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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 TUESDAY, 29 MAY 2001, AT 9.40 AM

Continued from 28/5/01

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MR BANKS: Good morning, ladies and gentlemen. Resuming the commission's hearings into its position paper on the national access regime. The first participants this morning are the energy users group. Welcome to the hearings. Could I ask you please to give your names and your positions please.

MR DOMANSKI: Thank you, Mr Chairman. It's actually the Energy Users Association of Australia. Perhaps just for the record you might correct that. My name is Roman Domanski. I'm the executive director of the Energy Users Association of Australia.

MR REICHEL: Alan Reichel, I'm the director of gas markets for the Energy Users Association of Australia.

MR BANKS: Thank you. Could you perhaps just begin by telling us a bit about your organisation and who it represents.

MR DOMANSKI: Sure. It's an organisation that represents end-use customers. Most of our members are larger users of electricity and gas. We cover both areas and we've got a national perspective so we look at issues at the federal level as well as at the state level and across different regimes that are in place on a national basis as well, but purely electricity and gas.

MR BANKS: Would you overlap with other user groups or large companies that may be involved in the hearings?

MR DOMANSKI: In terms of membership?

MR BANKS: Yes.

MR DOMANSKI: I'm not quite sure who else is involved but it's quite possible that there would be some overlap in terms of membership, yes.

MR BANKS: We had BHP, for example, here yesterday providing a submission but are they a part of your - - -

MR DOMANSKI: BHP are members of the association, yes.

MR BANKS: Okay, thanks for that. As discussed, thank you for the outline of your submission and I believe your submission is coming a little bit later. But you provide quite a helpful outline of that and I'm happy for you to draw on that and then we can have some discussion about the points you raise.

MR DOMANSKI: That's fine, Mr Chairman. Maybe just one point before we commence. We have put a fairly expansive record of notes to you. The reason for that is (a) we hadn't previously made a submission and (b) it hasn't escaped our attention that in terms of the submissions that you have had up to this point probably in terms of the participation in these hearings as well, there is a fair dearth of representation from end-use customers in the electricity and gas area or focusing on

the electricity and gas area. We thought it therefore important that we do put to you a reasonably expansive set out of what our views are on the issues and responding to your position paper.

MR BANKS: We appreciate that.

MR DOMANSKI: I just wanted to let you know that. Perhaps we will commence and we are more than happy to truncate this presentation a little bit and allow you to ask us questions and spend most of the time on that. First of all, just to say formally that we welcome the opportunity to make a presentation to your inquiry into national access regimes and we welcome the fact that the PC conducts public hearings and does so in an open and transparent manner. We see that as very important in terms of being able to get our points of view across to you and also in terms of the quality of the decision will emerge from this review. I just wanted to say that as well. I know the PC and its forerunners have been sticklers for transparency and publicness and so I'm glad to see that continues from the time that I used to work for you guys.

Our comments will naturally focus on the electricity and gas sectors which is the area that we represent in terms of end-use customers. We note that your predecessor organisation did estimate large gains from the Hilmer competition reforms and including the access issue which was a significant factor in those gains. Also that one quarter of the gains that were estimated in that report by the industry commission actually relate to energy. Clearly this is an important issue for us and our members. Many of our comments that we make today and in our submission are based on the substantial experience that we've had in dealing with access issues and monopoly regulation issues right across Australia across different regimes in the electricity and gas areas from an end-use customer perspective.

Also important to say is that we do believe, based on our experience, that national access regimes and the national electricity code, national gas pipeline access code have brought benefits to end users and to the Australian economy more broadly. What we intend to focus on today is give a little bit of an overview of our position and our response to your position paper and then really try and hone in on a couple of the specific areas that we think are particularly important in terms of this review. So we certainly have noticed from the submissions that owners of infrastructure are generally opposed to access regulation and have advocated arguments for why there should be less regulation or even no regulation. That's not surprising to us as really any form of access regime will limit their ability to confer or deny access on such terms as they think fit.

We consider light-handed regulation in the form advocated by infrastructure owners will likely allow monopoly rents in energy networks to persist and to lead to dead weight losses in the economy. The reason why we see access to infrastructure as economic welfare enhancing are really twofold: firstly, that monopoly or near monopoly facilities in energy mean that users are exposed to the extraction of monopoly rents or the denial of access to them. Combined with this that energy networks are among the most important determinants of international competitiveness of our economy and engendering competition in upstream and

downstream markets means for users lower prices, a choice of provider, more innovation, better quality service et cetera.

Unlocking these benefits depends critically on the terms and conditions of access including the prices charged by facility owners, quite importantly. We're pleased to see a recognition of these sorts of factors in the PC's position paper and we urge the PC not to resile from that position in its final report. Our experience with economy regulation in Australia clearly shows that infrastructure owners are good returns and investments in energy infrastructure have diminished due to existing regulation and that's a point that I will return to later on and cover in a little bit more detail.

Just looking at your position paper and I'm not sure to what extent you want me to cover these points in detail, but we have outlined a series of responses to what we say as your main areas. I might just say in an overall sense - - -

MR BANKS: I'm happy for you to go through it. If you don't mind us perhaps stopping you on the way through and we can have some discussion. That might be a way of covering both sides.

MR DOMANSKI: No problem at all. What we would say up-front and as an overview is that we're pretty supportive of what the PC has put in its position paper. We have a few areas where we're still getting clarification or we might have a few concerns but I think generally the approach, the direction we don't have a great deal of problem with. I wanted to just say that as an overview thing. Also just to make it known that whilst we believe that you're correct in your conclusion in the position paper that there's not a need for significant change to the existing regime and indeed, it's probably premature in some ways to engage in significant change now. Nevertheless, we do also have a view that it's very important for you and for others that will follow your review to ensure that there are continued improvements to the regime over time.

We definitely see it as an evolving thing and that's very important to us that there is a mechanism to allow that to occur. Our response to specific proposals that are put in your position paper are as follows: we certainly agree that there is a need for a clear objects clause to be included and that a generic framework is important for disciplining industry and state specific regimes. We also see value in the inclusion of an economic efficiency test or objective in that clause but we call upon the PC to make clear that competition is normally the best way to ensure economic efficiency. We don't really have a problem with including that criteria in there, but we just think it's important to make clear that competition is normally the main means for deriving that, although we would acknowledge and agree with the comments made in your paper that it's not always necessarily going to be the best means. We also support the coverage of both vertically integrated and non-integrated facilities or the continuing coverage of those.

MR BANKS: Just on that, Roman, it has been argued by some that the non-integrated facilities having no incentive to deny access are not well suited or

aren't really the primary target of the IIIA regime and that indeed if there's any problem there then it should be picked up through the PSA or some version of that. I'll perhaps just give you the opportunity to respond to that.

MR DOMANSKI: I can only comment insofar as the energy sector goes because I don't really have a brief to comment beyond that so I want that to be made absolutely clear. But I guess our concern there is that the need to ensure that non-integrated facilities don't extract monopoly rents. They're still in a position to do that. I guess you could cover that by regulation, that's one way of doing it. I'm not sure whether the PSA Act is necessarily the best way to handle that. I think there would probably have to be some significant changes to that act before end users could feel comfortable about it. I don't think it was really set up or intended when it was established to deal with this kind of issue which has really come along in the intervening period through changes to economy etc.

