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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO THE GAS ACCESS REGIME

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

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON THURSDAY, 11 SEPTEMBER 2003, AT 10.02 AM

Continued from 3/9/03 in Adelaide

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

The inquiry's terms of reference were received from the Commonwealth Treasurer in June this year and in brief terms covers the following six matters: first, benefits costs and effects of the Gas Access Regime including its effects on investment; secondly, improvements to the Gas Access Regime, its objectives and its application to ensure uniform third-party arrangements are applied on a consistent national basis; thirdly, how the Gas Access Regime might better facilitate a competitive market for energy services; fourthly, the appropriate consistency between the Gas Code, the national access regime and other access regimes; fifthly, the institutional and decision-making arrangements under the Gas Access Regime; and my sixth summary point is the appropriateness of including in the Gas Code minimum requirements - that's price and non-price requirements - for access to users. We have already talked to a range of organisations, companies and individuals with an interest in these issues and submissions have been coming into the inquiry following the release of an issues paper in July.

The Commission is grateful to the various organisations, companies and individuals in Victoria who have already participated in the inquiry for the purpose of these hearings, just to provide an opportunity for interested parties to discuss their submissions and their views on the public record. Participants are welcome to comment also on the issues raised in other submissions. We have already held hearings in Perth and Adelaide last week and, following these hearings in Melbourne this week, further hearings will be held next week in Brisbane and Sydney. We will then be working towards completing a draft report for public comment for release in mid-December and will be inviting participants for another round of public hearings in 2004 to discuss and have reactions to that draft report.

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

To comply with the requirements in the Commonwealth occupational health

and safety legislation I draw attention of those present today to the exits at the back of the room and to my right and to the fire exit stairs on this level opposite reception on the other side of the lift lobby to this room. In the case of an emergency, an alert and evacuation alarm will sound and this will be the traditional well-known beep-beep whoop-whoop system which is used in this building. In the case of an emergency, well, they're the instructions you will need to follow. There will be fire wardens available of course.

That's the conclusion of my introductory statement. I'd now like to welcome our first presenter to these Melbourne hearings, Mr John Dick, from the Energy Action Group. Thank you very much, Mr Dick. I appreciate your attendance today. At the outset, in part to test the sound system but also for the record, I'd like you to identify yourself and who you represent and I also invite you to make an introductory statement. Thank you.

MR DICK: John Dick, vice-president of the Energy Action Group. In addressing the commission there are a couple of points I think we need to make. The Energy Action Group has been representing the interests of small and low-income energy consumers for the last 26 years. So we've actually had some experience of the changes that have occurred across the market from a - in the case of Victoria a state-owned instrumentality through to the industry we have currently.

We've got some fairly serious concerns about the way the market has developed and I think in fact the gas industry makes a really good case study of market failure for a couple of reasons, particularly when you look at the entire way the industry has developed. One can make a case that one or two things have been successful but, if you were to look at the overall industry, you've got to ask some questions about why is gas losing market share to electricity and it's fairly clear that the new opportunities for the gas industry are tied into a particular direction; one is large industrial consumers, particularly the sort of great project which the jurisdictions and Commonwealth tend to promote, something like SAMAG in South Australia. You can go through a list of fairly large gas consuming projects. The second one is very much tied round the panacea for the electricity industry to provide peak-load generation and the net effect of this is going to have some interesting impacts within the gas access arrangement and it's also going to have a fairly significant impact on consumer prices and how the costs from setting up infrastructure to meet these two requirements are actually paid for by consumers.

I think to sort of develop this a little further, the Energy Action Group has actually participated in the full retail contestability infrastructure that developed in Victoria, particularly via the work that VENCorp has done and the Victorian government put together to try and get full retail contestability for all consumers. It's worth noting - and I also had the experience of dealing with electricity and to be fairly polite about it, it's a dog's breakfast. You go from one jurisdiction to another

and there are different market system operating rules. There are different business-to-business requirements for the various retailers and it is almost impossible at this stage to be a national retailer given the complexities of the infrastructure that you need to put in place, the number of licences and the number of rules and codes that you have got to comply with.

So gas shippers themselves have got major problems and the 85 pages or 90 pages of the National Gas Code do very little to help in that particular direction. So in that context our view is that the gas industry needs to get a common sense of direction and that a retailer or a shipper of gas can basically have one path and one set of requirements to get gas from A to B. That doesn't happen currently. The second part about it is that the introduction of summer peaking loads, particularly for electricity generation, causes some major problems for system balance, how a line pack is managed and how one manages the various market system operating rules which, in theory, come under the code but in practice also come under the jurisdictional regulators and Victoria - one jurisdiction - in fact highlights the problems. At this stage Victoria, in one form or another, has somewhere in the order of five different market system operating rules.

Mildura uses the South Australian arrangements. We've got one on the Eastern Pipeline. There's the Principal Transmission System. There's the Western Trunk System and there's the Carisbrook to Horsham. So how does a gas retailer, wishing to sell or move gas from one point to another, actually do it effectively and efficiently when you've got to set a system up to take into account the various refinements that are basically put in place by, in this particular case, a single jurisdiction? The other part about it is I've always some bemusement about South Australia who in theory has full retail contestability for gas but doesn't have any market system operating rules that you can apply because these pivotally underpin the way in which the gas market is going to develop.

More importantly, as we continue to add more peaking gas-fired, open-cycle gas turbines to produce electricity, is going to create major problems for Victoria, New South Wales and South Australia to meet the summer electricity demands. Victoria has a unique operation. South Australia is still coming to some sort of grips with it and, hopefully, the SEA Gas pipeline will do something to address that. However, you have still got to work out how does Texas Utilities ship 2 PJ of gas from Longford through to South Australia. What are the arrangements?

We have then got to work out, how the hell do we assist and balance, given that you have a Victorian arrangement where it's a bet against the weather and whether people have ordered their gas at the start of the gas day. You then move to South Australia with the contract carriage model: how do you actually sit down and work out how the systems get effectively balanced to ensure that gas pressure is maintained, recognising that the SEA Gas pipeline was built because South Australia was getting

its supply difficulty from the Cooper Basin.

This will be further exacerbated down the track when the projected 800 megawatts of gas-fired capacity occurs in New South Wales, and that's the start of the New South Wales problem. New South Wales is just moving in electricity terms from winter to summer peaking. The independent Pricing Tribunal is currently holding an inquiry into the electricity distribution prices. They have a capital investment ask for new and replacement assets of around about $6.5 billion for the next five years to make sure they can meet summer-peaking electricity generation demands.

At this stage there is some mothball capacity in New South Wales for electricity, but the fuel of choice - the flexible fuel - is in fact gas. The question one then has to ask is, how does New South Wales, with two sources of supply - one from the Cooper Basin and the second one from Longford - sort out a balance arrangement and how does a company like TXU, again, ship gas and get access to gas, so we have just started to get some inter-basin competition and some pipe competition but, in essence, when you've got very few suppliers, the notion of competition between inter-basin and the distances involved, really make competition a bit of an illusion. That wasn't of course helped in the Victorian context when the Victorian government had in place significant producer legislation, which in fact stopped the development of third parties actually getting access to gas.

So there's a set of issues around the availability of gas, the way in which we've got limited inter-basin competition - in fact virtually no inter-basin competition - and how the industry itself responds - because this unfortunate position - and the group of people I represent are in fact one of the sources of the problem within the market: when we're hot we'll switch on our electrical systems to get cool; when we're cold we will basically switch on our heaters to get hot.

Small consumers are the volatile load in the market and it's not unfair to say we vote, which means that jurisdictions are very hot on the rhetoric about what needs to happen but, at the same time, rather - what could I say? - reluctant to actually run any sort of pricing regime which will disenchant the voters, so what we've got - with National Competition policy - is a rhetoric that we're going to do via pricing. The major source of problem is not subjected to any pricing regime of any sort, so one would have to say that the actual performance in the market is being driven by volatility, but there is no accountability, which then puts the pressure back on to the system planners and the regulators to approve the various projects which basically will set the future directions for natural gas transmission up.

Again one would have to say that various jurisdictional players have got an outcome. Their outcome is that they would like to have their pipeline in their area, but it's quite fascinating to listen to the different jurisdictions talking about how they

will deal with something which goes between jurisdictions, raises some serious questions, so there is an illusion that there is a national gas market. There is an illusion that we actually have pricing as the basis of that market. We then have a situation where we have in all 14 national regulators and, having appeared before a number of them, I have to say that I spend an awful lot of time writing submissions around pricing determinations.

It is clear that the utility regulatory forum and the various regulators talk about how they actually set up regulatory determination and they tend to follow each other fairly closely and they also tend to be very conservative, which means that consumers are currently underwriting the asset owners fairly heavily and every time I have spent before ACCC or one of the other regulators I have been trying to find out where I can end up getting my superannuation as a real investment with a just under 7 per cent real rate of return because, as a regulatory outcome, it's an extremely generous outcome when you start comparing it against most of the blue chip listed companies on the stock exchange.

The other part about the regulatory regime and the access regime is that it is supposed to reflect a competitive outcome. The way that's being reflected currently by the regulators is, it's clearly not. Companies are also supposedly benchmarked to try and reproduce a competitive outcome. There has been no evidence that I've seen where any regulatory determination with one exception has actually had an outcome where, by being basically lazy, you can get a real rate of return, reasonable op expenses, guaranteed depreciation, and do nothing, so I would actually argue that the current regulatory regime fails to reproduce any sense of a competitive system and I would actually rather like to own a regulated pipeline because the conditions that actually prevail - if you sit down and examine it - I mean, it's very easy to run through a regulatory process, using reels all the way through, because it's comparable but, as an actual player who has a real world to deal with, it's a very easy ask for those companies.

Energy Action Group had an opportunity four months ago to intervene and it's the first time consumers have actually intervened in any regulatory appeals process nationally - and we ran with a debate via our barrister about what should happen to consumers having access to the appeals process. The Australian Competition Tribunal ruled that we could only address the grounds that were used by the applicant. We argued fairly strongly that it should be a merits review; once the decision has been challenged, all of the decisions should be up for grabs.

As it panned out - and the determination and the judgment still has to be given - but as it turned out we could have challenged at least 20 per cent of the revenue determination. What was actually under challenge was about 2 to 3 per cent, and under the cherry-picking approach which currently exists, it pays an applicant to go to appeal against errors in the determination. But you only go for the areas of the

determination which are to your detriment; in other words, you will put down the ACCC or the jurisdictional regulator made a slight mistake at law. So you can go for more money, but there is no way that the decisions which in fact were extremely generous to the companies are challenged or questioned.

As I said, it's our contention that we would have and could have challenged at least 20 per cent of that determination, which would indicate that the regulators and the utility regulators forum have in fact been rather generous to the regulated companies. So it is our belief that the access regime in fact does not represent any benefit to consumers at all, yet it supposedly represents a view which was going to give us benefits. I would in fact argue that that's not the case at all.

The other area I quickly wanted to address was the issue that the various industry proponents run with, about the rates of return on investments being too low. I think it's worth pointing out, because the gas market is in fact not developing at the same speed as the electricity industry and because there are few owners of upstream resources, gas is not a competitively priced fuel, particularly given the distances for transmission and the nature of the way loads are actually developing.

It is clear Victoria is a mature market. The experience coming from a gas distribution roll-out in a place like Mildura, where Investra based their assumptions on a gas market of 8000 consumers and actually only got 1000, raises some interesting questions about the costs of actually developing a gas market in this day and age where full-cost allocation comes across onto consumers, particularly when you look at the costs of connection, and in the case of Mildura my understanding is the average consumer cost is about $3000 to access the Investra system, then you pay your DUOS and TUOS. So small consumers nationally are not flocking to gas.

The second part of it that sort of further exacerbates this sort of analysis is the Victoria government has put 70 million on the table for rural and regional augmentation of the Victorian gas distribution system. My understanding is, the companies want at least 400 million to do it properly. So gas in Victoria is a reasonably mature market. It's going to be interesting to see what happens in Tasmania. New South Wales is a reasonably mature market. The ACT has fairly high market penetration. Western Australia, it's penetrated where it is, and Queenslanders probably use gas most of the time for cooking.

