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PRODUCTIVITY COMMISSION

DRAFT REPORT INTO GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON THURSDAY, 25 MARCH 2004, AT 9.38 AM

Continued from 24/3/04 in Brisbane

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

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

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

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

To comply with requirements in the Australian government's occupational health and safety legislation, I draw to the attention of all those present that the fire

exits are out the door at the rear of this room and to your right. The standard evacuation procedures apply in this building.

I would now like to welcome our first presenters, Dr Henry Ergas and Mr Jeremy Hornby, and also Dr Ric Simes, representing Network Economics Consulting Group. Welcome. It's a pleasure to have you here this morning. As I understand it, you're going to make a presentation for the benefit of the hearings. For the benefit of the transcript, if you refer to a particular slide, refer to it by number so that copies available from the web site can then be linked back to the transcript of the hearing itself. If you refer to a particular slide, if you note which one it is, those wishing to understand the transcript can then have the document in front of them and link your comments appropriately. I also note that you are now going to pass out copies to those present. Welcome again and over to you.

DR ERGAS: Thank you very much. My name is Henry Ergas and I'm here with two of my colleagues. On my left is Ric Simes and on my right Jeremy Hornby. We will all be participating in the presentation and hopefully in addressing any questions that you might want to put to us. The presentation today focuses on submissions that we have made to your inquiry on the issue of the weighted average cost of capital - ie, WACC, as it is conventionally referred to. I hardly need to emphasise here the significance that regulatory determinations with respect to the weighted average cost of capital have for investors in the industries and activities that are covered by your inquiry, but also not merely for investors but for Australian society more broadly.

MR HINTON: Excuse me, Henry. I apologise for interrupting. There is no amplification in the room. While it's certainly taking transcript because that's recording through the microphone, for those present it would be very helpful if you could just raise your voice a little. I apologise for interrupting.

DR ERGAS: No problem. The activities that are the subject of your inquiry are highly capital intensive. As a result, very small changes in the rate of return that regulators allow to firms in those activities can have very significant effects on the revenue streams that accrue to investors. Should regulators determine allowed rates of return that are even only slightly too low, then the consequences for the legitimate interests of investors can be extremely adverse. But in addition to those private consequences that would flow from inadequate rates of return, there are also very significant social costs that would result were regulatory rates of return too low.

The fact of the matter is that even firms that are natural monopolists in their product or output market have to compete in a global market for finance and, if in that competition in the global market for finance the rates of return that they can offer investors are inadequate, then the consequence will inevitably be that projects that are socially worthwhile will not be undertaken. This is all the more significant

as it is widely recognised - also thanks to the good work of the Productivity Commission - that the social costs of underinvestment in infrastructure industries and activities, such as gas pipelines, are likely to be extremely large relative to the social costs that might flow were allowed rates of return in those activities slightly too high. As a result, we believe that it is of very great importance that regulators, when under the code they come to determine rates of return for regulated pipelines, do so in a way that is mindful of the social costs that would flow were those rates of return set too low.

In our view, even with a move to light-handed forms of regulation, it is inevitable that consideration of allowed rates of return, which in turn must come back to assessing the costs of capital to the activity in question, will always play a part in any workable regulatory regime. Indeed, I would say that looking at experience internationally I am unaware of any regulatory regime in which consideration of allowed rates of return does not play an extremely important part. As a result, though this is certainly not the only issue that needs to be addressed - far from it - it is an issue of vital importance if socially desirable investment in pipelines is to be made.

The approach that we have adopted in the submission that we have put to you is to examine critically the claim that has been made, particularly by the ACCC, that the rates of return that it has determined as allowed for regulated activities, including pipelines, are generous in international terms. That is a claim that the ACCC has made on many occasions and that applies not merely to the former chairman but it has also been repeated on at least two occasions recently by the current chairman. Since that's a claim that the commission has made, we believe it is appropriate that that claim be subjected to rigorous testing. To do so we have amassed what evidence we could on how the weighted average cost of capital, as determined by Australian regulators. compare to those that have been set by regulators overseas.

International comparisons of any kind are fraught with difficulty. There is a famous aphorism of Seymour Martin Lipset, who is one the leading scholars in the general field of the methodology of international comparison. He said that the problem with international comparisons was that you inevitably had too many variables and too few observations. There is no perfect way of overcoming the constraints which that creates, though perhaps in a future world, which I am sure my friends at the ACCC would find very appealing, in which every country had an ACCC equivalent that acted not quite as a clone but as an independent observation, then perhaps some of the difficulties that we have at the moment would be eased, if not overcome.

In the reality of the situation we're in, it's inevitable that to make meaningful international comparisons you do have to make adjustments for all the factors that

make situations different, and those adjustments inevitably entail a degree of judgment and hence room for disagreement even between reasonable people. That said, the methodology that we sought to adopt in the submission we made did attempt to (a) be transparent with respect to the assumptions we had made and (b) as well as being transparent in providing our justification for those assumptions, also to err where we reasonably could on the side of being conservative, in the sense of erring towards perhaps a greater risk of corroborating the ACCC's claim than of undermining it and, where we did not feel that it was reasonable to be conservative in that way, to clearly note that and to note its implications.

We believe that the adjustments we made in that submission were individually reasonable, but that even if one disagreed with some of those assumptions, we felt that the overall result was very robust. The overall result is that, when you compare allowed rates of return across a range of activities, there is certainly no evidence that the ACCC's claim that its allowed rates of return are generous - that that claim is capable of being borne out. Indeed, our view is that though the results do differ by sector, they differ by jurisdictional regulator, they differ also by time period; that by and large there is evidence that Australian regulators, including in the activity that you are reviewing, have set allowed rates of return that, correcting for those factors you need to correct for between countries, are relatively low.

Since we put in our submission, the ACCC has responded to that submission in some detail and we welcome the ACCC's response. We believe that putting aside the question of whether the individual points raised by the commission in its response are or are not correct - and in our view, on the substance, they are not correct - but putting that aside for the moment, it surely highlights a central point we have made to your review. That central point is that there is great uncertainty with respect to the appropriate determination of allowed rates of return. There are sharply differing views as to how that ought to be done and whether that is being done correctly, and that resolving those, providing a greater degree of certainty, would be of great value, not merely from the point of view of investors in regulated or potentially regulated assets but also in helping to ensure that the benefits of socially efficient investment are reaped and reaped in a timely manner.

It's precisely because of those substantial and persistent differences and the uncertainty that they create that we came to the view that this is an area where the problems cannot be resolved by glib claims that the rates of return allowed by Australian regulators are generous but, rather, that is calling out for thorough independent review to establish a framework and key parameters which can be used by jurisdictional regulators.

That said, it is our view that the specific points raised by the ACCC in response to our paper are incorrect. The essence of the approach the commission adopts in

responding to our paper is to appeal to international comparisons of total rates of return - ie, to suggest that if Oftel in the UK, with all the conditions of capital markets in the UK, allows a rate of return of 6 per cent, and the ACCC says the allowed WACC is 10 per cent, then that is prima facie evidence. Indeed, if you take the commission's response seriously, it is determinative of the issue that the ACCC's approach is generous.

Seen very superficially, this is a curious contention. It is curious to believe that the fact that the Brazilian regulator allows rates of return which in total look high compared to the ACCC is determinative with respect to a claim that the ACCC is generous. You would think that, instead of focusing on the UK, the US, and European Union countries, more generally New Zealand, had we used Brazil, Argentina, Ecuador as our comparators, all the countries that do have forms of regulation in which allowed rates of return play a role, the ACCC would have been more reluctant to argue that the integration of global capital markets means that you can set the total return in those countries as the benchmark for which to judge the ACCC. They would have said there are obvious differences in country risk that are factored into those rates of return and that you would need to adjust. So even taken very superficially, the claim seems a curious one.

The substance of the claim analytically is that the relevant model for analysis is one which treats global capital markets as being so fully integrated that you would appropriately use a global model, such as the international capital asset pricing model, in seeking to determine appropriate rates of return. Again, viewed superficially, this seems a curious claim, given that the ACCC in its own deliberations does not use that particular model. It uses the domestic version of the capital asset pricing model.

But analytically it is sensible to go back and look in more detail at the particular claims that the ACCC makes in responding to our earlier submission. I would say that in essence those claims centre on three points: there are other elements of difference but I'll gloss over them for the sake of time. Those three points are the assumptions you need to make so as to compare prices across countries; the second issue within that is the appropriate adjustments to the market risk premium, and then a third issue is the weight to be placed on material that was put in a submission by BHP Billiton with respect to the apparent valuations that investors have placed at the time of purchase on assets that either are covered or are potentially covered by the code. This is the issue of the Tobin Q ratio.

What we will do is, if you would permit us to do so, I will ask Ric Simes to comment on the first point, then Jeremy Hornby will comment on the second and then I'll come back on the third and conclude.

MR HINTON: Please, yes.

DR SIMES: Briefly, what the ACCC argues in relation to comparing rates of return across countries is that our methodology requires an assumption which in the literature is known as uncovered interest parity. The ACCC in fact says in a perfectly integrated world capital market, NECG's adjustment for differences in interest rates between countries would be correct, as any differences in rates would reflect a combination of expected exchange rate movements and compensation for exchange rate risk. They then go on and argue, though, that the evidence, in their words, overwhelmingly rejects the theory of uncovered interest parity, UIP.

A few points on that: the first one is, to make any comparisons across countries you need some sort of assumption to do with prices, and indeed if you looked at some of the work that the ACCC itself has previously done, it seems that it relies implicitly on another theoretical construct - namely, price purchasing parity, PPP. In a short-term predictive sense, neither UIP nor PPP is an assumption that financial markets rely on heavily because the short-term predictive power of them does tend to be questionable. But you need some sort of assumption, and in both cases in fact the empirical literature is increasingly giving more weight to their usefulness in longer-term comparisons. For example, with UIP - uncovered interest parity - comparisons using 10-year bond rates across countries as the starting point tend to give some better results than some of the very short-term predictive empirical results.

Two points there: the first one is you need some sort of assumption; the second one is the empirical evidence is not so bad as the ACCC claims. In fact, it is increasingly providing more support and, based on those, that is the heart of it really. To make some sort of assumption across countries at all, you need that sort of assumption. Ex ante economists in a lot of areas would assume - rational expectations, if you like - ie, expectations related to exchange rate movements or expectations related to any variable will be formed in such a way that there's not an obvious arbitrage implication or possibilities for investors, and if you believe in that then UIP will hold. Thank you.

MR HORNBY: Taking Ric's point on further, the next point of difference between ourselves and the ACCC is, given analysis along the lines that we undertake, like subtracting the risk-free rate from their WACC, how do you deal with the fact that there is different equity market in different countries? For example, the market risk premium in the UK may differ from the market risk premium in Canada, may differ from the market risk premium in Australia.

Clearly this is a very subjective area where there's a lot of research, and a lot of it comes up with different results. I don't propose to go through all these results, and

in the paper we decided it wasn't fruitful going through all these results, simply because what we were trying to look at was differences between countries rather than absolute levels or different estimates for different countries. In trying to take our results and adjust for this differing market risk, we concentrated on studies where academics have looked at a broad range of countries at the same time so we had a standard methodology to look at, and there was a limited number of studies out there, and there were three main bits of evidence we considered.

Firstly, there was a study on historic market risk premium conducted throughout the 20th century by Dimson, Marsh and Staunton, and they came up with estimates of the market risk premium for investing in various equity markets for the period of the 20th century, and it came up with a range of - the estimate for Australia was 7.9 per cent, the estimate for the UK was 5.5, and so on.

Another piece of evidence we looked at was some work by Prof Harvey, who looked at the actual market indices for the various markets and tried to estimate relative market risk by regressing one on the other. Another piece of evidence we considered in making adjustments for market risk was regulatory precedent. In Australia the majority of regulators have concluded that the market risk premium in Australia is around 6 per cent. In other countries, regulators have made different conclusions. In the UK, for example, the opinion of regulators about the prevailing level of market risk in the UK is between 3½ and 5 per cent, and based on these pieces of evidence, we tried to see if there was any consistency in the findings of whether academics and regulators consider that market risk is higher in one country than another.

We looked at these bits of evidence and in the end we decided the best way to move forward with the analysis was to standardise other country results as if the regulators in that country were assuming the same market risk as existed in Australia, or was the regulators' view it existed in Australia. So when we prepared our results we worked out what the WACC less the mystery rate was for a range of decisions but then made adjustments to say, well, what would that WACC margin have been had the regulator - had Oftel, had Ofwat - provided an MRP of 6 per cent.

By doing so we tried to almost take market risks out of the equation. The adjustments we actually did by doing that were relatively consistent with the other pieces of evidence, so we were satisfied that this was probably the best assumption we could make. The ACCC didn't actually propose an alternative adjustment, partly because they thought the total return line was the way to go. They did question the 6 per cent value we adopted, but we adopted that because that was a view of the majority of regulators in Australia including the ACCC.

DR ERGAS: The final area of difference is with respect to the weight that ought to

be placed on some estimates that were submitted in a report provided to you by BHP Billiton, those estimates being estimates of the ratio of the amount purchasers paid for regulated or potentially regulated assets to essentially the value of the regulatory asset base, the assumption being or the inference being that if that ratio was greater than one, then that implied that investors' required rate of return was below the allowed rate of return as it had been set by regulators.

What that study was calculating was in the jargon of economics what we refer to as the Q ratio or Tobin's Q, and the main result of the study or the claim being made in the study was that Q ratios for regulated pipeline assets systematically exceeded one, the inference from that being that investors' required rates of return were lower than the allowed rates of return. There are many many difficulties with that study and we will be providing material to you that speaks to some of those difficulties.

The fact of the matter is that ever since Tobin proposed a Q ratio there has been a very large number of studies done looking at Q ratios. In fact I'm sure if you tried to bring into this room all of the PhD theses that have been done on Tobin's Q in relationship to investment, you would not be able to - I suspect even in microfiche - fit them all into the room. I certainly wouldn't claim to have read them all, thank God, but I have read a few of them and one of the conventional results of these exercises is that there are many many difficulties involved in properly assessing the Tobin Q.

When you look at the work that was done in the submission at issue, there are some obvious problems. For example, it's selective in its coverage, so those instances where the Q ratios are actually less than one don't appear in the study or, where they do appear, they are heavily qualified, whereas the cases where it exceeds one are not so heavily scrutinised or qualified. Additionally, the study did not make adjustments which, in my view, would appropriately be made. For example, it did not make adjustments for the value of foundation contracts, it did not make adjustments for the value of tax shields, all of which have a significant effect on asset valuation.

The result in technical terms is that what the study actually calculated was a rough and, in my view, inaccurate approximation to the total Q, whereas every schoolboy learns, or in an ideal world would learn, that what is relevant for investment is the marginal Q and not the total Q. The bottom line is that, whilst the results in the study are interesting and they will doubtless provoke socially valuable debate, at least in the sense that it will enrich the economists on the different sides, I fear it will shed less light than wealth - the wealth at issue being a transfer from the community to the economists engaged in the study, and I certainly would not believe that point could put a huge amount of weight on it.

In conclusion, we stand by our original finding, and our original finding was that the allowed rates of return in Australia do not bear out the claim that the ACCC has repeatedly made and recently made that its WACCs are generous in international terms. We believe that any viable regulatory regime will have some element in it which turns upon allowed rates of return and we believe that that element will be very significant given the capital intensive nature of the regulated activities in general and of pipelines in particular.

It's our view that there is less certainty about how allowed rates of return will be determined in Australia by regulators. There is less certainty than there is in major jurisdictions overseas and that lack of certainty is apparent in, for example, the ACCC response to our submission. I find it startling that the commission, the ACCC, would at this point suggest that the appropriate market risk premium might actually be 3 per cent, as they do in this submission, which implies a very major change, if it is being taken seriously by the ACCC, if they really believe that that is arguably appropriate. That is injecting a substantial degree of further uncertainty into an already uncertain area.

We note that, despite a recent finding by the Australian Competition Tribunal that the ACCC erred in a significant component of the application of the capital asset pricing model - ie the maturity of the risk-free rate - that there has been no agreement by the ACCC that that was indeed an error and, more recent statements by a jurisdictional regulator suggests that that issue remains, despite the tribunal's very clear finding and its strongly worded criticism of the approach the ACCC adopted - that that issue remains open. As a result, we would at this stage renew our call for you in your report not to attempt to resolve these issues because we don't believe that you necessarily can in the time that is available to you and within the confine of the range of activities you're considering, but to recommend that those issues go to a thorough independent review to establish a framework which can guide all Australian jurisdictional regulators going forward. Thank you very much.

MR HINTON: Thank you very much for NECG's submission on this matter and also thank you: your input is appreciated. Thank you also very much for Ric's and Jeremy's comments this morning. They quite precisely and with some articulation outlined a very important issue that clearly arises with regard to the role and methodologies of regulators across a number of sectors. It's a big issue. The WACC and how it's calculated and the impact on outcomes of regulatory intervention is an important issue for all parties.

I confirm your comment right at the end, Henry, that resolution of this issue is not going to rest with this particular inquiry and therefore I note NECG's call for a review of WACC calculations, WACC methodology and the role the WACC plays in

regulatory intervention. We of course will take that on board as part of input to this particular inquiry.

I have a couple of questions - and I'm sure Michael might have some as well - that flow from your submission and discussion this morning. I suppose the first one is in terms of, if an inquiry of the type you call for was able to come up with, in your words, a more substantiated basis by which a WACC could be calculated and applied with appropriate, more defensible outcomes - even the possibility of agreement between ACCC and NECG - at the end of the day there's still uncertainty. You would not anticipate precision here that would not have some debate about whether or not the WACC being used in that regulatory intervention for that particular case was the right WACC. That raises more directly to our terms of reference issues concerning the nature of regulatory intervention for the Gas Access Regime and how it might be improved.

I'd welcome what comments you could have, might possibly make, on that issue - the regulatory uncertainty associated with intervention, based upon the building block approach or CAPM. I'd welcome your comments.

DR ERGAS: Certainty is not of this world and, of course, if we were blessed with social planners who were not merely omnipotent but also omniscient and omnibenevolent, then the world would look like a very different place from that in which we actually need to live. The uncertainty is perhaps greatest in respect of determination of the appropriate WACC, in part because many of the parameters that go to determining the required rate of return are not observable in any simple way. They have to be inferred from a mass of evidence, much of which changes over time.

As a result of that, there is in my view a trade-off that has informed regulatory decision-making internationally, and that trade-off is between trying to get it just right and hence introducing all of the difficulties and unpredictabilities associated with particularised decision-making or, alternatively, accepting that you're not going to get it just right but placing the primary emphasis on establishing a regulatory framework in which investors and other participants in regulated activities will have a reasonable degree of certainty.

Perhaps the clearest contrast in that respect is if you compare the approach that, not merely the ACCC but I would say generally, jurisdictional regulators have adopted in Australia, with the approach that both the federal and state regulators have adopted in the United States. In Australia, broadly the emphasis has been on trying to get it just right, as if this were a battle between regulators intent on ensuring that not one centime - I expect it's no longer a centime; whatever they now have in the euro - eurocents - not one eurocent of monopoly profits goes to the owners of regulated assets and the owners of regulated assets, trying to ensure that if there is an

opportunity to squeeze another eurocentime, or a eurocent out of the regulator, that that opportunity is exploited as best one can.

The result of it is that the country is, in some respects, a paradise for those with any claim to even rough expertise in finance economics, who can make a good living by opining in the resulting debate and much less of a paradise for investors and other participants in regulated assets. In contract, in the United States the approach that was adopted was that of saying, "This is something that we are not going to get perfectly right." So for years and years and indeed, still to the present day, there is a very rough and ready approach where everyone knows how it's going to be done to setting the allowed rate of return. It's basically a kind of rough market benchmark that says, "What do people who invest in the New York Stock Exchange generally require for assets that are not no-risk but are not high-risk?"

So ever since - I think this would be fair to say - my early youth, and that's not as recent as I would like it to be, the FCC had this 12.4 per cent rule and when you queried where the 12.4 per cent came from they said, "Well, you know you're not going to get it right so 12.4 per cent seems pretty reasonable and investment is continuing." So in that sense I think one of the most important elements that could come out of both your inquiry and of an inquiry that looked more specifically at the issue of the WACC, would be some guidance about that trade-off and how that trade-off ought to be embodied in regulatory instruments such as the code.

There, I thought, the tribunal's recent decision has a great deal of merit in it, where the tribunal said this is an area where, if you look at the code, there is a range of WACCs that can be consistent with the criteria it sets out and regulators should not disallow proposed access arrangement or agreement merely because within that range, which is a broad range, they prefer a lower WACC to a higher WACC. In my view, if that were implemented and made clear in the code, that would shift the burden of proof from being solely on the owner of the regulated asset to make out that the particular WACC it has gone for is the only one that you can appropriately go for. It would shift that burden and say to the jurisdictional regulators, "You, too, must bear the burden of making out that a proposal is not solely the best conceivable but before you can reject it you must also show that it is unreasonable."

MR HINTON: Thank you for those comments. There is a flow-on issue, and that is this question of the pursuit of efficient investment, and if the WACC is too low then presumably we get under-investment and if the WACC is too high we might get overinvestment, in terms of regulatory intervention. Is there any asymmetry in over and underinvestment potential here or is there a symmetrical relationship?

DR ERGAS: Well, the one thing that I think in terms of the underlying economics must be pretty certain, is that the investment will decline more rapidly below the

efficient level when the WACC is below the cost of capital and it will increase above the efficient level if the allowed rate of return is slightly too high. Additionally, it's in the nature of most of these assets that if there is a case for regulating them, that case hinges on the fact that there are few close substitutes for those assets. As a result, if there are few close substitutes then the social costs of under-investment will be high, simply because there won't be alternative assets that consumers can readily turn to. As a result, you would think that if you had the balance of costs, you would say that a bit of overinvestment is much less likely to be socially costly than a bit of under-investment.

This is an issue that, of course, has been extensively studied in the academic literature because it goes back to the so-called Averch-Johnson effect. The Averch-Johnson effect is merely a form of overcapitalisation associated with situations where the allowed rate of return is above the weighted average cost of capital and there have been again - though the fashion seems to have faded, but in the late 60s and 70s, the flavour of the day, if you were in the graduate department of economics and interested in regulatory economics, was to do an empirical test of the Averch-Johnson hypothesis and then cost out its social consequences. I am unfamiliar with any one of those papers which came to the conclusion - even those few that found that the Averch-Johnson effect was significant.

Most of them found that the social costs of the Averch-Johnson effect were trivially small. There are lots of reasons for that and one reason is that if there is a bit of market power then the actual level of output will be a bit less than the socially-efficient level of output. So if you induce slight expansion in capacity you'll reduce the allocative distortion associated with the slight shortfall between efficient output and actual output. If you look at that mass of empirical studies of the Averch-Johnson effect I think you'd have to conclude that there isn't a lot of evidence out there that the social costs of slight overinvestment are particularly great. I may be wrong on that and I would be very interested in being pointed to studies which come to a different conclusion, but that's certainly my own reading of that mass of evidence that has accumulated over the years.

DR FOLIE: Any CAPM assessment, basically you've got to access what, if you like, the profit stream is going to be and you've also got to assess the asset base. Both are fraught with difficulties. Without going for a very long question - the asset base for these empirical studies, where does the information for that derive from?

DR ERGAS: You raise an important point but if I may just use that point to add one small element to the response I gave a moment ago, most of the studies that were done of the Averch-Johnson effect assumed that regulators accepted the regulated entities' asset base.

DR FOLIE: As defined by how?

DR ERGAS: Well, it would then be the question of whether you measured it at historical cost or replacement cost, but nonetheless in those models what happens is that the owners of the regulated asset determine the appropriate level of investment and then the regulator validates or accepts that level of investment.