There are regulatory regimes in electricity transmission, in electricity distribution and also in gas transmission and distribution. We'd seek to regulate the behaviour of monopolies by imposing some sort of pricing disciplines on them and we see those regimes as of value. I'm not sure whether they, strictly speaking, fit into the access regime, but I guess what we're saying is that we would be concerned if this sort of industry was removed from the access regime and that led to any kind of flow-on effects in terms of other regulatory regimes and some movement away from where we are now in terms of regulating those sorts of facilities. That I think is an important issue for us that there isn't that movement away.

MR COSGROVE: If you have the time in formulating your submission to have a look at the recent submission from the Institute of Public Affairs, it's number DR57 which does contain some extensive argument on this matter. I would be interested to see what you think of that.

MR DOMANSKI: I've had a few debates with - I assume it was Alan Moran.

MR COSGROVE: Yes.

MR DOMANSKI: Yes, with Alan about these issues. I think it's probably fair to say that we don't see eye to eye but we respect each other's views.

MR REICHEL: If I can just go back to one of Roman's early points in terms of support for the existing regime. This is a review that's being done five years after the initial agreement was set up and it would be fair to say that the process is still fairly early on and it's in its evolution with the first round of access reviews not yet completed and the first review here in Victoria being first cab off the rank by the ORG and the ACCC only being finalised in 1998. So it's still early on in its evolution. It has got a long way to go. But we are strongly supportive of the existing regime.

MR DOMANSKI: On the issue of pricing principles we see that as an important one raised in your issues paper and we're glad to see it there. We agree with the need

to include such principles, however, we just wanted to emphasise that they need to be effective to be of any use. Again, that's based on our experience. It's an easy thing to say, it's not perhaps such an easy thing to do and we've just been through a fairly torturous process with IPART in New South Wales on a pricing principles working group where it's probably taken the best part of 18 months to come up with a set of pricing principles to apply to the New South Wales distributors. I'm certainly not saying they're perfect but I guess what I'm saying is - I'm not sure if IPART has made or is intending to make a submission to you, but I would just probably recommend to you that you have a bit of a look at those pricing principles because, as I said, they're not perfect but they are at least an attempt to get some sort of principles in place.

For the most part we had no difficulty with the points made in your paper especially the need for facilities to meet efficient long-run costs to earn a return commensurate with the risk that they face. For their prices not to be so far above costs as to detract from efficient use, to facilitate multi-part tariffs and efficiency promoting prices, and not to permit price discrimination in favour of vertical integrated operations within those facilities. We are concerned to see that there's no scope to extract monopoly rents, or to practice monopoly price discrimination, which will require well framed and tight guidelines, plus some monitoring and enforcement mechanisms to see how those principles and guidelines are actually operating in practice.

MR BANKS: Could I ask you perhaps there to just comment on your opposition to monopoly price discrimination. I mean, you would be well aware of the basic problem you have here in relation to efficient pricing and for the facilities to recover their fixed costs. So there's sort of the gap between average cost and marginal cost and ways of dealing with that. Could you comment on why you would rule out what otherwise would be seen as perhaps efficient price discrimination?

MR DOMANSKI: Yes, okay, well, I guess an old saying here would probably have some application. It's sort of a case of once burnt, twice shy, sort of thing, but our concern here I guess is from a sort of principle point of view that monopolies, or near monopolies are in a pretty powerful position, and their position is really asymmetric, even in terms of most large customers. I mean, when you sort of think about it, a monopoly kind of has 100 per cent or close to 100 per cent of a market, and even large customers in electricity would be consuming only a fraction of that, and we see many examples where in the electricity area and the gas area where customers suffer the disadvantage of that. For example, a number of our members have tried to negotiate individual tariffs for their use of networks, both in Victoria and New South Wales, and you wouldn't even need the fingers on one hand to count the number of cases where they've been successful.

Now, more recently, what we've seen in Victoria is in the aftermath of the regulator-general's price review, a process of implementing new tariffs, which was, to be kind to it, far less transparent than the process of undertaking the price review in the first place, and the implementation of new tariffs as a result of that was largely done almost behind closed doors between the regulator and the distribution businesses. Now, what emerged from that was of great concern to a number of our

members, and in particular TXU and United Energy, two of the Victorian distributors have implemented that price review by introducing tariffs that disadvantage larger sites, including in some regional areas. These are arguably examples of inefficient monopoly pricing, which the price caps and the side constraints that are an important part of the price review determination, seem incapable of preventing. Our analysis of a selection of sites from our members shows that some have actually had distribution price increases, and that many have had decreases well below the lower bound of those price constraints.

Now, just keep in mind here that - just going from memory here - but the average price cap reduction in year one, that's 2001 for this price review, was CPI minus about 15 per cent on an average for the six distributors. In the case of TXU, it was CPI minus 18 per cent. In the case of United, I think it was CPI minus 12 per cent or something like that. But some of our members on some of their sites have seen actual price increases, so that's the sort of - we would argue that there's a prima facie case there for the practising of some inefficient monopoly price discrimination, and that's the sort of thing I guess we're trying to avoid. The expectation of all customers I think was that with those sorts of price reductions on offer through that price review, that there wouldn't be anyone in Victoria that actually saw a price increase as a result of that price review. Now, we don't fully understand all the reasons behind that price discrimination that's been going on in the implementation of that review. We've raised it with the regulator-general. I think it's fair to say that we haven't had a response that satisfies us, but that's the sort of think I guess we're trying to guard against in future, and that's made us more cautious than we probably were before about this particular area.

MR BANKS: Okay.

MR COSGROVE: So in terms of handling the gap between marginal costs and average costs, what's your preferred approach, a multi-part pricing formula, is it?

MR DOMANSKI: Yes, we certainly see benefits in that sort of approach, but I guess whilst we were probably once of a view that there should be a relatively liberal approach applied in terms of things like side constraints on price caps, that we would now probably take a more cautious view of how those side constraints are applied. Having been through this fairly bitter experience for some of our members, I think it's probably made us a lot more cautious about what even large users can be exposed to.

We also see worth or benefit in the use of a substantial increase in competition test - uneconomic for anyone to develop a second facility test for declarations. However, in saying that, we also thought it important to note that in putting something like that forward, the PC should ensure the legal interpretation of a word substantial competition, which does have a very long history of legal interpretation under the Trade Practices Act, as I'm sure you're aware, is appropriate for access, and that also care is needed to ensure that cosy infrastructure geopolies don't develop as a result of a test like uneconomic for anyone to develop a second facility. So they're two comments that we wanted to make.

We strongly endorse your proposals that access seekers be given sufficient information to engage in effective negotiations, and we believe that in implementing that, it's important to establish some useful guidelines that would apply both to the owners of facilities and those people seeking access. There has been, just point out that there has been some work done in this area, and just from the electricity point of view, there has been some development of negotiating guidelines by NECA in terms of a number of reviews they've been working on in the network pricing and network regulation area, and there are a series of code changes before the ACCC at the moment resulting from those reviews that do address this issue to some extent. So again, it's probably worthwhile for you to have a look at that, because we would, I guess, support a lot of the direction that those guidelines go in. There may be a bit of a question about some of the detail and whether they go far enough in some areas in terms of the asymmetry between owners and access seekers.

