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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 MELBOURNE ON MONDAY, 28 MAY 2001, AT 9.05 AM

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MR BANKS: Good morning, ladies and gentlemen. Welcome to the first day of the public hearings for the Productivity Commission's inquiry into the national access regime. My name is Gary Banks. I'm chairman of the Productivity Commission. On my left is my fellow commissioner John Cosgrove.

The purpose of the hearings is to give those with an interest in this matter an opportunity to present their submissions in response to the commission's position paper, which was released at the end of March. The commission released that draft earlier than usual to allow it to coordinate its findings with two concurrent inquiries on overlapping issues, namely, the inquiry into telecommunications competition regulation and the inquiry in the Prices Surveillance Act. Since then the commission has also received an inquiry into airport pricing, which again raises overlapping issues that we need to consider. I should say at the outset that the commission has been quite fortunate in having received many excellent submissions in this inquiry and, indeed across the four inquiries that I spoke of, including in response to our various draft reports.

Following our round of hearings, which begin here in Melbourne then process through Sydney, Brisbane and Perth, the commission will be giving further consideration to the matters raised and will move to prepare a final report, which it intends to provide to government again to align or synchronise with the final report for the telecommunications regulation inquiry in particular. We like to conduct the hearings as informally as possible, but we remind participants that a full transcript is taken of proceedings and is made available fairly promptly on the Productivity Commission Web site, usually within three or four days.

While there's no formal oath-taking in these proceedings, the Productivity Commission Act does require participants to be truthful in their remarks. Written submissions can be made until the end of June, including in response to the submissions of other participants, and indeed we welcome that kind of cross-fertilisation. The submissions are also made available on our Web side and can be ordered in hard copy, as can the transcript. The hearings themselves provide an opportunity for anyone to make comments on the record in response to what they've heard in the course of the hearings and, if anyone wishes to do that, could they please advise the staff and we'll make time available.

I'd now like to welcome our first participant today, which is Freight Australia. Welcome to the hearings. Could I ask you please to give your name and your position with the company.

MR HOUSTON: My name is Michael Houston and I'm general manager access with Freight Australia.

MR BANKS: Thank you. Thank you very much for coming today, and also we've received two excellent submissions from Freight Australia. As discussed, I'll leave it to you to address the main points that you want to raise.

MR HOUSTON: Thank you, chairman. First of all, I must say that we appreciate the opportunity of appearing here today to amplify some of the comments we've made. Basically Freight Australia is a vertically integrated railroad operator, so we have an interest in provision of access to access-seekers but in our own right we purchase access from other infrastructure owners, and in particular we purchase access from the Australian Rail Track Corporation and from the Rail Infrastructure Commission in New South Wales. We are also attempting to purchase access from Australian Southern Railroad in South Australia. So we're familiar with regimes which operate both across the country and in different states.

The basis of our initial submission was that we saw that access regulation is certainly important and necessary for promoting and supporting competition while preserving the efficiency benefits which a natural monopoly has. I think this is the real thrust of our submission. It is to strike that balance between efficiency which a monopoly access provider can provide and the rights of others to compete in related markets.

I suppose our principal concern is that as an owner - and I might just qualify the concept of "owner" in our case, because we do not own the infrastructure on which we operate. We have a 45-year lease from the Victorian government, for which we paid approximately $90 million two years ago, in 1999, when we purchased the business of V/Line Freight from the Victorian government. So we're not an infrastructure owner in the strictest sense but the long-term lease of the infrastructure gives us, if you like, the rights and obligations of an infrastructure owner.

Concurrent with the obligations of lease is the obligation, if you like, to invest in the asset, to upgrade it, to modify it, to extend it to suit business purposes. So our concern is that under those circumstances any access regime should provide necessary incentives to the owner, in our case, to make those investments. So we were pleased to see the emphasis in your position paper on this particular point. We note that in many cases your position paper in fact conformed with a lot of the issues that we were raising in our initial submission. In particular we noted that you too believe that regulation is necessary, for those reasons that I've just spoken about. You've noted that overregulation, if you like, can deter investment in essential infrastructure. You noted that the national access regime can provide an overarching framework in which industry-specific regimes can operate, and I think that's important, because we see a Victorian regime must conform with the national regime in as many respects as possible, although we realise that for our specific industry some finetuning if you like is going to be required.

We note in the position paper that there were problems identified with which we felt a lot of sympathy: the lack of overarching objectives and pricing principles, the emphasis on promoting competition rather than efficiency per se, the inadequate investment on incentives to invest, which I've already spoken about, and the cumbersome administrative arrangements, and we have concerns about the

regulatory costs of access regimes.

Looking at your tier 1 proposals, we certainly support the idea of an objects clause, the inclusion of pricing principles, the requirement in declaration criteria to emphasise that there needs to be a substantial increase, not just any increase, in competition which is generated by the declaration of a facility or service. We are also interested in the concept of access providers being able to make access undertakings if there's a declared regime in place. We think that there certainly should be scope for that to occur. We note also that the position paper proposes that the role of ministers in declaration decisions should be either minimised or removed, that there is an administrative process, with appropriate appeals processes in place, so that the idea that ministers may be able to use discretionary powers to overturn or reject recommendations is probably something that we believe - or support the position put in the paper that that should end.

We also support the concept of access holidays which is noted in the position paper. We are currently interested in the reopening of railway lines in south-east South Australia. The South Australian government has recently called for expressions of interest from parties to reopen the lines around Mount Gambier in the south-east of South Australia. In the expressions of interests there's an indication that successful parties will be given an access holidays; in other words, if they're going to invest in reopening those lines, then they should be given an access holiday of an unspecified period, although there was an earlier indication that perhaps an access holiday of seven years might be appropriate under the circumstances. So we note in the position paper that concept is brought up and we totally support that concept.

So that, chairman, is really the essence of our initial submission and our thoughts on the position paper. We have put a supplementary submission in which focuses on just two aspects of the position paper. One is the question of the concept of sufficiency of information which is provided to regulators and the other one is a further discussion of pricing rules and pricing principles. We are particularly interested in the concept of sufficiency of information because with the proposed regime in Victoria, where regulation disputes will be determined by the Office of the Regulator-General, we believe there is a very onerous requirement on the access provider to provide information to the office. We were very concerned late last year when the government introduced amendments to the Rail Corporations Act to strengthen even further the powers of the office in requiring information. If I may, I'd just like to quote to you from the legislation. This deals with section 38O of the Rail Corporations Act, where it says:

> The office may be written notice require an operator to prepare and keep any information that the office considers may be useful in the future to the office for the purpose of making a determination under section 38F.

"Any information that may be useful in the future." There may not be a dispute

before it at all, but it can require in our case Freight Australia to supply any information which the office may require. Not only is that bad enough in itself, but if we fail to comply then there's a penalty of 100 penalty points or imprisonment for two years. We just feel that that sort of obligation is out of kilter with the concept.

So in our supplementary submission we've dealt at some length with the concept of what is sufficient. We make the following points: that information asymmetry is an actual state of affairs and that in any bargaining position there is always one party has more information than another. In fact, the process of bargaining and negotiation is usually an attempt to minimise that asymmetry of information. We believe this is a natural state and two parties who are negotiating usually arrive at some sort of symmetry. Certainly if an access provider has the bulk of the information but is satisfied that there are pricing incentives to reach a commercial position with an access seeker then there is little point in withholding information. You can reach a better commercial deal if the parties voluntarily exchange information.

But if there is going to be mandatory disclosure, and there may be cases where there are recalcitrant access providers if you like who are unwilling to make those disclosures, then we have three principles we believe should be observed; first, that any information which is supplied must be verifiable; that wherever possible there should be no duplication of record-keeping. In other words if I as an access provider keep certain statutory records then I should have no obligation other than to provide what is already in my record-keeping sphere. I shouldn't have to keep a separate set of records to satisfy the regulator, and there should be mutual obligations.

In other words, if I am obliged to provide information to an access seeker then there should be a mutual obligation on the access seeker to provide me with information. I can't realistically put a commercial proposition to an access seeker unless I have intimate detail of what it is, what service or what facility, that the access seeker seeks to access. In particular, referring to the position in Victoria, the regulator is seeking to have information which will enable him to determine whether we are operating efficiently or not. This concept is fairly difficult in the railway industry in Australia where we have quite a small number of operators. We operate in different commercial circumstances so it's going to be very difficult to benchmark efficiency in the context of the Australian rail industry.

To benchmark industries overseas I suspect is equally futile. People quote class 1 railroad operators in the United States. They operate a completely different set of circumstances to those in which we operate in Victoria. I believe that the concept of efficiency in this context is going to be very difficult to benchmark and can go only cause protraction of any dispute determination. So much for sufficiency of information, although I might add that sufficiency also depends on both the quantum of information being sought and the type of information being sought.

Secondly, we talk about pricing principles. We believe that there should be

pricing principles in part 3A and they should as such increase certainty; should be established so that both parties have some certainty in the outcomes of any negotiation process. They should be of sufficient clarity so that the arbitration process, if it comes into being, is speeded up. They hope to be generic enough to cover a wide range of industries. You obviously can't have principles which are so tightly prescribed that various industries feel they can fit into that mould. They have got to be stable over time because if they're going to be enacted by legislation, then as we know parliaments are very loath to go back and amend legislation 12 months, two years down the track, and they find that things aren't working out quite as they thought they would at the start.

They certainly should promote the objectives of part 3A and they should be able to be applied practically and easily. So we believe they are the criteria, if you like, for pricing principles that are going to be established in part 3A. Then we can look at what pricing rules can be embodied in those principles. The commission in its position paper did identify in fact four principles or rules. We believe that when you look at the pricing rules there are a number of options available, some of which are a bit beyond my ken. They're more in the field of economists and I'm a poor engineer, but never mind, I have a vague grasp of the Ramsay pricing principles or the efficient component pricing rule, but suffice to say that there are a number of options available and I think that any pricing principle ought to recognise the fact that there are rules which are applicable to particular circumstances, and so when we look at the pricing principles which I espoused in the position paper, there are four of them, we believe that they're basically sound, but we have suggested that perhaps pricing principle 2 could be eliminated. In other words, you condense your pricing principles into three, and for the sake of the transcript I will read out what our proposition is. We start off with an objective:

> The purpose of the pricing principles in part 3A is to promote efficient use of an investment in essential facilities and to provide guidance for access pricing issues in industry specific access regimes. The pricing principles are that access prices should generate sufficient revenue to cover the efficient long run costs of providing access to these services, including a risk adjusted return on assets used in providing the services; prevent anti-competitive pricing such as discriminatory pricing by vertically integrated access providers and favour its own downstream operations unless the cost of providing access to other operators is higher; encourage pricing innovations such as multi-part tariffs and Ramsay pricing that are efficiency-enhancing.

So I think to a large extent we are supporting what has been said in the position paper but a little bit of fine tuning of the words and a little - perhaps a condensation of what the commissioner is suggesting. In particular, in terms of pricing innovations, let's not restrict it just to multipart tariffs but let's leave the situation open for different types of pricing which can suit different industries or different circumstances.

MR COSGROVE: Good.

MR HOUSTON: Mr Chairman, that ends my presentation.

MR COSGROVE: Good.

MR BANKS: Thank you very much, Mr Houston. I think you have covered a variety of areas. On a number of those we would probably like to discuss some of the particular points you have made. As you say, there were a number of points made in your first submission that we ended up agreeing with I think - perhaps not always in the detail of it in our draft, our position paper. I thought it was of interest that you had had experience in negotiating access that, as you say, you both are a provider and a seeker and you had experience in negotiating access as a provider previously. I thought I might just give you the opportunity to talk a little bit about how that operated, particularly in the context of this question of information disclosure and if you were able to perhaps elaborate a little bit on the nature of the information that was made available in the context of those negotiations and how the outcome developed.

MR HOUSTON: Yes, certainly. There are, I think, two distinct situations in which we found ourselves. First is dealing with, if you like, government owned access provider which is the Australian Rail Track Corporation and the Railway Infrastructure Corporation of New South Wales where there are posted prices, if you like, and pro forma access agreements. So that when one starts the bargaining process there is a pretty clear outlook on what the outcome is going to be. In other words, there is a pro forma access agreement which is subject to negotiation but only in the fine tuning sense, and there are posted prices where there is some room for negotiation but not a lot.

I might take for example we negotiated access in New South Wales for a new log traffic business. We were carting our logs from near Canberra, from Hume, near Queanbeyan actually, to Port Kembla. Now, there were posted prices for access to the network but as part of the negotiation the access authority had to upgrade or rehabilitate part of the railway line and so there was a component of that upgrade which is built into the exit pricing and we had negotiated what the level of that was a fairly satisfactory arrangement. Similarly, dealing with the Australian Rail Track Corporation they were posted prices but for a use of their network in Victoria for our intrastate traffic we had to negotiate a separate set of outcomes and there was a free exchange of information. We specified the sort of services we want to run, the nature of them, and they are peculiar in that for a lot of our grain traffic for instance we don't have timetable services so we had to negotiate what we called conditional powers. We couldn't specify clearly to the access provider we wanted trains to run at a certain hour and a certain day and they would be a certain length and a certain mass. There had to be a good deal of flexibility in the way we specify the nature of the access we sought, but that was accommodated in the access agreement.

We find ourselves in different circumstances in South Australia where we're dealing with an operation or an operator in exactly the same circumstances we are ourselves. We are dealing with a vertically integrated private company and we're finding it immensely difficult to negotiate access under those circumstances. There is a great degree of information being sought by the access provider. Every time we think we have given enough information, no, we need more, we need more. On the other hand, getting information from the access provider is like drawing teeth and we have sought the intervention of the regulator in South Australia to try and expedite the process there so in answer to your question we have had these different experiences.

As far as we're concerned in our South Australian application we have been quite happy to supply information and we have gone to some detail. I have been to negotiation sessions with our regional operations manager so that he can really sit down with our operators and go through chapter and verse what's required.

MR BANKS: When you say that it has been like drawing teeth, what sort of information have you sought that has been hard to obtain?

MR HOUSTON: I suppose we are trying to separate - I might go back a step. In South Australia the act requires the access provider to provide an access seeker with an information kit. The legislation prescribes what information is required. It is reasonably prescriptive but not onerous I would have thought. There is certain corporate information. There's information about the physical characteristics of the network itself and there's information that's required about access pricing, and bearing in mind in South Australia there's a floor and ceiling access pricing regime so that depending on the nature of access which is required you can operate within the floor and ceiling range with a reference tariff being required as a sort of negotiating starting point for the start of negotiations.

The company with whom we're dealing there has published their version information brochure which has got information about services they provide mixed up with information relating to access per se. I went through an exercise of identifying items in that information brochure which actually complied with the South Australian legislation and those which didn't. I think there was something like 32 items prescribed in the legislation and there were only six or seven actually embodied in this so we had to keep going back and saying, "Look, we haven't got this. Can we have that now." I think we're pretty close to the point by the way of getting all the information we need but it has taken over a year to get to that point.

MR BANKS: The South Australian legislation, the items they prescribe, do you think that's a reasonable - - -

MR HOUSTON: Yes. I mean, if we are to apply in Victoria we would say, yes, that's reasonable. There is certain corporate information. When I say a company organisation, the characteristic of the network, tariff regimes, pricing principles, the

sorts of things we think would be, you know, reasonable to ask, and in particular, no duplication of what we already have on our records. I think that's the key to it. I think it's unreasonable for a regulator to say, "You've got to keep a separate set of records or accounts to satisfy our requirements."

MR COSGROVE: Does your experience with the South Australian company cast some doubt on the points you've made in your more recent submission, Mike, about incentives for voluntary disclosure?

MR HOUSTON: Well, because we don't - the point I'm making is that if an access provider knows at the end of the day he's going to get a satisfactory commercial outcome, there's no real incentive for him not to provide information.

MR COSGROVE: Because of a concern that an arbitrated price will be lower?

MR HOUSTON: Yes, that's right. Yes. I think in the case of South Australia, the feeling is the arbitrated price for the access provided might be lower than what he's trying to extract.

MR COSGROVE: How quickly in that regime can arbitration be invoked?

MR HOUSTON: Well, it can be invoked within - I think it's 90 days. I'd have to check, but that time has long since elapsed.

MR COSGROVE: Yes.

MR HOUSTON: I mean, our attitude is that we would rather achieve a commercially negotiate - outcome, other than go to arbitration, although we have threatened arbitration but the regulator in South Australia has said, "Well, just hold off. Can you have another round of negotiations? Sure, I understand that you have the case for going to arbitration, but our preference is for you to try and reach a - we feel that you're very close to reaching a negotiated outcome. I would prefer to hold back on arbitration."

MR COSGROVE: Why has your company taken that approach? You would seem to face the prospect of an arbitrated outcome, which might provide you with more favourable terms and conditions than you may be able to negotiate with the service provider, yet you are continuing to negotiate. Why is that?

MR HOUSTON: Well, I suppose the first issue is that we're negotiating for access to a facility which we don't require immediately. We simply want to have an access agreement in place so that if we get orders from customers, and I'm talking specifically about bringing grain from western Victoria or eastern South Australia into the port of Adelaide. We don't have orders at present, but we want to be in a position that if we got an order next week for 30,000 tonnes of barley to go to Dimboola to Port Adelaide, that we'd be in a position to move swiftly to fulfil that

order. But the order's not there, so it's hard to go to a regulator and say, "We must have an arbitrated outcome because we can't fulfil our business commitments unless we do. So we've not been in that position, and I simply want to have something in place so that when we do get the order, we can move swiftly.

Secondly, the regulator of South Australia has been reluctant to proceed to arbitration, and we can't unilaterally say, "Let's go an arbitrate." The regulator has to decide that the commercial negotiations have been exhausted, and there is no option now but to proceed to arbitration, and the regulator is not yet satisfied that that's the case.

MR BANKS: You also have experience as a provider in providing access to some access seekers. Could you just perhaps elaborate a little bit on your experience there?

MR HOUSTON: Yes, certainly. When we bought the business, there were access agreements in place with passenger operators of Victoria; in particular, V/Line Passenger, which operators on the - passenger trains on the country network, virtually throughout the state, West Coast Railway, which operates a service from Melbourne to Warrnambool, and Hoy's Coach Lines, which operates a service from Melbourne to Shepparton. Those agreements were in place. There was also an access agreement in place with a company, Great Northern Rail Services, which provides miscellaneous freight services such as running ballast trains and sleeper trains for track maintenance. So those agreements were in place.

Last year, in April last year, we had access applications from Freight Corp, the New South Wales railway freight operator, and Australian Transport Network, to operate freight trains in Victoria. We had preliminary negotiations with those two companies, but around about that time, Victorian government announced the details of its proposed access regime, and both those companies withdrew from negotiations then awaiting on the outcome of that. So we were prepared to negotiate commercial arrangements for those two freight operators, but they withdrew from negotiations, waiting on the outcome of what was going to happen in the Victorian regime.

We are currently in the process of negotiating with the Victorian government for renewal of the West Coast Rail and the Hoy's Coach Line passenger access agreements. They expire on 30 June of this year, and so we're negotiating terms and conditions, although there is an agreement in place with the Victorian government which says in essence that any new agreement we negotiate has to be on substantially the same terms and conditions as the agreement we have with V/Line Passenger. So the room for negotiation is reasonably limited there, although I must admit that we've been able to identify some problems with the existing V/Line Passenger access regime, and hopefully we'll be able to draft a new regime with the other passenger operators, which will minimise or eliminate some of those problems. So it has been a good opportunity to review, two years on, problems which were embodied in the original access agreements when they were drafted back in 1999.

MR BANKS: Okay. One question that I wanted to ask you. In your follow-up submission on our position paper, you approved the approach we took in our tier 2 proposal and the declaration criteria, particularly in relation to the promoted - the objective of economic efficiency or overall economic efficiency. But I wanted to ask you, because in your first submission you emphasised the need for the access regime to apply to vertically integrated facilities. In our report, we saw a number of reasons for in fact having a more embracing access regime that would also include vertically separated facilities. I just wanted to clarify whether your position had changed on that, because our tier 2 declaration criteria would have encompassed vertically separated as well - whether you had any further thoughts on that matter.

MR HOUSTON: No. Sorry, can you refer me to the particular - - -

MR BANKS: It's just on page 2 of your submission on our position paper, where you're talking about the areas that you support. It's the second dot from the top there.

MR HOUSTON: Yes. Yes, okay.

MR BANKS: Now, you're not - I mean, what you're saying there really is you approve the focus on efficiency.

MR HOUSTON: That's right.