DR FOLIE: Yes, but those models, when they were done they were done by economists, then study, and they would nearly always probably have used the replacement value or some, if you like, current economic value.

DR ERGAS: Yes.

DR FOLIE: I'm interested in the capital asset pricing model which is actually done by financial markets which are actually using financial information. What are they using as their capital base? I can't believe, if you're comparing hospitals, oil companies, banks, other groups, that people are actually - I don't know what they use as the asset base. Presumably they're just using the normal accounting information.

DR ERGAS: No. My point was this: assume that you set the allowed rate of return slightly too high.

DR FOLIE: No. I'm just wanting to know the international comparison, how it's done, and you're getting a lot of numbers and this spectrum of different rates of return and different asset classes are then being used to say what the different WACCs are; but effectively you're getting a spectrum of outcomes as to what WACCs are, I think; that is, how that has been calculated.

DR ERGAS: Right. Thank you.

DR FOLIE: That leads to another question after that.

DR ERGAS: I'm sorry. I see. I had misunderstood your question. In the submission that we put we did not calculate the allowed rate of return by comparing an income stream to an asset base. We used directly the regulatory statements about the rate of return that they had allowed. So if they said, for example, with respect to this particular pipeline, the allowed rate of return that we have built into our regulatory determination is 11 per cent, then we used that 11 per cent number and then we corrected that 11 per cent number so as to make it comparable with similar decisions in Australia or elsewhere.

DR FOLIE: My question is going one step before that because that's then comparing what regulators are doing before that. There's then the justification for

actually using the CAPM to then do all these things, so it's the basis under which the CAPM is done. A lot of weight is put on CAPMs. We take a number and then we apply it, and then you're looking at international comparisons. Before that you have to then determine what WACCs and things are going to be, using the capital asset pricing model, which is done on studying the Australian stock market - its various performance asset classes - you study the UK one. This is where you're actually determining these things and this is the fundamental basis and the justification for then using the WACC in a regulatory environment.

I'm asking the question as to where the asset base is calculated initially to give an idea of what the spectrum of allowed WACCs might be in different risk classes of industry. It goes back to betas and all the other things which are all done on fundamental sort of asset market bases. What the regulator is then doing is trying to replicate an imperfect thing to give an equivalent rate of return, but the justification for that number has actually come out of these other prior studies.

MR HINTON: The NECG model takes the capital valuation - what the regulator says it is. So the comparisons, you take the information that's given.

DR FOLIE: But then there's a prior set of studies. As you've actually studied this area, it's really the background. It's not really a comment directly on the paper per se. It's on the foundations under which then you're in a new comparison.

DR ERGAS: In our work we accept for the purpose of this exercise the assumption that is made conventionally by the Australian regulators to the effect that the capital asset pricing model is a reasonable framework for determining allowed rates of return. That's an assumption that personally I would query, but for this purpose.

DR FOLIE: I'm asking you for that assumption, if I can. I'm asking you, with your experience and in the area - it's an extension. In other words, it's the foundation stone under which your study - which the regulators are doing - I'm really - - -

DR ERGAS: For this purpose we accepted it because that's the approach Australian regulators adopt. That said, how does one then, using that framework of the capital asset pricing model, derive estimates of allowed rates of return, or of required rates of return, looking at, for example, experience in respect of listed assets or traded assets generally? There are approaches to doing that in which you do need to calculate underlying asset values, so in which you look at the actual assets that are being deployed, and the cash stream that is expected to those assets. Then you calculate some kind of rate of return.

But the more conventional approach, and the approach that is used by us and by Australian regulators generally - in the more conventional approach you actually

build it up, not from valuations of underlying assets but from the prices at which assets are traded in capital markets. You don't need to, for example, look at what is the value of BHP's physical capital to seek to determine the market's estimate of the weighted average cost of capital that BHP requires to finance investment.

DR FOLIE: That leaves the question that the value of the asset base is basically a traded valuation, like a market valuation, but the regulator sets the rate of return and applies a WACC onto basically an efficient cost estimate. In other words, he adjusts and he prunes and he reduces the asset base right down, and then applies the WACC on top of that. In fact, if the asset was freely traded and you applied the WACC on top of that, it could be a significantly larger number - the allowed rate of return.

That's the paradox I seem to have. The model seems to be applied under an estimated, calculated so-called efficient new depreciated asset, whereas the WACC in practice, in the market sense, as you answered, is the current market estimate of what BHP's asset base might be. They're two quite different numbers.

DR ERGAS: I believe that in the theory that underpins the capital asset pricing model the assumption would be that investors are valuing assets in a manner consistent with economic valuation, so that in the equilibrium that the capital asset pricing model describes, all assets would be valued in a manner consistent with some kind of economic valuation.

There's a complicated issue about exactly how you describe that underlying economic valuation but bear in mind that, for the capital asset pricing model to fully hold, you're looking at some very stringent assumptions about the world which include the fact that you have either complete markets or close to complete markets and a competitive equilibrium in those markets. The assumption that everything is valued in a manner consistent with economic valuation in that world would likely hold.

DR FOLIE: Without sort of getting into that, one of the overviews of dispute that takes place in this industry at the moment is that there have been changes of ownership, pipelines have changed, different prices. The regulator says these are irrelevant, they paid too much, even though there were third-party resales taking place which appear to have been sold higher than the so-called regulated value. That seems to be inconsistent with your proposition.

I'm really looking for some help in this because it seems to be that the capital asset pricing model as is being applied is different to the way it would work in the normal marketplace. That's because the game is being played, if you like, with disputes about the capital base, which is a point that hasn't been discussed very much by anybody in any of our submissions.

DR ERGAS: I'd like to also open it for my colleagues, but in my view the question that you are raising is fundamentally about the applicability of the capital asset pricing model in the context in which it's been used by the Australian regulators. In that respect, I think there are very serious issues, and those issues really go to whether you accept the core proposition of the capital asset pricing model, which is that only a particular type of risk, which is systematic risk, is relevant to the determination of allowed rates of return.

It must be said that again this is an area where there's a great deal of literature, and the bulk of that literature finds that that proposition is not supported by the evidence. So there's a case that I think could well be argued that the capital asset pricing model is, for a range of reasons, being applied inappropriately. That said, I think it is also fair to note that at the moment there is not a consensus about a superior alternative and, given that regulators are required to take decisions and regulated firms are required to embody a target or allowed rate of return in the proposals they put, then we are inevitably in second, third or fourth-best world where we're using a model which is vulnerable to any number of cogent criticisms.

The problems in practice are aggravated by the fact that we combine that model with a particular approach to asset valuation, which is this optimised ex post asset valuation. You can argue again about whether, even if the model were correct, it would be the correct model when you combine it with that approach to asset valuation. I believe that where you would come to is that the combination of the two certainly raises a number of analytical concerns and also in practice, perhaps more relevantly, introduces a considerable amount of uncertainty into decisions.

In my view, that really goes to the point that you raised about investors buying assets at prices which to regulators don't seem unreasonable - the Epic case of course being at the front of one's mind in that respect. The way I at least read the decision of the West Australian Supreme Court in respect of Epic is that they say, "Well, there are these models." Clearly economists have disagreements about them but if there's one thing they all agree about, it's that they rely on lots and lots of assumptions, some of which may hold; others likely don't hold.

When those models are applied in a way which seems very inconsistent with the expectations investors hold, then the regulator has to take that tension into account. That struck me as a sensible approach, though perhaps it didn't give the regulator as much guidance as might have well been desirable, which is why we're still discussing these issues today.

DR FOLIE: That leads to another one which is outside your submission but, as you're a consultant in regulatory affairs and an economic group, you do a lot of these.

I'm moving a little bit more to part of our report which is actually about moving much more to a monitoring regime, which is because of a lot of these deficiencies - at least get more into that area, rather than into this more vexed area, though it will still remain in that area. Why can't we rely on the normal corporate financial accounting standards which are laid down? There are rules laid down there for taxation. There are a lot of statutory obligations onto that. Is that a basis for - then, if you like, the cost base for them under which monitoring would be reported?

DR ERGAS: This is a very good question and I wish I had a simple, compelling reply to it. What I believe one can say in that respect is that when you look at those accounting requirements and, for example, all of the approaches, procedures and methods associated with GAAP, with our accounting standards, they are really aimed at providing not a basis for the setting of prices for a mechanical means of determining decisions with respect to pricing and output; rather, their aim is to ensure that investors can be given what used to be called true and fair view of the position of the reporting entity, and to do that again it comes back to this trade-off between being precisely right, or seeking to be precisely right, and accepting at the other end that perhaps you're better off only being very approximate but having less discretion in decision-making.

What the accounting requirements do is, because they want to minimise the monitoring burden on investors and allow the greatest comparability across reporting entities, they seek to narrow the scope of discretion by the reporting entity, as much as one reasonably can, whilst accepting that in doing so you are going to be reporting in ways that are often inconsistent with, or at least in tension with, underlying economic realities. Perhaps the clear illustration of this is the debate we had in Australia and elsewhere in the 70s and up to the mid or late 80s about whether we should require replacement cost accounting by reporting entities and, as you'll recall, there was an accounting standard for replacement cost accounting that was essentially phased out.

Why were we willing to contemplate a move to replacement cost accounting? Well, for the obvious reason that in a period, as that period was, of substantial inflation and significant change in relative prices as well, historic cost accounting would not provide an accurate indication of the economic value of the assets of reporting entities.

Why did we eventually abandon that effort? Well, in part it was because circumstances changed and inflation rates fortunately diminished, but also because the experience was that implementing even the rather simple kind of replacement cost account that was required or set out in that Australian accounting standard involved a very large number of ultimately discretionary judgments which meant that (a) investors' confidence in the quality of accounting information would be harmed

and (b) that comparability across reporting entities would be undermined. So we, faced with that trade-off, moved to a position where we said, "Look, historic cost accounting - you don't need to know a great deal to understand that it has problems in measuring the economic value of reporting entities. However, it has these virtues of consistency over time, of absence of discretion, and of comparability."

The question which then arises in the regulated context, and inevitably arises, is, do you accept that framework which has been used in the context of reporting entities subject to GAAP? With all of the compromises that that involves, and the trade-offs, do you accept that as the basis for these quite significant economic decisions that you're trying to take - about setting prices and outputs which are not the purpose for which GAAP was ever designed - or do you try to have more explicit approaches to economic asset valuation? Again, countries have taken different views. In the United States, where there is rate of return regulation, it is still overwhelmingly based on the statutory accounts. In Australia it is overwhelmingly based on some form of optimisation or economic asset valuation, and the result, to my view, in Australia is that we get some benefits from that, but we also get significant costs in terms of added regulatory discretion and inherent uncertainty.

To date, the balance of those costs and benefits has not been, in my view at least, systematically assessed. It's interesting to note that in the US there have been some recent studies which attempt a similar assessment and broadly conclude that the costs of optimised valuation outweigh the benefits, but it's still early days and there are different views. It's a very very significant issue that you raise. It will be a big issue going forward because it's an issue which at the moment is, for better or worse, unresolved.

MR HINTON: Thank you very much for those comments and very useful wider discussion beyond your initial submissions, but that's useful for us and directly relevant to our terms of reference. Thank you again for your participation and your submission. It's appreciated. Unless there's anything else you'd like to further add at this stage, I was going to close off this session. No?

DR ERGAS: Thank you very much for the opportunity to present to you today.

MR HINTON: We'll take a morning coffee/tea break and come back here at 11.15. Thank you very much.

MR HINTON: Welcome back to this second session of this first day of hearings in Sydney of the Productivity Commission's inquiry into the Gas Access Regime. I now invite the representatives of the National Competition Council to the microphones; Mr Mr John Feil, Michelle Groves and Ruth Thomson. Welcome. It's a pleasure to have you here and your input is very important to us. Over to you to set the ball rolling, so to speak. I invite you to make an introductory statement.

MR FEIL: Thank you very much. As you said, my name is John Feil. I'm the executive director of the National Competition Council and I have with me Michelle Groves, who is responsible for our access and energy work, so day to day she is very much involved in the application of the code at the front end. As we discussed, just so we're clear, what I make a distinction between is the implementation of the code and the application. Those can go round the wrong way, so to make sure we get it right, the implementation I regard as the decision or the set of decisions around how something is brought into coverage or not.

The application of the code is in my parlance the setting of the rates of return, the WACCs, the CAPMs, the whole variety of models that won't be used. As you'll appreciate, the NCC's role is very much at the front end of this process and we're largely going to confine our views to those areas and rely on the ACCC, NECG and various other parties to take you through the pleasures of doing the regulation.

The third member of our team is Ruth Thomson, who was the officer principally responsible for putting together our submission with Michelle, so Ruth is here to correct me when I get things wrong, as is Michelle. We appreciate the opportunity to discuss our submission and your terms of reference with you directly.

I think the first thing to say is that we do support many of the elements of your draft report. We think efforts to improve transparency and flexibility in the regime are highly meritorious and will produce better outcomes for Australia. We think that the adoption of a single overarching objective has considerable merit. It is difficult to apply a bundle of objectives that pull against each other on occasions and are complementary on other occasions. You either have to produce a detailed hierarchy in the code or allow us to do so, or you can come back to a more simple, high-level objective that doesn't have significant tensions within it.

Inevitably, we concentrate in these comments on the areas where we perhaps differ or at least have a different point of view, so despite the nature of the comments, I think in context we very much appreciate the direction that many of the recommendations in the draft report were heading. That said, we do need to concentrate on a few matters where we have a different perspective to offer, and I guess the first of those in a broad sense is the issue of coverage and the balancing of risk.

The code Part IIIA system is designed to enable a resolution where generally the market is less likely to produce a satisfactory resolution or, in some cases, any resolution. The alternatives prior to the existence of these provisions were attractive negotiations, stand-offs, recourse to litigation either in common law or accusations for breaches of the antitrust parts of the Trade Practices Act, and I think that by bringing in Part IIIA and, in the particular case of gas, the Gas Code, the aim was to come to a resolution so that access can be provided in a way that encourages an efficient outcome and discourages long-winded alternatives. So there is very much a balancing of risks and rights between the owners of transmission assets and those parties who are dependent on those transmission assets to either develop gas fields or to operate in downstream markets.

It's not solely a matter of debate between the regulators and the transmission owners. The implications of the outcomes of that debate don't only affect the amount of investment in transmission assets. They obviously have effects on competition in downstream markets where that's possible, and also in development of gas resources, and we think that there needs to be a broad consideration of all those ranges. There is a real risk that the debate is one about more or less transmission investment. Well, in the end, a large number of lines carrying no gas because there aren't developments of markets to produce it or to use it is hardly optimal in any way.

You asked Henry about the balance of upside and downside and whether it was systematic. I don't know whether it's systematic in respect of transmission, but I don't think that's the question; I think it is whether it's systematic in terms of all the changed risks that would result from a higher or lower number. I think also that quite an amount of this discussion centres on whether or not the regulators or the asset owners or someone else gets the number right. Ultimately that is the key issue, and in our view considering lowering or raising the bar for implementation of the Gas Code - that is, coverage - is an issue that would only be affected by the numbers being right or wrong, if you were convinced that there was a systematic and not correctable problem associated with applying regulation.

We do accept, as I think most people who are reasonable would, that regulation is not perfect. Despite Henry's suggestion that regulators may try and get the number right, I think most know that in the end that number, even if it's right in the technical sense, will only be a proxy for what a market would deliver, and the NCC's principal mandate is a regulatory reform one to allow markets to deliver solutions. Almost by definition, at least in the medium term in respect of gas transmission, we face natural monopoly questions, so the opportunity for a market to deliver through negotiation, reaching an equilibrium or alternatively through litigation, stand-offs and the like, are alternatives to the application of the Gas Code.

The most important thing about the code is that it's designed to provide a right of access at a price or under arrangements determined by a regulator. If the regulator gets the number wrong, then in our view that part of the process is what one should focus on to get a better number and reach the balance. Only if you were convinced that there was a systematic problem and regulatory failure was so pervasive and uncorrectable in our view would that justify a significant change to the level at which you would apply coverage; the crude analogy being, "Well, you're not going to cover this because the regulator is going to get it so wrong that the outcome is worse than the next-best alternative, of years of litigation," and, irrespective of the balancing of evidence, I don't think you could reasonably reach a positive view that that was the case here. I think there's evidence on both sides and you'll deal with that with the ACCC and NECG and others.

There is a set of criteria before coverage can be recommended by us, imposed by the relevant decision authority, and they are not simple hurdles. Each one of those criteria must be met and, if there is not satisfaction that any of those criteria are met, then coverage cannot be recommended and the council would not recommend coverage. The minister concerned, the relevant decision-maker, must then turn his or her mind to exactly the same criteria. They have the benefit of our recommendation. The practice varies somewhat but generally they also take additional submissions and they have recourse to their own officials for further information and, again, unless they are satisfied on all of the criteria, then coverage should not be imposed.

Finally, at least finally in the regulatory scheme here, there is a right of review to the competition tribunal or to a similar body on some occasions and, again, the obligation is to be satisfied on all the criteria before coverage can be imposed. It's not a low hurdle and it's not something that the council recommends lightly. We are acutely aware that there are costs of regulatory risk but we're also acutely aware that there is a need for access to be provided in a reasonably timely and economic manner; otherwise you have significant risk of distortion to markets downstream and upstream and it's the entire package that the council needs to be concerned about when addressing those issues.

I don't propose to take you through the criteria step by step but we would like to comment on the issue of substantial versus material. In our application of the test, we consider recommending coverage only when there will be a material increase in competition in a downstream market or an upstream market. The trivial increase that is ephemeral, not of consequence, would not justify coverage. We think that's consistent with our decisions, with the decisions of ministers and with the decisions of the tribunal on review. Adding it specifically into the test we don't think would make a change to how we approach the test because we say material is in our minds anyway. On the same basis it would do no harm but it would be nice to have it confirmed. I haven't come across anyone arguing that by imposing material we're

putting something into the law that shouldn't be there but I suppose one day someone might.

We have something more of a difficulty with "substantial" and I guess the first is how much bigger the material than substantial, and we think if there is a material increase in competition that can be provided by enabling coverage and recourse to the access regime, that should be sufficient to justify that recourse. We also see some difficulties, and Michelle may be able to speak more on this, where you get a difference in the height of threshold for access via the Gas Code as opposed to access by a Part IIIA and, if there were two steps, a lower step of material perhaps for going down the Part IIIA route and a substantial, assuming that's higher, test for the Gas Code, it's entirely possible that you could have gas pipelines seeking to be covered on the lower test through Part IIIA. That wasn't the intention.

If the tests are at the same level, then clearly we can steer them down the direction of the Gas Code. They would have the right. You I guess could put in a bar to applying the Gas Code to Part IIIA but that then again undermines the general applicability of that regime and gives you a range of definitional problems and the like. Maybe we can come back to that if you've got questions.

We'd also like to comment briefly on the form of regulation that might follow a declaration. We think the determination of the form of regulation, whether it be monitoring or rate of return or the current type of arrangements, should be separate and follow from the coverage decision if it's going to be implemented in that way. We don't think that a lower test that leads you down a monitoring arrangement and a higher test that leads you straight into rate of return is a sound way to proceed and the current suggestion seems to predetermine using essentially criterion A, which route you would go down. Broadly, we think that it requires a full cost-benefit assessment of both types of regulation and adopting, if one decides to recommend coverage, the regulatory option that produces the highest net benefit and that doesn't necessarily follow solely from a consideration of criterion A.

However, we have some broader difficulties with price monitoring because we regard the purpose of the Gas Code and, to the same extent Part IIIA, to provide an enforceable access right knowing that, through monitoring, the prices might be exclusionary and not to provide access on a reasonable basis does not amount to an enforceable access right. We don't support a binding decision in favour of price monitoring for a minimum period. We think that's inconsistent with the requirements of clause 6(4)(c) of the Competition Principles Agreement which requires that an access regime includes a means to enforce access rights. Some possibility of enforcing access rights at some future time we don't think is sufficient to meet that.

The fact that a pipeline in this case is to be covered indicates that a service provider has an ability and incentive to misuse market power. In these circumstances, the threat of price regulation at the end of a minimum price monitoring arrangement is simply putting off in allowing the consequences of an effective access to run for that period.

We do favour modifying the obligations proposed for price monitoring to include some formal requirement for an independent binding resolution mechanism if monitoring shows that access is not capable of being provided in any other way. We think that can be funded by the parties and would probably bring us back to a point where some sort of binding access right can be created. However, how much that differs from the current arrangement is highly questionable. It's a bit like the difference between providing material access and substantial access really; it may not be all that great a difference, and we think that there is a risk of proceeding down that way, adding an entire new layer for very little gain.

In our submission, we also note that despite the need for this review which is clearly important and comments about the application of the arrangement, the coverage arrangement is relatively well understood and there should be positive justification for making significant changes that are not unambiguously beneficial. Much of the legal precedent around this area has arisen from matters under Part IIIA and having the tests aligned enables the precedent from one part to be translated to the other without having to worry about whether it's relevant, given a different standard for material versus substantial.

Certainly we think that a change to the application of coverage that led to a departing of precedent as between the broader Part IIIA arrangements and the Gas Code would be unwelcome. As we said, the incorporation of a material test, we think, would support the changes that are proposed in Part IIIA and the council's practice and would not amount to a detraction but, as you will take from my earlier comments, we think that a two-tiered test could cause quite significant problems in that regard.

The next topic I'd like to just briefly touch on is the binding ruling arrangements.

MR HINTON: The greenfields.

MR FEIL: The greenfields for binding rulings. We support binding rulings where they can reduce regulatory risk and are appropriate but our key concern is that the binding ruling period should not be arbitrarily set. We think that 15 years might be the right length of time in some occasions - it might not in others - and we think that in terms of providing flexibility to regulate as little as necessary or as much as

necessary - hopefully they're the same number - the council should be enabled too in agreeing or recommending a binding ruling to tailor the period to what we consider appropriate in the circumstances of a particular application.

I don't think that a default option of 15 years - that requires us to justify in our reasoning that any alternative would be unreasonable. It provides additional certainty and the onus on us to explain in the particular circumstances why a longer or shorter period might be relevant. That might be a not unreasonable compromise but we think ultimately the length of time for any binding ruling should be determined on a case-by-case basis.

One other point we made in our submission was the issue of covering a service as opposed to covering a pipeline. Our interest is in avoiding overregulation and if by tuning regulation or coverage to a service rather than to the physical pipeline asset directly, we can in appropriate cases craft a degree of coverage that would be less, ie that would be enough to cover the bits that were of concern to us in terms of the criteria but did not cover other parts or other services provided by the pipeline, we think that that would be a positive increase in flexibility. Practically we're not entirely sure that it would make a huge difference although, depending on the outcome of various latter proceedings in relation to the MSP, there is some prospect that service from one point to a particular point along a pipeline or a spur off a pipeline might be a service that would deserve coverage but service to another point might not.

The ability to define coverage in terms of the service rather than the entire pipeline would give us the flexibility to tailor a coverage decision that dealt with the matters where there were market power issues and concerns about promotion of competition up and down stream without having to cover the other bits and that in turn would limit the regulators' requirements in terms of what they set reference prices for or engaged in regulatory activities in respect of. As I say, I don't think it's going to be the rule immediately but also as pipe networks develop it would give us the flexibility to ensure that what was regulated was only the bits that met the criteria and we didn't take in additional scope that wasn't necessary. Of course if the scope that you had to take in was so great that it changed the balance of whether it's worth covering it, then clearly we wouldn't cover it but at the moment I think that's not the case.

