incentive - should be adequate incentive for reinvestment in those businesses. What I don't draw from this analysis is that regulators have seriously erred on the upside and need to reduce prices immediately. I think that's a more difficult question.

What I am saying though is that when regulators say - or what I think this evidence suggests is that when regulators say that they're in favour of the regulated entities to ensure that there's continuity of investment, et cetera, then this evidence which I think is quite robust evidence is that the regulators are indeed correct and certainly there is no evidence provided from this that regulators have set price controls that are too low or the promised returns are too low for investors. This morning at the end of APIA's presentation, Dr Beasley noted that the WACC parameters have a range and he stated that he thought it was appropriate there would be further research into whether or not regulators have actually adopted a value towards the top of the range or the bottom of the range and I point out to you that this is the sort of research that would answer Allen Beasley's question that this doesn't provide evidence that regulators have - or this would, I would suggest, refutes the proposition that regulators have consistently selected values at the bottom end of the range.

One last caveat I should note before handing over to you is that this doesn't prove that everything that regulators have done is good or that they have met time lines, that they've got the appropriate set of arrangements in place. Having advised many regulators, and I'm not going to name any, there are many things they can do to lift their game but what it does say is, on the investment front in terms of picking the overall level of financial returns, that the companies need to continue reinvesting. This evidence suggests that our regulators haven't done the job that some may claim they have. So I will finish my remarks there.

MR HINTON: Jeff, thank you very much for those comments, important for the transcript, and thank you also for your detailed submission that you've referred to which is an attachment to BHP Billiton's submission. There's a wealth of information in that documentation and we're certainly not going to discuss it Friday evening, 19 September, but thank you very much for that detail. I have one question and that's very early on you referred to the alternatives of the building-block approach relative to the TFP approach - total factor productivity approach - that had similar but different information needs but you also referred to some perhaps advantages of a TFP over a building-block approach analytically or at least from an economic outcome point of view.

What I wanted to raise with you is the possibility of whether the current regime, without any change, could move from a building block to a TFP basis simply by ACCC taking that approach, bearing in mind that we've had five, seven years of building block that's underpinned what might then be TFP.

MR BALCHIN: I think, not without the risk of legal challenge - I think it would be very hard in the current regime to set an X factor without reference to forecasts of costs over the next regulatory period. In my submission I suggest that one change that could usefully be made is that section 8 of the code be reviewed to permit alternative approaches for setting the range of change in prices over the regulatory period so that you're not stuck to the building-block approach. I think probably your regulators will be bound to use the building-block approach now at least without a very cunning legal argument which I don't think any regulator - - -

MR HINTON: Which may not be conducive to regulatory certainty.

MR BALCHIN: That's right, yes.

MR HINTON: Michael?

DR FOLIE: No, I'll leave it be, I think.

MR HINTON: Okay. Is there anything else you'd like to flag that hasn't been emphasised that should be emphasised?

MR BALCHIN: No, thank you.

MR HINTON: Let me thank you again for your participation and a very substantive participation, very valuable participation, and I appreciate the time, energy and resources you're devoting to this exercise assisting the Commission.

I'd also say that this brings us to the conclusion of today's scheduled hearings but, as foreshadowed and in accordance with the Commission's established procedures, I would now like to invite anyone from the floor to make an intervention if they would so wish, the only condition being that they come to a microphone and identify themselves so that, for the purposes of the transcript, their comments may be recorded. I don't see anyone jumping up enthusiastically to take up this very generous and warm offer so I will then adjourn these proceedings with thank you again for everyone who has participated. It has been a very valuable process for the Commission. Thanks.

AT 4.39 PM THE INQUIRY WAS CONCLUDED ACCORDINGLY