MR BANKS: But you're silent on that other matter. I mean, perhaps it's something that you could get back to us on if you wanted to.

MR HOUSTON: Yes, I'd like to think about that question if I may, chairman.

MR BANKS: Okay, good. Well, perhaps we could leave that, and as I say, maybe you could get back to us on it. I guess the other sort of important general issue that you've raised with us, and it was very strong in your first submission, and indeed it's an issue that we've thought about a lot in preparing our position paper, and that is the impact on investment of access regimes and indeed regulation generally. Again, I thought - again, we have a valuable opportunity with you here as a member of that company to perhaps give us some insights from your company's perspective on how access regimes can impact or price regulation can impact on investment. Would you care to comment on that?

MR HOUSTON: Yes, certainly. I should by way of background explain that my company is 100 per cent owned by a company called Rail America Incorporated. It's a very large short line, a regional operator, in the United States and Canada and has operations in Chile as well. In the United States the concept of providing access to competitors is simply non-existent. I mean, people just don't comprehend that if you own a railroad then why would you allow somebody else to run on it, unless there are good commercial reasons for doing so, that there's some sort of synergy

between two railway operators. So our owners have a great deal of difficulty in understanding what's going on here.

I gave a presentation to the board of directors last year - no, earlier this year - as to what was happening in Victoria and although I was quizzed for about an hour I don't think they still fully comprehended that they've paid $163 million for a business including $90 million prepayment of a 45-year lease, "Why would somebody force us to allow our competitors to operate no matter what the commercial arrangements were?" So we have some difficulty persuading them, you know, this was a concept that is well entrenched, if you like, in Australia.

MR BANKS: But wasn't it, in a sense, entrenched at the time of the purchase? Because you spoke about the inherently existing - - -

MR HOUSTON: Yes, that's right. Well, it wasn't so much entrenched but certainly it was well known to the purchaser that an access regime would be in place, in the information memorandum and there were details in the data room et cetera. But I don't suppose the significance of it had dawned on the directors until the declaration was imminent, if you like. Anyway be that as it may, they've looked at the fact that the way the regime is structured in Victoria any sunk investment is not an allowable item for recovery and access charges. They looked at the fact that the rate of return on any new capital is prescribed in terms of the pricing principles, and they've taken the view that there is so much uncertainty about what one could recover through access charges that they're unwilling to invest at all in the freight network.

They have said that the company will of course meet its contractual obligations with respect to the passenger network - and there are obligations to provide certain track quality to passenger operators, and there's no way they will move away from their contractual obligations there - but if there is any discretionary investment to be made in the freight network, then they will not invest, categorically, on the basis that there is so much uncertainty being engendered by the Victorian regime that they don't know what the outcome of access determination will be. They could invest money, find that the regulator might determine that the allowable rate of return on the new investment is no more than the long-term bond rate plus the slim margin and they say no, in light of the risk associated with that sort of investment, we're not prepared to invest.

MR COSGROVE: Is that a decision taken regardless of the nature of the regime, or would they review that decision if the regime somehow became more safe for them?

MR HOUSTON: I think they would review the regime if they felt that there was some certainty that access prices would allow investment to be recovered at a reasonable rate, and bearing in mind the risk associated. I think this is an important factor to be brought into account. The rail industry in Victoria is a risky business.

There is no non-seasonal traffic available, or very little in the way of non-seasonal traffic, available to a rail freight operator. Our biggest commodity that we transport is grain, which is heavily season-dependent. Currently we're enjoying a bumper grain harvest and we're hard-press to meet our business commitments through lack of resources. We're hiring in locomotives from wherever we can find them. But this rain we're seeing here today is not falling in the grain-growing areas of the state and we could be facing a lean year next year. Revenues can vary by 40 per cent.

So if one is to make an investment in the freight network, one has to be assured that the revenue risk is taken into account. So, in answer to your question, if a different regime were in place or pricing principles were established which recognised that risk and allowed for higher rates of return on new investment, then I'm sure the owners' view would change.

MR COSGROVE: In practical terms, Mike, would such a regime, say, be sufficient from the point of view of you're a major shareholder if the pricing principles which you've suggested in this latest submission were in place? What would be the content of a satisfactory regime?

MR HOUSTON: I think so. We have two concerns with the regime as it's proposed, as it's been declared. One is the information requirements - and we believe their quite onerous and that's why we've dealt with that concept of sufficiency of information - and pricing principles. You'll note that the principles that we're proposing include the comments such as "a risk-adjusted return on assets used in providing services." I think if those principles were in place - and you'll note that we're not trying to provide a particular position for ourselves, because we refer to discriminatory pricing by vertically integrated operators, and I think in all fairness that has to be in place, because you will have vertically integrated operators who will go out of their way to protect their position. I don't think in a national regime you can afford to have that base not covered, so we're saying, yes, there's got to be cognisance made of that.

MR COSGROVE: I guess if I could pursue my question, would not the ORG say at the present time that it is allowing a risk-adjusted rated of return on the assets involved in your operations?

MR HOUSTON: We believe that the risk adjustment is not sufficient.

MR COSGROVE: Yes, that's where uncertainty seems to me to remain. The sort of practical application of these principles, which I agree it's rather difficult to spell out in more than general terms, still seems to leave your company in a situation of some degree of uncertainty. But you'd still say you could deal with that?

MR HOUSTON: I suppose in putting a submission like this one doesn't wasn't to be too extravagant in one's claims. Yes, if we could get something stronger in place that would be good, but anything stronger would help improve our position .

MR BANKS: Since we're talking about that, you've said that you broadly agreed with the sort of principles and you've provided some helpful suggested changes to those. The one you knocked out of court, though, was the second one, which talks about access prices, to quote us, "Not being so far above costs as to detract significantly from efficient use of services and investment in related markets." I think what you're saying is that it's too imprecise to provide an effective constraint in practice, and I guess there's a question as to whether there might be a more precise form that would work. But then you go on to say greater precision would lead you into a sort of micro-management situation in which the costs potentially could be quite high and the type 1 area problem loom again.

But I guess in response to what you're saying there, the signal in that second one is that the prices can be above costs and perhaps the regulator shouldn't be too obsessed with getting it right to the bone, given the uncertainty and so on that pervades these kinds of decisions. So I guess we saw it as having a complementary role to the first one in terms of providing a signal about not cutting things too much to the bone, which I would have thought would have supported the point you're making about uncertainty and the need to get a return on risk adjusted in a risk adjustment sense.

MR HOUSTON: I suppose in answer to that all I can say is that the anticompetitive pricing aspects are dealt with now in the pricing principles as they were in your original one anyway - I felt that was taken account of - and that the degree of precision required again gets back to the information base which needs to be brought into play. Then you get into higher regulatory costs, which might outweigh the benefits which come at the end of the day.

MR COSGROVE: So it's the reference in our second pricing principle to costs, is it, that's the problem for you?

MR HOUSTON: Yes, that's right.

MR BANKS: It might be something you'd reflect on a little bit more, though, because the first principle talks about:

> being at least sufficient to meet the official long-run costs of providing access, including the return on investment commensurate with the risks involved.

My colleagues talked about - there's still obviously some degree of uncertainty about how much allowance would be made there, and I guess the question would be again to think about whether the second principle could have a role in providing a signal about perhaps in a state of uncertainty erring more on the upside down the downside. But have a think about that, anyway. Any further thoughts you had, we'd appreciate.

MR HOUSTON: Okay. I can do that.

MR BANKS: As I say, we're grateful for your other specific suggestions about wording some of these things to make them more robust or more general. The other comment I guess I'd make is that you've restated the purpose of the pricing principles there, which I guess we would have seen in a sense covered in the objects clause that we'd put forward and in a sense these are more or less restating that overall objective of the legislation. Would that be right?

MR HOUSTON: Yes. I don't think it's bringing out any new ground but it helps to re-emphasise, particularly in a determination of a pricing dispute, for the regulator and the parties themselves, when the y look at the pricing principles - to say, to bring it to the front of mind, "This is what it's all about."

MR BANKS: Okay. Just while we're looking at that, there are some who've said to us that in a sense our objects clause has given equal weight to use and investment, almost implying that the regime could be used in a proactive way to facilitate efficient investment, where what they're saying to us is the primary objective really is about achieving access and efficient use without adversely impacting on investment. That nuance has been put to us as a more appropriate one. Have you got any reactions to that? I suppose it depends which hat you've got on.

MR HOUSTON: Yes, and I'm trying to determine under which circumstances I'd be answering the question.

MR BANKS: I mean, both are important, but the question of what is the overriding or the primary objective.

MR HOUSTON: I think the primary objective has to be the efficient use of the asset involved. I think that's got to be underlying the whole concept really.

MR BANKS: Good, thank you. John, did you have anything else?

MR COSGROVE: I was wondering whether you might be able to provide us with any information, perhaps not in any detail today, Mike, on these costs of regulating the access regime that you've emphasised. You cited I think part of the Victorian legislation which requires you to provide to ORG, I think the words were, any information that may be of use to them in the future. That presumably would put you in a situation where you were having to set up some additional accounting arrangements or what have you, but are you able from your own firm's perspective to give us any quantitative idea of the additional impost that you face as a result of having to comply with these access arrangements?

MR HOUSTON: I suppose there's going to be a one-off cost, because once you've supplied a certain amount of information then presumably, unless there are new requests being made all the time, one wouldn't need to keep on replenishing that, if

you like. But to provide the initial information I suspect would cost in the order of between 50 and 100 thousand dollars in terms of staffing and computer programs and development of models and things like that.

MR COSGROVE: That's the once for all cost, yes.

MR HOUSTON: Yes, that's right, and then maintaining it after that, once you've got your models established, I suppose, it's only a question of maintaining those models. I'm assuming this is separate from we already do in terms of our own business management purposes, so I suppose - and I'd like to examine this in more detail and come back to you - probably having got it established the maintenance would be in the order of $50,000 a year or something like that.

MR COSGROVE: It doesn't seem a large burden.

MR HOUSTON: No, but we're a fairly small company and it's the equivalent of having an extra person on the payroll, I suppose.

MR BANKS: You talked about this venture based at Mount Gambier as an example of perhaps something oriented towards an access holiday. As you know, that's something that we've been exploring and are attracted to in principle, but I suppose we're puzzling through the practical implications of it. Is there any further elaboration you can give on that project? I mean, they're calling for tenders in which the notion of an access holiday has been made explicit. Is that correct?

MR HOUSTON: Yes. Well, they're calling for expressions of interests, and we've expressed our interest, and in the documentation and the invitation for expressions of interest there's reference to the possibility of an access holiday. Subsequently in the South Australian parliament the minister has declared that there would be an access holiday, but for an unspecified period. My understanding is that the access holiday and its duration would depend on the nature of the investment that the operator might put into the asset. There's a whole mix of options which are available there, where the government could partly fund some of the rehabilitation work, a private company could fund the whole lot, there will be some investment in rehabilitating the network and converting it to standard gauge, then in addition there ought be investment in rail load-out facilities. It could be that the government funds the rehabilitation, the operator funds all the other, the ancillary infrastructure, if you like.

So certainly our view would be that if we were to invest in the whole lot, rehabilitation, standardisation, rail loading facilities, spur lines, whatever, we would want an access holiday for say seven to 10 years. If, however, the government were contributing a significant proportion of that investment, then you would have to say our exposure is less, therefore we couldn't expect to have an access holiday of such duration.

MR BANKS: Would you see this as a very risky project in the scale of risk-taking?

MR HOUSTON: In the scale of risk pain, yes, it is, because it's always very difficult once shippers have put product onto road to convert them to rail transport. Currently there's a huge volume of road traffic going through the region, principally from Mount Gambier into Portland, and that's expected to grow dramatically over the next five to 10 years. The impetus for growth is coming from blue gum plantations which were planted a couple of years ago. They'll mature in about seven to eight years' time and there will be something like 4 to 5 million tonnes a year or logs or woodchips being transported out of the region. Our view is that we would have to try and get a business going now, try and convert shippers and producers from road to rail transport, get some bread and butter business going now in order to be in a position to capture the market when the larger volumes of traffic come on stream. So, yes, there's significant risk in getting involved in those operations in the early years.

MR BANKS: So there's risk and there's also intermodal competition from road which is quite viable in competing for the kind of business that you're after yourself.

MR HOUSTON: Yes, well, the road rates are very low and the margins are very slim as far as we're concerned in trying to attract traffic from road to rail. The argument we run, of course, if that unless that happens, then the respective government are going to have horrendous road maintenance or road construction bills into the future. So the margins are unsustainably low at present in a total economic sense.

MR BANKS: Okay, thank you. That's very interesting.

MR COSGROVE: The transportation of mineral sands somewhere up there in the north-west of Victoria wouldn't be picked up by this particular network, would it?

MR HOUSTON: No, it wouldn't, although that would be picked up by the proposals to standardise the Mildura railway line so that you can carry product on standard gauge from the north-west of Victoria into the port of Portland.

MR BANKS: Thank you. I'll just have a quick look here to see if there is anything else I was going to ask. No, I think that's about it, is it?

MR COSGROVE: Just one, Gary. You mentioned in your opening remarks, Mike, that you agreed with our proposal that the role of ministers be removed from access regimes. That then leaves you with a question of what you have without them, and at present you might say you could keep the arrangements whereby the National Competition Council considers requests for declaration of access and, where it agrees, the actual final determination of access in the absence of commercial agreement is left with the ACCC. We've had a number of cases in the rail area especially where recommendations for declaration have not been accepted by ministers and have therefore lapsed under the present arrangements. So what would

you see as the likely situation in the absence of involvement of ministers, and what sort of model would you leave in the hands of the regulators?

MR HOUSTON: My concept is simply that, without major structural change, an application would be made to the National Competition Council, a recommendation would go to the ACCC as the ultimate regulator - because you are I think proposing that there be a single regulator - and the ACCC can either reject the recommendation or accept it. If it rejects the recommendation - I suppose in either case - if there is an agreed party it will be a party then that can appeal to the competition tribunal and that would be the end of the story, I would have thought. We simply feel that the intervention of a minister somewhere through that process doesn't add a lot of value to the process.

MR COSGROVE: Will you be worried about a possible tendency for a regulator to regulate, you know, in order to be more actively involved in those figures?

MR HOUSTON: I think by having - sorry.

MR COSGROVE: Yes. I mean, in a situation where it's easier than it is at present for a recommendation for declaration of access to pass into the hands of a regulator, would that leave you with any worries about regulation being applied improperly, about access being applied improperly?

MR HOUSTON: I suppose one is assuming that by putting more power into the hands of - the more powerful an institution becomes the more likely it is to become convinced of its own glory.

MR COSGROVE: Yes.

MR HOUSTON: I suppose there is a risk there, but then as long as there's an appropriate appeals process in place - well, I don't suppose one wants to erect an institutional arrangement were every decision is subject to appeal. I suppose that is the danger perhaps that you're considering, one that I hadn't really considered. Perhaps we need to look - - -

MR COSGROVE: I wonder whether in the end you can always keep the ministers out of the process as well. They may - well, the legislation itself would have a significant say in that I guess. But they might be able to intervene from the wings, so to say, to influence an outcome of access regulation which they saw as wrong and suggest to the regulator that the case be reconsidered and even if they can do so only on an formal basis then - I guess my question here is how clear-cut is a situation without ministerial involvement at the point of approval of a recommendation.

MR HOUSTON: I find that difficult to answer. I've had experience with ministers of various types, colours and creeds and they use their discretion in varying degrees, and I think it's very hard to generalise.

MR BANKS: You don't, however - I mean, it's implicit in what you're saying that you don't see a strong due process need, because others would argue, particularly at the moment and we're hearing it quite a lot, that the public interest dimension requires, in a sense, a role for the elected representative to consider these matters and once you're getting out of pure efficiency considerations - but you don't see that, given the rest of the process that's available, as a compelling reason for including the minister?

MR HOUSTON: No, I don't see it as a compelling reason, although I can understand people arguing that way, yes. Yes, if you're a consumer of gas or electricity and you feel that you're aggrieved and you rely - yes, you'd be looking to your elected representative to come to your aid, I suppose. But look, I haven't thought of it in a more general context. I'm just thinking of our own particular situation, that I don't see a minister adding a lot of value to the process.

MR BANKS: Thank you.

MR COSGROVE: Perhaps lastly, is it worth asking, Mike, whether you've given any thought to the proposal which we advanced of a role for price monitoring as a substitute for declaration of access?

MR HOUSTON: I haven't given a lot of thought to it. I recognise it as an option under certain circumstances where there are true monopolies operating and it could well be more appropriate to - - -

MR COSGROVE: From the point of view of an access provider, would it have any particular advantage vis-a-vis being subject to a declaration of access? That was the sense in which we were floating the idea.

MR HOUSTON: Yes, I understand.

MR COSGROVE: As kind of a halfway house, if you like.

MR HOUSTON: Under those circumstances one would still have some sort of access contract in place anyway and I think you need that to determine or to prescribe the roles and responsibilities of the two parties engaging in the deal. So under those circumstances there would be a commercially negotiated outcome and I suppose some form of prices surveillance would simply ensure that once the agreement is in place that the access provider doesn't unilaterally decide, "Oh, well - - -"

MR COSGROVE: Yes. Some people refer to it as the silent policeman rule.

MR HOUSTON: Yes, that's right. Yes, if you know that somebody is watching over your shoulder that's going to constrain any competitive behaviour. Certainly

administratively it's much easier than having a regulatory regime in place and it will certainly influence the behaviour of access providers. So it's something that we didn't pick up in our first submission but it would have merit in our circumstances.

MR BANKS: Again, if you had any further thoughts after today on that matter we'd be grateful to see them.

MR HOUSTON: Yes. Well, there are two or three items which have come out in discussion that I think we'd like the opportunity to come back to you on.

MR BANKS: Good, thank you very much. Thank you very much again for attending today.

MR HOUSTON: My pleasure, thank you.

MR BANKS: I'll break now for a few minutes please.

MR BANKS: We will resume now, ladies and gentlemen. Our next participant this morning is BHP. Welcome to the hearings. Could I ask you please to give your names and positions with the company.

MR BIGGS: Actually I can speak for all of us. My name is David Biggs. I am the vice-president commercial for BHP Petroleum. On my right is Bill Henson, the manager of Bass Strait Gas Marketing for BHP Petroleum, and next to him is Peter Fitzgerald, a consultant who BHP Petroleum has retained to help us with this exercise.

MR BANKS: Thank you.

MR BIGGS: We have tabled a brief pack which summarises what we would like to talk about today but in brief what we would like to do is commence with some general comments, move on to talk about investment and regulation, asset valuation, information disclosure, and close with some miscellaneous other issues. We will be following up our presentation today with a further written submission which will also provide some attachments and Prof David Johnson is also going to be presenting a report in Sydney on asset valuation issues.

MR BANKS: Thank you. Will your submission encompass the comments that you're making today?

MR BIGGS: It will, in a fuller form obviously, yes.

MR BANKS: I mean, as you know, you have got the order slightly wrong in that we normally like to get the submission first and then be able to discuss it with you so you have us at a slight disadvantage and we will reserve I suppose the opportunity later to perhaps respond to some of the points in your submission. Would you have your submission to us before the Sydney hearings or not?

MR BIGGS: That's the intention.

MR BANKS: Good.

MR BIGGS: You know, frankly if you think it worthwhile we're very happy to come back and talk to you further again if there are issues that come out of the written submission, that you don't feel you had had the opportunity to fully discuss.

MR BANKS: All right. That's very good of you. Thanks for that. Okay, over to you.

MR BIGGS: Peter Fitzgerald will just talk about some general comments on the review.

MR FITZGERALD: Yes. I would like to start with the terms of reference. I

think it's noteworthy that the proposals that have come out of the review so far are in an interim form but it makes some sense to look back and say if these proposals are the answer to a particular question what was the question. We think it noteworthy that the proposals have not come out of a broader set of identification of problems of the introduction of competition and reform to the energy sector. It has actually come from a review of the CPA, the Competition Principles Agreement, in part 3A generally, and we think that it's interesting that you can get different answers if you ask different questions.

If you said, "What have been the successes and failures of competition policy in energy so far," which was a question interestingly asked by the Business Council and had a report done by Port Jackson Partners, they identified around about 10 discrete problems and the access regime was not amongst those problems. So they said that there had been various issues with framing the access arrangements, the regulatory arrangements, the asset valuation, the way bidding had occurred, the structure of generation, the lack of interconnection in electricity, but they didn't say the problem was the access regime, and so if you said, "Look, let's be strategic about the objectives of national competition policy, let's make it work," what you would actually do is say what is working and not working with those reforms and then proceed to try to fix them.

