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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO THE NATIONAL ACCESS REGIME

MR G.R. BANKS, Chairman
MR J.H. COSGROVE, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT BRISBANE ON WEDNESDAY, 13 JUNE 2001, AT 11.00 AM

Continued from 8/06/01 in Sydney

MR BANKS: Welcome to the hearings here in Brisbane on the commission's position paper into the national access regime. My name is Gary Banks. I'm chairman of the commission. My colleague is John Cosgrove who is with me on this inquiry.

The purpose of the hearings is to give those with an interest the opportunity to present submissions in response to the commission's position paper, which we released at the end of March. We noted at the time that we released that position paper a little bit earlier than we normally release a draft report, in order to coordinate with two other draft reports that come out of concurrent inquiries on overlapping issues, namely the Prices Surveillance Act review and also the review of telecommunications competition regulation. Since then we have also got an inquiry into airport pricing which raises again issues in common.

I've noted previously that we have been fortunate in having a wide range of very good submissions in this inquiry. That continues here in Brisbane. After the hearings in Brisbane we have a last round of hearings in Perth. Then we'll give consideration to what we hear in the hearings and any follow-up submissions, which can come in until say the end of June, in preparing our final report, which will go to the government by September, again hopefully to align that report with the telecommunications regulation report.

Just a couple of points on the hearings. We like to keep them as informal as possible but we just remind people for the record that a full transcript is taken of the proceedings and will be made available on the commission's Web site. We try to get it on the Web site within a few days of receiving it. There's no formal oath-taking in the proceedings but the Productivity Commission Act does require participants to be truthful in their remarks.

Okay, with those formalities out of the way, I would like to welcome our first participants today, the Australian Gas Association, and ask you please to give your names and positions.

MR NAGLE: Thanks, Gary. My name is Bill Nagle and I'm the chief executive of the Australian Gas Association.

MR CRAWFORD: My name is Garth Crawford. I'm the senior policy analyst at the Australian Gas Association.

MR BANKS: Good, thank you. Thanks very much for attending today and for the submission, and indeed the earlier submission that you provided to the inquiry. As we've discussed, why don't you perhaps highlight any points that you want to make and then we can have some discussion.

MR NAGLE: Right, thank you. Just by way of background, the Australian Gas Association is an industry representative body. Our membership encompasses the full range of players along the gas chain, from gas production, transmission, distribution, retail and gas appliance manufacturers and importers. But our core

membership are those regulated businesses within the gas industry, the transmission and distribution businesses, and more recently the ring fence retail businesses. So issues of third party access loom fairly large for those membership categories and it crops up a number of times along the gas chain.

The gas industry is generally regulated under a specific gas code but that deals with obviously a number of issues that are dealt with by this inquiry. They're played out through various forums, either with the ACCC if it's the transmission pipeline generally, or state regulators such as the Victorian and New South Wales state regulators through access arrangements and rulings. Where coverage of these gas assets is not extended, it does not apply, then Part IIIA directly determines the regulatory framework for those assets.

We generally debate regulatory matters through forums such as the national gas pipeline access code committee, which I sort of call a clearing house for the code and regulatory anxieties within the gas industry. That tends to work on a lot of day-to-day technical issues to do with gas code regulatory matters. But on larger issues, such as what the objectives of third party access is all about and national competition policy and those bigger issues, reviews such as this one being conducted by the Productivity Commission are much better forums for those sorts of discussions.

Like you've said, we have participated in this process from the beginning, with a number of submissions, and also ourselves and most of our members, our regulated pipeline and distribution business members, have also signed up to two submissions by the network economics consulting group, which have been submitted. So the AGA welcomes the position paper issued by the Productivity Commission. We believe it's a comprehensive and positive examination of the challenges facing infrastructure owners, and also the regulators, under the current national access regime.

I guess our simple take-home message that we would like to emphasise in our presentation here today is that the AGA believes the current national third party access regime has led to increased uncertainty for investors in significant energy infrastructure and fails to balance appropriately the long and short-term interests of energy infrastructure owners and consumers of energy.

Access regulation has increased regulatory risks, while creating asymmetric risk for proponents of new gas pipelines and network expansions. Investors in new infrastructure assets bear all market risks associated with the failure of a project to achieve demand forecasts, but if the project is successful, however, the investors face the prospect of having project returns capped by regulated terms and conditions for third party access.

In addition, access regulation in the gas pipelines and distribution network sectors has had insufficient regard to the long-term benefits to consumers of the availability of new infrastructure services and the reliable delivery of existing services. As the position paper notes, this imbalance between consideration of long

and short-term interests of current consumers and potential new consumers has the potential to lead to costly underinvestment in key infrastructure services. That's a paraphrase of a quote from your discussion paper on page 61.

Therefore the Productivity Commission review comes at a fortuitous time for the natural gas industry, given the significant progress in implementing national competition policy reform since 1993 and our experience with the national third party access code for natural gas pipeline systems - ie the code, as we call it - since 1997. We believe it's an appropriate time to revisit access regulations and determine whether there are improvements that can be made.

The gas industry considers that experience with its own specific code contains some lessons for the future of the national access framework. It's also fortuitous and timely that only last Friday COAG, the Council of Australian Governments, which used to be called the Premiers Conference, met in Canberra where they considered, among other matters, the development of a national energy policy framework.

One element of the framework endorsed by state and federal governments includes examination of this very issue, of sort of balancing essentially the interests of various parties affected by energy market regulation. They have set up a new ministerial council on energy in a COAG energy review, tasked with examining regulatory approaches that effectively balance incentives for new supply investment, demand responses and benefits to consumers. So it's pretty well spot on with what we're dealing with here.

I take away from that though that implicit in this task that COAG has set itself is that they believe we currently do not have a balance of those interests, that there is in fact an imbalance, and the fact that they're going to be reviewing that is good news from our point of view. So I would recommend to the commission a close reading obviously of the COAG papers and particularly the various attachments and fine print in those various reviews that they have announced.

I guess one question I would like to leave you to think about here is how this inquiry can link into the COAG energy review process. I believe in the fine print of the COAG communique there is an opportunity for us to do that, in that they say that they're going to be cognisant of a whole range of other reviews and processes going on. So hopefully we won't have to reinvent a process such as the one that we're going through here on at least the national access regime elements of energy policy. So I'm hoping that COAG officials and ministers are cognisant of what the Productivity Commission has set in train.

A couple of specific comments. In our submission we raised a number of very specific matters to do with the Productivity Commission position paper and a couple of those I would like to emphasise here. Firstly, the AGA supports the Productivity Commission proposal for the insertion of an objects clause into Part IIIA. This clause is to stress the need for the efficient use of and investment in infrastructure assets. A well-drafted objects clause may help to ensure that all parties affected by infrastructure regulation have a common understanding of a key aim of access

regimes; that is, promoting economic efficiency by promoting efficient investment in essential infrastructure services.

A single harmonised objects clause could also assist regulators who face a number of inconsistent lists of objectives across such instruments as clause 6 of the competition principles agreement and a variety of industry codes. The commission correctly identifies the risks of multiple access regimes operating without a set of clear guiding objectives. An objects clause which highlights the underlying objectives of access regimes would be a valuable guide to regulators. Regulators currently face a variety of overlapping, inconsistent and confusing sources for the public policy objectives they are charged with pursuing.

At this stage the NECG's follow-up submission comments that the Productivity Commission's proposed clause is acceptable to us but with a number of caveats, which it goes through I think on page 17 of that submission, particularly the need to tighten up the provisions of Part IIIA itself to begin with.

Following on from the objects clause, the AGA strongly supports the inclusion of access pricing principles in Part IIIA of the Trade Practices Act, setting out the need for access pricing to lead to adequate investment in gas infrastructure and appropriate returns. The AGA considers that action on effective access pricing principles is potentially the single most important proposal of the position paper.

The existing patchwork of overlapping and inconsistent statements relating to pricing issues fails in the key objective of access pricing regulation; that is, the encouragement of private negotiations on access pricing. A clear consistent set of principles on access pricing would serve to promote the efficient resources of access pricing disputes by commercial parties, significantly improving overall economic efficiency in the infrastructure sector. Again that's referred to in our submission as well as the NECG's submission in detail.

The AGA supports the commission's findings that Part IIIA declaration criteria must also be reviewed to capture the fundamental objective of competition, that is promoting economic efficiency. Declaration or coverage in the case of the code - that's the terminology we use in the gas code - of significant infrastructure assets should only occur where market failure has been demonstrated and where efficiency would be promoted by the decision. The AGA therefore supports the proposed amendments to sections 44G(2)(a) and (b) of the Trade Practices Act, to ensure that declaration of infrastructure assets only occurs where it would lead to a substantial increase in competition and that it would be uneconomic for anyone to provide a second facility.

This amendment to the current declaration criteria is consistent with the principle that access regulation should seek to identify clearly the objectives and outcome being sought, not define the means by which it will be achieved. Declaration criteria and access regulation must seek the outcome of efficient competition, not simply the implementation of competition regardless of the risks of economically suboptimal outcomes - a risk which is significant in the context of

infrastructure services.

We had a recent example about the coverage of the eastern gas pipeline in this regard, in which I believe that decision by the Australian Competition Tribunal I think reinforces the commission's finding that the declaration criteria need to be redefined to ensure that assets which do not need to be regulated are not regulated.

Having said a number of good things about the Productivity Commission's position paper, there are a couple of concerns I would just like to table here. We have them also in our submission. The AGA has a concern regarding the commission's recommendations to end ministerial involvement in decision-making under Part IIIA. While the role of ministerial decision-making under Part IIIA does potentially create delays in the regulatory process, this involvement is nonetheless warranted. Concerns relating to potential delays in decision-making should be addressed through binding time limits on regulatory processes perhaps.

Ministerial representation in regulatory decision-making is important for the point of view of public accountability for decision-making. It is also important that, given the generic assessments of public interest that current legislation requires and which ought to be part of future access regimes, that an identifiable public representative makes a transparent decision; ie, a minister. Conversely, regulators with specific mandates under the legislation should not be put in a position of making unappealable public interest decisions with significant national consequences. Again we can cite the example of the eastern gas pipeline decision recently.

In conclusion of my opening comments, I think it's critically important that governments consider and implement the commission's proposals in a timely manner. It's likewise imperative that the commission's conclusions about the inadequacies of the current national access regime and proposals on measures necessary to enhance investment in infrastructure assets to meet the long-term interests of consumers be recognised by the various planned reviews of industry specific regimes in the gas and electricity sectors and by these new COAG reviews. So we're certainly not short of reviews in this particular area and hopefully the consistency and convergence between these reviews will occur.

The Commonwealth government has announced a review of energy market reform, as I mentioned, and we hope our long promised specific review of the operations of the third party access regime for gas pipelines and distribution networks will also occur. The AGA considers that these reviews should seek to incorporate the substantial progress made on key issues relating to third party access regimes and the commission's review. Thank you.

MR BANKS: Good, thank you.

MR COSGROVE: Just on that point that you ended on, would you see a review of the gas access regime as being separate from this other COAG process, potentially?

MR NAGLE: That's our strong view. We believe it should be. The COAG review I think will be three parts electricity and one part gas, I suspect, and it will be to do with generic issues like third party access and some of the more generic issues about interconnections and a range of other matters. I think in terms of our specific gas access regime there is a very good case to continue a detailed examination of that, separate to or parallel to the generic energy market review, otherwise I think we'll certainly lose the focus on that, because like I said, because like I said, we had this clearing house committee called national gas pipeline access committee which can deal with issues up to a certain level, then when they get sort of in the realms of what the whole structure is all about, it says, "Well, that's out of our domain," so we need to find a domain where we can actually have that debate. But if the COAG review process doesn't go that deeply then we still have this gap about operating under a specific code without actually being able to question the overall purpose of it. We can question the details of its operations but not the purpose.

MR BANKS: Okay. I mean, some might argue that you needed to do an embracing review just because gas and electricity are substitutable and it's an energy market rather than just a gas market but you don't see that as being a problem in terms of just reviewing the gas code as such?

MR NAGLE: Well, I mean, there will be some overlap in interest but we'd be very reluctant to give up the opportunity of having a specific gas code review separate to the COAG one.

MR BANKS: Right. Okay, thanks for that. The other thing I thought I might just come back to because since we put out the position papers, we've had another test case in the ACT, namely, the Duke decision, and I take it from your comments earlier and also on page 5 that you see that as a welcome development. You say here on page 5:

> It demonstrates that the decision to impose and regulate assets should be considered extremely carefully and it shouldn't be imposed where there exists the potential for actual competition.

I thought I'd just give you an opportunity just to comment on the Duke decision. I mean, do you feel that it really settles matters, because some other participants have raised concerns about aspects of that decision.

MR NAGLE: Yes. I thought it a timely decision and a timely case in that the arguments for coverage in the first place I didn't think were very strong, although the advice going to the minister, I understand, was unanimous of the view that there should be coverage. I always thought that some of that advice was all about defending the code in a way, that there was a view in government circles that if coverage wasn't extended in the code and new or nearly all new transmission pipelines in particular were to be regulated outside of the gas code, then that would be the death of the code because in many respects the history of the code was about transmission pipelines probably more so than distribution businesses.

The irony would be that distribution businesses might be - for the sake of people here, distribution businesses, I talk about gas networks around cities and towns and transmission pipelines being long-distance high-pressure pipelines from gas fields to cities - that the irony would be that distribution businesses would be the only parts of the gas industry still regulated under the code and most of the action of new projects would be elsewhere. So I think there was always an element of concern about that, which I always thought was a problem because the coverage test should be always determined on its merits and there was ample evidence that there was quite a competitive market developing in natural gas in the Sydney market. You had to interconnect between New South Wales and Victoria. You had head-on competition between EGP and the Moomba-Sydney pipeline and by APT, plus you also had a range of other fuels competing in the energy market. So for those sorts of reasons, I thought the eastern gas pipeline decision was good. The question of - and setting a high hurdle rate essentially for coverage, and I didn't think that high hurdle rate was properly understood when the minister originally made his decision. I mean, I can't speak for him, he may have actually fully understood it but it didn't strike me to be taken into account.

MR BANKS: I mean, the hurdle rate that you speak of I guess particularly relates to criterion (a) about increasing competition, but some concerns have been expressed about the interpretation of (b) in terms of how the service is defined, a sort of point-to-point definition of the service. We had Henry Ergas, for example, in Sydney being concerned that this sort of ignored the kind of natural monopoly interpretation of uneconomic to duplicate, that it had sort of seemed to be settling in previous to that. But I don't know whether that's something you had any views on.

MR NAGLE: Not well-developed ones I can give here, I don't think, but we can certainly think about it.

MR BANKS: You might have a look - the NECG, I think in its submission, only talked very briefly about it but in the transcript there was a bit more discussion in Sydney.

MR CRAWFORD: I think one thing we would say is that the Australian Competition Tribunal's decision and the reasons for the decision gave a pretty clear exposition about what it contemplated promotion of competition to mean and I think to that extent that was welcome, that sort of discussion following from the sort of Sydney Airport Terminal's case and a bit of an exposition on - the fact it's behind us and what the ACT will look at in determining what would promote competition and what wouldn't.

MR COSGROVE: Some people have put it to us that the second decision, the eastern gas pipeline decision together to some extent with the earlier SACL decision, mean that the existing criteria for declaration in Part IIIA are really pretty adequate now and that changes to them might not be necessary. From your point of view, do you have any reactions to that line of submission?

MR CRAWFORD: I'm by no means an expert on the declaration criteria so I'm

apologetic for any inaccuracies but it's my understanding declaration criteria are not exactly the same as the code coverage language used in a code. That dissonance between them I guess is one concern of ours but the same sort of issues arise under each. As Bill mentioned, you have to make sure you set the hurdle rate at the right height and I think one positive thing we took from the eastern gas pipeline decision was that a tribunal, a court in essence, was willing to give a presumption that competition would emerge without regulation, and I think that was a very welcome messages in terms of the overall gas regulation.

MR NAGLE: One could say that the fact that Duke were successful in their appeal proves that the declaration criteria is sound, but they've had to go to extraordinary lengths to get to that point. One would have considered that advice going to ministers about these sorts of issues about the declaration criteria and whatever and what constitutes competition would be such that would raise significant doubt in the minister's mind about whether or not coverage was warranted in the first place. So I mean, there is an appeals option and most of these companies are large enough to put the time and resources into pursuing that. But one questions why the default position is coverage unless you appeal, and if you've got declaration criteria which are clearer about that, well, they should be cognisant of those.

MR COSGROVE: You have indicated in your submission that you favour the small changes which we proposed to the first two criteria of the declaration arrangements. You haven't said anything about our second proposal, the so-called two-tier proposal which would have involved more extensive rewriting of the declaration criteria. Does that mean you're not keen on that tier 2 proposal?

MR CRAWFORD: No, it was simply a decision - when the submission was originally drafted we addressed every issue raised but in terms of consultation with our members, there were some issues which were to the fore of them and some tier 2 issues they really viewed as being a bit further down the road and something they didn't need to at this point express a view on. So it shouldn't be taken as expressing a view either way.

MR COSGROVE: You indicate - and that was the reason for my question - that these criteria must be reviewed to capture the fundamental objective of competition, that is, promoting economic efficiency. Now, that was an important element in our tier 2 proposal which specifically refers to, I think a significant improvement in economic efficiency at one point. But nonetheless, although you haven't ruled out tier 2, your preference is for the tier 1 change. Is that right?

MR CRAWFORD: Correct.

MR BANKS: I guess one of the things that we discussed quite a bit in Sydney with the lawyers is the perils of introducing new words into legislation. That can arise even with the tier 1 minimalist changes in a sense, that from a lawyer's perspective a change implies not reinforcing intent but possibly changing the meaning and a reason for doing that. In fact one party said that even talking about a second facility could be problematic in that it could be interpreted as an identical facility. So I make these

points just to alert you to the fact that even in relation to our recommendations on tier 1, you know, we'd obviously be wanting to think about the extent to which words that we would see as strengthening the case might actually create legal problems in interpretation. What seems to have come through is the word "substantial" seems to be generally approved of by lawyers. I think it's been lawyer tested sufficiently through Part IV and so on; they feel comfortable with it.