I suppose the last matter I'd just like to touch on very briefly because I don't think it's a critical issue but it is one that I guess causes me some interest and that's the nature of the review from the minister's - or a relevant minister's decision. We have absolutely no problem with layers of appeal and review. They are an important check and balance and over time they're an important way of bringing regulatory decisions to a focus point rather than having them splay off. However, in my opinion

you will get better decisions at later points in the process where you have a narrowing of the issues and a greater focus on critical points of difference. At the moment we have an arrangement where the hearing before the Competition Tribunal is a de novo reconsideration of the issue as if the tribunal were in the place of the minister. There is nothing to limit the issues that can be exposed for the first time before the tribunal and indeed evidence can be introduced that we, in forming our recommendation, and the minister, in making his or her decision, has never seen.

We think that is much more akin to a first instance hearing yet again without the benefit of appeal to narrow it. It's our view that a modest change to the arrangements where only evidence that had been put before ourselves as a recommending agency and the minister in turn should be available and it should be a reconsideration afresh by the tribunal but on the basis of material that is available below so that you'll bring together a narrowing on issues rather than simply having a new set only effectively tested once.

There would be a need of course for updating evidence to be introduced. We don't want the nonsense of an event occurring post the minister's decision but prior to the tribunal. That would clearly change and influence the answer significantly but in my experience courts and tribunals are normally able to draw the line between material that is novel and new and would not have been available below from that that's another try at getting a different answer.

We think that that has, over time, the ability to improve the regulatory outcome and reduce uncertainty, whereas at the moment you effectively have one set of arguments for us, possibly another set for the minister - although we rather hope that that is not too broad - but potentially a third set. That's three different ways of looking at it, rather than one or two ways being narrowed down and brought together. We think that would be consistent with the tribunal as a review and appeal body, rather than as the primary decision-maker, which they effectively can stand in the face of. I think my notes take us to this point. We are more than happy to elucidate on any of these comments or Michelle and Ruth, in particular, on the content of the submission.

MR HINTON: Thank you very much for those comments, John. They're appreciated. In fact, the Productivity Commission really appreciates the participation of the NCC in this inquiry. The Council brings a particular perspective and responsibility that's fundamentally related to the terms of reference so we really value your input. It's not surprising to hear many of the points you raise. They go very directly to the points that I had in mind in terms of raising with you, so that's an appropriate intersection.

What I would like to do, before getting onto what I think is a very important

area with regard to Part IIIA's intersection with the Gas Access Regime, I have got some more minor - not so much second-order issues, but more pointed issues. They particularly come out of your introductory comments. The first one is, I quite liked your implementation application distinction, in terms of, for example, NCC-ACCC. Do I take it from that you endorse one of our explicit, specific recommendations that the entity making decisions on coverage, importantly be different to the entity-making decision on regulatory application? Is that putting words in your mouth?

MR FEIL: No, I think those, if they're not exactly our words, are sufficiently close. That is certainly one of the areas we agree on and I don't think it's in any way a comment on the ACCC, but I think it is vital that the body responsible for determining what is within the scope of a regulator is not the regulator. There is just too much risk. Again, I emphasise I don't see this as likely, but there is too much potential for coverage to be used as a solution for an implementation problem with regulation.

MR HINTON: I was going to come onto that in a minute in relation to one of your other comments, but before I do, let me ask you another distinction question and that is: the terms of reference, of course, cover both transmission and distribution systems for the gas sector and we, therefore, had to examine whether or not the gas sector-specific regime is appropriately designed in a manner that addresses both distribution and transmission and did not distinguish between, or there was sufficient flexibility to distinguish where differences apply with regard to regulatory intervention. Given your experiences as the Council making coverage decisions, are you comfortable with our conclusions with regard to that - that the Gas Access Regime can be a single regime covering both distribution and transmission?

MR FEIL: My answer would be yes.

MS GROVES: Yes, I think the Council is. In considering applications for coverage and revocation of distribution and transmission pipelines, we have never experienced difficulty in applying the criteria to those different sorts of infrastructure in a way you would think that they were not appropriate. The council does support the single framework applying to both transmission and distribution.

MR HINTON: Thank you. A third question that emerged from your introductory comments - and it's something you just picked up a moment ago; I may be doing a disservice as to my interpretation of your comments - it implied that we may be seeking a higher threshold for coverage with regard to the building block approach of cost based price regulation, to address the issue that the regulator gets it wrong. I was a little uncomfortable with that formulation because it certainly is not what's behind our approach to having higher thresholds. So my first question is, have I

misrepresented you? If I have not, then I would really like to put on record why we make a higher threshold as a key part of our approach.

MR FEIL: I think that could be useful because I may have misinterpreted you on the other way around. It seemed to me from reading your report that there is something of a concern coming through - and I'm not in a position to comment on the validity of the concern, although I would say that the evidence either way seems scant - that somehow the application of the cost based pricing - whatever - approach was stifling transmission investment or leading to transmission investment that is suboptimal. The impression I was left with was that, at least in part, the idea of making it harder to bring something within coverage was a response in some part to that.

MR HINTON: It may be terminology here, John. The key criterion underpinning this higher threshold concept for the application of the cost based price regulation was one essentially driven by efficiency. If the benefits of intervention with cost based price regulation are likely to be greater than the costs, then that's a basis by which that intervention would be appropriately pursued. In those cases where the benefits might not outweigh the cost you would not wish to apply under an efficiency test that form of regulatory intervention, and it's that approach, broadly defined in terms of efficiency objective. The fact that it's cost based price regulation, there are all sorts of regulatory uncertainties, difficulties, getting the WACC right, for example - we have discussed that this morning - and a whole range of other factors that flow from a CAPM approach or whatever. But it's still within a concept of a criterion of pursuit of efficiency; benefits outweighing costs.

MR FEIL: I certainly don't have a problem with the pursuit of an efficiency objective, but I think that that's, in crude fashion, the coverage decision we make or the coverage recommendation we make now. If the costs of imposing coverage and the regulation that might follow are higher than the benefits, then the answer to that is not to cover, not to look to another form of regulation, particularly one that doesn't provide a right of access, because that just strikes me as - if it wasn't worth covering it under these criteria, then formal price monitoring or something else just seems to me to be a relatively pointless intervention.

There is always room for informal price monitoring - clients of pipelines, no doubt, do it and can come back - but the coverage decision is, I think, quite a stark one. Either it meets the criteria and, if it does, by definition the benefits should outweigh the costs including some allowance for the costs of regulation, broadly defined - ie, the dollars you spend on Henry - but also the risks or the consequences of the risks and uncertainties in that. I think that is implicitly taken into account in a number of the criteria. Conversely, if the coverage is worthwhile because it provides an enhancement of competition downstream or upstream, then clearly the natural

monopoly test is met and it meets the public interest requirements. Then the consequence of that should be something that provides a right of access and that's what the regulation is about.

DR FOLIE: It appears to be a slight tangent, but it's the same theme that just reading your submission - unless I've got it wrong - appears to focus on that range we were talking about where it, indeed, would be about price monitoring. Price monitoring is only one minor part. It really is about actually constructing a full set of criteria and access was very much behind the idea. So the idea as a monitoring regime is a lot about performance, not just about price performance. We have called for people to actually give us ideas about monitoring, and access is very very important. Access must be reasonable and we have even got issues about how to then resolve it. It's very important that a competitive environment stays in place, so it's a part of that.

MR FEIL: I hear what you're saying. From an interchange earlier I got the distinct impression that you appreciated my comment that by the time you got a monitoring regime with a consequence that amounted to a formal right of access, you come remarkably close to the other scheme anyway.

DR FOLIE: We are sort of suggesting that the body making the decision would actually have to then agree to parameters for this monitoring regime.

MR FEIL: Presumably then, as soon as you step out of those parameters the access right cuts in or something.

MR HINTON: It could cut in after five years, but we're jumping ahead.

MR FEIL: I think the five years would seem to be a problem.

MR HINTON: We're going to come back to the five-year point. We're jumping a little ahead in that. I now want to come back to what we foreshadowed, and you foreshadowed, as an important part of our exchange with regard to what's in our draft report, and that is the intersection of Part IIIA and what we have proposed. It is crucially driven by differences between the threshold as regard to Part IIIA, as you flag in your submission, and the thresholds in our draft report. If they are the same - that is, material versus what you apply today - then there is no coverage difference. There may be different forms of intervention in terms of regulation Coverage would apply and you have implied that's probably what you do now. Non-trivial, material is there.

MR FEIL: I think explicitly the Council, when it's asking that question about the degree to which competition would increase downstream or upstream, material is in

their mind.

MR HINTON: Right. The crucial issue becomes the so-called higher threshold. How high that is, is another matter, but it is substantial as opposed to material. As soon as we pursue a threshold test for applying the cost based price regulation that is substantial, which by definition - let's take it by definition - is higher than material which therefore is higher than Part IIIA, you've got this tranche of cases not covered under our system for cost based price regulation that are covered for your system. That has several issues for us. One is - and I think your submission makes it quite clear - the problem with that is, what about default to Part IIIA for those because the NCC couldn't certify that the processes applying, the regulatory structure applying to that tranche, would not meet the test for certification.

You, therefore, say, "Well, let's change that tranche's treatment to make it perhaps certifiable," but as soon as you do that it's virtually the same as the tranche that is subject to coverage under our system. So why do it? I would like you to think slightly differently about this issue and say, "How can we, therefore, change that intersection of not defaulting to Part IIIA?" You alluded to the possibility of a bar. There are other possibilities that might remove the application of Part IIIA default option - negotiate and arbitrate model for this middle tranche; our so-called monitoring tranche. One might be that we have an approach whereby the NCC could certify that the overall system meets it, even though there is no arbitrate disputation resolution process in this area. There is no challenge to access within a five-year period. Isn't there scope to say that the system overall is certifiable, even though a particular case is in this middle tranche? Is that an option?

MS GROVES: That has not been the approach the Council has taken to certification of baskets of services in the past. The clause 6 criteria, which are called up into Part IIIA as the test for an effective access regime, provides that a regime is effective for services of infrastructure. That can be one service and you sometimes have that for rail. We have a particular set of infrastructure; rail line from A to B. The state brings in an access regime for a service provider by that rail line and they have just applied the regime to that particular piece of infrastructure. That's what we're examining when we look at the certification.

In the case of the Gas Code, to provide, I guess, a greater deal of certainty and administrative efficiency going forward, state governments initially did that. They had the list of the schedule A pipelines which says, "We would like you to consider whether the regime could effectively regulate these sorts of pipelines." But what we recognise is that over time, and probably fairly rapidly over time, that list is going to change. Things will be brought in and things will be taken out, and that's what we are facing at this time.

MR HINTON: Yes.

MS GROVES: So what they wanted to do was devise a way of ensuring that as things came in or out the things that were in got the protection that a certification provides. The only protection we know that it provides is protection from declaration under Part IIIA. That's what the point of certification is.

MR HINTON: Yes.

MS GROVES: They devised a method by setting up a coverage process that was as closely based on the Part IIIA test as was reasonably useful for pipelines, put the process in that was similar, so that you had the concept of the council, in this case, being the coverage advisory body, and that was based on the fact that as services became covered the council could be satisfied they had met the criteria that were in clause 6 and because of that, the regime stayed effective for those services. It was recognised that the services of pipelines that were uncovered were outside the protection provided by the certification of the Gas Access Code, but the reason that they weren't covered was because they didn't meet the gas coverage criteria. It didn't matter because they weren't going to meet the Part IIIA criteria, either.

MR HINTON: Yes.

MS GROVES: The fact that they were outside didn't really give rise to any sort of regulatory risk there for them. What goes up to make an effective access regime is set out for state access regimes in clause 6. They are guiding principles that the council must take into account and must be satisfied are met before it can certify an access regime. One of the cornerstones of an effective access regime, that the council has always considered a cornerstone, is an enforceable right of dispute resolution. It is explicitly recognised in clause 6. When the council tries to think of, "What do those principles, those 20-odd principles in clause 6, add up to?" one of those things that has been an absolute cornerstone is an enforceable right to dispute resolution, a right of access.

We were concerned about our interpretation of your two-tiered approach which, at least potentially for covered pipelines that met the criteria at the minimum level, so therefore were pipelines that had an ability and an incentive to misuse market power in a dependent market in a way that could affect competition, that for those pipelines for periods of times people would have no enforceable right of access, though there would be some regulatory intervention through the bundle of regulatory products that you had coupled better and which we called "the prices monitoring" for shorthand.

MR HINTON: Okay.

MS GROVES: We recognised it included other things. They would be required to publish a third party access arrangement. There would be quality monitoring. We've just picked up the terminology of the prices monitoring regime rather than repeating each of those; but for pipelines that were caught in that bundle, for periods of time - the way that we had interpreted your perception is that for users of those pipelines they would not have an enforceable right of access.

MR HINTON: That's a correct interpretation.

MS GROVES: Which would then seem to go to one of the cornerstones of what an effective access regime is under Part IIIA, which is a provision of a right of access backed up by enforceability.

MR HINTON: I can see how that conclusion takes you down the track of what is in your submission; that therefore the way to address this is to add in certain things to that monitoring regime that has characteristics that would make it certifiable. But then I would endorse John's point that that then makes that tranche very similar to the other tranche, so that would run directly counter to the intent of our objectives inherent in our draft report. What I was wanting you to do was take off your NCC hat, leave on your NCC experience, and say, "Is there not another way to address this challenge?"

One way I'm suggesting to you is to have a look at clause 6; that is, the sort of parameters for the determination of "effective" maybe could be shifted in a manner that looked at this as a whole, saying that, "Sure, there is no dispute resolution mechanism. There is no guaranteed access for this middle tranche," but it's part of a total package whereby after five years you might move back into the heavier-handed intervention longer term if they misbehave or whatever, such that it would require an amendment to clause 6. Now, is that not a potential solution to the problem that - we clearly agree we've got a problem.

MR FEIL: Clearly, if you amend clause 6 to take out the cornerstone requirement we've been applying up till now, we could apply a revised clause 6.

MR HINTON: Yes, but sorry, I think you're overstating my formulation. It's not a pejorative statement of scrapping the cornerstone of certification.

MR FEIL: No.

MR HINTON: It's saying there are other ways to prescribe when certification is appropriate that still retains the cornerstone as long as you look at the package of the regime as a whole, not just one tranche of it. Now, I understand the cornerstone, and

the principle of it, and I'm not suggesting it should be scrapped. I'm really seeking to get your reaction to this suggestion that there is another way to address this problem.

MR FEIL: I think you're right in that we could have regard to the broad scope and accept that for the majority of situations there will be coverage and an access regime available. That's the ones that meet "substantial" and up. For the group between "material" and "substantial", I think at the very least we would have to be confident that whatever was there, as your monitoring and other parts proposal, had an effect on behaviour that was likely to encourage access even through that period. I think, if you approach it on that basis, it becomes something you can answer simply in the hypothetical by saying it's possible, but in practice it might be incredibly difficult to make the judgments around that, in which case we're either forced to reduce the scope of the certification so that Part IIIA is available to that group - - -

MR HINTON: What about amending clause 6?

MR FEIL: - - - and if clause 6 was amended then making a judgment about the overall effectiveness across the entire gas sector. That, in some ways, depends on whether you take the universal view of the gas sector or you concentrate on the balance of interests of parties that might want access to the pipelines that are between the "material" and the "substantial". Certainly, if you focus on their interests, they are arguably worse off than having Part IIIA. They might still have scope to other forms of litigation, particularly if there is an integration question.

MR HINTON: They may not be worse off than not having access to Part IIIA, in circumstances where the monitoring regime has force of threat; that if there is a misbehaviour - and I'm using shorthand here - then after five years that puts the service provider back into the other tier which is the force of the cost based price regulation. But just as importantly there are other powers within the structure of the Gas Access Regime that touch directly on behavioural performance as well. Section 13?

MR FEIL: Yes. So that might give recourse to those.

MR HINTON: Section 13 - and the recourse to that also reinforces the system's, as in the draft report, capacity to bear on behavioural characteristics of those service providers in this middle tranche where we are talking about here. To the extent that there is force for effect behaviour and to the extent that there is not an intrusive cost based price regulatory structure whereby the costs are not so large as the other tranche, then that's the rationale behind our structure.

MR FEIL: I understand that and I think, subject to Michelle's comment, my answer before that theoretically it's conceivable with some adjustment to clause 6, that that

could be something that it certified. I think whether it has force given that nothing can happen for five years - do you anticipate the outcome or do you wait and assume you're going to be covered in five years and make the most of the holiday? I know in some other jurisdictions there have been discussions about having a threshold, that if you stay on one side of you don't move straight to regulatory regime but if you step over it, you don't have to wait four and a half years, or six months or whatever the period is, before that occurs. It's a trigger that is set around conduct or price levels, presumably, in principle.

MR HINTON: The problem with threshold is that someone then has to calculate it and then we get Henry and we get all sorts of people coming to bear.

MR FEIL: Well, I'm not going to comment on the social desirability of how interpretative economists are - I think that's true but that, one would hope, would be a lesser task than the full cost based regulation and it might well be something that can be drawn from broad experience and the rates that are set by regulation or the market elsewhere, in a comparatively crude fashion and partly, I think, it would be an interesting question I haven't turned my mind to, as to where the responsibility for that threshold setting should lie - whether it would lie with the coverage recommender, ie us, or with the regulator. I have a horrible feeling that the right incentives probably lie in one place and the right information lie in the other.

MR HINTON: That underpins dramatically our draft recommendation that the coverage decision, therefore the entity making the coverage decision, is the entity making decisions as to the form of regulatory intervention, monitoring or - - -

MR FEIL: I have a feeling that if you go down that route - and again this is subject to our comments that we wonder about it - I think that is probably right. The difficulty I saw immediately upon that was where the experience and information - because as you say, it's not an entirely dissimilar task from the regulatory task. I don't want to be too glib but in past the ACCC gets to deal with Henry a lot.

MR HINTON: John, to come back to your other comment about this concern that the service provider being monitored might make hay while the sun shines for five years, it's still in an overall context where a judgment has been made about the nature of their market power, as a prerequisite judgment that puts them in that lower tranche relative to the higher tranche. Now, if one can make a judgment today about coverage and non-coverage, there would seem to be potential scope to make a judgment about another line higher than that again. I know it's subject to regulatory risk and hard calls by the regulator, but it seemed to me that the regulator making that first decision is eminently appropriately placed to make the judgment for the second decision, because it's all to do about market power judgments.

MR FEIL: I think it would have to be broadly about the judgments under all the criteria, not just solely the level of market power, because it would be the degree of market power held by the pipeline but also the benefits of enhancing competition up and down the screen.

MR HINTON: Precisely. The coverage criteria - all four, as refined - would apply at that stage.

MR FEIL: Yes.

MR HINTON: That reinforces the point about the coverage entity also being the entity making this judgment about the category.

MR FEIL: The only other point I'd raise on that, because I understand where you're at and I think you understand where we're at, as well, would be that the last thing you would want would be a de facto slippage down of the lowest criteria, because you've got a soft option, or a softer option. I think you do have to think very hard because of the costs and the consequences of coverage in terms of what happens when you've got the regulatory system.

MR HINTON: It's an interesting point you make because - - -

MR FEIL: Clearly that suggests that coverage is not and should never be something that is applied lightly. You must be solidly convinced and satisfied on all the criteria before you go down that way. There is always a risk that by having a lesser cost option in the nature of the regulation, at least for the public interest criteria, the balance could tilt. I don't think that would be desirable. I think you would want to be - - -

MR HINTON: Some have referred to it and some of the energy users have expressed concern about that - that you'll end up with wider coverage than you have today, even though it would be less intrusive for some of them. This so-called third umpire, I think, as someone put it - when in doubt you'd better put them into the soft one because - - -

MR FEIL: I think other people call it regulatory creep.

MR HINTON: Yes, and that's why clear prescription as to the meaning of the coverage criteria and the application of the four criteria has been very important, so that there is rigour to it; just as much rigour as you would bring to bear today on the coverage criteria, they would similarly apply for the formulation that we are putting in our draft report material though - it's very similar, but today you don't have that same pressure that you would have under our revised scheme, whereby there is this

option of monitoring. We've tried to say that the coverage would, if anything, be less rather than more; that is, material is higher than promoting competition, but you've said they're very close.

MR FEIL: I think what I've said, and I'm advised is the experience, is that when the council considers that test material is in there.

MR HINTON: Let's move on to this five-year point. We have put in our draft report the view that if you are going to go into the monitoring tranche tier that that in effect would hold for five years - and you have referred to it, as well. The idea behind that is that it provides scope for the parties to negotiate and get on with commercial business of dealing with service provider-service user in circumstances where that is also a key objective of the Gas Access Regime - to try and have a system that encourages commercial negotiation. If you have a non-binding period where at any stage you could end up being changed categories then you have the potential to very quickly erode this freedom to get on with commercial negotiation and we put some force to that objective and, appropriately, it is included in the existing code as an objective.

MR FEIL: And I think the objective is worthy and the point you make is quite true. If you think there is a soft option rather than negotiation there is always a risk and I certainly would be reluctant to be put in a position where we have to judge whether or not there has been genuine bona fide good faith negotiation. Some sort of test might be an alternative to an arbitrary time limit. Again I suppose the prospect of an arbitrary - and I mean arbitrary just because it's a number and not in a prejudicial way. A time limit with an extraordinary circumstance, but again that's - how convincing can you be for extraordinary circumstance?

I don't know what the effects of the incentives are, but you are quite right, I think, that if you had something that we turned down, covered it and sent it for monitoring, people go away and six months later they'll come and say, "We failed," and that might be true. I suppose it depends partly on how receptive they think when they're making the judgment about whether or not they negotiate and try and reach a commercial settlement - how willing whoever is deciding would be to reconsider its decision in a very short period.

MR HINTON: A related point though is that some have put to us, "Five years for that is fine, but why not also have five years binding for revocation?" Have you got a reaction to that? It's not in our draft report, but it has emerged in some of the other submissions in response to our report, that if you are going to get revocation then why shouldn't that be locked in for five years, too. Have you got any views on that?

MS GROVES: It's not something that I think we have turned our mind to. It would

seem that within the current arrangement you either meet the criteria or you don't. If you meet the criteria you're in and - upon application - if you don't, then you're out, and you're out for as long as you don't meet the criteria. We haven't had the experience really of something going out and then somebody popping along, as of yet, to try and say, "The circumstances have changed." The question of whether or not it altered any of the incentives or the underlying fundamentals of the regime by saying, "You can't come back within five years" and, "No-one can come and ask to put it back in the basket for five years," practically may have very little effect. Our current experience would suggest that it would have very little effect - as I have said, we haven't had anybody come back within five years - but, from a theoretical point of view, if there was something that resulted in a substantial change, such that these people did meet the criteria, you would wonder why they should not be capable of being caught up by the regime.

MR FEIL: Certainly if someone came back shortly after a revocation to have another go, they're going to get - - -

MR HINTON: And they have got deep pockets.

MR FEIL: They could have the biggest pockets they like, but they are liable to get the same answer frequently.

MS GROVES: Yes.

MR FEIL: But if there was a genuine change in circumstance then obviously we would consider the matter afresh, but the onus, I think, would have to be on that person applying for putting it back after taking it out of the box to make the case and, again, I emphasise Council is not looking to cover it. It's looking to let the market run.

MR HINTON: Yes. We're a little surprised at these views being expressed to us - that this was necessary. That's all.

MR FEIL: And I don't think the experience runs the other way either, where people have applied to get coverage; been refused; come back six weeks later. I guess they can go to the tribunal, but they can do that in both cases and try again. I just don't think there is the practical experience.

MR HINTON: Let's stay with the coverage criteria for a moment, the way it's proposed - the draft coverage criteria. We had another variation to that which is currently in the Gas Access Regime. "Promote competition" is there currently, and we're talking about "likely to lead to an increase in competition to a material or substantial degree". We've talked about "material" and "substantial", but the second

aspect was adding this degree of probability that our legal advisers also picked up in one of our appendices regarding this issue; that is, adding a slightly different formulation to just promoting competition; adding a degree of probability; likely to lead to. Have you turned your minds to how this also changes the height of the threshold with regard to coverage? We thought that was not unimportant in leading to perhaps less coverage overall and of the draft revised regime relative to what exists today.