This review by its terms of reference does something quite different. What it says is, "Let's take a slice of national competition policy and see whether it meets a cost benefit test of whether it can't be made more efficient," which is a different question, and actually ignores the point of where access fits in to national competition policy. So access per se is not a policy objective. The objective was not to say there are natural monopolies that must be regulated because they are natural monopolies. The policy proceeded on the basis that there needed to be competition in all sectors of the economy that could bear competition, and that a stumbling block was seen as those pieces of infrastructure that, by virtue of their management and regulation, might prevent upstream or downstream competition, and therefore access regimes ought to be put in place to promote competition upstream and downstream and for the betterment of the overall economy. So we can see a number of proposals that come out of the review undertaken as it has been in accordance with the terms of reference, but we therefore have to step back and say, "If you actually asked a different question would you get a different answer."

What you would probably get if you asked the different question which is, "Are energy reforms on track? Does the access regime in relation to gas and electricity need to change to make those reforms occur and occur better and more quickly and more effectively," then you would probably say, "It might be premature to answer some of those questions." If I could just use some of the sort of metrics. This review is undertaken because it's five years since the signing of the competition principles agreement. Since that time we haven't had five years of history of access. We have had five years of which most of that time has actually been writing the access codes that follow from a competition principles agreement in part 3A.

In relation to gas for example, it took two to three years to write it, the access code. Likewise in electricity. So it's only the last two, and at best, three years that demonstrate or evidence some experience with access regimes. Then if we say, "Well, has there been a fair period to judge," we would say in most of the initial access regime pricing arrangements they have incorporated transition arrangements. They have incorporated various unwinding of pre-existing arrangements, and so there is very few clean examples of cost reflective network pricing for example and lots of examples of something a whole lot different to that.

If we say access is a means to an end and we say, "Well, towards what end," we would say, "There are a couple of interim ends, one of which is the contestability of downstream customers." At this point in time 95 per cent of energy customers are not contestable. So as a household energy consumer I don't today have the choice of my gas or electricity supplier. I have a promise that this will be the case next year, and in fact last year I was promised this year, and so we have been subject to a set of promises not yet met. So if we say, "How successful have the access regimes been in allowing broad scale contestability," the answer is, "Too early to say." It has been successful in some areas and for some categories of energy consumers but it has not been successful against the objectives that itself set. That's point 1.

Point 2 is in relation to the success on the overall economy, we can say that there have been some successes and one of the barriers that were seen to, for example, downstream processing of Australian minerals, had been various pricing regimes or various arrangements for pipeline access and energy pricing in the Pilbara, just by way of one example. Those arrangements have now been undone and there are changes in the behaviour of people looking to invest in iron ore and downstream processing et cetera as a result of changes in gas and electricity arrangements. There are other issues in relation to rail access that have similar parallels but perhaps highlights the point that different infrastructure industries are at different levels of reform with different levels of outcomes for the economy against the sort of objectives. So it would be wrong to just view access per se and ask questions of, "Could it be more or less efficient? Could it be more or less heavy-handed in relation to regulations?" The real question is actually a much broader one which is, "What do we want national competition policy to achieve, and is it on track or not on track," pardon the pun in relation to infrastructure, but is it on track or not? We would say that it's premature and probably misguided in the terms of reference that we have to answer the question any other way than with regard to the broad objectives.

If we then also say that national competition policy were designed to undo a set of pre-existing problems, then it's notable that the reports so far written don't refer back to that; don't refer back to the days when we had two electricity commissions spending about a million dollars a day for a decade each building generation capacity they didn't need to build because there were not electricity interconnections between the states. So you had the point I think Kim Beazley made some years ago that there

was more electricity flowed between East and West Germany at the height of the Cold War than between Victoria and New South Wales in the 70s and 80s. So that was the sort of problem that we're trying to overcome by national competition policy and access was just a small portion of that big picture.

So what we see with some of the proposals is that history is not there on the record and it's not there for us to say, "Well, has it been solved?" A second example is for the first 20 or 30 years of the natural gas industry in the east coast of Australia there was no interconnection between New South Wales and Victoria for the exchange of gas. That has now been addressed but hasn't been mentioned so one of the key points of national competition policy was, it wasn't going to be state. We weren't going to have rail gauge problems at the border; that we were actually going to stop the hoarding of resources and allow a sharing of energy to flow between states. So that electricity interconnectors have a specific set of problems of which the access regime might be part of the problem but it's not the whole set of problems. There are other problems in relation to those investments occurring.

In relation to gas, I don't believe it can be said that the access regime has been a barrier to investment. It's just not the nature of those arrangements that they would upset that. It also needs to be said that access is only a part of an investment decision to build energy infrastructure. In gas pipelines for example most of the economics are dealt with by way of foundation shipper arrangements, so that if someone is going to invest $400 million in a pipeline they won't build it and then submit an access regime and hope that people come. They will go to the most likely candidates who already use it and say, "Can you underwrite by way of forward commitment the cash flow required to cover the necessary parts of the investment?"

Therefore when you have an access regime it's on top of additional to and in a different dimension to the foundation economics that underwrote the investment. So it's therefore potentially wrong to view access arrangements, and in particular, the cost of capital and return on capital that is quoted in an access regime as being determinant of an incentive or disincentive for investment generally because the investment generally will be primarily done by the shipper arrangements of a foundation nature and not the third party access regimes. That's slightly different in relation to electricity but I will leave that for electricity companies to comment on.

Just by way of summary in terms of initial comments, the key point about access and national competition policy is that it was an economic instrument competition policy instituted for economic purposes primarily related to international competitiveness. So if the country is to become more wealthy economically then there was some amount of domestic efficiency that would be part of the objective, but more particularly in relation to energy it was in the international competitiveness that had to be looked at. If we now say we want regulation to be less heavy handed because that sounds like the more efficient thing to do, and that's usually the case, we need to say, "Well, what would the impact of less rigorous regulation be? Would it just be a dumbing down whereby regulators look less seriously at the monopoly rents

taken by infrastructure owners? If we were to do that we would be inviting less competitive outcomes in terms of user cost structures."

So if I'm a coal mine if I'm a steel mill, if I'm a downstream minerals processor, energy is an input. Energy infrastructure usage charges are part of that energy input cost. If we were to invite a greater part of the industry chain to be taken by the infrastructure owners, then we might just view that as a distributional thing of arbitrary choice - is to be taken upstream, downstream, midstream? It sounds like one versus the other would make no difference. It does make a difference, because for input costs for internationally exposed exporters, it's an input cost that goes up without corresponding benefit, for the reasons that we've said.

I've written a fuller submission which will be included, but we would say that there's very little real evidence of a lack of investment in energy occasioned by virtue of the access regimes, and there at least two examples that we would use. One is, there's been a race for gas pipeline interconnection investment built off their own intrinsic economics that has not been stopped or delayed or disincented by virtue of access. Secondly, the regulatory regimes, if anything, have been two positive towards investment in two regards. One is, every infrastructure asset owner in energy in the 80s and early 90s did extremely well by the turn of the century in terms of their investment as a result of a number of things: asset sales, asset privatisations and, for those who held onto them and made them subject to access regimes, they were allowed to revalue them to essentially their replacement costs, so that someone who invested $100 million in an asset found that by the end of the decade they're allowed to say it was worth 3 or 4 hundred million dollars. So the message was, "Asset owners have done well."

The second incentive towards investment has been the roll-in of new investment for distribution companies in gas and electricity and, to a lesser extent, in transmission. So in Victoria we have a number of distributors who sent out electricity. Their investment plans in the next five years are about 1.5 billion. The regulatory regime that relates to access allows them to essentially roll it in under a not terribly rigorous or harsh test that says, "Are there network benefits in putting this investment forward? Would it improve reliability, would it de-bottleneck other parts of the system?" It's a technical argument of which there are very few opponents. So user groups are not really in the business of saying, "We don't think you need a substation here. We don't think you need reinforcement of the gas system in this part of the city." They tend to say, "Whatever you say as the incumbent goes." The investment that has come out of that has been quite significant, billions of dollars, and the infrastructure owners have been entitled to a fair return on that, and more than a fair return if their operating costs are below what's perceived as being reasonable.

So I think, just by completion of general comments, the terms of reference do limit where the review goes, I think to its detriment. But, secondly, if the commission had taken a more pragmatic approach to looking at the state of energy

reform and the history, you would actually come up with a different set of views around what sort of incentive the access regimes are or are not. Do you want to ask questions?

MR BANKS: I'd only just make perhaps two comments. One is that we produced a position paper which, as I indicated at the outset today when you weren't here, we expedited given the need to align the release of that paper with other reports that also dealt with access issues, in particular the telecommunications regulation paper. Your particular focus is energy. I guess we saw hours as broader than that, at looking at a generic regime which potentially could have application in a variety of areas. You didn't mention telecommunications, but we have people who are very interested in that particular dimension of access as well. So I guess just those two points.

Certainly in doing a final report, if we haven't done it sufficiently, we'll make the wider context in which this regime appears a lot more clear, but I guess we took a lot of that as given in preparing that report. But they're the only comments I'd make at the moment, and perhaps allow you to continue with your presentation.

MR BIGGS: I guess what I'd like to do next is just build on some of the points that have been made by Peter already in terms of investment and regulation. Just by way of background, BHP in the last 10 years has had a fairly extensive involvement, particularly with the development and use of pipeline infrastructure in Australia. We have at various stages been the developer, owner, seller of and user of the eastern gas pipeline, which runs from Longford up to Sydney. We've also been the developer, owner, seller and user of both the Pilbara pipeline and the Goldfields pipeline in Western Australia, and we have been, along with Exxon-Mobil, significant sponsors of the pipeline that is to be built from Victoria to Tasmania and by ourselves a pipeline that is to be built from Victoria to South Australia. So we, I think it's fair to say, have extensive experience in the promotion and completion of new infrastructure, particularly in pipelines.

I guess the one thing we've learnt from all of that is at the end of the day investment in energy infrastructure, particularly in our case through pipelines, is ultimately demand driven; that is, people will build pipelines if the market demands the gas at a certain marketplace. In addition to that, as Peter mentioned, pipeliners will as a rule seek to have somebody underpin a large part of their investment, and we have direct experience of that on almost all those pipelines I've mentioned. I think the key thing from our point of view is that access to the downstream market enhances the investment I pipelines and promotes competition. Regulation of its supports investment but it doesn't drive investment. The market itself does that. So when a pipeliner is looking at whether he'll build a pipeline or not, what he's looking at is, "Which market is the gas going to be sold in?" and ultimately he's going to buy transportation on that pipeline. I would think it would be very rare that a pipeliner would build a pipeline completely at risk, as Peter mentioned.

So I guess what we're saying is that at the end of the day the retail market for

energy is the key part of this equation, not the pipeline itself. What the pipeline does is bring production, in our case, together with the market. The pipeline is just a supporting act in that sense.

MR BANKS: I guess that's the point that was being made earlier - that the broader reforms have allowed access to markets that potentially weren't available previously.

MR BIGGS: They have, and I'll briefly mention them. Some of the activities that have gone on in the last little while are quite staggering when you actually look at them, and I think in many ways it's a resounding success, in terms of the regulation anyway, as far as we see it. I think the key components of supportive regulation we would see at the moment is that there needs to be strong regulatory administration. There needs to be effective administrative procedures, a right to be heard from all parties. The transactions need to be transparent. There needs to be effective accounting regulation and there needs to be room for judicial reviews of decisions and, finally but not least, one needs a skilled and resourced regulator.

MR FITZGERALD: And not 13 of them.

MR BIGGS: Yes, one rather than 13 would be helpful. As I said before, it's interesting to just reflect on what's happened in the gas world once we actually got an access regime in place. We've seen the development of resources in Bass Strait bringing gas to New South Wales, we've seen an interconnect between New South Wales and Victoria equally enables Cooper Basin gas to flow into Victoria. We're looking at three pipelines from Victoria to South Australia. There are two pipelines proposed from the Northern Territory to South Australia. We would guess that there's been about $10 billion of gas pipeline sales, that is, sales of assets, since 1998.

Our own view is there's been about a 30 per cent increase in exploration permits granted in Bass Strait that are not Esso-BHP related. I think we are seeing the commercialisation of Minerva and Yolla, both resources which were somewhat stranded and both resources that will be commercialised through the construction of pipelines. In New South Wales we've seen about $145 million in access prices reduced to $45 million. $100 million per annum of rents has been reduced from the New South Wales industrial gas market. We've seen growth in the New South Wales gas market, substantial growth for the first time in 20 years - Smithfield cogeneration project.

So in summary we would suggest that the last few years has provided some support to the proposition that regulation of pipelines has been beneficial for the economy as a whole and particularly to competition in both upstream and downstream markets.

MR BANKS: Good, thank you. Your point about the 100 billion of rents, what's that based on? What's the source for that number?

MR BIGGS: IPART decisions.

MR BANKS: But who's quantified the gains?

MR HENSON: I think IPART have determined the effective charging rate which previously existed from the city gate of Sydney through to end industrial customers. Prior to access regulation that approximately to $145 million per annum or about $2.50 a gigajoule, in other words, nearly as much as the wellhead cost of gas. IPART has made two decisions and that has been progressively reduced down to $45 million in their most recent decision. I have to say that BHP advocated that $17 million was the appropriate monopoly rent-free set of access pricing, so we would still say access prices have been set at something like twice the rent-free price, but I guess the point we're making is really there has been a very significant reduction, and that translates through to end users at about $1.50 a gigajoule reduction in industrial gas prices, which is very, very significant. That could be 25 or more percent off the delivered price of gas that was previously monopoly rent.

MR BANKS: The other thing I was just going to ask you, given that you said it with some passion, was the fifth component of supportive legislation being a skilled resource regulator, but not 13. Could you just elaborate on that. As we know, in our own report we saw some value in trying to centralise regulation in this respect, talking about the respective roles of the NCC versus the ACCC versus potentially another national regulator, but also the question of ministerial involvement. Could you give me any feedback on those particular problems?

MR BIGGS: Certainly. We obviously would support one regulator as far as pipeline construction is concerned. Currently we deal with the ACCC and then each state has its own regulator, which in our view, while there is a regulator's forum, tends to make consistency difficult and also adds to cost. So I guess our experience would suggest that one regulator is appropriate and highly desirable, and I think that view would be shared by a number of other players in this particular issue.

MR BANKS: Would one expect convergence nevertheless? I mean, one could argue that it doesn't matter how many regulators you have if you've got a shared sense of what the rules should be. I'm being a devil's advocate here.

MR BIGGS: To some extent that's possibly true. There's a regulators' form which I think the regulators do try to coordinate what they do in terms of outcomes, but I think one regulator would probably enhance independence, if I could use that word particularly. I mean, I think it's not unknown for regulatory decisions to be put under considerable political pressure. We've seen that on occasion, and I think one regulator would help resist that.

MR HENSON: I think the other point, though, is that there's a fundamental problem with the regulator and the asset owner being one and the same party, ie, state-owned assets being regulated by state-based regulators. There's a fundamental

conflict of interest there. Sort of an owner-regulator model really isn't the way to go, and I guess we've seen plenty of evidence of governments - and I wouldn't limit this to state governments - assisting the regulator as to how to make appropriate decisions, be it on the use of a single toll on airports or be it on how to value assets in New South Wales electricity and elsewhere. There's a fundamental conflict of interest, and I guess we're suggesting that a single national regulator - and we're by no means necessarily endorsing the ACCC to be that regulator - would help provide some greater independence.

It's also a question of how thinly skills are spread. As economic regulation of access is basically a new enterprise in Australia and there's not a lot of people around skilled to do it, and when those people are spread between 13 bodies then it gets even more difficult.

MR BANKS: You don't see any dangers in excessive concentration of regulatory power? I mean, we've talked about the virtues of the competition. You don't see any virtues in regulator competition, discovering better ways to go and so on?

MR BIGGS: I guess what we would say is that provided that, coupled with a single regulator, one has transparency and one has judicial reviews, I would suspect the risks of excesses, if you like, would be somewhat tempered by that. We would say any risks on that side would be outweighed by the benefits that Bill has alluded to, in particular the resourcing issues. Our experience has been that most regulators struggle with resources, particularly when they're dealing with industry owners or asset owners, who have considerable financial incentive to resource particular matters.

MR HENSON: I think it's true to say in the development of the gas access code there were three industry bodies at that time who were heavily involved. There was the Gas Association, the Business Council, and APIA, the upstream producers and explorers association, and there weren't many things which all three bodies agreed on. One was that there should be a single national regulator. That had unanimous support through the industry. Obviously it was not supported by the states, who prefer to keep things in their own patch.

Just in terms of the recommendation, I think your recommendation was for a single access regulator across all industries. I suppose we would see more practically a staged approach towards getting to that. A single gas regulator would be a very good start. A single energy regulator would be the next step after that, and then possibly add other regimes in time, but the big challenge is actually making that first step, in other words, convincing the states as to why they should let go of anything.

MR BANKS: Okay, thank you.

MR HENSON: I'd like to talk about asset valuation. As mentioned in the introduction, we do have a paper to present by Prof David Johnson which goes into

considerably more detail on the arguments about economic efficiency and the problems of asset revaluations, and therefore I don't intend to cover that material here. A number of points I would like to make - and we are yet, I have to say, to have this argument challenged successfully by any regulator - is that if asset valuations are switched midway through an asset life, they can be windfall gain and windfall loss depending on what the switch is from and to.

Traditionally, to the extent that asset valuations have been used as a way of pricing gas, they have been done on a historic cost basis. In the case of New South Wales it was explicitly done on an historic cost basis and rates of return were capped at long-term bond rate plus 2 per cent on the actual cost, the installed cost. If historic cost is used as an asset valuation methodology and that's continued over time, it produces a declining profile of revenue. Revenue starts very high when the assets are new and it ends up, in theory, purely at operating costs at the end of the asset life, so it produces a declining profile of revenue. If, however, a replacement cost methodology is used and is used consistently over the whole asset life, it produces a very much flatter profile. The revenue profile starts much lower, probably about a third or a half of the historic cost, but it ran flat over the full life of the asset. So, quite clearly, if you start off on the high revenue line for the first half and then you switch to the high revenue line for the second half of the period, there is a massive windfall gain.

Our estimation is that replacement cost pricing or something close to replacement cost pricing has been fairly consistently adopted by regulators. Certainly the ACCC is a strong proponent of it, as is the ORG. IPART is probably the only regulator which has moved away from full replacement cost pricing on more pragmatic grounds. Our estimation is that the use of replacement cost pricing has put up the cost of gas in Australia somewhere between 300 and 350 million dollars per annum, so that's an increase in the cost of gas compared to what would have been the case if historic cost had been used for asset valuation. So it's a very significant cost input.

MR BANKS: Because of this revaluation problem?

MR HENSON: Yes. Now, clearly, the asset owners, be it the state governments or private companies, are all in favour of asset revaluation to get the highest possible return, but it's very significant - just as another example we put down here. I suppose given the Productivity Commission is based in Canberra, we thought we would note that the household cost of gas in Canberra would be $115 per annum higher as a result of the use of replacement cost, and that's out of a typical household bill of about $350. So it's a very substantial portion of the cost of gas.

I'd just like to talk about some of the practical problems of replacement cost pricing. Probably the biggest and the easiest to understand is that it is essentially a highly subjective means of pricing. It's also non-reproducible because it is contingent on a number of key assumptions and there's a very large variety of

assumptions that can be used. Just to give some examples, in New South Wales AGL produced a replacement cost estimate, IPART produced a replacement cost estimate and BHP produced a replacement cost estimate. The range on those numbers was between 1.6 and 3.1 billion dollars. At the end of the day IPART selected something - that's straight replacement cost then to be depreciated. That's just an example of the sort of range of numbers that can be generated.

The second point we make is it's a very high cost regime to run. In the case of gas, under the gas code there is a one-off determination of asset valuation and that's it. Thereafter new assets are added in at their actual cost and any assets which aren't being used are then deducted, so it's a one-off exercise. But I guess that's not the case in electricity, where replacement cost is used on an ongoing basis. Our experience is that for estimating a new project we make an allowance of spending somewhere between 3 to 5 per cent of the capital cost of that new project in terms of developing a reliable estimate of the capital and operating costs of a new facility. That's the sort of level we would expect to spend to get a project of sufficient reliability for sanction to proceed.