MR REICHEL: It's certainly not a problem just restricted to electricity. We've had the same problem in respect of gas too in that the lack of information that has been provided, the lack of compliance with the code requirements, and in particular with attachment A of the gas code. In a number of access reviews in the states, it's meant that those reviews have taken a lot longer than they would have otherwise needed to take, so it's an area that needs some attention in terms of allowing access reviews to be conducted in a timely manner.

MR BANKS: In finalising your submission, you might have a look at the submission by Freight Australia, which we discussed yesterday, and they had particular views about this subject, and indeed were casting some doubts about how well guidelines could be devised that would meet the objective here without causing other difficulties, and indeed commented on the problem of a sufficiency requirement and how that could be interpreted. But you might just have a look at that.

MR DOMANSKI: I haven't seen it, but just off the top of my head a bit, but based on some of the experience we've had, I'm sure that a number of the points that they're making are very relevant, and I have no doubt that there would be difficulties in developing any set of guidelines, and that's been our experience as well. I guess the comment we make on that is it's probably still better to have some form of guidelines than no guidelines, because in no guidelines, you're kind of in the law of the wild west almost, and I think it really does expose customers. Now, I'm sure that any guidelines that are developed would be less than perfect. I guess the issue here is more one where we're not in a perfect world here. It's probably a matter of can we get to a more perfect world than the one we're in, and I think probably some intervention, if I can put it that way, in terms of having things like guidelines are quite important in getting to a better world than the one we're in at the moment.

MR REICHEL: It's not without its problems, that's for sure. Derogations are obviously going to sit there as a fairly central sort of an issue, and we've recently come across a derogation problem in Queensland in respect of the ACCC review of the Roma to Brisbane transmission pipeline where the derogations there have meant

that it's very difficult for interested parties, such as users, to comment effectively as a part of that review.

MR DOMANSKI: We generally agree with the proposals on the negotiate-arbitrate arrangements. However, we are concerned that a provision specifying the aim of arbitration is to promote the efficient use of and investment in infrastructure could be open to gaming by facility owners, and we believe that probably some further attention to those words and the sort of desires which surround them is needed, and probably some tightening up, I think. We don't really have a problem with what you're trying to achieve. I guess it's just an issue about whether this really covers it, and whether there's some further thinking needed on that.

MR BANKS: You're referring here to the overall sort of objects - - -

MR DOMANSKI: Yes, that's right, yes.

MR BANKS: Could you just elaborate on that a little bit. I mean, some have said to us that really the primary objective is about efficient use.

MR DOMANSKI: Yes.

MR BANKS: In a sense, the secondary requirement is that in achieving that, you should preserve incentives for efficient investment, and they've seen it more in those terms rather than in a sense them being dual objectives that both need to be actively pursued through an access regime. But is that your own sense of concern there that they get, in a sense, equal billing as sort of active objectives?

MR DOMANSKI: Yes, probably. I guess the other important issue for us is that efficient use of the facilities does not become a smoke screen for avoiding the granting of access and I guess particularly the sort of benefits that could come from upstream and downstream competition through the granting of that access - that's really the sort of nub of our concern I think - and to just have something like promote the efficient use of an investment in, without going a little bit further, I think probably makes it a bit more prone to people gaining the use of the words "efficient use and investment in". I think that's really the basis behind the concern we had when we looked at this.

MR BANKS: But does that reflect a larger concern that achieving efficient use of the infrastructure would still - I mean, that you could have a situation of inefficient use that still would provide other benefits that overall would outweigh added efficiency?

MR DOMANSKI: No.

MR BANKS: Well, it might be worth trying to elaborate on that in your submission if you want to - - -

MR DOMANSKI: Well, yes, okay. I guess we were kind of throwing the ball

back in your court, maybe a bit too much.

MR BANKS: I guess we would see that if you had efficient use of the infrastructure then that in a sense would be the broader optimum as well, so it might be worth just provoking us a bit more on that in your submission.

MR DOMANSKI: Okay, we'll try and do that.

MR BANKS: Thanks.

MR DOMANSKI: Thank you. We also support the inclusion of principles for assessing effectiveness of access regimes along the lines outlined in your paper but have a couple of suggestions to add to that; first of all, that we don't have a problem with what you're basically proposing but we feel that appeal and enforcement must be effective as well as cost-effective. I think you used the words "cost-effective" in your proposals but we think that that's certainly a laudable goal but it also has to be effective, too - just cost-effective is not enough we think - and that there should be a requirement for consistency across states unless good reasons to the contrary can be established and substantiated. I've forgotten the exact words you used in your position paper but I think it was "where appropriate" or something like that. Well, we think "where appropriate" is probably a bit loose and to us gives states too much scope to weasel or wiggle out of obligations and they need to be tied down a lot more I think.

We support the changes proposed to access undertakings, particularly the alignment of criteria with those for declarations, arbitrations and effectiveness. For reasons explained elsewhere, we're not convinced that there should be any move towards productivity-based price caps at this stage, even for intraperiod adjustments. I can elaborate on that now or if you want to come back to it - - -

MR BANKS: When we come to it, yes, thank you.

MR DOMANSKI: Okay. We support the proposals to remove ministers from decision-making and to assign a single regulator with responsibility. We believe it should be the ACCC. We also support full merit reviews by the competition tribunal and we support the proposals to increase transparency in Part IIIA but suggest that the PC clarify that all applications will be public unless they are commercially sensitive or raise commercial confidentiality issues I guess. So that completes the round of points that we wanted to make in terms of your position paper. We wanted to go on and cover some specific issues that are of interest and concern to us in terms of your review and, unless you have any further questions on those points, I propose to move on to - - -

MR BANKS: I'm happy for you to do that and we do want to talk a little bit about the productivity-based adjustments but I think you cover that - you'll come to that later so we'll pick it up then.

MR DOMANSKI: Okay. From your submissions we've noticed that - and indeed

through other mechanisms as well - we've noticed that infrastructure owners have been clamouring for a change to light-handed regulation without, however, really specifying in their submissions what they mean by this. The Energy Users Association is not an unqualified supporter of the existing approach to regulating infrastructure monopolies in Australia. We see the current regime as having some warts and needing to evolve towards something better over time. But neither to we support a radical movement towards something else, whatever that something might be, without knowing exactly what it is and what its impacts will be, especially when it's advocated by facility owners, I guess I could add, who have a clear vested interest and do a lot of their thinking on these issues in isolation from their customers, and that would require really a gigantic leap of faith on our part and a trust in them, at least as far as energy networks go, which we don't have at the moment.

We do not accept the assertion of facility owners that they are hard done by by the existing regime and that it amounts to heavy-handed rate of return regulation. The regime that is used relies on incentive mechanisms to give regulated businesses the incentive to pursue greater efficiencies. They then get to keep these for several years before they are returned to end users and these incentives are designed to ensure that businesses pursue them on an ongoing basis regardless of the timing of regulatory resets. The position adopted by regulated energy businesses has recently been tested in the Supreme Court of Victoria in the appeal by TXU against the Victorian regulator-general's electricity price determination of late last year. TXU appealed on the basis that the regulator had exceeded its authority not applying incentive-based price caps but rather rate of return regulation. The PC may be aware that on 17 May Gillard J dismissed TXU's appeal, concluding that, "In my opinion, the price fixing methodology was incentive-based and so was the result. It was not rate of return methodology." This decision sets an important legal precedent on economic regulation in Australia and puts a stake in the ground on the issue of incentive regulation and how to apply it. We believe that the PC should take note of that decision.

