INDEPENDENT PRICING AND REGULATORY TRIBUNAL

PUBLIC HEARINGS REVIEW OF ACCESS ARRANGEMENT AGL GAS NETWORKS

Tribunal Members

Prof Tom Parry, Chairman
Mr James Cox

Held at Meeting Room 1, Level 2
44 Market Street, Sydney NSW 2000

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THE CHAIRMAN: We resume our hearings into AGL's proposed revised access arrangements and we have BHP this morning. Please identify yourselves for the record and we will proceed.

BHHP

MR HENSON: Bill Henson From BHP Petroleum, New South Wales Gas Marketing Manager.

MR FITZGERALD: Peter Fitzgerald, a consultant with BHP.

MR GARROD: Bill Garrod, Energy Technology and Development Manager, Energy Services; and BHP Flat Products, Port Kembla.

MR HENSON: We thank you for the opportunity to present our submission to the Tribunal this morning on AGL's access arrangement. I also thank you for the opportunity to be the first speaker on April Fool's Day.

THE CHAIRMAN: We thought it was appropriate.

MR HENSON: Well, I guess in light of having read the AGL proposed access arrangement we think this day would be better named AGL Fool's Day because in our view AGL is seeking to fool the regulator and to fool consumers by supplying incomplete, inaccurate and inadequate information. It is seeking to fool residential customers by significant price increases and to fool industrial customers by denying them fair and reasonable prices. Lastly, it is seeking to fool the fundamental objective of gas reform, or one of the objectives, the elimination of monopoly rent through a $$1 billion asset revaluation.

I would like to go through this presentation covering six topics. Firstly, to talk briefly on code objectives; then to that familiar issue of information disclosure; to spend a little time on asset revaluation; touch on operating costs; my colleague Bill Garrod will talk about the tariff structure and some of the impacts of that proposal on customers; and we will draw it to some conclusions perhaps more in the nature of some recommendations for IPART for the next steps.

We start first with the objectives of the code. I guess the preamble to the code or the introduction to the code lays out fairly clearly the objectives we are trying to achieve with the national code. Essentially they were twofold. The first objective was to prevent the abuse of monopoly power and in the most pragmatic terms

one of the key parts of that is to eliminate monopoly rents and not for them to be disguised in some other form.

The second objective is the promotion of competition, that is, the competition in upstream markets which in this case means gas production and gas transmission, and competition in downstream markets, which is gas retailing. I guess this view is obviously shaped by IPART which I guess in its determination stated that access is not just a means in itself, it is a means to an end, and the end is promotion of competition.

In the case of AGL's application, there are some very specific issues which make this issue of competition perhaps more important than it is in other applications. I guess I refer here to AGL's 51 per cent controlling interest in the Moomba-Sydney pipeline. I am sure AGL will state that in accounting terms they are deemed not to have a controlling interest in that pipeline. I guess speaking practically as somebody who has operated in the market it is our view that AGL does hold a controlling interest in that pipeline. Therefore, as a consequence of that AGL has a substantial interest in seeing any gas that comes into New South Wales utilising their infrastructure.

For example, if gas was to be discovered under the Sydney Harbour, AGL would be very determined to try to prevent it from entering their system; rather they would prefer gas flow down the Moomba-Sydney gasline. Therefore we think that, in considering this application, it is extremely important that IPART have careful regard for any elements which may impact on competition.

In our view we are very pleased to see that there is a simultaneous review of the ACT access application, the Central West application and the New South Wales application. We would prefer to see that the Moomba-Sydney pipeline review was added to that group and we would encourage there to be a lot of cross-cooperation between IPART and the ACCC both on the Moomba-Sydney pipeline and also by the ACCC in this investigation.

The other key area of competition is in the downstream market, and in the access arrangement in our view there are a number of potential barriers to downstream competition. For example, the onerous gas balancing provisions, we have a concern that retailing costs be included in the networks and there has been significant cost shifting within the network arrangement.

Information disclosure, as I said, is a very familiar topic. Of course, this was a major problem in 1996 and a problem in 1997 and in fact the New South Wales code had to be modified to deal with the problems which had arisen from information disclosure to allow a second bite at the cherry in terms of setting a capital base. Also, the National Code was strengthened in terms of information disclosure in response to the problems which had arisen in New South Wales.

However, here we are in 1999, we are now into April, three months plus into the process, and we still do not have a compliant set of information from AGL. We are particularly concerned that these matters have not been rectified ahead of the date of these submissions and this public hearing. We are further concerned that the data which has been provided has in it to our mind a number of anomalies and inconsistencies, for example, the stated mid-1966 depreciated actual cost has moved from around $700m to $960m without explanation. The networking capital has gone from minus $30m to minus $270m over the same time period.

The last point under information disclosure is we are particularly concerned about related party transactions. A significant part of AGL Network's claimed costs are services bought from other AGL entities and we are very concerned that there should be full disclosure of the basis of those transactions.

We believe, and I am sure we have no disagreement with IPART on this, that there is a duty to consult properly and that consultation should be done with adequate information disclosure. I recall IPART organised a very successful conference last year on the benefits of informed regulation, the benefits not only to the regulator but also in terms of enabling full submissions.

I was also very pleased by the comments the Chairman made at the introduction of this session. We would, however, request that IPART take a couple of further steps on information disclosure. Firstly, it was mentioned that information had been disclosed under section 41 of the law and we would ask that, if there is any information which has been disclosed which is material in terms of IPART's decision-making, we believe that information should be disclosed to interested parties so they can properly participate in the process.

The second thing is we suggest that there be a second formal round of submissions, that a deadline is set for formal submissions because it has a great effect in terms of galvanising interested parties in getting submissions in and on time, with some further public hearings if necessary.

I would like to move now to the initial capital base. I would like to introduce this by talking about some of the changing positions, what has changed in the 18 months or so or two years since the middle of 1997 to 1999. There have been some quite remarkable changes in that time period. In 1997 I recall in this room Bruce Connery claiming there was no retail margin in gas. In fact, I believe this has been one of the paradigms of the New South Wales gas market for many years, that there is no retail margin in gas.

However, I do note that AGL last year, Energy Sales and Marketing, reported a pre-tax profit of $34m. Now, to AGL that may be no retail margin, maybe $34m is not significant, but there are many others of the new entrants who would like to share in that.

The second issue in 1997 was that there was a statement that the tariff market basically couldn't pay its way and in fact as I recall $75m of the gas customers reserve account was put aside to be used over a period of seven years to try to ameliorate any price impact on the tariff market. From that conclusion about the tariff market there was a claim made it was a cross-subsidy.

However, in 1999 we see a very different picture; we see a claim there has been a major turnaround in the tariff market but operating margins have improved from $88 per customer to $130 per customer and that the household sector can sustain increases. To our mind we have seen no explicit claim of a cross-subsidy in 1999. In fact, I think the "cross-subsidy" words only appear once in the entire access arrangement information and that is in the sentence which implies that due to low interest rates they no longer exist. So we are very confused in our mind as to whether there really is a cross-subsidy.

I am no economist but I share Trish Benson's question of yesterday, if margins have improved and the household sector can sustain increases, how can there be a cross-subsidy? That is a bit of an unknown to us.

Following on in 1997 again from the conclusion of the cross-subsidy was the conclusion therefore that the contract market must pay more to make up for the shortfall, and hence the stand-alone marginal pricing was made and in 1999 the fact that the household sector can sustain increases while, boy, will they get some, $$1 billion worth spread over the next 20 years. Notwithstanding the lack of a claim of cross-subsidy, there is still a claim that the contract market should pay more and the stand-alone pricing margin is proper.

I would like to go into that in a little more detail. This next overhead shows the change in operating costs per customer expressed in real dollars. This information is taken directly from AGL's revised access arrangement information. It shows pricing costs per customer falling from $211 to $148. In absolute dollar terms that is a drop from $141m to $111m or 6 per cent per annum. However, it is perhaps better expressed on a per customer basis as revenue is more driven by the number of customers, and on that basis there has been an 8.5 per cent drop per annum, a compound drop.

Of course, the price control formula which regulates prices for the tariff market makes an assumption about falling pricing costs. It assumes only a 1.5 per cent real fall in pricing costs. Therefore, we would say the benefit of falling operating costs has largely been captured by AGL and not by its customers.

Secondly, there has been a significant drop in the cost of capital over the last four years. The cost of capital I guess is best illustrated by the changes in the long-term bond rate which has fallen from 10 per cent to 6 per cent in the last four years. That is a 14 per cent reduction in interest rates. Assuming a 60 per cent debt gearing, that equates to a further 45 per customer reduction in the cost of gas distribution to gas networks.

Now, to the best understanding of ourselves of the price control formula, the issue of changed interest rates is not reflected in the price control formula, which is rather surprising in a capital intensive industry that there is not some explicit recognition of the impact of interest rates. As a consequence of that fall in interest rates not being reflected in the price control formula, it has been 100 per cent captured by AGL.

Having in mind the drop in interest rates and the drop in operating costs I think it is fair to say that we are inclined to accept AGL's suggestion that there has been a turnaround in the profitability of the tariff market. Obviously with falling costs this has a significant impact on profitability.

This next graph shows EBIT as a percentage of funds employed. The first two bars on the left are bars provided by AGL from their revised access arrangement information. The two bars on the right are estimates made by BHP. What we see is operating costs down by $63 a customer, interest costs down by 45 per customer and we believe that revenue has gone up because of increases both in price and volume. It is a bit of a mystery to us how under a CPI-X pricing formula prices go up in real terms, which is what they appear to have done in recent terms, and there have been volume increases. The net result is essentially excessive profitability.

For a network service provider that is a bit of a problem because regulators have a habit of believing that excess profitability should be returned to consumers, and where is the fun in that? So AGL have a different proposal. That proposal is to revalue the assets by $1 billion and capture that excess for the shareholders for now and into the future. Of course, an assets revaluation is a very effective means of doing that because it increases apparent cost, it does not increase real costs, but regulatory costs in terms of increased capital charges and increased depreciation. Also, resulting smaller profit is divided over a much larger asset base so it has the pleasing effect of reducing the apparent rate of return.

The further benefit of it is that once this asset value is set it can't be revisited in the future, so there is no risk of a future regulator deciding to change its mind and come back and capture this value. Once it is captured for shareholders that is it, it is locked in for good.

The issue of the appropriate asset value can't be looked at in isolation. It has to be looked at in the context of the form of regulation of AGL. I started this series here in this overhead at 1935, although I understand AGL regulation predates that time. In the time period from 1935 to 1986, AGL was regulated as an after profit cap on the entire historic cost of assets of the entire AGL group, so that included gas and any other businesses that AGL may enter into. Such a structure clearly created some insensitivities. It was considered to have resulted in some significant problems. Already in 1986 there was a restructure of AGL at the behest of the New South Wales Government and a new entity, AGL (New South Wales), was formed and the gas assets of AGL were transferred into that entity at their written down book value, which we take to be the historic cost, and I guess that is recorded in the deed of settlement between the New South Wales Government and AGL at that time.

For the following four years AGL continued to be regulated on a profit cap based on historic cost. In 1990, due to changes in fashion in regulation, they were switched to a CPI-X formula. However, CPI-X prices were applied to the prices determined under the previous cost regime, so we would suggest that during the 1990s AGL has essentially been regulated on an historic cost basis albeit in the form of a CPI-X form of regulation.

The situation is that AGL is regulated today. It was regulated, it has been regulated, and it has been regulated on the basis of historic cost. The entire natural gas distribution system of New South Wales was built under a regime of historic cost regulation. The shareholders put their money into that project to build a national gas distribution system on the clear understanding their rates of return would be determined from historic cost.

This situation, of course, contrasts very starkly with the situation in Victoria where the Gas and Fuel was never subject to regulation. There was a major debate, what was the basis of setting prices, and essentially the regulators in that situation approached the situation with a relatively blank sheet of paper. Very different in New South Wales. We have an entity which is regulated on historic cost and also has been regulated, so we see a very different situation here.

I show next a graph which would be very familiar to followers of BHP's submissions as it has been included in every submission to every regulator in every State for the last three or four years. We now have a new title for this graph following the presentation from Professor Johnstone yesterday, this is now called the "free lunch graph".

I do not intend to spend much time on it because for those who follow it they will be

familiar with it, but the vertical line shows the point that we are at 22 years now after the introduction of natural gas into New South Wales and shows that a price path which followed either of those lines would deliver a rate of return equal to the cost of capital. Clearly a movement from the red line, which is the historic cost basis, to the green line, would result in significant excess value captured.

In summary, I guess the way we regard AGL's proposal is really very straightforward. AGL is proposing to transfer $1 billion of value from New South Wales gas consumers to AGL's shareholders. If accepted, the AGL proposal would increase the cost of gas in New South Wales over the next 20 years or so by $1 billion. We think that is a pretty serious matter.

AGL has sought to show how the impact of that can be softened through optimistic growth forecasts and through fairly modest real price increases. However, I would ask the Tribunal to consider what happens if the growth forecasts do not eventuate, what happens to prices then? What happens if interest rates do not stay at 6 per cent and go back up to 10 or 12 per cent? What then is the price impact on particularly the residential market?

Our conclusions on the initial capital base are, as I stated before, the proposed asset revaluation has the effect of transferring $1 billion from consumers to shareholders. In considering this application IPART should have particular regard to the current and the past regulation of AGL, have particular regard to the reasonable expectations of the shareholders when they put money into this company and the returns they have enjoyed in the past and, of course, particular attention to the objectives of gas reform, so we are calling, requesting, that IPART should conduct an open, transparent and vigorous investigation into the past and present profitability of AGL in New South Wales.

Turning now to operating costs, this is a topic which has been covered by a number of other speakers so I will not spend much time on it. One thing I would note, however, is that we appear in the application to have a confusion between cost and revenue because in the breakout of operating costs there is a negative operating cost of some $24m. That looks to us more as some source of revenue rather than a cost. The unexplained presence of that $24m makes benchmarking somewhat problematic.

In terms of the marketing, it has been said before, $36m, to put that into context, equates to $53 for every residential household. The wellhead cost of gas for the average residential customer is $48, so AGL Networks alone, I might add, this is Networks alone, not obviously the retail operation, are proposing to spend more money on marketing than they do buying gas from producers. That is a little hard to believe. In fact, AGL suggested themselves that if the marketing costs were removed and 90 per cent penetration was assumed, they would come into line with benchmarks. We are very pleased to find one point on which we agree with AGL and we recommend that IPART do just as they suggest, which is to remove the marketing costs.