Even then, that would only generate a cost estimate with an accuracy of plus or minus 15 per cent, so even after spending 3 to 5 per cent of the value of the project there's a significant range, and of course practical experience has shown sometimes they cost a lot more than that. But I've heard it said that there is $50 billion worth of regulated infrastructure in Australia, and I think the figure is probably slightly higher than that. If you say that 3 to 5 per cent of that is going to be spent to get an accurate replacement cost estimate, we're talking about spending between 1.5 and 2.5 billion dollars on those valuations. Of course, in practice nothing like that amount of money is spent on the valuations and as consequence you get what you pay for. They're generally speaking of atrocious quality. Nobody would ever proceed in the real world to do anything on the back of those valuations.

So I guess we would say that to be used on an ongoing basis it's a very high cost. It's just inherently a very high cost regime to run. Bear in mind again the regulated entity is going to do an asset valuation, of course, to generate high numbers. The regulator is probably going to do one as an independent check and possibly some users might do one, so you're probably not talking about doing one on each review; you're probably talking about two or three being done at each review. So it's just a very high cost regime.

The other problem with replacement cost - and this again comes to the nature of it - is it's very susceptible to gaming. Different assumptions can produce widely differing results. It's very information intensive, and really of course the only entity which has that information is the service provider. The regulator doesn't have the information, nor do end users. To estimate what are the requirements of the gas distribution system in Victoria is a massive exercise in terms of nobody has access to that information except the service providers. We describe not as an asset valuation methodology; we call it a semi-random number generator, because essentially there's

a near infinite number of assumptions that can be made, all of which could be argued as being valid, and there are plenty of willing consultants to assist in the process.

So I think we would say that if you're starting from new, from an economic perspective you could operate a replacement cost regime and not result in monopoly rents. However, we would say that, given the cost, that would be a high-cost regime, it would be an unreliable regime and it would be susceptible to gaming. We don't see the efficiency benefits which have been claimed exist to offset that. At the end of the day, if a network is built with the best technology that was available at that time, then that's the best that can be expected. Certainly in the case of energy infrastructure the pace of technology change is pretty slow. There's been no evidence of where breakthrough new technology has come along which is going to make replacement of that infrastructure even remotely economic.

So provided that the regulated entity has the incentive to install the most efficient technology, cost-effective technology, at the time it makes each incremental investment decision, we think that's the bulk of the efficiency gains that can be gotten: therefore why bother with all of this replacement cost pricing and the problems that go with it?

MR BANKS: Okay. I didn't really have any questions. I'd be interested to see what further information you provide on that issue. Can I perhaps get you to speculate on why it's been such a popular methodology in Australia compared say to the United States?

MR HENSON: I think the principal advocates have been the asset owners prior to privatisation. That's what the whole name of the game was about - double the value of the assets and sell them off. Therefore it's been driven by state governments. This argument was had in the States around about the turn of the century, when there was tremendous argument about what was fair value and what was market value, and I think they settled this matter in about the 1930s, 1940s - that the appropriate base was historic cost because of the problems I've just mentioned with the other valuation methodologies. They're just too subjective. So they had this argument back in the 1940s, settled on that and they've lived with it ever since. But, as I say, if you're in the business of privatising assets then it's the last methodology that you'd want, simply the lowest. I guess, again, Sydney Airport is the classic example of this.

MR BANKS: Inevitably we're comparing imperfect methodologies, aren't we? I mean, you're not implying that there are no problems at all with historic cost.

MR HENSON: Not at all, no. No, obviously there are problems again with that. That can be padded as well or whatever. I would say there's another range of problems. But the problem seems to be less and it's a lot cheaper regime to run that replacement cost, just starting from scratch.

MR BIGGS: I think the point we're trying to make here is not really the merits of replacement versus depreciated; it's the switch-over issue that's causing the problem. That's really what we're saying. I think if you start with replacement costs from day one, ie, as it's built and continue with it through its life, that's as valid as depreciating it from day one. The problem is when you change horses midstream, so to speak. It either ends up with a windfall or a severe disadvantage for the asset owner, depending which way you change. But that's really the point.

MR FITZGERALD: Could I just add one point on that. A lot of the difference depends on the inflation regime. If you have zero inflation and no other technological changes, your replacement cost approximates to your actual cost and your rate of return under one regime will be very similar to the rate of return on another. But if you have inflation over the long-term life of the asset, you get deviations in the timing. So under the American regime where you have actual costs as the basis, you give a nominal rate of return on the capital base. Whereas under a base where the capital base grows by virtue of inflation, the rate of return on capital is a real rate. So you take the nominal rate and delete or subtract or modify it for inflation. But if those things were both zero then I would be the same over time.

MR BANKS: Good, thank you.

MR FITZGERALD: I'd like to add some other comments on information disclosure. Although there's aspects of the commission's proposals that we think might have been better informed by the practical components, we think the suggestions in relation to providing more information to prospective users is a good one in that it both improves the efficiency of the regulatory arrangements without any corresponding or significant disadvantages. This is informed particularly by gas but also electricity where we now have some history of providing information to users and therefore a history whether they've been misabused, whether they have informed or not informed regulation, whether they've disincented investment et cetera.

So there's a set of reasons why information disclosure is a good idea. The starting point is the one of information asymmetry. So when you have a user or a retailer looking to get access to infrastructure, they tend to have no information and the infrastructure owner has all the information in terms of not just cost but also availability and operating arrangements. So having some form of pro forma disclosure can alleviate the primary bargaining position asymmetry between the parties based on information. So it was the Hilmer report or the national inquiry in competition policy that said, "Look, let's have some elementary elements of information disclosure," and the real question is just what level of detail.

The gas access code has tried to address that issue by saying that users ought to have a right that sounds something like the right to sufficient information to enable the user to understand the derivation of the reference tariffs. So in other words, if someone is being asked to pay a certain price, they ought to be able to see the

sequence of asset valuation, return on asset, operating costs, volume assumptions, allocation between users that comes up with the price that that person is going to be asked to pay. So not more nor less than required to comfortably make that person aware of the assumptions. The benefits of this is many fold but one of them is that it avoids arbitrations. So it would be a dead loss to the economy if there were arbitrations around pricing or access arrangements simply based on a misunderstanding of how things were derived or a misunderstanding of what's a fair thing based on those assumptions.

If a user says, "Look, you've asked me to pay $2 a gigajoule. I can't see how it's derived. I'm going to have to bring in lawyers and engineers and whatnot and engage in an arbitration," then that's both costly and without benefit. If, with the benefit of information, the parties were to say, "Okay, I may not agree with all of these things, but I can at least see how it's done." So you can avoid that category of arbitration based on a misconception around what the assumptions are. Also information disclosure helps the regulators. In the US some your public utilities commissions are hundreds of people. It seems to be a consensus within Australia that we don't want that to occur. We don't want hundreds of regulators or hundreds of people within regulators' offices making all the decisions. One way of avoiding that is to arm the users with more information so that the regulator doesn't bear all of the burden of coming up with a decision themselves.

So rather than the regulator saying, "Look, we'll let you know in six months' time how things are going," and they have all the negotiations behind closed doors, the users are out there not really involved in the process, not really able to sort of participate in the more detailed components. So if we want to avoid that situation the way around it is to get as much out into the outside world as would enable informed groups to say, "Well, there might be two or three ways of coming up with a price or a set of terms of access, why don't we set down on bits of paper what we think the answer should be?" That both eliminates some of the burden for regulators. It informs users and therefore it means that users are more likely to feel some ownership in the outcome and less litigious in relation to the process and the outcomes. But also the regulator can be informed in a way that they just couldn't otherwise.

If I just use one example. The Moomba-Sydney pipeline was privatised in 1994 when it was still not quite clear how gas access arrangements would unfold. The federal government say, "Why don't we just have a pricing monitoring arrangement?" So they said that the Prices Surveillance Authority would do an annual report to the treasurer on pricing of the pipeline charges through that pipeline. In the first year after privatisation the owner raised prices by 24 per cent. The Prices Surveillance Authority didn't have a duty to have public participation, nor invite submissions, nor to allow users to have access to the underlying cost information. As a result it didn't understand that there was in fact a price hike, they just thought it was a change in methodology and a change in arrangements and were shocked to hear that users would actually describe it as a 24 per cent increase, but they'd already

written their report to the treasurer.

I think for us this is an example of regulators may think they have the expertise, they may think that they're not being misled by the provision of information from the regulative entity. But it's only if there is open participation and only if there is information disclosure that regulators can truly sleep well at night; that they're not both undertaking a burden that they can't uphold or that they're not being snowed and snowed in the sense of being given information and then a particular spin on how one should read it.

MR BANKS: Are you implying that under the gas code this information disclosure process was working well from BHP's point of view?

MR HENSON: I think it's actually been fairly patchy, Gary. The concept was fairly good in terms of it was simply but in practice service providers have been very reluctant to actually provide the information they're required to under the code. There's been delays of six to eight months before the regulators have even been able to get compliance with the information which is required. I think the other thing is that - - -

MR BANKS: Sorry, is this information to be made available to the regulator or information to be made available to the - - -

MR HENSON: This is information to be made available to the public. The service providers would far rather make the information available only to the regulator and prevent the regulator from essentially testing the veracity of their information and their conclusions by having participation from people who pay the bills. So I guess gas does require some information disclosure. I think we would say it was a good start, but with the benefit of hindsight it doesn't go far enough.

MR BANKS: You don't think there's any commercial in confidence?

MR HENSON: For a natural monopoly I suppose we struggle to see that. As an example, we developed the Eastern gas pipeline in a joint venture with West Coast energy. West Coast, of course, are a Canadian regulated entity. They assisted us in writing the information disclosure provisions of the gas code. So they certainly, as an experienced pipeliner, did not have any difficulty with the notion of disclosing information. The reason is because of the background that they came from. They came from the US where they've lived under that regime in Canada for many decades and they haven't found that as an impediment to doing business.

MR FITZGERALD: I think it also is relevant that what is normally commercially confidential contractual arrangements between infrastructure owner and users, it's not proposed that that be the subject of disclosure. It's the underlying costs that are the subject of disclosure. That doesn't even include actual financing arrangements. So the gas access code, for example, doesn't say, "What interest rate are you paying on

your bank loans?" It asks a different question, "What is a fair assumption about what a cost of capital might be including the cost of debt and the cost of equity?" So it's actually not the actual things but, "Please just disclose what assumptions should be used or have been used in coming up with this pricing." Likewise, if most of the energy infrastructure is to be done not on actual cost of investment but some other conceptual valuation which is a depreciated optimised replacement cost, then it can hardly be said that a conceptual number is commercially in confidence because it's not the actual investment, it's actually someone's assumption about what an investment might be today.

So you're really then only down to volumes and volume throughput, future investment decisions and operating costs that are of any potential commercially significant items. Having said that, in terms of operating costs most of the collective bargains are public. So it's not like the wage rates are secret. Most of the operating costs are the subject of industry-wide benchmarking in any event. In terms of future investment, if the regulated entity wishes to roll that investment into the asset base for purposes of pricing, it's only then that they need to disclose it. If they wish it to be a stand-alone investment outside of the access arrangements, for example, subject to a foundation shipper or arrangement separate of the particular thing, then it's not the subject of discussion.

So the commercial in confidence argument sort of invites a sort of next level detailed examination of which most of the concerns sort of evaporate. It hasn't really been a major issue in terms of the test of, "Tell me what information I need to know to understand the derivation of the price."

MR BANKS: We had a brief discussion with the previous participant about what incentives there may be anyway for the service provider to disclose information, if only to avoid a situation of arbitration with a likely outcome would be a lower price anyway. So the argument was that there are some incentives to provide the information that would be needed to clinch a deal. Any reactions to that - without mandatory provisions?

MR FITZGERALD: I might observe that we need to understand arbitration as having a set of limitations, primarily on the number of parties who might be incented to participate. We did some numbers - I say "we" BHP and myself - a couple of years ago to say, if an arbitration costs to its end point might cost half a million dollars and what you're dealing with is the last 10 per cent say, of your energy costs, so your gas costs, and that's only for a period of the determination of the access pricing - say five years - and if you're chances of success were sort of fifty-fifty, you can actually work backwards and say, "Who would actually have that much at stage to justify the risk of that amount of cost?" You actually came down to not more than 20 customers or consumers of gas in a state like New South Wales.

So you can't assume that a regulated infrastructure will be incented to avoid arbitration because the incentive is the other way. If it's going to go to arbitration it's

very unlikely - sorry, it's very unlikely that there will be a final arbitration because there are not enough parties who have enough at stake to justify it. So that we might say, "Well, gee, the regulated entity therefore will put forward the information to avoid that." I think you'd have to assume the opposite, there's a 90 per cent incentive the other way, for them not to disclose it because the fear of arbitration is not that great. The persons have self-selected, said, "This is going to be a fight to the death," that you then say, "Okay. Maybe you'll want this information."

MR BIGGS: Picking up that point, it's the same point that one would make in terms of the willingness of customers and others to participate in fora where the regulator is actually setting tariffs. I mean, unless you're a very big user of energy, by and large it's very difficult to justify spending an awful lot of money getting together expert reports and all those sorts of things, and I think the same argument would follow as far as arbitration is concerned.

Can I make one other point. I think you need in your own mind sometimes to distinguish between somebody who's a pure infrastructure owner and somebody who perhaps has other interests in the industry. This is I think where it gets very muddy. I mean, if you take pipelines, for instance, you can argue that if somebody owns simply a pipeline, then their incentives should be to promote throughput through the pipeline and to behave reasonably to try and encourage users, but there are situations where people who own pipelines also have other interests in the industry. I think the trouble starts when the two collide and people may have fixed incentives. I think we're perhaps thinking more of the latter and the former, and there are quite a few of the latter, I have to say, particularly in the energy industry.

I think if you have somebody, for example, like Duke Energy in the eastern gas pipeline, that's a very clear-cut situation. They have a significant incentive to increase throughput. But you contrast that with other infrastructure owners in eastern Australia and the picture gets a bit unclear. So it may in fact be in their incentives to delay matters as long as possible because there may be other market reasons why they prefer to see that happen, all of which goes to the point I think we made before, that the point of this exercise is really to try and get competition in both upstream and downstream markets.

MR FITZGERALD: Just a final point about information disclosure and rights of participation. It follows that the most streamlined regulatory arrangements will be one where the users or participants in the process are informed, that the information is streamlined and standardised. So it's a prerequisite really of successful information disclosure that you have a set of regulatory formats for the provision of information, so that you say, if it is a five-year period, what are your operating cost assumptions for the five-year period? If the regulatory pricing proposal is to allocate costs across three zones, show us the allocation of the costs between the three zones. If there are assumptions about volumes, what are the assumptions across those years across the zones? That then requires that there be charts of accounts that match the sort of disclosure requirements that are being imposed, so that it's not an additional

and separate burden on the regulated entity but actually one that's consistent with the way they keep their accounts.

That would also be necessary for those entities that have non-regulated activities. So, for example, if they have marketing activities or other non-regulated components there needs to be an allocation of central overhead costs, marketing-type costs, business development type costs that are not related to the particular access to be separated out, which has been a source of problem in a number of gas cases and electricity, for example, where you had the distributors also be the retailers. So there's an issue there as to how much is being recovered through the monopoly components of the industry chain and creating unfair competition with other non-integrated retailers in the downstream markets.

Consistent with that line of thought, openness for users, open participation, it follows also that rights of appeal ought to be open to the users in an equal fashion to the infrastructure owners, so in the gas code there was a non-parallel set of rights for appeals where the infrastructure owner could appeal a determination on access pricing but not the users. There's no necessary reason for that dichotomy.

MR BIGGS: I think just a couple of final things. We did notice that the Productivity Commission's telecommunications report recommended Part XIB be deleted. I guess we couldn't help note the similarities of that part with the Victorian significant producer legislation and just thought we might take the opportunity to raise that in this form, and we're very happy to give you a further submission on this if you're interested.

The Victorian significant producer legislation has a number of parallels with Part XIB and we would suggest that it has proven to be a barrier to competition in terms of its activities and, frankly, a frustration in trying to actually grow the Victorian gas market. So we just notice that and we would suggest that the Victorian significant producer legislation has the same negative attributes as Part XIB.

MR BANKS: I think what my colleagues, in that inquiry into telecommunications, heard also in Sydney, however, were those who were saying that XIB did serve a useful role as a kind of threat in the background, even though it may not have been used a lot, in terms of facilitating XIC. I don't know the details of the Victorian legislation to which you refer, whether there are kind of any parallels there.

MR BIGGS: I wouldn't have thought so. I mean, firstly, the Victorian legislation, for example, assumes that Victoria is a single gas market. The reality of course is different. Eastern Australia is rapidly becoming a single gas market. New South Wales and Victoria are probably a single gas market already. There are at least two pipelines interconnecting the two states, and I can only just observe that that particular legislation is causing a number of difficulties, in our view anyway, in terms of the development of that gas market, not the least of which is the legislation is tortuous, difficult to understand and putting us in the position where we cannot

with confidence sell gas in Victoria, which has to be a rather strange outcome. I make that point in passing.

I guess the other point we'd like to close on is Part IIIA and industry-specific codes. I guess our big concern here is we wouldn't like to see the encouragement of forum shopping, and I guess our view is very simple. We see really only two categories of assets: one, assets that are regulated, and assets that are unregulated, and I guess we're somewhat concerned if there is a suggestion that one has multiple levels or types of regulation for the same sorts of assets. A bit like a single regulator, I think we think simplicity is a good thing in this area and that therefore assets should fall into one or other of the regulated or unregulated categories and it should be as simple as that.

MR BANKS: Talking transition, you don't see any advantage again while regulators are learning their business in this area of having alternatives where perhaps a particular industry-specific regime may be too strict or have some other fault whereby the party can go to the more generic regime?

MR BIGGS: I guess I can only speak from the gas code experience. A couple of conclusions: one is the regulator under that code has extensive flexibility and discretion in terms of what they can and can't do. Secondly, we don't believe that the case has been made that that particular code inhibits investment in pipelines. In fact, the anecdotal evidence is completely to the contrary. Thirdly, I think if the case is such that regulation of itself is a real problem, then I think the onus is on the proponent or owner to argue that that particular asset doesn't need to be regulated. For instance, the eastern gas pipeline: if the argument is that that particular pipeline is competing with another pipeline, then that argument is open to be made and it has been made, with success, I believe. We have no difficulties with that.

MR COSGROVE: What about the argument that again during a transition period the availability of different forms, different areas of regulation which can enable forum shopping, might nevertheless lead to some convergence on the best practice model? Do you see any evidence of it?

MR BIGGS: I have to say no. I mean, intuitively the argument doesn't seem to work to me that one sort of has a smorgasbord and then the more people that gravitate towards one in the smorgasbord that's what you'll have. I would prefer, I guess, a more rigorous approach to deciding what the best model was than some sort of popular vote. That's our submission, so if you have questions - - -

MR BANKS: Thank you, yes. There were a couple of things along the way. Earlier on we were talking about pipelines and the way I guess decisions are essentially driven by demand and then the foundation contracts are really the key to it. It seemed to be implicit in that that the access regime was almost redundant, that it was having no real effects at all.

MR BIGGS: With greenfields pipelines I think that's probably the case, yes. Just to restate, unless a pipeliner wants to build a pipeline at risk, which I suggest is highly unlikely, then most pipeliners - in fact, all pipeliners - will require a level of precommitment from some shipper or other, and in that environment those negotiations are bilateral and are simply mutually settled. I think the issue then arises once the pipeline is in place in relation to future shippers.

MR BANKS: Yes, but surely the foundation contract itself would take into account the possibility of subsequent deals being done that may undercut a foundation contractor.

MR BIGGS: It may or may not. That's a matter of negotiation between the two parties.

MR BANKS: Wouldn't that be an inhibiting factor on the initial deal, if there was uncertainty about at what price subsequent deals could be done?

MR BIGGS: It may be. Again, it depends what levels of serve are being offered. The argument can go both ways. I think frankly - I'm not trying to duck it - it would depend very much on the particular facts of the case. For example, if a particular shipper has only got a certain quantity of gas to ship and does not wish to ship any more gas, then that would be a completely different scenario than if that original shipper had a lot more gas that he could potentially ship in competition with other future shippers. I think it turns a lot on the facts.