Okay, I was just going to ask a question on page 6. It's really in relation - this point about information provision by the provider of a declared service. You talk about - I think my colleague had another question but one of the points you make here is:

> The second principle is that maintenance of the confidentiality of information provided by commercial entities is the key to a process of information provision operating effectively.

So you're focusing on confidentiality there and I think there's a similar point made on page 18 where under the heading Sufficiency of Information you say, under the box there on page 18, that:

> Information disclosure requirements may create the risk of anti-competitive outcomes by promoting parallel pricing and so on enabling competing operators to know the intentions of competitors.

Now, in a discussion we had, I think in Melbourne and I think with BHP, although it might have been - BHP appeared in Sydney - their view seemed to be, "Well, look, if you're dealing with natural monopolies, you know, they don't have competitors by definition and therefore confidentiality is not an issue." So is this something - I just seek any reaction to that, particularly in the context of the gas industry I guess.

MR NAGLE: Well, just a general point, that clearly if regulators and regulator businesses are to have relatively open relationships, I think that confidentiality of information flow needs to be ensured otherwise you get into behaviour where the two parties are dancing around each other in terms of the information requirements and the use of that information. In terms of the natural monopoly argument, we often come up against this argument and clearly there's argument about whether or not - yes, there might be a natural monopoly in terms of supply of gas but I mean, there are other fuels that provide ongoing competition with gas and gas is not like electricity which is an absolute essential in most applications; in a number of applications gas is a discretionary fuel. So it might be a monopoly gas supply asset but is not necessarily a monopoly supply of energy, and there's a range of competition issues there.

MR BANKS: If that was a strong point, you'd wonder why it should be covered anyway, which is probably a question you've asked from time to time in relation to some project.

MR NAGLE: That's right.

MR BANKS: John, did you have a question - - -

MR COSGROVE: Yes, related to the same paragraph. The other principle that you've put forward to us is that:

> Information collection should be confined to matters relevant to the purpose for which the information is required.

Sounds okay but I wonder what it actually means. Another participant had earlier put to us that information collection should not require the provider to supply information which it doesn't generate in the normal course of its business. Would you see that arrangement as inadequate? In other words, would you want, if you like, a separate set of accounts kept for the purposes of access regulation over and above what the company might normally collect?

MR CRAWFORD: If I could answer that, I guess it's a point which arises specifically in terms of the fairly intrusive and information intensive gas industry code. Gas regulated businesses have experienced both cases, that is, information being requested by regulators used for purposes other than for which it was collected. So that's why that reference is in there. As to the question of information collected in the normal course of business, I guess in a light-handed regulatory framework of which the gas code was intended to be, you should not have to have a separate set of accounts for regulatory matters. I note that there are several regulatory proposals kicking around at the moment in various forums to harmonise regulatory sort of accounting frameworks across Australia. To the extent that that would promote consistency, that would be a good thing but I think we should be aiming at a regulatory framework which does not create unnecessary burdens on service providers to collect information at a level of which they didn't previously collect.

MR COSGROVE: I think it was Freight Australia at our Melbourne hearings who in their submission advanced the idea that there were incentives for voluntary disclosure of information in the marketplace. You, I guess, haven't looked at that but if you had any time or interest in doing so, I'd be glad to have any reactions you have to that thought.

MR CRAWFORD: Were they saying that there is or there should be?

MR COSGROVE: That there are incentives for voluntary disclosure.

MR BANKS: I was just going to ask a question on page 8. I think you endorsed the pricing principles that the commission put forward in its position paper and indeed I think you were saying earlier that you see the introduction of pricing principles as being perhaps the most important area for change or improvement. There has been some reaction to the use of the expression "efficient long-run cost of supply".

MR CRAWFORD: That's right.

MR BANKS: You seem to be endorsing that and don't seem to be concerned about it. Others have worried that that might reinforce the sort of building-block mentality and raise questions about, you know, judgments about what efficiency is, particularly in an ex post sense and so on. In fact I think NECG may well have put forward the proposal that the expression be something like "costs prudently incurred" or something, to try to overcome that. I don't know whether you had any reactions to that.

MR NAGLE: Yes. This issue was discussed quite extensively within our industry in terms of our discussion leading up to whether we would endorse the NECG submission. What we've done here is to generally welcome the development of a draft set of access pricing principles and repeated them, your principles in here, and then made a number of other comments about some of the other types of principles we would like to see. More recently, when we were looking at the NECG submission and the debate within our industry, we probably settled on the term "costs prudently incurred" rather than "efficient long-run cost" and that was the wording, I think, that went into the NECG submission which is probably our more recent exposition on this so - only by some weeks but if we had some more time we possibly would have included those words in our submission. So I don't think you can read our submission to be endorsing the term "efficient long-run costs" over the more recent term in the NECG one.

MR BANKS: Good. Thanks for that. Some of these additions, I think, pricing principles, are also probably ones that we discussed with NECG. There's probably not a need to go through them again.

MR NAGLE: I think the NECG submission went into a lot more detail on this, which they were in a better position than we were at the time.

MR BANKS: Okay. I'll just have a quick look here. No, we'll leave those. Thank you for that. Yes, you make the point about the need to retain ministerial involvement and others have made similar points. I take it that your own case is pretty much predicated on the fact that there are issues there to do with public interest, that a minister of the crown is really only qualified and accountable to make those decisions. Is that the nub of what you're proposing?

MR NAGLE: Yes, it is in that we believe that the involvement of a minister in declaration decisions gives the process some greater transparency and allows for a - I guess, another rough and ready rule of public interest to be applied over the decisions, or the advice at least.

MR BANKS: Are there any examples that would occur to you where decisions would have been better if ministers hadn't been involved?

MR NAGLE: There's probably always lots of those. I mean - - -

MR BANKS: Because I guess - I mean, some participants have complained that ministerial involvement has probably not advanced things too much and then subsequently, as in the Duke case, been overturned by the tribunal anyway. I suppose there are more pragmatic issues stacked up against the in principle one that you're making.

MR NAGLE: Yes. I don't think the issue is that by the inclusion of a minister you would necessarily always get better decisions but I mean, I think it does focus the minds of the official family, you know, providing advice or making these sorts of decisions, that if they can go via a ministerial decision process, I think that honestly does distil the type of thinking that agencies are involved in these sorts of - giving advice to ministers or making decisions in this form.

MR BANKS: Yes.

MR NAGLE: It's essentially a transparency issue. There are a lot of subtleties, particularly in terms of what is the public interest, and my understanding about the lead-up to the Duke decision was that there was quite a bit of time between the time that the advice went to the minister and the time that he ultimately made his decision, and during that time there was a large amount of consultation that he undertook with players on both sides of the debate about whether or not to cover the pipeline or not. Although his decision ultimately was one that I don't think was the correct decision and the courts ultimately found that as well, at least it did allow for due process and opportunities for people to put their cases directly to an elected representative.

MR BANKS: How transparent is that though? I mean, some have argued that that process could be made more transparent and rather than get rid of ministerial involvement, one should simply, you know, improve the time lines or the transparency of that.

MR NAGLE: Well, I think ministers, when they make decisions like this, have to give - I'm not quite sure what the technical term is, but a statement of reasons I think it's called, about why that decision is made. I don't know if that's the point you were getting at.

MR BANKS: Yes. My understanding was that that hadn't been - that was an area that hadn't really been discharged adequately and that there was a need to ensure that that happened. But I wondered whether - I mean, part of your concern with the removal of ministers may have been that it was compounding the proposal that we had there as a tier 2 proposal, which was the consideration of having one regulator.

MR NAGLE: Yes. Well, I was going to finish on some comments on that and that's also one of our concerns, and I noticed there was an article in today's Financial Review where a well-known national regulator was referring again to the desirability of having a single regulator.

MR BANKS: This wouldn't be a regulator who had recently been decorated?

MR NAGLE: Could well be. Yes, I think there's a bit of confusion around about this issue of the single body administering Part IIIA, whether or not we're talking about a single body administering Part IIIA or a single national regulator for regulated businesses and access. The issue of dividing up the steps about who makes a decision about whether or not an asset will be subject to regulation and access and separate from what those terms and conditions of access should be, I think that separation has very strong merit and I don't think that's consistent with what your proposal is. So yes, I think we would like to make that point, that those sorts of - two stages of the process should be separate.

In terms of a single regulator self, I would make a couple of points. First of all, if you're talking about that being the ACCC, I don't think that's appropriate; not that I've got anything personally against the ACCC but given that the ACCC has a range of functions, be it, you know, mergers and acquisitions, third party access regulation and consumer protection and pricing and a whole range of other matters, I would have thought that you couldn't have a single national regulator sort of carrying all of those functions that would be acceptable to us. So that's one point.

The other point would be that if we had these pricing access principles and an objects clause clearly understood and clearly prosecuted through the process, through Part IIIA and the various specific codes such as the gas code, the issue of consistency one would assume would be a lot less of a problem. The argument is really about consistency of approach rather than having a single body. But that's an issue that, you know, is kicked around in our industry a fair bit but generally that's where we came out at the moment.

MR BANKS: Just on the question of the minister again - I mean, if you look at having the two - the NCC and the ACCC both with their respective roles - I mean, some have argued there are distinct roles and that the NCC is appropriately there to make the sort of policy decision in a sense in the minister's place on coverage. I mean, one could argue that to the extent that you have declaration criteria that are reasonably well defined or becoming so over time, that the NCC is then well placed to make those decisions without having the minister involved, or would you still reassert the need - - -

MR NAGLE: I think we would stick to our original position where you would have separation of the decisions about coverage and setting the terms and conditions and still with a ministerial oversight and a ministerial decision-making process - a step in the process.

MR BANKS: All right.

MR COSGROVE: Could I just ask one further question on that matter. I think a part of our reasoning for suggesting a combination of the NCC and ACCC roles into one for coverage and setting of terms and conditions is that a lot of what you're doing when you're trying to assess the merits or otherwise of coverage is pretty much the same as what's done in setting terms and conditions; that is, you're looking at trying to assess the extent of market power, which has some reflection in terms of prices

which might be being charged and that sort of issue. But you would still see, as a sort of important matter of principle here, would you, that even if you had a minister in the system, there's still some point of principle in separating the coverage decision from the setting of terms and conditions?

MR NAGLE: That's true, yes.

MR CRAWFORD: I think, to explain our concerns a bit, I guess our key concern would be the aggregation of regulatory power and the principle that the same body would be deciding whether or not an asset would be regulated and then going on to regulate the terms and conditions. I understand what you're saying about assessing market power and the parallels in that process, but in our view EGP demonstrates that there are significant national issues in terms of coverage of major assets which are of a different kind to the day-to-day regulation of third party access.

MR BANKS: Okay, thanks for that.

MR COSGROVE: I have a question.

MR BANKS: Sure.

MR COSGROVE: Page 12 of your submission indicates that you're not keen on the proposal - this was a tier 1 proposal of ours - that the ACCC publish a post-arbitration report. This was a proposal which I think in a general way had been suggested to us by the NCC and we saw some merit in it. You say it would create a significant risk of participants in arbitration being reluctant to provide adequate information for initial arbitration. Could you tell me please whether your concern about this is again a problem of principle or more one of practice in terms of the possible content of such a report?

In other words, could you conceive of circumstances in which such reports might be okay, provided that their content was somehow confined to material which wouldn't run this risk of participants being reluctant to provide information at an earlier stage?

MR CRAWFORD: I guess this is a point which again flows from our specific experience with the national gas code - an experience of several regulated gas businesses. At a principle level I guess we wouldn't have a problem with information, which was strictly confined and agreed non-commercial by the regulated entities, then going ahead for publication. But our experience has been that regulators don't always make those judgment calls, those line calls correctly, and sometimes have gone ahead and published and released and dealt with commercially sensitive information in a way which was inappropriate.

MR COSGROVE: Does the gas code contain any guidance on the content of such reporting?

MR CRAWFORD: I'll have to take that one on notice, I'm afraid.

MR COSGROVE: Thanks.

MR BANKS: Just looking at my colleague's question and whether it came in the report, I have just looked at our own treatment of the publication of decisions by ministers. Just perhaps going back, clarifying that earlier discussion, our understanding is that while ministers are required to give reasons for their decisions to the parties concerned, they're not required to publish those. In situations where they don't make a decision and therefore you get a deeming of a not to declare outcome, they don't have to give any reasons either. I think in the rail industry that has been a problem in the past. So I guess we did see scope there to enhance the transparency of - - -

MR NAGLE: Yes. Well, in terms of where there's no decision but obviously an application, one could argue that a decision not to have a decision is a decision. We could understand why there might need to be greater transparency by some sort of statement from a minister about that. We don't have a big problem with that.

MR BANKS: All right. Yes, I just had a question on page 13, where you've got some useful information on the cost of industry specific regimes. It could be just in the phrasing of it but you've got a sentence there in the second paragraph where you say - it's the second-last sentence of that second paragraph. You say:

> The costs of providing regulatory oversight for access regimes make up, at least nominally, another half of the total cost of third party access regulation.

I just wasn't sure - maybe it's the word "another" in there - but I just wasn't sure what was being referred to there, and then what evidence you might have to support that.

MR CRAWFORD: That's an imprecision in drafting. That's just making a generic point that we can and sometimes do come across instances where we can actually quantify the cost of regulation to specific gas businesses. We don't have data about how much the cost of regulatory oversight in the gas industry costs. I guess that paragraph there is really calling that fact to mind: that we're not just talking about cost to bottom line but we're talking about the cost of funding ACCC and numerous state regulators and their time and personnel.

MR BANKS: Okay.

MR NAGLE: Yes, the term "half" in there - we assume that if our members are spending a huge amount of money in this area then the people on the other side of the negotiating table are also spending a large amount of money, in the agencies in particular.

MR BANKS: Yes, sometimes they complain that they don't have as much money to spend.

MR NAGLE: Well, I think we would all like people to be spending a lot less.

MR BANKS: Okay, thanks for that.

MR COSGROVE: Yes, on page 14, under the heading Impact of Access Regulation on Investment, the third paragraph there says:

> The proponents face an additional regulatory risk that any efficiently constructed spare capacity will be accessed at prices inadequate to give a long-run return on the asset.

Is there an implication there that, instead, people will put in place inefficient infrastructure, for example a small pipeline to remove any possibility of spare capacity that might be declared for access? I'm not quite sure what that sentence was trying to convey.

MR CRAWFORD: Yes, well, there's always debate when infrastructure proponents are designing their proposal. In terms of just say a transmission pipeline, the width of the pipe and the decisions about the width of the pipe always loom large, because it's essentially a proxy for the overall cost of the project. If there are arguments about ultimately how the pricing access spare capacity is actually going to - the tail of the dog, you know, if the tail is going to wag a dog - then the issue about the optimal size of pipes in transmissional distribution businesses does loom large in decision-making.

MR COSGROVE: Does it loom as large as the prospects, the assessed prospects for market growth?

MR CRAWFORD: I think they would always prefer to actually build pipes with spare capacity, because there always is the belief and the objective of growing the market where you're taking the gas to. Therefore building a pipe larger than current requirements is always the way to go. But it does come with this enhanced regulatory risk that once you actually do have that access then it may actually undermine the foundation contracts that gets the pipe built in the first place.

I think generally people do opt for building pipes with spare capacity. But those sorts of questions shouldn't really - you know, there shouldn't be an unintended consequence of the regulatory regime that people sit around sort of essentially using some of game theory model to determine how fat the pipe is going to be. From a market development in the industry and economic development point of view one would always hope that the pipes are essentially oversized, because that's really the objective - ultimately the objective of growing the gas market for a whole range of environmental and economic reasons. That's what we're all on about.

MR COSGROVE: I can see that regulatory regime is an element of all of this but are you aware of any cases - without of course identifying them - in which decisions have in fact been pushed towards what you might call the inadequate capacity, as a result of this regulatory regime?

MR CRAWFORD: There have been a number of cases where pipes haven't been built, which I guess is the ultimate undersizing.

MR COSGROVE: For the reason you've mentioned here?

MR CRAWFORD: Well, because of the uncertainty about whether or not there could be a greater return established that will actually pay for the pipe over the life of the project.

MR BANKS: We have been looking for examples and I guess we're having trouble sort of getting concrete ones. I suppose it's in the nature of it. Those sort of outcomes aren't always documented. I'm not sure that your submission addresses that point. But if there were any examples, concrete examples like that that you could make available to us, that would be helpful.

MR NAGLE: Yes.

MR CRAWFORD: On page 15 we discuss the delaying of the central ranges pipeline. That's one example which could have been assisted by better regulatory treatment and more adequate rates of return on investment, which has led to a significant delay in a pipeline to regional Australia.

MR NAGLE: Also, just immediately under that we have a TXU example, which led to the scrapping of the proposal to take the infrastructure to Barwon Heads.

MR BANKS: Yes.

MR NAGLE: That's quite a useful example actually as well.

MR BANKS: Yes, we heard a bit about that in Melbourne as well, thank you. You have got a point on page 16 that I was going to just ask you to elaborate on briefly. You're talking about contestability of greenfields projects and I think your discussion is quite useful. At the end of the second paragraph you say:

> Indeed, in a competitive market with limited investment opportunities, commercial positioning may lead to a company investing in the project just before it is marginally profitable in order to take advantage of economies of scope or scale.

I just wondered whether you might like to elaborate on that point.

MR CRAWFORD: Well, it probably works best in the case of gas transmission companies. All gas transmission companies would have a range of options on the table at any one time, about market opportunities, market development, regulatory regime, potential rates of return of a number of projects. One market player might in one point of time - either to take advantage of opportunities of economies of scale or scope - to essentially leapfrog other potential providers of a greenfield transmission

pipeline in order to build their business in way that they would value.