MR FEIL: I guess in the case of imposing coverage as opposed to revocation - let's put that aside - you're always looking forward and making predictions based on the structure and the incentives and the circumstances, so I always read "likely" as being more to do with the fact that you're looking forward than the probability of point-something or greater than 50 per cent or something like that. I guess if you put the phrase "more likely than not", then that implies a better than 50 per cent chance.

If that is what you intend I would rather suggest that it might be better done that way than putting "likely", because then we are simply going to have an argument about what the probabilities are and, in the end, I think that's a judgment that's not necessarily aided by having a quite specific provision. I think always you are looking forward and you are looking at a range of likely costs and a range of likely benefits, one of which is the potential for enhancement of competition because of the availability of access.

I didn't read your suggestion quite as firmly about applying a probabilistic type of approach but, to the extent that that's what you are intending, then I think that's just invariably the nature of the task. You are looking forward. You don't know for certain because you have only got a set of structures and a set of incentives and a set of players. It's somewhat easier if you are going backwards and revoking, because you can see what has happened, but you will never have that looking forward. There's always a probabilistic element to it.

DR FOLIE: I should like to go back to your concerns over the monitoring regime as to whether that would really be effective. There's a proposition there's a reasonable history of corporations when they are required to report on things. We've got issues about recruitment of a proportion of women in senior executive ranks. We've had the issues through the mining industry actually having to - even though they're reported statutorily, all their safety statistics report very clearly on deaths and that changed the attitude of that industry dramatically, and that was voluntarily imposed on themselves. We've had the other area about environmental reporting, which the mining industry picked up, and that changed the performance in that area; not statutorily required, but effectively going public on all these types of things actually shifted the attitude quite dramatically.

Part of the thinking behind this over a five-year period - many of these gas decisions take quite a long time to actually - there are multiple things happening while the access might be being negotiated, so there's not an enormous - a decade might be too long, one year might be too short, but effectively the period - then it has got to be long enough to enable behaviour patterns to change. The actors then don't immediately of course resort because that's the behaviour pattern now that you resort to courts and tribunals to try and do it. It seems to me that it would be a way to try and give it a go, unless there are really clearly very serious - which is what you are saying, and it seems that you are concerned about actually giving it the time to run.

MR FEIL: I don't think five years in these circumstances is an extraordinary period of time. I guess my issue is - monitoring occurs. People write letters to us, to ministers; clients observe what pipelines are charging, to the extent they can. If the monitoring regime were to force more information out into the public domain I think that has consequences both ways. It might discourage good deals as well as encourage them, so you would have to be concerned about that, and generally you end up taking the view that more information in most circumstances is better for the functioning of a market, but I think there will undoubtedly be commercial issues around that as well, but I'm not confident that additional information that after a coverage decision of some sort - whether it is the first tier or the second tier is applied as all that - sorry. I am not being clear.

I think what you are proposing is more than monitoring or a further information disclosure. It's not uncommon, I think, in some jurisdictions to have information disclosure requirements to enhance the market and perhaps the ability of people to make complaints, but I think that is generally done somewhat independently from what we would understand as coverage and the consequent regulation, but what I understood you were proposing was monitoring of companies that do meet the criteria - at least the current ones - rather than monitoring to decide whether or not they meet the current criteria.

MR HINTON: I know.

MR FEIL: It's very much directed at more information for doing the cost-benefit analysis of regulation rather than, should they be covered, and I think they are slightly different things. I would be somewhat more relaxed about the former. I am still nervous about the second because, in one way, it's exactly what you are saying. It's an enhancement that will affect behaviour in a positive way. It will reduce the need for full-on cost based regulation, and that's a possible outcome, but I regret to think that others might take a view that it's five years to make hay and we're going to get regulated either now or in five years' time because we are a natural monopoly.

We do have the incentives that meet the criteria and being covered would

enhance competition, so it’s an opportunity and you have got to make a judgment about what that balance is, and I think the crucial point is - on the current formulation, even if we can find a way of certifying it, for a potentially significant group of pipeline users, up or down stream, they don’t have an effective right of access for whatever period remains of the - say it’s five years, and the scheme was about providing them with a form of access, not - - -

MR HINTON: No. It’s about providing a form of access when intervention is warranted.

MR FEIL: Yes, and again I come back to the start criteria we have now and the council’s view. If you meet those criteria then intervention at the current level would be warranted. I don’t want to just keep repeating myself, but it's certainly not something that the council looks to recommend unless there is a clear meeting of all those criteria. Our principal mandate is one for letting markets work.

DR FOLIE: I'll follow on with a bit of that - actually, not to do with the inquiry but certainly in McFarlane's decision about the Sydney to Moomba pipeline, giving further evidence, increasingly there is a network, so that the pipeline is actually getting - even though they always go from source to market, but, in fact, there's a network growing. It is enhancing. There are further links.

As I understand it, the government's objective is to ensure that we have more sophisticated services, and we're certainly likely to see that as the years evolve. What I'm puzzled about is we then have derivative services. There will be forward contracts. Already there are some of them around. How that then goes - because that won't follow the molecules. It will be indifferent, so that competition will then come into play into another form. I'm not too sure then whether that regulation - if you're going to try to regulate those services which you alluded to earlier about - - -

MR FEIL: Not if there's a competitive alternative. If the market either develops physically or some financial mechanism so that there is not market power possessed by a pipeline from A to B - - -

DR FOLIE: I'm just curious as to how you might be able to move forward under that because we all have trouble - - -

MR FEIL: I think the way of moving forward is, once you're convinced that that's the case or that it's likely to be the case, you don't cover it. You know, there's a market operating.

MS GROVES: The council has already passed recommendations up to ministers. They've taken into account the potential for backhaul, the potential for various other

forms of service and for the contract market, and has taken those into account in its analysis of criterion A. To date, it has not found that those alternatives have been sufficient to constrain the market power of service providers, in the circumstances that they have been raised, but the council has always recognised that they were an important part of the market assessment.

If the markets are developing in a way which we all hope they are - because it was the purpose of where we started off in 1990 with this gas reform process in the first place - then those instruments - financial as well as alternative physical ones that you would hope the market will develop in an innovative way - will become an increasing part of the criterion A assessment. The council thinks all those things are entirely valid and appropriate to be taken into account. You may have different views on where the evidence stacks up at the moment as to what sorts of constraints apply or whether they actually exist or how effectively they exist, but the council certainly sees that they are entirely appropriately taken into account in its criterion A analysis.

MR FEIL: And I think that increasingly they are going to be factors that should feature in evidence and material put to the council as well, because to some extent our ability to make judgments on that is dependent on the evidence from parties that are contemplating operating in these markets as to what's feasible and what's not. We obviously go out and seek our own information, but as we get further applications for coverage or revocation we would expect - for exactly the trends you're observing - to see much more of that material being made available to us so people can demonstrate that there is or is not an alternative combination of pipelines, backhauls and swaps that means that, depending on what site they're on, in fact, the market is sufficiently served by competition and that coverage isn't required. If that's the case, then the competitive discipline will deal with the coverage issue, not the regulatory intervention. I think to date, as Michelle said, the council hasn't had evidence that's led it to be satisfied on that point. When it does, it clearly will be relevant to our decisions.

DR FOLIE: This is a hypothetical, and perhaps a little detailed, but part of the network development is that small little interconnectors and things can be built that link megasystems, if you like. In other words, the process which you currently go through to assess whether that interconnector should be covered or not or whether that then has flow-on effects for other decisions - is that process perfect at the moment to be able to cope with that complex process?

MS GROVES: Of course.

DR FOLIE: This is part of the network development to ensure that - - -

MR FEIL: It most certainly isn't perfect, but the criteria as they are would enable us to, in appropriate circumstances, deal with that issue. If we found that we couldn't, then we'd put our hand up and say so. I don't believe that there are such restrictions and the criteria are so confining that we're obliged to physically go out and kick a pipeline and walk it from A to B to be convinced that - and we need four of them, before we can not declare. That's not the case.

DR FOLIE: Okay, thank you.

MR HINTON: I have a couple more questions, and we're being squeezed for time, John. The first one is in relation to your reluctance to accept our invitation to assist in the preparation of guidelines for the monitoring regime. There are two aspects here. One, you point to the ACCC being much better placed to do that sort of thing. I'm not going to debate capacities, because that's not the issue. That can be addressed. The issue here was one of principle again; that is, if the regulatory body doing the monitoring is the ACCC, then it would be best, in terms of regulatory creep or regulatory capture, to have another separate entity do the guidelines. That was the origin of that. That's not a criticism of the ACCC. It's just the nature of this distinction we made before between coverage and application or implementation and application, as you put it. That, I thought, had some force to it.

MR FEIL: I think it does too, but I'm also cognisant of how difficult it might be. I think in principle the incentives are probably better for us, but the information is not. It's a trade-off of which of those imperfections is the one that will make the decision, and I suspect that you can devise mechanisms whereby we could receive information. I think you can devise mechanisms to oversee the incentives, if the decision-maker was the ACCC or whatever the regulator at the time might be. I think either way you can fix whichever is absent. My personal instinct would be that the incentives are probably the more important issue than information, but I don't have enough information to know how much information there is involved either.

MR HINTON: We were hoping to expand in our final report on these sorts of parameters, descriptions, prescriptions that would underpin the nature of the monitoring regime that therefore would form the bones of that which emerged - if it were to emerge - from government decision-making. The location then becomes NCC. It wouldn't be from a blank bit of paper. I'm just encouraging you to be less reluctant.

MR FEIL: Thank you for the encouragement.

MR HINTON: Perhaps my last question, and Michael might have some more as well, and you might also wish to flag stuff that we haven't covered. I'm sure we could spend the rest of the day, if we had the rest of the day. This issue of

significance test: we're a little uncertain here as to how this really works within your decision-making or analysis process, as to how you take account of the significance of infrastructure. We struggled with this a little in our draft report, about where it's appropriate to have criteria that bear on the issue of whether or not intervention is appropriate or inappropriate, because of lack of significance of the bit that might be regulated. Can you sort of help us out here?

MS GROVES: If we start off from the Part IIIA perspective, it has a concept of national significance as one of the criteria, and the Gas Code coverage criteria doesn't. I think we've tried to outline some of the reasons for that, which are mostly to do with the fact that the Gas Code is an implementation of a state access regime and those criteria are not carried through in that sense. The national significance was part of the concept of what it is that the Australian government, as it now is, should regulate under Part IIIA and what should be left to the states - I think has been one of the ways that we've seen it.

States are free to regulate whatever they like really. The national significance issue wasn't quite so sharp for the state access regimes. The question of whether or not there is some risk that infrastructure that is not significant could be caught up under the Gas Code coverage criteria I think can be addressed in two ways. The decision-maker, who essentially was the Commonwealth minister in this instance, for the certification of the application of the Gas Code in all jurisdictions, to the extent that it has been certified to date, needed to be satisfied that the infrastructure covered by that regime either was or was likely to be significant. That's one of the criteria in 6(3) - that access regimes should cover significant infrastructure - and then it addresses the bottleneck, the natural monopoly, and I think the third one is the health and safety issue in clause 6(3).

Already the decision-making process in certifying these regimes has said from the policy-maker and the decision-maker's perspective, "We are satisfied that the infrastructure that either is currently covered or will become covered under this regime will always be significant infrastructure." That said, I know that won't be a sufficient answer to you. The other issue, I think, from the council's perspective is it's difficult to imagine that, if you have infrastructure that needs the criteria of it's a natural monopoly with substantial market power that has an ability and an incentive to exercise market power in a dependent market and where regulating that infrastructure will promote public benefits that outweigh the cost, that piece of infrastructure could not be significant.

MR FEIL: I suppose the counter to that is if it's not significant then it's not going to be worth covering.

MS GROVES: Yes.

MR FEIL: The costs of doing so are largely determined by the nature of the regulation and probably vary to some degree, but not extremely, on how much you're doing. If you're only looking to do a little spur pipe, and yet you've got the cost of all the regulation that goes with it, you're never going to meet the costs - - -

MR HINTON: Wouldn't that argue for an explicit efficiency test in coverage - that is, benefits outweighing costs? I don't think you have got one. That's how you interpreted it, and that's why we've proposed an efficiency test.

MR FEIL: If the benefits of enhanced competition and the like that come from coverage were not larger than the costs of the regulatory impost, broadly defined, the council would not recommend coverage.

MR HINTON: But you do that under the - - -

MS THOMSON: The public interest test.

MR HINTON: - - - public interest test, which is behind my point about the explicit inclusion of it as opposed to your interpretation of one of the criteria that relates to the public interest test.

MR FEIL: I don't want to resort to a "if it works now, don't fix it" type of answer, but I think that what you understand from the words "an efficiency test" and what might be used, were the current test, which if you agree works - - -

MR HINTON: I think we're in heated agreement.

MR FEIL: Yes.

MR HINTON: It's just that I'm not so sure that we've got the solution. What you apply is what I think we would like to see explicitly applied, if I understand your system correctly.

MR FEIL: If you wish to recommend that, then I think you need to exercise particular care that what you propose does that and not much different, because we're pretty confident that what's there now doesn't.

MR HINTON: Okay. I understand your point. We take your caution with the full knowledge of the extensive NCC experience in this area.

MR FEIL: I think you can go around the room and ask people to define what they mean by "efficiency" and you won't get one answer.

MR HINTON: You would in the Commission.

MR FEIL: Then you're doing better than I think I'll do with the Council.

DR FOLIE: Just a brief one about legal precedent. We've had a lot of representations about, "Be careful, we don't want to change it too much, because now there's a great body of law out there after all these disputes have started to come true." One thing is that we have a body of law about horses and carts and things. It doesn't matter any more. In other words, if we change the regime then some of the body of law, so called, which was commenting on the old regime is redundant.

But you've made a point at the beginning. Is there an objective - just some objective low level - about actually trying to build a body of law that relates to access across all areas and to get the acts aligned so that then you can build on case law findings that might have applied to railways, airports, or something, that could also apply to gas in certain points of discussion, which may be about efficiency and may be about other words?

MR FEIL: Can I have a first shot and then I will let a lawyer colleague have a go as well?

DR FOLIE: Yes.

MR FEIL: I think that regulatory uncertainty is something that regulatory schemes should be very concerned about minimising. One way that you get greater certainty is from experience. If your experience in the Gas Code is limited to decisions under the Gas Code because it's different to Part IIIA, or to whatever else, then you will have a string of decisions that might be a dozen over a period of time. If you can broaden that experience so it brings in matters under Part IIIA as well, and matters from airports to gas pipelines, to the extent they are relevant, then you will gain experience more quickly by having similar words so that the precedents can't be distinguished too readily and therefore not held to apply.

I think that works towards greater regulatory certainty but you most certainly should not stick to a precedent that's wrong. So if something needs to be changed then continuing with something that's wrong because it maintains precedent to my mind is not a sensible outcome. If you are not sure if something is wrong then precedent and other examples somewhere else probably make sense until you are sure it's wrong. So I guess the "in doubt" answer might be one that clings somewhat closer to existing regimes of precedent and I think you would want to be satisfied in your own mind, to a substantial extent, that it is likely to be better with a change before you made that change. And that should be a high hurdle, as we say,

coverages.

MS GROVES: I don't have anything to add.

MR HINTON: Is there anything you think you would like to focus on that we've neglected to cover so far?

MR FEIL: Probably, but I won't think of it until I've left. If there are other specific issues - and I don't know whether your process allows it - we are more than happy to provide you with additional material or additional reports as the project proceeds.

MR HINTON: Thank you very much.

MR FEIL: We are more than happy to do that.

MR HINTON: Follow up with your staff accordingly. Thank you very much again for your submission, your participation today and your comments, but also your wider participation in this inquiry. It is crucial for us. So thank you.

MR FEIL: Our pleasure. Thank you.

MR HINTON: That completes this morning's scheduled appearances. We will start again this afternoon. We are scheduled to return here at 1.30.

(Luncheon adjournment)

MR HINTON: Welcome back to this first session of this afternoon's public hearings here in Sydney of the Productivity Commission's inquiry into the Gas Access Regime. For this afternoon's first session I invite the following three attendees to the microphone; they are already up there. Welcome. They are Roger Henderson, Roland Sleeman and Phillip Coulton. Is that right?

MR SLEEMAN: That's correct.

MR HINTON: Welcome. Delighted to have you here today and thank you for participating. We welcome a wide-ranging input into this inquiry and your participation is an important part of that. I invite you to make an introductory statement to get the proceedings under way. Then we can move to some discussion sessions.

MR HENDERSON: Just before we make that introductory statement, I'd just like to say that I am Roger Henderson and I am here in the role of chairman of a gas study that we have been undertaking as part of a regional minerals program. We are not here to outnumber the chairman of this, because Roland will certainly be the main speaker and it is his report - that's Roland Sleeman of Sleeman Consulting. He was the one that we contracted as part of this gas study, in order to investigate and report to us on the situation of facilitating a natural gas industry in the north-eastern New South Wales area.

I have also got Phil Coulton here, who is one of the stakeholders that we had as part of that gas study, representing those other stakeholders. Those are all listed on our submission, on page number 2. The only other thing that I would like to say, apart from thanking you for allowing us to make this submission, is that we have a more formal report being printed as we speak, on our study. We have made a draft attachment to our submission of that but we still have not made that public and the ministers have still not done their thing, with press releases and so on, on that, which we hope will be soon. Until that is done we would have to ask you, gentlemen, if that attachment could still remain confidential for the time being.

MR HINTON: Certainly.

MR HENDERSON: All right. Thank you. I think, without further ado, I will allow you to have Roland make a small introduction.

MR SLEEMAN: What I will do is quickly overview the submission we have made by background initially. The study document is in addition to the submission we have given you. There is a full document that will also become available shortly, once the ministers have made their press releases and so on. That's something that I'm sure the chairman will probably send through to you on CD as well.

The purpose of this study of gas, in north-eastern New South Wales, was to look at the impediments and barriers to development of the gas industry in what is effectively the top right-hand or north-eastern quarter of the state, excluding a strip down the coast, so a fairly big area; a region that has no gas industry to speak of in establishment today, and I'm talking natural gas of course. The approach taken in this study was to review three critical interactive components: if they are not in place you can't have a gas industry. They are simple and obvious. They are the source or sources of a supply of gas, markets for the gas and infrastructure to move the gas between the sources and the markets.

A couple of general, high-level observations to come out of this study were, firstly, that although the region - this north-eastern New South Wales region - today has minimal proven reserves of gas in place, it's an area that's considered to have very high prospectivity for discovery of gas in the future - in particular coalseam methane, but also complementary discoveries of conventional natural gas in pressurised reservoirs - so a significant prospective source of gas.

From a marketing point of view, the markets in the towns of the study region are modest. They are skewed towards residential and small commercial. The towns in the study region are service centres for the surrounding communities and so the loads are not large industrial based loads there, they are small residential-type loads. The nature of those markets is that they are not really substantial enough to underwrite any significant investment in infrastructure to bring gas to them. If there is gas on your doorstep you can probably make use of it but you can't justify big pipeline costs. In the longer term, if the region is going to be successful in developing its potential, from a gas production point of view, that target market is likely to be Sydney-Newcastle.

A final sort of high-level observation is that there is no infrastructure- as I mentioned - in the region either. There are two sides to that infrastructure issue. One is that the absence of infrastructure reflects the fact that there is no gas and the markets are small but at the same time the absence of infrastructure is a deterrent to aggressive gas exploration activities. For example, companies have had exploration permits in this region and also have them in Queensland and they tend to spend their exploration dollar in Queensland where there is access to infrastructure. If they prove up a pocket of gas they can monetise it quicker. That's a bit of high-level background.

What was the keen focus of the report was to look at the barriers and impediments to development of the gas industry and they tended to end up falling into a couple of natural groups. Some of them were what you just call regulatory, legislative and licensing-type requirements that are in the state government's control

and we are not going to talk about those today. Others were technical and cost-related factors that really industry has to focus upon; getting the costs of producing coalseam methane down, demonstrating a track record and so on. We are not going to talk about those today either. The final group was commercial regulatory impacts that come about under the Gas Access Regime and, although our report isn't public yet, it's those that we do want to talk about because the opportunity is too good to miss to present them to you.

The concerns that arise under the Gas Access Regime - and I am going to list four of them, and they are the same ones that are in our submission anyway but just to recap on them: firstly, the risk that infrastructure, if constructed in a regional area, might subsequently become covered by the Gas Access Regime, is a risk that the developer of the infrastructure can neither manage nor avoid. So when you are faced with risks you try to either manage them or avoid them or you've got to take account of their costs. Since they can't manage or avoid the risk of regulatory coverage they have to contemplate what it might mean and take those costs into account in their decision-making risk return trade-offs.

Possible consequences of regulatory coverage include things such as - and these are the ones I think that are most important - imposition of return constraints down the track that might be different to what was in the mind of the person when making a risky investment in this regional infrastructure, and our focus is regional. The return that could be imposed under a regulatory regime might also be determined over a longer period. It could be 60 or whatever years of write-off period for your infrastructure investment where the investor may have wanted to do it in a shorter term when they built it.

In addition, the setting of regulatory tariff levels might be inconsistent with what's required when you are selling gas into a mixed energy market and you are trying to actually secure a market; and there's no "one size fits all" solution. There's not even a "couple of sizes fits all" because you need to take account of every prospective customer, particularly the small number of bigger ones that might be out in the regional area, and come up with a pricing arrangement unique to them in all probability, having regard to their conversion costs as well.

Finally, regulatory coverage brings the requirement for ring fencing. So that's a sort of first overview. The first comment is that regulatory coverage brings with it consequences that you need to think about. The second point is that these regional gas markets are small, the distances are great, margins are tight; indeed it's challenging getting the economics to work. In this situation, where you are trying to build up a new market, there's a lot to be said for having an integrated approach, where, for example, a team of people are working in the street, rolling out infrastructure, living in the town, drinking at the same pub as the people that live

there, and can respond to the market and can market gas and do whatever it takes so that you don't have the double-up of the costs of having to have separate infrastructure and marketing.

The guy that's investing the money in the infrastructure and taking the risk can have some control over his destiny because he can be involved in marketing the commodity that his investment is dependent upon. Thirdly, in a similar vein to that issue, if ring fencing and open access is required, the implication is that he would be reliant upon others for the marketing of the gas. It is preferable that the infrastructure investor be looking after his own wellbeing.

Finally, even in a circumstance where joint infrastructure and market development activities were allowed, if you didn't have ring fencing in place the marketer still needs to have certainty that he can achieve his market outcomes that he's planning to or depending upon for his return. What I'm getting at here is that if the market is still contestable, then you can have a circumstance arise where the key customers, the ones that are the most profitable, might be cherry-picked by another party, driving down the returns that could ever be made from the project. The solution to the last particular point is franchising.

They're the four general issues. In the circumstances, with the Productivity Commission under way and the concept of a regulation-free period being talked about, the main point to make here is that that's a concept we would strongly support. The regulation-free period would deal with the issues I've raised, with the exception of the possibility of franchising. Franchising is something that's not addressed in much, if any, detail in the Productivity Commission's draft report.

We would urge that there might be merit in having a look at franchising and considering whether there could be a role for clearer rules in relation to franchising. It could be suggested that, in an environment where you've got a regulation-free period and you are therefore not subject to regulatory coverage, that is akin to having a franchise anyway, because no-one else would have access to your pipework; but it doesn't amount to the same thing. There is still a role for a franchise, as the Tasmanian and Western Australian governments have also determined. The main message, though, is that the regulation-free period is strongly supported. With that as a background, are there things that you wanted to ask for more explanation on?