MR FITZGERALD: I think it's probably also worth noting that it's intrinsic to Part IIIA and the competition principles agreement that third party access does not deprive any contractual right of a foundation agreement. So if in a greenfields transmission pipeline the initial shipper says, "I only have X amount of gas to ship. I just want a certain price," there's nothing about the national gas access code that would prevent that occurring. It's only if the foundation shipper says, "I have this amount of gas but I may have some additional gas in addition to this which I don't want to commit to, but I do have a right of access beyond that and I don't want to fix a price on it just yet," in which case that person will then potentially submit themselves to an access price down the track as a third party shipper would, and on the same terms. But the potential for there to be third party shippers is usually if anything a positive for a foundation shipper because otherwise they will bear all of the economic risk - sorry, they and the infrastructure owner wear all of the economic risk. The introduction of third party users is usually good news for all parties because it's more usage, usually more revenue, there can then be either additional revenue to the infrastructure owner or additional revenue potentially shared with the foundation shippers.

So a foundation shipper may have a contract that says, "In the event that you get more revenues I want a discount on my price," but if they do such an arrangement, the existence of an access regime and third party users doesn't hurt

them, it can only help them.

MR HENSON: I think the question also turns on whether subsequent access is granted on more favourable terms than the foundation contracts. Now, in terms of building new pipelines, it's quite a competitive market. So if a particular pipeline developer is seeking to charge significantly more than recovering the costs of constructing the pipeline and is going to charge that of a foundation shipper, then the foundation shipper is going to seek another pipeline developer. So there's unlikely to be significant monopoly rents built into the foundation shipper terms. Therefore again it's unlikely that access subsequently be granted at lower prices.

MR BANKS: Am I misunderstanding? I mean, you seem to be implying that there's no need for access regime at all in relation to this competitive industry.

MR COSGROVE: But there's a lot of contestability, yes.

MR HENSON: There is certainly contestability around the construction of pipelines and as we mentioned, there are currently three companies who are proposing to building pipelines from Victoria to South Australia. So, yes, there certainly is contestability around construction.

MR COSGROVE: On the construction side, yes.

MR BIGGS: Which is consistent with our point that the code - regulation is neither here nor there in the construction of a pipeline. That's usually a bargain struck between a number of parties to make it happy. Regulation is required once the pipeline is built and then operational, that's the issue.

MR FITZGERALD: I think it's also worth mentioning that the comments in relation to foundation shipping arrangements are cleanest in relation to greenfields transmission and it's a bit more muddied in relation to incumbent distribution. So you tend not to have long-term foundation shipper arrangements for a suburb, for example. If you're reticulating a suburb you may get the households to agree that they will switch and that this is the price they might pay, but it's probably not going to be a 20-year agreement which is different to greenfields transmission where your contract may of some longevity. So there are quite different incentives and regulatory issues applies to greenfields transmission versus greenfields distribution and also incumbent distribution.

MR BIGGS: Can I make one final point on that matter. I mean, if the suggestion is that the pipeline enters into an arrangement with the foundation shipper and the pipeliner's concern is that subsequently through regulation or otherwise the rate struck with the foundation shipper was to reduce as a result of arrangements that the foundation shipper made with other shippers, then that would suggest to me a couple of things. One, is that would suggest that the financial underpinning of the investment is not sound to begin with frankly because one would expect that the

pipeliner would be expecting to get some sort of minimally acceptable rate of return on the pipeline in the first place. If he's that vulnerable, then maybe that suggests that the investment is not that robust. Therefore, one has actually got a business problem rather than a regulation problem.

MR COSGROVE: In an earlier communication we've had from you you indicated that designing regulation to support investment is something that's already been effectively done in - it says here "many other countries with success". Could you identify for us the cases you had in mind and what the nature of those arrangements are or perhaps this is another matter you might want to pick up in your submission.

MR HENSON: I guess we put forward in this pack what we saw as five criteria of a regime, requirements for a regime to support investment, that was on page 4. This is the subject of a more extensive paper by NERA which we will be lodging as part of our submission. Of course I think they would tick five out of five of these probably for North America and would tick differing numbers for regulatory regimes they've been involved in other countries such as Mexico and Argentina and the UK and Australia. So I guess that's the experience we were referring to. But, as I say, we have a fairly extensive report by them to expand on this.

MR BANKS: Another issue on which we would be seeking some written comment, a submission, and you may already be thinking about that, and that is in relation to greenfields investment we've talked about but the possibility of access holidays and the circumstances in which they may be appropriate. This is something on which I think we will get quite a lot of feedback and we'd value any comments you have. As you know, we have some discussion in there and other people have raised it, the actual practicalities. You can sort of think of it conceptually at one level but the practicalities make it quite difficult.

MR HENSON: **O**f course we have been involved in the construction of the development of a number of greenfields pipelines which did not have any assurances around access holidays. In fact of those pipelines we've listed certainly some of those have been developed post-Part 3A and certainly post the gas code. We will make a submission on that but we haven't seen it as an impediment to date.

MR BANKS: Obviously they were ex ante quite profitable ventures or projected - - -

MR BIGGS: It comes back to market demand and the proponent's willingness to take risk ultimately.

MR BANKS: Sorry?

MR BIGGS: The proponent's willingness to take risk. Some proponents presumably are more risk-adverse than others which goes back to the specific facts again. But we will address that in our submission for you.

MR BANKS: Thank you.

MR COSGROVE: I just wanted a little clarification. It relates to page 2 of the notes you've given to us. That second dot point mentions, "Access refused or offered on unreasonable terms." I'm not quite sure whether that's an attempt to portray our position paper or whether this is something that you see in the marketplace.

MR BIGGS: The point we're trying to make here is that in our view the report doesn't, and perhaps possibly could, dwell a little bit on how far we've actually come in terms of the gas side of energy. What we're saying that in the not too recent past there have been access to pipelines has been refused or alternatively, access offered on completely unreasonable terms. We're not saying that necessarily happens much these days but there's certainly a history of it in some cases in the past.

MR COSGROVE: Was it common?

MR BIGGS: In some big markets it was, both sides of the continent.

MR FITZGERALD: If I could add a comment on that. It's fair to say that left to their own devices the former owners of infrastructure did not go out of their way to create competitive downstream markets. Nowhere in the country was there a competitive downstream energy market in gas or electricity in any state. So that we say the monopolies didn't maybe misbehave, but nor did they go out of their way to say, "Hey, why don't we have two or three or 10 or 1000 retailers," but if we're going to encourage that we'd actually have to have open network pricing and it would have to be fair and available to all. None of them of their own volition said that's the way of the future. It was only by competition reform that that became the mandated requirement. I suppose the simple point is we have to view access as part of that switch from an old strangled world of zero competitive markets to a forced restructure of the industry towards a competitive market.

MR HENSON: Just as a practical example on that, we had some particular experience in Western Australia where we were seeking to get access for gas that was produced as associated gas from an oil field being the Griffin field which under government policy we're not permitted to flare so we had to flow it to market. We had two impediments in being granted access: the first was the price and the second was the terms and in particular the specification. The price that was proposed to us was being made up of two components: one being the cost of using the infrastructure and the second being the cost of compensating the incumbent for competition in the downstream market. The second cost was quite a lot bigger than the first one.

The second requirement that was imposed on us was gas specification. The parties that are in that joint venture spent $70 million to build a gas processing plant to process gas to that specification. That plant was shut down about two months ago because under the new owners who don't have an interest in the upstream and

downstream markets found that the specification of the gas was now acceptable whereas in the past it had not been. That was $70 million of just wasted money. Those are the sort of examples we refer to when we mention that comment.

MR BANKS: Thank you. I think you indicated at the outset that you'd be able to provide a submission to us. That would be early next week or prior to - - -

MR HENSON: Later this week I'd hope.

MR BANKS: That would be great. I think we have you scheduled for Wednesday, 6 June at 9 am and that would include, I believe, David Johnson to talk about that more technical paper. I wonder if in the meantime, having received your submission, if there are any issues there perhaps we could get back to you and you may want to complement that group that appears in Sydney to deal with some of those issues.

MR HENSON: We're happy to do that.

MR BANKS: Thanks very much for that. Thanks for appearing today.

MR HENSON: Pleasure. Thank you.

MR BANKS: We will break now for some time. Our next participant - we had one participant drop out - is scheduled for 3 pm this afternoon. Thank you.

MR BANKS: Welcome back, ladies and gentlemen. We'll resume our hearings into the national access regime. We're here to receive feedback on the commission's position paper, which was released at the end of March. Our next participants, appearing jointly, are the Institute for Public Affairs and United Energy, Citipower and TXU, who have together put forward a combined submission. But I might just, to make sure I've got all that right, ask you for the record to give your names and your affiliations please.

MR MORAN: Thanks, Gary. I'm Alan Moran. I'm from the Institute of Public Affairs. I'm speaking on behalf of the Institute of Public Affairs. As such the IPA itself doesn't represent anyone in particular. We've got about 4000 funders and we also operate something called the Energy Forum, which about a dozen energy firms are part of. Energy Forum provides the wherewithal to allow me to spend pretty much full-time looking at competition issues with particular reference to energy issues. Again, we don't represent the firms in the forum as such, and there are occasions when we may take positions which are somewhat different from those of the funders. Obviously that doesn't happen too often, otherwise they'd stop funding us, but it does happen occasionally. That's who I represent and indeed, although there's a separate paper insofar as United, Citipower and Texas are concerned, that also is fully consistent with the kinds of views of IPA, otherwise we wouldn't be putting it forward in that respect.

MR TOWNS: My name is Geoff Towns, and I'm from United Energy. I'm mainly speaking to the paper from the three distribution companies, UE, Texas and Citipower.

MR BANKS: Good, thank you. Alan, you were saying that you have this Energy Forum, and I think the submission that you've made to us which we've numbered DR57 you've given the title Energy Issues Paper No 19. Is that a series of issues paper that are funded by the forum? Is that the way that works?

MR MORAN: Yes. It's a series of issues papers on energy that the IPA puts out. The forum itself operates as a sort of a talking shop, if you like, a round-table discussion shop on one part, and on another part as a sort of advocacy unit. That's where the IPA is advocating what we think is good public policy, the sorts of issues which I think you might be familiar with - I know you're familiar with - the kind of agenda of IPA, which is low regulation, smaller size of government, privatisation, these sorts of matters, and deregulation et cetera. So it's funded by firms themselves but they don't control the agenda and we don't try to clear it with the firms, although we might seek information for a particular paper from them but we don't clear it in any formal sense.

MR BANKS: Okay. The only other thing, just because I'm interested in these institutional matters for my own organisation: when you put out something as an IPA publication do you have a kind of a clearance process or something within the IPA for that, or is it that you, Alan Moran, in a sense are Alan Moran for the IPA?

MR MORAN: There are various levels of clearance. Normally Energy Forum stuff, yes, there's a clearance process but it's really a question of me trying to persuade somebody to read it rather than actually have it verified or vetted in any sense. So, yes, it is on behalf of the IPA and certainly, if there are issues which I think are controversial I'll try and seek clearance with others in the IPA, and particularly the executive director, of course, and anybody else who might have an interest in a particular position that's been taken.

MR COSGROVE: Just before we wind up on these matters, Gary, I notice the combined submission from United Energy, Citipower and TXU also has Jaguar Consulting Pty Ltd on its title page. Who are Jaguar Consulting?

MR MORAN: Jaguar Consulting is operated and run by Michael Rex Tainton-Smith, who's been involved in regulatory issues generally. He and I, I guess, assembled this with assistance from Geoff et cetera.

MR COSGROVE: Thanks.

MR BANKS: We're starting to see a coalition of regulation review chiefs emerging here. I don't know whether we can regard that as a group of vested interests - perhaps in the public interest. Alan, thanks for that. Would you like to perhaps make some brief overview remarks in relation to the submissions that the IPA has put in?

MR MORAN: I think the first thing we'd like to say is that we think that the position paper of the commission is very good. We don't necessarily agree with all of it, but I think it has adopted very similar sorts of philosophies as we have and it's worked through a great deal of literature on the matters. We're particularly heartened to see that it's very heavily focused on competition and property rights, and these are the two matters that from an IPA point of view we think are the kernel of good public policy on these and many other issues. One of the aspects I think early on in the paper is a quote from the Property Council to show that in the commission's view the access regulations are intrusive, and that's a matter which we've taken as a major point of reference in the IPA, in all three submissions indeed.

As you know, in terms of the IPA original submission our view I think is a longish submission - not long but it covers a lot of territory - and I won't try and cover that here, because in terms of the position paper it's clear that the submission itself has absorbed it very well. One of the issues we took as a major point of reference was that there really is no call for access regulation in greenfields sites, insofar as, at least in modern greenfield sites, nobody has a franchise; people spot market opportunities, they drive a line or a road or whatever to fill that market opportunity; and life went on before the road, railway or airport or whatever was built. So in that sense it's not an essential facility. Also implicit in that first submission was a view which is somewhat different from that of the commission in

terms of the treatment of vertically integrated facilities.

I'll come back to those sorts of matters later, perhaps in the context of the third submission, but let me just say a couple of words about the end user advocacy matter, because I think that is somewhat different and you don't seem to have had many submissions on this except from people who've got their hand out for the money. It's our view that end user advocacy funding is the role of agencies like departments, the ACCC, ombudsmen - or maybe we should call them ombudspeople - rather than funding it from a tax. Indeed, the tax, which is sometimes called a levy, is I think somewhat dangerous to impose. Last week was budget week, as you know, and whenever governments actually have a tax they are then subject to scrutiny in the media et cetera, and that's quite proper I think in our system. Indeed, the last thing you really want is the governments having a hidden tax which they call a levy and which is somehow funnelled to various groups and then is out of the scrutiny of the parliament.

It's our view that those groups very rarely, if ever, represent consumers. There are strongly representative groups of industry, but those who purport to represent consumers usually don't have a great deal of evidence that they are supporting the consumer and usually have relatively few members. They tend to be somewhat idealistic zealots pressing a particular cause, often anti-business, and it's our view that in a well-functioning market, as we're coming to in gas and electricity, the real representative is the retailer, as it is in any other industry. The retailer represents the interests of the consumer, not out of any sense of a directedness and not out of benevolence; it's basically out of his own interests and, if he doesn't represent the consumer adequately, the consumer goes elsewhere.

That's the system we are moving to, have moved to for half of the market in terms of the volume already, and it's a system in which I don't think we can see the case for consumer representatives. Moreover, the representatives and those that we hear most loudly from tend to adopt these anti-business views and tend to adopt views which are somewhat contra to the way markets operate. There is an assumption implicit in them that they're representing consumers and consumers are getting a bad deal, therefore they tend to promote policies like free connection for remote areas or a better deal for consumers who may be disconnected through non-payment of bills as though this is a sort of a free good. This isn't a free good. All these goods are in the end paid for by consumers in general.

I think the final issue on this end user advocacy that we're pointing out is that if we have end user advocacy in this case - in the case of gas and electricity and other communities we're talking about here - why not in everything? Why not in motor cars, why not in fridges, why not apples, why not pears, why not everything? Why don't we have a levy on all goods and services and have a consumer advocate there? You might say we do already because we have a GST and we have various other taxes and things and that is a levy and the government is the consumer advocacy; institutions like this are the consumer advocate. It seems to us that basically there is

no cause for that kind of expenditure on the part of the market.

MR BANKS: I don't have too much to comment on there. I note that you're making the point that government agencies do act as consumer representatives and therefore you wouldn't need any separate funding of them directly. The argument is put sometimes that indeed that is part of the problem with these government agencies and that they are too much oriented in that direction, but you don't make that point here. Would you like to comment on that?

MR MORAN: I think that might well be the case, that they are too much in that direction, but at least they've got some sort of a direct control through the politics, in the end through the government itself. We can certainly see individuals do matter, and I noticed there was a discussion this morning about the appropriate regulatory regimes and sort of not a hidden agenda but a hidden thought there that everybody wants a single regulator or this regulator as long as they can pick the regulator, and that's the case I guess with consumer representatives as well. It certainly is the case that on occasion they tend to be too gung-ho in favour of what you might call consumerist interest without a true appreciation that in doing so they're imposing costs which somehow or other have got to be picked up somewhere by other consumers, or alternatively you see the service as a whole deteriorate.

MR COSGROVE: Alan, could I draw your attention to the final paragraph on page 5 of this second submission from the IPA. It has some statements there about what you might call the non-direct costs of regulation against the background of a possible levy on consumers, and it goes on to present some indication of the magnitude of these different costs. Can you point us towards studies or evidence about these - - -

MR MORAN: I certainly can, John. This institution itself indeed has published this sort of stuff, and most of it is actually based on OMB material from the United States and we translate it in the Australian sphere. But the regulatory agency within the commission has published from time to time that sort of information. It's pretty rough, by the way, as you'd expect. Geoff can probably talk about it in some more detail, having looked at it from two sides of that sense, from within United Energy in this case and from a deregulator's point of view, and I'm sure he can give you chapter and verse about how much United Energy - and indeed it's not atypical - and other firms - - -

MR COSGROVE: I'd be interested in that too.

MR TOWNS: Probably the last electricity price review that was run in Victoria involved five distributors and the Office of the Regulator-General and probably cost around $20 million in both public and private sector costs over a two-year process. All the regulatory reviews that the ORG undertakes seem to go for that time period. You've got to question, if you impose these costs on both business and society, whether you can in fact come to a better decision about how you set prices really. In

terms of a cost-benefit analysis it's not clear that it's a significant net benefit to society. I mean, the argument that they have to be a public type of submission is removed from when the subject of the matter is industry costs, which people from the public generally know nothing about, and getting into arcane subjects like the WAC and inflation adjustments and GST pass-throughs and GST spikes.

I remember that the ORG, I think from one of their public transcripts, referred to one of their public meetings in Ballarat or Bendigo or one of the outlying regions, where they got two people and a dog along but one of the people got up and said, "Look, I've got a degree in economics and I'm completely lost in terms of what you're talking about." You wonder that governments put all these requirements in place for significant consultation which in many cases is just meaningless.

You have the other side of the coin here where, because consumers and consumer organisations have to deal with economic experts in these various subjects, they're clamouring for public money. We see the cost of this whole regulatory system that we've built in Australia just rising, rising, rising without any end.

MR COSGROVE: You'd say that the bulk of this 20 million that you cited would be costs otherwise not born; in other words, they're solely attributable to the regulatory review?

MR TOWNS: Yes. You could also argue that the costs of full retail competition - question whether that's in the public interest. Whilst everyone is in favour of competitive markets, the imposition of costs for new computer systems and customer information technology and customer switching technology - I remember recently seeing something from the UK which suggested that they methods they adopted over there, which are the methods they're adopting here, are not only not a net benefit to the public but they're a tax on the poor because we spread the costs of this system across all consumers while only a few switch and those few that switch are often at the higher income end of the market. So there's a train that's going along pushing everyone towards full retail consistability. I don't think anyone has every done any cost-benefit work on it in Australia.

MR BANKS: Thanks for that, Alan. We'll let you proceed.

MR MORAN: I'll proceed to talk roughly about both submissions, and Geoff will probably come in at a later stage. I'm filling in particular facets of them. I don't really want to give a long treatise on this because this, as I said before, the commission really has quite clearly understood in some detail the original IPA submission and I think the second DB submission too.

Let me just summarise the sort of things that we're saying. First of all, as I said before, competition and property rights are the twin things that we need in there and are sometimes overlooked, I think, by some regulatory authorities, who tend to think competition itself is not necessarily the end in itself but the main driver. But, of

course, competition like anarchy without property right wouldn't actually produce the sort of wealth that we all aspire to.

The second thing I'd want to say is that monopolies generally, those that impose excessive prices, are normally short-lived. If there are excessive prices, normally that invites new competition, and in this respect the regulator itself - and sometimes regulators I don't think understand this fully - can only force prices down. They can't force prices up because there's no control over supply, so they can only lower the price from those levels that the firm of its own volition would set. I think the implications of that lowering in price are that in itself it impedes new competition by making it less viable for newcomers to come in, and of course also it has a couple of other incentive aspects: reducing the incentives to maintain and indeed invest and augment.

MR BANKS: Just while you're on that, I think you make the point in one of these submissions that there's a sort of asymmetry in terms of - I think you express it in terms of type 1 and type 2 errors: if you set prices too high there are self-correcting mechanisms. I think you say there are other regulatory ways of dealing with it, but would you like to just elaborate on that; in other words, the potential self-correction that can occur through higher prices relative to lower prices?

MR MORAN: Yes. That's the point I was making at that stage - and the commission itself does make that point in its position paper also - that you should err on the side of setting the prices high. I think the commission makes that point; at least, it implies some sympathy for that point: that if you set the price higher than you think it should be, that itself will act less of a dampener on new competition. If you set it lower, on the low side, then you aren't going to get the competition in there and you're going to sort of ossify things at that low price.