MR BANKS: Just on that point, because you refer to it a few times, as you know there is an issue with CPI minus X for example in that over time it can collapse back down to a cost-based or indeed rate of return regulation and you have a quote from Whittington on the very next page which makes that point.

MR DOMANSKI: Yes.

MR BANKS: So I just wondered whether that in a sense is a contradiction of the point you're making. I mean, you're trying to make a strong point here about incentive-based regulation being just that but on the other hand you were also worried about gold-plating and so on that's been occurring and you've got a quote from Whittington that kind of gives a theoretical reason as to why things can collapse into rate of return regulation. Do you want to comment on that?

MR DOMANSKI: Well, only just to make a couple of points I guess. One is that again we're not in a perfect world here and economic regulation is certainly less than perfect and it is a science or a practice that is still evolving in many ways. I think it's

important that Australia contributes to that evolution and learn from overseas experience and developments in the literature et cetera on this, and it's important that we don't stand still. I guess what our position is is that the current regulatory set-up is serving us reasonably well and the current methodology that's practised at least in relation to energy utilities is serving us reasonably well. We don't want to throw the baby out with the bath water but by the same token we don't want to stand still either. So we I guess believe that the current approach certainly does provide some incentives and is basically an incentive-based approach. We also recognise that in the medium to longer term it's quite possibly going to lead to some disadvantages that will become more evident over time and that therefore that's recognised and there's a process almost put in place to deal with that.

So we for example would see it as important, and we suggested this to various regulators around the country, to the regulators forum that exists, that probably a body like the regulators forum needs to have - or it could be the PC even - needs to have a research facility which contributes to that debate and that evolution of regulation over time and make sure that there are things done which can improve it. We've got sort of I guess a couple of issues there that I was going to cover later on but I'm happy to cover them now in terms of what regulator businesses like to call "a peer incentive-based approach" and I guess they point to things like total factor productivity and DEA as being examples of that. Well, we probably agree that in theory or in principle it would be preferable if we could move to means of regulating like that. I guess the difficulty we have is several-fold in terms of that, first of all, that the overseas experience kind of tells us that anywhere where that's been tried to date, it hasn't been a roaring success and there's been some movement back towards a more intrusive kind of regulation.

MR BANKS: When you say it's been tried, do you mean TFP-type adjustment mechanisms?

MR DOMANSKI: Yes, there's been some attempts to do that in the US, I think in gas, Alan, is one area, and I guess the general view to date - I could probably - I've got a couple of papers on this buried somewhere that I could probably dig out for you if you're interested.

MR BANKS: Okay, that would be helpful.

MR DOMANSKI: But probably the general view has been that it's had a pretty mixed track record basically. The other things that concern us I guess are things like, to make that kind of regulation hang together you've got to have good numbers and numbers that people can trust on total factor productivity. We haven't go that at the moment. At least, in energy we haven't got it; I don't know about other industries. But in energy we don't have even an historical series, let alone an ability to sort of project forward and that, it seems to me, is a major stumbling block. Now, that's probably one of the areas where I'd say, "Okay, we haven't got it but we should be doing something about it" and I would probably say and recommend to you that that is one area where some sort of research facility could do some very useful work.

MR COSGROVE: ABS estimates don't exist in that area?

MR DOMANSKI: No, I don't believe that they're robust enough to deal with this issue and I think there's a need for - if we were to go this route I think there's a need for separate collection basically and to start developing a series. One of the things you've got here is, if I'm right and there isn't really a trustworthy or reliable historical series, then even if you started collecting it today it's going to be a number of years before you've got enough data to kind of move forward. So there's that kind of issue in there. I think the other issue is that what also needs to happen is we need a bit of a stake in the ground in terms of what the costs of these businesses are. Are they efficient, because if we start moving down this track I think we've got to have reasonably trustworthy benchmarks in terms of the costs base that we're starting with, and I don't think we've got that yet. Even in areas where we've been through regulatory resets, like in electricity in Victoria, in New South Wales, I think we don't have enough faith in the numbers that are coming out in terms of Capex, Opex, that they give us a good stake in the ground. So, again, I think that's an area that could take a bit more time to get to the point where we can all sort of have that trust and where we're sort of moving forward from.

I guess the other issue that's important to us is that in any of this kind of development work it's important that end-users are actually included as part of the process and involved and consulted on what's going on basically. I think they're probably the main points that we wanted to make in that area. In fact a lot of these points were the next ones that I was going to make anyway so I'll perhaps move on. We sort of believe that as a result of all that - and perhaps somewhat unfortunately including for users like larger ones, our members - we need to be rather more cautious and intrusive with regulating energy networks at this stage. We hope that that does change in the future as we become more experienced with regulation, as the developments in regulatory practice both here and overseas, and as network monopolies become more efficient and customer driven.

As I said, we'd certainly support processes that ensured there's a continued evolution of the regulatory practice over time, provided this is public and involves end users. Greater experience with regulating monopolies enhance competition between gas and electricity and the advent of things like multi-utilities will require regulators to adapt to changing market conditions and adjust regulatory activities accordingly. Just as a footnote here, I think I'd add that our discussions with, and involvement with, at least the main regulators in Australia and I guess the most credible regulators in Australia would indicate that their thinking on this sort of thing is not static, that they recognise some of these issues and concerns and they are genuinely interested in moving the debate forward.

Now, that doesn't mean you don't have to keep pushing them, but I think I do detect that genuine interest in doing it. Those sorts of changes may well make it possible to effectively move towards techniques such as TFP or DEA in the future. But in our view it would be premature and actually probably pretty reckless to move rapidly in that direction now in the energy area. In addition, we also think it's important that regulators should be encouraged to make more use of competition and

contestability in their regulation networks where this is possible. I guess two examples of that, that we've been involved with and that we see and we would like further development in, are things like the permitting of network bypass and a fairly liberal approach towards that, and also the issue of network augmentation, that there can and should be contestability in terms of how networks are augmented and possible competing means there are the installation of embedded generation rather than augmenting the network for reliability or something like that, or the greater use of demand side management as well.

In our view all these challenges require informed, effective and efficient regulation rather than adherence to labels such as light-handed regulation. We think it's more important to focus on those sorts of objectives rather than some sort of cliche. You've already seen the quote from Whittington so I won't bother with that. The next area I wanted to cover is another important one for us, which is really the issue of whether there are inadequate returns at the moment being earned by energy networks and whether they threaten investment in those networks. Now, the owners of those networks have complained that they're being harshly treated by the current regulatory arrangements, particularly that they must operate with set rates of return that are inadequate and provide inefficient incentives for investment.

But in our view the evidence doesn't seem to support them. Their returns are above the average return on shareholder funds for Australian businesses, notwithstanding their considerably lower risk as activities. Moreover the regulatory regime provides incentives and opportunities for them to out-perform those regulated returns. Asset values are set at replacement cost and there are built-in vices in this approach which almost guarantees that the values will be inflated. That to us is hardly a recipe for under-investment and regulators have permitted energy utilities to undertake substantial capital expenditure programs notwithstanding the concerns of some people like end users that those programs are not as soundly based as they should be and that there is insufficient pressure to examine competing alternatives.