So the small consumer part of the market is not developing dramatically and won't develop dramatically. South Australia is again another case where they've got a relatively mature market. So the new load growth and the new demand for pipelines clearly is coming from two new sources. One is the new big project, and the second one is gas-fired generation. Putting high rates of return on new greenfields projects isn't going to change that arrangement. So we would actually argue that the Commission in its last access regime report was running a line which

was saying, "We need to have higher rates of return for greenfield projects," but we would actually suggest to you that there is no evidence to actually support that contention. I would suggest to you if you sit down and look at what's actually happening with the gas market development, the volatility associated with gas market development, nobody has produced any evidence to say that we've got to build pipeline X, Y or Z, because as it stands currently, most of the markets are mature. It's just a question of getting gas from other upstream resources.

So in that context, we're suggesting that we'd like to see the review look much more critically at the information you're actually being given by the industry, the cost structures coming in from the industry, and what impact that will have, and also that the current arrangements need to be aligned between jurisdictions to ensure that we actually do have a competitive national gas market - it actually applies to electricity as well.

I just very quietly point out that it would appear that the full retail contestability infrastructure for gas in Victoria looks like costing about $300 million for five years. This, I would have to say, is for a huge gas market of about 450 million bucks a year. I think I'd suggest there's a bit of overkill there somewhere. You know, we've got to have some sense of perspective about this. We've actually got to come up with a long-term view, because pipeline assets are 50-hundred year - depending on how they're built - assets; we need to have a long-term strategic view, and it's not just about putting market conditions in place, because what I've suggested to you strongly is the National Gas Code has given us a dog's breakfast.

If you actually sit down and look at all the institutional arrangements, it's costing more to run this regime in one form or another, with the inefficiencies, than we're gaining in the benefits that we're supposedly getting from competition policy. I think I can finish at that sort of stage, but it's very clear that if you actually sit down and look at the numbers that it's costing for gas retailers to play in this market, we're underwriting very heavy capital investments costs for virtually no outcome.

MR HINTON: Mr Dick, thank you very much for those introductory comments. Thank you also for your submission that you put to us before this morning; we appreciate that. We thank you for your participation in this inquiry more generally. My first question relates to EAG itself. You mentioned it has been running for 26 years. I understand that you represent residential and small business consumers. Does EAG have a particular regional focus? It's incorporated Australia-wide, but is it - - -

MR DICK: It's a registered Victorian association, but what has ended up happening is, because we're one of the few groups that has been around for that period of time - in fact, the only group - I've ended up and a group of us have ended

up doing things nationally, because there's been virtually a vacuum in terms of the resources that have been available. Having to deal with electricity and gas, there is so much convergence occurring between both fuel sources that a lot of the issues are common, with the exception of things like system balance and the market system operating rules. The other features is that the Electricity Code, with 1000 pages, is much more doctrinaire than the Gas Code. But other than that we've tried to play things nationally, because we want a national market, national rules and a national structure that allows retailers to effectively compete.

MR HINTON: Thank you for that. My second question relates more to some of the points you said very early on, and that's about consumer interests. You particularly put emphasis on that in your written submission. Under our terms of reference, among other things we're also looking at the sort of ways in which a balancing of interests can be achieved; that is, of all the players in this particular sector and involvement in the Gas Access Regime - investor, asset operator, gas producer, current and future gas consumers - a balancing of interests. But you seem to have a particular consumer focus. Perhaps you could give some comments for this inquiry hearing this morning on your perspective about how a balancing of interest might occur, given that you are pushing very hard for the consumer interests.

MR DICK: I think it's probably worth commenting that the Commission is actually seeing or hearing from three people claiming to represent consumer interests in the Energy Users Association, the Energy Market Reform Task Force and Energy Action Group. I think the first point I could make is that all consumers who have some sense of what is happening in the market are talking to each other, because there are so few who actually do have an understanding, which means that we are invited to participate within the reform structure, the regulatory structure, but if you actually sit down and do a very quick look at the submissions that go to both gas and electricity you will find that there are about three or four organisations which are actually involved consistently.

The de facto position is taken by regulators that they need to represent consumer interests. At the same time they are supposed to be independent. You can't do both. What we actually need is an effective level of participation by informed consumers in this market and the development of this gas market. We also need the same in electricity. In theory it has happened in electricity with the advocacy panel, but there are some minor problems currently which we are hoping to work through. But in the case of gas, with the exception of the three or four organisations that have made submissions to this inquiry, there is very little consumer input to any of the decision-making processes, and that includes the political decision-making process as well.

I don't know, I'm fairly naïve in this, but I got the impression that competition was supposed to deliver benefits, at the end of the day, to consumers and/or users. I think

I have made a case. In fact, I can make a lot more convincing case that in fact we're not seeing terribly many benefits at all. We are in fact paying substantial sums of money for some fairly poor outcomes and it is important that the Commission actually sit down and work out what the efficiencies and inefficiencies are that we are underwriting. The other feature of it is that there needs to be more people involved in this debate. The industry is not the sole fountain of information or knowledge. I would have to suggest impolitely that the gas industry in fact has been trumpeting what a wonderful fuel it is, but the market share doesn't seem to be growing terribly dramatically, and in fact I think one could argue there that given that we are having a substantial increase in national energy consumption, gas's share is in fact declining. Not a terribly successful industry seeing that it's the fuel of the future.

MR HINTON: Certainly it's incumbent upon the Commission to consult as widely as possible to ensure that we have input from all interested parties relevant to the terms of reference. So at the outset that is one reason why I thanked you for your participation as representing a consumer perspective. It has been put to us that in fact the intersection of interests of some of those categories of players in this market are quite common, not necessarily competing, and that the longer-term interest of consumers is in fact dramatically aligned with the longer-term interests of producers and shippers of gas. Do you see that as a potential unsustainable view or is it - - -

MR DICK: I actually tend to sort of follow a collaborative model and I would then just briefly comment that the - I came to that view as a result of the Victorian government's carve-up of the Gas and Fuel Corporation. Yes, a range of players all sat down and started to talk about what was in common and that included producers, pipeline owners, consumers and retailers. I believe that's probably the best way to go forward. I also would suggest that if we can get a common national view - because one of the problems is that the only people who have actually got a common national view tend to be the gas retailers, the reason being that they are trying to move gas from one field to a market.

Other than that, pipelines tend to be sort of within the jurisdiction, with the odd exception of the transmission pipelines, but certainly the distribution companies tend to be within a state. They have got to comply to a state based licence system, so it would be interesting to hear what Investra has to say. Alinta has now moved out of Western Australia, and it will be interesting to see what they have to say, seeing they have now got Victorian assets as well, but they have got, I think, the same concerns as we have in terms of the number of jurisdictional regulators and the number of - sorry, regulatory arrangements they have to comply with.

So we all end up having a common interest in terms of getting a better regulatory outcome, and the regulatory outcome is to try and cut the costs of regulation. It is interesting actually, because in Victoria we have now had the separation of retail and distribution and one retail company has in fact got three licences in Victoria and

doesn't want to give up the three licences, wants to keep three separate companies. The same argument applies with electricity distribution. You can gain the regulatory system by having two licences, because you end up picking up 3 or 5 million dollars to play regulation for each of the licences.

MR HINTON: Let's go directly to a much more fundamental question for us, and I want to pick up here some of the comments you've made this morning, but also in your written submission. For example, you talked about the regime being a dog's breakfast. You also talked about systems balance not being delivered by this regulatory framework through the Gas Access Regime, and you gave other examples of regulatory failure that clearly indicates your judgment about how well the system is working today. That could take you down a track of leading to a conclusion of, "Let's get the regulator off the back of this sector and pull government away from regulation." Maybe the unregulated outcome could be significantly better than the dog's breakfast that you perceive to be occurring today. Would that not be a reasonable way to look at where we are, given the nature of this sector?

MR DICK: Whether we had 85 pages or 1000 pages with the rules and codes, we have got an arrangement where when it comes to actually delivering something to consumers each of the jurisdictions have intervened in a manner that has guaranteed that it is unworkable to be a national retailer. Electricity is even worse than gas to some extent, because you've got each jurisdiction with different business requirements for each of the retailers and their arrangements with the distribution companies. So the rules, codes and the regulators are not the major part of the problem either. It's the way in which each jurisdiction believes it can do better and it can also protect particularly the small-end consumer, because for some reason they believe that they can't upset the voters.

So what we've got is a failure to develop a national approach. It is not about getting on people's backs or off people's backs. The current arrangements are not delivering anything and it happens to be that there are basically a number of regulators, a number of jurisdictions, involved in this process, but even if you were to pull them out and go to the one single national regulator we are still going to have these sorts of problems. I actually come back to the comment I passed earlier about the single jurisdiction in Victoria with five different market system operating rules, which I would indicate was grossly inefficient, but one jurisdiction - in fact, a relatively light hand from the jurisdiction in that particular context. They are in favour of the market.

It does raise that interesting question of whether pulling people off is going to allow convergence to occur or not. What is interesting I think is the other one. I haven't been able to explore it effectively yet, but if you take the National Gas Code there are five different ways of doing the reference tariff, yet everyone seems to have stuck to the building-block approach and the use of weighted average cost of capital. Whilst

this code provides freedom, and an awful lot of freedom, it would appear that companies are tending to sort of try and get some sort of convergence, or something they understand. So if you're in one jurisdiction you've clearly got to have something similar in another jurisdiction, because it's almost impossible to run a business where you're running to meet different regulatory, or jurisdictional, requirements and whether you've got a light or a heavy hand, it's still going to exist until you pull all of that off and get some sensible long-term approach.

DR FOLIE: If we leave the Mildura MSOR out but stick to the case of Victoria where the other one - there's a bit more intercom activity between them - to what extent are the MSORs actually a function of the regulatory process or are they the desire of the pipeline operators because of the characteristics of the load down their pipelines? They've actually implemented particular MSOR for that pipeline.

MR DICK: I actually haven't thought about it strongly although I participate in that process but in general terms I've had the feeling that, if someone puts something up, then the regulator will rubber-stamp it and that's certainly what will tend to happen with the way the Gas Code is written because it's a fairly generalised code and what it's doing is allowing a lot more creativity and I'd then just push that one stage further and say you've given people creativity, they've exercised it and now look at what we've got?

DR FOLIE: But the pipeline owner has the incentive to move gas which way - it doesn't matter which way along his pipeline. Would he not therefore if the need arose - because the thesis you're putting is that under difficulties of peak loading, needs of retailers to be able to have flexibility of being able to ship gas along a pipeline - wouldn't it over time because we're in the early stage, basically the proposer of the MSOR then adjust over time?

MR DICK: Once a pipeline becomes covered there is a fair guarantee on your revenue stream so to some extent you really care.

DR FOLIE: So that's part of the regulatory process - is actually taking incentive away to actually be flexible?

MR DICK: I think that there is a certain case to make for that, yes. I would also then suggest that I am still learning about the regulatory regime and not having enough time to sit back and really examine all the pluses and the pros and cons of it all but I'd certainly argue that, if I was given a choice, I'd like to have a regulated pipeline as my investment.

DR FOLIE: The second part of your response is actually interesting because I think that probably everybody involved in the regulatory process is learning actually how to do it. If there are, if you like, abnormal consequences that are occurring, then

one has got to see whether they're rectified over time as people learn they could do better.

MR DICK: Well, the one bit of innovation though I think that I would allude to is CitiPower's massive cut in their opex expenditures in the first regulatory regime - the Central Service Commission in Victoria's regulatory regime when they dropped their opex expenses by, if I recall correctly, something like $50 million per annum. It got round about five years of the 50 million per annum saving, then got another five years where that was shared and I think the learning curve from that is why the hell would you do it when you can get a regulator giving you a determination for opex and then just running with that opex.

There is in fact a really good case, I'd argue, when you talk to GasNet, if you talk to GasNet, where there's the slight change in ownership and they wanted to float the company, that opex dropped just before it happened by about five to six million per annum. As soon as the new management structure came in place and ownership structure came in place, they managed to crank the opex up again and there was no incentive for them to be creative or innovative. So I would say that the whole notion of incentive regulation doesn't appear to have worked well and again, if I was a pipeline owner, I'd love to be a bloated monopoly.