More importantly, we again call for full disclosure of related party transactions and the basis of allocation of costs between the regulated and non regulated entity.

This next overhead just illustrates diagrammatically the point we made earlier. We will just go to the next one. In terms of our conclusions, our preliminary conclusions and recommendations would be that prices be set on depreciated actual cost with a 7 per cent real pre-tax cost of capital. At this point, the AGL opex is accepted, however, with $30m removed. That would still leave $6m for marketing, alternatively some of that $30m can be removed from administration and general, and that in place of AGL's stand-alone marginal proposal that non-discriminatory pricing is used where all users pay the same price to use the same pipe for the same service.

If such an approach was taken, the conclusions would be that the contract market's revenue could fall from $99m to $17m. The tariff market target revenue could fall from $202m to $182m. The net effect is that the benefits of the lower interest rates and the reduced opex could be captured by customers and not captured by shareholders through the $1 billion asset revaluation.

I would like to turn now to my colleague Bill Garrod to talk about some of the practical implications of this arrangement.

MR GARROD: Let me say I appreciate the opportunity to speak to the Tribunal, and in that context I guess I must make the point that I am not an economist, I am but a humble engineer and a customer - both perhaps increasingly rare breeds.

It seems to me that all of what Bill has talked about so far is really trying to determine the size of the cake that has to be shared amongst the national gas industry players and I guess it is the way that cake is cut that I want to touch on now. First of all, I have to say that we have had some difficulty in comparing the previous arrangements and the current access undertaking basically because of some information shortfalls, and I do not need to say any more about that I do not think.

The things that we have, I would certainly like to point out that there seems to be a quite significant changed cost revenue allocation between the trunk and the local network. This is, of course, intentionally or otherwise obscured by some changed definitions of trunk versus network and the examples of that are in the Port Kembla area where in the 1997 undertaking the trunk ended at Five Islands Road. It now stops at Mt Keira and I think there are some definitional changes in the northern trunk and coastal trunk. That makes comparison a little more difficult, if not impossible, for some things.

The other point is that there appears to have been included without comment, defence or any support the changed method for allocating individual site costs. There has just been no explanation for the move from a site specific model to a postcode model. I guess we would certainly like to understand that, to perhaps follow on my little cake cutting analogy, I suspect that gas networks see this as not a cake model but a caviar model and that you can't cut caviar, you just dollop it out and there is always some left in the bowl. I am just a little concerned that that total allocation, which I will show you, has had quite dramatic effects certainly on some customers.

The other area of concern, it was a concern that we had last time, was that the future load assumptions are unknown to us and it is difficult for a customer in isolation to understand that they are reasonable. There are obvious things, the Newcastle works closure, the front-end is known. Port Kembla has had and possibly will continue to have quite large load variability - I will touch on that later - and we also ask, what is the status in this of new loads? And an example of a known new load is the Port Kembla Copper Plant due to start later this year. Obviously it is difficult for us to expect networks to include unknown loads by definition.

Just in terms of supporting some of those things, let's now turn to the outcomes of this from a customer's perspective. Firstly, an observation that we feel is appropriate is that this undertaking is a response to competition by moving the revenue generation into the network and we presume this is a defence strategy against the Eastern gas pipeline and we would obviously be asking the Tribunal to consider the appropriateness of that.

To be more specific, I have got here just a couple of sites showing the annual unit charge for capacity. The 1997 one, obviously that undertaking and the current undertaking, you will see two things. First of all, at both sites there is a quite dramatic shifting of those charges into the network. Some may be due to definitional changes, some may not, but the other important thing to note is that the total of the take for 1997 versus 1999 is significantly lower and, let me tell you, this is going to create, if it is accepted, a price shock.

Just to give you some idea of that, if we presume - and we presume on a couple of grounds - that the 1997 undertaking which certainly stopped at the end of June, and we accept that, foreshadowed a revenue and a path which would have seen transition charges disappear, and if we also presume that in contracts that we have in place where pricing is basically predicated on that, with the rider that it will change with the determination of this determination, has created for us some expectations. And those expectations I would have to say on basically all our or the majority of our reference sites have been dashed.

In the case of the port Kembla site, the network charges that we expected versus what is proposed for the first year of this determination are some 126 per cent higher than what we had expected. The lowest site is 3 per cent, and we would not get our blood pressure up over that unduly. The other sites are in the 30, 40 and 80 per cent change. You might argue, or gas networks might argue, that is only an interim change, it includes transition charges, but when we take out the transition component of the 1999 undertaking four of our six reference sites still see 40 per cent increases in what they would otherwise have expected from the 1997 determination - not a pretty picture for a customer.

Future load assumptions, no way for us to check, and we are just questioning, will IPART verify those assumptions? We have tried to do some work with what information we had for Wollongong. The Port Kembla works is the largest and most variable customer and I think in the last 12 months our MDQ at that particular site has moved from about 20 down to 9 terajoules. We certainly welcome the changed rules that gave us the opportunity to do that.

Looking at Wollongong, which I guess is a limited number, we have tried to reconcile the contract revenue information presented and we can't do it from the information presented and from the information of, shall we say, the market intelligence.

Just to finish, on the last page, the operating rules have changed for the MDQ reservation and whereas before the situation was you made a reservation and it locked in, an incremental one, for 12 months, the situation now seems to be if you are in the position where one month after a contract has started you wish to increase that reservation then it is locked in for a minimum of 12 months, or to the end of the contract period, and our interpretation of that suggests that sites could be exposed to quite an increase in the length of time they are locked in.

Gas balancing - well, complex and mysterious were the words that I really chose. I think there are a couple of things on that. Is that complexity necessary? I believe there is some experience in other States that suggests it is not. The other point that is of some regret that I might make is that we have no real ability, or had no real ability, to draw on any gas balancing experience from that first three years. That opportunity has not been available and so we do not have the situation to comment on gas balancing first-hand, primarily because we weren't able to put those arrangements in place because gas wasn't available to us to do so.

Just to sum up this customer's reaction - well, outrage. I think that sums it up. We are very disturbed by the price shock. I note in some areas of the submission the gas networks people have suggested transition is there to prevent price shock. I think there is enough price shock for us, and I know other customers, to cause extreme anguish.

We believe this particular submission locks in the benefits that AGL will receive. We believe the rules for using it are complex and unnecessary and provide an unnecessary discouragement to using the system.

To close off from me, one of the issues for us in the mundane aspects of our budgeting is what does the world look like after July? We would certainly seek, first of all, the Tribunal's recognition that the delay in the process is a delay which flows benefits into the gas networks' pockets and we would certainly seek some determination that would give us certainty from hereon in.

As an overall view, if I can just finish by perhaps continuing my analogy, I suggest to the Tribunal that if we view this as a caviar proposal by the gas networks it is inappropriate for the Tribunal to take away the crackers and leave the caviar. I hesitate to say, let them eat cake, but be that as it may some of the customers are eating crow. Thank you.

MR HENSON: I will wrap up with some recommendations for IPART's forward action. Firstly, as we have said many times, we call on IPART to ensure full information disclosure with a particular focus on related party transactions and allocations of corporate overheads. Secondly, we are looking for an open, transparent and vigorous investigation into past and current returns and also into any cross-subsidy, if such a cross-subsidy is claimed to exist, and we are confused on that matter at the moment.

We call on IPART to complete the studies it already has underway, as they will be extremely useful for benchmarking the marketing costs, the five-year forward and backward capex. We believe you should investigate some of the competition issues closely because they can be very important in terms of determining prices. Clearly a $34m retail margin does not exist in the absence of competition.

We then call for a second round of submissions and hearings before the draft submission. As Bill mentioned, there are some very immediate issues coming up from prices from July 1999 onwards and quite simply BHP needs to decide whether to buy coke or gas and price is very important in making that decision.

In summary, we see in front of us a $1 billion proposal from AGL and I guess we are looking for a $1 billion response from IPART. We are not looking for it to spend $1 billion, however, we are looking for IPART to put resources, time and priority to this matter which

is commensurate with the claim from AGL for a $1 billion increase.

THE CHAIRMAN: Thanks very much. That prompts me to check what we are having for morning tea. I think it is hot cross buns!

We have had discussions and debates over asset valuation probably for too many years now. I note that your proposal looks at a 7 per cent real return on depreciated actual costs. I am wondering whether by nominating a real return you are suggesting that perhaps indexed historical cost depreciated might be the appropriate way to go or perhaps 7 per cent nominal rather than real.

MR FITZGERALD: The submission essentially puts the 7 per cent in on the basis that there is some indexing for inflation which BHP has said is not its preferred position but concedes that that is what has been agreed to by other regulators in other jurisdictions, and so what we have said is if that is to be the norm then you do need to do a real cost of capital; essentially that.

THE CHAIRMAN: You do not specifically mention - you may have in your submission but I do not recall - an issue that came up yesterday to some extent, the question of capital contributions, which clearly is still relevant even on a DAC approach to life. Do you have a view on capital contributions, how they should be treated? In particular, if they are to be treated, how the initial capital base is determined; should they be applied generally or should they be applied specifically to individual customers?

MR FITZGERALD: I think it may be worthwhile to actually have a hearing or workshop around the options of doing that because I think yesterday a compelling case was made for it not to be disregarded, past user contributions. I think a case as a matter of equity exists between the utility and the customer that has paid past user contributions. As a result there is probably a case for keeping the assets in the initial capital base so that if other people wish to use say a stretching of trunk line that are not made part of past user contributions the asset should still be in the initial capital base but that the pricing in a specific reference tariff for a specific customer should take into account the past user contributions and is therefore an adjustment to the total revenue that can be expected across the network, the specific 2A reference service to a specific customer, so I think, sorry to use the analogy, you can have your cake and eat it too by actually having both the asset in the asset base but also give equity to consumers by giving them the discount base on user contributions.

THE CHAIRMAN: If you can unscramble the eggs.

MR FITZGERALD: That is right.

THE CHAIRMAN: To paraphrase the two Bills, I am not an engineer and when engineers talk about the problems of the proposed gas balancing arrangements, MDQ reservations, I find it very hard for my eyes not to glaze over. Can you explain it to me simply, to a lapsed economist? What are the real issues?

MR HENSON: I think the best way of illustrating the problems is by looking at comparisons with systems elsewhere and I guess one system we are very familiar with is the Dampier Bunbury pipeline in Western Australia where gas balancing is a particular issue because it runs very close to full capacity and when you are in that situation keeping the balance is much more important.

The system which is in place there was originally proposed to be extremely onerous with very severe penalties and after a lot of lobbying by users it was agreed that the penalties would be waived to give a trial for the system. I guess some four years later those penalties have never been introduced.

THE CHAIRMAN: It is a best endeavours type approach to balancing?

MR HENSON: There is an obligation to balance but users understand it is important to keep the system running properly because they want to get their gas to market, therefore they have an incentive to try to make it work. A relatively simple system there has been operating successfully and does not create any problems, and we ask the question, the AGL system as we understand it has a lot of excess capacity in it and we just do not see the need for the complexity of what has been proposed and we therefore are suspicious it has been proposed as a barrier to entry. There is practice of this in the US, as I understand, where in the early days complex balancing regimes were proposed to try to discourage competition, and that may be the case.

THE CHAIRMAN: MDQ reservation issues, again for a non engineer.

MR GARROD: With MDQ reservation, where you have got a load or a business where you wish to tailor that MDQ reservation to respond to market opportunities or as regrettably at Port Kembla, as a result of a downturn in the business, you need the ability over a reasonable time frame to set a MDQ level and if you get it wrong you pay for it.

I do not have a problem with that, it is the duration of that period. Whereas the previous undertaking, as we had interpreted it, as you needed to you had gone down and if you wanted to go up again you had 12 months minimum at that increased slice, that is fine, but at the end of that time if your base load had reached the end of the contract period you could reduce that so you could tailor a drop-off in your load again.

The current undertaking, if I am correct, suggests that once you have made that reservation that reservation is not the top slice, it is the total load increase and it can only decrease at the end of the contract period. In the worst case, by my numbers at least, you could be sentenced to paying for 12 months rather than one. That just seems to us to provide some constraints both on the upside and the downside because of the inability maybe to pick up business opportunities that might be of a short nature, because of the concern you will be locked in.

THE CHAIRMAN: We might again pursue that, as with other issues. One of the other issues, once you cascade down the caviar or pie, to those who pay, is the question of tariff structures. I am not sure that I really understand, at least in the presentation today, when you talk about non-discriminatory pricing, that is everybody pays the same for the same use of pipe, so what is it you really have in mind in terms of pricing structure because there is a push to move away from what I think is recognised is a very complex "follow the molecule" process at the moment.

I am interested in your views on tariff structures.

MR HENSON: I guess we have not put forward in much detail here what we would recommend as a pricing structure because we focused very much on the pot of dollars. The non-discriminatory things were not addressed in the postcode issue but in the stand-alone marginal issue and therefore our view is that there is no economic justification and there is no ability under the code to adopt stand-alone marginal and therefore that is what that addresses.

As we say, the "follow the molecules" approach, while although a little complex to generate initially, certainly had the benefit of maximum cost reflectivity and as soon as you moved to postcodes, postcodes are pretty large and therefore there is a lot of averaging within a postcode, where the large users loses out and the small users within it benefit. I guess it also results in substantial price shocks.

I do not know, we have looked at about 120 sites and the majority of those sites are facing changes of 40 per cent or more up or down, which mostly relate to the change in the pricing methodology. We do not see at the moment any offsetting benefits from the postcode regime.

THE CHAIRMAN: Another issue to pursue. Thank you.

MR COX: Thank you for your submissions and presentations. You do raise obviously a number of very important issues. I want to start off with the competition issues. You mentioned that that is something we need to take especially seriously. I think you have mentioned this morning a number of aspects of the proposed agreement that may be anti-competitive in agreement, things like gas balancing and the reservation conditions and, indeed, the pricing. We have had less comment from you on the question we pursued yesterday of the services offered and whether there is any competitive impact from the way that has been presented. I wondered if you would care to comment on that?

MR HENSON: I guess in our submission we have called for certainly one additional reference service which is the interconnection reference service. I guess we are very concerned about interconnection. There are some words in there about interconnection for offtakes but I notice that anybody who might wish to have an offtake automatically puts them on the top of the load shedding list and therefore I do not see the reason for that. It seems to be a mechanism for discouraging interconnection for offtakes.