MR BANKS: What about people who would say that might be generally true but we're dealing here with a particular kind of market, and that is a natural monopoly where by definition you're not going to get entry and therefore there isn't a self-correcting mechanism?

MR MORAN: Yes. These are some of the important points that we're coming to in terms of, if you like, entrepreneurial greenfield sites and existing sites. We have a major transition problem with the existing sites or existing facilities. In some ways - and I mentioned some ancient tracts on that - we seem to have influenced the whole of legal thinking on it - Lord Matthew Hayles - in terms of "affected by the public interest". In some ways all things, whether they're greenfield or not, fall under the general umbrella, and I think that's a matter on which I've now changed views somewhat from the previous one, the earlier IPA submission, which made a sharp dichotomy between those that were established monopolies and the sovereign's franchise or by the sovereign themselves, where you do most clearly have to regulate. Then it's really a question of how you regulate and some of the issues, some of the niceties that you're talking about there - do you sort of err on this side or

that side? I think you should normally err on the high side because that will introduce new competition, unless you think that it's absolutely impossible, in which case it doesn't matter very much except from the point of view of the general incentives within the economy.

But where you have something which doesn't exist at the present time, then prima facie you've got to say it's not an essential facility. It didn't exist; life has gone on: why would you regulate it at all? The answer is that we always have, apparently since the 15th century or whatever, one way or another, and indeed the most modern facilities of this type or the first modern facilities of this type were railways. We were kind of starting to regulate them from about the 1850s, as far as I can see, and probably not doing it well, but nonetheless it certainly is part of that overall view that an essential facility is sometimes created even though it doesn't have the sovereign's franchise behind it.

But that then comes back to how do we actually ensure that this incentive is in there and we don't have this chilling effect, which I think is mentioned a lot, quite appropriately, in the position paper. It comes back again to access holidays. I note since they've been mentioned there seems to be almost a growing consensus in favour of access holidays now which, I think the position paper makes clear, are akin to a patent. The issue I guess then from the access holidays is how long they last and what they comprise, and some of those matters doubtless you'll be torturing your way through.

MR BANKS: Sorry, I interrupted your flow, but maybe we'll come back to some of those points.

MR COSGROVE: There's just one point that I'd like to check on, Alan. You mentioned that a service which doesn't exist at present can't be essential because we've done without it, yet there are almost certainly some services which do not exist because of regulation. The demand for them might have been conceivably quite high but because of government regulation there's been no incentive to provide them. Isn't that an important qualification?

MR MORAN: I think it is. Essentially, if I understand you correctly, you're saying that the government regulator has crowded them out one way or another.

MR COSGROVE: Yes.

MR MORAN: Yes, I agree.

MR COSGROVE: Price controls at the retail end might have weakened substantially the incentive to put in say a gas pipeline.

MR MORAN: Yes. I think that really is related to what we're talking about. On the one hand the government can crowd them out by using the term "fiat" to say,

"Only we may build this pipeline. Nobody else may build it." That's one way. The other way, it actually has built it and it's got this facility at an ultra-low prices and therefore nobody else can get in. Sometimes it's not built it itself. Sometimes the private sector has built it under the misapprehension, as it turns out, it's going to make some money out of it, and the government has artificially lowered price. Again that freezes out newcomers.

So there's a major issue. Once you're actually going to regulate, how do we do it? There are all sorts of complications: do we use historical costs or current costs and what rates and all that sort of stuff. These are matters where there's obviously no clear answer. I don't think there's a clear answer in that. But then there's the other issue: do we have a dichotomy of things that didn't exist before we lifted all regulations and those that did, and if so how do we handle that? The point I was making was that I made a very clear dichotomy. It was actually rejected by the commission, I think, the dichotomy I made between the totally greenfield sites and others. For one reason or another, maybe that rejection is correct, simply because t here seems to be a whole history of facilities becoming essential, if you like, once they're built even though they weren't build the sovereign's franchise.

In terms of the other aspects, one facet of the paper generally is coming back to Hilmer and saying: what did Hilmer really need. Hilmer was addressing state or government-owned institutions in the end. He was addressing institutions that are owned by the state or government or, like AGL, essentially controlled by them. There's actually been a remarkable transformation since 95 because really the only institutions that were natural monopolies at that stage were actually government-controlled and almost all government-owned. We've now seen those institutions in a lot of cases privatised - at least in two states - and in other cases, even though they've been corporatised, and that's not in our view as good as an outcome as privatisation, it is an outcome and it has separated them somewhat. We have boards of directors who have been, as far as we can see, chosen to actually give expertise and mimic private corporations. So a lot basically has changed there in terms of what Hilmer was targeting. He was rather coy about targeting just state-owned things, perhaps for clear reasons given the government of the day et cetera, but nonetheless in one or two areas he does make it clear that those he was really looking at were institutions or facilities owned by the governments themselves.

The other aspect we wanted to make and we made very strongly in that IPA submission, the original one, was that once competition breaks out, then there's no role for the regulators, and the sad thing about regulation is that once it's in, even though some of the people themselves are well-meaning and maybe come from us, part of us, originally, they want to keep hold of it. We saw that with the Duke pipeline, where competition had clearly broken out. The NCC was campaigning very strongly to maintain its control and fortunately a court of law has overturned their aspirations there. So I think that that itself is going to be a useful point for the future providing it does have some force of demonstration effect.

Consistent with that general role that we'd see of light regulation generally - and now it's moving a bit into the third submission, if you want me to turn to the DBs - there are a couple of areas where we would suggest some backing away from regulation. We'd certainly with minimalist regulation where we can have it and we certainly, as I've said, agree with access holidays. We tend to the view, although this is going to be a matter for debate, that rather than access regulation, which is clearly very intrusive and most people recognise it as being so, we ought to try and to something lighter whenever we can. We tend to the view that price surveillance or section 46 could be superior, and I know that the commission itself has said, "One in, all in. It's going to be easier if we just bring them all under the access rules." We take a different view of it: that really we ought not to make intrusive regulations for that sort of completeness.

There is the case: just how intrusive is that form of regulation versus another regulation, and that's clearly a matter which is going to be debated. We don't have a definite answer on it, but the general view is that it would be lighter than access regulation, and we'd say that as being a bonus for the community as a whole. Buttressing our view about this light-handedness and the fact that we shouldn't be regulating where it's not necessary, there are plenty of areas where we don't regulate for access at the moment. Obviously, manufacturing plant is defined as being out of the ambit of those, but it's an arbitrary decision of what is a manufacturing plant and indeed the original case, which came from Queensland Wire, was a manufacturing plant. So, ironically, that might be the begetter of all this regulation. So it is an arbitrary question of what is a manufacturing plant and certainly we've excluded that.

We exclude gas gathering lines, for one reason or another, and I know that there's been a move by the ACCC to try to bring them under the ambit of the regulations. Our own view in that is that we ought not to, that basically we ought to limit the bottlenecks, the things that we're defining as bottlenecks. The bottleneck facilities, where they exist, are really those facilities into a market, not the facilities into a production process. The facilities into a production process are businesses dealing with other businesses, and that's the way they have to deal. If somebody is looking for gas in Bass Strait and they figure that it's absolutely essential that they have access to the Esso gathering lines, then before they go looking we ought to make some sort of a deal with Esso in that respect. That's what businesses do all the time and it's not really up to us to try and force one party to open its facilities to another party. That's basically opening its own private facilities, probably its own property rights, to other people to use as the government says, and that's a pretty extreme form of regulation which ought to be avoided and it can be then.

The other thing is that, coming back again to Hilmer, Hilmer was really talking about integrated businesses. That's why we had access: we had integrated businesses. It wasn't simply to say, "You've got a bottleneck here, therefore this ought to be controlled in some way as in the ancient tracts of Lord Matthew Hayles et cetera." It's not that kind of oversight - it's much more than that - that insists upon you opening your facilities to somebody else who you might not to open them to. A

clear analogy would be requiring Ford to open its production lines to Nissan. It may well do that, but it would only do so on its own terms.

So we see that we should limit these to integrated facilities. We'd actually go a bit further than that, at least tentatively, and the position we put in the paper is that when we're talking about integrated facilities it's never quite clear whether we're talking about different ownerships or about separately structured companies or about ring-fenced. In our view it's absolutely clear when it's different ownerships, it's different ownerships. I notice one submission made much play of the fact that AGL owns some 30 per cent or whatever of EAPL, therefore the submission was, colourledly in our view, suggesting that that means that EAPL is under the thumb of AGL, which says mountains about the other directors, who are clearly operating against requirements and ASIC codes and ought to be prosecuted. Clearly that's not happening.

So whenever there is a case of the governments as separate shareholders, then I think we have to have adequate means of ensuring that we've got that clear separation. We've tended to the view also that when you've got separate companies that's there, but we'd go further actually, just based on pragmatic grounds of what we see in electricity. We've got at least two companies in this state who, if they're not - I'm not sure whether TXU is structurally separate or not, but it's the same shareholders, clearly. Citipower is ring-fenced. Yet I've been around this industry for four or five years now: I've never heard anybody level an accusation that they're using that similarity of ownership, of identity of owners, in the case of a retailer and the distributor to force business into the retail arm. Indeed, the best checks on all this aren't any regulators but the competitors themselves. It's an intensive, rivalrous industry, and they sure as hell would find those sorts of things if they existed. That's consistent with our philosophy of lighter-handedness. Both submissions are going to that. We're suggesting particular areas where that light-handedness can manifest itself in terms of policy.

MR TOWNS: I think that about covers it. If you're not vertically integrated, you have no reason to refuse access. You may still be subject to monopoly pricing concerns, and that can be handled in other ways rather than being subject to codes which only impose costs upon you for virtually no benefit.

MR BANKS: Just pausing on that for a moment, what would be the implication for United Energy of that being followed through? United Energy is not vertically integrated?

MR TOWNS: No. We own 25 per cent of our retailer and we have pretty big companies there, like Shell and Woodside - currently separate companies - who can't be pushed around or wouldn't act in anything other than their own interests in terms of their majority ownership of the retailer. So, no, we'd have no reason to deny access.

MR BANKS: So if that flowed through into an electricity code, for example, United Energy would be out and then would be covered by whatever separate price surveillance mechanism would be - - -

MR TOWNS: Yes. We'd support even beefing up the price surveillance mechanism, as the commission in that paper itself recommends.

MR BANKS: Could we just pause on that point, because that's where I was a little bit confused. The way I read what you were saying was that you were acknowledging that there may well be a monopoly power problem there and extraction of rent and inefficiency costs that would flow from that, but it would be preferable to deal with that through perhaps a beefed-up PSA. Would what be the beefing up that you would see as being appropriate but still not as heavy-handed as having the access regime apply?

MR TOWNS: I suppose a price monitoring power. In New Zealand they have a system where the retailers are structurally separate and they have a price monitoring mechanism with a threat that, if things get out of hand in terms of price movements, they'll bring in a more authoritative regulatory regime. When you've got public companies also running it through the press that they're price gauging or something, it's not good for the share price, so there's no incentive. I don't think we'd have that many incentives anyway, because we'd have to price through retailers anyway. We deal with two retailers in our gas business, so one retailer is not part of our company whatsoever. So if we tried to increase prices those retailers would be disadvantaged and they'd be off to the regulator to complain.

MR BANKS: So what you're saying is that it's sort of a price monitoring with the threat - my colleague referred to the silent cop approach earlier, built price monitoring with the threat of price regulation if you stepped out of line you would see as much more light-handed than an explicit price regulation regime or access regime?

MR TOWNS: Yes.

MR BANKS: In what sense? You could argue that in a sense that system would second-guess - because you talk here about broadly being comparable to the access regime, so you could argue that at the end of the day the access regime and the rules that the regulator devised there would influence and condition perceptions about when the silent cop would step forward and so on.

MR TOWNS: Yes, and perhaps the other benefit might be starting off with a new regulator rather than one who's used to doing things in certain ways. There significant costs we think with that, and there are a lot of advantages with starting off with a clean slate.

MR BANKS: A clean slate in terms of the kinds of principles that the regulator

would apply?

MR TOWNS: Yes.

MR MORAN: You may be getting at something here which is almost true - well, it is true - that you can define the different forms of regulation in such a way that they become identical, so you're saying, "So what? Why would you prefer that compared to this?" because the two could be identical. I guess that is possible, that if we are talking about some oversight, the regulatory oversight could be identical. Nonetheless, if you're thinking why access regimes were brought in it was because I own this bit and I also have affiliates up here and I want to actually ensure that they do better than some other people. Therefore we have an access regime, not just a price monitoring regime. I think from that point of view the access regime starts off by requiring more intrusiveness than the price monitoring regime. The end product may be that they're both pretty much the same, and that occurs with a lot of regulation.

MR COSGROVE: Would you see any differences in terms of the degree of sovereign risk under each approach? If you had a regulator operating under an access regime with well-spelt-out principles to follow, would there be any lesser degree of sovereign risk as compared with what could be arbitrary interventions at unpredictable times in a price surveillance situation?

MR MORAN: I think it's a good point. I'm sure the DBs would argue, as many of them did when they went to the High Court - there we had in Victoria apparently very tight regulation, the way that the price ought to be reset, and even so the regulator chose a different approach, which was upheld by the courts in the end, one that was contrary to what I think all of the DBs expected, even though only one took it to the court.

MR BANKS: I'm asking these questions because in the PSA report I think the role they saw for monitoring in that inquiry was more light-handed again and that it would be simply monitoring and that's that without the implied threat of, if the monitoring reveals excessive prices or potentially excessive prices there would be some sort of automatic stepping in. I think they saw if there was going to be scope for that, then you'd need to have an inquiry or something beforehand that would then recommend some stricter form of price control. But I think what they had in mind there was a PSA that in a sense had a potentially wide remit, so you wouldn't want to introduce those kinds of price controls or threats into something dealing with a product outside the natural monopoly field.

MR MORAN: As we understood that, it was actually that - that they were picking and choosing. Obviously, there are some things that you might just take a cursory look at and others you've got to look at in detail. The other aspect of that is, of course, section 46, which people have criticised as being difficult to apply. But certainly that's the law of the land, if you like, to prevent people from exercising

monopoly power.

MR BANKS: It's something we may look at bit more at, but I guess the consensus was in going through this that section 46, at least as it's currently constructed, wasn't really up to the job, and if you change its construction then the possible unintended consequences of that were problematic. But if you had any more thoughts on that. I think it's implicit in what the combined submission is saying here that there could be some change to section 46 to make it more effective in this area, but there's no elaboration on that. It is something that's been discussed for some time, but any further, more specific thoughts you had on that would be welcome. We have some other questions, but did you have anything more that you were planning to say by way of introduction?

MR MORAN: No.

MR BANKS: Okay. If you'll just bear with us for a moment, I'll have a look at some of the other points we were going to ask. I just make the observation that you've referred a couple of times to Hilmer and what Hilmer envisaged and so on, which I think is important, but I suppose we took the opportunity to have a fresh look because the context was different at the time and so on. But I think that even Hilmer was somewhat ambivalent about the question of vertically separated facilities and what might be done there. You may not be as avid footnote readers as we are, but let me just find it and it may be something you could consider. On page 48 of our report we quote from the Hilmer report. Indeed, we say that it's significant that Hilmer, or that committee, saw no presumption in favour of restricting regulation to vertically integrated facilities. Then we have a quote at the bottom of page 48 there, where it says:

> Whether the pricing issues arising in relation to a particular facility would be best addressed under the access regime or a prices oversight process would be considered on a case-by-case basis.

What's sort of interesting about that - and coming back to the idea of monitoring - is that we put forward the idea in this report that there may be borderline cases where you could use price monitoring within IIIA itself as an alternative to declaration, particularly in situations where, while they may more typically involve separated facilities, it was unclear that there was sufficient case to go the whole hog. I don't know whether you have any additional comments to make in that context of having something like that embedded in IIIA itself, that kind of price monitoring option. Indeed, in the PSA report they saw a recommendation to that effect by the IIIA regulator as satisfying the kind of inquiry conditions that would lead to price monitoring under that part of our recommending in the TPA.

MR MORAN: Yes. I suppose we could rake over Hilmer with alternative quotes backwards and forwards.

MR BANKS: You'd probably find quotes to both sides, and it's always an interesting issue how footnotes get in.

MR MORAN: Yes. The one I'm looking at is on page 251 of Hilmer. Again there's a phase 2 formula. That's what we were looking at. But, listen, it's not that important, except Hilmer was a pretty authoritative piece of work and things have moved on since then. It's our view that Hilmer saw this notion of access as being pretty intrusive and ought to be reserved. He talked a lot about how it could freeze out new investment and it ought to be reserved for some special cases, and indeed I think on page 251 that's where the hidden meaning there in my view is that he's really talking about government facilities. He says these are more often than not government-owned facilities, and elsewhere he says that you've got to make sure that this doesn't freeze out the new regulation by intruding on the normal property rights.

So that was our view, really, that Hilmer was talking about more than just a bottleneck, that this is a bottleneck which is controlling something upstream or downstream and therefore he's going to be using that to squeeze out competition. But there are other views.

MR BANKS: Okay. But we don't disagree on the fact that, whether it's vertically integrated or not, if it's a bottleneck essential facility with natural monopoly power that does create a policy problem which can be approached in one way or another.

MR MORAN: Yes, that's right, and certainly the first submission, the IPA submission, was very much focused on the idea that again this chilling effect - I don't think we used the word "chilling"; you used it - on an investment; basically we ought to do very little about anything new coming in, but of course the way round it is the access holiday or other means of doing the same thing.

MR BANKS: Yes. Just pausing a bit more, you've quite helpfully gone through some of the arguments we use in relation to encompassing non-integrated facilities and we'll sort of take them as read, but I just wanted to have a look to see whether there were any other questions I was going to ask about that. We've talked about a PSA-type approach. You raise in section 2.2 on page 18 that in a sense strategic separation or dis-integration or whatever we call it would actually be a very high-cost option for a firm. You raise the question:

> What are the possibilities a facility owner would find it in their interests to incur such costs?

You conclude that the effective cost of the access regime would be very large. What's not stated there is that the potentially the monopoly profits or the rent that was associated with that might have been very large as well. In a sense you might be talking about the cost to them rather than the social cost.

MR MORAN: I guess what we had in mind there, Gary, is that most of the

facilities that we're talking about here are separated. Sometimes they're ownership separations, as is the case with United, where it's clear that there's no way in the world that United is going to be operating for United as interest when its other shareholders are Shell et cetera, and the same could be said of EAPL, where it's got major interests there. Many from their own volition have done that. It's a question of synergies, and the synergies all differ. Some of them see it as in the energy business and therefore they want to be offering integrated packages. There are others that see themselves in a sort of integrated upstream and downstream electricity business and want to ensure that that's all under some sort of control.

It's our view that, unless there's some particular reason to require them to incur costs of having separation, then you shouldn't require it. Those reasons actually get to be quite significant when you're talking about very small facilities. I can recall in the case of gas talking about very small gas lines from Darwin to somewhere, and to actually force them into two separate companies with two separate boards of directors holding themselves at arms-length is actually imposing a cost that is needless or at least is significant in that case.

MR BANKS: But isn't that the point, though, that by having separate regimes for vertically integrated or separated facilities, in a sense you are forcing them to think about incurring that cost, depending on how they perceive the two regimes?

MR MORAN: When businesses from their own volition are deciding, as United or others would have done, that they're going to have two separate companies and they're going to be at arms-length from each other, then they've clearly weighed up the costs and they've made a decision. But why would you force it on other businesses unless you've got some reason to believe that there are some sorts of values which can be disgorged from that process? Now, clearly there were when we did the first separation of electricity into transmission and generation and retail distribution. The point that I think the commission may be making here is that there may be some additional benefits by splitting distribution down into distribution itself and retailing. Maybe that's so, although I can't see them.

But you can go ad infinitum with any aspect of production and say, "Why don't we split this down and split this down?" until you're basically talking about a pure commodity, when you can do your sort of traditional economies price without any facets of the product imposed to pollute your analysis. It's a bit other-worldly, though.

MR BANKS: The tail wagging the dog. I guess the only other comment I'd make in relation to 2.3 - and we'll look carefully at the arguments you're making there - is that perhaps to the extent that these are your views, Alan - which presumably they are - as well as your clients' here, they're showing a much more rosy kind of attitude towards government business enterprises, I think, than I might have expected. Indeed, you made some comments earlier that raised questions about that. What you're really saying in that section here is that you'd expect them to be

profit-maximising and that they have a lot of pressures on them to make pretty high returns, so you think it's very unlikely that vertically separated facilities would be doing anything other than proceeding along that course.