MR HINTON: Can I take you to the greenfield pipelines issue. It has been put to us that greenfield investments have their own risk profile that could be quite different to and certainly much higher than an existing asset that might have an established income stream with established customer base. The question arises that the threat of regulation by coverage after the commercial decision to construct a greenfield pipeline could in fact be a fundamental impediment to actually constructing that greenfield pipeline. Do you have any views on that sort of hypothesis?

MR DICK: Can I tackle it obliquely. I think there is in fact a case in this country which actually highlights the reverse to that and it's in fact MurrayLink - a rather well-litigated bit of electricity transmission asset - and I think a case can be strongly made that TransEnergy went and built MurrayLink on settled and residue auctions between Victoria and South Australia which were quite large at the time - something like $60 million. They've evaporated since with more gas-fired generation appearing in South Australia and MurrayLink has gone across to ACCC and wanted an unregulated interconnector to be made into a regulated interconnector because they're at least guaranteed some revenue flow if it's made a regulated interconnector.

I suspect Basslink may actually follow the same way, which is one of my concerns, but I am then suggesting to you that I think the ability to start as unregulated or as uncovered and then moving to a covered actually provides the companies with the potential to recover from what could be seen as a rather bad decision. I'd strongly argue that I think that's what's happened in the case of

MurrayLink. So all business entities run a problem of risk. What you've got, as soon as you've got a covered pipeline, is the risks to some extent are substantially less than a company which is trying to compete with the export market, value of the A dollar. If you go through a whole list of things, you know, over the years this country has had an organisation running out of the federal government of which this Commission has made some reports on, on things like people dumping.

The average business has a business risk and there's clear empirical evidence that large blue-chip companies have made some disastrous decisions. That applies to pipeline owners as well. Until it becomes covered, when you're covered you've at least got some way of cost-recovering unless you get a stranded asset out of it. So I'd actually argue the converse to that and I'd then say please let me know where I can get my real investment with my real rate of return because - - -

MR HINTON: Let me take you to one final area of discussion and it's in relation to your comments about EAG being involved in submissions and appeals and reviews and certainly the Gas Access Regime has a range of options and mechanisms that involve appeal processes of sorts. I'd welcome your comments on your experience as to your perception and assessment as to whether or not we're getting timely regulatory outcomes from the administration of the Gas Access Regime or are the appeal processes, review systems, merit reviews or otherwise, generating regulatory delay in efficient regulation and untimely decisions?

MR DICK: I think one can rest one's case on South Australia's Gas Access Regime where I think one would have to use the word "incompetence" but one of the problems is there are too many bodies to deal with and the new career path for any one joining the gas industry is not in terms of being a technical boffin or retailing, it's actually regulation, you know, because the real career path in the industry these days is being regulatory managers because you've got an awful lot of people to deal with, a huge range of inquiries, and I'd love to know what the cost of regulation, given the plethora of regulators we've got, is actually costing. If I was actually to be competent, I would be dealing with at least one 25 to 30-page submission per day to keep up with what is actually happening nationally in terms of gas and electricity. The reality of it is that I incompetently lurch from one disaster to another.

MR HINTON: Mr Dick, thank you for those comments. Is there any item that you think that we haven't covered that you think you'd like to give a short emphasis to at the end of this appearance?

MR DICK: I would really like to see the Commission actually justify some of its decisions in a much more rigorous manner than it has in the past. There are assertions that competition gives you the best outcomes. I think I've made a partial case to suggest that certainly competition - full retail competition in gas in Victoria probably hasn't and probably won't, and in fact the whole structure that's in place is

that you give the retailer a rather generous tariff - usually defined as the "standing offer" and hope like hell competition will erode it. If you've got no upstream competition in gas, how the hell can you erode anything?

I rather resent the idea of parting with 300 million bucks, which I really didn't need to, because the jurisdiction had a fetish that it thought competition was important; because they certainly haven't looked at the costs of the implementation of full retail contestability in both gas and electricity. So I'd basically say, look, I represent the source of the problem and the tragedy of what's happened in the process is that people haven't examined the long-term impact on both gas and electricity for volatile loads, and in the case of electricity it is going to cost a bundle.

In the case of gas, gas is still going to have to come up with some solution to meet the huge increase that's going to occur in peaking generation if we're going to continue with summer airconditioning and summer airconditioning load, and it is a national problem of monumental proportion. We're not talking five or 10 dollars. In the case of electricity, investment at this stage is about 20 billion in the next 10 years and generation is free. Let's start looking at what the impact of providing sufficient gas infrastructure to meet peak load generation is going to cost as well. That way we might actually think about changing some behavioural approaches of the more volatile consumers in the market.

MR HINTON: Thank you again for participating in this inquiry. We have a short break now. We're scheduled to have our next attendee commence at 11.30, so we will break until shortly before 11.30, assuming arrival of the representatives of Alinta. Thank you very much.

MR HINTON: Let's commence the second session for this morning's hearings in Melbourne. I now invite to the microphone Mr Geoff Towns of Alinta. Welcome, Geoff. For the purposes of the transcript and to check the sound system is working correctly, I'd be grateful if you could identify yourself and who you represent. Then I invite you, as you foreshadowed, to make an introductory statement to get proceedings under way. Thank you.

MR TOWNS: My name is Geoff Towns from Alinta, and I'm representing Multinet Gas and Alinta Gas Networks of Western Australia. Alinta is the asset manager and owner of those two companies. The first point I'd like to make is that we think that the Gas Code is in substantial need of reform in terms of an appropriate set of objectives, given the clear lack of directions in a multiplicity of objectives under the code, and the impact of the legal decision in the Western Australian Supreme Court which was interpreting the code. Alinta considers that the new objectives should be to promote efficient investment in essential infrastructure within the context of a workably competitive market; provide a framework for encouraging commercial negotiations and regulatory decision; and maximise the long-term economic welfare of the community.

We also consider there's a need for a more robust appeal mechanism in the National Gas Code, as an appropriate appeal structure is critical for cost based regulatory models like the building-block models. Under the code there are different appeal provisions for coverage and for regulatory decisions, different appeal bodies with different administrative rules, limited access to judicial review, and appeal on the basis of facts and no access to full merit appeals, which is the preferred model of appeal under the Trade Practices Act for Part IIIA. So Alinta considers that a full merit appeal system should be implemented in the code and access to judicial review should not be restricted.

The issue of appropriate pricing model also needs to be considered in the reforms of the National Gas Code. Alinta favours an approach to pricing models based on the ability of the firm to abuse its market power. In this regard we submit the following needs to be taken into account. The regulatory and compliance costs of the building-block model are extremely high and it's mainly designed to ensure capital and operation costs are efficient. The building-block model that was introduced into Victoria does not encourage efficient investment. It's led to a system where Multinet has lost over $30 million of permitted revenue in the first access period, which cannot be recovered under the current regulatory approach. That's made it difficult to finance investments.

Victorian distributors have been through two price reviews, hence their costs should be efficient. Non-vertically-integrated businesses such as Multinet have no incentive to inhibit access and distributors have constraints on the exercise of market power such as those provided by retailers, alternative energy sources and large

customers. So Alinta submits that a system of price monitoring such as has been introduced for airports will adequately protect the community against monopoly prices in light of the above analysis. It will also encourage greater commercial negotiations, be consistent with a workably competitive market and significantly reduce the compliance costs. It will also eliminate regulatory areas that exist in the current regulatory model and lead it to bias against investment in efficient infrastructure.

MR HINTON: Geoff, thank you very much for those introductory comments. Thank you also for your written submission. We appreciate that. We also appreciate your participation in this inquiry more generally. These processes are importantly dependent upon that sort of input from industry and sector interested parties, so thank you. My first question I'd like to explore with you is in relation to the first area of your comment. In fact it's in the area of your first recommendation in your written submission regarding the objectives of the code, the objectives of the Gas Access Regime, the sort of raison d'etre for intervention. You put forward a view that certainly others have shared - that is, greater clarity to the objects clause or the objectives of the intervention would be an important improvement, a necessary improvement to the access regime, the National Gas Code. In fact, you put forward a specific set of words.

MR TOWNS: Yes.

MR HINTON: Thank you for that. I wanted to explore with you why you would wish to have your item (c). I'll read it - the objective being under item (c), "To maximise the long-term economic welfare of the community." I of course am not questioning the ideal objective of maximising welfare. It's the inclusion in the code that was - - -

MR TOWNS: I suppose that was a catch-all phrase to reduce monopoly power and do all those sorts of things, so it was to improve consumer benefits from, you know, efficient investment. It was more a catch-all phrase to include a number of different things which economists could read under that.

MR HINTON: My reason for raising it, though, is that by the very nature of how you describe it means that it is almost whatever it wants to be in the eye of the regulator. That is, it doesn't bring clarity in itself. By having a catch-all, item (c) in effect gives discretion that does not become an explicit set of criteria but rather a broad, generic objective that obliges the regulator to have interpretation as to what it might mean. I was wondering whether that in fact could run counter to your basic objective of refining the objects clause.

MR TOWNS: Well, there's a balance between writing - the Gas Code at the moment has a multiplicity of objective clauses. They run forever. I think that sort of

system doesn't encourage clarity or certainty. Alternatively, if you go to a smaller set of objectives, you've got to be in more summary mode, so I guess that's the trade-off that you have to make. I think the important thing is that you've got the workable competition, competitive market there to constrain regulatory decisions in terms of a correct market structure. So we think that should be the limiting factor which will constrain regulatory decisions. And of course there'd also be a series of price - I mean, there's a whole package of things that go with a set of objectives. It's not sort of stand-alone. There might be other objectives that relate to pricing models. There might be other objectives that relate to market power issues. So it's not just that set of objectives that will constrain or in any way influence the regulator. They're sort of the headline, just main objectives.

MR HINTON: Overarching objectives?

MR TOWNS: Yes.

MR HINTON: So you see the code structure - perhaps not ideal today in that there is not a clear hierarchical structure of how the code works with regard to objectives. Is that reading between the lines?

MR TOWNS: In many ways there wasn't until the Supreme Court in the Western Australian Epic case produced a definitional set and a hierarchy of objectives and they probably made one error in their judgment, where they said that you could look, for pricing and costs, to other than economic criteria; that, you know, you could consider social and more political objectives. Of course, that could open up a regulator to do all sorts of things, so you could - had the judge said that you've got to take risks into account that might impact on future investment, then he might have found a better way out of it than saying that issue, you know, that decisions could be broader than just economic ones.

MR HINTON: But your item (c), I think, if I heard you correctly, was also designed to pick up consumer interests. Is that - - -

MR TOWNS: Yes.

MR HINTON: This is item (c), long-term economic welfare of the community.

MR TOWNS: Yes, efficient long-term investment, consumer interests.

MR HINTON: Can you explore for me the intersection of segments of the sector - that is, consumer interests not being aligned with or being in conflict with or otherwise with interests of, say, producers and shippers? Have you got a feel for that?

MR TOWNS: Well, I guess you want consumers to get the right pricing signals from energy markets. You want consumers to get reasonable prices. You want investment to be there for the long term that encourages efficient long-term prices and pricing investment, so that's probably the main intersection. That's always there for a regulator to make a judgment on and it's not an easy judgment to make, obviously.

MR HINTON: No, especially if they don't have clear criteria by which to make the call.

MR TOWNS: No.

MR HINTON: Let's move on to a second area that you've touched on in your introductory remarks, and you also pick it up in your written submission, with regard to your second recommendation about a merits appeal system. We in our discussions with interested parties, and also it has arisen in our public hearings, have heard a number of views about regulatory inefficiency with regard to the timeliness of decisions - that regulatory outcomes have proven to be quite delayed in many instances and we have been exploring the sources of those delays. It's not always clear-cut what are the driving forces behind the timeliness of decisions, but I'd be interested in your comments about the tension between your merits based appeal system and ensuring that you have a system that generates timely regulatory outcomes, timeliness of decision-making. Maybe you don't see a conflict.