We certainly would like to see that issue addressed and that would therefore also require a couple of other issues to be addressed, if an interconnection occurs within or part way along a trunk, how should that be priced; paid at pro rata or not?

Secondly, if interconnection is made at one point then the issue of backhaul immediately

arises to customers which are located upstream, so I think with interconnection there are a couple of other services which are important.

One of the problems is that we are looking here at a period where we can expect some fairly dramatic change in the New South Wales gas market. We can expect a second source of supply to be connected in, a competing pipeline and, on some people's expectations, full retail competition. One of the difficulties in terms of predicting what does that require is the proposal to have a five-year access arrangement and it may well be more appropriate for a shorter access term such that the changing market is better reflected, rather than trying to get now what will be required in the new market, to shorten the term of this arrangement and then respond to the market requirements.

MR COX: If we move now to the asset valuation questions, as you understand we hear a lot of arguments about asset valuation and people come to us asking for essentially a DORC valuation, so we have a lot of experience in that. One of those put forward is that DORC valuations are appropriate in terms of economic efficiency because it treats incumbent gas suppliers on the same basis as new entrants. I wonder if you would care to comment on that?

MR FITZGERALD: If I can comment, the submission includes what Bill has referred to as the "free lunch chart" and you will see that in the free lunch chart the DAC price actually exceeds the DORC price in the first seven and a half years in the chart. So if the proposition is that a new entrant would have a price that looked more like DORC than DAC, we contest that because a new entrant comes in not with DORC but ORC, actually comes in with a higher price than an depreciated asset and therefore is actually more likely to have prices in excess of all existing players.

If that is the case, it is more likely that the DAC price in the first seven years of the pipeline life would more accurately reflect a new entrant than the DORC value. So the proposition being put by various parties, without evidentiary support, without numeric support or otherwise, is as has just been said. And that is because DORC has traditionally been seen as an economic concept and therefore it has to be ipso facto closer to efficiency. Well, numerically I do not think it stands up. We have evidence in there which hasn't been contested.

MR COX: I would like to ask you to comment on

Professor Johnstone's presentation yesterday where essentially he said that the really important thing is take account of revaluation in the income statements. I do not think he was saying that the asset valuation is a matter of indifference, but the more important thing is to make sure of accounting for it. Would you care to comment on that proposition?

MR FITZGERALD: I think his primary point is that it ought to be true that you recover NPV equals zero or that over the life of the asset it should be that. You do not get that if you actually switch between the two. That is a point he makes, but what he says is if you do want it to undo the free lunch effect you ought to then put it to income and essentially what he is saying here is if AGL wants a $$1 billion revaluation and that is its preference in terms of recovery of NPV it could do that by giving five years free use of the pipeline system, but that is not what is being proposed.

It is certainly true that giving the benefits of inflation to the asset base can put it into the income line, and that is essentially what is being done in the choice of a real versus nominal cost of capital, so what you are saying is that even though the current nominal cost of capital might be 10 per cent, we will give you only seven per cent now because you are actually getting a three per cent appreciation in the asset value during the course of that time.

So his proposition is unambiguously true at an economic level. It is to some extent being used and is incorporated in the proposal, at least in the choice of a real versus nominal cost of capital, but to take his proposal forward would require, certainly on the numbers that BHP has put forward, five years free use of the system. If Networks wants to propose that, we would have to think about it.

MR COX: I wanted to move on to the issue of growth forecasts. I think Bill Henson said they were a very difficult thing to do. Both Bills said that. I think I agree with that. We heard some evidence yesterday to the effect that AGL's growth forecasts for the contract market were perhaps if anything too pessimistic, that there was scope for growth they had not identified. I think you would tend to argue the reverse, that things are a bit tougher than AGL was suggesting.

In the tariff market we have a submission on your behalf by NERA which suggests that, once

again if I read it correctly, AGL's projections may well, the tariff market growth, be too pessimistic. I refer you in particular to pages 46, 47 and 48 in the NERA submission. I wonder if you would care to comment?

MR HENSON: Perhaps I can just address the NERA question first of all. The submission put in by NERA is a submission that was prepared at the request of BHP. I guess at the last hearings IPART expressed a preference for professional advisers not to be represented in the hearings and I guess we have followed that and that is why we do not have NERA here today. However, we think it is quite a significant submission that they have made and we would be very happy to put any questions you might have to NERA and get answers in writing, and we can turn that around in 24 hours and that can be added to the public record if you would like to ask questions on their report.

Turning back to growth, a couple of things: First, it is a little difficult to decouple growth with price. Clearly there is an elasticity of demand. I guess we heard Allen Mawby talk about the fact that companies are making decisions all the time where to locate investment. Often it can come down to really that gas can be a significant issue in that decision where to locate investments. That is why communities are so pleased to get gas connected, to try to bring investment to their areas.

It is not possible to decouple the two. However, I think AGL's zero growth forecast is conservative in a couple of areas. Firstly, while there has been zero growth in the contract market since 1980, a couple of comments on that. BHP started in the 1980s by taking 22 petajoules per annum and ended taking I believe 10 petajoules last year. So there has been a significant drop in the gas take from BHP which has been made up by some underlying growth from other industrials.

I guess again if there are the price reductions which we are recommending we would expect that to be accelerated. Secondly, while we share the short-term pessimism on electricity generation, this proposal would not run for five years I guess, and we can certainly see some potential for some gas and electricity co-generation towards the end of that period. It is very difficult to forecast. That is one of the difficulties of a five-year review, that it becomes very problematic, but we think there is some upside there.

There is of course, I guess, a surprisingly large amount of coal being used still within the system. For example, at Botany, five kilometres from the city, they are still burning 2 terrajoules of coal. That is quite remarkable, that trucks are hauling coal into Botany. I am sure in time that will switch over to natural gas. I guess we see some growth forecasts. We think the forecasts, the approach by AGL, is not a forecast but a straight-out claim and that there is no substance to it, that it is not a forecast at all.

MR GARROD: Perhaps I can just mention Port Kembla. Well, I guess it is a sizeable load and from November last year we basically started to go down into lower production and all the time use less natural gas. If I look at the Port Kembla steelworks site, in December it was running on an annualised basis of 1.5 petajoules. Probably six or 12 months before that it was up over three and in some cases four. So we are in a trough at the moment.

We are in the process of ramping our production back up and we expect to increase our MDQ reservations, building up over the next 12 months. We actually went through somewhat of an agonizing decision yesterday to decide what we would do for this month and next month, but notwithstanding that I guess we have some idea of what we are doing over the longer term and I do not think history, or a decision based in time, particularly at the bottom of the trough, is necessarily the right way to go. We have not been asked I guess to provide MDQ long-term projects but we are anticipating that by the early part of next year we will be up from our nine to around 20, 22, somewhere around there, just as a result of changed operations and a little bit of optimism in the market. That can really swing things around.

MR COX: One final question about the stand-alone cost basis being ORC rather than DORC. I believe you are saying in your submission that this approach, ORC rather than DORC, is not consistent with the code. Would you like to elaborate on why you think that, and perhaps if you want to comment on the approach more generally?

MR FITZGERALD: It was said yesterday by Bruce Connery that it was consistent with the code. Legal advice as late as last night said there was nothing in the code that would support it. To the contrary, the code says that total revenue

shall be based on a depreciated asset base and that the principles that apply to individual tariffs should be the same as the principles that apply to total revenue.

Secondly, the stand-alone approach actually uses depreciation, actually puts a charge to depreciation, so if the ORC base continues on and is not depreciated how can depreciation be charged to the contract sector? You are actually charging for something that has not been taken. So the code is quite specific that the capital base going forward takes into account where it started, you add what has been added in terms of new facilities and you subtract the depreciation taken. Now, if that is not the mathematics being applied to the contract market it cannot be said to be consistent with the code. The submission says that BHP has no legal doubt about this. That has been confirmed again yesterday.

THE CHAIRMAN: Thank you very much for that. That has been most helpful. There are again a number of issues that will be pursued over the coming months.

INCITEC

THE CHAIRMAN: If could you identify yourself for the record and we will proceed.

MR McLEOD: My name is Jim McLeod and I am Supply Manager with Incitec Limited. As an introduction, we have not put a lot of time into producing a lot of computations for this presentation. Our major concern is a lack of information. When we have that information we will certainly do that as we trust there will be further deliberations in public and private to take that into account.

Another comment I should make is that Incitec's keen interest is in the transmission line from Wilton to Newcastle and we will not be in a position to comment in any great detail on other matters. What we would like to do is to talk to principles only.

There are a number of key issues that we have identified. The first one is the issue of the term of this determination. The proposal put forward by Gas Networks is for a five-year term. It is our position that that is far too long given the current state of the market. The first key issue I draw attention to is the term of the determination. In our view two years is the actual maximum at the current state of evolution of this market in this State.

I will list some of the major concerns. The first one of course is the Eastern Gas Pipeline, which I understand will be in effect in one year's time, which maybe an argument for a one-year determination. That would not concern us any. That must change matters. There will be matters of backhaul. I do not see how a five-year term can possibly foresee all of the matters that will be caught up by this major change in gas supply.

The second item is co-generation projects, and that has been covered. There are a couple that are well known. No-one has canvassed them. They are good ideas maybe waiting for lower costs or higher electricity prices. I would expect both are quite likely. We ourselves would like to put in a small unit in Newcastle. I am sure we will be hindered in that by the cost of gas. I know many other people are.

The privatisation of the electricity industry - I wrote this before the election and I do not think I need withdraw it. In the context of a five-year time, surely there will be another

election and we will know what the Opposition's view is on the sale of assets. The point there, of course, is that it is easy to envisage AGL acquiring say EnergyAustralia's electricity assets which will produce considerable benefits in syllogise. However, I draw your attention to the current state of the derogation by the New South Wales Government to the regulation by ACCC of transmission pipelines. As I understand it, that may well be an event that occurs in July 2002, if not before. I think it would be highly inappropriate for this regulation to constrain the ACCC as and when it appropriately moves in to regulate the transmission lines.

Finally, I come to incentives. A five-year term under current conditions gives the proprietor of the network an awful lot of incentive to improve costs. I did read somewhere that that job has been finished. I do not know that I am prepared to believe that on the few costs that I have seen. For instance, I am sure that famous $35m marketing cost can be reduced. I believe it is quite inappropriate to have an incentivisation with such a poorly understood base line.

The next issue which I would regard as one of my key concerns is delayed determination. This is really going to drag on. We would like to see it finish in time, but certainly not at the cost of getting it done right. That is a comment I would put for future reference; once we are comfortable with our basis, we must start these things on time and finish them on time. The key point is that I do not believe either party should be able to benefit from a delay in producing a determination and therefore I commend to the Tribunal that they consider seriously how to have the effect of this determination from 1 July, but I do appreciate the problems that will cause to individual customers.

Provision of information, that has pretty much been done to death, but it does not mean we do not support it extremely strongly.

Lack of information - no-one needs that. That is the basis for the provision of information.

(Overhead: "Information we do not have and should")

This overhead shows the sort of information we would have liked to have got and certainly the sort of information that was contemplated when the gas code was introduced. Without that information, we cannot really do much; we can only suspect. From what little information we have, we have already found quite a number of concerns. I leave that to the Tribunal. Just to finish up on information, I suppose, if it really is not forthcoming, the Tribunal is free to produce its own determination.

Asset valuation is another very key issue. The only thing that really stuck with me in Professor Johnstone's talk was that DORC was inappropriate. I can find very little to commend DORC. From a special perspective, it seems to jump around all over the place. It started off a couple of years ago at $1.4 billion. I have seen it at $2.2 billion and recently I have seen it at $1.8 billion and $1.7 billion. It seems to jumps around a lot and when it jumps around, it does so in massive sums of money. For any industry, hundreds of millions of dollars is a very large amount of money indeed, it builds whole pipelines.

I just do not think that we can contemplate DORC. It seems to also have another spin-off in that it encourages something called current cost accounting. I do not properly understand it. It does seem to permit an asset to inflate with time, but it still seems to let depreciation happen and it seems to let depreciation itself inflate with time. I believe that would cause an awful lot of problems, so I think DORC is not appropriate.

DORC may well have grown from a precedent in Australia in the electricity industry, where those kinds of concepts came with close involvement of state government, state treasuries, who have a vested interest in the valuation of their asset. Those determinations at those times have very little user input. Mercifully the gas deregulation process has had considerable gas user input.

Only DAC will do. I think everything else is philosophy, variable, subjective, but DAC, depreciated actual cost, is not. DAC is what the competitive market uses. DAC is what everyone reports in their accounts. DAC is certain, DAC is simple, and there is precedent. There is a reluctance, I believe, for Australian jurisdictions to closely follow the US precedent, the Canadian precedent, but DAC is widely used over there. I put to you that a country that can put a man on the moon and can invent the Internet can probably get asset valuation right. Moving down the list, I come to transitional charges. These really defeat me.

(Overhead: "Price Shock")

This seem to be some kind of a straight line tax and the difference I have estimated is the transmission charge. It seems to be necessary for various parties in the industry to avoid rate shocks.

(Overhead: "The Real Price Shock")

As Crocodile Dundee once said, "That is not a rate shock; this is a rate shock". I am just putting that up as our example, but everyone is well aware that the same thing is happening with zinc, it is happening with wool, it is happening with sugar. If we are going to emulate competitive industry, we will see those kinds of graphs and variations. It's a fact of life. I do not see why anyone needs to be protected from it. In particular, I would really appreciate if someone could explain to me why Incitec must pay Gas Networks $1.3m next year for this transitional charge, I do not understand why we must pay AGL that much money. It is an awful lot of money.

Moving down on the key issues, we come to real costs. Again I am going to seize on the example of marketing. I know everyone else has used it, but to be honest, it is the only real cost we can see that is separate that we can comment on. I will use it just as an example.

I think some $37m or $38m of marketing costs have been incurred. As best I can follow the trail of calculations through the access arrangement, some of that is applied to the transmission line from Wilton to Newcastle. To be honest, we do not need to have that line promoted to us. We know it is there: we know it is there because we helped pay for it. I have done a calculation and I believe that we must have paid $300,000 and we have been invited to pay a further $300,000 each year for the promotion of that line to ourselves. The only evidence I have seen of that is some sandwiches. I would like the record to show that Incitec has not had a free lunch.