MR MORAN: I think that's true. We'd make no pretence - indeed, I guess our clients wouldn't either - in saying that privatised businesses are much better than government businesses, and there is more of a risk with government businesses that you can get ministerial intervention. Having worked for the bureaucracy which was in control of government businesses, even ostensibly separated ones, I've seen that at first hand and perhaps you too, John, have seen it at first hand as well, where ministers can monster entities to do their political bidding. But once you've actually got them ring-fenced and you've got independent directors, it's more difficult. It's still possible to do.

MR BANKS: Okay. The only other observation maybe is to direct you to have a look at the commission's recent publication on financial performance monitoring of government enterprises. What's quite striking - and the reasons for this I think still need to be looked at - is that the profitability measures across a range of sectors indicate that these enterprises are still earning very low returns, so low that it's hard to imagine that being sustainable in the longer term and raising questions about governance and so on that we draw attention to in that report. Anyway, that's somewhat to the side of this particular inquiry.

MR COSGROVE: I was interested in the example cited at the top of page 28 of the combined submission which concerns TXU networks and its problem in varying its access arrangement so that it can reticulate gas into Barwon Heads. The end of that paragraph says that the variation requested was rejected by the ORG and as a result TXU deferred the investment to supply gas to the area. Is that an indefinite deferral of this investment or are we looking here at a more marginal - you're not sure?

MR MORAN: It's my understanding that they have actually now commenced it because the government gave them a subsidy to do so; the state government, that is.

MR TOWNS: The subsidy has gone to the Bellarine Peninsula project but not the Barwon Heads project and the Bellarine Peninsula project is going ahead.

MR COSGROVE: So is that a smaller project, do you know?

MR TOWNS: I think it might be.

MR MORAN: Neither of them are that big. I mean, we've got a fairly high coverage of gas in Victoria anyway. There are bigger ones but - - -

MR COSGROVE: Did ORG explain why this requested variation was denied? I guess you're not directly involved so you may not know about it.

MR TOWNS: They did. They did put out a discussion paper on it.

MR COSGROVE: I see. We could get hold of that.

MR TOWNS: Yes. Greenfields sites of gas are a particular problem because the way the old Gas and Fuel used to operate, they used to heavily cross-subsidise over a number of years. But now with access arrangements you can't cross-subsidise and if you try and impose a reasonable rate of return on these new greenfields areas because they're so marginal you end up pricing at levels that bunch up against alternative sources of energy. So, you know, it's very difficult to attract people off the thing. So they're definitely a problem and I think everyone recognises they're a problem.

MR BANKS: Okay. Can I go on, John? Just on page 29 and 30 you talk about consistency between access regimes and you talk about the need for five-yearly review period. Now, I just want to clarify what you're talking about there is five-yearly reviews in relation to the industry specific regimes as a whole? Is that what we're - - -

MR MORAN: Yes, we are talking about them as a whole there.

MR BANKS: In a sense analogous to what the commission is currently doing with telecommunications.

MR MORAN: Yes. At least initially, because we are talking about some fast-moving things happening and obviously even faster moving in terms of telecommunications.

MR BANKS: That's right. Yes, okay, thanks. You then have a section on pricing principles which is useful and we'll go through that. One of your points there is that use of - this is now on page 31. You talk about CPI minus X regulation instead of compatible needs to incorporate price resets calculated on the basis of reference to industry TFP rather than rates of return or cost-based building blocks. I thought I'd just check with that. I mean, as you know, we ourselves have talked about that and you urged us to strengthen that part of our report, but just to check with you what role, if any, you saw for costs in this area and whether you would see the whole thing kind of abstracting from costs and simply relying on benchmarking or productivity-based industry data.

MR TOWNS: The reason you might look at costs initially is the fear that if you set up a sort of total factor productivity incentive regime there might be excess profits because costs were too high initially. But that system still gave the incentive to get the right costs, you know, eventually, but maybe the political problems associated with it would have been too great. But certainly once you've been through one detailed cost analysis I don't think there would be any need to go through any more

than one because the regulator has done their job in the first place. The system, moving to an incentive-based system like TFP will still encourage businesses to reduce costs. So it's not as though we've got a different incentive system operating. But certainly if there's any reason it should only be done once.

MR BANKS: Is it conceivable that you could get a situation, even beginning the way you said, where over time the correction could actually be inappropriate in terms of the local industry or the cost structure of particular firms and therefore act to the disadvantage of the firms, subject to this kind of regulation; in other words, that it could start to cut out too much profit?

MR TOWNS: I believe in America they have the option for the firm to request a cost of service-type approach for the regulatory authority to check their costs that - yes, that total factor productivity movements might have hurt them too great for any one of a number of reasons. So they have that option in the PBR-type regulation that has been introduced into a number of states in America.

MR BANKS: Right, okay. So in other words, you would still see the potential for cost information to be introduced somewhere down the track potentially as well, but putting the main emphasis on the TFP approach.

MR COSGROVE: You raised an issue - maybe you were going to focus on this yourself, Gary - about the need in the pricing principles for an approach that you'd call conservative in the sense of erring towards allowing facility owners to retain monopoly profits rather than risking under-compensation. We thought we had that there in the second of the pricing principles, namely not be so far above costs as to detract significantly from efficient use of services and investment in related markets. You don't feel that's adequate?

MR MORAN: Well, that's funny because we knew it was in the draft report but we just didn't see it in the actual proposal itself.

MR COSGROVE: It's in proposal 8.1 on page 206 of the position paper. I'm asking the question partly because you're not the first person to have expressed such a view and taken together with the first principle which talks about including a rate of return on investment commensurate with risks, we thought we had that angle covered. But how do - - -

MR MORAN: I guess when we read it through we didn't think it was coming through as strongly as it was in the text and we just thought we'd bring it in there.

MR COSGROVE: I see.

MR MORAN: But that's fine. If it's your understanding that it is as strong, that's not a big issue we're making on that.

MR BANKS: One of the problems, as you'd appreciate, is actually finding words that convey what is intended and no more and no less, and don't convey something else. But again, if you had any alternative words to offer us, you know, on reflection there that would satisfy that objective - but I guess we're conscious that we have the two objectives and, as we talked about earlier, with Freight Australia, that in some respects the overriding objective is about efficiency and use, but at the same time wanting to preserve the incentives for efficient investment. They're both part of it and how you get that conveyed, I guess, in words is the trick. But any further thoughts you had on that would be appreciated. We don't want to keep you much longer.

I just want to look through to see if there are any other points that we haven't raised. Yes, access holidays: we've talked a little bit about this and, as you say, there does seem to be increasing interest in this although, as you point out in your own submission, different parties have different views about how it would work and in particular what happens ex post. I guess we are very conscious of what happens ex post in condition, what happens ex ante, and it's one of the problems in this area. You argue against having a null undertaking and I just wanted you to take us through the logic of that, and you end up saying the negative declaration might be better. Would you care just to explain the basis for that? It's page 32 going over into page 33.

MR MORAN: Basically when we looked at the null undertakings - and it may only be matters of terminology and semantics but it seemed to us that that null undertaking was pregnant with some other sorts of regulatory inclusions which we weren't - you know, that the owners voluntarily seek this rather than - we thought they should be quasi-automatic, you know, that you've got a greenfields site and it basically is quasi-automatic unregulated for a period of time, whereas a null undertaking, it seemed to us that you approach the commission, the ACC, and apply for it in some way, and then you get a null undertaking.

MR BANKS: I guess we were trying to think of it in a forward looking sense, you know, where a business is thinking about investing in a facility, so there's nothing out there yet and then wanting to get an assurance that it would have a period free of access, and therefore the undertaking route, which is forward looking - - -

MR MORAN: One of the things that coloured my thinking in this early on - and again there may be ways around all this. There may be sort of no real difference in view in this. But one of the things is that the commission, the ACC, is already of the view that you can have an access holiday. It has always had it in the sense that you can bid for a particular line. You put it at the tender and the lowest tender wins, which is really an access holiday, although you bid for a particular gas line or electricity line or whatever connecting two places and you bid in an open market and therefore the price is determined by the lowest bidder. That's a sort of form of access holiday.

The problem with it of course is that that's an open contest and it doesn't allow for the entrepreneur to actually spot an opportunity and go build it. He spots an opportunity, then others can come on his coat-tails and obtain all the advantages of his market research or whatever else he has put into it, spotted in there. These sorts of issues were behind the null undertaking and perhaps the commission can come to a good form of words in it, but we actually want to just try and make sure that this is as automatic as possible, that you don't have to go cap in hand asking for it and then being queried, that you just go do it and there has got to be some extraordinary circumstances which wouldn't allow you to do it.

MR BANKS: So it would almost be a presumption that any greenfields investment would qualify.

MR MORAN: Yes.

MR BANKS: Which raises the question of what is a greenfields investment and the bona fides of that. But these are the sort of issues I suppose that gave us pause in the process of the months leading up to the position paper and we'll certainly be thinking more about that. You talk about a pre-set holiday period and you say parenthetically - I mean, you don't make much of it but you say "say 10 or perhaps 20 years". Would you care to comment on the sort of considerations that apply there?

MR MORAN: No, not really. I mean, I think it might not be a bad idea to actually have a bit of research done or, you know, of your own as to what would be an appropriate time, given discounted cash flows and all that sort of stuff. I mean, that's why we gave such a wide spread there before we came to the number and I guess implicit in that is, 15 years is the number. But we left it as a wide spread because we needed to have done a bit more arithmetic and maybe even market research analysis before we came down to, like - - -

MR BANKS: I mean, conceptually I suppose you're talking about a period sufficient to allow a risky project to go ahead.

MR MORAN: Yes.

MR BANKS: And that would vary from project to project. These are the sort of things I suppose that need to be resolved. Okay. I think that's about all the questions I had. John, did you have anything else?

MR COSGROVE: No.

MR BANKS: I'll just check whether I had - yes, Alan, I'll just ask you whether you had any comments about the role of ministers in all of this. You may have it in the earlier submission and I've forgotten about it but would you see - I mean, how would you see the role of the minister, political representative in this whole process? Do you think it's important or not? As you know, we've actually recommended that

ministers not be involved and we've raised a question about how many regulators you would have and seen value in having one regulator and then looked at the various merits of the different possibilities and on balance thought the ACCC may have the strongest claim. I'm just interested in any reactions you have to any of that.

MR MORAN: Our view is similar to yours that we shouldn't have ministers particularly involved. They somehow want to be involved and feel they need to be involved because electricity is an essential service et cetera and when they do become involved it does create disincentives. We saw that last year in Victoria where heavy-handed - certainly in retrospect - action by the government resulted in changes to price which resulted in overdoing a reduction and indeed, exports from the supply constraint flows into New South Wales from Victoria as a result. There may have been some further ramifications of that in terms of the incentive to invest. Certainly I have information that at least one company, having seen that political intervention, decided the sovereign risk was too high and indeed told the government so but hasn't said so publicly because they're not in the business of making political statements like that and so that kind of thing will happen.

Essentially what we're aiming at here is actually creating a framework - frictionless for ministers themselves. I notice that governments, in particular New South Wales and indeed, Victoria to some degree, keep talking about government stretches for the market and somehow wanting to be involved in some way and I'm at pains to find out what they want to be involved to do. When you look at the statements they don't really want to be involved, they say, to intervene on this or that or one or other except in the case of New South Wales to force the taxpayer or the ratepayers to pay for a line from New South Wales to South Australia. But that aside, they don't seem to have an agenda in mind but they do want to be involved in the governments. It would be my view that they shouldn't be, any more than they involved in the car industry or the fruit industry or any other industry.

MR BANKS: You don't think there are greater public interest components in these kinds of decisions of sufficiently subjective nature that would warrant ministerial input?

MR MORAN: I think there may be, but that input usually has a perverse effect when it's introduced, as I think was the case - perhaps the government here has recognised it was the case when they intervened in February last year. So, yes, it's obviously an industry which has implications throughout the economy and in that case is a very important industry. One could say, "Well, food is just as important and we don't have a minister for food as such." I think the two industries are different, but even so the more meddling we have of governments in this industry I think the less healthy it's likely to be. After all we've just emerged from an era - we're only five or six years out of it - when the governments controlled it totally and nobody thinks that was a satisfactory outcome.

MR BANKS: What about the question of the regulations, in particular NCC and

the ACCC and that structure?

MR MORAN: A number of people have said it would be a good idea if there were fewer rather than more and I guess that would be our view as well.; But like everybody else, our view is that if you can pick the right regulator then that's great. We would tend to say that there should be fewer regulators. I don't really know what the role of the NCC is, whether the NCC itself has a legitimate role in this. But perhaps it does, perhaps it could be more easily fused with that of the ACCC. There are the specialist kind of regulators, NECA and NEMMCO in electricity, as well and I must declare something of an interest with NECA in this respect. Perhaps they too could be fused with the ACCC. Once you've got a regulator it becomes really an administrative question, what is the best means of regulating.

There could be a case, for example, of saying, "We have these technical regulators too and they have quite an impact in terms of the policies for the regulated entities." Maybe they ought to be part of the overall system. I don't know that anybody suggested that but there would be a strong case for bringing them into holistic regulatory structure. But I don't think the particular structure, whether - the numbers of regulators or whatever is our strong card to give you good advice on it.

MR COSGROVE: But for the action or inaction of ministers, at least in the rail sector, we presumably would have had more regulation of rail services. Does that condition your approach to the involvement of ministers?

MR MORAN: What do you have in mind?

MR COSGROVE: The NCC has made a number of recommendations for declaration of certain rail services and typically I think a state minister has either said no or by dint of inaction the application or the recommendation for declaration is deemed to be dead. So in those cases ministers have had the effect deliberately or otherwise of overturning recommendations for access. Is that a significant factor in your approach to this question?

MR MORAN: I think it probably is. I mean, the rail lines themselves were or are - indeed state owned, I think, in each case so the minister prior had total control. Now there is some sort of pressure on the ministers to open it. I guess I would always examine it from the point of view of, "What would a private sector entity do?" If the private sector entity was simply a rail line, it would want to get as much as possible along that line given certain constraints. Indeed, if it was a bottleneck rail line then it would fall under some sort of oversight. In these cases these are rail lines which were constructed by governments in circumstances where it would have been either impossible for the sort of pricing decisions that you mentioned earlier or perhaps even impossible anyway for anyone to contest them. Really the best means areas to open them up and get a justifiable pricing system in as soon as possible. So, yes, the NCC does a useful job in that respect.

MR COSGROVE: In fact it would be part of the taxonomy that was spelt out in your first submission as a legitimate case for access.

MR MORAN: Yes.

MR BANKS: We can't stay too much longer or the light will go completely. Just one thing struck me, Alan. When I read your first submission on page 7, at the bottom of that page you said:

> The IPA sought revocation of the coverage of the Moomba to Sydney EAPL gas transmission pipeline with a building of the rival Duke one.

I mean this is all quite relevant with the recent decision on Duke and so on. Could you just explain what's happened there. Did you support a revocation application or did you make the first application. I just wasn't sure what was meant there.

MR MORAN: We did actually. We put an application up then the NCC tried to skim us for 5 thousand or 7 thousand dollars to do it, so we decided we wouldn't do it.

MR BANKS: This is the IPA?

MR MORAN: Yes. We wrote to them and said, "We ought to actually rescind now the regulation of the EAPL pipeline because there's another pipeline going forward." Of course, NCC wasn't sympathetic to that view because they wanted to control both of them, as it happened. We didn't proceed with it on that basis. We did contact of course some of the partners and said, "Why don't you go forward and seek that," and indeed they have done that. The ramifications of the Duke decision has still got to play but it seems clear to me that that will soon unravel the EAPL coverage and perhaps also the Victorian system's coverage, depending on what the view is of courts or regulated whatever else it has agreed to which they are intertwined with it.

MR BANKS: Good thank you. I don't know whether we used your Coke v Pepsi analogy but I quite like that. Thanks very much for that. Thank you for the submissions. It has been a very useful discussion. There were a couple of points there, if you are able to get back to us on those we would appreciate it. But if you don't have anything more to say, thanks very much.

MR MORAN: Thank you.

MR BANKS: Just break for a couple of minutes please. We have one more participant for the day.

MR BANKS: Our next participant is Mr Perera who has kindly offered to make some remarks, having been present during the day. We don't have a full and written submission at this stage but perhaps just for the record if you could give your full name and the organisation for which you work.

MR PERERA: My name is Lasanta Perera. I represent the Electricity Markets Research Institute which is a private organisation looking after, as it was, public interest in the electricity market and also engaged in doing some research work to see whether problems affecting the electricity market can be resolved. One of the things we are doing is we are in the process of making a patent application which will help bring about a satisfaction resolution to the problems in the fuel type of markets. That's why I don't want to talk too much about it because it is a patent that we are pending. The other work that they have been doing is looking at things in the electricity market and making submissions to organisations like the ACCC, (indistinct), the ORG and so on, and mostly in the areas of electricity pricing, the pool arrangements, network pricing et cetera.

Giving a little bit of background about myself, I'd been working with the SECV for about five or six years just before the transition from the SEC to the new organisations and I was engaged in the electricity pricing, looking at the pricing reviews we did every year, submitting to the government for approval and so on.

MR BANKS: In the State Electricity Commission of Victoria?

MR PERERA: At SECV, that's right. I was then opted to Eastern Energy where I started up the pricing and forecasting section at Eastern Energy and got the electricity market contested by customer offers and so on going, and was instrumental in setting up one of the now sort of fairly industry-standard tariffs which you call (indistinct) tariff. When the national electricity market was being formed I got involved in the national electricity market and represented the Eastern Energy towards the liberations of the National Electricity Market forums and continuing that role, I have also been instrumental in forming the national retailers forum which is the forum for retail organisations in the national electricity market. So I've been right through the (indistinct), as it was, in the electricity reform industry, starting from the early days of the government organisation to the present in terms of the work we have now.

So it's with that background that I've been able to sort of make some - because of the insights that I have from that background, that I've been able to make some submissions at various stages. My objective has been that there has to be a fairly independent and objective reviews for inputting the process rather than having consultants who sort of look at particular sides and give you different angled views as such, because we have the generators giving their consultants and the retailers their consultants' views, so everybody sort of thinks in terms of having consultants to give views and nobody seems to be looking at the underlying causes and trying to see how the working can be resolved. So that's one of the reasons why the Electricity Markets Research Institute has in a sense carved out that area to say, "We will be

doing independent work rather than being sort of looking to in a sense just propose particular courses as such." So we look at objectives in terms of where different groups of people are affected and also how the market itself is affected.

MR BANKS: Could you just indicate there whether you have particular clients, whether you're affiliated with any other institution or whatever?

MR PERERA: There's no affiliation with any other institution. We have worked for one or two clients insofar that where there was particular expertise that they required or in terms of trying to help them to resolve a problem area that they are sort of faced within the electricity market. So it's a fairly balanced set of plans but not very high-profile assignments as such. I will look to some other work in terms of when I actually given some comment but not necessarily in terms of saying, "This is what we did in the assignment," as such rather then not sort of make my positions in those matters reflect what the information that I'm sort of putting to the commission today.

MR BANKS: I think, as we discussed earlier, if it's possible for you to provide us with a written submission we'd appreciate that, and perhaps today while we have this opportunity if you could just point briefly to the areas that you want to draw to our attention. When we receive your written submission, then if there are other things that we can get back to you on, if you would allow us, we'll take that opportunity. But we'll give you the opportunity now perhaps just to signal what some of those points will be.

MR PERERA: Yes, that's fine, sir. Thanks actually for making available - or sort of give me the opportunity to meet with you because I didn't know the actual procedure so I think I barged into the situation. I'm sorry about that. I've been going through your position paper. I was quite attracted to the sort of introductory part of it and especially where you talk about the reason why the position paper was necessary, to give you a view after five years from the establishment of the national competition policy and also because the area of concern affects the infrastructure assets to the value of $50 billion. They are fairly important criteria, no doubt. But the next two criteria I picked up was I think more important insofar as it concerns the major importance to the fortunes of most Australian businesses and the next point was vital to the quality of life and enjoyment of Australian households. I think it is the last two points that probably justify the conclusion that reliance on anticompetitive conduct provisions of Part IV of the Trade Practices Act would not be a viable (indistinct) that's very true insofar as there is the marketplace where sort of producers come in together and where producers need to sort of have had other producers to get their things moving as such, but then also the market is, if you talk of the total market, there has to be the consumers, enter the consumer.