MR TOWNS: Well, I suppose there is a conflict, but I guess you've got to protect private property rights and other rights in a full merit appeal system. Merit appeal systems that are just based on fact don't deal with a lot of the subjective issues that are in the code and are quite a lot constrained, particularly with the current code. Certainly a full merit appeal system does lengthen the appeal process, but then again if you've got nothing to appeal, then maybe there should be some criteria under which to appeal, some sort of materiality clause and maybe the Competition Tribunal should be adequately resourced to get a decision quickly. But if you do a costs benefit on it, I think even with the cost of a slight lengthening in the approval process, the benefits would still outweigh the costs.

MR HINTON: Do you see any link back to our earlier discussion about a greater clarity to the objects clause - that if that were to apply, then that in itself would perhaps make a more efficient merit appeal system.

MR TOWNS: I think that's undoubtedly true, that the greater guidance you can give to the parties, obviously the more limited there will be an appeal process. I mean, you look even at the current structure. The number of appeals have not been great but there's been some pretty big appeals - you know, the Epic case, the coverage issues with Duke - so they've been pretty important cases but there's not

been a multiplicity of cases. No-one has been deliberately lengthening the approval process with less than valid cases.

MR HINTON: It's been put to us that sometimes there's a commercial imperative for delay - that is, if a lower pricing outcome for a provider is going to be the inevitable regulatory result, the later that has effect, the better, therefore why not backdate the effect of the regulatory outcome, such as the lower price? The system therefore would not provide an incentive for the service provider to use delaying techniques through appeal. Is that oversimplistic?

MR TOWNS: I suppose you could have the regulated price applying from when it's made and then if it's subject to appeal and that appeal is then overturned, then the price changes. I mean, you could have some process like that to get over that, but wherever you have a regulator you're always going to get gaming from one party or another.

MR HINTON: Yes. I was really trying to explore with you a mechanism by which gaming can be minimised.

MR TOWNS: Yes. Again, you minimise it by providing the right set of rules around which the code operates, with appropriate objectives structure and clear objectives, much clearer than currently exist. You do it by having rules about when the price starts from and you have rules about materiality and you can do it. You can minimise it. I don't think you'd probably ever get rid of it because gaming is a part of life, particularly where you have it regulated.

MR HINTON: Particularly where you have it regulated.

MR TOWNS: Yes.

MR HINTON: You mentioned coverage a moment ago. We would welcome your comments on how the coverage framework works in the regime in the sense that it's an on-off switch approach. You're either covered or you're not.

MR TOWNS: Well, it's an on-off switch where everybody was covered and now all the small players are being uncovered so it's - we've imposed all those costs on all those small pipelines and now they're being liberated from coverage, yes, so there has to be some hierarchy in coverage decisions because - well, the rules on coverage should specify in greater detail what is to be covered. I mean, if you look at the coverage decisions in the Trade Practices Act, they have an additional clause which doesn't appear in the National Gas Code and that is it must be of national significance. That seems to have been dropped out of the National Gas Code to use as a method of controlling prices at the state levels for distributors and - so the National Gas Code has been used for other purposes other than access.

MR HINTON: So if I hear you correctly, you would like the national significance criterion to be incorporated into a super-refined and improved - - -

MR TOWNS: Yes. Well, I don't think that's highly likely, somehow.

MR HINTON: Why?

MR TOWNS: Well, it would lead to most distributors exiting the regulator.

MR HINTON: Though you could have something consistent with that concept, not necessarily of national significance, but be significant.

MR TOWNS: Yes, you could say that.

MR HINTON: That is a size criterion as opposed to a national - given the nature of the sector, it's hard to say national - that the west doesn't have interconnectivity.

MR TOWNS: But, yes, you could do it with a size criteria. I guess again you need with coverage also to take into account the dynamic changes in the market and the development of other pipelines so the system needs to be flexible enough to change and I'm not sure that we've got that level of flexibility there yet with the sort of appeals that are on coverage now before the ACT.

MR HINTON: Where do you see the criterion of market power, significant market power, having some force here? Is this a prerequisite for coverage, a prerequisite for intervention?

MR TOWNS: Yes, we would see - I think - unless, yes, you would have to base it on some ability to exert market power and pipelines that are subject to competition obviously have very limited ability to exert market power and therefore they should have a lower coverage test or a lower sort of pricing. They should not be subject, necessarily, to the same sort of pricing approaches that others are subject to because of the monopoly power aspect.

MR HINTON: So that suggests a regime that isn't an on-off switch but a matter of different buckets.

MR TOWNS: Yes. I think we would support that and I think that is more supportable under the ability of market power - the ability to exert market power is not an on-off switch. It's a continuum that changes over time.

MR HINTON: Can I explore with you then the forces at work in market power in the sector and whether or not the current approach of the existing regulators are

sufficiently open to the sort of taking into account the forces at work that represent competition that might erode market power, or at least challenge market power. For example, the sector is different today relative to 10 years ago.

MR TOWNS: There's a lot less vertical integration of the sector today than there was 10 years go.

MR HINTON: Yes.

MR TOWNS: So that is one dynamic market change. A non-vertically integrated distributor has no reason to refuse access because they've got no retail to protect. In any case, I think access for distributors probably isn't as important an issue as access for a transmission pipeline in any case. I can't remember any access request from anybody to the Multinet system, although access might also be covered by use of systems agreements at the state level where retailers have the right to hook up under a use of systems agreement, so it's not quite clear whether access could be restricted, even from a vertically integrated distributor under the current sort of regulatory model.

MR HINTON: Interconnectivity or expansion of the sector more generally, has that sort of brought competitive forces more to bear today, relative to seven years ago?

MR TOWNS: It's a much more interconnected system than it was 10 years ago, that's true. We have, you know, two pipelines to Sydney now. We have basins competing as well as pipelines.

MR HINTON: On this competition and perceptions about gas/electricity competition, are regulators sufficiently attuned to not only the developments you have been describing; do they seem to look at competition in the context of energy or is it more narrowly focussed on gas only?

MR TOWNS: Substitutability between gas and electricity is quite high. Maybe 7 to 10 per cent of consumers change their energy source at any particular point in time. Certainly if a gas distributor can't hook up two services, which is heating and cooking, then it's probably not economic to connect a gas distributor, that is. So gas distributors compete against the electricity hot water tariff and that tends to be low peak and relatively low so if you can't get substantially under that electricity hot water tariff then you probably won't be successful in getting a customer.

This is a particular problem in greenfield sites. Like, we looked at Tasmania, going to there, where you would have to compete against wood and that had sort of 10 per cent of the market and that was a lot lower price but the environmental costs weren't taken into account and so maybe the pricing wasn't appropriate for that area.

But the hot water tariff was the main one. We can't get consumers to switch because they've got to change capital equipment, get a pay-off over that five or six years, whatever their - - -

MR HINTON: Cost of the gas heater.

MR TOWNS: Yes. So it really restricts you at greenfield sites to connect customers.

MR FOLIE: Just still on the theme, if you like, of electricity, to what extent do the codes inhibit, or is it neutral, the following propositions - for a distributor, I'm now talking about - distribution network. If I wanted to build a modest-sized gas-fired plant which was probably going to be very peaky, then you could imagine this emerging sort of - these packet sizes. To what extent would it be easy to be able to, you know, structure the gas off-take because of the peak loads it might put onto your system? Do you have the freedom to be able to negotiate that or does it have to go back to the regulator or is it well-covered in the existing access arrangement?

MR TOWNS: It seems to be reasonably well-covered in the access arrangement. I'm not that familiar with that area but I haven't heard of any problems of the new peakers in Victoria getting access to gas, although that might be a property of the system we have in Victoria - the market carriage system where you can easily get off-takes although you've got to get the gas to off-take and that's probably the biggest problem, that there aren't enough competing gas providers. Aside from that, I don't think those peakers have any problem getting access to gas because the Texas underground facility can also assist in that regard.

MR FOLIE: What would happen in Western Australia for such a system where you've got a less mature distribution system that - though there's extra burdens you could put onto it?

MR TOWNS: You see, Western Power is thinking that it can't get enough gas because the Epic pipeline is full and - - -

MR FOLIE: I'm trying to get away from the Epic pipeline. I'm trying to actually focus on distribution access.

MR TOWNS: Unless there is enough capacity in the gas pipeline, you know, you can't get a contract and you can't supply your peaker under those conditions.

MR FOLIE: I'm trying to solve the next problem and it's to the extent then that the gas distribution system, even if the pipeline had sufficient capacity, I've got to stick to the areas where you're in but is then access within the distribution system a problem because you've got lower pressure, you've got issues and then if you get

more electricity, smaller generators growing which could be - and I'm hypothesising - very peaky, that puts strain onto your system or it may not and to what extent that is possible, to be able to do those deals or to just have to go back through the regulator is another process. It's probably a problem which you might face..

MR TOWNS: The regulatory model can't handle those sorts of investments because you don't know when they're going to come up and you can't forecast them five years out so, yes, demand type - those type of investments are very difficult to handle in the current regulatory environment. You might have to go back to the regulator for more capital to spend on pipes to connect a customer that wanted to produce electricity within the distribution network.

MR HINTON: A related point is that it has been put to us that the code's origins are essentially driven by a need to address market power in the transmission area and that the coverage of gas distribution networks was belatedly incorporated into the code being applied but then it was put to us that the flexibility in the code itself meant that it was capable of addressing those two different segments of the sector. From your perspective, do you think that's a fair characterisation of where we are today or is it - - -

MR TOWNS: Yes, I think that's a fair representation and I think that some of the changes that have been made to the code about the need for distributors to having queuing policies and all those transmission type things in there, there have been some attempts to change the code to limit the amount of crossover between transmission type activities and distribution type activities. Pretty much it's the pricing principles in distribution in the code that really matter for distributors rather than all the rest of the stuff which is really neither here nor there. I mean, ring fencing only applies if you're vertically integrated and so, yes, there should be a requirement in the code that if it's going to cover those sectors that might - you could be excluded from those particular sections of the code if you weren't a transmission company or vice-versa.

The issue we like about the Gas Code is the propose and accept model. This is a model we would like to see on electricity also because gas has got to get an access code under the - a state-based access code. The others have state-based undertakings. Electricity doesn't have any sort of appeal processes, virtually, nationally. Gas has got a nice propose/accept code which does need to be reformed but nevertheless it has got a much greater protection for property rights, I think, than the alternative electricity model.

MR HINTON: That's a structure which applies to get commercially negotiated outcomes but the experience of the code has been put to us that there's been next to no commercially negotiated outcomes and in fact the default option - that is, the regulated outcome - seems to be the dominant end result and that we need to get back

to a code that is more conducive to commercially negotiated outcomes. You would share that perspective?

MR TOWNS: I would. I think that commercially based outcomes are much better because they link price service offerings to the benefit of both parties. I think those sorts of outcomes are to be preferred, rather than replying on regulated price setting, which involves also a gaining aspect to it - that it's always better to go to the regulator because you will almost certainly be assured of a lower price.

MR HINTON: So how can the code be changed to shift the balance back to commercially-negotiated outcomes as opposed to the default option of a regulated outcome, Geoff? Any creative ideas?

MR TOWNS: It seems to me a workably competitive market is one which encourages commercially-based outcomes.

DR FOLIE: Obviously one of your models is to switch to a price-monitoring model.

MR TOWNS: Yes.

DR FOLIE: Perhaps to elaborate a bit on your views about the operability, price monitoring could actually lead to a far more detailed amount of information being given to regulators. If you talk with them they feel they need a lot of information. They've got to be able to monitor effectively - - -

MR TOWNS: It would be hard to believe. Hard to believe.

DR FOLIE: The other point is that price monitoring, particularly if you have got - how then in a system, if you had a complaint effectively from a dissatisfied consumer who felt that - possibly to do with capacity rationing or something like this - a particular pricing policy was implemented and he felt that he had paid too much for that particular service, et cetera, et cetera, how do you envisage price monitoring? It sounds good but, when you start to implement it, you see a few snags. Could you elaborate a bit?