There is another cost too which I have gleaned from the AGL Retail Energy submission where there seems to be a cost in IT for producing customer profiles for would-be retailers. They, not unnaturally, do not want to pay that cost. Well, neither do we. If we are paying for it, we would like to opt out. We would be quite happy to put our information on our web site or contribute to someone else's web site. As I said, these are examples only. We have attempted to calculate the contract revenue applicable to this business and we find it very hard to come up with a figure of more than $30m. Of course, everyone is aware that the figure that is being proposed is something like $87m, declining to $70m, so there is a real task there to work out what that difference is and then remove it.

(Overhead: "Average Australian Pipeline Tariffs")

This nonetheless is how we have done our own benchmark, it actually grows off someone else's but I think that referred back to ours anyway. I am sorry that those figures are not so clear. The column on the right is the cents per hundred kilometre equivalent that Incitec is being invited to pay AGL for the Sydney to Newcastle haulage.

The next column, reading from the right, is the AGL pipeline in Queensland and the next one is our calculation of our own tariff based on very generous WACC of 10 per cent and an asset valuation we do not accept. So really the difference is quite incredible.

I might draw the attention of the Tribunal to the series of determinations. The first draft invited us to pay 14 times what we thought we had to pay. The final draft reduced that to about four times. This one is about twice. I think the Tribunal will understand our enthusiasm for more and frequent determinations.

Finally, in what we see are the key issues we have the capital payments. They will not go away. We spent $12.4m on the Horsley Park to Walsh Point pipeline in 1982 dollars. The line itself cost $83.4m. That was an actual cost, an AC, if I can contribute another acronym to the jargon. The Tribunal disallowed that as a consideration for reducing our tariff. The reasons were not closely understood, but they seemed to boil down to the fact that if the recipient of that money was forced to fritter it away, then it probably was not paid in the first place; or, secondly, that we probably got some benefit anyway, we just do not know what it is. This is in spite of the fact that tariffs in those days pre-regulation were higher than they are now. As a minimum, of course, it is very insensitive to have the market required to pay a WACC and a depreciation charge on capital it has already put in. Those are the key issues.

(Overhead: "What the Regulators Must Do")

We are not short of advice either for the Tribunal. Overall, we are recommending that the Tribunal should adopt an active approach. I do not think the Tribunal should be afraid to step outside of current precedent as applied in this country. Without information disclosure, there is nothing. It must happen and it must happen to the full extent provided by the legislation.

We have separately provided the regulator with our own legal opinion for its own benefit. If it has to be fought through the courts, so be it, but without that information, we will get very second-rate regulation.

Transition payments - what can you say except refuse to accept them. It is iniquitous that industries such as ours should have to pay. I heard the same stories from other industries yesterday, who said "What on earth are we doing paying those charges? Let's stop them". We believe the regulators should drop DORC, percentage after DORC and simply adopt DAC. We understand that a different WACC is appropriate to DAC. That is nonetheless our strong recommendation and this is an area where I believe this regulator can and should be interventionist.

For my company, it is absolutely mandatory that we slash costs, we have been quite successful. We are not going to survive unless we do. This process must continue and we can see an awful lot of bloat in this particular cost in getting gas from Wilton to Newcastle. The capital contribution question must be addressed.

I have not raised before the issue of stranded cost, which we hope to develop. Very briefly, the line from Horsley Park to Newcastle was designed to handle 30PJ. I do not think that it has ever handled more than 22PJ and it is currently sitting at 20PJ. The question will be who pays for those other 10PJ?

That finishes my presentation, Mr Chairman. The whole thing is not funny. This is a deadly serious enterprise and the future of industries such as ours really hangs on it, let alone the introduction of new industry into this State. I will conclude there. Thank you very much.

THE CHAIRMAN: Thank you very much, Jim. Thank you for your submission and thank you for coming down today.

I cannot resist talking again about capital contributions. I think we discussed them last time. The reality seems to me to have been that whatever negotiations were entered into by your company and other companies with AGL, as it then was, to make a capital connection towards getting a pipeline to deliver gas, it was well before open access, it was well before this type of regulation. I would imagine that there was some commercial decision about the contribution which, in some way, was part of whatever agreement was there between you and AGL to deliver gas. I am hearing you say that that was one-sided, it was not reflected in price, it was not reflected in the commercial outcomes. That is the difficulty I have with understanding that particular aspect of the capital contributions to date. Can you help me understand a little bit better.

MR McLEOD: I have to have regard for the confidentiality of the agreement that we entered into with AGL, but I do not think AGL would mind my making a couple of statements. Our tariff was not entered into, and in addition to that tariff and separate from it was a further tariff such that if the there was a blowout in capital, then we would pay half, which did happen and we paid. So the tariffs were already set. If that is not an adequate answer, I can go into more depth outside this meeting.

THE CHAIRMAN: We might do that. The only other issue for me is the five-year term from your perspective - and I think others have raised it - being perhaps too long, particularly given the uncertainties of the market apart from perhaps a pure selfish aversion to having too many and too frequent versions of this hearing, as much as we enjoy it. There is an argument as to certainty for players in terms of having a view about what the market conditions under access may well be.

Perhaps the corollary to that is the question: what about the use of triggers and rather than go to a shorter term, as I understand the code allows, what about building in some triggers? It was mentioned yesterday by NCOSS or PIAC as an option and I think they were looking at volume triggers. Is that an alternative?

MR McLEOD: I would have guessed that triggers and certainty are opposite circumstances. If you have triggers, then you have uncertainty. I do not know that it is sensible to talk about certainty over a five-year period. That is a long way in the future. I appreciate that AGL would gain certainty. Our contribution to that would be we do not mind certainty for two years,

but we would rather the lower cost beyond that and wear the uncertainty. I just cannot see how you can move forward five years with the uncertain base that we are starting from.

It may well be in North America that the trans-Canada pipeline can have a three-year determination, but that is based on many determinations to form the base. As I understand it, all parties are happy with the information, the base, the asset valuation, everything, and they are quite happy to move on. But we certainly do not have that here.

THE CHAIRMAN: Thank you,

MR COX: There are just a couple of things I would like to understand a bit better if I could. I think you mentioned that the justifiable revenue environment for contract market was in the order of $30m a year. Can you explain how you made that assessment?

MR McLEOD: Well, you have DAC or you have DORC or you have 7 per cent or you have 10 per cent and you put benchmark costs on top of that and you get a figure roughly like that. I am sorry, I have not done this in great detail. I would be delighted to respond to you with some calculations.

MR COX: If you could, I think that could certainly help us. We have heard a fair deal yesterday about the shift of costs from the trunk system to the local network. I do not know whether you were here. I would imagine that you were a beneficiary of that, is that correct, and that perhaps explains why , if I understand what you are saying correctly, the result of AGL's proposal would be, in fact, reduced tariffs for you; is that correct?

MR McLEOD: Well, I certainly would not want to benefit at the expense of pensioners and those other people we are hearing about. We are going from, say, three times or four times what we ought to pay to twice what we ought to pay. As for shifting costs, the comment can only be that they are all far too high. If you had proper costing, then I do not think the tariff market would have anything like the concern it is rightly expressing. If the right costs were available, then I would guess we would not need to talk about contention between contract and tariff market; they would be happy with their prices. That is a supposition.

THE CHAIRMAN: We will have a break for about 15 minutes.

(Short adjournment)

ENERGYAUSTRALIA

THE CHAIRMAN: We will resume with the representatives EnergyAustralia. Please identify yourselves for the record and we will proceed.

MR MALTABAROW: Thank you, Mr Chairman. My name is George Maltabarow. I am general manager finance and corporate secretary of EnergyAustralia. My colleague is Michael Martinson, who is the manager strategic support at EnergyAustralia. Most of you are probably familiar with EnergyAustralia, but I might take a few minutes to outline who we are.

(Overhead: "Who is EnergyAustralia?")

We have the largest electricity network and we are the largest retail electricity supplier in Australia. I hesitate to say what our asset values are, but for today's purposes, let us say $4 billion. We have a staff of around 3,000; around 1.3 million customers; 2.9m people are served in our areas, which cover about 22,000 square kilometres; our sales are about 21,000 gigawatt hours, which represents 42 per cent of the New South Wales electricity sales and about 15 per cent of the national market. Our number of customers, I might add, represents around 20 per cent of the national electricity market.

EnergyAustralia was formed not in 1898, as the slide says, but in 1996, by the merger of Orion Energy and Sydney Electricity. EnergyAustralia is a statutory state-owned corporation.

(Overhead: "EA - An Integrated Energy Company")

The next slide is fairly interesting from our point of view. It illustrates our service area and that of AGL. 25 per cent of our 1.3 million electricity customers are gas users. EnergyAustralia has considerable retail expertise, which it is able to bring to gas retailing. It would also, given the scale of that retail operation, be able to bring significant economies of scale to bear.

I might also stress that our mandate is energy not just electricity. In fact, the establishment of the legislation makes that fairly clear. If we put those things together, we would submit that that gives us a very powerful case to have access to a competitive gas market.

(Overhead: "National Competition Principles")

Most people in the room would be aware that, under the COAG framework, there is a national competition principles agreement, to which New South Wales is a signatory and the State has obligations under that agreement. The area of the agreement covers the limitation of anti-competitive conduct of firms, reform of regulations, which unjustifiably restrict competition, the reform of the structure of public monopolies to facilitate competition, the provision of third-party access to certain facilities that are essential for competition, the restraint of monopoly pricing behaviour, and fostering a competitive neutrality between government and private businesses where they compete.

(Overhead: "IPART's Competition Mandate")

We come now to IPART's competition mandate, which I accept in a legal sense is not as simple as what might be depicted on this slide. Nevertheless, there is a Gas Supply Act, whose objectives are to encourage the development of a competitive market in gas and the regulation of gas reticulation and gas supply to promote customer choice.

In respect of the attainment of those objectives, there is an overall framework within which we would submit that IPART would need to do more than approve the requirements of the code and could take an active part in championing competition and meeting the State's competition mandate.

At this stage I would like to hand over the presentation to Michael Martinson, who will deal with some of the specific issues related to access and in particular some of the impacts of any delays to access arrangements.

(Overhead: "Delays to Access Arrangement")

MR MARTINSON: I would like to talk about some of the specifics of the access arrangements. Over the last couple of days, most of the issues have been addressed by almost everyone. I will not bore you by going through the details of everything again, but there are some key points that EnergyAustralia would certainly like to address and the first one is delays to the access arrangement.

The passage that is up on the screen has been taken from the AGL Retail submission, basically saying that they do not know what will happen if IPART does not make a decision on the access arrangement and make that decision effective before 1 October.

EnergyAustralia clearly views that AGL benefits from any delays to having the access arrangements in place. There is uncertainty in the market, which advantages AGL. As may have been mentioned, all the customer contracts are structured to expire on 30 June 1999, so there really is uncertainty as to what will happen after 1 July this year.

We would hope that there would be no benefit available to AGL because of the delay. Certainly, if there is a delay, we do not want to see all the customers locked up by AGL with long term contracts once the access arrangements are in place. From our perspective, we think the answer is not more delays; we would like to see something in place as soon as possible

(Overhead: "Inter-Fuel Competition")

One of the issues that I think every single submission has touched on is the marketing cross-subsidy or the level of operating costs in the marketing budget for AGL. EnergyAustralia welcomes inter-fuel competition. However, it has to be on a level playing field. We think that the amount of money of approximately $1,000 per new connection on the AGL network really does skew the inter-fuel balance between electricity and gas. We certain have some serious concerns over AGL Gas Networks' potential funding of AGL Retail's inter-fuel aspirations.

The $1,000 per customer is something that seems to be of similar value, anyway, to some of the numbers that have been thrown around for what has been valued for retail customers in the recent Victorian sales. The point is that if AGL thinks that $1,000 per customer is needed, that is fine if they are willing to fund it. We do not think that the customer should be funding this initiative

(Overhead: "Other Issues")

We turn to some of the other issues. This is pretty much a well-trodden path, but interconnection, and other flexible services are needed. It seems apparent that will be a major pipeline connection into the AGL network within the next couple of years. We would obviously like to see reference services addressing that so that it happens efficiently and on an equitable

basis.

From the reaction yesterday when AGL was mentioning that connection to the AGL network should happen by negotiation, I think there was a bit of scepticism as to whether or not that would happen on an efficient and equitable basis. So we would like to see some more clarity and transparency regarding how those additional services will happen.

As Forcenergy mentioned yesterday, there needs to be more flexible options and trading needs to be allowed on the system in order to get the market happening and growth to occur.

The next point on this slide refers to the growth forecasts. I think AGL has been very conservative. BHP, as mentioned in the Forcenergy presentation yesterday, have been able to grow the market. I think a more competitive gas market in New South Wales would really drive out inefficiencies, bring down the price and increase flexibility, and that package would be of benefit to customers. If that happens, if the market is competitive, you will get growth and it will not be through the inter-fuel cross-subsidy. At the end of the day, New South Wales benefits by making sure that growth happens and that competition is allowed to occur.

(Overhead: "Other Issues")

The other issue that I would like to touch on is the pricing structures. From EnergyAustralia's perspective, it does appear to be flawed. The process allows cost shifting between the tariff market and the contract market. One of the issues that Jim Cox identified yesterday was really how can the gas tariff market bear significant increases when the electricity industry may not see similar increases? I guess if BHPP and Incitec have mentioned what the contract market and the revenue requirement of that should be, maybe this is an non-issue if that is what the Tribunal adopts.

The issue of price capping, I thought that was quite interesting, how it works and why it is there. One could maybe argue it is there to guard against potential bypass opportunities. However, as the Gas Advice group mentioned yesterday, there are ample bypass opportunities in the market, anyway. Clearly I think there needs to be more information and the Tribunal needs to look really closely at how the pricing structures are set up and hopefully there will be cost reflectivity in the approach. Thank you very much.

(Overhead: "Conclusion")

MR MALTABAROW: Chairman, in conclusion, we would submit that IPART should drive competition. EnergyAustralia wants to be a player in a competitive energy industry. It can bring a retail expertise and very substantial economies of scale, but it does need a level playing field.

We submit that an access arrangement is certainly needed from 1 July 1999. Access arrangements are required to eliminate the $1,000 per customer inter-fuel marketing effective subsidy of AGL that Michael Martinson has referred to. We would also submit that there is a requirement for reference services to ensure that commercial negotiations are not delayed by the parties being unable to reach a close.

We believe that competition will deliver benefits to customers in the form of reduced prices and the increased flexibility and service. This is what the governments desired when they signed the competition principles agreement, and competition in gas is one of the fundamental goals, if you like, of that competition principles agreement. Thank you.