MR BANKS: I'm sorry, I got a bit distracted by the noise there. So what you're saying here is that they would move earlier because of the synergies with their other business.

MR CRAWFORD: That's correct.

MR BANKS: So there's in a sense a sort of a time - for a period, there's an element of cross-subsidy involved.

MR CRAWFORD: Well, in a perfectly efficient market, at the time when the net present value reached their acceptable standard every single company would presumably make that investment. The point I guess I was making was that some companies, because of their strategies, may make that investment ahead of others.

MR BANKS: Yes, okay. Gentlemen, time is passing by. The other thing that we perhaps could just talk briefly about is this notion of access holidays that you have addressed. Again you have got some helpful discussion in there. You say:

> One key operational issue that would require careful consideration is eligibility.

Just in terms of your earlier discussion of contestability, we have had some discussion in other hearings about to what extent that notion of contestability could become the criterion, and indeed that you could have an arrangement whereby basically all new investments were excluded, other than those where there was unlikely to be contestability. They would typically be extensions or augmentations by an incumbent, either an incumbent with an access holiday or just an incumbent who is in a position to exercise some market power in terms of the timing of that investment.

I don't know whether you have any reactions to that, in which case, what you would have in those situations, is that other than in those sort of circumstances the onus would be on the regulator really to show why the proposal shouldn't have an access holiday. In those circumstances where you could argue that there was a lack of contestability then the onus would be placed back on the investor really to demonstrate why there should nevertheless be a case. I don't know, you might want to take that on notice perhaps, or if you have any reactions now to that, because you talk also about the need to include expansions of existing infrastructure networks. I guess we can see some merit in that but again we think the notion of contestability would be quite important.

I mean, if it was a declared facility and there was an expansion occurring there, then almost by definition that expansion or augmentation would be contestable because it is a declared facility, but if it had an access holiday and it was doing that, then perhaps not. I guess we are trying to find ways of drawing lines around particular types of proposals to give it a bit more clarity.

MR CRAWFORD: I guess our initial reaction would just be that that could be a useful approach and a top priority would be to ensure that the process of establishing eligibility wasn't sort of more painful than the benefits of the access holiday reaped at the end anyway, so rules of thumb and appropriate sort of presumptions could play an important role in that.

MR BANKS: If you have any further thoughts on that, again you could have a look at the discussion we had with, I think, NECG where we talked more because they had a whole section of their submission devoted to creating more ex ante kind of certainty and looking at safe harbours, as they called them, and a range of ways of doing that, but we would value any independent reaction you had on that point.

MR COSGROVE: You also raised an important question of the length of such an access holiday, whatever you call it. Do you have any guidance for us on that? For example, would a typical use of a discounted cash flow approach to an investment decision provide any guidance of what might be a reasonable period?

MR CRAWFORD: I guess in terms of particular gas infrastructure distribution, networks and gas transmission pipelines, economic life of the asset is around 20 to 25 years and certainly that sort of framework for timing as the starting point, perhaps with the ability for particular infrastructure types to argue the merits of their own cases would be the sort of magnitude we were looking at, but I don't have a specific time in mind. The key thing is that the investment horizons and the regulatory certainty - the period of regularity certainty matches, to some degree.

MR BANKS: One issue has come up where - I mean, some have said the holiday should be unlimited and I guess others have raised concerns about whether that would lead to perverse incentives in terms of the investment decision initially, perhaps, your Honour, sort of over-specification or putting in infrastructure that would be of much longer life than normally would be economic and that sort of thing. I don't know whether that would be an issue in your industry.

MR NAGLE: I think there is always a commercial break on that sort of behaviour in many respects.

MR BANKS: I mean, some industries like telecommunications, technology is changing so fast that I could see it being an effective break there. You know, you make a kind of gold-plating decision and three years down the track technology has, you know, been overtaken so comprehensively that was a waste of money. In pipelines, however, you are busy taking gas from A to B along that one route so that sort of technological obsolescence isn't such a problem. It does really come down, as you were saying, to the economic life, the physical life, of the asset. It's another point you might just think about, if you have any reactions to, in the context of what the ideal period would be. I think we have probably detained you long enough. We will have a quick look and see if we've got some priority questions left.

MR COSGROVE: I think the last question I have is in connection with the

statement you made in the section, Valuing Infrastructure Assets on page 22. This is in the context of discussions of CPI minus X regulation. You say it would be crucial for the X to be a credible benchmark such as total factor productivity. You go on to say that benchmarks from densely populated countries with substantially different geographic and climatic conditions from those in Australia would be of limited use here. Could you outline for us some of the problems that you have in mind in making that statement? International benchmarking is not, you know, an uncommon technique these days. You seem to have significant doubts about it.

MR NAGLE: If you have a look at the US market I think there is something like 400 networks or distribution businesses compared to 400 major ones from around the cities. There is five or six in Australia where, because of the size of the cities and the nature of our population spread, the distribution businesses are probably - there is a lower ratio of customers per kilometre of pipe basically.

MR COSGROVE: So you could get distortions because of differences in the scale of operation?

MR NAGLE: There is a lot more capital buried in the ground per customer in Australia's distribution businesses, say compared to the US, where they are much more concentrated. So we're not very keen on these international benchmarks. I mean, we think our businesses and the way they operate here are highly efficient and they have got nothing to hide but there is always these arguments about, "Let's shoot over to America and let's measure the foreheads of six or 10 distribution business managers and compare them to Australian ones." You might actually miss the point; and the point is that they are entirely different geographical and capital tensive arrangements. So that is our concern there with - - -

MR COSGROVE: Are there no, what you might call, similar situations in Canada or western United States where the population is less dense?

MR NAGLE: I think there are different orders of magnitude. I mean, if you look at Canada, for example, and the type of climate they have, the gas intensity use per household or business or whatever is much, much, much higher than in Australia. We've got distribution businesses below our feet, as we speak here. Brisbane is a classic case where you have got a very small number of customers hanging off a distribution business which is quite extensive, which might sort of be the equivalent in size to distribution businesses in some of the larger North American cities where they have subzero temperatures for three or four months of the year. We're in the middle of winter here. You can look out the window there and there is - I don't think too many gas heaters are actually on at the moment.

MR COSGROVE: Might need it for cooling.

MR NAGLE: If you can crack the gas cooling conundrum I think we would be in a better position in Queensland. I mean, if you look at the two distribution businesses here, one on the north side of the river and one on the south side and compare those to North American cities with different population intensities and

different climatic profiles, you are really comparing cheese and chalk.

MR BANKS: Thank you. Thanks very much for that. We appreciate it.

MR NAGLE: Thank you.

MR BANKS: We will break now for a few minutes please.

MR BANKS: Our next participant is AGL. Welcome to the hearings. Could I ask you please to give your name and the capacity in which you're here today.

MR CONNERY: My name is Bruce Connery. I hold the position of general manager regulatory affairs with Agility Management, a wholly-owned subsidiary of AGL. Today I'm here to represent and speak on behalf of AGL.

MR BANKS: Good, thank you. We just received - this has the status of submission, what you've given us, but we haven't read it yet so we'll give you the opportunity to go through it. But perhaps if you would like to - I mean, we may not have time for you to read it all but if you could draw on the main points, we'll leave you to it and then pick up any questions.

MR CONNERY: Thanks indeed. Just to my experience on the record, I've been involved in economic regulation of gas infrastructure since 1986 and I lead a team that's been involved in a number of access reviews under current codes, both in electricity and gas. In terms of the gas code we have prepared access arrangements for AGL Gas Networks New South Wales which is the operator of AGL's New South Wales network. We've presented one access arrangement on behalf of AGL Gas Networks ACT which used to be their ACT network; for the Moomba to Sydney pipeline, the central west pipeline and NT Gas. In terms of electricity, under the tariff order in Victoria, we participated in the year 2000 distribution review.

AGL is a member of the investor group which submitted a response prepared by NECG to the commission's position paper. 24 organisations endorsed that response and four industry associations and 20 investors in infrastructure, including gas, electricity, airports and telecommunications. AGL supports the comments and recommendations in the NECG submission. That submission covers a range of matters but my focus today will be on pricing principles. The NECG submission makes the point that current regulatory systems expose infrastructure owners to regulatory risks which is unnecessary and inappropriate in the context of the commission's proposal 8.1 which was designed to encourage efficient investment in infrastructure. At the outset I wish to make a point that we in AGL do not blame regulators for much of what we consider to be less than appropriate regulation.

They have got a very, very difficult job. We recognise that. Our regulatory systems impose significant demands on them to do things which because of the informational uncertainties facing them are bound to increase risk. In addition, those regulators are exposed to significant pressures from parties in may walks, including gas producers, electricity generators, large industry users, consumer groups and infrastructure owners, of course, and to significant pressure - whether it's real or imagined - to comply with the expectations of government. So it's certainly not an easy task and we recognise that. We think the focus needs to be on improving regulatory systems if we are to get better outcomes.

I want to demonstrate by way of illustration the inappropriateness of those aspects of current pricing principles, including the absence of some principles which give rise to the uncertainties identified in the NECG submission. Just briefly

summarising the NECG submission, it argued that to remove unnecessary and inappropriate risk, pricing principles should not permit stranding of assets; should require that efficient cost be revealed through the operation of incentive regulation rather than require regulators to estimate them, those costs; should provide for investors to know that regulatory costs of capital be set initially prior to making investments; should require that the risk element in the regulatory cost of capital be fixed for the life of investments and provide for pre-investment compacts or the application of regulation similar to the petroleum resource rent tax for greenfield or risky investments.

This presentation will cover some undesirable consequences of exposing investors to asset stranding; to the limitations of benchmarking in the search for efficient costs; to incentive regulation as a mechanism to reveal efficient costs; the need for investors to know the regulatory costs of capital; the implications of changing the risk component at price resets and the option of a system modelled on the petroleum resource rent tax for regulating risky projects.

Firstly, I'd like to discuss some of the undesirable consequences of exposing investors to asset stranding - some examples from gas and the gas code. The NECG submission made the point that access regulation in Australia leaves it open to regulators to strand part or all of an asset if market circumstances have changed or if changes in technology would result in a different investment today; and that the threat of asset stranding creates risks, increases costs and acts as a deterrent to efficient investment. What I want to draw on today is on the national third party access code for natural gas pipeline systems - and I'll refer to that as the gas code, if I might, in future - to provide some illustrative examples of the risk of stranding that investors face.

However, before turning to the examples, it might be useful if we first describe the economies of scale that lie at the heart of gas transmission and distribution industries. Other things being equal, the cost of an installed pipe varies with some power of the pipe diameter, usually less than one - so it goes up with about the size of the diameter, whereas the capacity of the pipeline, however, increases it something more than the square of the diameter. The figure we have there on the screen now illustrates how capacity increases and the unit cost of capacity falls with increasing pipe diameter. As a consequence of this relationship there are significant economies of scale that can be realised by installing a few larger pipes rather than a lot of smaller ones. In the past it's been the practice of infrastructure investors to err on the side of installing larger rather than smaller pipes to take advantage of those economies.

However, a number of provisions of the gas code are likely to have the effect of discouraging that practice with consequent loss of efficiency. Firstly, I'd like to just refer to stranding via the redundant capital provision in the gas code. There's a section in the gas code, section 8.27, which allows a regulator to remove from the regulatory asset base redundant capital associated with assets which cease to serve or which provide reduced service. Before doing that, a regulator is required to take into account the uncertainty that such a mechanism would cause and the effect that

uncertainty would have on the cost of capital and the economic life of the assets.

So the code does provide for stranding and it does recognise, however, that this risk has a cost that must be factored into regulatory prices. The gas code also contains an analogous provision to deal with oversized new facilities and that's in section 8.19 of the code, provides for the cost of oversizing to be set aside in a speculative investment fund. The fund is not included in the regulatory asset base unless and until the additional capacity is used. It's our view that the risk of asset stranding via both of those provisions will deter investment in larger more economical pipes in anticipation of demand growth as was mentioned early in the AGA presentation that that's certainly been a driver in the past for companies putting in pipes in anticipation of future growth because of the economies of scale that exist in doing just that rather than putting a whole series of individual, small pipes to individual customers.

Thus when growth materialises, relatively more costly reinforcement or duplication is required, resulting in a net cost to the community. That is our view that the community would be better served if there was no provision for capital to be made redundant. For example, we suggest that the oversizing of the first leg of the central west pipeline to Dubbo in New South Wales to meet the projected needs of an extension to Tamworth would not occur today. The pipeline today would be sized for the loads en route to Dubbo alone, making an extension to Tamworth significantly more difficult to justify. The central west pipeline runs from Marsden to Dubbo and it's 255 kilometres long. The diameter needed to service the projected load along the line up to Dubbo was six inches. The cost of a six-inch pipeline was approximately $27 million. This is not a big pipeline but it's just an illustrative example. As you mention, it's difficult to find examples.

If I could turn to the next overhead. It was possible that this pipeline could in future be extended north-east to Tamworth and to service towns en route. However, this would require duplication of approximately 130 kilometres of the six-inch line from Marsden to Alectown which is just near Parkes. The cost of that would be some 10 to 15 million, that duplication. That would have been done at a future time. Instead of duplication in future, an eight-inch diameter pipeline could be installed at the outset to Alectown, as far as Alectown - from Marsden to Alectown. The cost of the additional two inch diameter to Alectown which doubled the capacity of this segment of the pipeline was about $3 million instead of the 10 or 15. The additional cost of duplication over and above the cost of increasing the diameter from six inches to eight could undermine the economics of an extension to Tamworth.

AGL was responsible for the development and construction of that project and did install an eight-inch pipe as far as Alectown. That was done before we knew the intricacies of the gas code and I suspect now that had we been aware of those - we were making our plans in 96 - then there would have been a real question and shadow over whether we'd put in that extra 3 million. It sounds like a small amount of money but these regional development projects are so fragile and that's part of the reason it hasn't yet gone forward to central ranges. As AGL mentioned, there are other concerns as well, the regulatory concerns. But they are just very fragile, these

projects, very hard to get up and running.

The next one, the generic type of stranding, I wanted to mention was the stranding via threat of bypass. It really stems from the fact that regulatory pricing needs a rationale. It has to be capable of explanation and that's a requirement the regulators have. It can't be just you throw things up in the air and they come down where they come down. However, the requirement for rationality can lead to exposure to the risk of bypass, the reality of unintended price discounting and in the context of regulatory pricing, revenue and asset stranding. This perhaps wouldn't be an issue if not for the fact that the risk of stranding may cause asset owners to adopt infrastructure design and construction which remove bypass risk but at the cost of efficiency, especially the loss of economies of scale.

> The following example is illustrative of the issue. While it is for illustrative purposes only it's not very far from some of the facts that we faced which did lead to stranding in New South Wales. Customers near a major trunk are served from an off-take which as it tracks from customer to customer initially travels away from the trunk and then turns back towards it to connect to the last customer in the group, customer X. On this occasion the rationale used for determining prices is a form of distance pricing known as "follow the molecule". For customer X the distance driver includes the whole length of this off-take. However, X is closer to the trunk as the crow flies, then is the distance that underpins his pricing.
>
> X threatens to bypass the existing service by tapping into the trunk and building a line of shortest distance to his premises. To avoid this bypass, the infrastructure owner discounts his price below the regulatory tariff. In effect, part of his asset has been stranded. He's no longer going to get a return on part of that asset base. The gas code does provide for prudent discounts to be rolled into the revenue requirement to be recovered through reference tariffs or regulated prices, however, bypass discounts are not prudent discounts under the code.

So they're matters that the owner faces at his own risk. In its 1997 access undertaking, AGL Gas.

> To avoid this bypass, the infrastructure owner discounts his price below the regulatory tariff. In effect, part of his asset has been stranded.

He is no longer going to get a return on part of that regulated asset base:

> The gas code does provide for prudent discounts to be rolled into the revenue requirement to be recovered through reference tariffs or regulated prices. However, bypass discounts are not prudent discounts under the code.

So they're matters that the owner faces at his own risk:

> In its 1997 access undertaking AGL Gas Networks, the operator of AGL's New South Wales network, employed to follow the molecule pricing and was then faced with threat of bypass leading to price discounting below the regulated tariff. In its 2000 access arrangement the company adopted zonal pricing and again experienced revenue losses from bypassed discounts which could not be recovered. It is our view that it is not possible to devise a tariff policy for a complex network which will meet the needs of regulators for explanation which does not leave a network exposed to bypass risk.

That's not to say that you can't have pricing that will eliminate all bypass risks; clearly you can. But that's not going to be one - it's going to be one that's designed for each individual customer and it's very difficult to explain that in a rational manner of how we allocated overheads, you know, in this way and that way. It's just not possible:

> In future, an infrastructure owner can avoid bypass risks by designing and constructing its network to be bypass proof.

It is possible:

> However, this design will not be optimal and will not produce the extent of economies of scale that come from conventional design -

or from optimal design:

> Rather, design and construction would reflect bypass opportunities. In the example given above, AGL would not extend the existing offtake to X but build a new, more expensive, direct connection to the trunk; that is, the existence of the threat of bypass is likely to lead to economic loss.

I will now discuss some limitations of benchmarking in the search for efficient costs. Before I talk about benchmarking for efficient costs, I perhaps should distinguish a couple of different forms of benchmarking. There's benchmarking which I think is what people traditionally refer to, which we would normally think of as being process benchmarking, and that's the benchmarking where the aim is actually to identify a better way of doing things by looking at people who are good performers and then try to take lessons from that, bring them back home or bring them to your plant and adopt those processes if they are transportable.