MR TOWNS: I suggest we just adopt the model that has been adopted in airports, and that seems to be a well thought out design model that protects all the parties adequately. I mean, you've got to look at the other criteria that are a most cost-effective solution to managing monopoly prices. Distributors in Victoria have been through two price reviews - cost-of-service price reviews - so costs have to be efficient, particularly with an incentive mechanism in there. We have got independent retailers sitting there that - if we increased our prices, it squeezes the retailers' margin, so they would be the first port to complain.

MR HINTON: But if I understand your preferred course, this price-monitoring regime is only to be applied in a segment of activity; that is, that have particular characteristics, including they would not apply - would apply if there was difficulty in exercising market power, so if I understand your recommendation 4 correctly in your written submission, it's not saying price monitoring should be the sole regulatory regime. You're saying that should be the regulatory regime for that segment and it would have an additional regulatory regime for another segment that in fact did have substantive opportunity to exercise market power. Is that the correct interpretation?

MR TOWNS: Yes, that would be more in keeping with the recommendation. Certainly if you are a new pipeline that hasn't been through a cost-of-service review before then you probably should go through that sort of cost-of-service review because you would never be sure that your costs would be efficient otherwise, but after they have been efficient and, if you haven't got a problem with access, then you could go to a different system of pricing because your ability to refuse access to exert market power is significantly constrained.

MR HINTON: How about the other extreme - almost the prior case to those two - and, that is, greenfields, where it's felt that regulatory risk could in fact truncate profits - blue sky profits inappropriately, given the risk that's inherent in setting up greenfields. Is that another part of your sort of staged - - -

MR TOWNS: We're an urban distributor and - - -

MR HINTON: I realise that it's not really pertinent to your actual activities in this, but you're - - -

MR TOWNS: From our experience in Tasmania, I can't see any reason why you would bother regulating greenfield pipelines because, to build a business, you've got to compete with wood and electricity and get your products to market. Maybe 15-20 years out - once you have been successful as - the marketing - you should think about regulation then, but certainly not for a long period of time.

MR HINTON: It may be an over-simplification: you've got sort of three tranches to your model. You have got the access holiday regime for greenfields and then you've got price perhaps intervention by the regulator for a new pipeline that's been operating and then you've got one that is operated - thirdly - one operating in a market that has got competition, constrained power to exercise market power that should be subject to price monitoring only.

MR TOWNS: Yes.

MR HINTON: Maybe that's an over-simplification.

MR TOWNS: No. That's broadly correct, yes. It's a model based on ability to exert market power in all those cases.

MR HINTON: Market power being the crucial criterion by which you are determining the degree of intervention?

MR TOWNS: Yes.

MR HINTON: Thank you for that.

DR FOLIE: Is the code - interest in the interface between where the pipeline ends and the distribution system takes over and where you end up then with final customers - there can always be interface issues in any operating commercial environment there? Is the code actually imposing more problems there or is it effectively neutral, as much as it - - -

MR TOWNS: It's probably more neutral, I think. In addition to the code there is a whole lot of state-based regulatory instruments which pertain to interconnection and use of service and even information-gathering power. Whilst the code is supposed to be the predominant piece of legislation about the gas industry, I think the states' regulator has ignored that, at best - produced a whole lot of other instruments that - some conflict, some enhance, some deal with retailer connections, some deal with transmission connections, and so the regulatory system is not just the Gas Code. It's other state baggage, which is more advanced in some states than others.

DR FOLIE: It's a bit outside the scope of our hearing but, for all those additional regulations to get to the code, is that actually significantly impeding or are they reasonably workable, being in the bounds of reality, idealism?

MR TOWNS: I suppose there are vast numbers of these codes and it provides a significant gaming opportunity to people. We've had one case where you come along as a new retailer and you say to the regulator, "We want to enter the market but, gee, we can't afford the bank guarantee like those other distributors (indistinct) therefore we want a lower entry price," so the regulator does a review and discussion paper and, six months, seven months, later, the new retailers get a Dun and Bradstreet tick instead of a bank guarantee, so you have a perverse outcome, where the most risky party gets the lower entry price, which is - or gaming - one generator got it; shouldn't have deep pockets; in fact the generator requires the bank guarantee from all its retailers under the national code. It's not good enough for the Victorian system though when you can get a lower price from the regulator.

MR HINTON: Can we move on to information gathering? It is perhaps an

over-simplification again, but a number of regulators would express the view that they need more information than they're getting, so that the robustness of their judgments can be improved by the best possible database by which they can then seek to make judgments under the code under the Gas Access Regime. The corporations would say - and companies would say - that, "Well, there is always uncertainty about the future; therefore more information doesn't necessarily remove regulatory risk or reduce uncertainty and these requests for information are spurious precision and somewhat resource demanding and time consuming." Do you have a perception on your experiences regarding that sort of tension or pressure in views?

MR TOWNS: The Gas Code was originally based on an access arrangement period when prices were set and terms were set and certain information had to be provided as part of that - and then there was nothing in between. In Victoria we have a licence condition to provide anything to the regulator that he asks for in the form that he asks for it, so effectively the Gas Code information gathering requirements are overrun by (indistinct) the regulators ultimate power to gather any information at any time of any sort.

MR HINTON: So what is driving that? Is it the nature of the code in terms of the items the regulator feels obliged or required to look at, or is it - - -

MR TOWNS: I think it's the building-block model, which needs - the regulator needs to know more and more and more and more things because he's never quite sure he has got all the information necessary to make a judgment about - and we've got pages and pages and pages of codes and guidelines, and this is all this intrusive regulation which just seems to keep on growing - and it's growing in other states, too. You see states now adopting all the Victorian models and New South Wales model for guidelines for codes and other activities, and the regulators have all sought more information-gathering powers, even under the Gas Code - for a new clause to be put in the Gas Code - but that has been opposed by the industry. I don't think most states have that licensing condition that's in Victoria though - the provision of information.

DR FOLIE: Just to follow up on that. In other words, these other regulatory situations can be used to actually invoke the information-gathering power?

MR TOWNS: Yes.

DR FOLIE: In other words, it may be light in the code but because in each state they have got other - through the licensing arrangements and other things they can use that power to then require you to give any information, which they could then use in a code determination.

MR TOWNS: That's right.

MR HINTON: Geoff, let's move on to NGPAC, the advisory body. Has Alinta been involved in that as an industry participant?

MR TOWNS: Not directly. We have been notified by the Australian Gas Association - we get involved in some of their code change proposals and get to comment on them via the AGA, but we've not been involved directly.

MR HINTON: Right. I see that your submission does refer to your involvement in the AGA's forthcoming submission to us and that you endorse that submission, as well, which has quite detailed views on a whole range of aspects of the operations of the code. I understand that linkage - but are you in a position to give any comment on the operation of NGPAC from your coalface experience?

MR TOWNS: I think the representation on NGPAC is the problem in terms of - you have regulators there; you have governments there; you have industry there, and that model sort of doesn't lead to efficient decision-making processes, I don't think. I prefer the Parer model, where there is a clear separation of regulation of policy and it is probably better - the Parer-based model had more of an industry base to develop changes, which would then have to be ticked off by an independent policy-maker body, so probably we've got the wrong model NGPAC and it probably hasn't been used to make major changes to the codes. It has certainly been a very time-consuming process.

MR HINTON: Thank you for that. Any other matter that you think you would like to emphasise that we haven't focused on this morning and which you would like to draw to our attention now?

MR TOWNS: The only one I would like to mention is this issue with the current regulatory model, where we have to forecast five years forward and we have to forecast volumes and, as you will be aware, there is a big connection between volumes and cold weather, so we have to forecast weather five years out. Now, this has caused significant problems because, leaving regulators to forecast weather, is - I mean, even the weather department can't forecast weather five years out - and so we have this issue where, if we are - the regulator adjusts the forecast by VENCorp effective degree days - and effective degree days are a compendium of weather adjustments like temperature and sunshine hours and wind speed and a whole lot of things.

If you look at effective degree days in Melbourne, they have been declining consistently since 1994, and this has got a bit to do with the overall weather situation and a bit to do with the Melbourne heatsink effect, where it cools down slowly once it has warmed up, and so the regulator invariably gets the adjustment wrong because he always assumes that the EDD aren't declining - that they are in fact constant - and so we lost around $30 million in the last regulatory period because of the wrong

weather forecasts; in fact we forecast at a much higher rate than we actually performed because the weather figures were wrong, and so we under-recovered and, because of the structure of the regulatory regime - with a maximum price constraint - we cannot recover that amount - all of that amount - in the following regulatory period, and that significant loss really hurts investment because, the regulatory model is a package and, if you haven't got the right level of income, then you can't fund the investment if you're under bank covenants about your debt and so this is a serious problem in the gas industry for the sort of regulation we have, where we have to forecast five years out.

MR HINTON: Is this linked to a view that perhaps revenue should be the focus rather than price? Is there a link there?

MR TOWNS: The original regulatory model was a revenue cap, which really didn't protect you against weather changes, and the second regulatory period moved to a price basket, but that doesn't - because there are other side constraints about how you can move your prices, you can never accommodate the necessary movements in weather. Already the regulators assumed an EDD level of 1440 for the regulatory period and VENCorp has just changed the regulatory standard again to 1400, with a declining level over the period, so it looks like we might be in - the same problem during this access period. It's a real problem for the current regulatory regime - this issue of weather forecasting.

MR HINTON: What's the solution?

MR TOWNS: Don't have regulatory regimes which look forward in gas.

MR HINTON: How about the five-year period itself? If there is going to be regulatory sets have you got any reactions or views on the sort of five-year cycle?

MR TOWNS: I guess where price reviews can take anything up to a year, five years is probably not long enough. If they were shorter or if the price monitoring - five years would be fine.

MR HINTON: Well, Geoff, thank you very much again for your participation in this inquiry. We appreciate it. It's important to get industry perspectives and perceptions on these important issues, so thank you very much for your time.

MR TOWNS: No problem.

MR HINTON: That concludes this morning's scheduled hearings. We'll recommence this afternoon here at 1.45. Thank you very much.

(Luncheon adjournment)

MR HINTON: We have in front of the microphones Mr Alan Moran of the Institute of Public Affairs. Welcome Alan.

MR MORAN: Thank you.

MR HINTON: What I'd like to do is invite you to identify yourself, just to confirm that the microphone is working and for the purpose of the transcript - - -

MR MORAN: And that I'm the right person.

MR HINTON: Yes, indeed, and that you're the right person, and you can then if you so wish make an introductory statement to facilitate this afternoon's proceedings.

MR MORAN: Thanks. Alan Moran, director of the deregulation unit at the Institute of Public Affairs. The Institute of Public Affairs or IPA is a think-tank which promotes free market solutions, small government deregulation, et cetera. We made a major play of activity within the energy market, gas and electricity, since it was deregulated and have made a number of submissions and published a number of papers promoting privatisation, less regulation and particular facets of regulatory change over the last four or five years.

We actually aren't speaking on behalf of any particular body, although a number of bodies do support us - a number of bodies within this industry do support us, but we don't vet our submissions with them beforehand, and we don't purport to be promoting them or to be representing them in any way.

Briefly, my submission is on the table, I don't really want to read through or go through it; just spend about three or four minutes going through some of the highlights as I see it, and those are basically that until the mid 90s we had a monopolistic system of gas transportation, it relied very much on government imprimatur. Since then the Gas Access Regime has been very successful in eliminating monopoly profits and monopoly privileges and opening the way to greater competition and bringing a far greater accent by pipeline businesses on cost savings, and it has also brought gains to users by forcing down prices.

However, in our view the regulations as they stand are highly intrusive and operationally tend to be biased in favour of price reductions, even perhaps when price reductions aren't justified in terms of productivity and underlying costs. Moreover, the present regulatory leadership in the ACCC and the NCC in our view finds it very difficult to relinquish regulatory oversight, and they've sought continued regulatory control where, in our view, competition has made it unnecessary. The ACCC has even developed a regulatory approach for greenfield pipelines which are not yet developed and which, by definition, enjoy no monopoly and have no government favour.

In our view the regulatory stringency does reduce incentives to build new pipelines. Enterprises are concerned that government regulatory institutions are likely to be motivated by populism and will in any event require very intrusive and very invasive oversight, and this has to some degree led businesses to tailoring their development activities specifically to avoid controls, and in doing so they have incurred wasteful costs.