THE CHAIRMAN: Thank you very much for that and thank you for your submission. It is very useful to us to hear from not only another energy company but one that has expressed a potential interest in being a participant on the retail side of this part of the energy market.

I am not sure whether you heard this - if you have not, I would strongly recommended your reading the transcripts - but we have heard loud and clear from at least one other potential entrant from the wellhead end, if that is the correct technical term, and certainly from customers, their views about asset valuation and the impact of the DORC or ODRC asset valuation on prices for use of network.

I have to ask: in your submission, you do advocate or suggest that we do adopt a DORC asset valuation methodology. I wonder how you reconcile that with level playing field, low use of network charges, which you also call for as a potential entrant. It seems to be a disconnect.

MR MALTABAROW: I think we are entirely consistent. We have advocated DORC methodology in the

valuation of electricity network assets.

THE CHAIRMAN: Yes, I understand.

MR MALTABAROW: In terms of inter-fuel equity, I would submit that we are entirely consistent. I do not think it would be open for us to argue one thing for --

THE CHAIRMAN: No, probably not --

MR MALTABAROW: And we would fully expect that arguments of convenience like that would be rejected by the Tribunal.

THE CHAIRMAN: So even if it means that the use of network charge would, almost inevitably, be higher than through the use of some other method of valuing the initial capital base, as a potential competitive retailer, that is something that you see as customers pay; it does not cause a problem for you as a potential competitive retailer?

MR MALTABAROW: Well, I think the principles that underpin asset valuation have to be consistently applied and have some integrity.

THE CHAIRMAN: That is the main point.

MR MALTABAROW: That is the strength of our argument.

MR MARTINSON: Obviously EnergyAustralia's position on asset valuation is on the public record. It is in the submission that we put forward in EnergyAustralia's submission and the joint history submission. Again, I do not know whether it is appropriate to go through those at this point.

THE CHAIRMAN: No, thank you, George has certainly answered the question. The delay issue raises a couple of points, and we have heard from others about delay. If delay occurs, I have to say that the processes, probably rightly, at least in the early stages working under this code, will inevitably mean there will be a delay beyond the July 1 start. We reluctantly accept that.

There seems to be two issues, one is the benefit to the incumbent in terms of dollars. That is an issue that there have been submissions on. The more difficult one you have raised, and it has been suggested by others, is what if the incumbent is able to use the likelihood of delay and current contracts expiring to write long-term contracts and what effect might that have in terms of potential new entrants?

I wonder whether you could help us understand some options for dealing with that and whether there are any lessons that might be learned from what happened to electricity as contestability was opened up and, indeed, what was the experience of electricity in terms of the nature of competitive behaviour by incumbents and new entrants.

MR MALTABAROW: May I make one observation before inviting Michael to pursue this further. In electricity, with the contestability unfolding, you had a situation where the jurisdictions were committed to contestability. Basically, at that stage, they owned the industry and certainly had control of the regulatory framework. I think the path to competition was much smoother because of that. That is a salient feature that distinguishes gas. In general terms, I think some sort of measures that mitigate the advantages of incumbency are required to make up for that. I do not profess to know in detail what specific measures should be taken, perhaps Michael does.

MR MARTINSON: In electricity there was not the issue of contestability, so far, being delayed and an issue being whether the incumbent may or may not have any advantages. I would like to say that in electricity, clearly the customers can get basically anything they want from the retail contracts depending on their individual circumstances, which clearly is something that is not available currently in the gas market. Anything beyond that, certainly EnergyAustralia would like to provide some options to the Tribunal on what some options to alleviate that would be.

THE CHAIRMAN: That would be helpful. Again if that were to be on the public record, it would be even more helpful. Finally from me, you make some comments on pricing structures, the sort of ultimate cascading down of the pot of cake dollars or caviar, whatever it is, to the structure of prices. As an energy participant with a network with a retail business in electricity, you have experience on that side. What views do you have about lessons or appropriate structure for pricing in use of gas network, the structural issue?

MR MARTINSON: For efficient pricing to take place, it needs to be cost reflective. Clearly in electricity, it is moving that way. I guess that is the issue in the case of gas; it does not seem as if it is cost reflective and that there is considerable scope for cost shifting. I think it

seems, in some way, that it is a system that has been designed but that had to be sort of tweaked at the edges in order to accommodate some new developing issues, bypass, being one in particular, and the price capping. So it is certainly time to have a look at pricing structure from start to finish and say, really from a cost reflective basis, how should it be established? That is what we do in electricity. We would expect a similar sort of process for gas.

THE CHAIRMAN: It is probably an area that we will yet again do more work on and the involvement of EnergyAustralia and others will be appreciated, thank you.

MR COX: Thank you very much for your submission. I was interested in the statement you made this morning to the effect that IPART must do more than simply approve what meets with the code. This contrasts the argument that was put forward by AGL yesterday which was to the effect that if the undertaking complies with the code, then we must prove it. I was wondering why you take this particular view of where our duty lies and what supporting analysis you can provide to us as to why we are, in fact, required to do that.

MR MALTABAROW: As I mentioned earlier, the legal framework is somewhat unclear. In a practical sense, if IPART merely took the view that it was going to approve arrangements under the code, there would be no driver for competition and in several years time, we would be exactly where we are now.

So I would be happy to take on board some of these legal issues and pursue them and I would be happy to pursue them further with government, but I was simply making the point that a passive regulator will not deliver competition, and the State has obligations to deliver competition. If the State cannot deliver it through one agency, I guess it has to look at which agency will be the driver to ensure that the goals that the State signed up to are achieved.

MR COX: If you were to develop further thoughts on that, they would certainly assist us, thank you. I cannot resist this question. You mentioned in your submission the importance of benchmarking AGL's operating costs. As you well know, and perhaps members of the audience do not, we have had prolonged controversies with your colleagues in EnergyAustralia and elsewhere in the electricity industry about precisely how one should benchmark the costs of electricity distributed. Reflecting on that experience, how do you think we should do it for gas?

MR MARTINSON: There have been a few issues with benchmarking. At the end of the day, benchmarking certainly has a role. EnergyAustralia finds some difficulty with certain benchmarking results in their entirety in order to set prices. There is a role for benchmarking. Clearly the issue that you referred to in electricity gives us a bit of grief.

However, even the numbers that were presented by AGL themselves using benchmarking still really did not make them to look very good. To me, if benchmarking is going to be used, which I expect it will be in some capacity, that is fine, but we should recognise that there are some difficulties with benchmarking. Even given that, AGL's cost structures still do not look all that great.

MR COX: Thank you for that. Finally, there is the vexed question of the marketing costs of the network. I was wondering whether your experience in operating electricity networks gives you any insights as to what the levels of marketing costs for a network should be and to what extent those might be transferable to the gas network owned by AGL.

MR MARTINSON: I think that --

MR MALTABAROW: I would be inclined to take that on notice.

THE CHAIRMAN: Thank you very much indeed. There are a couple of issues on which we would welcome your coming back to us.

MR MALTABAROW: We will certainly come back on those three matters that were mentioned.

THE CHAIRMAN: Thank you very much. We now have Harrison Manufacturing.

HARRISON MANUFACTURING

THE CHAIRMAN: Thank you for coming today, could you please identify yourself for the record and we will proceed.

DR MICHELL: My name is Richard Michell. I am director of marketing and operations for Harrison Manufacturing. I thank you very much for this opportunity to speak to you, which I must admit came as a complete surprise to me, following a two-page letter on the subject.

I did suspect, when I accepted the invitation, that I may be somewhat out of my depth. Once the agenda arrived, it just confirmed how deep that depth was. I do apologise, but I am speaking here as somebody reasonably ignorant about the subject at hand but certainly somebody who will be significantly influenced by the outcome.

THE CHAIRMAN: That is why you are here.

DR MICHELL: In order to try to achieve one objective, which I hope you do not think it is impetuous that I do not have to achieve, as an outsider I have attempted to wade through the various documentation. It does smack a little of a somewhat academic MBA approach to the subject and I just wish to remind everybody that out there there are some very real people in a very real world and that the world does not look necessarily like a Lotus or Excel spreadsheet. Maybe I am a little impudent, and I apologise, but that is my objective, to remind people that a lot of people out there are affected by the ultimate decisions made here.

Given that we are not a household name, very briefly, we are a privately owned family company established in 1923, we have just celebrated 75 years. On the manufacturing side we employ 25 people. That is a contrast obviously with the previous presentation.

Our business activities are that we are a toll manufacturer of lubricants, oils and greases. We actually make almost 20 per cent of Australia's grease requirements. We do not market under our own brand. We manufacture sulfurised oils, which is the reaction of sulphur with vegetable oils, and we toll manufacture fire-fighting foam concentrates and, for something different, we provide calcining and grinding of alumina.

Our turnover is $12m per annum, 70 per cent from within Australia and 30 per cent - this is a little bit out of date - from South East Asia. It is 15 per cent currently and coming back up, we trust.

So we are a micro drop in the Australian natural gas market. Our consumption, I have put there as at 1 August 1998, essentially the start of the new arrangement for us, was a consumption of 27 terajoules. The fraction of our manufacturing costs made up of natural gas was 15 per cent. 60 per cent of that went into process heating and the break down is shown on this overhead for gas use.

Essentially overnight the new arrangement arrived. We were, as I say, essentially overnight given a 35 per cent increase in our gas cost and zero time to adjust to it. Our own management response - we are based at Brookvale, about 15 kilometres from where we are speaking today - overnight we were hit with this problem and we essentially shut down almost a third of our operation which was rendered uneconomic and laid off a couple of people. We installed gas use-rate monitoring equipment and we actually commenced, and will go ahead if necessary, with negotiations to actually truck in gas for peak smoothing.

I realise the costs that are contained within the various submissions relate to Networks but I would remind the audience and the Tribunal that there are perhaps costs a little wider than that, that there are societal costs and societal expectations. Most people had anticipated that it would be cheaper to bring gas in via pipelines than via a truck. None of these moves we have taken will result in a significant cost reduction until one year has expired because the MDQ, the fixed charge, represents 60 per cent of our gas bill today.

Graphically, as shown on this next overhead, again these are minuscule numbers compared with other people in the room but you will see what we have done on gas, although not a clever approach, largely shutting things down; and the next slide shows the cost where we were hit with the big spike and where to date we are back to a position of reducing gas by 25 per cent and we are still 10 or 15 per cent up in cost.

I am also very aware that I am speaking on the current arrangement and I should be speaking on the proposed one, but again my objective is perhaps slightly different to the Tribunal's. The entire source of our problem comes from where

we happen to have built our plant. This next slide shows that in fact we are downstream of the Willoughby regulator station. The network charge there is 130 times as high as the charge at Horsley Park. Horsley Park may be considered a one off. It is ten times as high as Auburn Flemington and typically five times as high as most other locations across Sydney.

Our problem or our simple plea is that, if it is the desire to stop natural gas use in the Brookvale area, we would have pleaded for some time to have made more reasonable responses to what was done.

I would point out that although we would support the general concept of cost recovery, we have a problem with the fact that I guess AGL Network has been able to recover all of its costs and all of its inefficiencies. No one asked it to build these networks and, if these inefficiencies were already there, what a wonderful scenario to be presented with, that you can suddenly recover it all from your customers in one hit. To come along with a 35 per cent price increase and be able to do it behind the umbrella or shield of the Tribunal, no one else I do not think could approach any customer with that sort of increase and say "pay it" and you have no alternative.

Coming briefly to the revised arrangement, which again I am about to demonstrate my large ignorance over most of it, we do support the cap, I guess for the obvious reason that with a contrast of a factor of 130 across Sydney it does make it very difficult to continue operations. We query whether it goes far enough. As I said earlier, there are societal and other reasons that need to be looked at because we see the postcode approach still allowing AGL to fully cost recover its partial mistakes at the expense of its customers and we see no apparent incentive for AGL to address all of the factors that led to that high cost, such as they have no incentive to begin more throughput, it would appear, no incentive to look at maintenance costs, et cetera. We will pay it all for them. We also question what their incentive is with a cap to go on maintaining that network.

I hope I have the terminology correct, as we see a potential managed category which is to be based on the highest single day MDQ of the previous year. That appears to be unnecessarily punitive and we would suggest a statistical approach, a more rationale approach which would say there is a 99 per cent chance or whatever of you staying within that MDQ.

On the capacity reservation front, which we are on at the moment, we still see MDQ overruns as very, very punitive. In particular I mention that with South East Asia hopefully recovering, they penalise us enormously for increased working hours and we can see no apparent reason for that. If you have more business and you want to extend your working hours to later in the evening there would seem to be no capacity question, it is a compressible substance, it would seem to benefit both parties by greater utilisation of the infrastructure, greater utilisation of our asset, yet we would suddenly hit a very, very large cost penalty just for the simple fact of increasing working hours by perhaps 2 hours. You are only allowed to do it perhaps three or nine times a year. Is the real issue there MHQ rather than MDQ? If it is, we would rather move in that direction.

Finally, given particularly that we are at the moment way below our MDQ - I have no idea whether this is a factor anybody has discussed - I would be interested in the trading of MDQ. That would be a way of balancing out this three and nine day problem and it would be a way of getting benefit earlier if one does take steps to reduce gas. At the moment you are penalised if you reduce gas and if you want a managed category you would be rewarded if you increased gas.

That is all I have to say; and I thank you very much for the opportunity. I do apologise for taking up the time of so many people who know so much more about the topic than I.

THE CHAIRMAN: No apology is necessary; and thank you for coming because we have tended to hear indeed from perhaps the squeaky wheels and the large players in this game. It is very helpful to us to hear from smaller players.

Perhaps you can help me understand, because again I am not an engineer, the impact of the last determination. Certainly there seems to be a locational effect as AGL moved under the determination to a so-called "follow the molecule" design to be more cost reflective and therefore an effect in terms of where you sit in terms of the network and characteristics of the network. There is that bit.

The bit I do not really understand - you might be able to help me understand - is the impact of the MDQ arrangements. Are you able to tell us or do you indeed know what the different

impacts of location, change in pricing which reflects location, versus the MDQ arrangements were and are likely to be under the new proposal on your price paid.

DR MICHELL: I would like to be able to. For us the impact of the locational problem was just so massive that I guess it took up most of our attention. It almost didn't matter what we did on the rest of it, it was irrelevant. We did look carefully at the choice of MDQ, and this is the big lottery you are now in because I am not the expert, but essentially if you have three overruns you are into a penalty for that month irrespective of the size of the overrun; and if you have nine in a year you are into an ongoing penalty for the rest of the year.