This is a form of benchmarking that doesn't really require a lot of cost information and detailed costing. I learnt that lesson from Prof Hilmer who gave a course on this sort of benchmarking, and he made the observation that he could find the best or better practice company in - whether it be in warehousing or laying pipes or whatever - in about four phone calls. I think I can do it in five, and my first one is to Prof Hilmer. So I wanted to distinguish that from the benchmarking that I'm now going to refer to which is the benchmarking which is aimed to identify what's an

efficient cost for carrying out a particular activity; very, very different processes:

> The NECG submission refers to the risk that arises when regulators are required to determine regulated prices which provide for recovery of efficient operating and maintenance costs. It makes the point that regulators will not usually have the expertise to estimate efficient costs with sufficient precision to set prices, and to overcome their informational deficiencies regulators have turned to cost benchmarking.
>
> The submission then quotes Vogelsang to explain why most owners of infrastructure have little or no confidence in benchmarking approaches to efficient cost determination for use in setting regulated prices. Vogelsang argues that efficient cost benchmarking "is risky for a utility to the extent that its costs differ from the yardstick by virtue of such factors as geology, climate, population density, local wage rates, taxes or the like".
>
> I would like to take you through a cost benchmarking exercise which provides a good example of the issues raised by Vogelsang. It is an example which comes from benchmarking conducted by the American Gas Association in 1995. It relates specifically to the cost of laying gas pipes, but similar issues arise with -

with all costs, whether they're capital or O and M, same sorts of issues:

> The US benchmarking: a significant difficulty for benchmarking studies is the establishment of a reliable and consistent base of input data. It is not sufficient to rely on a potted database, even if this database is a compilation of publicly reported information against uniform accounts.

Such uniform accounts and information is available in the USA but I think one has to be very careful even with using that sort of information:

> To make meaningful comparisons between different players, detailed analyses are required to ensure consistency between what is included in costs and consistency in accounting practices.
>
> Even with standardisation at the data collection level, results cannot be compared directly. Some attempt must be made to normalise results for the factors referred to by Vogelsang.
>
> A real life example will indicate the complexity of that task -

of trying to normalise and how approximate it is:

> The American Gas Association has coordinated an annual benchmarking process for about 10 years.

On each year they choose a number of key subject areas for benchmarking:

> In 1995 one of the areas was new construction of distribution mains.

It just happens, I think, to be a particularly good example to point out the issues raised by Vogelsang:

> The Association goes to great lengths to ensure consistency. It defines what is meant by each subject. The following slide gives the definition for main piping new construction -

which is probably fairly self-evident so I think we can move on to the next slide where it then:

> Lists the activities involved in each subject area. The following slide gives the list of activities for main piping construction.

You'll see it's a fairly comprehensive list covering utility coordination, site preparation, traffic control at job site, surface preparation and removal, excavation - and I won't go through them all but it goes through a whole series and that's all designed to ensure that there's consistency in what people are putting in by way of their benchmarking numbers:

> It then identifies the non-controllable and controllable factors which impact on the amount of work required in the subject area -

the amount of work in laying a particular length of pipe:

> The following slide lists those for main piping construction -

in the non-controllable, where clearly the length or the size of the job, the number of feet, size of the job, the soil type, whether it was a developed location or undeveloped, what was the surface type, the length of the job, the pipe size, obstructions, and there's a whole series of them:

> It then attempts to normalise for non-controllable factors by adjusting the length of the pipe installed by multipliers for each of the non-controllable factors.

So it's in effect saying, "Well, if you've got to lay this pipe in rock, it's the equivalent of laying double the length in soil," or something of that - that's the nature of it:

> The multipliers are the best judgment of a panel of distribution company experts. An adjusted length of installed pipe is calculated from the multiplication of actual installed length by the relevant multipliers. The following slide gives the multipliers for main piping construction.

You can see they range over those non-controllable areas so the soil type and the

multiplier for stable soil is one, and then it goes through loose soil, 1.25; rocky soil, 1.5. It talks about the location, whether it's undeveloped or developed and different factors, multipliers for those. The frost factor there is - and they're using heating degree days as a measure of frost factor but you can imagine that it's more difficult to lay when the ground is frozen - so they've got factors for 4000 heating degree days or less, which we'd love to have here but we don't, a factor of one moving to 7000 or more where it's getting pretty cold, to a factor of 1.5. Then it goes through the others, the length of the job, the surface type and pipe size with multipliers for different break-ups there:

> The amount of work to install pipes is collected in terms of full-time equivalent direct labour. This is to reduce the problems associated with the categories of cost to be included: what level of overhead, for example. Results are then compared in terms of man hours of direct labour per adjusted length of pipe installed.

Now, gone through a fair bit of detail there but I think it was important because that's really how complex this subject matter is:

> There can be no question that the American Gas Association has gone to considerable lengths to make the comparisons meaningful.

We went through the process with them and we can vouch for the fact that they really do take a lot of precautions but:

> Despite this care, it is clear from the approximate nature of the multipliers and the number of them that there is significant room for imprecision.

It comes back to the matter that was made earlier by the Australian Gas Association, that it's these factors that vary, the factors outside your control, whether they're climate or density, and there's a whole range of them that make it very, very difficult to make comparisons at a level of precision:

> If at the end of this analysis one can say with confidence that the normalised numbers are comparable within plus or minus 20 per cent, that is, a result anywhere between 80 and 120 for one company is equivalent to a result of 100 in another -

then I think that's pretty good analysis on the basis of these assumptions:

> In terms of applying benchmarking in Australia, there has been a strong inclination on the part of regulators to look to the performance of utilities overseas, principally the US and the UK, as representing best practice. The use of international information introduces further significant uncertainties because of the additional requirement to normalise data for currency and cultural/jurisdictional differences.

I think the conclusion that I draw there is that:

> Reliance by regulators on highly uncertain benchmarking results exposes service providers to significant risk.

That risk has got to raise the cost of supplying service and deter investment or be a deterrent to investment:

> The NECG submission suggests that to remove the uncertainty and consequent cost that arises if regulators are required to estimate efficient costs, those costs be revealed through the operation of incentive regulation. It is probable that policy-makers and regulators believe that we have incentive regulation today -

by virtue of most forms of regulation that I'm exposed to anyway, and gas and electricity are either price-capped or revenue-capped type of regulation which we would normally take to be an incentive based regulatory system:

> I would like to make some comment on the incentive properties in today's regulatory systems and the properties necessary to reveal efficient costs and stimulate dynamic efficiency -

because I don't think we have that today:

> The most common approach to incentive regulation employs some form of price or revenue cap which is set for a fixed regulatory period, often about five years. Since prices are set for the period, any improvement in productivity which reduces the average cost of providing the service will result in additional profit to the firm; hence the incentive to improve productivity. The future benefits from past productivity improvements are then transferred to consumers, either by way of a Po adjustment or by way of a glide path.
>
> The rationale for incentive regulation is that the lure of improved profits will stimulate service providers to generate efficiency improvements which might otherwise not be realised. The outcome of effective incentive regulation is a continuous journey towards efficient costs. It is in this sense that incentive regulation can be utilised to reveal efficient cost and be employed instead of regulator assessments which, because of informational uncertainties can give rise to mistakes and therefore do give rise to risk. In the NECG submission the UK and the US approaches to price cap regulation are discussed with reference to Vogelsang's depiction of the key differences between them. In particular, the UK approach attempts to determine X in the CPI minus X type environment so that the resulting price path provides for the continuous transfer of regulator assessments of efficiency benefits to users. This is achieved by determining a price path designed to give the service provider the opportunity to recover regulator assessment of efficient costs

and efficient growth over the forthcoming regulatory period.

This is the approach that is used in Australia. It is designed so that if the regulator assessments of future improvements in efficiency prove correct, the service provider will not share in them but just earn a return commensurate with risk. The clear objective of this approach is that the service provider should not benefit from improvements in efficiency. Anticipated or yet to be achieved efficiency gains are transferred immediately to consumers. That this is the objective is evidenced by the view which seems to represent current wisdom, that if the service provider actually earns more than the cost of capital then the regulator has failed. He has set the price cap too loosely.

We make three observations regarding the current regulatory approach: firstly, that because regulator assessments of efficient costs are imprecise, this approach is high risk for investors. Secondly, if regulators could accurately forecast efficient costs, service providers would never reap any incentive payments and the approach becomes rate of return regulation. Thirdly, a scheme which is designed to deny any reward when the desired behaviour is delivered cannot be an incentive mechanism. We all know that the best way to get a job to change its ways is to reward it with something special when it exhibits the desired behaviour. Simply relying on normal sustenance of a daily bowl of Chum or, worse still, threatening to give him less than normal rations if he doesn't perform won't work.

If we are to employ incentive based regulation we need regulators to feel okay when service providers actually earn better than their cost of capital. Rather than regulators feeling they have failed, that they have set the bar too low, they should be shouting from the rooftops, "The system is working. A's better than expected profit is evidence that it has produced efficiency improvements. Those efficiency improvements provide the foundation for lower prices in future. Well done, A."

We haven't had many well done's.

The NECG submission provides an example of an incentive based regulatory system which relies on incentives to reveal efficient costs and provides real opportunity for a service provider to earn superior returns from improved efficiency.

I won't go through that but just I would refer you to that. I would now like to raise some matters about the regulatory cost of capital. Under current regimes the cost of capital that will be assumed by regulators in determining prices for access is not known by investors at the time the investments are made and is only revealed subsequently, you know, either at access reviews or through arbitrations. Infrastructure owners have to factor in this uncertainty into the cost of capital used in investment decision-making. The increased cost of capital is likely to rule out some investments which would otherwise have proceeded.

We note that there is precedent for the pre-investment disclosure of the regulatory cost of capital. It used to apply in terms of regulation of gas before 1990 until we moved to price cap. It is in the petroleum resource rent tax, for example, and I am sure there are other examples. We suggest that economic efficiency would be better served if today's regulatory systems required such disclosure. I think it is very hard to understand why it is not disclosed. It is just hard to give a reason for it. It just doesn't seem to make sense. It just seems to me to add cost to the community. Maybe we have just overlooked it.

> Assuming that the initial regulatory cost of capital is made known pre-investment, the question then arises as to what cost of capital will apply at subsequent resets of regulatory prices. While we have limited experience to date, the experience we have suggests that regulators are likely to redetermine the cost of capital based on conditions which apply at the time the reset is determined. This clearly makes sense in relation to certain matters - for example, the risk free rate, but it is questionable if the component of risk, beta, should be adjusted at periodical resets to reflect the forward looking project risk at the time. The consequence of such a practice is that the revenue of successful projects is likely to be less than is necessary to cover the cost of capital on which the investment decision was based.

This is illustrated by the figure. You have got it there, thanks indeed. On this figure it is supposed to depict a project that is just successful. If the beta risk remained fixed over the life of the project then the revenue accruing to the owner would be the top revenue line, the one with the little diamonds through it. That is what that would expect. That would represent just a viable project over the life of the period the investor would get a return equal to the cost of capital at the time at which he made the investment.

But what happens is as we go along, we've had five years of experience, it has come to the reset. The regulator looks at it and says that, you know, it is now a stronger project. The risks are no longer so great. The market has grown, it's established, so we can now apply a lower beta risk, looking forward, and the revenue as a result that can be derived by the investor is now less than what it would otherwise have been. We see those adjustments downwards so by the time we get to the end of the project this is no longer a successful project.

> Investments are evaluated on the basis of the risk that exists at the time investments are made. This is reflected in project evaluation whereby a project is deemed successful if over its life it realises a return equal to or in excess of the cost of capital at the time the investment was made. If it is known pre-investment that future prices for successful investments will be determined on the basis of assessments of beta risk at each reset, investors will inevitably take this into account in their investment decisions. The consequence will be that some investments that would otherwise have been undertaken will not proceed. It will raise the cost of

capital. To overcome this we suggest that it should be a requirement that the risk component of the cost of capital used to determine access prices be fixed for the life of the investment.

Finally I would like to make just some remaining comments on the regulation of risky projects.

The commission did note that there is a strong in principle case for providing investments in essential infrastructure that are expected to be just marginally profitable with some immunity from exposure to access regulation and discuss the implementation of access holidays as one possible response. It has suggested that access holidays could be implemented through a form of null understanding that specifies no regulated access will be provided to the service in question for a designated period.

We have a lot of sympathy with the concerns that are driving the suggestion of an access holiday but, in addition, we would ask that the commission consider the scope for the introduction of a number of mechanisms that address directly the specific issues that are raised by greenfield type investments and other investments that are particularly risky. Some risky investments will clearly be successful and others are likely to fail. Regulation becomes an issue when returns for successful projects are truncated by regulation of the cost of capital for the project, because there is just no symmetric regulatory action that can turn failed projects into successes.

Successful projects need to return more than the cost of capital to offset the losses associated with projects that are not so successful, so that for the industry as a whole all projects in aggregate return the cost of capital. Regulatory mechanisms employed thus far to manage particularly risky investments fail to address the real issues.

Turn again to the example of the central west pipeline where a marginally higher cost of capital was assumed by the ACCC and a longer period between regulatory resets, 10 years instead of five, was offered to address the issues that they saw or faced in this regional project - or this project which relied on regional development for its success.

However, the reality for that project is that the viability does depend on significant regional growth. Even if all potential gas consuming premises connected today, and remained connected for a long time, that project would fail. The only way it will succeed is if there is regional development. So it depends on significant regional growth and the market determines the prices that can be charged. The project will not recover over the next 10 years anywhere near the amount that would be allowed through normal regulatory processes.

Now, if you took the normal building block or some other approach to regulation. In other words, there is no need for regulation of this project in the foreseeable

future, the market will do that. The proposed extended regulatory period does nothing to reduce risk because it is all market risk. We don't think that an access holiday provides the answer for investors concerned about regulatory risk. Any holiday that would remove the risk that the returns for successful projects may be truncated by regulatory intervention would have to occur towards the end of the project, not at the beginning of the project when the returns are below the cost of capital; we don't need a holiday up front, we need one up back. Instead, we suggest that the commission consider the scope for regulated firms to be given some assurance ex ante that the additional risks they are bearing will be reflected in regulated access prices.

> Two potential approaches for the commission to consider are the petroleum resource rent tax approach and the pre-investment agreement approach. I will just talk a little about the petroleum resource rent tax. The PRRT applies to offshore petroleum exploration and production. Under the approach the tax itself is not imposed until such time as the net present value of the project discounted by a factor equal to the relevant cost of capital is positive. The discount rate or cost of capital employed in the petroleum resource rent tax is the Commonwealth long-term bond rate plus 15 for exploration expenditure and long-term bond rate plus five for other expenditure. Once the project is net present value positive, the resource rent tax is levied at 40 per cent.
>
> We suggest that an approach along those lines could be applied to greenfield type investments. Price regulation would not apply until the NPV of the greenfield's project, discounted by a factor equal to the relevant cost of capital is positive. I guess in a way that would be the access holiday, the period until such time as it became net present value neutral or positive. If the project becomes net present value positive then the sharing of benefits would be 60 per cent to owners and 40 per cent to users. They are just the numbers that come out of the petroleum resource rent tax. This approach would ensure that returns on successful projects would not be truncated at the cost of capital, thereby allowing some blue sky to offset the losses on projects which are not so successful. This would provide a more favourable environment for entrepreneurial investments.

The alternative proposal that we have put forward is that a pre-investment agreement approach - which we're not suggesting necessarily as an either/or but it could be - both could apply, and we suggest that procedures could be introduced to allow the investor to obtain increased levels of certainty prior to the investment being made on how access prices will be determined. That could be through a requirement for an explicit regulatory contract between the regulator and the regulated firm which would determine the terms of access that would apply for that particular pipeline or asset. I thank you very much, that's the end of the presentation.

MR BANKS: Thank you. Well, we're actually almost out of time and the only sort of questions I was going to ask was just towards the end here really. The

pre-investment agreement approach - and I can see the logic of this in trying to get some greater certainty up front before the capital sunk, so to speak, and that that would make a big difference. Would you see this agreement relating to the entire life of the project, is that the idea? I'm just wondering - - -

MR CONNERY: I don't think it necessarily would have to relate to the entire life of the project. For example - although we've already canvassed this in the petroleum resource rent tax - but an agreement could almost be the petroleum resource rent tax. That could be the sort of agreement that could be determined between the regulator and the party that there would be no constraint on prices until such time as the project had become net present value positive. Now, I know we've already covered that separately but I'm sure there are other types of mechanisms that minds more fertile than mine could come to which may be different than the whole of the life of the project.

MR COSGROVE: I was just going to ask a question related to the PRRT. It provides for non-expiration expenditure, a cost of capital based on a long-term bond rate plus 5 per cent. Now, if we think - I'm not quite up to speed on present bond rate but I think it around about 6 per cent so you're talking 11. I had the impression, although I don't have the information with me today, that some of the regulator's decisions on cost of capital have in fact allowed more than that. Is that right?

MR CONNERY: Yes. It's very hard to be sure exactly how that, you know, whether that - - -

MR COSGROVE: It depends on risk structure but - - -

MR CONNERY: - - - there's a bond rate plus five, is that a real pre-tax return, is it a return on equity? I'm not even sure what that return is. We weren't really proposing that the long-term bond rate plus 15 or five are the right numbers. It really wasn't that.

MR COSGROVE: I see.

MR CONNERY: It was simply the concept of saying once the rate of return is agreed then that apply in a way such that there be no regulation until such time as the project became net present value positive. So no, it wasn't - they were just simply put there to complete the description of the petroleum resource rent tax. But there was no intent that either long-term bond rate plus 15 or five were the right numbers. I don't know.

MR COSGROVE: I see, yes.

MR CONNERY: And the numbers would certainly I think vary from project to project, whatever is the right number. So it was really concept.

MR COSGROVE: Okay.

MR CONNERY: I think it will be one that in terms of light-handedness would be fairly - a process or a regulatory system that would be fairly easy to monitor, to set up and identify when a project became net present value positive, I suspect. Clearly it's already been done in terms of petroleum. So it just seemed like not a bad mix of light-handedness and covering some of the other issues.