But on balance it would be our view that the regime has been relatively successful. It hasn't actually led to an upward trend in gas usage as far as we can see, and the gains that it has made have been accompanied by some constrictions on decision-taking and quite a lift in the paper burden costs. We have identified 460 officials around the nation in gas and electricity economic regulation - that's excluding greenhouse and safety, et cetera, and we are in the process of trying to assemble the numbers involved within companies themselves.

In terms of the price reductions, one of the focuses from the regulation has been in a sense translating the gains which have been made through corporatisation and privatisation into gains to the users, and that's been quite successful, with 15 and 20 per cent reductions in prices across the board. But these are kind of one-off gains. I think to rely on those gains in the future we do need to see increased efficiencies based on market processes.

It is therefore, I think, in our view time to move on from the existing gas regime. Just to give a little bit of flesh on the issues where we can see the suboptimal efficiency, I go into some detail on the SEA Gas case within the paper, which is clearly a case where the companies felt the need to try to arrange their affairs in such a way that they could be kept out of the regulatory control and indeed, when a third company TXU tried to join, they were reluctant to do so and eventually did do so, but there is clear evidence - which I don't think any party would deny - that the costs involved in that pipeline were far higher than they might have been had the companies been free to build a pipeline and to operate it as they wished.

One of the things that we focus on heavily in the submission is the role of gas and electricity, the interaction of the two. Gas is very important, I think, as a peak generator in the future. Peak generation is where we're fairly short given the airconditioning trends in the country, and we need to ensure that that source of fuel is readily available. There are some impediments with the existing regulations. There's a major impediment in our view in the Victorian market carriage system, this unique system we have whereby VENCorp really runs the company, and in doing so is not able to sign contracts with counterparties to actually assure the supply of gas, and indeed we need to not only get rid of that and bring it back into the more conventional contract carriage which operates, as far as I know, everywhere else in the world, but also to think in terms of bringing the gas and electricity into line.

Two matters we raise in particular is that there's a different price cap for them both, and that gas is on a revenue-capping basis of regulation, which really harks back to the days when we essentially wanted to prevent firms from selling too much energy because there was an energy shortage or a greenhouse problem or whatever it was; but it certainly doesn't seem to be the best way to go ahead.

In terms of the future, we can see that development of the gas market is leading to increased competition of gas on gas. We can see that already taking place in Sydney with the Duke pipeline, and we can see it about to take place in Adelaide. The gas on gas means that we've got rival pipelines, we've got rival fields. It's not perfectly atomistic competition, miles away from it, but it certainly is competition and it's time, I think, that we can actually have the regulations step back, where we do have more than one source - step back from actually determining the price and specifying the price, because what the experience of that is so far is that they will tend to actually find some economists or accountants or whatever to prove that the price is too high, and try and drive it lower, and driving it lower, that means a deterrence then to new pipelines.

So I think there are three things which we stressed in the paper where we ought to move on. One is to get rid of the regulatory oversight for greenfield pipelines, and the Commission has made some very sound recommendations in its Part 3 report on this, which I think the regulatory holiday, in whatever form it progresses, ought to be examined, ought to be a major feature of this review. Secondly, require the regulators to exit control where competition is actually in place, even if there's only two sources of supply. Thirdly, and this really refers more to, I guess, the Victorian system, which is still a monopoly system or a single supplier, and perhaps Western Australia - that the regulations of these dominant pipelines ought to revert to what it originally was intended, the CPI minus X, or reference light-handed regulation, rather than the building block.

Finally, there's a couple of points I think which the Commission seeks advice on, which I guess we haven't focused on. One is the objects proposal. We certainly think it's worthwhile trying to improve this, and emphasising the need for workable competition rather than perfect competition. But we haven't focused on it because in a sense our own view of enterprising regulators - and we don't really have any shortage of those in Australia - is that they will work their words around in such a way which will justify them, and I think with the changes the courts appear to have brought in place as a result of the Western Australian Dampier pipeline, I don't think it made any difference in fact to what the ACCC decided in later cases, for example in Moomba to Adelaide. So, yes, I think it's probably a good idea to try and get some better advice, better specificity in the regulations there, but I don't think that's the first order of issue, and I wouldn't be surprised if it had little effect in the end.

MR HINTON: Thanks very much, Alan, for those introductory remarks and also, as you referred to your submission, thank you very much for your submission, and thank you for IPA's involvement in this inquiry more generally. To focus the discussion in the available time, I'd like to pick up in the first instance those three areas of reform that you have covered in your submission, but also have referred to in your introductory statement. I'll take them each in turn. Let's take the greenfields issue first of all.

You've put forward the view that regulatory oversight of greenfields, the regulator should exit from that category, and you in that context referred to Commissions' references to the possibility and others' references to the possibility of regulatory holidays, access holidays. I'd welcome your comments on a slightly different variation on that; that is, a regulator being involved in greenfields but being specifically required to take account of intervention that doesn't truncate blue-sky returns, that is, have a different rate of return approach to, say, a greenfields operation relative to, say, a pricing regimen for something that's already in existence. Would that sort of rate of return approach, that would be cognisant of the market imperatives - commercial imperatives - be a valid option for intervention here, or do you think that the access holiday period is the way to go?

MR MORAN: I'd certainly prefer the access holiday way to go. It does seem to me that there could be a case for saying, okay, let's have a blue-sky, let's have a better rate of return for something which is by definition risky, because nobody has built it so far. I mean, it seems to me that would be a second-best solution. It would still leave the provider basically under clear obligations to furnish the regulator with a lot of information; it would leave a lot of uncertainty on the provider's part; it would create the same sort of invasiveness that's there at the present time.. It would be very much a second-best solution.

I think one of the things, and one of the attractions I saw of the regulatory holiday, is that as you go through the centuries on these issues there has always been a situation where somebody has developed a natural monopoly, whether it was a port originally or railways in the 19th century, that you've found the authorities have moved in to require it be open access in some form or another.

I think you might well find that the case at the end of the holiday, that what became what was an entrepreneurial line which served nobody, because it didn't exist, becomes an essential facility, and some provisions need to be put in place. Thinking through what those provisions are 15 or 20 years down the line needs to be done at some stage. But to actually go through a dichotomous sort of regulatory arrangement whereby you've got the monopoly existing and then you've got the new wanting, a lot of them, a higher rate, would I think be a second-best - very much a second-best solution.

MR HINTON: On your regulatory holiday option you refer to 15, 20 years. It's interesting that some around have referred to 15 and others have referred to 20. Do you have a feel for or a view on what sort of time horizon would be appropriate?

MR MORAN: Not really. It's a matter of detail, I think, really. If you do your DCF calculations, essentially in 15 years most things are paid for. I think 15 years would be adequate, but I'd be persuaded 20 years was better. That might be the case. But a long time, which gives somebody plenty of blue sky and plenty of opportunity to make money, but of course having no protection against anybody who wants to come in parallel or from a different area.

MR HINTON: Yes. So the threat of market entry would provide some constraint on the misuse of market power.

MR MORAN: Not only the threat of market entry, but the actual fact that nothing is in a vacuum. You know, life went on before the new pipeline was developed. People were using whatever they were using, electricity and things, so it's not actually a licence to just do what you want, because you've got people in there who were living there already and were actually accessing some form of power and can continue to do so.

MR HINTON: Your second reform suggestion relates to circumstances where competition is in place, and you're seeking to have the regulator once again exit from that category of activity. That seems to be a very black and white switch on and off approach. That is, competition comes in varying degrees of presence. Can you sort of elaborate on that sort of very black and white approach to this area of intervention?

MR MORAN: Yes, that's a good point. I think what I had in mind was a major competition and not - if there was some very minor pipeline offering - I had in mind the Adelaide situation and the Sydney situation where you do have major competition and, indeed, as the Duke pipeline was being built you saw the Moomba-Sydney prices being reduced quite markedly in response to the competition there. So I mean I think it would be quite useful for this inquiry to sort of develop criteria about what major competition was. Any sort of competition has an effect, but obviously, like, 2 per cent of the market would be quite trivial and wouldn't have any real effect. 10 per cent would probably not be enough either, but basically if you've got a major player coming in with about, you know, 25 per cent additional capacity or more, then I think that has a major effect - where there is surplus capacity - a major effect in ensuring prices are more competitive.

MR HINTON: So you're really referring here to a criterion associated with significant market power.

MR MORAN: Yes, it's not simply a very small line. It would have to be a significant line, I think, before you would decide that you were going to exit the area, otherwise of course then you fall back on that third approach that - - -

MR HINTON: You're anticipating my question.

MR MORAN: I think that third approach is basically saying that there is a lot of controversy over what the regulators have done and it's not an easy job to actually decide what the price should be. There is a lot of people with a lot more information than them in the companies themselves, who quite legitimately are trying to persuade them that they are in a hard-luck situation. By and large, looking at the outcomes in terms of stock exchange levels and other values, I don't think they have done that bad a job, but that was that first cut and certainly they were run by public servants in the past. You know, they are always likely to be about 20 per cent overstaffed, except of course the PC is 20 per cent overstaffed, and that has an effect in running the - the ability to cut prices without harming the companies.

That's basically what has been done with the building-block approach, which was not, I don't think, what the governments had in mind, but nonetheless is being implemented. But you can't carry on doing that. You can't carry on cutting like that. You've got to go back to the sort of reference price model, the CPI minus X, for the future. Like, you've got to let life go on. You've got to allow the companies to make productivity gains without whipping them off and cutting them to the bone all the time. So I think in that case, where you have the pipelines that are genuine, that remain monopolistic, I don't think you can again subject them to a regime of very, very marked price cutting.

MR HINTON: In your formulation you've got, in effect, a decision about market power not being significant, such that they are not covered, they are outside the focus of the regulator. Then you've got those cases where there is a degree of market power that warrants coming under the focus of the regulator and you're saying lighter-handed intervention would be appropriate. It has been put to us that there is this possibility that in between those two categories there may be a case for having even lighter-handed intervention than your formulation, such as price monitoring only, a surveillance type of function that does occur in fact like declaration under the Prices Surveillance Act. That sort of lighter-handed non-approval process, just a monitoring surveillance of behavioural activity within that market to test, in effect, the judgment of whether or not there is being a misuse of market power. Do you think that particular option fits into your ideas, or do you think that's not worth the candle?

MR MORAN: I think it could well do. I mean, the surveillance is automatic with the control, so you're going to be looking at how the price is moving. I don't think there is anything wrong with a body doing that all the time, but surveillance of itself

always does imply a mailed fist behind it somewhere I think, otherwise you wouldn't undertake the surveillance, unless perhaps just publicising things had an effect in limiting potential price gouging, which I don't think it does. But there might well be roles - you know, it would be interesting to develop the idea of the dichotomy I've got there and to say, "Okay, well, something in between. Maybe we do surveillance there and we don't do anything unless the prices have risen by a level which looks like it is exorbitant."

In other words, where you have an area which might have 85 per cent of the gas supplied by one supplier, one pipeline, you might use a CPI minus X, but on a more casual basis than the really strict way. So I wouldn't rule that out, but to me the main task is to try to get the regulators out of it and let competition, let markets, do the job of making sure you've got good productivity and we've got fair prices, whatever fair prices are. I don't think you can do that where one firm has got 100 per cent of the market.

MR HINTON: I had in mind that another way of looking at it is that the threat of regulatory intervention in itself could be a constraint on misuse of market power, and I was wondering whether or not you would have a view on whether or not that has an efficacy to it or - - -

MR MORAN: I think, one other thing, the interesting area where that seemed to apply was in New Zealand, at least until recently, but they appear to be moving much more to our system. Actually the outcome in New Zealand, as I read it, was that for one reason or another the market power wasn't abused. I don't know. It may have been the threat issue, but the prices bubbled along at some underlying rate of productivity and price levels, even though the suppliers of electricity and gas, electricity mainly, did have monopolies into particular towns and didn't have anything formal preventing them from raising the prices very steeply, but don't seem to have done so. The New Zealand government has recently taken the view that they can't rely on that, that they would have to put something more formal in.