THE CHAIRMAN: That applies equally to a relatively small player whose overrun will be a very small part of the system as it applies equally for a very large purchaser?

DR MICHELL: I assume it applies equally, as it is the same set of rules. Whether it is the same set of penalties, I believe it is, but it is an enormous sword hanging there, as I tried to indicate. If you are doing something like taking on new business, just want to extend two hours a day, suddenly there is this enormous penalty hanging over your head. You may only do it for a fortnight but you pay gas at that rate for the rest of the year.

THE CHAIRMAN: That is in the negotiation?

DR MICHELL: No. You can negotiate it up but not down, other than giving three months notice before the end of the contract.

THE CHAIRMAN: What did you do prior to access arrangements before this or was it not an issue?

DR MICHELL: We were on a contract with an agreed annual offtake and a penalty if you went below 80 per cent of that and not a guarantee of supply if you went more than a certain amount above, but no cost penalty.

THE CHAIRMAN: No penalty other than the price you paid?

DR MICHELL: A cost penalty if you went below 80 per cent of your annual quantity.

THE CHAIRMAN: What would you prefer now?

DR MICHELL: I would turn the clock back about 18 months ago, but to come straight to the point, our gas bill went up enormously, by 35 to 40 per cent. Even with all the moves and all the new proposals on caps that gets us back, with one third less production, to essentially where we were 18 months ago. We would rather a system where, as I say, we understand cost recovery, we do not believe that the consumer should pay on day one all of the costs as we played no part in setting the network up. It is not transparent. The retailer will not show us the necessary costs of the network charge versus the trunk charge, so we see that as a problem. It is a societal problem, not just our own.

In terms of what we would like, we would like more flexibility in the system, particularly if one takes a move which significantly reduces - which both parties agree reduces consumption, by shutting down a process. You get no benefit until the contract runs out. It is transparent to both parties why you have gone down. Equally if there is an increment due not just because you have tried to finetune it too much but because there is a genuine reason, it would seem to me there should be room for negotiation right back up the network.

THE CHAIRMAN: Thank you very much.

MR COX: Can I just ask you two questions: Have you had a chance to look at AGL's proposed new access arrangement and what it might mean for you?

DR MICHELL: I have had a chance to look at it. If I can chance my arm again, I would strongly recommend that at future inquiries there also be a document put out, a much slimmer document, aimed at consumers because it is very, very difficult to work out the impact on yourself. Fairly easy to work out the straight-up network impact but very difficult to work out the other permutations and combinations.

So, to answer your question, I am relying a large part on AGL retail, on the information it gives to me, and I do not like to be reliant on that information. I would like to look at it independently. We will be better off under capping as proposed. We will be back to about 15 per cent above where we were before the arrangements were changed nine months ago.

MR COX: You showed us this graph of a monthly dollar outlay which shows it shooting up and you brought it back, so as you are saying there will be a further reduction as capping comes into place and then your outlay will --

DR MICHELL: There will be a further reduction under the current scenario because we are still running on historical MDQ. It is running at something like 115, yet our contract is 150, so we are suffering a significant penalty even though we have taken these steps. It will come back under that. Now, the figures I have been given from AGL retail compare with our current MDQ. They do not necessarily take into account what will be our new MDQ. Although I am answering the question that capping is better, it may not be under the new MDQ. Ultimately we would prefer to be in a more flexible system that does reflect your actual use and the actual costs.

MR COX: Thank you.

THE CHAIRMAN: Thank you very much. That really was most helpful. We will have a break until 2 o'clock.

(Luncheon adjournment)

UPON RESUMPTION:

TOOHEYS

THE CHAIRMAN: Good afternoon, everybody. We will resume with Tooheys. Just identify yourself formally for the record and we will proceed.

MR STOCKLEY: My name is Cliff Stockley. I am team manager for energy services at Tooheys Brewery. Thanks for having me this afternoon. I will be giving a fairly short presentation. This is more from the point of view of Tooheys being a medium-size gas user.

(Overhead: "Tooheys Overview")

I will just give a brief overview of what I have prepared today. Our gas use is of the order of 260TJ a year. The costs are over $1m. I am not sure where that ranks us as a gas user, but they are significant costs.

I am basically here to talk about seasonality as it affects our business and the undertaking rules, I guess, for MDQ and so on, and the gas price path and the timing of that, and network charges, in particular the postcode issues, and how we think that could affect Tooheys in the short term.

(Overhead: "Seasonality")

From the seasonality point of view, beer is produced mainly in summer, so we use more gas in summer and not as much in winter. I have a short graph to show you just to give you an idea of the usages.

(Overhead: "Tooheys Gas Usage is Seasonal")

I have cut off the winter usages just to show the peaks over the last four years. So around that September, October, November December period, we have gas peaks, and that is the nature of our business.

(Overhead: "Seasonality")

What does that mean for us? I guess it comes back to the current or the proposed MDQ or maximum daily quantity rules, I guess you would call them, in the proposed undertaking. We see this 12-month fixed ruling as negative as far as our business is concerned. It does not allow any flexibility for adjusting MDQ during the year for seasonality effects.

The new managed capacity option uses the last 12 months history. Once again, that is very demanding for a company like us, because if you have one peak, one production breakdown or one issue on one particular day in the last 12 months, you end up paying for it potentially for at least the next 12 months and possibly for longer than that.

I just pose the question: with our peaks being in summer, is there restriction on the network as far as getting gas to industry in those summer months? What is the logic of having such rigid MDQs? I have not seen any evidence of a gas restriction in summer months; whereas, in the winter months there may be gas pressure problems and so on with the network upstream from us. That was the seasonality aspect.

(Overhead: "Tooheys - MDQ Peaks Mainly Seasonal")

I have another graph here showing the MDQs, the maximum daily quantities. We analysed these figures over the last two years. We have actually had a substantial number over our contract nominated. I will just focus on the first section of the graph. Most of those occurred before we actually had signed the contract with AGL. AGL had not informed us that we had actually gone over the peak quantities, and that was after a four-month period.

Issues like that, I guess, are a problem for medium and larger organisations. You are being billed on something where AGL did not have systems in place to actually tell their customers what the maximum daily quantities were. I believe they do have systems in place now. We have certainly installed our own system at the expense of some $20,000.

So we actually negotiated with AGL and got out of our overrun situation, and this shows where we are now. That is our MDQ. We have been virtually under our level for the last 12 months. So we can manage it if we know about it, but we prefer a seasonal MDQ approach or at least we would prefer to have more flexibility in the MDQ rules.

(Overhead: "Timing")

Timing issues - for us the indicative network prices actually show a price rise in July of 1999. Our understanding, with the transitions and so on, was that prices were still generally supposedly trending down at least over the next

12 months. We cannot see anything in the undertaking that explains why we would actually get a potential price rise in July.

Basically with regard to the remaining $87m transitional costs, we expected the removal of that over a 12-month period. From what I can understand in the undertaking, the removal of that last transition step as proposed is to occur over a three-year time period. So what effect does that have on us?

(Overhead: "Network charges - We understood the remaining $87m transition would remove over 1yr / not 3yrs")

These are indicative prices, but I think they are there to present the way it affects Tooheys. Basically, this top line here is the proposed new undertaking and the bottom line was the 1997 undertaking. It appears to us that Tooheys will not see the savings from the revenue under the curve here, but potentially AGL will see more revenue. That is the timing issue for us.

We were expecting savings over the next couple of years at least, but the new undertaking seems to negate some of those savings. Eventually we will get there, by the looks of it, but it will be another three years down the track and we just cannot understand that at all.

(Overhead: "Timing")

My last point on this slide was that we obviously have a gas contract with AGL Retail and with the July 1999 timing, that was supposedly the last step for removing of transitions. Our question is: will AGL be honouring - if that is the word; it is probably a strong word but I couldn't think of anything else - the price drop at July 1999 and perhaps adjust, if there are adjustments, when IPART makes a determination, which may be two, three or four months down the track?

From our company's point of view, we budget at least 15 months ahead. We have actually budgeted that gas price drop into our cost structure for the next six or seven months. All I am saying is that, from our point of view, if there is an adjustment, we would rather see it at the end of the contract period rather than three-quarters of the way through the contract period.

(Overhead: "The postcodes")

The final issue I wanted to bringing up was the proposed postcodes and how it will affect Tooheys and maybe some other companies, I am not sure. I will go through the first part of this slide which refers to the apparent cost anomalies. Basically you have a chart here comparing the previous undertaking where the network charges were really proportional to the pipeline distance from the nearest pressure reducing station and they are quite clearly laid out in the coloured maps in the 1997 undertaking.

(Overhead: "Postcode - Gas Network Changes")

We found that Flemington, which is postcode 2140, was actually zero distance from the pressure reducing station and the indicative costs are $0 to $100. In the new undertaking, it is quoted at $472, which is a substantial variance. I am not sure whether the maths are quite right there, but it is certainly an upward trend.

If we go downstream in kilometres from the pressure reducing station, Homebush, which was $0 to $100, is now proposed to be $472. Next is Tooheys. Obviously, with our location, we were in that range. The proposed undertaking for us is a network price rise of between a 6 per cent and 17 per cent. Rosehill, which was towards the end of the pipeline, was the most expensive. It has now almost become the cheapest. I could not find postcode 2143, but it is obviously in that area, and it is $114.

We just cannot understand the logic. The undertaking does not explain where these numbers come from. That is obviously the cost driver that is driving or may drive our gas costs up after July. That is basically all I have to say.

In summary, we were expecting gas prices to continue reducing as far as the network components are concerned and the current undertaking seems to mean that there is a step rise and it looks like that step rise will not be filtered out until the next three years, which is cost to us and revenue to AGL Networks.

THE CHAIRMAN: Thank you very much. We will just pursue a couple of issues with you. I note your seasonal MDQ issues, and you are a summer manufacturing business. My recollection is that, with some additional costs, tradeable capacity is allowed under the current arrangement. Is that something that you explored; that is, trading capacity with a winter peak user of gas?

MR STOCKLEY: When we looked at that option, it still has, if I could call it, strings attached. It looks back over the last 12 months and if there is one high MDQ day, that is what your MDQ has to be based on for the next 12 months.

THE CHAIRMAN: So that would not have helped? Trading capacity would not have helped?

MR STOCKLEY: Not with looking at one day. There may be some scope there if it was a little bit more flexible.

THE CHAIRMAN: As you point out, from July this year your contract with AGL Retail expires. Have you had any indication from Retail as to what is likely to happen? Have you had discussions with Retail that you may be able to share with us about what does happen after that?

MR STOCKLEY: Basically, the indications we received were we got an indicative price graph, but around that July period, it was a bit vague. Our understanding is that the next price drop that we expected actually will now not be forthcoming pending IPART's decisions. With the existing undertaking as it stands, we actually will not see a price drop; we will see a price rise. But for our industry, we have set our budgets, our forecasts and our plans expecting a price drop in July and from the concept that there is a contract there, albeit that it was signed almost two years ago, we would be interested in seeing out the term of the contract and if there are adjustments, that they occur at the end of the term of the contract.

THE CHAIRMAN: But does the contract roll forward in the absence of anything new or do you have to write a new contract?

MR STOCKLEY: We could roll it on, but I do not think that would be our preferred position until we know exactly what our price path will be.

We have a couple of other options on our site. They are future options but we could actually stop using gas altogether in the future, change to a coal situation. It will cost us money but they are the types of issues that we look at for the longer term, three or five years out.

THE CHAIRMAN: Is there a bypass option?

MR STOCKLEY: There is a bypass option. I mentioned that in the letter to the Tribunal. The costs on that option really are not feasible for us. It is kind of a grey area because we do not know which way it will go. If it is postcode, it is definitely not an option for us. If we can negotiate with AGL, it may still be an option for us.

THE CHAIRMAN: I understand. Thank you very much.

MR COX: I just have a couple of questions. You mentioned that the MDQ arrangements are very inflexible in New South Wales. Are you aware from any discussions with your colleagues in other jurisdictions whether things are more flexible elsewhere and whether there are any good models that you can point us to elsewhere where it is working well?

MR STOCKLEY: No. Our parent company is Lion Nathan Beverages. We have sister breweries in Adelaide and --

MR COX: And Melbourne and so on?

MR STOCKLEY: Not Melbourne, that is our opposition. But we have mainly Adelaide and Perth and the XXXX Brewery in Brisbane. Brisbane uses coal, so they do not use natural gas. In Western Australia, there has been a bit of activity as far as gas is concerned. I guess our brewery site there was fortunate in that there has been a new pipeline or a new pipeline is under construction, so their gas price virtually dropped overnight. They are actually paying less than we are. I think they paid about $3 a gigajoule more than us up to six months ago. In South Australia, our Adelaide site has the cheapest gas in the group. Even after this undertaking, Adelaide prices are still cheaper than ours. I think that goes back to when the Moomba to Adelaide pipeline was built. I do not know how many years ago that was, but certainly the pricing in Adelaide is a lot more favourable.

MR COX: What about Auckland, as a matter of interest? What about Auckland in New Zealand?

MR STOCKLEY: Auckland, I couldn't answer that. They certainly use gas. I do not know. I am not aware of the pricing.

MR COX: I was interested, particularly from the MDQ aspect, in finding out whether there is a good model where that is being handled well. It would be of interest to us if you knew of it.

MR STOCKLEY: No, I have not examined that aspect from the Auckland or New Zealand point of view.

MR COX: I think I understand the points you are making, so thank you very much for your submission.

THE CHAIRMAN: Thank you very much indeed. It seems an interesting juxtaposition to ask the Department of Health to come up after Tooheys.

DEPARTMENT OF HEALTH

THE CHAIRMAN: Thanks for coming today and thanks for your submission. Could you just identify yourselves for the record and we will proceed.

MR HAWKINS: Jim Hawkins, director administration of commercial services with the Department of Health. On my right is Jim Snow, a consultant from Energetics, and John McCarney, who is manager of business development of Northern Sydney Health Area Service is to my left.

The Department of Health virtually handles the policy aspects and liaison with government and the area health services are actually the direct service providers, so John will in fact give the presentation on behalf of New South Wales Health.

(Overhead: "NSW Health")

MR McCARNEY: Whilst the Department of Health is responsible for the delivery of health care in New South Wales, the actual delivery of it takes place through 17 area health services. Those area health services deliver tertiary, secondary and community health service to the population of New South Wales.