In general competition policy has tended to look at the competition among businesses and to some extent not that much to the end customer. The position paper makes a point that, "Competition is a means to an end, not an end in itself. The

current approach necessitates that under the declaration process efficiency and its effects are just as part of the residual public interest test rather than being a first role of consideration." The public interest test actually has been one of the bugbears of the whole process to my mind insofar that different people say that - they sort of look at the public interest test but there is no specifics of how that can be done. Now, I sort of allude to situations like social costs benefit and analysis which we economists have been engaged in in terms of trying to quantify these sort of nebulous things that we talk of in public benefit area sort of thing, shadow pricing and so on and, as you have to see, a document which say, "Okay, the public benefit is this because they have been evaluated and here's the results: A, B, C, D," sort of thing, see.

We're also told that, "While the impact on economic efficiency is always a primary consideration in community welfare the NCC has indicated that it will consider other matters. These include environmental matters, social welfare, equity considerations such as the maintenance of community services obligations and regional development." They're all great stuff. Unfortunately, that is the beginning and end of the story as far as the document is concerned because I didn't see in the document sort of any specifics how these things are going to be brought about or how it is going to be assessed and so on. So in that sense when we say that we do all these things but we don't have the mechanism to do those things, then there's a big gap. These wonderful concepts they are supposed to be (indistinct) and do not get a mention in the (indistinct) comment, analysis and recommendations continue the rest of the document. There's a deafening silence as to how those noble concepts can be assessed and incorporated into regulatory guidelines. Maybe they fall into the too-hard basket. I don't know what the reasons are. What a pity.

Without these items being accorded their due place in the regulatory framework there will always be something missing. I call it the soul. In the regulations the soul is missing in regulatory decisions, leading to dissension on the part of intended beneficiaries. So in a sense if you want to sort of have the regulations to work and for the public to accept that regulation works, then you have to have these things. Otherwise it's missing and there will always be dissension. You satisfy one party but not the other party because everybody is trying to come to a sort of common understanding and say, "Hey, this is why we do these things."

Now, I come to basics in terms of what sort of these things mean. Victoria established statewide uniform prices in 1940 after much protracted public debate going far back as 1920. There was a lot of public debate at that time. Whether this is a CSO or a USO - which is now becoming more sort of popular, universal service obligation, it's not (indistinct) yet - but what is important is that it was the wish of the people, the community. They wanted it. "Given that it used to be (indistinct) electricity, gas and water are vital to the quality of life enjoyed by Australian households (indistinct) there is accompanying reason for ensuring that at least reasonable quantities of these items are afforded to all in the community, be they rich or poor, town or in the country, remote or near. To everybody it should be equally available. If the community expressly require (indistinct) prices for all, the

government must accept the charge" - that means that the will of the people and sort of - the word "charge" can be actually two things in terms of taking up the cost as well as sort of making sure that they follow the will of the people - "and meet the cost from the public purse or some other efficient arrangement. The auction system proposed by Prof Milgram comes to mind." That's in the daily communications area that has been proposed and that was implemented by the US government.

"In the past state governments owned these utilities and ensured equitable prices by different means. In Victoria there was an implicit location cross subsidy from urban and rural customers. In New South Wales the state government achieved similar results by requiring different rates of return from the urban and rural distribution and retail businesses. It is unfortunate that the move from the national market was done without due acknowledgment of this prior public benefit. The national market now gets the blame for the actions of the respective state governments responsible for withdrawing the prior public benefit instead of making them an explicit arrangement." So we had a situation where there was a public benefit and that has been taken off and you have this dissension now in the regional areas where people are saying, "Hey, life is becoming impossible for us," and it's nothing to do with the national market because it's not really not the national market because it is not really the national market that is in this, it's a question of there was a public benefit and you have taken away that public benefit. So that's a problem.

I want to come now to proposal 7 which is contained in your document and it talks there that, "The Commonwealth government should be required to submit it's industry access regimes for certification. For existing Commonwealth regimes any immunity from Part IIIA should be removed." The question I had to pose is what state-industry access regimes? Why only the federal access regimes? I'm now talking of state insofar that electricity is somewhat slightly different compared to some of the others because it so happened that the national electricity market came in and their access regime for the national electricity market in a sense overtook some of the state things that had been done. But Victoria is a special case. It is special insofar that Victorian electricity structuring was before the national market situation arose and it is sort of (indistinct) insofar that at that time in April 1995 the Victorian government wanted an assurance that it's reform privatisation agenda would not be hampered by the new amendments of the Trade Practices Act which was expected to become law in July 95. The Trade Practices Commission was charged by the Australian treasury to review and report whether the Victorian arrangements were consistent with the completion principles agreement and can be considered effective, and this is their report.

In May 1995 the TPC put out this report but I didn't see any mention of that in the position paper. I'm not sure whether you thought it's not relevant or whether it was not (indistinct) but I think it's very important that this report has to be updated because this report had many adverse comments on the Victorian arrangements. One of the areas of concern was the handling of the urban and rural cross-subsidies. Cost reflective review suggested it would be better to use some means other than price

distortions to deliver support to target groups. Nevertheless it is apparent that the (indistinct) role for CSO in principle 24(b) provided the instructions are explicit and the CSO is transparent. Good stuff, because this is something we should have been sort of saying for a long time that if the governments want the CSOs to be maintained, make it explicit and if it has to be funded make explicit funding arrangements, either from the purse or from other means. That was something that was brought up. In this regard, the commission concluded that they, in terms of the arrangement, are not inconsistent with the CPA and also the MCM, GMC core arrangements make provision for such adjustment and (indistinct) during the period to 2000. Only up to 2000, not the last year, it was the period to 2000. As most of you would know, the oil distribution pricing has extended the price distortions in question for another five years.

MR BANKS: Sorry, can you repeat that?

MR PERERA: The pricing review that was concluded recently has extended the price distortions in question for another five years, because the pricing review prices will apply for another five years. Probably even after that it might be still going on, but it depends on whether the ORG will do the review as such. Therefore what they're saying here as being applicable only up to the year 2000 has been extended beyond that.

Another area of concern expressed in the report was regarding capital contributions for net field augmentation. The two guidelines do not have any detailed provisions to ensure that distributors cannot double dip for augmentation costs already covered. There are guidelines given for the ORG for its determinations, but there are no detailed provisions to ensure that distributors cannot double-dip for augmentation costs already covered.

Yet another area of concern was going to be the dispute-resolution procedures and the process to appeal a determination of the ORG before a government-appointed panel. The words of the report are:

> The appeals are limited in that they can only be on grounds that there has been bias or the facts on which the determination is based have been misrepresented. The grounds for appeal to the courts are also limited in that they can only be made on grounds that the ORG has exceeded its powers or a failing of procedural requirements.

So they're very limited appeal processes. Now, in most of these sort of cases we talk of - that, okay, there should be regulation but the effective regulation is ensured by having an appeal process. But that appeal process is the one that this report says is not really effective in Victoria. Sad to say, there was a case where both these concerns were justified. It so happened that they were shown to be justified concerns. A customer made a contribution of 1.9 million to get two 60 KV lines from a factory to the terminal station. The terminal station is a boundary for the

distribution system as such. This payment covered the full cost of one line, half the cost of another line, as it was upgraded from 22 KV, the cost of connection assets at the terminal station and the cost of connection assets at the customer's site. So in effect he has almost had the full facility.

The contribution was made after a regulatory asset base was established, because before the setting up of that regulatory asset base customer contributions were supposed to be in a sense rolled into the asset base. But from the moment the asset base was established, the customer contributions had to remain outside the asset base. As such, the 1.9 million is not included in the regulatory asset base for the distributor. There was a specific tariff set for this customer for in the pricing review and it did not give any credit for the 1.9 million contribution. The decision by the ORG to approve this tariff was appealed to the appeal panel which was constitute under the ORG order, who held that they had no jurisdiction to hear the appeal as the approval of a tariff is not a determination by the ORG. So that appeal was failure because the panel said they had no jurisdiction.

Effectively this 1.9 million contribution by this customer is a loss at the time the industry was struggling to make a profit. It's a lot of money for an industry, 1.9 million. For distributor it would be not much, but for a customer it is. The distributor was able to shield under the ORG determination, which said that the tariffs had to lie between the upper bound of stand-alone costs and the lower bound of marginal cost. The determination gave two bounds as such. There was no specific requirement to give credit for customer contributions, nor their portability when tariffs are created and changed. They are important considerations because that's where double-dipping is happening, and it's actually happened there and there was there was very little of course the customer could do. His chance of going to the appeal - he had tried to go to the appeal panel - just taken out.

So these are problems you have and these actually were brought up before in 1995 and seem to have fallen through the cracks as it were. The sad thing is that this rural distributor was also given a raw deal by the ORG. That's sort of sad in a sense. Being given the biggest price reduction out of the five distributors almost twice the price reduction of a very well-endowed urban distributor. I'm talking of an urban distributor - I said well-endowed in that its customers are more affluent, more densely packed, and this distributor happened to have the highest franchise fee.

I'm not sure whether you're aware of what happened in the Victorian situation. The franchise fee was a means whereby the government said, "The business is allowed to make a certain return and if you have excess of that we'll draw that back, as it were, to living on franchise fee." This distributor-retailer combination had the biggest franchise fee, and still this rural distributor got almost twice as big a price reduction than this urban distributor as such. It seems like a knee-jerk reaction that when the rural distributor is under pressure he applies the pressure onto somebody else as such. This distributor unsuccessfully challenged the decision of the Supreme Court and now, according to a recent paper, has decided to get out of the distribution

business. So there seems to be a problem there if they're driven to the extent of saying, "Hey, we've got to get out of the business now." Maybe the decision they took was wrong, whatever it is, but this needs to be looked at by a panel like yours because these are very important matters that are coming up.

Of course, that doesn't mean that - I was talking about this particular distributor but also as a residential customer who lives in that distributor's area as such. If you sort of think in terms of the pricing review, in glowing terms it said that prices are going to come down by 19 per cent for some people, for 12 per cent for other people and so on - that this has filtered down to the customers? I'm sorry to say, no. I as a customer in that area have had a price increase of about 10 to 15 per cent. Considering the fact that net field prices came down, considering the fact that the energy prices before that - I'm talking now of vesting contracts because before you stop being a franchise customer the franchise customers were covered by vesting contracts which the Victorian government gave. They were originally set at something like about $14, which is about 4 cents per kilowatt hour. That's far above what the market price had been. Now there had been sort of moves, the marketplace had been moving up, still that 4 cents was too large and it should have decreased.

So there were two things: net field prices came down, the franchise vesting contracts were being (indistinct) and also the franchise fee was being taken out. In spite of all those three things the prices to the customer still went up. Therefore what I'm saying is the regulatory benefits did not flow through to the customers in that particular instance for that particular business.

MR BANKS: Mr Perera, perhaps just to remind you, this inquiry is about the general access provisions of the Trade Practices Act, IIIA, rather than the energy market reforms as such. I think you're getting into a level of detail here that really goes beyond the capabilities of this inquiry. We'll certainly have a look at that earlier Trade Practices Commission publication. I do recall seeing that at earlier times. But perhaps if that's the main focus of your comments - - -

MR PERERA: No, I will come to something more because whatever is going to (indistinct) the regulatory regime as such was really not approved at this stage. They gave a view and they highlighted some areas of concern as such. In terms of the peak body prior to the commission sort of looking in terms of how the access arrangements had been down the line has been sort of worked up - needs to look at whether these concerns were brought up are valid and something needs to be done about it. These were just examples to show why I'm saying that these things have not been working properly sort of, you see.

MR BANKS: Okay. How much more time do you think you need to go through these points?

MR PERERA: Another 10 minutes, maybe less even.

MR BANKS: Okay.

MR PERERA: Next I want to highlight the unintended consequence of the asset value adjustments involved in the Victorian approach to the allocation of cross-subsidies. As I said, they sort of distorted the price in terms of assets were written up and assets were written down in certain areas. During the SEC days when there was uniform pricing in Victoria, the small rural customers were mostly subsidised by a very large number of commercial and urban small customers, because in rural areas, the density of population being very scarce, the costs were high, so they were the main beneficiaries of the cross-subsidy. The asset adjustment only met part of the high cost of serving rural customers.

Initially the target differential between urban and rural was going to be 1 cent in the net field prices, but this was raised to 1.25 cents because of the impact on asset values when it came to the sale of the assets. The asset adjustment only met part of the high cost of serving the rural customers. Now, mostly the large customers in rural DBs had to meet the subsidy shortfall, because the subsidy is now confined to the rural DB as such, so somebody has to meet the shortfall and it is these large customers. To do that, the premium is as much as 40 per cent sometimes. So the large customer in a rural DB, maybe down Stud Road because Stud Road is a boundary - and one side of Stud Road a customer pays 40 per cent more than if he was on the other side of Stud Road. So because of this cross-subsidy now they have a smaller number of customers.

Although the distribution (indistinct) of a large customer is not as high as for a small customer - for a small customer distribution charges are about 60 per cent. For a larger customer it's about 40 per cent, but now 40 per cent on 40 per cent, you get a 40 per cent difference. That's still a quite large amount for the customer. So the impact on the bottom level of a large customer is significant, especially in the context of the economic conditions as they are today. This is another reasons why the problems that were highlighted in this report are important.

Then I want to make some general comments in terms of coming out from the (indistinct) on this one to things like trade-off of equitable prices and availability of facilities. We were talking earlier of equitable prices and availability, and availability in terms of investment. So there was concern in the market, especially in the generation market and electricity, where the prices were not enough to encourage investment. But there were some problems in terms of availability because in the national market the arrangement to make it available, the obligation to supply, in a sense rests with NEMMCO. NEMMCO is having the power in a sense to say, "Okay, we want some new investment," because they have a six-month time period to say, "Okay, there is going to be a shortfall, therefore put up (indistinct)".

The generators in a sense also didn't want to invest, not only because the price was so low but because of certain other things, vesting contracts coming in. So in effect to say, "Okay, because the price is so low there's not enough investment," is

not a good argument, because one of the things I sort of worked on when I was in the (indistinct) was there were other areas where the shortages could be met. One of them was increasing the link between Victoria and New South Wales, and now Vencorp has said, "Okay, that is now feasible," and they're sort of going ahead and doing that. Then there were a number of stations which were mothballed. At one time they said, "Okay, Newport is going to be mothballed," so they sort of closed down Newport. The point was, if you had facilities which could easily be brought on stream in preference to somebody who was investing money and then (indistinct) market, then of course that person is going to meet the market. So it's a draconian sword that is hanging over this new investment because there are some other things which can easily come on.

So then you also have to look at - it's not good that the investments are now driven by the prices as such. In the old scenario the question about prices was, if the prices are low, there's excess demand, more demand comes in, because the prices are met by supply and demand conditions, and therefore, because the SECV was charged with obligation to supply, they needed to put in more and more generation. The time the prices were set sort of more or less that level of prices still continued and in a situation where there's no investment coming, as far as the ACCC was concerned, was because there was limits being placed on their capability to raise loans. Then again because the nature of the business was such that if you had to put in some extra facility, you brought in a facility, the plan for it, and you took a loan to meet the cost of that. But if your loans were being cut back then of course you won't have an investment or due to the investment they started (indistinct) had to be curtailed because they were not able to bring in the loans and therefore their costs soared up. So investment and prices has a little more implication than in a straightforward arrangement, especially in infrastructure.

The other thing is that we have a situation where most industries, we talk really of the public benefit of having the infrastructure like electricity. In most industries the market works because, like Adam Smith said, there is a supply and demand and that's the invisible force. So invisible force means that if the supply side prices too high, demand side will fall off. So that's the invisible hand that guides the markets. But in electricity you can't have that, you don't have that, because the customer who continues today will get his bill maybe two months, three months after the consumption date and the price is set every half an hour. So the customer doesn't know the price as such, so therefore this invisible hand, the arrangement breaks down.

So it's not a free market in that sense. However much you might talk of increasing supply side competition it won't in this free market situation. So the free market situation requires that the demand side also can take off supply when there's a problem. Now, electricity I just mention to the panel sort of for information, that SECV those days had arrangement that if there was a strike in the valley they would put out a public statement and appeal to the customers and we always had the significant demand reduction and so much so that before we had the restructuring for

the last 10 years or so we didn't have a supply breakdown because there are work problems in the valley and when those things happen you put all on the statement and plus their public view was that there is a (indistinct) and they dropped their consumption.

Now, that was listening to the market. So there has been various ways where the market has been met. But how you have a situation where those things aren't likely to happen because all of these things are now by contract. So I have a contract for somebody to supply me electricity and why should I go and switch off my light, because I have a contract? So these are problems really that come up in the market. So the market, insofar that you can say if you have only competition supply that you don't give this facility or don't have this facility for one side to come in, then it's a problem.

I want to also touch on this question about funding arrangements because that's something which I've been sort of trying to take up with a couple of other organisations elsewhere and I thought I might sort of make my point here as well. Now, we heard earlier about customer groups wanting to have funding arrangements and so on and in fact one of the customer groups wanted me also to do a bit of work for them and I said, "Okay, I will do some actually, some modelling and sort of tell you exactly how you stand and so on, and you can then use that information in a sort of enlightened manner to sort of argue your case," and they said, "No, no, we want you to write reports doing this sort of thing." I said, "No, sorry, I won't do that report," because what is happening is that you need to do an analysis which sort of looks at all these things within the perspective and you get a sort of all-round picture then, you see, and that, as I said, has not been done.

If you said okay, you want to sort of arrange for customers - these things to be funded, I would also suggest there should be some funding arrangements for independent research where you look at the total picture, than only look at newer sectors of the industry as such. Yes, I think with those sort of, in a sense, jumbled up set of points that I made - I'm sorry if they were, in a sense, a bit jumbled up - I sort of rest my case.

MR BANKS: Thank you very much for that. As I say, a number of the points that you made I think are broadly relevant. If it's possible for you to give us your typed script later for us to look at, I think that would help in terms of us taking on board the things you've said. I had no particular questions, I don't know about my colleague.

MR COSGROVE: No, except perhaps to say that we did have a look recently in the commission at a lot of these problems to which you referred concerning how the implementation of the competition policy reforms affect people in different regions and cities versus country areas, and that report might be of interest to you. It's not as though we're not cognisant of them ourselves, but we did - - -

MR BANKS: We'll take a copy of that document.

MR COSGROVE: Yes, so we can identify the document, yes.

MR BANKS: I've probably got it somewhere but I'd have difficulty finding it. I guess the other point just to make to you - I mean, I take your point about the public interest and perhaps the lack of consideration in here about how in practice that comes into play in terms of Part IIIA and it might be something that we think a little bit more about. It's assuming more and more significance I think in the debate and may well be something that we look more at and indeed, as I was saying earlier, it's a consideration that some people raise in relation to the potential role of ministers or how many regulators you have in the sense that there are many subjective elements in the public interest that are very demanding in terms of the discretion available to a particular administrative or regulatory body. So we will give that some more thought. But look, I think given that it's the end of the day and that we've accommodated you at the end of the scheduled day, we might close there and thank you very much.

MR PERERA: I might just add a little bit of comment in lieu of what you said, because at the moment what happens, the supply side as I was saying before, is more or less the wholesale area and the demand side, which is more to do with the retail part, is left to the states because states have more or less kept back, as it was, the retail market aspect of it, you see, and what you're saying is true in that that is because of the political impact when you come to the retail customer as such, as opposed to the wholesale customer. So in the national market, although I've been arguing to say, "Hey, if you're talking of a national market it can't only be a wholesale market" - you can't have a national market and say that's only the wholesale. Then you must say, "Okay, national wholesale market."

But then you can't sort of differentiate because when you come to this full contestability it has to be opened up, and that's one of the sort of main problems that we're having at the moment, you see, because how do you sort of, you know, accommodate holding the national market then. The structure is in a sense - as I said, the ACCC also had this public benefit criteria to look at, but not properly sort of been looked at because they're not the people who are looking at retail, in a sense. So again some sort of arrangement needs to be worked out, but I'm not sort of suggesting any particular one but saying that there has been a sort of a bit of a crack where things have fallen into, you see.

MR BANKS: Okay, thank you very much. We will adjourn the hearings now and we will resume tomorrow morning at 9 o'clock with the Energy Users Group. Good, thank you.

AT 5.19 PM THE INQUIRY WAS ADJOURNED UNTIL
TUESDAY, 29 MAY 2001