MR HINTON: Thank you very much, not only for your submission and your appearance today but also those comments. That's very useful for our discussion. I'd like to explore a couple of matters with you this afternoon. You're suggesting that this regulation-free period is certainly strongly endorsed and potentially therefore directly relevant to developing this part of north-eastern New South Wales with regard to the gas sector.

I'm a little uncomfortable, though, with your implication that that regulation-free period should apply as a matter of course to all new pipelines - you pick up this on page 7 of your note - as opposed to what is contained in our draft report, which is clearly a coverage judgment - the entity, on this occasion the NCC, National Competition Council, making a judgment whether or not that particular proposal would be eligible for a regulation-free period. That involves, as contained in our draft report, judgments about market power. I'd welcome your comments on why that sort of construct doesn't meet your particular needs with regard to north-eastern New South Wales.

MR SLEEMAN: I guess the underlying desire is that there be certainty; if a regulation-free period is available and a party is able to achieve it, that they're certain of having it. In the circumstance where you have someone that's prepared to make an investment in some regional infrastructure, and those circumstances are sadly few and far between nowadays of managing to achieve regional development of this nature; in the absence of certainty that you have a regulation-free period, then you're faced with the risk of coverage and the consequences that arise under it. So if it is a case of going through a process initially with a determination by the NCC to determine whether or not you're entitled to it, perhaps that is a step that can be accommodated provided at the conclusion of that period, if you've got the regulation-free period, it is yours for the duration, because otherwise you're putting people back into the unknown.

MR HINTON: Sure, but this process is ex ante - that is, while there have been expenses associated with development of the concept, it is something that has all the characteristics of a proposal that's clearly been capable of being delivered; that clearly is not costless but it's still not an investment that's taken place and therefore the regulatory risk is not huge in circumstances where there is potential to get a regulation-free period. If that is forthcoming, then the investment could proceed with no uncertainty.

If it is not forthcoming - that is, it doesn't qualify against the parameters of a regulation-free period approval, a binding decision for coverage or non-coverage - then the investment might or might not proceed, depending upon then the judgments of the parties concerned as to whether they would wish to proceed with that uncertainty. I therefore was really questioning what seems to be a challenge for our proposal not meeting your particular needs.

MR SLEEMAN: I accept your point that if you go through a short and perhaps not expensive process initially to determine whether you're entitled to the regulation-free period, and if it's determined you are, that may well proceed. If it's determined you're not, the party may well decide not to. The issues that perhaps remain in there

are, in the event that the determination is that there's not an entitlement to a regulation-free period so the project doesn't proceed, I see that as a - - -

MR HINTON: It still could proceed.

MR SLEEMAN: Or could not. In the event it doesn't, because of the absence of a regulation-free period, I see that as a really sad outcome. That then leads back to the criteria that may or may not be applied in determining eligibility. In a regional context where, as we're finding by what's happened in Tasmania, by what the Victorians are doing with their funding for regional developments and circumstances in other places, it is tough, the economics and commercial aspects of getting projects up to serve regional communities are challenging, to say the least.

There can be no doubt that when you put a pipeline into one of those regions, particularly if you follow the path of having a regulation-free period and/or a franchise, then it would be pretty easy to conclude that the party building that may have market power. But they don't really because they're supplying into a market that's already in existence. A whole range of different fuels are being consumed - wood, LPG, distillate, whatever.

They are going to be desperately trying to come up with arrangements that will see gas become the fuel of choice, and those will be pricing and other terms that will make fuel attractive for use. If you take a superficial look at it, you say, "Well, clearly they've got market power because they're going to be the incumbent and only provider of gas to the region." But what a challenge they've got because they're supplying into a region that's already satisfied with fuel; maybe at too high a price, but it's already got it.

MR HINTON: So your concern is fundamentally driven by a view that it's the doubts in your mind as to how rigorously the judgment calls are made with regard to whether or not it's eligible for a regulation-free period against potential misuse of market power and, to the extent that that is unclear, it makes you uncomfortable about whether or not that construct fits your particular needs?

MR SLEEMAN: That's it, yes.

MR HINTON: Can I come at it in a slightly different way, then. If I hear you correctly - and please correct me if I'm wrong - you're looking to have characteristics of the national Gas Access Regime designed to facilitate, encourage, have incentives for rural and regional Australia development. Is that an overstatement?

MR SLEEMAN: Rather than incentives for I'd probably word it differently and say that these regulatory frameworks and Gas Access Regimes are of our own making

and if they are of our own making and within our control - meaning government control or whatever - it would be sad for those things to be a deterrent to investment. So I'm not looking for an incentive but looking to avoid deterrents and issues and obstacles that might restrict the developments we're talking about. The challenge may lie in that, how do you draw a line - if you need to - between what might be regional and what might be not regional, for the sake of these things?

DR FOLIE: Could I ask you a follow-up question on that, because here are the proposals, but essentially in what you're proposing one would imagine there's a chance that you would be uncovered anyway, because if the representations are made - in other words, there is competition for other fuels, there's a limit to pricing power, therefore it should be allowed to proceed. You clearly seem to have some feeling and you've stated in fact this is not actually happening, therefore the existing system is not delivering, because it's meant to be able to deliver if you can make the appropriate case. It should deliver what you want, so somewhere either your case isn't strong enough or the commissions you're representing it to are really uncomfortable about the assertion. Could you perhaps elucidate a little bit about that?

MR SLEEMAN: Yes. In the current arrangements, if you proceeded with a development you wouldn't be covered unless you sought coverage or another party was successful in seeking it, so I think at the outset you would be uncovered. The risk is that let's say you put a pipeline to a town in the middle of this, the north-eastern New South Wales study region, to supply some small load and another party decides that it wants to put a little bit of gas through your pipeline as well from a pocket that it's found and is unable to negotiate terms for access to the pipeline, then of course it can go and make application to the NCC to have it declared and covered. There's no clarity or certainty of outcome in that context.

Whilst the pipeline might at the outset be uncovered, if you're left with this risk that it could, somewhere down the track, become covered, then the whole basis upon which you've made the investment is taken away from you and the ability to put gas in the market - in each case getting the best price you can for it, but on terms that are attractive to the customer to make them want to use it; if that all comes unstuck, then your ability to ever earn a return might be lost.

DR FOLIE: Is that then not lost in the lack of clarity in the objectives clause, the efficiency, this esoteric argument about trivial increases in competition, national significance, et cetera - in that area therefore the code is deficient, because if it's a small town, quite tiny, it could be construed that from a national point of view it has little impact on competition, though possibly it actually may be important for that little town. Is that the area where the current - - -

MR SLEEMAN: Yes, probably; the lack of certainty as to what the outcome may or may not be, at the time when you're deciding to put money into the ground that you can't get back again - you can't take it up and - - -

DR FOLIE: I understand that. But therefore are you saying that existing rules aren't crafted effectively enough to be able to cater for that situation, because what you would contend is that an access seeker wanting, in a small regional town - in other words, somebody builds a pipeline and somebody wants to fill 10 per cent of the capacity, say, with another customer and he says, "No, because I need that franchise to make my thing pay," you feel the rules that are currently in existence within the regime are not clear enough to be able to say that it doesn't really have an impact of national significance on competition?

MR SLEEMAN: The rules and/or the way in which they may be applied. It's probably a combination of the two.

MR HENDERSON: Could I just say something? You mentioned the north-eastern New South Wales region, and that was the region of our study, but I think we would like to contend that it's typical of any region in Australia, really, in the way in which we've uncovered these difficulties or constraints.

MR HINTON: There have been a couple of other suggestions that go directly to the point you've just raised. One has been, put to us yesterday in Brisbane, that there should be scope for a fold back in of a higher price for a regional service into a network, the network more generally, such that the regulator then would enable use of a higher price to capture higher returns commensurate with the sort of risk and commercial parameters of that regional development. That raises real issues of who's paying for the regional and rural development. Other gas users are therefore paying for it. Others have put to us that the state of Victoria has a public policy program of seeking to have distribution networks expanded to regional areas through direct government interventions; subvention by some subsidies - that is, the taxpayer more generally funding that.

MR HENDERSON: Yes.

MR HINTON: That has a transparency to it and a greater equity in some ways. I'm not putting it forward either as a proposal or as a preferred option but it seemed to me that some of those issues bear directly on the sorts of things that you're exploring, particularly in the context of you saying it has Australia-wide application.

MR HENDERSON: I think Roland has drawn attention to all of those issues pretty much, too. It's just that I think there's a feeling around that New South Wales is not as progressive as Victoria might be in terms of providing government assistance.

That's off the record.

MR HINTON: It's not, it's on.

MR SLEEMAN: Our comments are certainly aimed at infrastructure that we would hope would be viable in its own right. We've stopped short in the full documentation of suggesting that there be subsidies or incentives or anything. Those are issues for state government, probably not for the Gas Access Regime, as we would see it.

MR HINTON: Picking up Roger's point about Australia-wide aspects, which cities are captured by your north-eastern New South Wales? Does it go as far west as Moree? I assume it takes in Tamworth, Armidale. Does it go as far south as Murrurundi?

MR SLEEMAN: There are 32 shires. It doesn't include Newcastle but if you imagine a line going from Newcastle to Nyngan, and then up to Lightning Ridge, up to the Queensland border and back out to the coast, but excluding the strip to the east of the Great Dividing Range.

MR HINTON: Coffs Harbour?

MR SLEEMAN: You don't include Coffs Harbour. It includes Moree, Inverell and Walgett, and all those sorts of places. Tamworth is the single biggest regional centre in the study area.

MR HINTON: Let's come back to one of your other comments in your submission about 15 years; you take us to task that 15 years is too short. Would it be unfair to say that if I'd put 20 years in you'd say that was too short, too? That's a flippancy. Can you give some substance to the real point? Is there some reason that 20 years is more appropriate than 15 for regulatory-free periods?

MR SLEEMAN: Ultimately there is no right or wrong answer to that, and I wouldn't want to in any way suggest that the desirability of the regulation-free period was dependent upon 15 versus 20, or some other time period. Great concept, but the 15 or the 20 or any other number - what we would be really encouraging you to contemplate is what is a right number, and suggesting that maybe it is something a bit longer than 15 because to make a return just from the numbers we've done in relation to this region, it's hard to imagine anyone getting close to even making a return in a 15-year period. You're going to be probably making a decision that's going to require 25 to 30 or perhaps 40 years before you would say you've made your return.

So it's not 60 or 80 but it's in all probability more than 15. If you found a project where you could start to make good cash flows within a 15-year period, you'd have a very healthy project in a regional context from this sort of gas discrimination point of view.

MR HINTON: The last question I had was in relation to you picking up this topic of franchises. You suggested the Commission might explore this a bit further. I'm a little unclear where you want us to go here on this. Is it related to scope within the access regime to have public tender arrangements, giving sort of authorised monopoly practices with market guaranteed and selected through an open competitive tender? Is that what you're getting at?

MR SLEEMAN: It's an issue that can be a little hard to come to grips with. Every time I look at it I have to think about it long and hard to get my mind back around it. First off, by way of scene-setting, in the days when you had - with the exception of WA, where there was an integrated utility - electricity and gas companies competing with each other and having a franchise, the way that a gas company could grow was to seek new gas customers and to try and get people to convert from other fuels and electricity to gas. So the incumbent gas utilities in various markets had a desire to go out and chase gas markets.

In a marketplace where you no longer have franchises and you've got full retail contestability or customer choice, then there is considerably less incentive for a gas retailer to try and build gas market by actively pursuing conversion of customers to gas, because it's cheaper. They can sell electricity. Other people are going to be coming in and trying to take their gas customers from them in all probability, so it's easier to churn a customer than it is to get a new customer. There's a cost difference there. I can't quantify it but I'm sure there are those around that could.

So that's a sort of a bit of a scene-setting and if you then have a situation where you don't have ring fencing and you don't have franchises, then someone investing in new infrastructure is faced with the predicament of I guess, on the one hand, maybe not being masters of their own destiny, because they're dependent upon retailer or retailers and those retailer or retailers in this day and age, given the background, I don't believe have the incentive that they used to have to go out and pursue pure gas market growth, because they're probably selling a range of products in their own right.

How all these things pan out in a regional context where, as I said, if you have a regulation-free period - in other words, you're not covered and ring fencing doesn't apply - you may well suggest that that is akin to having a franchise anyway. But it doesn't quite get there. There might be circumstances where others could still come in and duplicate a bit of pipe in a street and take your key customer upon which the

whole of the economics of the investment were based - or one that was critical to it anyway.

So I still see a complementary role for franchises in getting new greenfield developments up and going. There are Tasmanian submissions in that regard, but also the recent experience in Western Australia where they've passed legislation that provides for the granting of franchises in that case after a tender period, after a tender process, but in either case for 10 years for distribution or retail. I think it's for 10 years. There seems to be experience and precedent elsewhere that's seeing a role for franchisors.

MR HINTON: Licensed monopolies.

MR SLEEMAN: Licensed monopolies, but give the incumbent a chance to build a market and, indeed, they're spending money, so they've got a matched incentive and an opportunity to build a market and actually make a return on their investment but, in so doing, expanding the benefits of natural gas to more Australians, I guess - regional communities.

MR HINTON: Presumably electricity is the prime alternative energy source in this region. Are there other substitutes that gas would be seeking to take over in the marketplace?

MR SLEEMAN: I think one of the key things that gas would be seeking to displace is LPG and/or distillate. There are not many big loads out there but when you find a town that's got an abattoir or a pet food manufacturer or some calcining, or whatever, they're typically using LPG and those are prime markets that natural gas would seek to penetrate.

Where you have complementary heat loads and electricity loads, then opportunities arise from this and more innovative cogeneration applications or the like in order to help build the gas load and make the economics of the project work. Outright competition between gas and electricity is probably not the main game because if you've got a heat load or whatever, you tend to be using another fuel for it anyway, not electricity.

DR FOLIE: Just on the franchising, as it was a study about the future rather than an existing, was there any feeling under the franchising that you may have the major franchisors, for want of a better word, who specialise in - they've got electricity and gas but they may well be responsible for electricity in their regional area. Is there a feeling from the people looking at gas developments that if they then - which they're entitled to - get the gas franchise as well, that they would never market it; they'd just continue to market the electricity because they have no interest in the downstream

infrastructure away from their - - -

MR SLEEMAN: That’s a very interesting issue that you’ve raised. It’s not one that we’ve addressed as part of our Regional Minerals Program study but I would accept and agree with you that there could be issues in there in relation to the competition between gas and electricity where an incumbent or major electricity supplier wants to also be the gas franchisee. It’s not an issue we’ve given thought to, so I don’t have answers or firm views on it.

MR HINTON: Is there anything we haven't focused on that you’d like to emphasise or pick up that you think we haven't done justice to? We're happy to hear from you.

MR SLEEMAN: In summary, I think it was one of the better government-type reports that I've had a chance to read. From a Regional Minerals Program study point of view, timing was opportune. We had some views and conclusions that had been found, albeit consensus views; not those of any individual participant. That's important, I guess, to point out. It's very opportune to be able to put those views to the Productivity Commission review.

MR HINTON: Thank you again for that submission and the documents that are going to be released shortly, and your participation today.

MR SLEEMAN: Thank you.

MR HINTON: It's important that our process has input from the likes of yourself. Thanks very much.

MR HINTON: Welcome back to this next session for the Sydney hearings of the Productivity Commission's inquiry into the Gas Access Regime. We have now in front of the microphones representatives of the ACCC: Mr Ed Willett, Commissioner; Mike Buckley and Warwick Anderson. Welcome. It's very important to have the input from the ACCC, given the crucial, significant, fundamental role that the Commission plays with regard to the Gas Access Regime. Your extensive experience and responsibilities are fundamentally germane to the inquiry's terms of reference, so thank you very much for your participation. I invite you to set proceedings under way by making an introductory statement.

MR WILLETT: Thank you, Chair. It's certainly a pleasure to be here. We recognise this is a very important review and we're keen to contribute in any way we can. I'm very happy to make some opening comments. We of course have provided you with a pretty weighty document, which I am sure you've read diligently.

MR HINTON: Every word.

MR WILLETT: It has a number of attachments to it, most of it in consultant work that we have put together. We thought it would be helpful to your processes to do that, and I'll refer to some of that as I go through. I'm not going to go through everything that's in that submission; it would take too much time. I'll just draw attention to a few issues that I think would be useful to focus on this afternoon, but by all means ask questions when I'm finished and we'll discuss any aspect of the submission or any other matter relevant to the review that we can.

One of the things that's reflected in that submission and, in particular the ACIL Tasman work, is that we see some strong parallels between the regulation of gas pipelines and the regulation of electricity infrastructure. We see those parallels as being important for a number of reasons: one, there are some trends to market convergence, although we do have, I think, still separate markets for gas and electricity, but gas is becoming an increasingly important source of electricity generation, and that needs to be recognised. There's also a desire by governments to converge the policy environment for the regulation of gas and electricity, and that's reflected in the move towards a national energy regulator and other initiatives under the auspices of the Ministerial Council on Energy, and of course the Parer review took the approach of looking at both industries at the same time.

Perhaps more importantly, however, particularly from our point of view, there are some common issues in gas and electricity regulation that I think need to be recognised, and I think the environment for the regulation of energy markets needs to be considered in the context of this review. Certainly there are suggestions being put in the context of electricity that draw upon some of your findings in the gas review which are significant and I think they should be borne in mind. I'll say a bit more

about that as I go.

Some of the lessons from electricity regulation are interesting and perhaps clearer than in the case of gas. It is very hard to say that inadequate returns through regulation of electricity transmission and distribution are having a chilling effect on efficient investment. In fact it's hard to say they're having a chilling effect on investment, any investment. We find in our regulatory roles in electricity that by and large what we are doing most of the time is assessing whether either prospectively or retrospectively investment in electricity transmission assets has been prudent or not. It's in effect judging the prudency of investment holding back the investment floodgates as we see them, rather than any concern about a chilling effect of investment.

In fact, over the initial regulatory periods for electricity transmission in Australia, over the last five years, investment in electricity transmission infrastructure has on average increased the value of electricity transmission infrastructure by about 50 per cent over five years, and that takes into account the five-year periods that are coming to a close now and the five-year periods that are in the process, and we've allowed for that sort of investment as prudent. Certainly the network owners would invest more if they were allowed to, and indications are to date that in fact investment is exceeding the allowances that were provided for.

So its very hard to say that there are inadequate returns there; that inadequate returns are chilling investment in electricity infrastructure. As a consequence I think it's just as hard to make the case that returns in the context of regulation under the Gas Code are inadequate to support investment. I think one of the key things that we bear in mind in looking at electricity infrastructure investment in particular is that investment is not a good in itself; it's a means to an end and its value stems from the value that it contributes to the performance of a network, and really what regulation should be trying to do is to promote efficient investment, not just any investment.

I wanted to focus my opening comments on some of your findings in particular that I think have played a pretty major role in where you've come to with the draft report. Those findings are, first, that the Gas Code does currently chill and distort investment and, secondly, and as a consequence, that the costs of the current regime exceed the benefits.

In relation to the first finding, what you've said is that it's difficult to assess the counterfactual in the investment environment because we don't know what investment would have occurred without the Gas Code in place, and that there have been other reforms, and the gas industry in particular suggests that it's the other reforms that are driving investment, not the Gas Code, and I understand that point. I might point out that it's quite common to conduct this sort of counterfactual

analysis in the context of the Trade Practices Act. That's what you need to do all the time when you're assessing whether something will reduce or lessen competition or whether some conduct is contrary to the act, so it's not an unusual thing to have to do to try to make that judgment about what the counterfactual might have been compared to what's actually happening or what is likely to happen.

Because you say that the counterfactual is important, then you fall back to relying on what you see as relevant literature to form a view that regulation, I assume, inappropriately chills investment, although you say chills investment. Two problems that we see in particular with that approach: we think, as reflected in our submission, that that is a rather narrow reading of the literature. We certainly agree that regulation may chill investment in certain circumstances, but we also would say - and with some support from the literature I think - that a lack of competition can chill investment in certain circumstances as well and, indeed, in some circumstances regulation can inappropriately promote investment or increase investment, and that's the classic problem of gold-plating. So we don't think you can just look at the literature and say, "Well, regulation necessarily chills investment, therefore we need to pare back regulation."

That leads me to the second point that I wanted to make about that finding. It's a question of what regulation. In the literature we refer to, it talks about regulation in a more generic sense, not the Gas Code in its application to Australia, and you really need to make that judgment, particularly since not all regulation does chill investment. You've got to come to a view that this particular form of regulation inefficiently chills investment, and I make the point that regulation that does no more than curtail the returns of pipelines with market power could not be said on any reading of the literature to inappropriately chill investment. That's a finding you have to make about this specific form of regulation before you can go to the step of saying there's an inappropriate chilling of investment here, even from a theoretical sense.

I might just add there one point that I think is missed in the draft report - that investment in some pipeline infrastructure, even if it's just focusing on that narrow issue - is and can be reliant on the regulation of other pipeline infrastructure. It's conceptually easy to see in looking at a proponent for a new transmission pipeline, who is not going to invest in that pipeline unless they're confident, that the access rules to the distribution system that they rely on to get the gas to market is actually going to work. In practical terms, in the time that I've been involved in the Gas Code, and that goes back to its design, there has been a lot of interest by both proponents of transmission pipelines and current pipeline, or then pipeline operators in, "Well, what's going to happen to the application of the Gas Code to the distribution system?" because that's really important to them, and I think there would be some horror if - - -

MR HINTON: And vice versa, perhaps.

MR WILLETT: And vice versa perhaps. Indeed, if you're looking at pipelines coming down from remote destinations, they're probably going to need to rely on existing pipeline infrastructure to get the gas that they're supplying to market in an economically viable fashion. So that sort of interdependence in regulation and investment I think could do with a bit of unpacking in your reporting.

You say that the evidence on pipeline investment is ambiguous, and I understand that view, but let me just point to a number of what I think are incontrovertible facts and then see where that leads us. There's no doubt I think that investment in pipelines has increased under the Gas Code. There's a question about the causal relationship, and everyone talks about that but, as a matter of fact, investment in pipelines has increased while the Gas Code has been in place, and we gave, I think, a fair bit of evidence on that in our first submission.

There is, in our view at least, no currently unmet demand in pipeline capacity. That's an important point because our view as reflected in the submission is that the biggest driver for pipeline investment is demand for transportation services, and that's the key issue, not the Gas Code. Where that demand for transportation services is present, then pipelines have been built, and that's been the recent experience in Australia, I think, and most pipelines, with a couple of exceptions, have spare capacity. So it seems to us that there's no case for saying that underinvestment in pipeline capacity is leading to constraints in transportation services.

A corollary of that perhaps is there appear to be no pipelines that haven't been built as a result of the Gas Code. We refer to the Parer review findings on that point and we adhere to that point. We still think there's been no evidence put by anyone that suggests that pipelines that there is a viable demand for that are not being built because of the Gas Code. Transport of gas overall is increasing. That's in part a reflection of the growing infrastructure but also reflects increasing consumption and increasing production. And something that wasn't referred to in our submission because there have been some recent developments: we're rather fortunate I think that two - I use the word "fortunate" cautiously - we can observe the impact of Epic and Duke selling some pipeline infrastructure and quitting the country in terms of providing gas transportation services. Some people have suggested they're doing that because of the Gas Code. In fact Duke in particular have said, "Well, we're consolidating back into the US because we have some concerns there." We've had that directly from the CEO of Duke Australia. I think there are similar issues with Epic although the experience they've had with the Dampier to Bunbury pipeline is a driver there as well. That's a very specific issue in relation to

that pipeline. It does not reflect application of the Gas Code generally.

We can talk about that issue more if you like but what those sales have meant is that we can observe how much interest there is investing in gas pipelines in Australia and I can also say that since Ross Jones left the commission I've taken his role in merger regulation in the commission so it provides me an opportunity to look at the level of interest in investment in gas pipelines owned by Epic and Duke and, while I'm not going to reveal confidential information, it seems to me, certainly in my experience and the experience of people I've spoken to, that the level of interest in buying those pipeline assets is unprecedented compared to other assets that have been available.