To give you an understanding of what Health is, we could say that the number of in-patients that are treated in the State is 1.346m, the number of out-patients is just under 22m, and we employ roughly 78,500 staff. The scope of those services taking gas ranges from the Hunter to the Greater Murray and west to Bathurst. You can see that we actually encompass a fair amount of the AGL gas network.

As I said earlier, of those 17 area health services, 12 take contract gas. In those 12 health services there are 31 contract sites ranging in size between 10TJ and 200TJ, ACQ, a total of 1,400TJ, and the average MDQ is 210GJ.

(Overhead: "New South Wales Health II").

In relation to the revenue structure of AGL Gas Networks, we believe we pay 5 per cent of AGL contract revenue. Our total contract gas cost is $9.5m, under the last IPART agreement, and the Department of Health's total energy cost for electricity, LPG, contract and tariff gas is $53m per annum.

I want to stress that we have literally hundreds and hundreds of tariff accounts as well as those 31. I do not know exactly how many we have, but we have a lot.

(Overhead: "AGL Arrangement")

Health did not get terribly involved in the previous IPART agreement. In retrospect, that was unfortunate. We were involved in other things at the time, but it was only when the impact of the last IPART agreement became evident to us that we actually started to get involved.

With respect to this AGL arrangement, I wish to say a couple of things. It is good that AGL has begun cost cutting and has responded to some of the issues which we raised back in December 1998 in our first document on that determination. I think we would have to admit that we do not have the detailed knowledge that IPART has in particular in relation to the valuation of the pipeline.

I came in yesterday just to listen to see what would happen in a place like this and heard a professor explaining the reconciliation between accounting and economic values and DORCs and ORCs and DACs. I understand it and read it, but it seems to leave me fairly soon afterwards.

The ICB sought in the AGL arrangement is much higher than the 1997 IPART determination. It seems to me quite unusual that, in such a brief period of time, a valuation can change to such a degree without any cash being paid in relation to it.

I also note in recent times that IPART made a determination on that Great Southern decision in which they claimed that they gave 82 per cent of the DORC. On reading the previous determination, I think 86 per cent was the figure you gave from AGL.

I wish to make two points: first, it seems to me that the valuation seems to be somewhere in that range of 82 per cent and 86 per cent, but I want to stress that we should spend time to get this right. If it is going to go on for five years, it is absolutely critical that we get it right because we do not want to go through this the next time round, so we have a need for certainty

(Overhead: "Contract Market Revenues")

This is purely just an observation. After the determination came out, we read some of the previous submissions to try to get an

understanding of what it was about. In that particular example we note that the Boral company estimated that a comparable market contract revenue would be in the vicinity of $50m. We know, under this arrangement now, that the figure will ramp down from $87m set by IPART to $70m in the years 2002 and 2003. When one looks at the potential cross-subsidisation that we will talk about later on and takes that from the $80m, it seems the Boral estimate cannot be too far out.

Also at that time, BHP came out with a fully distributed calculation using DAC and they tried to justify a market of $17m. From our point of view, we will certainly talk about how a stand-alone contract comes against Health. If you did have that one, it would be to the benefit, I think, of both the tariff and contract segments of the market.

(Overhead: "NSW Health GN Issues 1")

The next slides deal with some of the major points Health wishes to make with regard to what resulted from the first IPART decision. We have to take health services directly to where the people live. It is particularly important, in order that we get equity of access, that hospital services, community health services, whatever they are, be located where the people are.

In the stand-alone situation, we actually have to pay the full cost of gas being delivered to the community in which the bulk of our hospitals exist. We have to be careful. I speak from one area health service perspective, but I know there are two health services who do get the benefit of contract customers, and I am saying that, in the main, the majority of people are having to pay the full costs of the pipeline to them.

It is unreasonable that the amount of revenue generated by tariff customers at least could not be used to offset some of the costs that come into the hospital. We are not like energy dependent industries. They can place their plant alongside a pipeline or can take it to a State with cheaper energy costs. We have to put our hospitals and services where the people are. We are not able to move things around. Some of our hospitals are worth hundreds of millions of dollars and we need them to be there for 50 or 100 years.

Just in that particular vein, as the previous speaker mentioned, we believe we have a very strong seasonality of consumption. In the four months of winter we use approximately 250 per cent more than we do for the rest of the year. We believe that there is some need for some flexibility of MDQ that brings that into account. Individual hospitals with hard-working engineers and what have you are attempting to get their MDQ down, but when they see it takes 12 months for any effect to come through, it is a long way off.

Unfortunately in Health we tend to be fairly short term in some of these things, so it is hard for those people to focus on something that will take 12 months to come through. We believe strongly that at least twice a year you should be able to change your MDQ. I do not profess to have a great understanding of it, but it certainly happens in some other industries, and I cannot see why it cannot be done in this case.

I also want to say that in terms of capping, the AGL arrangement does not talk about capping. In our submission, which is a lot more complete than these points, we raised the point that we first heard of capping from an AGL Retail discussion on the arrangement. When they were asked where the numbers came from, they said the Network people.

I think you need to clarify within this determination the $5.50 that we have at the moment for capping down to the range of capping that has been alleged to be available. That needs to be done. It has an amazing influence on Health and I will show you that towards the end of the presentation.

(Overhead: "NSW Health Issues 2")

I know this next point has been raised by other people, but if we have a stand-alone situation, I am at a loss to understand how a significant amount of the marketing costs that contract customers are paying can be paid to AGL Retail. It is a subsidy for them to grow retail market through the tariff. They should grow the tariff market either through the tariff or through their shareholding. They should not be using my contract money to do that.

They say in the arrangement that they could not possibly bring their costs down any more; yet I understand some of their administrative costs are still high by interstate benchmarks. I think they should look at that and I think this determination should tie them to benchmarks.

With respect to fuel substitution, since the

last IPART determination, most hospitals have been severely hit by the increased cost of fuel distribution. Many of them have gone out and looked at the capacity to cap through LPG direct or synthesise, and coal. We have developed the business cases to do that.

In many instances, even though those cases have been put to AGL Network, I only know of one area health service that has been successful in a non-reference price. I had trouble even being able to put the case. But the point is that Health believes very strongly in the quality of the environment that we live in. We have come from a coal base. We are unlikely to go back to a coal base purely for commercial reasons. We promote things like wellness and good health. We are not about to pollute the atmosphere with fuels that are not as efficient as gas, and we do not really see why we should have to pay that individually. I think it is more of a general society issue, not just one for Health.

The last point on this page, which is linked to fuel substitution, is the issue of ring fencing and separation. I read the previous determination and it talked about how people will be good to each other and how the number of the bypasses will be seen to be a sign of how well they have done.

I want you to be aware that you really have to be there to understand how difficult it is to talk to AGL Network. For a long time, they would not discuss anything with me because they said the determination was an arrangement between the retail arm of AGL and themselves, or any other of their retail people, and that it had nothing do with me and I was not their customer.

I think you will find that attitude has softened slightly in recent times, but it is extremely difficult to get anyone to even look at a case for a non-reference price. As I said, I know of one area health service that got a case through, but there was a bypass option being offered at the time and maybe that is the reason why they did it.

I think these disputes should be resolved in a cost effective way so that it puts the onus between Retail and Network and that they do not have to compete against each other. We need a third party to get in there in a cost effective way to resolve disputes.

(Overhead: "NSW Health Issues 3")

With the second IPART determination - we should have reached the stage now whereby we have had two years of trying to understand it - it seems strange to me that we will have a transitional charge situation over the next years. It seems that there will be a continued cross-subsidisation issue if it takes three years for us to actually get to lower prices.

The last point I wanted to raise on that slide is that this determination is due on 1 July 1999. Health would request resolution within that time or that some interim arrangement be put in place to ensure that the early advantages to Health are realised.

I have raised with AGL Retail that if they are offering at least the capping to take place now, and that is before the determination has been made, that at the very least that should be their interim, if there is a delay in this determination. That has not been decided yet and a letter has gone to the Network company, but we have not had any decision back.

We are concerned that the significant amount of money we are expending now will continue on if the determination goes to January. We believe that some interim arrangement will be required if that does take place.

(Overhead: "Table 1. Cost to NSW Health of Using Capacity Reservation Service")

This graph is difficult to see and I do apologise to you. This graph shows the 12 area health services on the left-hand side in the first column. The next column shows what we are paying at the moment under the existing IPART arrangement, and the amount is $9.5m. The next column would show under the arrangement that we would be paying $9.0m, so there is a reduction of roughly half a million dollars to Health under the arrangement. Under that, some hospitals will gain some advantage under postcodes but significantly more do not.

Then under the capping, which is the third arrow to the right - and this is just to show you how important the capping is to Health, and to the majority - there is $1m savings in the first year, there is $1.1m in the second year and, from memory, it is roughly $1.3m in the third year. Those are savings to health on the existing arrangement through IPART.

In conclusion, on behalf of Health I would like to say thank you for the assistance given to

us by our consultants and Jim Snow from Energetics and Col Ericson, my colleague from Western Sydney Health, who helped in this submission. Thank you very much

THE CHAIRMAN: Thanks for that. Thank you for your submission and for assisting us in this exercise. I believe that in your submission, although you did not raise it today, you did raise the issue of capital contributions which has been raised by others. Just a point of clarification - has Health made capital contributions to network extensions?

MR McCARNEY: I come from the Northern Sydney Area Health Service. In putting this together, because we only got this information a couple of days before the closure, we were not able to question all those people as to whether they have made contribution. I know that Northern has made none. My understanding, from engineers, who have said that some contributions have been made, is that there are one or two of them.

THE CHAIRMAN: As a matter of principle in something --

MR McCARNEY: We think that is fairly important. I cannot for the life of me see why you would pay for the full cost of the pipeline if you pay for part of it and the contribution must come back as revenue or you get a discounted rate.

THE CHAIRMAN: I should actually have made a point of clarification for the record. The Tribunal, in its draft and final determination on Great Southern Networks, set an initial capital base. It may have coincided with 82 per cent of the value of DORC on the particular day the DORC was measured - it may have been a cold day; it may have been a warm day - but we did not set an 82 per cent value of DORC. It was a coincident in terms of initial capital base which happened to be some percentage of something else. That is important for the record. I was very interested in your comments about dealings with AGL Networks. Perhaps to draw out a little from your dealings with AGL Retail, how does that compare with electricity where I presume you have some contestable sites, and I do not know but I would assume you have some encumbent networks and retailers who aren't associated with a network.

MR McCARNEY: I think I can say that Health set up sometime ago an energy working party and all the area health services came together. It was more of an exchange of ideas and to help people come to grips with deregulation a couple of years ago. We individually went out to tender for electricity back at the time of deregulation and the majority of the health services did particularly well.

Once again, I can just talk about Northern Sydney Health Service where I belong and some of the anecdotal things I hear from that energy working party. In Northern, the people who won the tender are the distribution people, so we didn't have that particular problem.

From what I can gather almost everywhere, it was won by the local people. They went out of their way, because the local hospitals are the largest employers of people, so at the moment health is going out to a "whole of health" tender that is being advertised at the moment and it is obvious if that takes place that there will be a significant number of people who will have a different retailer to distribution people.

THE CHAIRMAN: Do you have direct dealings with the network company for electricity as opposed to the retail distributor?

MR McCARNEY: To be honest with you, it is just through Northern, the same people won the tender at that particular time so EnergyAustralia was our distribution and retailer, so we deal with them. Even so, there are some problems sometimes because of the distance between them. We tend to work through the retail arm but sometimes have to work direct with the distribution arm of EnergyAustralia to make sure we get the point across.

THE CHAIRMAN: I have also have picked up your points about flexibility of the MDQ issues and the structure pricing, and thank you for that.

MR COX: Thank you very much. You explained that you are both a participant in the contract market and the tariff market and you said you are spending in the order of $9m a year on your various contract items. Do you have any idea how much you may be paying in the tariff market?

MR McCARNEY: I just have to express my ignorance in that I am terribly sorry, I just know that at Northern, we have only just completed about six months ago a database of all the gas accounts so I would imagine perhaps somebody at area health may not know that. We intend to know it and it is one of the things that the energy working party has asked for but we do not know. There are literally hundreds and hundreds.

MR COX: Last time I think we felt that the

Department of Health may well have been disadvantaged by the access undertaking which tended to disfavour those at the end of long-line pipes, so we understand why you are in the position you are in. I am wondering to what extent the shift to a postcode method of cost allocation actually helps you?

MR McCARNEY: Across the 30 sites I honestly do not know. I can tell you that at Northern we have six sites, four of them were disadvantaged and two were advantaged, so when we talk on behalf of Health you have to understand that some of them are disadvantaged and some are not. We are not going to come out and say, "You should do this or do that", the principle seems to be okay, it is just that the result was not that good.

MR COX: You mentioned that you thought the $17m stand-alone cost for the contract market would be a fair thing, both for the tariff market and contract market. Can you explain how you came to that judgment?

MR McCARNEY: It just struck me that in reading the submissions that went before, what I thought they were saying was that there was a faulty distribution cost, if you didn't have a stand-alone methodology that they came back to the fact it was $17m. I do not know if that is right or wrong but if that was the case it seemed to me that certainly we would be advantaged by using that DAC method.

MR COX: You are really using what seems to be a fair thing.

MR McCARNEY: It would be worthwhile if we at least had a look at it to see what impact that would have for people on the fringe at the moment.

MR COX: Finally, I wish to turn to the issue of capping. I do not want you to breach commercial confidentiality, but if you could explain to us a bit how it actually works that might be of some assistance.

MR McCARNEY: To explain how it works, at the moment, for example, in the Northern Sydney Area Health Service there are three hospitals where the cost exceeds $5.50 and so their cost is capped at $5.50. It is not a huge amount of money but it is some money. Under this other capping, I have not got the figures.

MR SNOW: It would be somewhere about 3.50, 3.70, so you are seeing an enormous drop of almost $20.

MR McCARNEY: There was a range of $3 to $6 if you were over 100 terajoules, up to $3.80 I think if you were over 10, so it was a significant saving to us.

THE CHAIRMAN: Thank you very much indeed. Next we will hear from AGL Gas Networks.

AGL GAS NETWORKS

THE CHAIRMAN: We now have AGL Gas Networks back for I guess a further presentation and perhaps to address some of the issues that have been raised in the past two days. I will ask you to identify yourselves again for the record.