MR BANKS: It's a useful suggestion that we'll think about along with others. Is it rather your main concern about the access holiday is simply the problem of defining a period that isn't too short in terms of a riser needed to compensate for the losses in the early years of the project?

MR CONNERY: Yes, it really is that. As I said, with most of those risky projects, in the early years the regulator is in a sense superfluous. When we put in an access arrangement from something like the central west the prices that we put forward are driven by what the market will bear, and we're normally looking at something that starts off fairly low and goes over time perhaps equal with the CPI or perhaps even a little bit faster than that, but also relies very much on that regional growth to generate revenue. So if you looked at it in terms of revenue, the revenue is going to rise steeply over time whereas if you looked at, as I say, the building-block approach you'd be charging a lot, lot more than that up front. But those projects just won't run on that sort of pricing. They need to have entry pricing that matches customers' needs and then the growth fills in the revenue gap, you hope.

MR BANKS: Yes. If you had to go for a number what period do you think would get you out of trouble with an access holiday arrangement?

MR CONNERY: If I took the period over which it would perhaps take some of these projects to become net present value zero - it's very hard to say there is one time - but it's certainly going to be a long time. I mean, you're looking at 20 and 20-plus years and even then - that's assuming that the project is reasonably successful based on your expectations are actually met in the marketplace, that growth does occur to your expectations. So, yes, they can be a significantly long period of time. That's been the nature of the industry for many, many years, that we have taken very, very long-term views of return, being very positive about putting in pipes that provide for growth in the future and I think there are really significant risk to that in current - unintended I'm sure, but I think they do come out of the current regulatory systems.

MR BANKS: Well, maybe that's - - -

MR COSGROVE: Just one last question. One thing that I think we haven't had covered in your presentation is the complexities that can arise with the valuation of capital as distinct from the rate of return that is to be applied to it for regulatory purposes. That's a pretty big issue in itself and I wonder whether that doesn't drive you more towards an access holiday approach as we had outlined earlier today compared with these seemingly more complicated assessment methods.

MR CONNERY: Under the gas code, if it is a new investment then there is a bit of

clarity about what is going to be their regulatory asset base, ignoring the risks of stranding.

MR COSGROVE: The clarity you mean in terms of the methodology to be used?

MR CONNERY: Well, yes, the methodology is set out in the code and says for new investments the initial - they have a starting one they call the initial capital base and the initial capital base will be the actual cost of construction.

MR COSGROVE: Okay.

MR CONNERY: Then as you move forward it's one where you add on at cost any extensions and expansions, less depreciation, and normally it's combined with a real rate of return so the capital base is escalated; in other words, the inflation is taken in escalating the capital base rather than in the cost of capital.

MR COSGROVE: So there's no use of a replacement cost methodology, is there?

MR CONNERY: No, the only way you get there is if there's going to be some stranding of assets where you actually get some application of - but, no, there isn't. The only time that comes in is when you've got to draw a line in the sand, when you've had an existing asset like for example the NSW network that - parts have been there for many, many years. I suspect there's not too much that's 160 years old, that it goes back that far, but there's certainly bits that are all different ages and it's very, very difficult in those cases to work out a starting asset base - what is the cost or what is the value - and the gas code provides a whole series of matters that a regulator must take into account in establishing the initial capital base and the regulator must do that at the time of the submission of the first access arrangement. That's probably the biggest task perhaps he has to do that first time. But once that's set then you just add on additional capital and take off depreciation. The matters that the regulator has to take into account, there's a whole string of them, but they include the depreciated actual cost, the DORC, valuations that come from other well-accepted valuation methodologies. They've got to look at past returns, past depreciation, the expectations of users and the owners under previous regulatory regime and it goes on. There's the international best practice - very, very difficult task to do. But, yes, there is a structure there for gas.

Now, I think electricity is different. Generally, there's a reference there in the national code to a preference for depreciated optimised replacement cost but the in Victoria it's different again, because they don't use that. They actually establish the regulatory asset base at the time that the businesses were sold and they're just adjusted by additions less depreciation.

MR BANKS: All right. Thanks very much for that. We'll break now until around 2.30.

(Luncheon Adjournment)

MR BANKS: Welcome back, ladies and gentlemen. We're resuming our hearings on the commission's position paper on the national access regime. Our first participants after lunch are Specialized Container Transport. Welcome to the hearings. Could I ask you please to give your names and positions.

MR SVIKIS: Thank you. Martin Svikis, chief executive officer.

MR McAVOY: Mark McAvoy, general manager, group development.

MR BANKS: Good, thank you. Thank you very much for participating in this process and making the submission which we've read. As we discussed, you might like to just highlight some of the key points before we discuss them.

MR SVIKIS: I guess to summarise, in terms of opening position or remarks, SCT has been in the transport business for 25 years. In 1995 we were the first private rail operator - super freight train operator or interstate rail operator in Australia. That has meant we've probably been going at access to public goods on railway lines longer for profit than a lot of other people. We've got a fairly unique view from that point of view. We've got a fairly unique view in the sense that we've invested about $50 million over that period of time. We also make the point that we did that without access undertaking. We literally got out there, sat down with the governments and said, "Come on, let's do it," the Victorian government, South Australian government, and we went and did it - Australia's first train.

What's concerning us at the moment is since then, a lot more of this topic about access regimes, undertakings, Productivity Commissions, ACCCs, is coming up, and we're genuinely quite concerned about what the outcome of these will be. So one of the biggest positions we have is what about existing users? A lot of the access submissions we've read talk about access seekers. We're there already. We're not seeking it. What will happen to us? Where is our 15-year, 20-year commitment to our investment in the whole process? We refer, for example, to the ARTC's undertaking before the ACCC, and there's about two words in the whole 50 pages that refer to existing users. It's all about what will happen in the future.

I guess the other point there that's also relevant, and we do pick up some words in other documents - and I've read so many of them, I can't sort of recall them exactly - but our industry is also relatively immature. Given that we've been operating since 1995, which is now six years, it's not a long time, say, compared to the road transport industry, one of our biggest competitors. So we still see an environment that is getting to understand itself and we're very concerned if things are locked in now quickly when it hasn't really had a good chance to understand itself - pricing regimes, valuation of railway lines - let alone the access conditions themselves.

There is also no doubt in our mind that if you're an access provider on a railway line, whether you're vertically integrated or not vertically integrated, you're a monopolist. We're concerned about the existing use of that power. We have very particular examples where it's already been used, in our view, against us, and we're concerned that those powers may even be formalised, for example, in an undertaking

which is before the ACCC at the moment. So that's our view, our position.

MR BANKS: Okay. Are you saying that in terms of the current access arrangements you have - I guess they are access arrangements - that you don't have any security over those - so in other words, they could be overturned by an undertaking?

MR SVIKIS: One of the interesting positions that we are in - we'll be very honest with you, Gary - we're not too sure what rights we've got. It's an interesting one. For example, are we still operating under an AN access agreement that was signed with a letter that had a two-week time frame on it? Are we operating under a Westrail agreement that's been subject to a wholesale agreement that's been taken over by the ARTC which concerns the Kal to Perth part of our line? We have a $15 million terminal setting at the end of that, right in the middle of this dispute, sort of thing. Are we operating under the ARTC's standard terms and conditions which were issued in July last year with a very polite note to people like ourselves, saying, "If you enter the track from 4 June onwards, you are deemed to have accepted these conditions," so we are concerned about the future and the effect on it. We're also wondering, "Well, what's happening now?" The ARTC were the first ones to tell you that we're under those terms and conditions and we have disputed those actively - we're pretty consistent in our approach - for over two years.

What the point is for us is there's no doubt that monopoly power and behaviour is being used in certain ways. I'm not a legally trained person, by the way. I'm a line manager. I've been 17 years in transport, so I might be saying things that are technically incorrect and someone might pick me up on the words, but I'm sitting here today because of the gravity of the concern that we have. Mark and I put this paper together ourselves after I read eight inches of submissions - including the ARTC's, yours - myself. I'm not just reading off Mark's documents. So I'm not too sure how to answer your question.

MR COSGROVE: Has the ARTC been able to put in place an undertaking which has been accepted by ACCC or is that still - - -

MR SVIKIS: It's in process.

MR COSGROVE: It's in process, I see.

MR SVIKIS: Which is another sort of concern that we have; like, we're talking to yourselves about what should happen in industry, yet at the same time in parallel, we're up against a very tight deadline - which closed yesterday in fact, and they last for a period of two or three months which is not long in our environment - to submit on it. My understanding of the weight of what an undertaking is that if we don't get up and stop it or change it or modify it or convince the ACCC, we will live with that and it's beyond appeal.

MR COSGROVE: The ACCC has to satisfy itself that the undertaking should be accepted.

MR SVIKIS: Yes. That's happening as we're sort of speaking to yourselves and developing an undertaking of access regimes and how they apply to railways, so we think that's probably a little bit unfair too.

MR COSGROVE: You're not the only customers the ARTC has, I'm sure. Do you know how other rail freight companies are being handled under these present arrangements? Do they have similar concerns as you?

MR SVIKIS: Yes, they do. To give you a flavour of it - and we'll come straight to the point again - two years ago, the interstate rail operators, National Rail, Toll, Patricks and SCT - but really Patricks run Melbourne-Adelaide - if we're talking about the interstate freight market, which is like the road competitor - and mind you, when we're talking about rail, we're excluding mining, bulk wheat, logs, iron ore. We see that as a very different subset of the industry, by the way, which we are not involved in. Also I'd like to say that in our current policy, we will not be a bidder for National Rail either. We develop our own markets. We don't have a bias there. But we formed a group called IROG, Interstate Rail Operators Group. It brought together the arch enemies. We really dislike National Rail, we really dislike Toll Transport, and there's us. There's three interstate operators. Our common dissatisfaction with the ARTC's approach brought together that group, arch enemies, to the same table.

To give you an example of how alive IROG still is today, there was a recent letter published only two weeks ago by the ARTC. I'm not here to debate individual correspondences of course, but the first thing is that the phone started ringing. The IROG elected representatives got together in joint letters, and will now be going back to the agency re this recent correspondence from National Rail, Toll and SCT under my signature, verbatim, complaining about the same topic. So yes, there is a common dissatisfaction.

MR BANKS: We note nevertheless that - to quote you - on two occasions, you have successfully applied to the NCC for the declaration of services under Part IIIA. Would you care just to elaborate on your experience there, whether you found it an easy experience, a difficult one, and how you achieved your successful outcome?

MR SVIKIS: Yes, it goes back a number of years, when we first started, back around 95, 96, 97. It related to us seeking access for a Sydney train to go to Perth and therefore to declare to the New South Wales Access Commission - RAC at that stage - to declare that track to get access to it to go to Perth from Sydney, through the NCC. We then also applied for a declaration of the Kal to Perth line. The significance of that of course is it changes from strongest to weakest link. When you get to Perth, you've got to go through Kal. Now, Kal to Perth has always been the end of the railway line, always run by the Western Australian state government. To give you an example of how hard we've pushed for common access over the years, we applied for that line to be declared. Now, Mark will correct me here technically if I say it the wrong way: we felt that that gave us a significant amount of muscle. We used the threat of a declaration to force the Western Australian access regime to

negotiate with us fairly about the railway line they had. So in that sense, it was a good experience. We ended up with an agreement which lasted for how long?

MR McAVOY: A 10-year agreement. So a few weeks after lodging the application, the Competition Tribunal more or less negotiated an agreement.

MR SVIKIS: Yes, we had to go to the tribunal to get it.

MR McAVOY: Very briefly.

MR SVIKIS: The NCC said, "Go and talk to these guys to declare the track." The WA government effectively said, "No, bugger off," so we went to the tribunal and the tribunal said, "Well, you'd better talk to them," so they did. We believe - and it's hard, obviously it's our summarisation of the situation, it's not their view necessarily - that they agreed because they could see, "Crikey, if this thing gets declared and we can't get an undertaking, we're going to lose market power to negotiate the way we want to negotiate. We end up back where we may not want to end up. Perhaps we'd better talk to these blokes." They did, and we signed an agreement which we felt was reasonably satisfactory. That agreement has survived the recent Western Australian sale which, by the way, we objected to publicly and vehemently, that that bit of the railway line should not just get sold off, which is what they went and did, including the ARTC - actually the Commonwealth government body actually formed a joint venture purchasing partner with an American rail company called Freight Australia to buy it off the West Australian government. That failed too. It went to another American operator, Westnet.

Now, there is talk of a wholesale agreement the ARTC has with Westnet to allow us ARTC-type access and the Western Australian government have written to us and said, "If you wish, you may have your agreement novated to the ARTC." Our position at this point in time is we're not too sure what that really means, but we have dealt with them. We dealt with the Australian government for a while and now we have to deal with an American rail company with the same document. We actually have had similar experiences with documents that, for example, were novated from AN to American rail companies who, lo and behold, took a slightly different view of the wording. They're commercial things though.

By the way, though - I think Mark would agree - we did find that a heavily legalistic experience and we racked up a fair few legal bills. For a company like ours that turns over just short of a hundred million, even legal bills of that degree are something we'd have to seriously consider. Probably that's a valid comment, Mark?

MR McAVOY: There were high legal costs.

MR BANKS: How long did it take to get these things resolved?

MR McAVOY: I can't recall off the top of my head how long it took, going through the NCC process.

MR BANKS: Okay.

MR McAVOY: I can get back to you on that.

MR BANKS: Yes, actually I'd be interested just to know how long it took from start to finish.

MR SVIKIS: We are actually evaluating whether we should take that course again, still, so we're relatively happy, but regretful about it. One of the points we actually made to the ARTC - and we do talk to them regularly and actually we put them up against some of the best rail providers in Australia - and we get far worse, certainly in terms of customer sensitivity - but we did say that at the end of the day, we're in the business of managing our costs by issuing competitive tenders. I described the process of competitively tendering our fuel for trains, our hook and pull, our locomotive services for trains and also we just finished competitively tendering our maintenance, where we sought six different proposals and came up with some great ideas for maintenance providers to improve our maintenance strategy, and not necessarily price. A lot of it was to do with value. Maintenance on trains is probably the last thing you want to screw down. Then we get to the access. "If you don't like it, go talk to the ACCC. " That sort of slows us right down.

MR COSGROVE: I guess a part of the process you had with the Western Australian section of the line would have involved a role for a Western Australian government minister. Is that - - -

MR SVIKIS: Yes, we corresponded with Murray Criddle mostly.

MR McAVOY: Yes. You're referring to the decision whether to reject or accept the - - -

MR COSGROVE: Yes, the NCC recommendation.

MR McAVOY: That was the premier, Richard Court, at the time.

MR COSGROVE: How did that strike you? Some people have put to us - I've forgotten whether you were one of them - that ministers should be removed from the process.

MR McAVOY: Our view is that they should not be in the process, absolutely.

MR SVIKIS: We should probably go further too. We've had an interesting time in Western Australia for other reasons as well - like, rail terminals and noise - so at the same time, we might say we don't want ministers involved in this process; we'd also have to confirm that governments have been extremely supportive of getting our organisation going in 1995. Richard Court was one of them in terms of helping us out when we had noise issues and finding alternative sites in Perth, for example, so we've got a good and bad experience, depending on what the topic was.

MR BANKS: But from the point of view of the process of the move towards declaration or not of a particular essential piece of infrastructure, do you see the role of the minister there as helpful or not?

MR SVIKIS: If I could probably comment on an experience we had with the Western Australian government, Murray Criddle, the transport minister at the time, that was his role - so I'm not talking about himself, just the fact that that was his role at the time, the transport minister. We complained about, for example, the sale of the Kal to Perth line during the Westrail privatisation process and we received a document back at the end of that process that said, "Bad luck," and they attached - I'll never forget the letter - to the back of the letter the reasons and the rationale for that sale. None of them contained any interests of interstate freight operators which have to travel that line. So we're talking about ministers - maybe are we really saying state based interests versus federal interests? Are we really saying that when we say, "Do we want to take ministers out of the process?" We'd probably say yes, on the basis that we've seen some pretty bad state based approaches being taken, and that's that one approach.

MR BANKS: The original suggestion was to have the Commonwealth minister involved. How would you react to that?

MR SVIKIS: We call that a one-stop shop. We're a strong support of having a common rail access regime across the country, except our issues really fall into the category of exactly how that would work. But yes, one-stop shop, one minister, that would probably be enough, with all due respect to the - - -

MR McAVOY: I recall at the time that the reason given was that in WA, there was going to be a regime lodged with the NCC which I understand was withdrawn then subsequently.

MR BANKS: Yes, I think that's right.

MR McAVOY: That gave us no satisfaction.

MR BANKS: You talk at a couple of points about what costs the providers should be able to recover, I think, and you're concerned, for example, on page 2 about substandard infrastructure and you say:

> Regimes should ensure that access providers' costs don't reflect the costs of maintaining substandard infrastructure. The additional component of current maintenance costs that arises from past decisions to reduce maintenance resources should not now be borne by access seekers.

That sounds like a heartfelt comment. I just wonder whether you would like to just elaborate on that. This reflects an actual experience that you've had?

MR SVIKIS: Yes and no. The east-west railway line is probably the best one out of the lot to keep things awfully simple. However, if you look at, say, the recent

track audit published by the ARTC, it shows the dilapidation of the current Australian railway network. If you look at the experiences that we have for our hook and pull provider, Freight Australia, and what they have said publicly about the network that they have inherited, we would suggest that there is fairly strong evidence to say that when trains are travelling at 20 kilometres an hour because nobody can be bothered repairing the bridge, because it's too dangerous to travel at a hundred K, which is what we want to do - we actually want to travel at 110 K - at two kilometres long, thanks very much, we would say that the Australian railways probably have been dilapidated more so maybe than other public infrastructure goods, certainly more so than we believe roads. They seem to get a guernsey more often than a railway line will - excuse that little dig at the other mode. But that's what we're trying to get at, that how could an access regime be set up, start off from day one tomorrow - no matter who is running it or how many ministers are in it - and then come up with a fair price when they have got to actually make up for 20 years worth of lack of maintenance.