But that is not to say that, you know, you could - there are ways of handling the CPI minus X reference model without it being deterministic. You have it being observed and not intervening unless you feel that the price has gone up far out of the line of any market forces. I mean there are ways around that, but to me the underlying thing is either it's one thing or the other. In having the regulation there are ways of tailoring it to allow some more flexibility than simply the sort of building block, deterministic approach that we've had here for the last five or six years.

DR FOLIE: One of the points you make in the paper is about actually gas and electricity, with these markets certainly converging more. From reading the paper it would appear that although we hear that the 1000 pages of the code for electricity is awful, and we don't want to go near that, it does appear, in some elements, that the

electricity market may be more flexible in pricing and rationing, whereas the gas market is not. Would you like to sort of elaborate on the deficiencies between the gas price-setting issues versus the more flexibility one perceives in electricity, particularly for the peaks?

MR MORAN: Yes, well, I think that the way the gas market is being run here is that after $10 a gigajoule basically, they intervene in there, whereas they would go, in the electricity market, to 10,000, which probably about $1000 a gigajoule roughly is the equivalent. So there are issues there that there is greater flexibility for handling the peak in the electricity market by its rules than is present in the gas market. We really ought to move to something like that, which would then encourage firms to invest in storage and perhaps demand reduction measures or faster - or an ability to switch themselves off pretty rapidly, all of which would add to the flexibility of the gas market and make it mesh better with electricity. That's the main area, I think, where the two markets haven't been - that's the difference between the two markets there in terms of the vol price.

DR FOLIE: Do you view that as being impeded by the code or by the regulator sort of stretching his arms?

MR MORAN: I don't know that it is actually impeded by the code. I think the code could be amended quite easily to allow that in, and it would obviously need a bedding-down period, an announcement and things. I think that we could then get it. There is an issue that there is a less immediate need for this in gas, insofar as there is automatic storage anyway in the pipeline and there isn't with electricity, but one of the matters that we draw attention to particularly is this issue of the gas using electricity generators, which can suck a great deal out of the gas in a few hours out of the pipelines. We have seen at least one occurrence where they have been ordered off as a result of that, which is not desirable if you are building a gas peak to take advantage of extreme circumstances that at the very time you want to use it you aren't permitted to, and it devalues your investment quite markedly.

So there is a few things that can be done in terms of greater flexibility in the pricing mechanisms. VENCorp actually is examining some things there, which will improve the operations of the market, but it still seems to me that VENCorp, in the Victorian situation, is automatically fatally flawed. It's a government body really operating somebody else's assets. They don't have the same incentives to look for ways of costs savings and trying to do deals, and nobody can actually sign an agreement with them, a long-term agreement, because they don't have equity.

DR FOLIE: Just following on that if I could, because it has come up a few times. In other words, if you want a bit more national uniformity you've got to have a common carriage system and this clearly wasn't possible with the code, and especially recognises the market carriage you would need to Victoria. What do you

see, if you like, are the impediments towards going to a national model?

MR MORAN: I don't think there are - I think there are legislative impediments - - -

DR FOLIE: Yes, there are a lot of them.

MR MORAN: A lot of those, but I don't think there is very much. I mean, you would have to make the de facto usage - give them some rights along with that de facto usage, like how it is to be traded, et cetera. But aside from that I don't really think that there are a great many impediments to it, other than the governmental legalistic one.

MR HINTON: I would like to come on to another item you raise in your submission, Alan, and it's to do with competitive tendering. Certainly, prima facie, many would argue that a tender process is certainly a market mechanism. It's market operating presumably on the basis that the parameters of any tender are properly established. But your submission concludes that a competitive tendering system is a flawed approach in practice and it is always likely to be so. Could you sort of elaborate on your thinking behind that sort of conclusion?

MR MORAN: Yes, it's more like the issue of, say, in the mining industry. You know, you could sort of say, "Well, if you've got a highly prospective area for oil, for example, you could put it out to tender and give it to somebody who is paying the highest price." But there are very few areas like that. It's essentially that an entrepreneur in the oil industry, and even more so in the gas pipeline business, spots an opportunity which hasn't been seen before. So if you actually then say, "Okay, he has spotted an opportunity. We are going to put this out to tender now," it's less than certain you would get any alternative bids, but if you did it would basically mean that the other bidder was coming in basically using the information that the initial firm had developed in spotting the opportunity, then coming in and therefore not incurring some costs, which the other one had incurred.

So I think that that element of the competitive tender is always likely to be flawed, that either you're going to reward the Johnny-come-lately, who doesn't need to put out the same sorts of expenditure to discover the market opportunity, or more than likely that you won't get any bidders. Actually I think that was probably the case in the Tasmanian retail area, where there weren't any bidders in the end. The only one that would have gone for it - I'm not quite sure what the developments have been - was Duke and the government said, "No, you've got to light everybody up or nobody," so nobody is lit.

MR HINTON: Is there anything we've not covered that you think you would like to give an emphasis to?

MR MORAN: No, I think I would commend you actually for a very fine paper basically, outlining I think all the issues, it has done it very well. I think, having read some of the submissions, quite a lot of them do a great deal of justice to it. No, I don't have any further issues to raise than those I've raised there. Thank you for the hearing.

MR HINTON: Thank you again for appearing today, and for your submission, and look forward to further contact down the track. Thanks very much.

MR MORAN: Thank you.

MR HINTON: We will take a one minute - don't move from your seat - break.

MR HINTON: For the next session of this public hearing this afternoon in Melbourne I invite Mr Graham Holdaway of KPMG to come to the microphone. Thank you, Graham. I'd like, as for others, to check the system is working and for the sake of the transcript, you to identify yourself and where you are from and I invite you also to make an introductory statement to facilitate proceedings this afternoon. Thank you very much, Graham.

MR HOLDAWAY: Graham Holdaway. I'm a partner with KPMG. I'm responsible for a group of about 25 people who spend most of their time on public policy and regulation in one form or another and a fair part of that in the electricity and gas industries. I work with quite a number of other colleagues who brush up against the Gas Access Regime in various ways as part of their work in corporate finance or transaction services or the other things that we, as a firm, get up to.

I'd like to thank you very much for the opportunity to present to the Commission on this review. Presenting to inquiries like this is not something that my firm does as a matter of course but on this occasion there are some special circumstances that led us to want to add our perspective. Those special circumstances relate to the degree of interaction that we've had with the National Gas Code over the last five years.

In the mid-1990s KPMG was an adviser to the Kennett government on the reform and privatisation of the electricity and then the natural gas industry. As part of the gas reform process we played a role in developing and submitting the first four access arrangements under the then brand new National Gas Code. We've continued to have an interest in energy policy and access regulation and have worked for most Australian governments, regulators and energy network businesses over the last five years.

Our work tends to be at the practical end of energy policy and access regulation and its insight drawn from that practical experience that we wish to contribute. What we have put into our submission and what I'm able to talk about today is necessarily general in nature rather than specific to particular pipelines and investors. This is due, as I'd hope you understand, to our normal obligations as to client confidentiality. Our practical experience suggests to us that the Gas Access Regime is, in most cases, not working effectively in the interests of service providers, users and potential users.

For us this is essentially a pragmatic judgment that might derive from answers to a number of fairly simple outcome-oriented questions: are things that really matter to customers prominent in the major regulatory debates; is government engaged in the issues that the market won't resolve on its own; are the big deals in energy infrastructure getting a good run on roughly their commercial merits; is what we would term "consequential investment" pretty much happening as a matter of course; are good competent companies doing relatively well and are less than

competent companies being confronted with consequences related in some way to their errors?

We don't think you could actually give a decisive yes to any of those questions in relation to the natural gas network industry in 2003. There are of course a variety of reasons for any particular outcome but our view is that the primary problem with the Gas Access Regime is its regulatory implementation. We think that's also reasonably well established. Your Commission's review of the national access regime recognised that it is an issue as did the government's response to that review. The Parer review also focused on regulation and, finally, there was the judgment of the Western Australian Supreme Court in its Epic decision.

We've described in our submission what we refer to as the current regulatory paradigm which we would say is at the core of the problem. Some might describe our characterisation of it on page 6 of our submission as extreme or in some way slanted to our client's interest but I'd resist that suggestion very strongly. When we work for network-owning companies we have an obligation to advise on the world as it is rather than on how we think it ought to be. The characterisation of the current regulatory paradigm that we provided works at the practical level in that it helped us to reasonably accurately predict what regulators will do and how they will respond to particular proposals.

Businesses, particularly ones responsible to shareholders, have no choice really but to respond to the incentives that are put in front of them, and they have. We just don't think those incentives have been particularly well aligned with the public interest. What we have to recognise, however, is that the regulatory community, in particular the ACCC and the ESC in Victoria, seem to have considerable confidence in the current regulatory paradigm. You only have to read Ed Willett's recent speech on new investment in the national energy market to understand that they think they're on the right track and presumably the criticisms of the Commission, the Parer review and the Epic decision were really peripheral rather than as we would see them as being fundamental.

We think that means that this review needs to be quite strategic in the changes it proposes to the Gas Access Regime. It seems clear to us that the Australian regulatory community is determined to read the current National Gas Code in a particular way and, even the Epic decision's quite specific guidance as to the responsibility to balance interests and to use benchmarks drawn from real-world markets, is not going to change things very much. Therefore it seems to us that it's essential that the Gas Code be changed essentially to make the underlying message of the Epic decision stick.

Again from a practical point of view, we don't recommend changes lightly. Any changes are inherently disruptive in a market where paybacks happen over

many decades. What we have suggested therefore is a couple of reasonably subtle but very important changes in the framework and they are, firstly, explicitly requiring that in exercising regulatory judgment, the regulator must adopt benchmarks and standards drawn from real-world markets and must not use standards and benchmarks drawn from theory of perfect competition; and, secondly, to explicitly require that in balancing interests, the regulator must give primacy to the public interest in timely investment in natural gas network infrastructure. Then, in order to make such changes effective, we would recommend that there be a clear right to a merits review challenge.

In our submission we set out supporting argument on these two issues. While we have said that our interest is fundamentally a practical one, we think the economic arguments also support the case if you care to go beyond simple neoclassical economics. In concluding, I'd just like to reiterate that our interest and our experience is essentially that of practitioners trying to operate within the Gas Access Regime. We haven't come here representing the service providers who are often our clients or for that matter governments who are also often our clients.

In some ways our experience over the last five years gives us an investment of our own in the current code and in the current regulatory paradigm. If we didn't think that the way the Gas Access Regime is operating was quite so comprehensibly contrary to the public interest we should probably be here supporting it as a positive contribution to the consulting industry. Thank you once again for the opportunity to contribute. Clearly your task is a very important one.

MR HINTON: Graham, thank you very much for those comments and also thank you very much for your written submission and I particularly note that appreciation in the context of your comment that, as a matter of course, KPMG do not usually front these sorts of hearings. So it's thank you and I have also taken note of the factors at work that have led KPMG to be involved in our inquiry.

My first question picks up your reference - it's on page 10 of your submission, though you did allude to it in your introductory remarks - about workable effective competition as opposed to, well, concepts associated with what you perceive to be as perfect competition. Is it possible you can give us some flesh to that expression "workable competition"? What is workable competition? What sort of forces are at work that occur with regard to workable as opposed to perfect?

MR HOLDAWAY: I have colleagues who assure me that there were many papers written on this in the US in the 1970s and that it had its period of popularity within the economic literature and regulation there. I suppose from where I come from I would go back and say not define it in those terms because that's just getting again into the problems that we have currently that it's an endless debate about arcane economics instead of being an essentially practical judgment about things that are of

value to consumers and businesses. So to me workable competition takes you back to saying what are the outcomes?

If you want to go to some practical examples of that that don't go into things that I know are in the public record, a good example is when the DBNGP was sold. I think the price of transporting a gigajoule of gas was somewhere north of $1.20 and the government went through a negotiation process and it talked to different bidders about what it thought was a good result going forward and Epic believed it had understandings as to a dollar and $1.08 - a dollar at Perth and $1.08 at Kwinana Junction.