On our reckoning there have been 14 bidders or bidding groups interested in each of those pipelines. There has been some overlap between those groups because some have bid for both. We have seen I think seven bidding groups come to see us about each of the Epic and the Duke assets. We only see the people who think there might be section 50 issues. There would be other bidding groups who would know there would be no section 50 issues and they wouldn't come to see us. I could only describe the level of interest in those assets as very strong. Now, some would say, "Well, that doesn't tell you anything until you know prices we pay." Well, the Duke assets have now been sold and we know the price that the Alinta and Maquarie Bank consortium was prepared to pay, 1.7 billion, which is regarded in the market, I think it's fair to say, as at least top dollar if not over the odds. Certainly on my back-of-the-envelope reckoning it's at least top dollar in that it wouldn't cost you that much more to build all those assets from scratch I think.

So what we're seeing is a very - what could only be described as a very high level of interest in putting money into pipeline infrastructure in Australia. Now, some will say that some of that infrastructure is not covered under the Gas Code and that's true. The Duke assets included three pipelines, only one of which is currently covered under the Gas Code. Those same people will tend to tell you that there is a lot of uncertainty about the future coverage of those uncovered pipelines and that's inappropriate. I'm not seeing a lot of that uncertainty being reflected in the bidding process for those assets and it seems to me it's just untenable. Bearing in mind all the facts I've outlined, but particularly that scenario for the sale of those pipelines, it's just untenable to suggest, to my mind, that the Gas Code at the moment is having a chilling effect in pipeline investment. It's just very difficult to reconcile that conclusion with the facts that I've just outlined.

So I'll leave that at that and move on. You've reached the finding that the costs of regulation exceed the benefits. We say that's because, not only have you exaggerated the costs I've just outlined but you've also understated the benefits of the Gas Code. There's no economy-wide assessment of net costs and benefits included

in the draft report and I think it's fair to say that the terms of reference do suggest that that sort of analysis should be conducted and that all those costs and benefits, including impacts on investment both in pipelines and in dependent investment or investment in dependent markets, should be taken into account and I've always had the view and I think the PC has always had the view, it's in its mandate, that a dollar is a dollar in investment and there's no extra value in a particular dollar as an investment in the gas pipeline as there is in a dollar's investment in dependent markets or elsewhere. So I think that economy-wide assessment of costs and benefits needs to be conducted.

We think in particular there has been inadequate consideration of the impacts of the proposed winding back of the Gas Code, and I don't think there's any other way to describe it, on investment in upstream and downstream industries. Upstream - we need to think about what the role of the gas pipeline is. It's to get gas from a source of production to a market and there can be - just as in electricity - there can be a tension between the building of an interconnector and investment in an electricity generation unit at closer to market. There can be a tension between investment in gas production close to market and investment in a gas pipeline. Both can perform the same role and it's important that you have neutrality in the investment environment between those two forms of investment otherwise you are going to introduce distortions in itself and that suggests that, where there is scope for a pipeline to exercise monopoly power and charge prices above cost, then that in itself will distort different forms of investment.

Downstream of course there are substantial potential impacts on electricity generation from the exercise in monopoly power in gas transportation services and, as I said earlier, gas-fired electricity generation is becoming more and more important in the national electricity market. Fertiliser plants are very dependent on the gas as an input and I'm not sure whether you've heard from Alcoa or similar companies but they've certainly taken a strong interest as a user of gas. Mining activities can be heavily dependent on gas supply, et cetera. All of those industries are going to be impacted by relatively higher prices for delivered gas as a consequence of exercising monopoly power in gas transmission services.

Next I think there are some dynamic and second-round effects that need to be taken into account in terms of the impact of exercise in market power in gas transportation services. I won't say much about those. I think they're modelled very well by ACIL Tasman and the commission is more than familiar, I think, with second-round effects and dynamic effects flowing from the benefits of competition. It's also worth noting that those issues aside there are other costs associated with limitations on access as a consequence, not of higher prices, but of the leveraging of market power and the constraints that might be put on third party access to pipeline services by downstream interests who monopolise what would otherwise be

contestable markets.

So it's important to note that there's a focus on whether pipelines with market power can charge prices above costs - well, officially they can - there's a focus on the difference in relative prices as a consequence of regulation but it's also important to note, as Hilmer noted originally, that some of the important benefits come not from differences in prices but in the availability of alternate sources of competition downstream and the availability of access to promote competition downstream. Some of those distortions can be extremely difficult to detect.

As I said, we thought it's important to have some economy-wide-type work done on the costs and benefits and we've got the ACIL Tasman work provided to you on that. I think it's fair to say that that work demonstrates that access regulation in gas or electricity offers substantial potential benefits to the Australian economy and I think that finding, as we said in the submission, is consistent with the Productivity Commission's work on the benefits of the Hilmer reforms where I think you modelled reductions in gas transportation prices as the shock to generate some benefits downstream.

I'd just like to make some specific comments on some findings and recommendations in the draft report, first in terms of the proposed new two criteria A in the draft report. I'd like to note that there are some existing terms in the Trade Practices Act, terms like "substantial lessening of competition," "substantial power in a market," and of course in Part IIIA and the Gas Code the notion of promoting competition. All of those terms I think relate to the juxtaposition between workable and effective competition and monopoly or substantial market power and I use the American definition of monopoly which equates to a market where there is substantial market power.

That juxtaposition is important I think and what courts do when they make judgments about these terms is compare those two worlds, whether there's substantial market power or whether there's workable or effective competition. The words you're proposing are new to the Trade Practices Act. I don't think you can say that simply a material or a substantial increase in competition is the opposite of substantial lessening of competition.

MR HINTON: Say that again, please, Ed.

MR WILLETT: I don't think you can simply say that the words "material or substantial increase in competition" is simply the opposite of a substantial lessening of competition. I think that's an important consideration. My feeling in the draft report is that what you simply thought of those two things is the opposite and I'm not sure that that's necessarily true. The words will need some interpretation before you

can say categorically what that means.

MR HINTON: Thanks.

MR WILLETT: But more importantly I think what you're proposing to do is to draw lines or delineate different levels of competition in a way that hasn't been done before and I really do worry about the ability of courts or tribunals to draw the distinctions that you're proposing to make. It's extremely difficult to quantify prospective increases in competition. It's one thing to say, okay, are we going to have workable competition or are we going to have monopoly. You can make judgments about those things, courts do it all the time, but to say, well, are we going to have a small increase in competition or a large increase in competition is a much more difficult thing to do in my view and I really do wonder whether you are asking a lot in a judicial or quasi-judicial environment to make those sorts of distinctions.

We found in some work on again the electricity environment on judging the net benefits of proposed electricity interconnectors - we found it extremely difficult to try to measure the prospective benefits of competition as a consequence of that new interconnector and I just can't see how, drawing on my experience in running these sort of matters before courts and tribunals - I don't know how you would go about actually trying to draw those distinctions that you're asking to be drawn.

The other point I wanted to raise is the difference between the environment for competition which I think is the current interpretation of the word "promote" competition, In other words a promotion of competition goes to a change in the environment of competition as evidenced by reduced barriers to entry. That's the current interpretation of the promotion of competition test. Comparing that test with an increase in competition test, which on one view is just the same as promotion competition but another view would be seeking to look at evidence such as more competitors in the market, for example, or more competitive behaviour - some tangible evidence of the actual increase in competition.

To the extent that there is a difference between those two notions, I'd like to make the case that it's actually the environment for competition or the promotion of competition that is actually the right test and I'll use an example that came up at the utility regulators forum last Friday where there was reporting on the performance of the Rail Access Regime in Queensland and the question of whether the Rail Access Regime had failed because no-one had actually got access and the point was made by John Hall that, "Well, no, that's not the case.

What has happened is that the Rail Access Regime has made haulage services much more contestable, that the mining companies have conducted tenders for the

haulage of coal from their mines. As a consequence, Queensland rail has won all the business but also as a consequence the mining companies have saved several hundred million dollars in transportation costs." Now, that to me is a promotion of competition with very tangible benefits. A demonstrable increase in efficiency - - -

MR HINTON: Competition for the market not in the market.

MR WILLETT: Well, it is, but is that an increase in competition? To the extent that you mean a difference between an increase in competition and a promotion of competition, are you seeking to delineate that situation of Queensland Rail, where there have been clear benefits associated with the promotion of competition and a reduction in the barriers to entry making the market more contestable, but no actual increase in competitive behaviour because there’s only one haulage company?

DR FOLIE: Basically there we are uninformed about the detail. Shift to the property rights, where you had to deal with Queensland Rail come hell or high water when you had to get there.

MR WILLETT: Yes.

DR FOLIE: But in the new regime you actually shifted the rights of people to be able to go and bid and do alternatives. They didn't have to set prices under that and you've got quite a significant shift in outcome.

MR WILLETT: That's right.

DR FOLIE: It is promoting competition but you don't need to do price regulations. It actually changes, if you like, the rights of different groups.

MR WILLETT: I'd argue that you need the fall back of price regulation.

DR FOLIE: Yes.

MR WILLETT: The other tenderers - I won't go through who they are - needed to be confident that they could access on fair terms.

DR FOLIE: Yes, I agree.

MR WILLETT: And that ultimately might mean going to arbitration, and if they weren't confident of that they wouldn't have bid.

MR HINTON: Sorry, I've interrupted you.

MR WILLETT: That's okay. I know I'm going on a bit. Can I say something about the new efficiency test that you are proposing and suggest that at present criteria A and B together cover most efficiency issues. Basically there is a presumption in the current coverage criteria that regulation of a natural monopoly with market power promoting competition in dependent markets will lead to, or tend to lead to efficiency. There is a presumption there that's built-in but, if there are special efficiency considerations, then it's possible to overturn that presumption through the application of criteria D. We could argue at length whether the criterion D is focussed broadly on efficiency or public interest considerations but it certainly includes and has been interpreted to include efficiency considerations, so that that opportunity to take those into account - I think that current test is the appropriate balance.

There is a bit of a concern in my mind about whether the proposed changes to the coverage criteria and the application of regulation of the Gas Code set up some inappropriate inconsistencies with Part IIIA and the declaration process, and whether you're setting up incentives to actually go for declaration rather than coverage in the Gas Code, which I think would be unfortunate. Why is it when there's a justification for an industry-specific Gas Code and you've found that, do you actually want to have high criteria and less availability of arbitration than is currently available on the general declaration test and will still be available when the government responds to the Part IIIA inquiry?

I think in the draft you put there is some misunderstanding of the way the regulatory regime works. I would say it's not a cost of service regime, as is suggested in the draft report. Basically, what the regime does is to attempt to model or benchmark forward-looking, efficient costs of running a pipeline. That process is then used to determine an appropriate revenue requirement for that pipeline. The revenue requirement is divided by expected utilisation as is generally suggested by the pipeline owner over the regulatory period; that dividing one by the other you come up with a reference tariff.

While that reference tariff is binding in any arbitration process and is likely - although not certain - to cap prices for third party access of that pipeline, the pipeline owner is free to do better than the benchmarked efficient costs if they can increase utilisation or reduce costs or whatever and they retain the benefits of doing better than the benchmark over the access arrangement period, which is usually five years. I think that's consistent with the notion of workable competition where, while there are opportunities to exercise some market power and earn returns higher than costs for a period until competition starts to bite, that's the notion of workable competition. Similarly the regulation approach I've just outlined seeks to provide incentives for people to do better than the benchmark, to keep the returns for doing better and then bring them back to costs at the time of the regulatory reset.

I'm not sure whether this is reflected in the draft report, but certainly in some submissions there is some misunderstanding of the optimisation process as well, in the DORC approach. Optimisation is conducted over the life of the pipeline based on the pipeliner predictions of utilisation over the life of that pipeline. Each pipeline is not optimised for each regulatory period because that would be a bit nonsensical, given that you can only build one pipeline and it's got to be a certain size. We recognise that. We say to be efficient that pipeline should be providing the services and only the services that are needed over its life, and if it's much too big there might be some room for optimisation but otherwise that's not going to be an issue. It's an issue that rarely bites very hard, I must say, in terms of the regulatory process.

Finally, if I can just pick up on your findings in draft finding 2.1, on the current constraints that are available, or the current constraints and the exercise of market power by pipelines. You have identified three of them. I take issue in all three. I think in terms of the availability of substitutes you fall into the cellophane fallacy, a substitution trap, which is looking at substitution at a monopoly price, not substitution at the competitive price. Of course, if you've got a profit-maximising monopolist exercising market power they will set prices at the profit-maximising price and at that price it will look like there are viable alternatives available. That's the cellophane fallacy for substitution. That term derives from the US Supreme Court getting it wrong in the Dupont case.

I will suggest some reading on all of this rather than go through it in detail right now. The second constraint you refer to is the size and concentration of users. I question whether that's currently a function of the difficulties facing third party users to date and currently, and whether there is scope with effective regulation of monopoly power by pipeliners. There is scope for smaller users of gas who access pipeline services to enter dependent markets. Certainly that sort of notion is seen built into the government's response to the Part IIIA review, that we should facilitate smaller players in dependent markets by access regulation where appropriate.

The third point you made that elasticity of demand downstream might be a constraint on the services of pipeliners - that's a difficult issue. Differences in the elasticity of demand between pipelines and dependent markets can actually increase leverage opportunities. So looking at elasticity of demand downstream is not definitive. On the first and third of those issues can I refer you to some work that was included in the NCC's recommendation on the Moomba-Sydney pipeline. It's under a section rather ambitiously entitled The Economics of Vertical Leveraging. It starts at page 225 of that recommendation. It touches on the cellophane fallacy problem and indeed, the relationship between elasticity of demand downstream compared to pipelines. It draws on, I think, some relevant literature.

I won't say it's a good piece of work. Modesty forbids me because I was involved in the drafting of that work, but I think it covers the issues that you might need to think about against those issues. Can I just conclude by saying on that point that it also raises a circulatory problem, in that all three of those constraints on the market power of pipelines are taken into account in coverage decisions of pipelines. To say, well, there are these constraints on market power, therefore - and I think you go from there to suggest that regulation might currently be inappropriate - I think in that stepping stone process you need to take into account that if those sort of constraints are present then a pipeline is unlikely to be covered under the Gas Code. If that's intended, I apologise but it's not clear that that's recognised in the draft report. I might conclude on that point.

MR HINTON: Thank you very much for those very detailed comments and articulated very precisely and succinctly. I think they are very valuable. In fact, you've anticipated a lot if not all of my questions, in terms of the intersection of your submissions and our draft report, but that's not surprising given your background and the role of the ACCC. I found each of those areas - investment, cost benefits, levels of competition, environment for competition - all those issues are very germane to our draft report and we welcome your perceptions and judgments about those, so thank you. I'm not proposing to revisit all of them in terms of question-answer discussion, given that you've outlined them in succinct form in your presentation, and backed up by your very substantive written submission.

But let me take your last point first, while it's in my head. We were not having a formulation about the constraints on market power in the way you've constructed it. We were rather saying that natural monopoly characteristics exist in this sector. However, that ipso facto doesn't lead you to the view that market power exists because in the real world out there, there are constraints on market power that therefore can, in certain circumstances, modify, erode, even counter natural monopoly characteristics. It follows from that that the access regime needs to make judgments about case by case where market power might or might not exist. Hence you need coverage decisions.

It was not in any way making judgments about the application of those coverage criteria. It was setting up a line of analysis that showed you that prima facie there is market power through natural monopoly characteristics, but that doesn't necessarily mean that that's the right to or rationale to intervene. In fact, if anything it was countering the point that there is judgment here - or making the point there are judgments here - in setting up the appropriate form of intervention; but that's jumping to your last point.

MR WILLETT: And that is the burden of criteria in A, isn't it? If there's market power, then there's likely to be - on the Ordover analysis, at least - the ability and

incentive to distort competition in the dependent markets. So the ineffective competition is an indicator of lack of constraints.

MR HINTON: To some degree. To varying degrees, though the other criteria are also very important and valid considerations.

MR WILLETT: Mm'hm.

MR HINTON: Now, we also want to acknowledge and thank you for that supporting material from external parties. Thank you for that. There is some challenging reading there as well, plus your further references that you modestly put on the table.

MR WILLETT: It's not very long.

MR HINTON: I want to explore an area that in part is driven by the Epic decision, though it's not just the Epic decision. It touches on issues of perfect competition versus workable competition versus, well, effective competition; but before we get into your understanding and how the ACCC treats those terms - because there have been significant allegations, if not statements rather than allegations, about how you go about these things with regard to perfect competition in particular - I want to come back a step and raise with you the more systemic issue of as administrator of an access regime you then have a moving environment of judicial and quasi-judicial process that leads to decisions, that therefore can have potential impact by precedent and other.

MR WILLETT: Mm.

MR HINTON: It has been put to us that it's crucial that our final report take account of a number of decisions, including the Epic one. It has been put to us that the code needs to be changed, the Gas Access Regime needs to be changed to reflect those events, so my systemic question becomes: which is your best approach regarding taking account of the moving set of events? Should the Gas Access Regime be changed? Are those results, those events, incorporated into the day-to-day activities of the ACCC in administering the existing regime? Or is there something in between; is there a mix?

MR WILLETT: Okay. I think I can say some things about that. I must say that since I started with the NCC some eight years ago, one of the things that has really struck me is the discipline that is created on large parts of your work by the fact that you know that that work is reviewable by a judicial or quasi-judicial body and you know that when you make findings and you make recommendations that you really need to be able to be in a position to prove those, if a review is called for. In both my

life at the NCC and my current life I can tell you that everyone involved in these sorts of matters is very cognisant of the fact that we are likely to have to be able to establish what we're saying to the satisfaction of usually the Australian Competition Tribunal. And that makes you very careful about how you go about things and it makes you feel the discipline of really being very rigorous in the conclusions you draw and the evidence you - - -

MR HINTON: A bit like public hearings.

MR WILLETT: Indeed they are a bit like public hearings. I don't argue against those sorts of forum because I think they are very important to the process. I think it's the process here that we need to focus on, not individual words in the Gas Code or what does the ACCC say about this, but what sort of results do we get out of the whole process in the end. I have got to say I think it has, particularly the tribunal process, been working very well. We would suggest some changes to review of access arrangements. There are arguments for a full merits review, rather than the partial constraint process that is there at the moment. I am relaxed about that, I must say.

I think it's important that reviews of access arrangements continue to be constrained to being reviews on the papers. Otherwise the reviews just explode and there's an incentive for the infrastructure owners to hold material until they get to the tribunal and then lay it all out. Having the available new evidence before the tribunal, I think, can make those processes more lengthy and resource intensive. There are arguments within this organisation that actually it would be in our interest to allow new evidence, because we think we would do better out of that. It's not a clear issue at all, but I tend to favour leaving it as it is.

What we also suggest is that there is an opportunity at the moment in those tribunal reviews to cherry-pick particular issues that the infrastructure owner thinks they can do better on and leave those issues alone that they're quite happy with. Whereas we have tried to say to the tribunal, "Okay, you might think that the ACCC has been a little bit hard on this particular component, the building block approach, but overall we think you should look at the outcome and say there are adequate returns, more than adequate returns built into this access arrangement, so no change is needed."

The tribunal has resisted that approach so I think there is a case for saying that it should be more open to either the commission or to third parties to contest other parts of the access arrangement, to suggest that the infrastructure owner is doing all right and reduce the incentive that's there at the moment, I think, for pipeliners to take relatively minor issues to the tribunal because they think they can get those changed and sit relaxed with the other components because they know they won't get those changed or they're probably more than the tribunal might consider was appropriate.

The discipline that the tribunal might come to a less advantageous approach to the pipeliner than the commission is an important discipline. I have referred to this earlier and I think - at the last hearing - that when there has been a prospect of the tribunal coming to a result that's less advantageous to them, the pipeline owner then - what they have simply done is withdraw that issue from consideration. But we think, overall, that process has worked pretty well. It has been a very timely process. I think the process where you get more certainty about these components over time is a good one. I think it's very hard to set up exactly the right approach, prescriptively, in the Gas Code. The Gas Code, I think, should be not a totally prescriptive set of documents, but a reflection of the rights of pipeliners and the rights of access seekers and processes to ensure that the rights of both parties are satisfied.

MR HINTON: Let me give you a hypothetical. Let's say the WA court - and this is perceived by some to be the case - rules that the ACCC has been in error to apply their building block approach to the pursuit of perfect competition and what they should have been really doing is pursuing workable competition. It then follows, having got this decision, some parties would say the Gas Access Regime should be amended explicitly to record that that's what the ACCC should be doing. The other extreme is to say in it's day-to-day operations the ACCC will take account of that decision, knowing that if it didn't, it would be subject to potential litigation based upon the precedent of the WA court. I want to get into a discussion about workable competition later. That's a hypothetical example of trying to explore with you how the ACCC might perceive the best way to implement quasi judicial process that, in fact, impacts on commercial outcomes.

MR WILLETT: Yes. I agree with the approach which says that the ACCC should be cognisant of those sorts of decisions, because we always are. It's always open for a party who disagrees with that to seek further declaration by the court. It's not a process that the ACCC likes to be on the wrong end of, being told by a court that it got it wrong. To some extent it's inevitable, but having been told once we're not going to risk having to be told again, and we'll abide by that decision or appeal it or challenge it in some other way.

MR HINTON: Yes. In the absence of challenging it, it feeds into your processes.

MR WILLETT: That's right. What I'm wary of is that people can get a decision, like the Epic decision, and they can suggest that it means X or Y and suggest that, "Well, as a consequence of that the code needs to be changed," and their interpretation is not necessarily an interpretation that's shared by all others. I was somewhat amused to note that upon the Epic decision being handed down, all parties declared victory, so it can be a subjective process. I think there have been some

exaggerations about what the Epic decision said and meant. We've done some work on that. We think what has been said by the court is entirely consistent with the approach that we've taken, entirely consistent with the notions of workable competition that we apply.

I think what can happen here is a bit of confusion of terms. Perhaps this is where you want to get into some discussion later on, but there is a difference between notions of workable competition and prices oscillating around efficient costs over time as markets ebb and flow. There's a difference between that proposition which is undeniable, in our view, and the proposition that says, "Well, there needs to be an extra margin or an extra allowance in the regulatory process to accommodate or inject a fudge factor over and above whatever allowance is provided now." That's where I think we get into a bit more difficulty.

MR HINTON: Some in these hearings have made very strong statements that the Epic decision clearly indicates that the ACCC's approach does represent the pursuit of perfect competition and that they are in error in that pursuit and that, in fact, they should be pursuing workable competition. That's come from more than one party and I'd welcome your on-transcript rebuff, just to at least hear that you are responding to it, because it is out there in interested-party land, as they say.

MR WILLETT: Sure. I think it's actually covered pretty well in Darryl Biggar's work that we've provided, but let me touch on it.

MR HINTON: That's Darryl's. That's the point.

MR WILLETT: Righto. I think it's important to note that the Epic decision was actually focused on a pretty narrow issue. It was focused on relevant considerations under one part of the clause 8 objectives: what are the legitimate interests of pipeline owners? There is a bit of a danger, as there is in any court decision, in drawing too many lessons from one decision, out of context about what the decision was about. But the court does say some things about the difference between workable competition and perfect competition.

Let me start by outlining what I understand by perfect competition and then go from there, because I think probably we need to go back to that. Perfect competition is where you have unlimited buyers and sellers of a product. You have a flat supply curve. You have perfect information. You have suppliers being price takers and no opportunity to charge prices different from the price reflected in the flat supply curve. It's a theoretical construct that's probably not replicated anywhere in any economy, but it's a useful theoretical construct.