These capital programs are also financed out of regulator charges in contrast to competitive industries where investment has to be financed through debt or equity markets. In a recent study for the ACCC the well respected consultancy organisation NERA compared regulated rates of return for electricity, gas and water utilities across the US, Canada, the UK and Australia, and it concluded that - and I quote:

> The average declared vanilla WACC in Australia is significantly higher than those surveyed from the UK and slightly higher than in North America. This suggests that Australian regulated businesses are not under-compensated compared to their international counterparts.

Just for the information of the commission, the results of that survey showed that the so-called vanilla WACCs average 5.6 per cent in the UK, 6.6 per cent in North America and 6.8 per cent in Australia.

MR COSGROVE: Is that NERA paper the basis for these various statements that precede the reference to it?

MR DOMANSKI: Not entirely, no.

MR COSGROVE: Or is there other evidence that you would like to - - -

MR DOMANSKI: No, there's other evidence. For example, we've tracked this fairly closely in all those regulatory reviews that we've been involved in because it's of considerable interest to us and our members.

MR COSGROVE: Well, it's of interest to us too. So I think if you could include this other evidence or at least a reference to it in your submission, that would be good.

MR DOMANSKI: Sure, yes. We actually have a little graph that we regularly update which compares WACCs across different regulatory decisions in Australia and also overseas, and it basically gives you the same result. In fact I would say NERA has probably been a bit generous in some of their interpretation, generous to the network owners that is.

MR BANKS: I'm just wondering whether vanilla was a technical term.

MR DOMANSKI: Yes, it is. It's a regulator's term. Sorry, I mean, once you start dealing with these regulators you get into your own kind of world of jargon and whatever. But basically - - -

MR BANKS: No, I think I get the point of it, yes.

MR REICHEL: We also had access to some work done that looked at rates of return achieved in the share market over the last 70 years. That information is available and on average real rates of return there averaged about 5.8 per cent over those 70 years. In more recent years the returns have been a couple of points higher than that and we took that to be indicative of the top end of the scale where you're looking at a fairly high risk area, so 5.8 per cent. At the other end of the scale 10-year bond rates, you can also access information on that over a similar period of time and if you do that you'll find that the real rate of return here in Australia has been typically, on average, about 2.8 per cent.

So we took the 5.8 and the 2.8 and started to compare those against the real rates of return that were being offered by regulators and being requested by service providers, and there's marked differences. Typically the regulators are looking at somewhere between 7 and 8 per cent and certainly to begin with the service providers were looking at figures in excess of 10 per cent. They have come back to figures a little in excess of 8 per cent typically for gas and also for electricity. But we're still a long way away from the sort of work that we've done, which tries to give us a fix on the relative risks involved and the relative rates of return available on statistics here in Australia.

MR BANKS: Are you talking primarily now about existing businesses or

greenfields? Are you extending this logic to apply to greenfields investments as well?

MR DOMANSKI: We're going to come to that point next.

MR BANKS: So at this point you're not distinguishing or?

MR DOMANSKI: We're talking about mature networks basically.

MR REICHEL: There is a case to be made, a special case to be made we feel, for greenfields developments and we expand on that over the page. That's an important point.

MR DOMANSKI: I should have clarified that at the outset, that we were talking about mature networks. We wanted to make the point to the commission that that situation actually creates a risk for end users, particularly the risk that they're continuing to be exposed to inflated rates of return and inflated rates of return that are applied to inflated assets, which is a kind of double-jeopardy, and that have monopoly rents and uncompetitive energy network charges embedded within them. Our customers have to pay for that. Now, having said that, I did also want to note that we do believe that the application of independent regulation to this area has had as significant impact in improving the situation compared to where we were, say, four or five years ago in this area, in both electricity and gas.

We also note that in relation to the claim that there will be a lack of investment that that has been refuted by a number of other parties and evidence put to the PC has been that, at least the evidence that we've seen anyway, there has been no diminution in investment in gas pipelines for example under the National Gas Access Code. On the contrary, there's a number of examples cited where it has even promoted investment and I think the Eastern Gas Pipeline was one area where that is true. On the issue of greenfields projects that's an area in which we're very interested because we want to see the continuing development of our energy suppliers and our energy infrastructure and the delivery of competition, increased competition, through that. I guess particularly intra-basin competition is important in terms of infrastructure and that's certainly critical to the future needs of our members and their consumption of energy.

The ACCC has recognised the need for greenfields pipelines to earn higher returns, given that they can involve higher risks and less certain demand. We support that, although we would note that in doing that the ACCC has applied those higher returns to a benchmark set of returns for mature infrastructure, which we would argue is already inflated by some other factors. So I guess on the whole you're kind of getting a premium on an inflated return for a greenfields project. So to us that is something that we wanted to bring to the commission's attention. Nevertheless we do recognise that an approach to regulating mature networks may not be well suited to greenfields investments and that is essentially what we've got at the moment, albeit one that applies a premium, and we believe that this is an important area and one that needs further investigation.

Now, having said that, there's also a risk that if you let go completely in the regulatory area that you might just create a set of duopolies, at least initially anyway, and that raises some risks and concerns for us. But we see this as a particularly important area and it's one that we're focusing on within our own organisation and in fact in the gas area we're currently developing internal strategies for three areas, of which this is one, where we're trying to put our thinking caps on in terms of what we believe might be a need to make some changes in how this area is currently regulated. So we don't have any answers for you unfortunately at the moment but we recognise the importance of the issue. We recognise that there are maybe some problems in terms of how we're approaching it and it's something that needs addressing.

Again I come back to the comment I made earlier on, that one thing that I guess we'd like to see is some kind of a process set up where these regulatory issues can be debated, discussed and developed over time through the PC or through the regulators' forum, something like that.

MR BANKS: You come to a discussion later about access holidays, which I guess we've collapsed pretty much into the same issue in that it's greenfields investments where we've discussed that issue. In that context you talk about, "consideration be given to auctioning monopoly franchises."

MR DOMANSKI: Yes.

MR BANKS: Would you just like to elaborate on that now because I think it's related unless you see it as a point you want to make separately.

MR DOMANSKI: No, that is a possible area we see as having some in-principle attractions and we wanted to kind of float it. We haven't done our full round of thinking on this either. That is something that is certainly advocated in some of the literature about how to deal with monopoly facilities in what they call competition for the field rather than competition by the field.

MR BANKS: Yes.

MR DOMANSKI: It has certain attractions. It probably has some uncertainties about it as well that I think need further investigation. We're hoping you might contribute to that.

MR COSGROVE: We mentioned a few possible disadvantages in a box in our report, 4.1.

MR DOMANSKI: Yes. Do you want us to specifically comment on those for you?

MR COSGROVE: Not now but in your submission.

MR DOMANSKI: Okay, we will have a look at that. We will see if we can give you some thoughts on that.

MR COSGROVE: Could I come back to the WACC's point briefly, Roman. How important is it in practical terms if you take an asset with a value of 100 million and you're debating about the level of the WACC, maybe 5 per cent or 6 per cent then you've got a 5 million or a 6 million dollar effect. But if the asset value itself was the subject of contest as to its proper size then a 50 per cent change in the asset value would be a much more practical significance that the sorts of marginal changes in the WACC.

MR DOMANSKI: The WACC has been very significant.