MR HARVEY: Chris Harvey, Manager, Regulatory Affairs, Gas Networks for AGL; and Mr Bruce Connery, General Manager, Regulatory Affairs for AGL.

The Tribunal has asked to us respond today to three matters, and we will address these before making any closing comments. The first matter was gas balancing, and we believe two issues have been raised. Firstly, there appears to be a concern that balancing is overly complex. Gas Networks knows that balancing procedures are complicated. However, a balancing process is necessary to encourage users to ensure the quantity of gas they withdraw in order to avoid the need for interruption to customers. In the case of a network the complexity is a consequence of designing a system which sends the correct signals to users to be in balance while at the same time being fair to all participants.

Secondly, there appears to be a misunderstanding in the submissions that balancing is site specific and is therefore restrictive. Users under the access arrangement will generally be retailers supplying numerous sites. Under the existing and proposed access arrangement retailers can aggregate those sites for balancing purposes, thus alleviating the problem.

The next matter is trading policy. The proposed access arrangement reflects the intent of the code by permitting assignment of capacity and change of receipt and delivery points except where this is not technically or commercially reasonable. Gas Networks has not offered the ability to trade capacity as a reference service because in a diverse network, usage in one location generally has no relationship with usage in another location. That is, not using capacity in one section of the network does not release capacity on another section. However, where circumstances are such that capacity trading does make sense this could be part of the negotiated service.

The last matter is the participation of Gas Networks in the New South Wales Energy Ombudsmans scheme. The Energy Ombudsman is primarily established to deal with disputes between electricity companies and the franchise customers. The Gas Code establishes a mechanism for resolving disputes between network operators and users by referring them to the Tribunal for arbitration.

In relation to disputes between gas retailers and their customers, the consumer protection regulations require retailers to provide a dispute resolution scheme in their customer service code.

There are two other matters which have arisen over the last two days that we would like to address. There have been references to AGL's revaluation. This is an incorrect interpretation of the code. The establishing of valuation, the initial capital base, is a requirement of the code and applies to every service provider. The code anticipates that initial capital base will normally fall between DAC and DORC and lists factors which must be taken into account in consideration of determining the landing between DAC and DORC.

Gas Networks has addressed the factors in the code and has considered the way in which regulators have determined those matters in recent decisions in proposing its base between DAC and DORC and consistent with those factors.

Secondly, there have been suggestions that the existence of bypass opportunities is evidence that the pricing structure proposed by Gas Networks is deficient. Gas Networks believes that whatever pricing structure is adopted there will be some opportunity for bypass because the focus of network design and optimisation has been minimisation of cost to a group of customers in aggregate.

It did not have the effect of minimising the cost of serving individual sites. It seems incongruous that an individual can choose to join the group and reap the benefits when it suits that individual and then leave the group when it does not suit. The effect of availability of partial bypass is that network operators will in the future design networks to minimise bypass exposures. This is unlikely to lead to economically efficient outcomes.

An additional point: While we consider that price capping is important in moderating some of the locational impacts it will tend to increase the number of opportunities for bypass.

We would like to make several general observations about the nature of this process. The submissions and these two days of hearings have raised many issues which will be addressed by the Tribunal. The code establishes objectives which conflict in their implementation and it gives the Tribunal discretion to determine how those competing objectives will be reconciled. Gas Networks recognises the role of public submissions and these hearings as a means of assisting the Tribunal in exercising that discretion.

The consultative process under the code is by its very nature adversarial. As a result, users in their submissions put forward views of the access arrangement and code which most closely align with their interests. One of the results of the adversarial nature of the process is that where a participant's interpretation of the code suits their argument the Tribunal is urged to ensure compliance with the code. Conversely, where the code does not suit their argument participants are asking the Tribunal to require changes to the access arrangement which effectively require a rewriting of the code.

I will give just three examples of this: Firstly, it has been suggested that there should be a reference service for every possible service which might be sought by any potential user. However, the scheme of the code is to provide sufficient prescription to produce the potential for arbitration while allowing flexibility for parties to negotiate contracts within an appropriate framework. Reference services for the services likely to be sought by a significant part of the market establish that framework and negotiation remains a cornerstone of the access regime.

Next it is asserted that discounts given to customers should be recoverable in reference tariffs. It should not be recoverable in reference tariffs. However, the code specifically recognises the need to allow recovery of prudent discounts.

Another claim is that as the trunk lines are gas transmission lines they should be regulated by the ACCC. This overlooks the New South Wales derogations to the code which require the trunk lines to be treated as part of the distribution system and to be regulated by the Tribunal.

Clearly the role of the regulator is to implement, not rewrite, the code. While there would be merit in some arguments which users have presented these would require a rewriting of the code. They are therefore not relevant to the review of this access arrangement.

In recognising the nature of the review process Gas Networks accepts that participants will promote their own interests through code requirements. However, it is inappropriate that Gas Networks is alleged to have failed to comply with the code where the real complaint is that the participant is not satisfied by the outcome of the access arrangement.

Further, Gas Networks would like to put on the record its strong objection to the misuse of this process to make allegations of illegal behaviour on its part. We do not intend to address this matter further here except to categorically refute such allegations.

In closing, the submissions have identified many issues arising from the proposed access arrangement, including issues on which the Tribunal has indicated that it will focus. The Tribunal has indicated it will seek independent verification of information provided by participants, and Gas Networks will continue working with the Tribunal and its consultants in the course of the Tribunal's investigations of these areas.

Finally, we wish to reiterate our belief that Gas Networks has complied with the code in relation to the preparation of the access arrangement and the provision of information to the Tribunal and the market. While there have been and will continue to be differing interpretations as to the information requirements of the code and valuation and allocation methodologies, Gas Networks has submitted a proposed access arrangement which falls within the parameters established under the code and which provides a fair and reasonable basis for open access to its network.

Thanks for this opportunity to speak to you.

THE CHAIRMAN: Thanks very much. Having talked about asset valuation, rates of return and all these economic things for so many years, I am actually going to ask some clarification questions on technical things like gas balancing and MDQ, which I find terribly exciting.

To the extent that I think I understand gas balancing, and I may not completely, what struck me was the example I think from Harrison Manufacturing - and presumably that is typical of

fairly small users of gas, but still contract customers - if I understand correctly what he was saying, and your point about aggregation by retailers is potentially quite relevant here, he faces the same sorts of restrictions and penalties if he overruns outside of what is allowed by what is ultimately a very small amount and a very small proportion of the total and, if I understood him correctly, they are the same sort of penalties as a large contract customer who will overrun again against those rules.

Is that factually correct? And a second question, is it right, is it factually correct and does it actually work that way?

MR CONNERY: If I can just perhaps clarify a little, gas balancing is not about capacity or about MDQ or overruns, gas balancing is about the input of the commodity equalling the output. It is not about capacity and transport and the whole design of gas balancing is to provide an incentive for each individual user to put into the network what it withdraws on a day because a consequence of there being a shortfall is that the pipeline or the network loses pressure and it does not have a lot of capacity or line pack in it and, when it starts to lose pressure, to maintain the operational capacity one has to interrupt some customer. It could well be a customer who is doing the right thing in putting the right amount of gas into the system, so in other environments, perhaps in North America, you might have storage near the demand centre and that would mean you would not have the same issues with gas balancing because if there is a shortfall on the day you can actually withdraw from that storage and put it in. But with the supply being fairly remote from the market, a long pipeline, it is hard to ensure that we will be able to achieve that balance unless people put in the right amounts of gas.

THE CHAIRMAN: Am I right in my understanding, which is that the very small user who is unlikely to have such a large impact on the total balance compared to a large user faces the same set of rules and penalties?

MR CONNERY: The rules are the same but they have been specifically designed to try to moderate the impact of imbalances on small users. That actually explains a fair amount of the complexity. We agree, there is no question, it is complex, but it has been designed to try to moderate the impact on small users.

THE CHAIRMAN: Probably that is an area that we might try to explore in seeing what happens elsewhere.

MR CONNERY: We are not surprised on that.

THE CHAIRMAN: On the trading and the MDQs, to the extent that I understand it, the main thing that worries me, that puzzles me, is in a system that appears to have a fair degree of excess capacity what is the issue? Why do we get so excited about MDQs if we have that much excess capacity in the network?

MR CONNERY: There is excess capacity in parts of the network, not in all parts. I think this is the issue, that we have imported a lot of terms which are more relevant to pipelines, transmission pipelines, than they are to networks in terms of what services should be provided. Networks just do not have the same capability. They are perhaps a little more like an electricity network than they are a gas pipeline in the sense of the sorts of flexibilities and how they operate.

As I think Chris mentioned, the fact that someone is using capacity in one part of the network, it could be Liverpool, does not actually increase the capacity of the system in Strathfield because they are remote from each other. That is where the complexities arise.

THE CHAIRMAN: Again, perhaps naively, it seems to me if there are opportunities for seasonal trading which do align with where there are constraints on the network, the system should be designed to actually encourage that rather than put cost penalties on that trade?

MR CONNERY: One of the difficulties with that I guess is the very nature of the way in which we and others have tried to reflect cost reflectivity by using a maximum daily quantity as the measure. Once you start to offer services which are available for a shorter period than that then clearly customers, or supply retailers, will - so would you or I - start to manage their profile to follow that and then you have effectively got to start looking at a whole different pricing structure.

THE CHAIRMAN: One of the messages coming out was - I paraphrase some who were here the last few days - we can live with it but we believe there is scope and benefit for more flexibility in the way the MDQ works. Do you think there is some scope to actually develop greater flexibility in the way a MDQ type arrangement works?

MR CONNERY: I would have to leave it to people who

are more expert than me on how much flexibility within a MDQ system. It does bring rigidities, no question.

THE CHAIRMAN: Postcode: I asked you yesterday about the tariff structure implications and I think you answered, yes, we would like to hear suggestions, because you are not necessarily locked into anything as being necessarily the only correct way of doing it. Over the last few days we have heard examples of the problems of different types of price structures. Nothing new. With the benefit of those two days, any further thoughts on perhaps the way it works?

MR CONNERY: That is another one that really goes to the very foundation of the proposed access arrangement and we would like a little more time to consider that.

THE CHAIRMAN: I accept that. Again, it is something that is clearly on the table. One of the other issues I think we have all been aware of for a while is that with the best will in the world, and perhaps even with a better code, we still won't get an approved access arrangement out by July 1 when the current arrangement expires and that issue has been raised by several people in the last two days. Does AGL Networks have a view as to what happens after 1 July until we sort this out?

MR CONNERY: I think in a pure, if I might use the word, pure legal sense then, as you say, the access arrangement concludes as of the end of June and no access arrangement applies from 1 July until such time as the Tribunal approves an access arrangement. You have asked, what are the options that might be available? Without having explored those in great detail, the options that come to our mind are that there could be some form of undertaking from Gas Networks in relation to the continuance of the existing access arrangement and its pricing structure.

Another alternative could be an undertaking that related to the adoption of the proposals that are before the Tribunal at this moment. We know none of those are the answers that people necessarily want to hear but it is very, very difficult to think of other alternatives.

THE CHAIRMAN: I think it is easier to think of other alternatives.

MR CONNERY: Yes, and we may need someone to rule on where they might lay.

THE CHAIRMAN: Yet another issue to explore.

MR COX: I would just like to explore the point you raised about people trying to rewrite the code. I understand the point you are making, that most people are self-interested. We understand that. The issue has been raised, however, what exactly should be in the reference service suite and how do we decide that issue? You may not want to answer that now but it is an important issue that we have to grapple with.

MR CONNERY: We could make at least an early response and we could provide you with a fuller answer no doubt in the future. But the code does - I do not have the exact words in front of me, I would feel more comfortable if I did - it provides that there be provided a reference service which reflects the services that a significant part of the market would seek. Then it does provide for the opportunity for negotiated services to cover a whole range of different parameters that users may need to meet their specific needs.

MR COX: It probably depends on the meaning of important words like "significant", which is a difficult issue.

MR CONNERY: It is, but once you start to open it up and have a reference tariff for everything I think you move away from what the intention of the code is, not only that it becomes very, very difficult to determine what price one applies to each of the various services.

THE CHAIRMAN: The words apparently are "each service that is likely to be sought by a significant part of the market for which the relevant regulator considers a reference tariff should be included". The follow up question I have is, and there is judgment about what a significant part of the market is about before even worrying about what definition of the market is, but if it was the case that a number of players put on the table their proposals for what was appropriate and, as required by the code, subject to the regulator's views on that, will that help us move towards a sensible resolution, I stress sensible, I hear what you are saying, that we do not want 3000 possible services?

MR CONNERY: I think it is a matter that clearly the Tribunal will explore, I know it will, and in those considerations I know you will look at the whole area and look at it in the context of the whole code because we have not had time to look at that in that context. I am sure you will look at the issues that arise with how does one

project how much volume will be sold on this particular bit and how much on that and how do you work out tariffs. All those things need to be considered.

MR COX: There are a number of issues we would like to know more about. You may not be able to respond now but perhaps later. Issues of price capping and how that works. You have heard a certain amount about that today. We are interested in your view on that and the importance of that. The forecast volumes. The revenue allocation between the trunk and the local network, how that works. And, finally, the impact on customers, including contract customers. These are issues we would like to pursue with you and understand better than we do at the moment.

MR CONNERY: I suspect that any answer that we might be able to give now is probably not going to really contribute greatly. They are significant questions that you have raised.

THE CHAIRMAN: Thank you very much indeed. That does bring to an end an exciting two days. The next step is perhaps to reiterate what I said yesterday, or to clarify, that there has been a section 2.9 order issued for further information to be put in the public domain and when that information is provided it will be provided to participants to assist them to assist us in assessing this application.

We have certainly heard and accept that there is always benefit from further submissions and it may be, as I think may have been suggested by Jim McLeod, some merit in having a closing date for further submissions. That is something we can consider, but there is no question that we will allow for further submissions.

There will be further consultation and processes. There is a lot of work that is being done and is about to be done, including work by consultants looking at issues such as asset valuation, capital expenditure and pricing costs, and clearly we want to explore more and better understand some of these exciting technical issues like MDQ and balancing and pricing structures and the like.

Whether there is the need for, benefit from, a further hearing as opposed to other public processes prior to the draft determination is something that the Tribunal will form a view on. Then there will be a draft determination.

So with that outline of the next steps, again I think all of you, AGL Gas Networks and other stakeholders, for helping us because I know that for Jim and I the last few days have actually been of great benefit. Thank you very much.

(At 3.10pm the Tribunal was adjourned accordingly)