Now, that seemed like a pretty good deal at the time and I think it was open to a regulator to look at what was put to them in terms of what seemed like a pretty good deal and move forward from there rather than go back and say, "No, we've got to start at the bottom. What's the DORC? What's the rate of return? What's the - oh, that's not a dollar and $1.08," because behind that dollar and $1.08 was not only a rate of return, there were a whole load of expectations as to the level of demand there was going to be, as to whether Kingstream would go ahead or not. There were a whole variety of things behind that and regulatory second-guessing several years later has its practical effect and that practical effect is not positive for investment.

MR HINTON: Well, let me explore with you in more detail then the conclusion that KPMG thinks that the code is not working effectively and you've touched on perfect competition versus working competition, which we've already discussed, but what I'd like to explore more with you is whether or not it's the shape of the code, the content of the code or is it how the regulators interpret the code - - -

MR HOLDAWAY: It's how the regulators interpret the code.

MR HINTON: Can you sort of disentangle those sorts of forces?

MR HOLDAWAY: I guess I was around the edges of the code being put together and some of my colleagues were more closely involved in, for instance, putting into the code the references to market carriage, putting into the code things that, I guess from our perspective, we thought were going to lead to regulators behaving in a certain way. They didn't and it took us and investors a while to just work out exactly how they were going to approach the discharge of their responsibilities. So there's no question the people who were involved, or at least a significant number of the people who were involved, thought that the code could be interpreted in a way that would work, but it hasn't.

Another example that I referred to briefly and, without going into sort of too much of the ins and outs of it, we were actually involved in that Tasmanian tender, heavily involved. Now, that was a situation in which I can assure you we were very

interested in getting a deal done. So was our client, the Tasmanian government, so was in fact the regulator. We couldn't really - either ourselves or the government couldn't really point and say Andrew Reeves frustrated the process. There were certain things that happened because Andrew looked at the precedents and said, "I've got to give consideration to this," and there's a requirement in the code that says, "A tender shall be decided principally on the basis of price."

For example it took a while to convince some people that were advising Andrew that "principal" in fact didn't mean exclusively, so the first thing was, "This must be exclusive." Principal - you know, somewhere way over there is the possible - - -

MR HINTON: It's what you're buying, isn't it?

MR HOLDAWAY: I would have said price - if you're a punter in Tasmania, surely the reality of getting gas is far more important than the last 10 or 15 or even - on the price. It's almost irrelevant, and many of those tenders, I think, would work far better if the people who were putting it up were able to define the price and say, "Bid me the support that you require in order to be the proponent," but again when you talk to regulators they will go back to that section of the code. I can look at those sections of the code and imagine how we might be able to do it, but not within the current paradigm.

MR HINTON: Let me be a devil's advocate here in terms of defending the good name of regulators. If that's what the law, guidelines, rules say - that they should be looking at those factors - I am not talking tenders here. I'm now talking code - they're almost obliged, in doing their jobs, to look at those factors, those parameters, those indicators; therefore it's not a discretion to whether or not they look at a particular activity indicator. It therefore follows that if that is leading to bad regulation in terms of outcome it would, prima facie, lead you to conclude the code needs to be changed, not say, "Regulator, turn a blind eye", and that was behind my question about disentangling the effects of regulator culture versus the Gas Access Regime.

MR HOLDAWAY: Yes. I agree with you. I guess what I wouldn't be keen to see out of this review is the problem of implementation not addressed and acknowledged and said that the changes in the code have to lead to the right outcomes, and the changes in the code need to be specific enough to lead to those outcomes, and many of the other submissions made have pointed to exactly the sorts of things that need to happen, in our view.

MR HINTON: Okay, so you're not - - -

MR HOLDAWAY: I'm not saying, "Leave the code as it is." Absolutely not.

MR HINTON: Exactly. Thank you for that.

MR HOLDAWAY: Absolutely, because then you would be relying on sort of persuading them. Forget it.

DR FOLIE: It's sort of associated with that that - a very strong plea for a merit review. The general judicial experience, just in general, is that judges now spend their time writing their judgments very, very carefully, about actually making sure they don't get knocked-off on appeal. Similarly here, the merits review - which means you open the whole thing up all over again - is that not likely to make the regulator even more protracted, to seek more information, to make sure then that the - almost certainly every judgment that comes up, there is a high probability he will get a merit review on it, so he starts it all over again. Do you really think this is the way to go?

MR HOLDAWAY: I was not by any means a primary author, but I was around the edges of that debate the last time, and the thought was that regulators ought to be given that broad discretion so that, providing they're applying the right sort of judgments - no, you don't want to encourage businesses to sort of be setting up that process or what you lead to, but you then have a pretty significant problem with regulatory accountability.

I've been banging on about these same issues for the best part of four or five years now and it has taken that amount of time for it to seep up through to a point where it's being talked out - that public inquiries may lead to changes in the code - so I think regulatory accountability is an issue and perhaps - I've changed my mind versus last time - to say that you need that merits review there, but again - if somebody puts themselves back in a situation of saying, "Well, I'm considering something put by a service provider and I have to determine whether it's in a range and, if it's within a range, I'm going to give it a tick," rather than saying, "I'm going to take the information provided by the service provider in their access arrangement and I am then going to determine the one perfect answer myself," then if somebody is saying, "Yes. As a whole this is reasonable" or not, then maybe - you've got to anticipate that the first thing they do is reject it and then they can't negotiate to something that they can approve, but again if it's something that fits within a range that is consistent with the real world - if you want to move away from workable competition then I think you are much less likely - - -

MR HINTON: Let's move on to - I think it's your second area of ideas and suggestions, second to the real markets having been the benchmarks, you then referred to the focus being in the public interest of ensuring investment in infrastructure was encouraged and facilitated, and that raises questions of balancing interests. What is the objective of the code? What is the objective of the Gas Access Regime? In your written submission you say balancing interests is one heck of a task

for regulators, but if it has a focus on investment that suggests there is no need to balance interests. The outcome is quite clear. The objective clause can be written fairly singularly. Is that an over-statement of what you are saying?

MR HOLDAWAY: Yes, because I suppose it picks up on a point Alan made before. I would be very keen to encourage investment but not to ultimately protect people from bad choices - bad investment choices - and so where I would say - when people put assets in the ground, allow them to make a return and to do well out of them if they run their business well and things go their way, but equally allow other people to come in and don't be paying for so-called "stranded costs" or guaranteeing in some way that people won't lose their investment, but the public interest is in someone taking a chance. The public interest is not in saying, "You've put those assets in the ground and we'll make sure you get your money back by hook or by crook," which is again where the current regulatory paradigm ends up going. They say, "Well, we'll hold your prices down but, if things don't turn out too well, we'll look after you later on." Now, that's not explicit, but you can read it in light of the way they do things.

MR HINTON: A sort of guaranteed rate of return. Is that it?

MR HOLDAWAY: Guaranteed and kept, although a regulator can't do that totally. If it's a flat-out bad idea and no-one wants to buy gas, well - - -

MR HINTON: It does raise questions of coverage. What sort of comments can you make with regard to where the government should intervene in this sector. Discussion this afternoon with you essentially is focusing on the system that should operate when the regulator has a role, but the question then is about the judgment when should they have a role?

MR HOLDAWAY: Yes, but also in relation to when. It beats me why we should have any access regulation of transmission pipelines - almost any. The one that you might say is the one that sort of comes up from the valley into Melbourne but, as stuff comes in from the north and from the west, maybe you don't even need it there, so I'm not sure why you need to regulate any transmission tariffs, and certainly because of the greenfields distribution that I've been involved in, I don't see any particular point in - you know any practical benefit in regulating those, and so you do come back to really light-handed regulation of existing distribution networks and, even then, it's hard to see what value is gained by regulating, for instance, investment in all gases networks in Queensland. I think the average throughput there is about 11 gigajoules and if you do the numbers you need an absolute minimum in the 30s to make the things pay. Now, someone has been kind enough to put them in the ground. I just don't see what benefit - they are desperately trying to get their throughput up. They have got their own incentives not to set the prices at levels that will discourage use.

MR HINTON: If I read you correctly, you are suggesting there may have been grounds or a basis for intervention for a Gas Access Regime 10 years ago but, today, you think the sectors move on, such that there are very few occasions which would warrant intervention of that kind. Is that right?

MR HOLDAWAY: Yes, relatively, but again you may in fact - I, and I guess my firm, have always taken the view anyway that in terms of essential infrastructure there are three things that matter to consumers: one is its availability; the second is that its - safety and, you know, if it's electricity, it doesn't fire your appliances and, if it's gas, it doesn't explode and things; and the third thing is that you don't want to be abused on price. It's probably in that order, and certainly the last one is that you don't want to be abused on price but, if you thought you were going to build a new house and then have someone tell you that you were going to have to wait six months for the infrastructure, or if you thought you were going to get it and it wasn't going to be safe, what is the trade-off you would make with the price? The way the regulatory paradigm has worked is that it almost assumes these things will happen in all good time and is focused on the elimination of rents, and it doesn't produce the right sort of outcome from the public interest point of view.

DR FOLIE: Following on that point - because it has come up - it would seem that it's difficult to recover any return if you actually put in additional investment to improve, if you like, system reliability - whether it be the pipeline or the other regulator, more or less says you can have nothing for that.. However ongoing we are hearing more and more constraints in the system; therefore additional capacity may be warranted. Do you have any solutions how one can move forward because, if you give a guaranteed rate of return, then you could expect the facility owners to actually over-invest because they actually prop up their returns, so you've got to balance the issue.

MR HOLDAWAY: I have just said, I think, that safety and availability are the absolutely critical issues, but again it comes back - I find it easier to relate this to electricity networks because the examples I can think of relate to the ESC and the electricity networks here. Because you have got a building-block approach it gets more and more intrusive, so you get a situation where the ESC is virtually going out at the feeder level and seeking to assure its constituency that the things are in place; it's got its eye on the ball and it knows that the feeder at the end of Smith Street in so-and-so needs upgrading and it's going to happen.

Now, that seems to me to be nuts for an economic regulator, to be that deep in it. That's an accountability that ought to be being imposed probably even by the safety regulator rather than the economic regulator. But that whole risk and responsibility ought to be with the businesses, without interference by, particularly, economic regulators.

DR FOLIE: I've another one. It's not specifically mentioned in your paper, but one of the - if you need to do light-handed regulation; and the response that regulators come back with often is, "Yes, we'd agree with that but what we need to do is have an agreed set of standard regulatory accounts. We need more information to be able to do it." With your background in an accounting sort of firm, what value do you think you'd get out of another set of accounts. Is it all that easy to produce and what value do you think they'd actually give?

MR HOLDAWAY: There's a bit of history here because I was involved with writing the first set of regulatory guidelines for the ESC, regulatory accounting guidelines. Within accounting there's a reference to sort of the American model or the European model. The European model sort of says - it is much closer to, "Accounts ought to be true and fair and you show me how they're true and fair," whereas US GAAP is sort of four-foot deep and highly specific. We provided - guideline number 3 was very much around saying that it ought to be true and fair and you ought to get somebody to say that it was true and fair. Almost inevitably, given the paradigm, where they're going is more towards the US GAAP. Now, I'd have my views as to which produces in the long run the best set of accounts and the best set of information. I don't think more information via regulatory accounts is the answer at all.

MR HINTON: Graham, is there anything you think that we haven't covered that we should have covered from your perspective that you want to emphasise?

MR HOLDAWAY: No, not at all.

MR HINTON: Good. Well, thank you again for your submission and your appearance this afternoon. We appreciate your involvement and thank you for bringing your perspective to this inquiry.

MR HOLDAWAY: Thank you.

MR HINTON: That concludes our scheduled proceedings for today. As foreshadowed in my introductory remarks at the start of proceedings this morning, I now provide an opportunity for anyone in the room to come forward and make a statement if they so wish, the only requirement being that they come to a microphone for the transcript purposes and identify who they are and who they represent, and we'll continue to provide that opportunity through the course of our proceedings ahead. But I see that no-one is willing to take up this wonderful, warm offer, so I will therefore end today's proceedings and note that we will resume tomorrow at 9.15 in the same location. Thank you very much.

AT 2.54 PM THE INQUIRY WAS ADJOURNED UNTIL
FRIDAY, 12 SEPTEMBER 2003