MR COSGROVE: You've got asset valuation issues coming up later in the - - -

MR DOMANSKI: It's a good point. The WACC has been very significant up to now because historically WACCs for energy networks have been set at quite high levels and set in ways which I think have been challenged and overturned by the main regulators in Australia and overseas as well. That having been done, I guess now the issue is, "Well, should the focus really be on the asset valuation question," and we're very pleased to see that you had an open mind to that in the position paper and were wanting further debate on it, because we have seen from regulators a very closed mind on this particular issue. I guess we think it's important that the debate is open and therefor that you can make a significant contribution in this area because we certainly have some concerns, and I think, you know, you express a number of them in your position paper as well with the sort of unquestioning almost acceptance of DORC as an asset valuation method and we certainly see that as exposing us to a number of concerns. I was going to sort of cover those - - -

MR COSGROVE: Why don't we talk a little bit more about that. I mean, you make the point that, to you quote, "DORC allows a systemic overcharge of actual cost by infrastructure providers".

MR DOMANSKI: Yes.

MR COSGROVE: Would you like to just elaborate on that and what your concerns are. Indeed, I thought maybe for your submission, if you could give us a hypothetical example, or even if you have an actual example, of where you see the main problem arising.

MR DOMANSKI: Yes, okay. What I can also give you is we actually commissioned a report a couple of years back now at the time when the first review of Victorian gas infrastructure was being done. What we asked that report to do basically is to highlight what's the impact on end use customers of different asset valuation methodologies and what do the regulatory settings actually say about what needs to be applied. My memory is a little bit hazy on the report because it's a couple of years ago but what it basically said was that DORC, more or less what I have said here, exposes customers to systemic overcharging and then outlined the

reasons for that in some detail. It also said that there is nothing in the regulatory arrangements which actually specifies that DORC must be used or that DORC is the only means of measuring asset values at replacement cost. I'm happy to make a copy of that report available to you because it does go into it in some detail and probably with a lot more authority than I can deal with given that it was done by the South Australian Centre for Economic Studies which you are probably familiar with.

MR COSGROVE: We're not saying that there should be no inflation adjustment.

MR DOMANSKI: No, no. What I'm saying is that with a DORC asset valuation there's a tendency, because of the way that DORC is applied, for assets to be over-valued, and on top of that there's an incentive on any regulated business to put forward asset values using DORC which it has put forward as a science of valuing assets but it's actually probably more like an art to valuing assets. We have seen examples of this and because of the information a symmetry between the regulated business which has commissioned the asset values typically and the regulated business on the one hand and the regulator and the end users on the other hand. It's quite difficult to challenge those.

You have to go into a forensic look at their asset values basically which is not something that you would take on lightly. It actually costs a lot of money to get done. I mean, regulators or regulated businesses are paid, you know, like half a million dollars, maybe more, for some of these valuations to be done, you know?

MR COSGROVE: Okay.

MR DOMANSKI: So I guess that raises the other issue which is it's non-transparent to us which worries us as well.

MR COSGROVE: Okay, thanks.

MR DOMANSKI: There are specific things in it. Like, some regulators, probably most of them actually, have accepted DORC values for easements as well. That's something that we will bring out in our submission a bit more, but sometimes easement, particularly when you're talking like transmission assets, can be quite significant and I think it's highly questionable that they should be valued at DORC. I mean, you're talking about bits of land with sort of cows grazing on them and things like this. Anyway, we'll bring that out a bit more in our submission.

MR REICHEL: We certainly could include some of our observations in our submission. If we go back to the ORG review back in 1998, the distribution network in Victoria. There were two studies done there; one by Gutteridge Haskills and Davey and another one by St Clair Knights, St Clair Knight Mertz, on DORC and they varied by some 30 per cent and subsequent discussions with those two organisations indicated that that wasn't particularly surprising where the 30 per cent variation could be quite typical when you're looking at those types of networks and the sort of assumptions that are made.

More recently in the EAPL review in New South Wales by the ACCC on the transmission pipeline there, there were DORC estimates made there for that pipeline; two estimates, one 670 million, another one 900 million. The DAC estimate was 100 million so not only were we involved in large variations in DORC estimates but we were also involved in instances where there is a lot of difference between those DORC estimates and a DAC estimate. The thing about a DAC estimate is that it is identifiable and it is a firm figure, and in our view should be used as the basis for asset valuation, and any adjustments that are considered necessary should be made using that rather than DORC which we feel is discredited because of the inability to come up with accurate estimates.

MR COSGROVE: Yes.

MR DOMANSKI: It's also - a couple of other points maybe on this. It's very difficult to challenge also because there are only a few, less than a handful probably, of acknowledged experts in this area who can undertake these kinds of estimates. It just so happens, and I'll let you draw your own conclusions to my comment, but it just so happens that for those experts a lot of their bread and butter, a lot of their business, comes from regulated utilities so, you know, there's the old kind of saying, "Don't bite the hand that feeds you." There are suspicions about that sort of thing, you know. We have seen the use of DORC also leading the New South Wales regulator IPART to consistently discount DORC asset values by somewhere between 10 and 20 per cent because, as they put it, they did not think that DORC led to a proper balance between the interests of asset owners on the one hand and asset users on the other hand, customers on the other hand, and unfortunately in my view do that with pretty well a kind of a black box sort of approach which made it non-transparent, non-scientific, difficult to test or dispute, which I don't see as a sort of a credible regulatory outcome, I guess, but I understand why IPART felt pressured to undertake that kind of approach.

We have also seen asset owners play games with it. I mean, we had a circumstance in electricity distribution in New South Wales in the 1999 review where the asset owner, in that case the New South Wales government, recognised that IPART was probably going to reduce the WACC significantly. So what they did is they got the government to put a lot of pressure on IPART to move away from their discounting of DORC and accept full DORC asset valuation, so we reckon that has led to a probably 20 per cent plus inflation of the asset values for those six New South Wales distributors so, you know, there are a few examples.

MR COSGROVE: Okay.

MR DOMANSKI: Maybe I will just briefly cover a couple of these other points in here, Gary. Information disclosure, that's very important to us for obvious reasons, and I think a lot of what we have been saying means that it's important. One point that we wanted to emphasise there I guess is that it's a kind of a case of - it's no good if there's not enough information but there are also concerns if there is too much or if you haven't got the resources or the ability to assess and deal with the information. We're very concerned along with many others in submissions of this inquiry,

including infrastructure owners, about a plethora of regulators. In the energy area we have, I think at last count, about 10 and then a couple of quasi regulators chucked in for good measure. We had to deal with all those people and it creates a lot of costs, a lot of inefficiencies, overlap, leads to delays. When we get state ones we see a lot of evidence of sort of narrow parochial requirements being put on those regulators or that's how they choose to operate, which we don't see as a desirable thing, and we also see that those sorts of state regulators are a lot more prone to having pressure applied to them by state governments for reasons of revenue-raising, particularly where I guess those states still own those assets.

We therefore would support a well-resourced and focused international regulator of energy issues, which we believe would be better placed to deal with many of the concerns expressed about regulatory performance, including things like delays in completing reviews and also the perception of conflict of interest through a regulator being seen as a "computer advocate" or else as a regulator being compromised by the position of a shareholder that also happens to be the government. However, to be effective those regulators would require high-quality resources and certainly dispersing those sorts of scarce resources among multiple state regulators is we believe wasteful and inefficient, and we welcome the PC's recognition of many of those points in its issues paper.