More useful is the notion of monopolistic competition where you actually

inject some slope into the supply curve and you recognise that from time to time different participants might have some discretion over price. The notion of perfect competition is, on my view, totally irrelevant to the polar extreme of dealing with a natural monopoly, where you have a decreasing cost curve and a concept of a problem of applying the generally efficient outcome of pricing at marginal costs to be not viable for the infrastructure owner because they don't recover capital costs. Nonetheless, it serves to provide the theoretical optimal output point, where marginal revenue intersects with the marginal cost curve.

That's not the approach we take either and it's got nothing to do with those sorts of theoretical constructs. Marginal revenue equal to marginal cost have nothing to do with what we do. What we do is more akin to an average cost approach, recognising that infrastructure owners should have the opportunity and incentive to do better than average costs during a regulatory period in order to pursue efficiency and increase the utilisation of pipeline. So, as I was saying earlier, what we do is benchmark the efficient total costs of the pipeline.

We identify a revenue requirement - they're total economic costs, of course - we divide that by a projection by the infrastructure owner, generally, of their utilisation of that pipeline over a five-year period, and come up with a reference tariff. That's a benchmark price. It's not binding. It doesn't necessarily apply to all services and from there the infrastructure owner can do what they like to maximise returns. They can, over that five-year period, and we hope they would, earn some monopoly returns by reducing costs below the benchmark or by increasing utilisation of the pipeline above the projection.

At the reset period which is usually five years but can be longer, as I said, we then have another look. We try, through that regulatory process, to replicate the competitive environment which says, "Sooner or later in a contestable market, any producer with substantial market power is going to be brought back to earth by a new entry and new competitors, forcing prices back to efficient costs," which we tried to replicate - recognising that it was a natural monopoly. There is no automatic market mechanism that does that. That's what the regulatory process does and that's why these pipelines are regulated - because there isn't that natural market process.

We think that's a reflection of what we understand to be notions of workable competition, where there is the ability to exercise some market power, but that market power, from time to time, is conditioned by some process that revisits what the efficient costs of production are and tries to push the pipeliner with market power back towards prices reflecting efficient costs, recognising again that they'll have another opportunity to earn rents over the new regulatory period.

I must say, having said all that, I get a little bit confused about the proposition.

I think I described it as nonsense last time, but I obviously didn't pay it enough attention. I get a bit confused about notions that what we do is apply a world of perfect competition, because from my understanding of economics, the notion of perfect competition is a theory and construct that has no relevance whatsoever to what we do and is never taken into account in what we do.

MR HINTON: In some ways the debate about perfect competition versus workable competition and the terminology associated with that is a red herring.

MR WILLETT: Yes.

MR HINTON: It's all about the end result, which is what the reference tariff might be, particularly in reset periods.

MR WILLETT: Yes.

MR HINTON: As a diversion - not so much a diversion as another detail; perhaps too detailed - but in this discussion with other interested parties it invariably takes us down the track of - in circumstances of the return, the price, the tariff, being too low, as determined by the regulator; it's now having serious implications in some circumstances as to the engineering capacity and the actual safety operations of the infrastructure themselves in circumstances where the resets lead to further erosion of that particular return on capital against your description of replicating the effect of competition moving in to take away some of those profits.

MR WILLETT: Yes.

MR HINTON: And it has been put to us that this is now in some cases a serious situation.

MR WILLETT: Yes. I understand the arguments. I must say I see those arguments much more commonly in relation to electricity infrastructure than gas pipeline infrastructure.

MR HINTON: That was put to us yesterday in very direct terms, yes.

MR WILLETT: Yes. The notion is put but, I must say, looking at the evidence, it's just very hard to support. Let me say two things: first of all, I referred in my earlier comments to the fact that people seem to be falling over themselves to invest in electricity transmission and distribution assets and the investment has been very high, and that does not say that allowable returns are too low; in fact, it says allowable returns are probably more than adequate. It is difficult to imagine people wanting to invest more than they do currently and our job generally is to try and

constrain that investment to prudent investment, and we get criticised for not allowing investment that is needed to ensure that the grid works as well as it can.

We just don't see that those accusations can be sustained in any way, and we look at these things in a very detailed way. So I'm a little bit cynical of the arguments that are put in relation to gas. I've referred also to evidence that I think there is a lot of investment - or people wanting to invest - in gas infrastructure; again would not tend to support the proposition that allowable returns for covered pipelines are too low or that the risk of coverage is deterring efficient investment.

Finally, in terms of the questions about maintenance costs not being allowed for sufficiently to provide for adequate maintenance or that investment in the pipeline is not being made to ensure that it operates safely, again in terms of the processes that we have conducted, it's very difficult to see that. Most of the debate is actually about what an existing pipeline is worth. What is the value of that asset in the ground? That's what really counts to people.

MR HINTON: I was going to raise the WACC with you.

MR WILLETT: Indeed. You start with the ICB and then the return on that value.

DR FOLIE: The operating cost is quite small in the total equation. It can always be swept aside.

MR WILLETT: Yes, indeed.

DR FOLIE: The challenge is that if it is then sort of shaved on maintenance and different things, it can have catastrophic effects on the investment - whether that's true or not - but effectively it is actually an important element. It was put to us that - as we're told - you do the studies, you do the work but, in essence, other people have contended that you don't actually have the true expertise and knowledge to really be able to then say what is best practice of, you know, maintenance practice in the United States or the UK or here, and how is it actually applied or is it not?

It's getting very very detailed intervention into the day-to-day operations of a technical asset. Then the second allegation made is, if the costs are set at a certain level, then the easiest way for short-sighted management - it's also blaming the pipeline companies - they then will defer delay; in other words, instead of an 18-month maintenance schedule you drop it to something like 24 months - a few things - because that's allowed under the reg cap. It's these detailed forensic, technical operating things that almost you've got to get involved in to make the judgments about prudence rather than actually leave it to the companies.

MR WILLETT: Yes, I understand that point and we do rely on a lot of consultant work in these sorts of judgments. If anything, any advantages the pipeline owner might have over the commission in terms of technical understanding tends to work in favour of the pipeliner. We tend to accept their estimates of those sorts of things. We're recognising that they might be a little higher than they need to be but, in the end, in the full context of the access arrangement, those things don't matter very much in terms of the total costs and the risks of us second-guessing the infrastructure owner on an O and M issue and getting it wrong can be quite serious. So we tend to be very cautious in relation to those sorts of things.

DR FOLIE: The other one is about - I don't want to get into electricity - but, if you like, gold-plating investments, et cetera. Different companies do different things. Some companies genuinely forget about this industry - will tend to build a slightly more gold-plated - this is in a competitive environment; nothing to do with getting an angle from the regulator - because they deem that's the sort of way they want to design it to cater for their particular sort of future. Then there is also the idea of - it flows through on prudent investments and a little bit about what you were saying about electricity - we don't go into that. But, in essence, why do you feel that it's your duty - other than the part of the regulatory process about setting, if you like, the capital return - to be bothered about whether it is gold-plated or, if you like, shaving the edge on the investment? If we could forget about it's impacting on a capital base a little bit for setting a rate of return, then why should you be as involved in worrying about whether it is a gold-plated investment or possibly sort of shaving it right down to the bare bones?

MR WILLETT: Because there is a gulf between those two things, an enormous gulf.

DR FOLIE: Yes.

MR WILLETT: In electricity, unconstrained, we'd probably see investment of 30 per cent of the infrastructure value on an annual basis and, before too long, you have infrastructure that costs a great deal of money. The return is automatically infrastructure (indistinct) and consumers aren't getting value out of that. So there is a big issue in terms of the accumulated effect of very high levels of investment, much beyond the needs of the electricity infrastructure. There is a big potential problem there.

DR FOLIE: Certainly that was very prevalent in the previous government owned area, but I'm not too sure whether you continue to see that rolled on in the new, if you like, completely privately-funded power stations.

MR WILLETT: Power stations?

DR FOLIE: Whatever. If you are talking about electricity, you're saying - - -

MR WILLETT: I'm talking about transmission primarily.

DR FOLIE: Transmission?

MR WILLETT: Yes.

DR FOLIE: Transmission only.

MR WILLETT: I haven't done the numbers, but I think you would find that investment in transmission infrastructure is currently higher than it was under the public monopoly days, and there's a question in our minds about the extent to which more investment is needed. We're allowing what we think are very high levels of investment. As I said, the asset value of transmission infrastructure on average throughout the NEM has increased 50 per cent over a five-year period and people want to invest more than that, much more. The risk is that 15 years down the track you've got infrastructure that is worth five, six times what it is now, and people have got to pay for the cost of that. If it's not there to meet demands, why are we doing it and what are the efficiency costs of allowing that to happen?

DR FOLIE: The final one is actually about reliability because we have seen in the gas industry what happens when it hasn't been any pipelines, but when the customer doesn't get it - and we've had quite a number of examples in Australia - there are issues, and we've had representations about actually that reliability-type investment in pipelines is very strongly discounted and disallowed by regulators.

MR WILLETT: I can't even think of an example of that.

MR BUCKLEY: You'd have to think of the example. You talked about operating costs. Generally they're accepted. We largely have to take the word of the operator. They're the ones who know the pipeline, and most of the discussion is really about the value of the optimised replacement cost, because that's a theoretical cost. The forecasted O and M costs - well, that's what the business thinks their costs are going to be, and their forecast costs will be observable in five years' time anyway, so we will know whether or not they were achieved or not.

DR FOLIE: Let's get back to the big numbers.

MR HINTON: Bearing in mind the time, I have got a number of questions left, but it will be a sort of miscellaneous grab-bag sort of thing - no thematic approach - and so I will be a bit sporadic, but take the WACC first. It's probably an unfair question,

but this morning Network Economics Consulting put to us that this is an area that's fundamental to CAPM methodology that's being used in a whole range of regulatory interventions, and a key issue of CAPM is this issue of how to reach the right WACC and questions of whether or not it is being reached correctly. They therefore push for a review of how this might best be done. They're not seeking this particular inquiry to reach a substantive conclusion on that matter but I think, if I read between the lines, they would be pushing for us to express a view on their proposal that a review be held. That of course does relate to an ongoing debate that has occurred involving the ACCC on the ACCC's approach regarding the WACC. Do you have any reaction to this idea?

MR WILLETT: At some point I would like to be able to say that we don't have a review coming up about gas or electricity regulation so that we can have a period where things can settle down and we try to move to a position of more certainty in all of these arrangements. Certainly that seems to be what the industry wants. I said some things about the processes that are set up to get the right sort of response over time. I still think they are appropriate, and I think the important task for this review is to ensure that those processes are working and will work effectively, because I am confident that they will get the right result.

These sorts of questions are very difficult to set up a review for. They take a lot of expertise and there is a question about whether you can find the people who have greater expertise and the people who are currently dealing with these sorts of things and making submissions into it to make a valuable contribution. It's a very difficult task. We have provided you with a pretty comprehensive submission from Allen Consulting on WACC questions and the NECG work and the approach in Australia. I must say a couple of comments. I think, as Henry Ergas would concede, it can be very difficult to unpick particular components of the building block model and focus on that and say, "Well, this needs to be tweaked this way or that way."

That's consistent with what we say about a bit of a problem with the tribunal review of access regimes - that you are focusing in on one component without looking at the big picture. The other general point I make about the NECG work is that it is rather pessimistic on the Australian investment environment, I must say, because it seems to me what it's saying is that Australia is a very bad place to invest because you need this extra return to offset the risk - - -

MR HINTON: The risk premium inherent in their comparisons. Is that what you're saying?

MR WILLETT: Yes, indeed, and I would want to ask, why is that so? We're all not doing our jobs in terms of microeconomic reform if that's the case and the reforms that have been put in place to date perhaps haven't worked as well as they

should have if Australia is that bad a place to invest. I would have thought the recent evidence is that, particularly when you look at the productivity measures and performance of equity markets et cetera, Australia is looking a pretty stable place and a pretty positive place to invest. Their judgment is not backed by a lot of detailed work, but it does raise a question in my mind about why is it that Australia is such a bad place to invest? Do you want to contribute any more to that?

MR BUCKLEY: The Allen report is comprehensive. I don't think we need to.

MR HINTON: A related issue is that some service providers argue that the CAPM doesn't allow for dynamic efficiency to be picked up. You alluded to this in your introductory statements but is there a better model, a better methodology?

MR WILLETT: It allows for dynamic efficiency in that an infrastructure owner is free to pursue whatever dynamic efficiencies they can see and to benefit from it. The modelling is just that: modelling. It sets a benchmark, and if the benchmark doesn't capture all of the efficiencies, then that is a bit of a bonus for the infrastructure owner because their costs have been benchmarked at too high a level and there's an opportunity for them to do better than that, which is exactly how it's supposed to work.

MR BUCKLEY: Industry acceptance of CAPM is discussed again in that Allen report; the use of the model by the industry itself undertaking their investment planning. It seems to be the model of choice.

MR HINTON: What about the total factor productivity approach? Does this lend itself to the gas sector?

MR WILLETT: Yes, we've been doing a bit of work, and it's really only been toe in the water work, in the context of electricity on moving to higher powered incentives. The approach in electricity and gas at the moment is to model the costs of a particular service provider. What if we tried to model benchmark costs for the industry as a whole and tried to set up some competitive dynamics in regulation between different infrastructure owners, and indeed that set of approach does set up much more high-powered incentives, but it is difficult because - - -

MR HINTON: And information intrusive, I assume?

MR WILLETT: Well, it is information - different sort of information, but in the end you've got to take into account the peculiarities of particular pieces of infrastructure, and the fear is, of course, that you set these benchmarks up and people don't think they can perform to them, or are not performing to them, and they want to get back to a cost-for-service model or benchmarking their own particular

infrastructure. But I must say there's been a lot of interest in moving in this direction from the industry. I think we have made some progress. It's a difficult area but I think it's worth pursuing and we'll continue to pursue it. It's just that it's going to take - - -

MR HINTON: As a complement, not as a substitute.

MR WILLETT: It could, in the end, end up taking over. Basically what we're doing is applying broadly a CPI minus X approach, identifying different ways of calculating the X. At the utility regulators forum we had a presentation on a particular approach to calculating X in the WA rail regime which tended to rely on TFP in the economy as a whole, against a sort of benchmark productivity measure in the long term for rail infrastructure, and a very interesting potential approach. These sorts of approaches that rely less and less on information provided by a particular service provider and information that's available from the economy as a whole are certainly worth pursuing.

MR HINTON: The ACT - the tribunal's decision regarding the Pelican Point expansion, and of course I'm not getting into the particularities of the case in terms of decision-making, but this is related to one of our recommendations that touch on whether or not expansion of existing pipelines should be automatically covered if that pipeline itself is covered under the Gas Access Regime. Some have put to us that that particular ACT decision represents a judgment that the ACCC was in error in incorporating that expansion in terms of coverage and therefore that should be challenging our recommendation. There's a question of extension and expansion here, I suspect.

MR WILLETT: Yes.

MR HINTON: And there may be a misunderstanding of terminology but that's why I put it on the table for you.

MR WILLETT: Yes, indeed, and there are issues associated with both. Let me talk about extensions. We don't think, and I think it's consistent with your findings and recommendations, that the regulatory process should be in the business of determining coverage of particular pipelines, and that should be the role of the coverage process, and that's the issue that arose there. It was a coverage issue basically. We'd prefer not to be making judgments about that. Leave it to the NCC. So I think that issue can be hived off.

In terms of expansions, we did have a view that where a pipeline is approaching constraints - in other words, its utilisation is approaching capacity - then an access arrangement should include an expansions policy, so that there is some

certainty about how excess capacity is going to be accommodated. But there can be different issues, and these have arisen in relation to the Dampier-Bunbury pipeline as I understand - it's not our job but it's the Western Australian regulator - in terms of expanding that pipeline, and of course the expansion of that pipeline has reached a point where you're not necessarily talking about expanding it at reducing costs. You've got to that tricky point in the pipeline where you've got to start looping, and that sort of expansion can be costly. Do you want to do anything particularly about expansions?

MR BUCKLEY: I think the MAPS case had its own peculiarities. The tribunal has made its determination in respect of the application of market power, and we'll certainly be guided by what the tribunal said in that instance. The issue before the commission at that time was the effect of a reduction in regulated capacity. The commission was also mindful of the effect that changes in volumes would have on tariffs for users in future years when regulated volumes fell, and the asset base of the regulated pipeline remained the same, and that had an implication for the tariffs which would be charged to other users, but again we've seen what's been said there and I think you have to judge each expansion and extension on its merits.

MR HINTON: One last question, bearing in mind the time, although Michael also will follow up. Apologies, Michael. One of the draft recommendations touched on information provision, information collection, and we put forward the view that there were divergences across jurisdictional requirements reflecting the nature of federation and state systems being implemented through a national approach to the Gas Access Regime. We put forward the view that there would be benefits in having some sort of harmonisation of informational gathering requirements across jurisdictions. A number of parties have baulked at this and said, "Well, what are the benefits?" and I note that the ACCC has expressed the view that you quite like flexibility across jurisdictions. Have I misrepresented you? Have you got a view on this?

MR BUCKLEY: Is this in relation to accounting guidelines?

MR HINTON: Sorry?

MR BUCKLEY: Is this in relation to the accounting guidelines?

MR HINTON: No, I don't think so. It's partly to do with the powers, what powers different jurisdictions have, but it's not a major issue. We'll explore this further with you.

MR WILLETT: Perhaps we'll take that question on notice and get back to you on it. I think it worth noting that perhaps a move towards the AER might have some

implications there as well.

MR HINTON: Yes. Michael?

DR FOLIE: The ACCC in its wider role is really charged with looking at all sorts of competitive behaviour and all sorts of different markets. We've proposed and you've had the comment about the problems about where to put the middle range. If we were to set that aside and not - would you like to make some comments about the effectiveness of a monitoring regime? We believe that it is possible to have a light-handed monitoring regime. I'd just like to hear some of your views about that per se; not how you actually might decide whether to put - - -

MR WILLETT: Yes. The first question to my mind is, what are you monitoring?

DR FOLIE: It is actually to just be clear on the previous one. It's not just price; it's full access. Performance must be done. A performance oriented access must be granted.

MR WILLETT: Yes.

DR FOLIE: There must be measures in place to ensure that access has been denied, it's up there, and then there is an ultimate threat that goes with it, too, so it's not just chug along and nothing happens. There is actually the big bad basket you can be dropped into in the end.

MR WILLETT: Yes, indeed. What you seem to be talking about is something that was contemplated at the time of the design of the Gas Code, which is to develop reference tariffs that are not binding, that are simply indicators, and short of going through that full process, then there is a question in my mind about how you make judgments about the prices being charged and whether they're appropriate. Even trends in prices over time can be ambiguous, and we're finding this in our work on airports at the moment; that we can observe large increases in prices and revaluation of assets by airport owners, and it tends to be ambiguous on whether there's a problem or not.

Is it just a shift towards a more efficient approach to determining prices, because we don't know whether the old approach was necessarily right, or is it exercise of market power? Without being able to benchmark efficient costs for a particular service provider, which includes some process to determine an asset value, then your results of that sort of monitoring process can be highly ambiguous. That's why we say we're not sure about the efficacy of a monitoring regime that is going to be less intrusive than some approach that benchmarks efficient costs of the service provider.

With the Gas Code it could be said that we've got a good start in that. For covered pipelines an ICB has already been determined, and that ICB will apply for that covered pipeline for its life of coverage. But what about pipelines that haven't been covered and new pipelines? How do you go about effectively monitoring, and monitoring performance in a meaningful way without making judgments about those sorts of things?

MR HINTON: Is there anything we've left out, should have covered this afternoon, that you would want to particularly flag in support of your submission?

MR WILLETT: I think I made sure I covered everything I wanted to in the opening.

MR BUCKLEY: Just one point, Tony. In relation to certainty and the tribunal and the Epic decision, I might point out that the MSP access arrangement will be considered by the Competition Tribunal starting next week, and that review will actually look at whether or not the ACCC has correctly applied the Epic decision in that access arrangement. So there will be further judicial review of the commission's interpretation and application of the Epic decision.

MR HINTON: Do you have any idea when the results of that particular process will be - - -

MR BUCKLEY: Well, you'll be getting the transcripts as it goes, and that's from next week, so you'll be able to access debate, but we can hope that that outcome will come before June. I'd like to just pick up on one of the points from NECG this morning, and that was in relation to the GasNet decision in relation to the establishment of the risk-free rate in the CAPM model. That was reviewed in that matter and the tribunal determined that the commission erred when it used the five-year bond rate rather than a 10-year bond rate. We've noted that fact in our submission - that we've accepted the judgment of the tribunal, and that that will be applied in future decisions - so there is that certainty which comes out of the implementation of that. There was some discussion that we hadn't actually acknowledged that. Well, it has been acknowledged.

I will point out that what that was dealing with was the difference between the five-year bond rate and the 10-year bond rate - today the five-year nominal yield was 5.15%; it's 5.317% for the 10 year. We're dealing with 16 basis points. This is not the major element. The commission was looking for certainty about whether or not the bond rate should be aligned to the regulatory period, and we now have that certainty and the commission will adopt that in future.

MR HINTON: Thanks for that information, Mike.

MR WILLETT: Could I just pick up perhaps one comment that relates to that, and we do refer to it in our submission. There have been a lot of suggestions that the findings of the tribunal are suggesting that the ACCC is getting it terribly wrong. I think we've provided some good information to suggest otherwise. By and large, if you take into account the issues that have been contested during access arrangements and the issues that have been raised initially for review and then withdrawn, and the issues considered by the tribunal, the commission has been getting it, by and large, pretty right, and the incidents of the tribunal finding we've got it wrong are by and large in the minority. I'm sometimes amused to see declarations of victory after these tribunal findings and I'm prompted to think, well, if it was a soccer game, you'd be having one side doing a lap of honour after an 11:2 loss, because that reflects the number of issues they have gone down on in the end, compared to the issues they've got up on. So I think that's worth noting.

MR HINTON: With that football analogy, I'll conclude this session, once again reiterating thank you very much for your substantive input into this inquiry. We will take a 10-minute break; back here at 5 to 4.

MR HINTON: Welcome back to this last session of today's hearings in Sydney of the Productivity Commission's inquiry into the Gas Access Regime. I now invite to the microphone Mr Mike Lauer of Project Consultancy Services Pty Ltd. Welcome, Mike.

MR LAUER: Thank you.

MR HINTON: Thank you very much for your submission and your appearance today. It's appreciated. What I'd like you to do is make an opening statement to help us out to proceed further. Over to you.

MR LAUER: My company's submission was filed late. It was filed late because of a growing concern with a particular thrust in the draft review in the report. I've tried to develop an analogy for the concern and I think the concern I have with the draft review, which in general I think is a very positive and powerful statement, is that it risks making third party access a bit like Christmas: everybody celebrates it, very few people understand it, and even fewer people get any benefit from it.

It's an interesting concept that the Gas Access Regime is about third party access and there's no focus in the way the code has been administered to date, or indeed there's confusion in the review as to what a third party is. A third party is not a foundation shipper by definition. If you think of the concept, the first party in a gas transmission contract is the service provider; the second party is a foundation shipper or multiple foundation shippers; and the third party is somebody that's not in place at the time the project proceeds, so they don't even know at the time the project is going ahead that they will want access to the pipeline in the future, or they don't represent a significant marketplace - one that can influence the outcome. They're not seen as a foundation shipper by the first party and the second party.

So when we talk about third party access we're not talking about arrangements between foundation shippers and service providers. What we're talking about is arrangements between service providers and those who didn't qualify or don't qualify as foundation shippers. Third parties are best understood by comparison with foundation shippers, but in general they are people with smaller load requirements because they don't qualify generally as foundation shippers; shorter duration load requirements because they don't deliver a significant bankable cash flow to represent a foundation load; the need for flexibility in requirements. There are a whole series of issues like that which, if you start thinking about what a third party looks like, there's somebody - and the commission has correctly at times in the review identified the fact that we're talking about selling spare capacity in pipelines to people that may not even exist yet, or entities that may not exist.