I'd also quote, for example, the recent experience of a copy of a letter that National Rail, Vince Graham, has sent me - it was sent to him - and it was from RAC, the new New South Wales Access Commission. This letter was only issued in the last month or two. It says that the chief executive of RAC has instructed one of his people - and he names the person in the letter - to not issue any more paths whatsoever on the north coast railway line from Sydney to Brisbane because it's in such a bad state of repair. That's strong evidence to suggest that the railway lines are not in good shape, certainly in particular areas, let alone a little bit further information that the ARTC itself has issued on, say, gauge conformance, comparing their gauge conformance on the interstate line to, say, parts of the Victorian railway line.

MR COSGROVE: So how do you see that problem addressed?

MR SVIKIS: I think if we look, say, at the ARTC's audit, saying that the Australian government needs to cough up the money - excuse the expression, we're operators, by the way, that's where we come from, line managers - to get the railway line back to where it should be and then hand it over.

MR BANKS: So I suppose in a sense you're saying that for years, there's essentially been an underpricing because maintenance hasn't been at the level it should have been, and you're objecting now to what would be - you know, trying to recover that from current or future users.

MR SVIKIS: Absolutely, agreed, except it may not have been a result of underpricing. It may have been a result of not enough income to maintain it because not an efficient use of it or volume of use, for example. The volume of use hasn't been there to generate the income to fix it. That could have also been an aspect of it. We point, for example, to justify that opinion - and it's published information - that freight on the Western Australian corridor has gone for 15 per cent on rail to 75 per cent of the freight market on rail in a period of the last five years. We actually put ourselves forward as being a fairly big part of making that happen. So I look to

that and say, well, that's a fairly sizeable increase in income to allow a railway line to be maintained properly, let alone the pricing aspects.

MR COSGROVE: Could you clarify for me please a couple of points in your submission which bear on the effect of regulation on your investment willingness, if you like. On the bottom of page 4, where you're talking about non-price principles, you say that:

> Part IIIA needs to provide that the term or period for which access is to be granted be sufficient, having regard to past investment and future investment by users.

I'm not quite sure what you really mean by that, but I sensed that it was a statement of a potential problem in terms of investment by companies such as yourself, yet at the beginning of your submission, at the bottom of page 1, as you've told us this afternoon, you've invested more than $50 million in new terminals in Perth and Melbourne, you're completing construction of another one in Adelaide and you're also into refrigerated rolling stock. My question really is, how much of a disincentive do these regulatory arrangements present to you in terms of your investment decisions, if at all?

MR SVIKIS: Yes, they do quite significantly. I think at the bottom of page 4 - Mark, correct me if I'm wrong - relates to the five-year term that's been sought in the current undertaking.

MR McAVOY: That's right, the undertaking. That comes back to before the National Competition Council, they basically expressed the view that it should at least be 15-year terms, having regard to the investment and customer focus et cetera et cetera.

MR SVIKIS: So, yes, that's where that particular comment comes from. But you're quite rightly pointing out, "So, okay, Martin, that didn't stop you guys investing 50 million bucks anyway," but it's a funny statement to say that sometimes a level playing field with no bad rules and no negative rules in it is quite okay to work in because, see, that's the level playing field that we work in in the rest of the commercial market. We go to somebody and say, "We'd like you to provide goods and services to us." There's no access commissions there. So that sort of behaviour is really what we would call normal commercial behaviour, to knock on somebody's door and say, "We want this. Can we have an agreement?" and away we go.

MR COSGROVE: You feel you could deal with ARTC, for example, on that basis? I thought you were saying earlier that they had monopoly power that - - -

MR SVIKIS: That's it. The ARTC were not around and nor was there standard terms and access conditions when we were making these investments.

MR McAVOY: For example, you'd be pretty hard pressed to build a $10 million terminal now with ARTC's threat to auction train paths. I mean, how do you know

you're actually going to have, for example, in a year's time, the particular train parts that you are now offering to your customers? You don't know. If you're a financier, you're certainly not going to lend $10 million on that.

MR SVIKIS: So the concerns there - that's an example of one of them - are that a set of rules are being promulgated now which will give another body a significant amount of power which we believe doesn't really exist at the moment. Up until now, we've been negotiating with ARTC for two years, and it was only last July that they got really strong and said, "Well, bad luck, you can accept it or you don't go on the railway line," so that's when the nervousness started. Now the undertaking has gone through, our nervousness is increasing, because the same things we objected to then are in that document.

MR COSGROVE: In their proposed undertaking, yes.

MR SVIKIS: Correct.

MR COSGROVE: Which may or may not be accepted by ACCC.

MR SVIKIS: Correct.

MR McAVOY: I guess a fair bit of the uncertainty there, John, is - you know, operators just don't know what guidelines the ACCC will follow when they're looking at - - -

MR COSGROVE: Yes, I can see there's uncertainty at the moment.

MR BANKS: Are you also implying that the ACCC will not consider the interests of existing users?

MR SVIKIS: No, we're not. Our issue is we've never been to the ACCC before, we don't really know how they work and we're concerned that - again, we're in a business, and don't take this the wrong way, you guys, but we don't normally come and talk to people like you to get our business done. That's a worry.

MR BANKS: You shouldn't have to.

MR SVIKIS: We're just not comfortable dealing like that. We don't have banks of lawyers, we just got on with it before. Things are changing - and we've had direct experience of what we would call negative behaviour to boot.

MR McAVOY: We're not terribly familiar with the legislation but from our quick look at it, in the declaration section of it, they have got a reference to existing uses and the ACCC won't make a determination which will take away the reasonable expectations of existing users. I think the most we can find in what the ACCC will take into account when considering an undertaking is the interests of access seekers, and of course the general one at the end, taking into account whatever they wish, I guess, so there's not the direct reference there which is a bit of a concern to us.

MR BANKS: As you probably know, we've also recommended that there should be appeal on the merits and the undertakings side which currently doesn't exist, where the ACCC has the final call. So you do support that?

MR McAVOY: Absolutely, and if there's not, at least I think there is an appeal pursuant to the - not following the administrative procedures and all that. If that's the case, they're going to at least have to have some guidelines to follow, otherwise how do we know whether they have followed the correct procedures or not?

MR SVIKIS: In other words, come back to the opening remarks, that it's an immature industry and things will get set in concrete if we're not careful.

MR BANKS: You suggest on page 4, towards the top there - you make a couple of points. One is that there shouldn't be any price discrimination between users with similar access requirements and I guess what you're saying there is that those who are competing are essentially the same markets. Your new-found collaboration with your competitors - I guess you'd see the three of you as being in that category. Is that right?

MR SVIKIS: As not being discriminated against? Yes, certainly.

MR BANKS: Then you talk about other access costs and you talk about:

> The further costs arising from the demands of the access provider -

and you give an example of:

> Standards required by access providers for private sidings can create unnecessary barriers to new entrants and limit benefits available through competition.

I thought I'd just get you to explain a little bit about that. It seems to be, in this and also your other comments about ARTC that their monopoly power isn't necessarily consistent with their own best interests and I just wondered whether you might like to explain that.

MR SVIKIS: That's correct. I mean, when you say to the ARTC, "Can we talk about this?" and they say, "If you don't like it, go talk to the ACCC," and they write us letters like the one at the end of the network, "You accept it, bad luck," we could go on for - in the ACCC submission, we've got probably 10 pages of issues we've got with the access agreement. That's been tabled as a public document as well. So those sort of documents where we've got a lot of detail available on what we don't necessarily like about - let's just take on, the auctioning of train paths. The ARTC are very familiar with our combined approached on that matter. We see auctioning of train path as a process where people with the highest amount of money or capacity to power will - - -

MR BANKS: Placing the highest value on that particular time slot and place.

MR SVIKIS: That's right. It's not just willingness to pay, it's also capacity to pay. Let's unfold the circumstances that could occur in our worst nightmare. Mr National Rail, 200 movements; Mr SCT, three movements a week, to give you the size of the market power difference there. They're a pretty keen pricer of goods and services, but then again, so are we. They can walk in one day, a train path comes up; we will overbid every single time in the process. The ARTC's statement within their undertaking suggests that the only guideline used for that auction will be the highest net present value to the ARTC. So we have the motherhood statements at the beginning of the document that says, "Let's look after the rail industry," and we have a statement like that, a real clanger; that's the only thing with a big fat full stop after it. That's the only thing they're going to do. So the path gets auctioned; NR bid up three times to what we value it at. You might say, "Martin, what are you worried about?" If they don't want the path, because they haven't got the freight, they'll have to give it back. But if they knock us out, they will get our freight, and they will put our freight on their path up to where you have to lead the market. So that's a process where that could actually just destroy competition, and we believe will put power into the hands of a few large organisations.

What we will put to you today and put to the ACCC is that's exactly the scenario that occurred pre-1995 before we started rail freight. What did we have? We had one big interstate rail provider called Australian National or NR - it's called NR now. They were on the road. We could actually see the whole thing reverse back to where it was again. The history books say we did start that competition, and in fact the benefits of our competition have even been quoted in ARTC's documents. I could give you, for example, customers' ref sheets - that's the quote sheets - that I could show you from 1995 to now, 30 per cent reductions in prices to Heinz, to Uncle Ben's, to Coca-Cola, to CUB, direct benefits to consumers of those products. So yes, take that auctioning as an example of what could happen.

In a sense though, the ARTC might say, "What are we worried about? This is just a transfer of income," because the documents - I forget again which one in particular - one of their issues I think says, "Is price discrimination necessary to link it to access or not?" because if you're not vertically integrated, then you're never going to stop access, it's just about price. Then you go on to say, "Well, is that just about transfers and incomes?" and the suggestion is made in the issues paper, "Well, does it matter?" we would say yes, it does matter. Transfers of income to large organisations will put the clock back to pre-1995, and that's exactly what we had in Australia, one only. It was big, fat, lazy and uncompetitive.

MR COSGROVE: That's the point, I think. Isn't there some degree of constraint on the sort of overbidding of prices for access that you've mentioned on account of the competition from road freight?

MR SVIKIS: To a degree, yes. There's about a 30 per cent differential on the current door-to-door price between road and rail, and you could look at access charges have been, say, 10 to 15 per cent of that rail selling rate. See, one way you

might say, "Well, gee, Martin, they'd have to go up a fair way to come back to road," but there'd be a few casualties like us on the way before it got there, because we only make 1 or 2 per cent on the bottom line, so a small movement in that access fee could cause us significant commercial problems and start the escalation of prices up because people who compete like us - and we don't just compete on price, we actually think we've got a good service offer, got good marketing strategies, we have a blue-chip customer list, Uncle Toby's - we could name them all day - because we're good at what we do.

We're also unique in the sense that we offer door-to-door services. We will pick it up from your door and deliver it to your door. National Rail, for example, are generally a wholesaler of space on trains. So we think we're unique in the sense that we are a retailer and a train operator. But yes, you could easily see a spiral upwards in price.

MR BANKS: I guess from what you're saying, you see yourselves as being the same, as being competitive with the other two providers, that your costs aren't any higher than theirs.

MR SVIKIS: We think our costs are better and our service is better.

MR BANKS: So you've got large-scale competitors who have got higher costs than you. I mean, that doesn't necessarily translate into them over time dominating the market. What you're describing is a situation which you're going to grow at their expense unless there's some funny economics in there that I can't understand.

MR SVIKIS: There are some differences in economics, yes, certainly. Remember, the conversation we're having now really relates to access which is 10 to 15 per cent of the cost base - an awfully round number. We're talking about the shift of income will reduce the number of players in the market and the shift of income could reduce the number of players in the market very quickly.

MR BANKS: But by that, you're saying that your competitors are willing to take a beating on particular deals through the auction process in order to drive you out eventually.

MR SVIKIS: It's possible, yes. It allows them the opportunity to do that. It's like when you go to a bank; you want the most secure position you possibly can in terms of being able to control and influence your marketplace. We can tender in every other cost bar access, and the bank will get the access paper and say, "What's stopping that happening, Martin?" It just puts risk and uncertainty into ours. Now, it may not necessarily happen but it will put risk and uncertainty back into small competitors, and we would put to anybody that small competitors like us have been very successful.

In terms of the other economic factors, there are a lot of other factors that make or break a profitable train business. We have seen, for example, government railways; take Freight Australia, for example. They are a supplier to ours. We're

pretty familiar with what they've done in terms of rationalising the same railway system in the same state but doing it a little bit better, and that wasn't to do with changes of access. So there are other factors that can differentiate - and maintain themselves in the marketplace against people like Mr Toll and Mr NR.

MR COSGROVE: They could have used the same strategy in an unregulated world, couldn't they, if they wanted to dominate the market more?

MR SVIKIS: They could, except the input price of access - we'd be able to shop around to six different people. None of my other rail suppliers could auction off a unique good like a railway line. That's the way I view it. It's a business cost. We manage it through competitive tender, except that one.

MR BANKS: Just going on, on the same page to the question of cancellation fees, you say:

> The regime needs to provide that when access has been granted, the access provider will not charge fees in circumstances to where access is not utilised as requested.

I was just thinking that the dentist doesn't follow that principle when I don't turn up, but what explains why that should be the case for your business?

MR SVIKIS: Yes, it is more the degree of the fee here that we have a problem with. We're again referring to some very specific statements that have been put into the undertaking before the ACCC. However, if we go back to the principle, it's like penalties should not apply. If we lose the good, if we damage customers' freight, we compensate the customer for the value of that freight; we don't compensate them for the consequential loss or the opportunity forgone of not getting that freight to a marketplace on time. We never accept consequential loss. In a sense, you could argue that cancellation fees are consequential loss fees.

MR BANKS: But what they have lost is their prime business. What they're selling - and that is time and space on that railway line - that's their product.

MR McAVOY: And the freight would move to another operator.

MR BANKS: It may. It depends, I suppose. It might just be dead time because they can't get anybody to use it at the time slot that you had.

MR SVIKIS: Therefore it doesn't matter and therefore they didn't have value in the first place.

MR BANKS: Well, the dentist would say to me, "If you'd called me three days ago, it would have been okay."

MR SVIKIS: In some senses, again, there is this idea in the rest of the business world that direct loss, fair enough; consequential loss, no. So it really is a matter of

degree, so we can certainly appreciate their need. Their argument of course is they want security, but I would say, "I can't tell Mr Coca-Cola or Mr CUB or Mr Uncle Ben's or Mr Heinz, 'You will give me a guaranteed volume.'" I'm saying in the supply chain, if I can't get guaranteed income there, I need to make sure my cost base reflects the marketplace I'm in, and there's only one bloke that wants the guaranteed income. The rest of them live with it like I live with it. That's fair.

MR COSGROVE: Are they claiming the full fee that you would have paid for the access or part for it?

MR SVIKIS: The flagfall component, the fixed component. Mark, did we work out a rough number of what that could be worth in a year?

MR McAVOY: We did. I can't specifically recall it. I think there's about a year or two where you've got to provide a year's notice. I just can't recall the figures, but it could be about a year on flagfalls if you don't operate on the path for a year.

MR SVIKIS: We can confirm a number, but we did actually scratch out the piece of paper the other day. It's about 300,000 to us, to give you an idea of the degree of the fee being acquired in.

MR BANKS: We've discussed quite a bit of the material there already, but there's a statement which says that a vertically separated access provider may act in a way that concentrates the market with a view access seekers which would limit competition. I think you also alluded to that before. But why is it that a vertically separated service provider would operate in that way? I can see why a vertically integrated one would, but a provider which has only a part of the market chain presumably would be in a better position to improve its profit by gaining more customers, ie, giving more access. Is there something different about long-haul railway - - -

MR SVIKIS: That really refers in some sense back to the auctioning. It's the flavour of the undertaking that suggests that they can operate in any way they choose, without any kind of really strict regulation, depending on how they feel on the day, that leads us to think that they may not treat everybody fairly. They also made the point, for example, to some of their parties the other day that one even rule to all parties can actually have an incidence to a smaller party, and then for the people we want on the railway line, more people, more competition, by definition they won't walk on big, they will come on small and grow big if they're good enough. That one rule, even across all people, may actually discriminate unfairly towards a small operator, and these are price and non-price conditions.

MR COSGROVE: Again, it wouldn't seem to be in the interests of the service provider though to behave in that way. He is literally reducing the number of his customers.

MR SVIKIS: Potentially.

MR COSGROVE: And putting the remaining number of customers in a situation

where they have more power to bargain than would be the case if there was a larger marketplace.

MR SVIKIS: Not if he's got a right to put the price up - he's down or one or two and he's got the right to put the price up regardless as well as doing that, not if he reserves the right to just increase his price regardless. Ultimately, yes, there's no doubt he could end up in the same boat. He can shoot himself in the foot. But it comes back to saying, well, do we trust them or where is our market power, where is our protection to make sure that we manage these things as we go? That's really what it's come down to. It's an awfully sort of grey area. It's like we are looking for power. Where is our power? Where is our lever? So we sort of think, well, practically the buggers could do that to us one day, sort of thing. Again, to come back to our opening remarks, whether we're having a go at ourselves or not, we certainly feel like we have a major part on putting 75 per cent of rail freight to Perth, so we sort of know what's needed and we certainly shook up a couple of large companies that were asleep.

MR COSGROVE: That's why, as I say, it seems rather surprising that an access provider who has been gaining from this increase in rail's share of total freight would somehow or other see value in wiping out a potential customer.

MR SVIKIS: Whether they saw value or not value in it, we would not want to see a relationship become law where they could do that if they wished to. This is about the certainty. It's like when we go to the bank for funds, "Show me how you're going to control your costs? What are you going to do about this?" and we have to be able to say, "Yes, these are our skills in these areas to achieve our costs, our inputs and marketing and our service levels," and we want an undertaking or an agreement or declaration or whatever it is that gives us power against someone who in the first instance has got monopoly power. But ultimately, we couldn't agree with you more; they can shoot themselves in the foot if they did it.