So we would see merit in establishing a single national regulator covering energy, either by adding to the powers of the ACCC or through having a specialist independent regulator with perhaps the ACCC continuing to oversight competition issues and acting as a review body similarly to the sort of OFGEM-UK Competition Commission nexus that exists in the UK.

Consumer funding: we do support the need to fund participation by all consumers in access and monopoly regulation issues, especially given the formidable obstacles that all representatives of end users face in dealing with these issues. We just wanted to draw your it to your attention that NECA has recently recognised the need for that and supported it in relation to the national electricity market, but there are currently no similar arrangements either in existence or proposed in non-NEM electricity issues or in gas matters. So even if that NECA thing comes about, which looks a pretty fair bet, we'd still have gaps in that area.

MR BANKS: Without discussing it in great detail now, you might have a look at the submission that Alan Moran put forward yesterday, where he was arguing the opposite point of view and made particular mention I guess of the role of government agencies as in a sense taking into account the interests of consumers, if not consumer advocates, and then the role of retailers and so on.

MR DOMANSKI: Okay. I'm aware of Alan's views on this and - - -

MR BANKS: But given that he's written them down. It's a fairly short - five-page - submission, but it might just be worth you cross-referencing that in your own submission.

MR DOMANSKI: Sure, yes. I'll just make a very few quick observations on it here, because I have discussed it with Alan on a number of occasions and, needless to say, we don't agree on this one. But just a couple of those points that you raised: the role of government agencies - I think that's just ludicrous. That's akin to saying that some government commissar or something should be set up to represent end-use consumers. I kind of liken it to the trade unions that were set up under the Soviet Union, which we can all be pretty cynical about.

The other comment that I'd make is a regulator is given that role, that's inappropriate. It's very important to us to get credibility and balance into the regulatory process. If a regulator has a specific remit to be an advocate for consumers, I think that detracts from that role and in fact does great damage to the regulatory process in the long term, and that's not something that we want to see. So I did just want to make that observation on what Alan is putting forward.

Just to highlight to you that we're going to make the following recommendations in our submission: we consider that the national access regime and national electricity and gas pipeline codes should be maintained and strengthened along the lines that we've suggested in the interests of informed regulation. We consider that effective access regimes need to have the following foundations: (1) strong primary legislation applying equally to all stakeholders without exception; (2) independent regulatory body; (3) credible and comprehensive administrative procedures and rules; (4) consistency of accounting regulation; (5) clear and fair pathways of judicial review of regulatory decisions; (6) adequate and effective information disclosure provisions, symmetrical debate and end user access to the resources needed to ensure that there's symmetrical debate. We think that the sorts of proposals outlined in your position paper would make a significant impact in terms of addressing those issues, but I think we've probably highlighted some areas where we'd welcome it if you did some further thinking.

MR BANKS: I guess we were finely balanced on it and are really looking to you to convince us a bit more in your submission, so that's why I mentioned Alan Moran's submission as something you've got to contend with.

MR DOMANSKI: Okay. We recommend the establishment of a single well-resourced national regulator with responsibility for energy. That could be the ACCC, but it would probably need a special part or whatever in its act a la telecoms or something like that. We recommend that the PC should ensure that the competition policy agreements, legislation and subordinate codes prohibit the setting of network charges based on notional costs, ie on replacement cost valuation or, more appropriately probably, on DORC valuation, and should require regulators to include in the regulatory cost base only costs which have been actually incurred. The EUAA recommends that Part IIIA and industry-specific codes provide for marginal cost pricing principles.

We also recommend that competition policy agreements, legislation and subordinate codes prohibit the setting of user charges based on DORC and we recommend that legislative guidance be inserted into Part IIIA to ensure ongoing

efficient investment is balanced by specific requirements that policy takes account of the need to remove monopoly rents. We're cautious about the public benefits of access holidays but would recommend that consideration be given to developing contestable mechanisms along the lines that we've talked about to ensure the public or infrastructure users can capture more of the potential benefits from those facilities for a specific time. Just finally, we look forward to your final report and again urge the PC not to depart in a major way from the overall approach outlined in its position paper. Thank you.

MR BANKS: Thanks very much. I think we've had a fair bit of discussion along the way. We've obviously got some more questions but - - -

MR COSGROVE: First of all I think I gave you a bum steer earlier, Roman, about the number of the submission which dealt with the issue of vertical versus non-integrated facilities. It's actually DR61, I think you'll find. Alan Moran still had a hand in that one.

MR DOMANSKI: Okay, thanks.

MR COSGROVE: It's from a combined set of electricity and gas distributors.

MR DOMANSKI: Distributors, is it? Thanks for that.

MR COSGROVE: Secondly, without wishing to spend more time on this DAC-DORC issue, you might in your submission try to address the question of whether or not is inadequate in a dynamic sense. It's quite clear I think from what we've been told already by you and others that at any point in time the establishment of a DORC estimate of the value of an asset can involve a wide range of figures, but the real value of an asset, one would think, shouldn't really shift over time except for reasons of changes in technology, which on the whole would tend to decrease its value, or as a result of different claims about the impact of inflation on the value of the asset. It's a question of whether or not DORC is inadequate in that second sense, as a measure of change in real asset value through time.

MR DOMANSKI: Okay, yes.

MR BANKS: I suppose there are two issues. There are the conceptual issues and then there are the more pragmatic issues, and you've been dealing with both, but also I think you've emphasised the problems in the real world of devising them in a way that avoids the problems of gaming and so on.

MR DOMANSKI: Yes, that's right. That's been a major concern for us.

MR BANKS: I was also going to ask you: just in that list of your final recommendations there you talk about marginal cost pricing principles. You hadn't said much about that earlier, and indeed I thought you'd said the two-part tariffs were something that you thought was a reasonable way to go although you didn't like discriminatory two-part tariffs, I guess.

MR DOMANSKI: Yes, discrimination is an area that worries us.

MR BANKS: Can I ask you just to clarify that then. You're not pushing for a pure short-run marginal cost pricing regime?

MR DOMANSKI: No. We think that would be the ideal, but we recognise that with these sort of natural monopolies you've got a bit of a problem in terms of the short-run marginal costs and the ability to recover the investment made, and also I guess as a secondary thing what's usually the fairly lumpy nature of the investment, if you apply it in a strict sense anyway, leads to some pretty scary-looking price changes when there's new investment made. So we're not sort of saying it in a pure sense but we're saying that this is something that has certain attractions. We don't want to lose sight of it completely in this debate but we want to recognise that in natural monopolies there are some problems. I guess things like the two-part tariffs or multi-part tariffs have been devised to overcome this. We see that creates over jeopardies for end users, particularly that they can be exposed to forms of monopoly price discrimination which we see as being undesirable, and we gave the example of what's recently happened in Victoria, at least to some of the large sites.

I guess we're a bit perplexed that there isn't some sort of constraint in terms of that sort of impact and we're probably also concerned that there needs to be some ability for users to go to the regulator and put their views on the table about these sorts of issues and actually have the regulator take some notice of it. The regulator is basically reacting to our concerns in Victoria on that issue with very much a hands-off approach by saying, "I'm not here to micro-manage the business; I'm here to set average price caps and it's up to the businesses how they implement them." I have a fair bit of sympathy for the regulator not micro-managing the businesses, but I also have a concern if that leaves customers exposed to price discrimination which is in some ways inefficient or is evidence of monopoly abuse, if I can put it that way.