That's the nature of the third party access problem and that's why the analogy.

There's very little emphasis in the review on third parties. There are some points where the commission very clearly arrives at a reference to that dilemma: the need to provide access to people who at the point when access is being considered and regulation is being considered don't know they want access to the system and may not even exist. The commission actually identifies those points but halts at that point and doesn't proceed to consider the problem from that perspective.

On the contrary, in most forums and in the review, there are signs that the focus is on adopting reference tariffs by averaging foundation contract prices. There are multiple references. There's extensive reference in the commission's review to the competitive nature of the foundation contract process, which isn't the problem at all and is not the issue, and the competition between foundation shippers and service providers is not the focus of third party access. The submission that we've made is a question about the point of reference from which the problem is viewed. It's not about the specifics, necessarily, of the report.

The first order issue in third party access is an assurance of access. The problems that existed in the pipeline industry prior to access regulation were that third parties with their peculiar requirements and who are normally under time stress in any negotiations - that is to say, they are confronted with an opportunity to participate in the market or they're confronted with an opportunity to continue to use assets that rely on gas, but they're confronted in a time frame which is not necessarily consistent with the need to sign a contract. By contrast, the service provider is not under time stress. It has an existing asset. The asset was or is underwritten by foundation shippers and really the service provider is largely indifferent as to whether it sells capacity today or tomorrow.

Third parties lose business opportunities if they don't have a guarantee of access at reasonable tariffs at some point in the future. Interesting to note, under both the National Access Regime and under the code, it is legal to hinder access to infrastructure assets which are neither covered nor subject to a determination. That is, under the code you can hinder access to an essential infrastructure asset if it is not covered. Under the national regime and the Trade Practices Act you can hinder access to an asset or a service. You can even hinder access to a service which is declared, if it's not subject to a determination.

So this essential need to get access to exploit business opportunities is the key problem with the third party access. The reason that it's so important is that those business opportunities are exactly the competitive tension in the upstream and downstream markets that criterion A in the coverage test talks about. So if I'm a potential entrant to the power generation industry confronted with an opportunity to produce electricity, and I haven't got an assurance of access or the price at which access is at large, I withdraw as a possible entrant to that industry. It's that guarantee

of access which is the first order issue when it comes to people being able to compete in downstream markets.

The second order access is the need that there be some regulatory oversight of that access right. Now, unfortunately, the way the code has been administered - and let me say this is not an issue with the ACCC because I think the industry has failed to understand how to use the code and take it where it could go. The second issue is that it has become a price regulation model of the worst kind. The code, as it currently is administered, is seeking to define foundation shipper contract terms to apply to third party shippers.

People who don't want to provide parent company guarantees, don't want to write 20-year take-or-pay contracts, but want flexible short-term arrangements, are being offered those arrangements for foundation tariffs because of this nonsense with continually refining the mathematics of the WACC. They're being offered access at foundation shipper tariffs and the service providers are insisting that the terms match the tariffs, so the terms have to look as rigid and inflexible as foundation shipper terms.

Therein is the fundamental problem. As I say, we've got the worst of the Prices Surveillance Act in its first guise in the current code. The issue then becomes: what do we do about that? We actually do have some precedents for different models. We have two in Victoria which have been approved by the regulator as valid third party access regimes under the code, and they were two tenders lodged - one for the development of a reticulation system in East Gippsland, and one for the reticulation of gas in the Mildura region which included a 150-kilometre transmission pipeline.

Those projects were tendered. They were not tendered as foundation contracts but the tenderers put forward the distribution tariff that would apply generally in the market. That is the tariff that would apply to gas users who would be generally small, seeking access on a casual basis because in those reticulation systems access is day to day or month to month, have extreme flexibility in MDQ and in their volumes because their charges are based on their previous peak, rather than any going forward - or contracted peak.

So we actually have models where tariffs have been struck for true third party loads. In those two tenders that were run in Victoria, there were foundation shippers in at least one case, in Mildura. There was one anchor load that the distributor was seeking to bring onstream to make the project bankable and viable. The terms that the distributor offered to that anchor customer were not a part of the determination of third party tariffs; that is, the process wasn't to find out what you would offer people that are going to use the system on an everyday basis as third parties and then once

you've done that and somebody has gone out and found a foundation customer with an anchor load and a quality contract, and less flexible terms, to import that price back into the third party access problem.

So we actually have precedents for defining what a third party customer looks like, defining what a third party contract looks like and setting reference tariffs. The rates of return in those two models were regulated and approved. One was 8.82 per cent real pre-tax. The other was 9 per cent real pre-tax. There's another example, which is not quite so clear, of a similar model, but under the Goldfields Pipeline Agreement Act, the Goldfields gas pipeline publishes a green book or a gold book, an access package. It has several tariffs. The principal differentiating factor of those tariffs is the contract term. The short duration contract, one to five years, is a 20 per cent margin over the base tariff, which is a 20-year rigid transaction.

So again we've got this idea that if you want third party, short-term, flexible access to pipelines, then there's a tariff applicable to that. There's a risk profile associated with that contract and with that investment in serving that market, and what the service provider does to then underwrite his investment is a matter between him and the shippers that deliver value in underwriting the investment. Those negotiated outcomes are below the line, effectively, of regulation. Anybody can come along and get the third party tariff, and anybody that wants to contract less flexibly can negotiate the terms. If the service provider doesn't see value in that, then the third party can always take the published third party terms.

Paradoxically, the terms of third party access, while they need to be fair and reasonable to the third party, desirably shouldn't be attractive to either the third party or the service provider because what we really want is for negotiation to take place for the concessions that the shipper is prepared to make and the concessions that the service provider is prepared to make to get properly valued. But the third party shipper always has a right to access at a published third party tariff and on third party terms.

If you take the vantage point and you look at the recommendations of the commission - that is to say, if you put the fire on each of the commission's recommendations and say, "If I came along to a pipeliner with a 10-petajoule per annum requirement for gas, what would I think about the way this recommendation would impact on me?" - then I think what you find is grave concern about some of the commission's recommendations that appear to make coverage more difficult to secure - that is, move pipelines out of coverage.

Unfortunately, I may be like others - guilty of misunderstanding the commission's monitoring regime. My understanding is that the commission's recommendations would either lead to a large number of pipelines not being covered

that are currently covered, but maybe some of them being monitored, or almost no change in that regard and almost no change to the way they're regulated. The problem I have with both of those outcomes is that if a lot of pipelines which are currently covered are moved outside of coverage, then access is no longer guaranteed or assured for third parties, and really third parties that are under time stress don't have the time to go and chase the coverage of a pipeline in the middle of a tender evaluation or in the context of a major business decision.

So there's a real timing problem if you move pipelines out of coverage and say, "If the situation changes in the future, then you can apply for coverage." I can assure you I've been there many times. The shipper does not get coverage because he doesn't have time - or she doesn't have time. That system doesn't work. So if we move pipelines out of coverage, shippers are going to be disadvantaged because there will be no assurance of access, and there will be no assurance of ultimate regulatory supervision. I understand that the commission sees a group of those pipelines being monitored, but unless at the end of the day there's an ability to actually intervene on pricing behaviour I don't believe monitoring delivers any real meaningful outcome to the shipper - and note that, if a pipeline is not covered, you can hinder access and it's legal. So what does monitoring really relate to - that is, under the law as it stands?

The second issue is, if the recommendations of the commission are put in and they result in no significant change to the number of pipelines that are covered, then the current, very invasive pricing intervention will continue and all the problems that the commission sees with the current model will continue; we won't have made any advance. I believe that there is another model and that model is to move all pipelines into a framework where the terms of third party access are clearly defined in a direction to the regulators; that is, the regulators are directed not to define foundation shipper status or equate foundation shipper terms and status to third parties, but the terms of a foundation shipper contract are prescribed and that becomes the matter which is priced.

I believe that price, like in the cases that have been established by tender, would be more attractive for the service providers than the current tariffs, regulator tariffs. I believe the terms of supply would be far more attractive to shippers because they would be evergreen short-duration contracts with no take or pays and little credit support, and there would be a trade-off taking place, and below that level negotiations will take place because concessions by both sides will be able to be valued. So I think there is an alternative to the idea of making coverage more difficult to get and then introducing monitoring; that is, to actually relieve the burden of the current price intervention model by changing the point of reference for that to the point of third parties.

As far as the specific recommendation of the commission is concerned,

regarding material or substantial or significant, I can only agree with the minister, the relevant minister, under the current legislation in his comments in the BPL revocation decision, where he said, at paragraph 106:

> Notwithstanding the expert argumentation developed by the counsel, the conclusion as to what would be a non-trivial outcome in competition terms remains a relatively subjective one.

So the minister has problems putting merit on judging non-trivial. Where he would be with "material" and "significant" and "substantial" I'm at a loss to say. So I find the whole subjective nature of that problematic. The ultimate situation is, if you qualify for coverage on criterion B - that is, you are a natural monopoly - then the onus of proof, to my mind, on whether you are covered should fall back on the service provider to establish that they actually cannot extract rent from the market and distort investment up and downstream. That seems to be the model that we currently have and I believe it currently works. I think the problem is with the tariffs that we set. If I can I wouldn't mind commenting on just a couple of issues that were raised in this morning's sessions, with Henry Ergas.

MR HINTON: Sure.

MR LAUER: Mike talked about the relevance of the WACC. I've got a major problem with the WACC, as you can see. I think it's a reference point. It is a reference point from which third party tariffs can be gauged but it's not a mathematically precise answer, the question that we should be asking. I think if you want to understand why that's the case, have a look at the recent report out of Western Australia on the WACC, where it seems that if I build a pipeline for a mining company and I've got to build a pipeline from Dampier to Kalgoorlie for that mining company, the tariff I charge that mining company should be reduced because later on I'm going to build a pipeline from Longford to Hobart. By building two pipelines I can diversify my risk. Therefore, the tariffs on each pipeline should be less.

Presumably, when I do the pipeline from PNG, which has some really great country risk in it, my risk will be so diversified the discounts will just keep coming all round. There is an extreme confusion in the way the WACC is applied. It's derived from a model that talks about traded instruments in highly liquid markets. If you look at that paper and you look at the first page, it talks about projects and investment. If you look at the second page it occasionally talks about projects and investment. If you look at the next 30 pages it talks about bonds, shares and yields and the words "investment" and "return" surface only very occasionally after the first two pages. Therein is the problem with WACC. It's an inappropriate tool. It's a useful device for setting a reference point. It's the answer to the wrong question.

Mike talked also about backhaul and swaps. The only difference between a backhaul and a swap is that a backhaul is a swap but the pipeliner does it instead of the client. The reality is that if I'm a gas producer at Moomba and I'm trying to sell gas into Sydney and I say, "I can give you gas that goes from Moomba to Sydney in the MSP or, according to the minister, I can give you gas that goes from Moomba to Adelaide to Melbourne to Sydney, via some other pipeline," because there are options. "If I give you the one that goes from Moomba to Sydney, then if I go down as a producer you won't get gas. If I give you the one that goes all the way around, if I go down you won't get gas. If somebody supplying South Australia goes down you won't get gas. If somebody supplying Melbourne goes down you won't get gas." It's not the same service, Mike. It's a patently different service with a much lower reliability. The difference in the service gives the MSP - or the Moomba-Sydney pipeline, the opportunity to extract rent, to put a value on the differential service.

As far as derivatives are concerned, derivatives are just instruments that are traded over the top of physical contracts and really, the third party access problem is in the physical contracts and not in the derivatives. They don't connect, in essence, because we still have the third party problem even if we've got derivatives sitting over the top. I think there is a lot of smoke and mirrors at the moment about how the market getting more complex is going to take away the third party access problem. That's all I have to say, Mr Chairman.

MR HINTON: Thank you very much, Mike. We appreciate your submission and your appearance today. I have a number of questions, and Michael might have a few too. My first one is, you appropriately remind us all that this is partly related to issues of third parties, and I thank you for that. Do you have any perception to bring as to the nature of third parties with regard to transmission versus distribution networks? This bears on the issue of terms of reference, where we have a Gas Access Regime that encapsulates both. Maybe a third party interest perception may differ between distribution and transmission. Do you have any views on that?

MR LAUER: Distribution entities will always have people who are seeking casual use of the system on an evergreen basis that don't really want to put up long-term contracts or additional contract security or cash flow security. So distribution systems will always have this enormous number of small customers who can never transcend from being third parties to being something different. You can contemplate on transmission lines - if you went up to a major transmission line today with a 10-petajoule load, 15 years, prepared to provide a parent company guarantee and all you are doing is using spare capacity, then the pipeliner may not really want to give you a discount unless he can use those attributes to what you are prepared to offer. He may be able to use them in the future.

The fundamental difference is, I think, that most people using transmission systems actually are capable of delivering some value to the service provider that will see them ultimately move from being a third party shipper with casual use on an evergreen basis to being something more than that on a contract. The issue is, how do you value the concessions between the third party and the contract regulation? The way we are doing it now has the ACCC putting those values on, whereas the code - it was contemplated that negotiations would establish those values.

They will change over time in the transmission system, depending on whether the transmission company is looking for cash to do other things or whatever. So you may be treated as a third party initially but be able to move to more acceptable contract terms long term. In distribution you will always have the bulk of your customers who are not on contract, who are on short duration terms. Other than that, I don't see a lot of difference between them.

MR HINTON: Let's move to your concern about the prime focus needing to be on third parties. The nature of regulation: let me be a devil's advocate here to some extent. I'm not denying the rights of third parties being the objective. The nature of intervention by government regulation, certainly in the case of Gas Access Regime, involves the erosion, to some extent, of property rights. Therefore, it shouldn't be pursued lightly and, importantly, it should be pursued transparently with some sort of robust accountability. That requires, therefore, systems of criteria and decision and review and appeal or whatever - all of those processes associated with natural justice. So I really question your questioning of the draft reports appropriately examining the need to ensure that the regime robustly delivers those requirements with regard to when and how property rights might be eroded. I may be overstating your concern, or your statement, but let me put that counterpoint to you - that one should be careful about eroding property rights.

MR LAUER: I agree. I can probably show you the places that I've written in exactly the same language. If the third party tariff is set at an appropriate level - and I believe there are already precedents to help us to do that, and if the tender is restructured properly the precedents can be refined - then I don't think you substantially erode property rights. The issue is whether there is a right to have or to exploit a monopoly. Interestingly enough, in Australia even now, it's not illegal to make monopoly profits. So some measure of monopoly profits, as the Epic court decision said - and I think as the law allows - is reasonable.

The issue becomes at what point does that distort resource allocation in the community? Providing the model that we use is not too intrusive, I believe you diffuse a whole lot of the issues about appropriating property rights. If the third party access tariff is set at the right level and on the right terms, then I don't believe the erosion of property rights becomes a major issue.

MR HINTON: That's one of the issues though. In circumstances where there is scope for commercial negotiation to reach a price, then intervening in those circumstances, whereby a price is set by a regulator, means it's at least second best if not third best. So you would want to be cautious about when you set up a regulatory intervention, if it erodes the capacity to negotiate commercially.

MR LAUER: I beg to differ. The government is entitled to make a law that says the distortion of investment in upstream markets and downstream markets is not an acceptable feature of the way the economy runs - sorry, the distortion of investment and competition in those upstream markets and downstream markets, by the exploitation of a monopoly position. The government is entitled to say that. The moment the government passes a law to that effect, the issue is diffused.

The only question then is how intrusive is the model that we use to administer that law. At the moment the model we are using is terribly intrusive and in itself, in my view, is distorting the marketplace. But the issue of property rights: once the government says that it passes a law that says you will not engage in behaviour which exploits your monopoly position to the extent that you distort investment in upstream and downstream markets, the question of property rights is resolved. I don't understand why you necessarily would argue that, at that point, you've got to be careful. I mean, the policy is written.

DR FOLIE: It may be you didn't understand our report, because we believe that in the monitoring regime we weren't spelling out in detail what was there, but effectively - as I said this morning to the NCC - it is not price regulation; it is - price monitoring. It is really a lot of things and a very key important part is actually access and the right of access. If you actually don't deliver access over that period, you're likely to be dropped into the heavy-handed bucket. So a very important part is about recognising, I believe, third party access.

When you say there's not much of it around, my understanding is there is the Duke pipeline. We have had representations that they actually provide a quite detailed variety of standard contracts which then are available on that eastern Australian pipeline, as well as then representations in Queensland yesterday that the Murrumba pipeline, which they are developing at this stage that's all running on open access - in other words, third party access and crafting all the agreements and things. They are both uncovered. There is a strong incentive to remain uncovered by providing third party access. Do you believe those arrangements are quite effective, because you haven't - - -

MR LAUER: Yes, I do. I think they fit within the model. It's always within the rights of a service provider to go beyond offering a short-term offering. The

interesting aspect of the examples that I quoted (1) they were tendered so there is a strong competitive element to them but (2) they also help, if you look at them, to define what a third party is. But if pipeliners, having established a reference point, want to establish some others, the other thing you might look at is also associate contracts.

I mean, if you back off the third party tariff, to be that which applies to third parties, and companies can then negotiate with their associates deals below that, then the issue becomes: how do you manage that? Maybe that becomes a reference point for the whole market. Maybe you keep them honest by providing that where they enter a third party - a contract with an associate, that that is within the reference points for third party access. There's nothing wrong with creating more than one, but I think there is this problem that the application of the code to date has focused on the minutiae of the mathematics of WACC. It has focused on the rate of return and virtually to the hilt with every other contractual term of any relevance to any body.

So you've got a situation where the tariff is set, the regulator doesn't really care too much about the rest of the contract form, and the service providers are trying to make the contracts look like the tariff. So they're trying to make the contracts look like foundation contracts because that's the only cash flow that matches; whereas, you know, you can define multiple terms, and Duke is a good example. It's got its standard offering out there at the moment and it's got another offering, which is a little bit different, for quite a different price, and they are obviously looking to find market niche opportunities, and that's what they should be doing.

DR FOLIE: Can I ask you a further question on that. It would seem to be that a further part of your proposition was that things - possibly what Duke and the others are doing are fairly normal sorts of contracts. You seem to be saying that you wanted to have very small contracts coming in and do you feel that therefore the market is showing any signs of giving those, if you like - and let's ignore the smaller regional ones, but in the metropolitan areas there may be people suddenly decide they want to have access to pipelines, for sort of six-month long contracts. Do you find there is an issue there?

MR LAUER: No, the market is not sophisticated to that extent at the moment. I mean, two years ago I had a situation where a client in the west was looking to place some gas that he couldn't use. We couldn't find a place for it. Half the people we talked to - we talked to all the major customers in the system - wouldn't talk to us because they had long-term contracts and didn't want to get up the nose of their service provider; the other half said, "Look, we'd love to talk to you but we're fully contracted."

So part of the problem is this focus has been all at the foundation contract end

and everybody is pushing regulation and the foundation contract end. People aren't backing off and signing shorter contracts so you're not getting the flexibility in the market that you would like to see. I think it would be a most interesting situation for pipeliners and the ACCC to say, "Here's a one-year contract that you can have on an evergreen basis and this is the tariff that's applicable to that," and see where the market goes. There are potentially some of the larger customers in the system who might be attracted to that flexibility rather than 10-year take-or-pay deals.

DR FOLIE: The last one is related to that same stream. We've had representations made to us by another party that there is a lot of competition now in the upstream area, et cetera. A lot of that competition is actually minnows coming in against the few megasuppliers. Do you think there is an outlook for shorter-term contracts, more flexibility? Do you see that pressure coming through in the market you've alluded to? Because you're around doing a lot in this sort of area, do you see any changes in the duration of supply contracts and other things desiring in the market and maybe being frustrated a bit at the moment, but a growing pressure for it?

MR LAUER: Western Australia is a useful example of markets that have been subject to competitive pressure for a bit longer, and the WA government does produce a book which purports to have the details of many contracts in it. They are not all very accurate but they're useful. What you've seen in the west in the last 15 years is a shortening of gas offtake contracts with gas producers to three, to six to eight years from the 30-year deals that were done by the Court government to underwrite the developments. You've got things like Goldfields pipeline signing short duration contracts; most of the contracts on goldfields, I think you would find, are not 20-year deals; most of their clients are mining companies with three, five, four-year mine lives.

I think, yes, we are seeing that; we're seeing it more probably at the gas field end where there are multiple suppliers, because in order to sign a short-term contract you really want to be confident that when it comes up for renewal you are going to be getting access at the market price, not subject to exploitation by somebody with a lot of market power. So the west has been a good example of that. Therein is the issue with coverage. If we move pipelines out of coverage, then some of the independents that are developing in Moomba at the moment will not be able to mature as suppliers and we won't see the sort of competition in the market as a whole that we need.

DR FOLIE: Have there been problems with any of the rollovers, you're aware of, because that is exactly the same as negotiation again - in other words, this is an area where monopoly power could be deemed to be exerted.

MR LAUER: You mean rolling over of foundation contracts?

DR FOLIE: Whenever there is a rollover that occurs and you've got to negotiate again, have you any evidence of problems about them, because you can take advantage of your monopoly power at that duration point?

MR LAUER: I think I would refer you to the shippers that you've talked to in these hearings. I don't think there are a lot of happy shippers. Most of them feel as though they've been abused in the market over the last 20 years, and many of those have gone through the process of rolling out of one transmission contract into another. If you had a whole lot of happy shippers turning up telling you that the system before the code was spot-on, then you might form a view that the rollovers were happy events, but I don't see that.

DR FOLIE: Okay, thankyou.

MR LAUER: And I can't talk to you about specific - - -

DR FOLIE: No, that's okay.

MR HINTON: Mike, is there anything we've not focused on that you'd want us to pick up again?

MR LAUER: I suppose I'd like to finish on a more positive note than negative note. I see an enormous amount of convergence in your monitoring model, what I've talked about as defining a different reference point for what a third party shipper is and what third party tariffs are - and Henry Ergas's comments this morning about the problem of the mathematics of WACC and the need to actually sit down and figure out what the right WACC is - I think there's a real convergence from different angles on really the same issue. I would urge you to look at your monitoring model in the context of what I've said and in the context of what Henry said.

MR HINTON: But at the end of the day, what's the criterion by which, and the main reason by which the third party access is at what price - how do you determine the price?

MR LAUER: We still do it under the code. The code would allow the application of the model I've outlined to you right now. I believe it is open to service providers to deliver to the ACCC today a draft access regime based upon a third party contract which is short duration, evergreen and has a higher tariff than the current regulatory settings. None of them have; I don't know why. You need to talk to service providers about that. So the answer is we do it exactly the same as we do it now and we already have some precedents for it, for competitively determined rates of return that were set in open tenders, not involving government entities.

These were public tenders with private enterprise participants. Private enterprise ran the tender and with one exception, all the bidders were - sorry, that's not true. There were government bidders and non-government bidders in the package. In both instances they were won by non-government bidders. I think the answer to that question, chairman, is we do it exactly the same way we do it now; we just change the way we look at the problem.

MR HINTON: Thank you. Mike, thank you very much for your participation and your submission. We appreciate it.

MR LAUER: Thank you.

MR HINTON: It's been a long day for the people who have been sitting here, but that does conclude today's scheduled proceedings. As foreshadowed, and in accordance with the Commission's established procedures, I now offer the opportunity for anyone else present to make a statement, if they so wish. I'm looking around for volunteers. The Commission staff are excluded, so that does in fact complete the proceedings today. I now adjourn these proceedings and note that we shall resume with public hearings at 9 am tomorrow morning at this same venue. Thank you very much.

AT 4.38 PM THE INQUIRY WAS ADJOURNED UNTIL
FRIDAY, 26 MARCH 2004