MR BANKS: We don't have any other questions. Did you have any other comments to make?

MR McAVOY: I don't think so.

MR SVIKIS: The only one closing comment too in terms of what is a fair price - we talked a lot about the conditions and power - it's also clear to us that the way to strike a fair price is probably not too clear out there; that we would like to see less of DORC models and all that sort of stuff, and I explain why, and more a concept of greater amounts of income to the users and the providers. There is a very high price elasticity to demand factor here when we're talking about cross-mode competition, an extreme relationship. We do not see that recognised, except conceptually - and, John, you're pointing out, well, why would they shoot themselves in the foot? Conceptually, yes, it's all written in all those beautiful words all over the place. But where is it today, where is it tomorrow? Where is the benefit of 75 per cent market share from 15 per cent - equally to all parties, not just to us, to everybody. Give the same data to everybody. Keep that one table published on the Internet, one price to

everybody; that's fine by us. But where can we get more freight on rail? Where is that sensitivity and that understanding? Yet we go to pick up these documents, the submissions, and they've got Booz Allen reports a half-inch thick. We reckon it's a fair bit simpler than that in the way these things work.

We also believe that the floor and ceiling prices that Booz Allen came up with, for example, in this study, one is a factor of 400 per cent of the other, going upwards. So if you've got a floor and ceiling price guideline line, I mean, that's not a guideline. So we've got a problem with the valuation methods. We understand the Bureau of Transport Economics is conducting some studies now into alternative methods of evaluation, and we will simply go back to saying, how about price elasticity to demand, more income for us, more income for the access provider? Where is that? That doesn't appear to be there either. Thank you very much for the opportunity.

MR BANKS: Good, thank you. We'll just break for a moment before our next participants.

MR BANKS: Our next participants, in fact our last participants for today, are Energex Ltd. Welcome to the hearings. Could I ask you just for the record to give your names and positions with the company please.

MR LEE: Trevor Lee, group manager, regulatory affairs and legal compliance.

MR BRADFORD: Nev Bradford, operational compliance manager.

MR BANKS: Good, thank you. Thank you very much for attending today and also for the submission, in fact for the two submissions that you've provided to us. As we discussed, why don't you provide an overview of the points you want to make and we can go back to some of the issues later.

MR LEE: We'd like to thank the commissioners for the opportunity to put a view to this inquiry and we hope that you'll take that view into account in your deliberations. I have to say that the commission and staff ought to be congratulated for the quality of the position paper, the quality of the arguments, and also the attention to the various views that have been put. I have to say that in a number of access and price reviews in the past, as we noted in our first submission to you, that there have been quite a few complaints from community groups, customers and regulator businesses about regulators not taking notice of different views, but those complaints could not be repeated here.

MR BANKS: In our defence or further to that point, I'd say that we're not a regulator and that might make the difference.

MR LEE: As I say, Energex has made two submissions to this inquiry. We're a Brisbane based energy company with aspirations to become a significant player in a number of national markets. We could be regarded, I suppose, as a new breed of multiple services, multi-utilities, that is evolving as a result of the structural reforms of the 1990s.

Our first submission provided argument from a number of columnists and regulators - former regulators, I should say - and other experts that basically the economic and social benefits of utility reform, both those benefits already achieved from restructuring and those in prospect from greater dynamic efficiency and contestability in future are being undermined by the sorts of regulation being implemented. In the time we have for this presentation, we'll just cut to the chase on the main issues in this inquiry which affect energy companies, leaving the supporting evidence and arguments to the submissions, but we believe that the general points we would like to make about energy have applicability to all infrastructure providers.

Just turning first to a few words about the regulatory environment, we feel that the structural reforms of the 1990s that spawned a variety of regulatory agencies has done nothing else perhaps than to demolish Stigler's dictum that regulation only exists to benefit the regulated. However, we don't subscribe to the view that regulators are only doing their job if everyone is unhappy. Our general view is that good regulation can provide win-win outcomes for both regulated companies and

their customers.

As I said, our first submission listed the deficiencies of Australian regulation as identified by a range of eminent economists and others, not only in Australia but overseas, as well as by banks, credit rating agencies, financial houses and by consumers and regulator businesses themselves. In short, the conclusion of that evidence and those arguments was really that the original objectives of the Hilmer reforms, the national competition policy, didn't appear to be being achieved by the regulation that was being put in and there was a general consensus of the parties that there would be adverse consequences for economic efficiency, investment innovation and state development. Our view is that Australian regulators have been determined to apply what we call "commander control regimes", although in recent months it has to be said several are now voicing doubts, most recently at the conference in Melbourne of regulators. In our view, for energy industries at least, these cost plus rate of return models acts as a disincentive for companies to invest in the networks and additionally, for energy, many of the potential technological and other developments hanging off the networks will not be taken up until the incentives are there.

The purpose of Energex's submissions are threefold. The first objective is to basically try and eliminate all forms of heavy-handed commander control regulation and shift to light-handed true incentive forms. A corollary to this has been the development of new forms of incentive regulation which provide by dynamism, including those new forms being developed in the United States. The second objective is to return the focus of regulation onto customers. We feel that regulators have interposed themselves between businesses and their customers and in our view are making decisions which are not in the long-term interests of anyone. The third objective of our submissions is to revamp the regulatory architecture and governance arrangements surrounding regulators, so that the first two objectives are complied with.

In the commission's position paper, there's very much with which Energex agrees. In these opening remarks, we'll just focus on matters where we differ. One area is the objects clause itself. The potential paucity of investment under the current regimes I think is well recognised in the position paper. That argument is something that the regulated businesses have been putting to regulators in successive reviews with little effect. Regulator uncertainty and regulatory squeeze on profits are what the energy distributors at least have called the race to the bottom on the WACC and eventually will have serious consequences. In the paper, we drew the analogy of the monetary policy as being apt, where one may put on the elastic, tie it to a brick for a very long time with no ill effect, then suddenly the brick hits you in the face, and we don't think there's a better example of that than in California. The real lesson from the fiasco there is that companies react to regulatory signals. When the signals are distorted or biased, poor outcomes will eventuate over time. We're not saying here that Australian regulators don't care about investment or that we're going to go to California here, what we're really saying is that there will be lost opportunities rather than a meltdown of the supply system.

What is missing from the position paper in this area in our view is insufficient recognition of the twin to investment, which is innovation, as well as other aspects of dynamic efficiency. These include technical progress and diversity of choice for consumers. Energex's second submission lists some of the possibilities of technical change and innovation in electricity supply if the incentives are there. The submission also furthers the debate on what those incentives should be, including the Schumpeterian argument that potential returns must be above the perfectly competitive rate and firms are to be induced to undertake the risk of innovation.

Taking all those matters together, we have suggested a new first part of the objects clause which is "to promote long-term productive and dynamic efficiency, focusing on the desirability of fostering investment, innovation, productivity improvement, technical progress and diversity of choice and taking precedence over allocative efficiency". In our submissions, Energex also suggests a further clause which seeks to mandate all forms of commander control regulation for elimination as regulatory options, unless there's clear preferences made by regulator companies and its customers.

The problem this is addressing is that the fine words in an objects clause we don't believe will have very much effect on regulatory practice. The five energy distribution companies in Victoria would no doubt point out that the regulatory regime down there is replete with statements about light-handedness, self-regulation, the need for strong incentives for investment, innovation and dynamic efficiency. Their view is what they've actually got is probably the most heavy-handed regulation there is outside of the UK order regulation, OFTWAT. While this ensures there is no prospect of abuse of the market power, it offers very little else and sends out distortionary signals.

Four of the five companies down there appealed a recent decision by the Victorian regulator through a very narrow mechanism that only dealt with procedural matters and not merit, and one of those, TXU, took the matter to the Supreme Court on the basis of law. This situation of ongoing contention, acrimony and legal challenge could become commonplace, we believe. The problem is that governments may set certain objectives for regulators, but they also provide a wide legal framework for independent and discretionary action and there is, unlike in the US, little in the way of meaningful appeal mechanisms or other checks and balances. Indeed, we have the worst of all worlds. We have rate of return regulation without the checks and balances needed to make that sort of regulation equitable.

If the objectives of an agent - that is, the regulator - differ from those of the principal - that is, the government or the community at large - then the tensions between the objectives and governance principles such as independence can snap. The commission itself has earlier suggested that interstate rivalry could result in good regulation driving out the bad. However, in our view, that would only work in good time if regulator companies could choose their regulator and that is very unlikely under COAG.

We're not arguing that the addition of this banning clause of cost of service rate

of return would solve the problem, but it would be a start. The Victorian tariff order 510, which sought to ban rate of return regulation failed, but there's really a question of insufficient precision in the wording. Basically what's needed is a revamping of the regulatory architecture and governance arrangements and principles to ensure that no principal agent problem arises.

I was going to show a slide at this stage of some various forms of the regulation and just say a few words about them. It's on page 11 of the subsidiary or supplementary submission. Just a couple of points about that, and I apologise for those who do not have a copy. Basically what it does is separate what we call heavy-handed commander control regulation as currently applied in Australia on the left-hand side, and we've lumped US-style rate of return on that side too. That heavy-handed regulation we defined basically as costs up, to which a rate of return is added to the top. In our view, the focus is on controlling profits and there's a whole range of problems for that, including, as I said, that squeeze on the WACC, methodological changes that come from left field, the principal agent problem, the micro-management of the businesses that regulators get into, the second-guessing on investment. There's very little innovation or provision of services to customers. There's no choice. We believe there's higher prices over time, but there's no abuse of micro power.

On the light-handed side, we have a range of new forms of regulation, what we call true incentive regulation. It begins at the left-hand side of that, saying a price cut where the X is determined externally with periodic costs of service; the next one along is called a glide path to externally determined targets. Another form is total effect of productivity. A fifth one is performance benchmarking as applied in California, and the last one is price service offerings which I'll say a few words about further on. But we believe that those methods also do not allow abuse of market power, but profits are uncontrolled and they allow for diversity of new services and provide for investment and innovation.

There's a step down too, in the sense of how you actually apply these, and our second submission deals with prices oversight methods, particularly formal monitoring under the Prices Surveillance Act and to some extent, reliance on section 46 of the Trade Practices Act. So I'm sorry it took us some time, but that's really what the diagram is showing.

The key message that Energex wants to put to the commission today in this inquiry is that we believe that any form of regulation that achieves the outcomes of the objects clause should be provided for. Moreover, it should not be up to the government or a regulator to determine the form but for the regulator company, its customers and other stakeholders. This would provide for competition, not only between jurisdictions but also within each state. It may be, for instance, that the publicly owned energy distribution companies in New South Wales and the rural companies elsewhere may prefer some form of price cut. In privatised Victoria, we understand AGL also prefers a price cut, whereas Citipower favours a TFP model and United Energy prefers the price service offerings. Over time, both regulator companies and their customers can observe what is happening elsewhere and change

their preferences at the next review.

I'd just like to say a bit more about the United Energy method because it's something that Energex is very taken by. In Victoria about a year ago in their price review, United Energy provided three price service offerings to the regulator. They became known colloquially in Victoria as the Lada - this is a type of East German motor car for those that don't know - the Holden Commodore and the Mercedes-Benz. The Lada conformed with what the regulator wanted, cheap price, basic service, not much else. The other two were constructed in line with United Energy's customers and included a whole range of output benefits such as undergrounding or beginning of the undergrounding of the whole network and world's best reliability. Even though the Holden Commodore and Mercedes-Benz were shown to be by independent surveys overwhelmingly supported, the regulator just rejected them out of hand and they got the Lada. I have to say that Energex in the recent determination here has also got the Lada. We have been given the lowest rate of profit on the WACC of any Australian distribution company, even though Energex, by the regulator's own independent benchmarking, shows Energex as the most efficient distribution business in Australia. That confuses me as a bit of an economist, that you can be the most efficient but you can get the least profit. Nevertheless, that's what we've got. Price service offerings that we've put up have been rejected. There will be no improvements in quality and a number of other innovations that we have suggested have been rejected. We have the Lada.

Just turning to the regulatory architecture and governance arrangements, Energex can see now compelling reason why the interplay of market forces and preferences, allowing companies and customers to decide on regulatory options cannot be easily provided for in the regulatory framework. For one thing, the resource needs of jurisdictional regulators will be much reduced once the costs of service and rate of return regulations are removed and the array of objectives to which they currently have regard is reduced to a simple objects clause. The set of teams of accountants and others scrutinising every cost item of each company and assessing investment and other plans, their role will be reduced to checking proposals against the objects clause and verifying independent surveys of customers and benchmarks.

Energex's first submission provided a range of recommendations on governance arrangements and principles based on World Bank and other research and the supplementary submission provided further material on formal monitoring of prices surveillance under the Prices Surveillance Act. I won't go into any of that there; it's taken as read.

I have to say that on a reading of the submissions from bodies such as the Treasury and the then TPC to the Hilmer committee, suggesting that there were strong reasons for supporting a national economic regulator, there's also a report by Rick Symes from Port Jackson Partners, funded by the BCA, also supporting a national regulator, but that body should not be the ACCC. In our second submission we have noted that the tripartite governance arrangements of the Prices Surveillance Authority may be superior to the arrangements applying at the ACCC for that sort of

work.

But in conclusion, our view is that whether there's a single national body or jurisdictional regulation, it is less important than constructing a national approach to regulation which will allow evolving forms of incentive regulation focused on customers to flourish. Let a thousand flowers bloom. In the tariff debate, a previous head of office at the Productivity Commission argued for the full adoption of free trade, with the line, "Why should you want to stop halfway across a room to open the door?" The same applies here. Why would Australia want to stop halfway to the full adoption of good regulation that emulates what happens in markets? Thank you.

MR BANKS: Good, thank you. We might just go back through your submission, I think, and take turns, depending on where we've got questions. Your system depends a lot on this objects clause which is quite a complicated objects clause, I guess. I suppose what we were hearing in the first round was a lot of people telling us that the current access regime had no sort of guiding principles to it at all, in a sense, and therefore there was an important need to get some key issues to do with not only efficient use but the investment side of the equation and that's what we've tried to do. What you've done here I guess is flesh out that investment side, in the sense of the dynamism or the dynamic efficiency side and reduce quite significantly the question of efficient use. I sort of just wondered how purpose-fit this was for the question of third party access to essential - I mean, to me, it looks quite a good overall objects clause for a much wider remit of regulation than one that's specifically looking at natural monopoly bottlenecks where the issue is quite often access or the price and conditions of that access. But I thought I'd just give you the opportunity to elaborate a little bit on why you've cast the objects clause this way.

MR LEE: Part of our understanding is that once the Productivity Commission comes out with its final report, that a lot of the argument and principles in this inquiry will be basically transferred to state jurisdictions, so we have that sort of long-term view in trying to get matters fixed now so that when perhaps further reviews take place at a jurisdiction level, that those same principles will flow through. So we're possibly in a different position to some other people that submit. But I don't think the objects clause we put here is very innovative from our point of view; it's almost straight out of Hilmer. Also taking some of the arguments that have been put in this inquiry, all we've done - you know, I think the commission has well recognised the investment point. What is less recognised is this innovation and diversity of choice and technical progress, those points, that we don't want to pursue.

MR BANKS: Could one argue that in a sense, they're related, that if you have a regime that doesn't inhibit investment, that it follows from that that it's also a regime that doesn't inhibit the innovation that's often associated with investment anyway? I mean, investment is one of the main ways of introducing innovation, at least technological innovation.

MR LEE: That's true. Let's not get too fixed on the sort of capital equipment though. Part of our argument is that we're not focusing enough on the customers. Reliability, certainly, is one of the big things in energy. I find it absolutely appalling

where United Energy can say, "We're going to get world's best practice reliability up," from that second submission, from around about 200 minutes down to 52 - world's best - and the regulator rejects it. It's mind blowing. But the very extensive surveys that United Energy did with all its customers and consulting groups found that there's a whole range of other things. You see those in the 150-page United Energy submission; this comes from hardship, disconnections, looking after people, new rental accommodation. There's a whole raft, 150 pages of the stuff, of what they would have done. This is all what customers actually want, the support.

Undergrounding is a very good one, where they were going to actually start a program of undergrounding the entire system, focusing in the first five years on a lot of key areas. You spoke earlier about the evidence of lack of investment; well, in the United Energy submission, it had 120 million to be spent on undergrounding, which was rejected. We've had the same sort of thing here which we'd want to say a few words about. But the real point is, it's not just investment, it's services to customers and that's what we want to focus on. That's what United Energy did and that's what we want to do.

MR BANKS: So in a sense what you're saying is that there's a kind of fixation on keeping prices down regardless of the quality, regardless of the overall package. I think you make the point here somewhere that these alternative offerings that are being put forward by United Energy and others, it's not as if they contain a lot of red. It's really, as you say, perhaps a higher quality offering at a higher price.

MR LEE: It's aimed at world's best practice though. Each part of the package was based on their surveys of European and American practice. So just take the guaranteed service levels; they scrolled through all the networks to find what others were offering in terms of what they call guaranteed service levels and each one was designed to be world's best practice with an incentive and a penalty attached to each, so if you don't achieve the thing, whether there's a breakdown in the network and you're there within 30 minutes or something to fix it, if you fail to be there in 30 minutes, you pay a penalty. You will reimburse consumers. It's a very complicated system emulating a market. There's no investment particularly involved here, but it's innovative. It's seeking to reorganise our business to get a world's best practice service to people. That's what it was about.

MR COSGROVE: I'm interested in the second leg of what you propose in terms of the objects clause, those two boxes on page 10. I think the first box is clear but I wasn't quite sure what the second one was conveying.

MR LEE: The original submission had two extra ones which is really to say if you still allow commander control regulation to continue, the building blocks particularly to continue, then you should only do so if two further clauses are added. One of those clauses is that you should facilitate entry into the relevant markets by pricing in a certain way. The next one, which doesn't really appear in this supplementary submission, was to do with fair sharing. I thought it was a bit sort of superfluous, given that it was really - - -

MR COSGROVE: I guess the confusion in my mind arose from your repudiation, if you like, of cost based pricing in the first box and then the reference in the second box to facilitating entry by setting prices based on the efficient cost and risk structures applicable to new entrants. Is that the proper way to read it, that it's these costs and risk structures for new entrants?

MR LEE: Yes, if you look at the regulatory framework, say, in Victoria or here, they refer to a number of objects clauses that the states have put up in Victoria - four or five pieces of government legislation or government statements or letters from the treasurer to the regulator - if you take all those into account and put them together, it comes out with about five or six basic clauses that the regulator should have regard to. One of those is barriers to entry, where the words are "to improve competitiveness by inducing entry" or words to that effect. Now, in a sense, it's inimical to the costs of service approach because the costs of service approach is saying, "While they're costs of an individual company and then we'll add on a bit of profit to that for you," whereas the barriers to entry clause would say that a bit of basic economic theory suggests that you're only going to get entry if you get prices above the perfectly competitive rate, otherwise there won't be any entry at all. So when the regulator faces those six clauses, in our view, what he's done is take one objective, which is that there should be no abuse of market power, and he's ignored the other five objectives which are induce entry, increase dynamic efficiency and several others that - yes, I can't remember. I'd have to come back to you on those.

MR COSGROVE: That's right. I have no difficulty with the concept of having facilitation of new entrants as one of these things that the regulator should be considering, but what puzzled me was why that particular consideration should be based on efficient cost, because there, you did seem to be back into a cost of service-type mechanism.

MR LEE: How else would you fix a price that induces entry? In a normal market where there's no interference, as competition is reduced as players go out for some reason, prices go up. New players come in and erode those profits down. If too many come in, it goes below the perfect competitive rate and they earn less than returns and the marginal ones will go out and the profit will come back up, so you get these continual fluctuations. But how would a regulator emulate that? How does he induce new entry? Sure, you'd have to look at the marginal potential new entrant, look at the risks and the costs of entry and base the entry price on that.

MR BANKS: Again, I just come back to whether this is a sort of a generalised proposition because here, we're often talking about bottleneck infrastructure, and if you're talking about competitors for that infrastructure, almost by definition you're going to have them. So the whole problem is that they can price very high without inducing entry and that's the problem that has led to the access regime.

MR LEE: Yes. Our view is longer term to what happens down the track with jurisdictional regulators. That's what's driving us and driving our submissions in all respects. What happens in a year's time when the QCA regulations are revised? What are they going to have regard to? They are going to have regard to things like

the Productivity Commission final report and what it finds, and that's what we're trying to get into your final report.

MR BANKS: A cynic might say, looking at the combination of that, that you basically are denying the proposition that there is market power that could be misused and that you're really wanting a free hand here. It's a very gentle regulatory environment in which there's significant provision for quite high charges.

MR LEE: Let's have a look at what United Energy came up with. It came up with the price service offering that regulated what the regulator there wanted which is pure cost of service rate of return. The price fall in that case was quite nominal. I forget what United Energy has said but it's minus 2 per cent or something like that. The Holden Commodore option had no price change. There was a potential fall in real terms but no price change. For that, it offered a whole raft of services and as I've said, all to world's best practice, including undergrounding and massive increases in reliability for almost no price difference between the two. In fact, I don't think there's any profit difference either. The Mercedes-Benz certainly made more profit but also had a price increase of about 2 per cent, so that was the choice. Customers want choice; they had it. They could make their own price/quality trade-off and that's what they did.

MR BANKS: I think we probably should have a look at that submission in a bit more detail, I think.

MR COSGROVE: The light-handed true incentive regulation that you advocate seems to require a fair bit of use of performance benchmarking and productivity measures, right?

MR LEE: Yes, it all depends which form you pick.

MR COSGROVE: Leaving aside the price service offering for the moment.

MR LEE: Yes.

MR COSGROVE: I'm not quite sure that I understood the fundamental distinction that you were drawing between so-called external X and the residual X there at the top of page 12.

MR LEE: Yes.

MR COSGROVE: External X is reflecting expected productivity, by which I take it you mean essentially some sort of productivity performance benchmarking. Is that the case?

MR LEE: Yes.

MR COSGROVE: How does that differ from residual X? Is that not also a similar concept?

MR LEE: No.

MR COSGROVE: What's the difference?

MR LEE: This was the point of the appeal in Victoria against the regulator's judgment and then that was done by United Energy, and then TXU took it to Supreme Court on a matter of law, rather than economics. You must remember procedure was the only thing they could go to the appeals mechanism on, not merit, although they got the merit argument into it. If you read Prof Gans and King on this distinction, what they're saying is that the government expected the regulator to put in a CPI minus X mechanism, not rate of return. What they're saying is that the regulator disguised - in other words, instead of doing incentive regulation, he put a disguised form of rate of return regulation in.

MR COSGROVE: So it's an implementation issue.

MR LEE: Well, the X in the CPI minus X under the building blocks has got nothing to do with productivity, it's just a residual from the way that they approach the building blocks, which is cost plus. It denies the whole point of what - - -

MR COSGROVE: It could also be a choice by the regulator of a perceived gap which is available because of the capacity of that particular company or industry to raise its productivity. It doesn't need to be a rate of return. That's why I asked whether it's an implementation issue. I think the early intentions of CPI minus X were very similar to your external X. The regulator would set some measure of productivity improvement.

MR LEE: That's right, and how much you improve, given this international data or what have you.

MR COSGROVE: Yes.

MR LEE: That's what (indistinct) back in the early 80s said.

MR COSGROVE: But it's turned out to be something different.

MR LEE: But the building blocks, it's a rate of return around - - -

MR COSGROVE: Okay.

MR LEE: You know, this presentation showed a chasm, this big chasm. There was no continuum between these - costs up, top down from prices and incentive regulation. The trick was to put a CPI minus X in, but you go round the other way; where the X just comes out of the residual of the cost plus methodology.

MR COSGROVE: Okay. I understand that now. More substantively though, earlier today some other participants were raising questions about the practicality of

the sort of productivity based pricing that you advocate. You might care to look at the transcript from this morning with views put forward by the Australian Gas Association and AGL, and I noticed also in one of their submissions I think a reference to an academic by the name of Vogelsang. You have an extensive list of references at the back of your submission but his name wasn't there. Anyway, while I can't recall the precise details, it said that use of international benchmarks - and I imagine that that's to a fair extent what would be involved under your proposed procedure - is very difficult because of the problems of comparing like with like, climatic conditions vary a lot. That can have a lot of implications for costs and efficiency, density of population, a range of factors of that kind. As I say, if you've got time to have a look at those arguments and give us any reactions you have - I mean, it sounds a sensible conceptual approach, but there is I think a question of how easily it can be applied.

MR LEE: Just a couple of comments about that: I agree that it is extremely difficult. The argument has always been from the regulators here, "We can't afford any benchmarks. It's all too difficult and it will take too long," what have you. I and Citipower fronted the Utilities Regulatory - whatever the national body is called of the regulators about two years ago and offered that (indistinct) businesses would cooperate with them to get these benchmarks going and that offer was rejected unfortunately. So four out of the five distribution companies in Victoria did it themselves with Kaufmann of the Pacific Economics Group and those benchmarks, I must say, were pretty costly, but he got those benchmarks up in certainly less than six months. There was no problem. That's on the basis that a lot of work is done - - -

MR COSGROVE: I'm sure you can do that. The real question is how valid they are.

MR LEE: We would rather be arguing about what the precise level of international efficiencies are than arguing about the costs of our HB pencils in all the offices. That's what we get. We get people coming down with no experience of running a company at all, telling us how much we should be spending in all these different areas and penalising if we're under or over, whatever. We have got objections to that, I have to say.

MR BANKS: You talk about - on Price Service Offerings - the ORG's response and the objection to that and you say at a public forum they gave a response which was subsequently retracted. Has there been any further illumination of the reasoning for that? Surely the ORG in knocking it back had to give some reasons for it?

MR LEE: I attended a conference afterwards. It was a public forum, but you must remember that United Energy had gone through its own customer consultative committee and a whole range of community interest groups to get these options up, Mercedes-Benz and the Holden Commodore, and a lot of those groups had felt committed to the thing, also not just the community welfare groups but a lot of customers had been surveyed and we had all sorts of people from just ordinary households, pensioners, coming to the meeting. Anyway, the VCOSS guy got up and asked the regulator, "Why did you reject United Energy's options, given that in

my view, they're 10 years ahead of any other regulation in the world?" and he gave an answer which he's retracted, so I shouldn't repeat it - he retracted it at the meeting. He said that he misspoke, so I am very reluctant to say what the answer was. But in the second submission, I've suggested the sort of problems the regulator was having, that it just didn't fit within the profit control box. Profits would be uncontrolled.

MR BANKS: Yes, okay. You can understand probably where the regulator is coming from if profits had no control on them, and I guess what I thought your argument was was that the Mercedes-Benz model involved higher profits but not profits that would be considered unreasonable given the services that were going with them.

MR LEE: Yes. First of all, we don't believe that profits are bad; we believe that profits are very good and higher profits are better, but there's no problem in arguing either that higher profits aren't necessarily - can exist simultaneously with lower prices. We do not believe in profit control in any shape or form. What we believe is emulating markets. I have to say that what the perfect competitive model being applied to this now does is to stop us earning profits by improving, in all sorts of ways, our services to consumers. The United Energy approach had penalties and rewards all the way though and you would get far less profits than under a regulated rate of return if you didn't perform. That was the whole point of it. It induced you and it drove you - the carrot and the stick melded into the whole structure of the price service offering. It is possible that one of those six objectives that I forgot just now, one was financial viability, that the regulator must have regard to the financial viability of regulator companies. We would argue, why? Why is that so? Why do we have that as an objective? The network is always there. If the management of that company can't run it efficiently, it will be kicked out and others will come in. We're not talking about the viability of the network, we're talking about the viability of the people who run it. So we don't believe that that particular objective should exist in the objects clause. That's what we talk about, screwing down the objectives that the framework gives them - just the one that we've suggested.

MR COSGROVE: You mention that this price service offering arrangement was strongly supported by the great majority of UEL's customers. Are those customers a fairly typical range of customers?

MR LEE: Yes.

MR COSGROVE: Major industrial concerns as well as local governments or what have you?

MR LEE: Basically what happened is that, first of all, they built the options by going out and talking to people, including the user groups, Roman Domanski and all those people that represent the very large users and the small users. All the local councils and so on - which I have to say were particularly taken by the undergrounding option - they thought that was absolutely wonderful. So all that was done, and then after the options were put to the regulator and they were being considered, United Energy went out and surveyed households through an

independent survey company. I don't know the numbers now, but it was all ABS-type levels where many thousands through cross-demographic groups were surveyed, "Which ones do you prefer?" and similar questions. Roughly what you got was about 85 per cent strongly supporting the Mercedes-Benz or the Holden Commodore and a few per cent wanted the Lada.

Powercorp and Texas down there also did similar things and went out with similar sorts of questions, "Would you prefer a price drop to something else?" those sort of very general questions. Really, the same sort of level of response came out. 80 per cent were saying, "Yes, we want that," rather than the Lada-type approach. Price, it became evident, was a consideration, but maybe only fifth or sixth down the list of characteristics that people were looking for for electricity. Electricity is cheap.

MR BANKS: How explicit was the price trade-off in the survey?

MR LEE: It's not just what they found but also the UK has done a number of surveys about what people are willing to pay off in terms of a drop in price for electricity against all these other services, and they all support the sort of conclusion that I'm giving to you, where 80 per cent of people are saying that price is much less important than getting reliability and getting these other things or getting underground. I must just add that point, that electricity is very cheap. People want the service of electricity and they want reliability. They want the thing to work. Slight variations in price isn't that important to them.

MR BANKS: The only other comment I was just going to make is in an area that you haven't really developed too much today and that's that section 5 on prices oversight and Trade Practices law.

MR LEE: Yes.

MR BANKS: You say there:

> It is understood that the commission is currently contemplating these matters in ways beyond its stated position in the position paper.

I just wondered whether you were aware that we actually have a separate inquiry into the Prices Surveillance Act which has already put out a draft report and I guess what we're trying to contemplate in a sense is a coherent position across inquiries in relation to, for example, the role of price monitoring and how that would jell in with the industry-specific or the generic or the PSA-type approach to things. I mean, if you haven't had a chance to look at that draft, you may find that useful to do so, and if you had any comments in response to that, we'd be quite pleased to have them, as would my colleague who is running that particular inquiry.

MR LEE: Yes, thank you for that. I worked for the Prices Surveillance Authority for quite a few years, so I do know what they're about and how they went about things.

MR BANKS: Broadly what period was that that you were - - -

MR LEE: That was from 92 through to the joining with the ACCC in 95, up to about 98. I was in the Sydney office of the PSA, senior government officer of the PSA for four or five years.

MR BANKS: Yes. An issue that's raised here I guess is the extent to which you would use a PSA-type approach to bottleneck-type infrastructure as an alternative to Part IIIA. I guess broadly we see IIIA as being the main vehicle there and then there's a question of how the PSA would operate. But given your background, any views you had to communicate to us on that would be quite helpful.

MR LEE: Yes.

MR BANKS: Thank you.

MR COSGROVE: Can I just come back to the price offered and try to understand properly what would be involved here. If you allowed, under your type of objects clause, the customers who wished to use a price service offering to do so, the other 15 per cent, let's say, for argument's sake, would still be covered by Lada-type regulation. Is that how you would see it working?

MR LEE: Yes. The people that voted Lada that weren't poor would have to pay for the Holden Commodore, but the Holden Commodore approach had a lot of provisions for disadvantaged people in all sorts of senses. For example, people who couldn't pay their bill, there's a system where if you paid four out of four, you got the fourth one free and so on. There's a whole complicated system to take the pressure of price shocks or price rising or just difficulty in paying bills off the backs of poor people. That's what all these community groups wanted. So all their problems that they have been putting to the ombudsperson and to the ORG for many years, United Energy's attitude was, "We will solve your problem." So the poor people, in a sense, were covered. Those people who voted for the Lada that didn't want all those services, they would have to be paying for the Holden Commodore, even though they wanted Lada. Does that answer your question?

MR COSGROVE: Yes, but they would still be separately regulated?

MR LEE: No. Well, I'm not quite sure where you're coming from. A network can't deliver a poorer level of reliability to some at a lower price.

MR COSGROVE: I see what you mean.

MR LEE: You all have to enjoy the benefits of a much increased - - -

MR COSGROVE: Yes, it's common.

MR LEE: Yes, you can't pick the term on that.

MR COSGROVE: Yes.

MR BRADFORD: I guess where I'm coming from - and I'm not trying to argue Trevor's economic arguments - is basically we are becoming more concerned that people's expectations for quality and standards of electricity are going far higher. They are growing very, very quickly, and we see continuing pressure for us to try to meet those expectations under the current regulatory regime. It's becoming very, very difficult for us, particularly in things like fairly big investments in undergrounding existing infrastructure. You know, we're looking at - for instance, just to give you a figure - if we tried to underground our existing overhead infrastructure, we're probably looking at about $2 billion. So it's a way of trying to get some money that we can meet those expectations. It's a way also of trying to improve our reliability where people today are relying more and more on electricity, simply because even little things like the use of credit cards for paying accounts - I mean, some time back, we had a small village at the end of a rural feeder which has got a post office. It didn't matter years ago because people didn't pay all their accounts at the post office. Today, most people pay their accounts at the post office. They want to pay them electronically. With a small outage, they can't pay their accounts. Bring in GST; once you went to a hardware store and if the cash register wasn't working, the guy would write out a receipt and give it to you and away you'd go. Today, they can't do that manually. It's got to go into the computer and add the GST and give you a tax invoice, so the expectations of business in terms of reliability are so much higher, and we don't see - given our current revenue structure, being able to meet those expectations is becoming worse and worse. In fact what it's doing is forcing the sorts of behaviour which might be, "Well, let's spend a little bit less money and try to change people's perceptions, which is completely unproductive.

MR COSGROVE: What I was thinking about was more in reference to diversity of choice. Let's say, for argument's sake, that you have two local government customers. They're within a single distributor's network but they may be 50, perhaps a hundred kilometres apart. One local government says, "Yes, I'll take the Commodore, if not the Mercedes-Benz. I like all those service frills," but the other government says, "Look, we're happy to stick with our poles above the ground. We don't place a premium on having them underground." Would that second example have choice?

MR BRADFORD: I mean, as part of the undergrounding, we would supply a certain amount of capital and local government would supply some capital and they might recover that capital in terms of an advantaged rate, for instance. So that balances out a little bit, but local governments can have different rules because they have still got to put up some of their money.

MR COSGROVE: But in terms of somebody being willing to accept a lower level of reliability, that's not so easy to arrange.

MR BRADFORD: You can only do that in terms of the whole - - -

MR COSGROVE: It's system-wide, yes.

MR BRADFORD: I mean, they do currently at the moment because, for instance, with a uniform tariff, people who live in rural areas, whilst they pay the same amount of money, they do get a lot less reliability because we're just unable to meet the same standards of reliability.

MR BANKS: I think we've run out of questions, if you don't have any other points to make. Thank you very much. We appreciate that, and we might follow up, I think, that United Energy submission and have a bit more look at the detail of that.

MR LEE: It's a submission to the Office of the Regulator-General, not to you.

MR BANKS: No, I know that. I say that, not being too daunted by the fact - I think you said it was 150 pages long. Perhaps we'll get the staff to look at it first. So thanks very much for that. We will adjourn this evening. Thank you.

AT 4.25 PM THE INQUIRY WAS ADJOURNED UNTIL
THURSDAY, 14 JUNE 2001

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