So I guess we're saying that we don't want the regulator to micro-manage but we want the regulator to have some powers to investigate and deal with these kinds of issues and to be transparent about what they've done or what they've accepted in terms of tariff implementation, not hide behind a bunch of averages and then when the pressure is on say, "I'm not here to micro-manage the business."

MR BANKS: Thanks very much for that. We look forward to getting your full submission and indeed you might allow us to get back to you if there any points in that we need some clarification on.

MR DOMANSKI: Absolutely, yes. You know how to contact us. We much appreciate that. Thank you again for you time.

MR BANKS: Good. Thanks again. We'll just break for a few minutes before our next participant.

MR BANKS: Our next participant this morning is Australia Pacific Airports Corporation. Welcome to the hearings. Could I ask you please to give your name and position with the corporation.

MR MUNDY: My name is Dr Warren Mundy. I'm manager strategy for Australia Pacific Airports Corporation.

MR BANKS: Thank you for coming today, for the two submissions you provided and for your patience in waiting this morning to appear. As discussed, why don't you outline the main points you want to make and we can either pick some up along the way or come back for a discussion.

MR MUNDY: Yes, no problem. We'll start off with a small background of the company. Australia Pacific Airports Corporation is a holding company that holds 100 per cent of the interest in the lease at Melbourne Airport and 90 per cent of the interest in the lease at Launceston, so we actually are in the position of being involved in both major Australian international airports and smaller regional ones, which are both of concern to the commission's inquiries. We continue to maintain aspirations for the acquisition of further airport assets within Australia and the Asia-Pacific region in general. Our shareholders are the AMP, who own just short of 50 per cent; Deutche Asset Management, who own 26; Hastings Investment Trust, which owns 10; and BAA-PLC, who own 15, who are the owners and operators of Heathrow, Gatwick, Stansted, Aberdeen and a range of others.

We have I guess been in the fortunate or unfortunate position of being the only privatised airport that's had the national access regime visited upon its doorstep, and it's those issues about the application of the national access regime to airports that I'm going to talk about today. We're aware of the commission's inquiries in relation to price regulation of airports' services and into the Prices Surveillance Act and we've made submissions in relation to those matters.

I myself sit on the regulatory committee of the Australian Council for Infrastructure Development, and we involved with them in the preparation of a broader-ranging submission, and in addition we were one of the companies that endorsed what we thought was pretty ground-breaking work done by NECG in the first instance, which we have sought to develop a bit further in relation to airports and what we might consider to be non-congested, unintegrated facilities, and that's in our submission to the commission's inquiry in relation to airport regulation, which raises some questions as to what the nature of the commercial and economic responses of an uncongested business with a lot of surplus capacity would be and what incentives there might be to use market power and those arrangements. We're continuing to develop that line of argument because there are some issues which I think, when you bring your mind to the questions that are there, raise some interesting economic questions. Essentially when you bought these assets off the state you ended up with a large amount of surplus capacity which you mightn't have otherwise created yourself, so that creates a different set of commercial incentives.

Often referred to in relation to infrastructure businesses is that people like

myself who come to forums like this complaining about pricing and things are really just reflecting the fact that they or their shareholders paid too much for the assets that they now own, acquire, operate or take under trust for the Commonwealth effectively in our case. We paid about $1.3 billion for Melbourne Airport. Our shareholders now carry that asset at about $1.8 billion in their books. Our credit rating has just been increased from BBB to A-minus, so in the sense of is this a company that was bought at too high an acquisition price, the answer to that is almost certainly no. What our concerns are, therefore, is a forward-looking question about the nature of prices, the structure of prices, the investment environment that we will confront.

We see that we have a very important role in the facilitation of competition in downstream markets. It will come as no surprise to the commission that one of the principal constraints on the development of competition in aviation is the availability of airport infrastructure - terminals, parking positions, railways et cetera. In very highly congested locations, Heathrow and increasingly Sydney and other places, the physical constraints get to the point where slots are required. We fortunately don't see that as a problem for ourselves or indeed, with the exception of Sydney, for most of the other major airports in Australia. The issue about capacity constraint will become when it is profitable to provide additional assets on the ground - new runways, new terminal capacity and so on. So the issue of slots is not something that's necessarily going to arise except in a short-run sort of rationing arrangement while new assets are brought in or while in a sense price bids up to the point where it becomes profitable to invest.

What our concerns has been and continues to be is the incentives that we are provided with to invest and our ability to get on and do that. Our industry is I think characterised fairly by market power existing on both sides of the fence. There's a degree of oligopoly around. There's a degree of market power in relation to the provision of services that we provide, and I think it's probably fair to say there's a degree of oligopsony on the other side. Airports need airlines, airlines need airports and that's the way the matters proceed. There are relatively small numbers of buyers in the market. Somewhere around about 50 per cent of regulated revenue, probably a bit less than that, round about 40, is accounted for by one customer, and that's Qantas. Other major customer groups - Air New Zealand accommodates sort of similar amounts. So there's a degree of - - -

MR BANKS: Is that 40 per cent of your aeronautical revenue?

MR MUNDY: Yes. Just as a guide, our aeronautical revenue constitutes about 30 per cent of our total revenue base but about 50 per cent of our asset base. I haven't done the numbers recently, but our return on our aeronautical assets is about the bond rate on our regulated businesses, and I haven't gone through the most recent set of ACCC regulatory reports but certainly in 1998-99 that was the best that you could find amongst Australian airports. So there's no issue of monopoly profits being earnt here, and indeed some airports aren't covering their depreciation costs. They bought those airports on those cash flows and that's fine, but the question going forward is the structure of prices and the investment arrangements that are going to encourage investment to occur.

In relation to the matters that are before the commission in the national access regime there are I guess three issues for us. There's the general application of Part IIIA of the Trade Practices Act, which Sydney Airport and Melbourne Airport prior to sale were subject to in relation to the ACTO matter. There is section 192 of the Airports Act, which you can I guess construe as an industry-specific regime, which enables the ACCC to determine whether a given service is an airport service or not, and we've been subject to the only two applications in relation to that. The first one was in relation to Delta Car Rentals and the more recent one, which is still before the ACCC, is in relation to Virgin's application for the recently-built and now not quite so profitable domestic express terminal. The third is the issue, and where most of the regulatory action takes place is of course the use of the Prices Surveillance Act for the declaration of aeronautical services and the administration of the price cap, and the necessary new investment arrangements by the ACCC under those arrangements.

I guess, turning to that last issue first - and we'll have more to say about this, I guess, in the inquiry that's being conducted by Dr Byron - we basically support the commission's propositions in relation to the abolition of the Prices Surveillance Act and the creation of a monitoring device within the rubric of Part IIIA, the national access regime, and so on. I think it's fair to say that the PS Act was a device built for another purpose in another time. It no longer represents anything that would even come close to regulatory best practice and it's well-despatched from the statute book for these purposes.

Having said that, while it's not a concern for our business, we have expressed a concern that there may remain a residual public policy reason that governments may wish during the scope of an inquiry to restrain what I call rogue pricing activity, where there is a situation where a company not subject to coverage under the national access regime undertakes a form of pricing activity which is just so unacceptable to the community that the government wishes to step in. That's what the declaration provisions and the inquiry provisions of the PS Act currently empower ministers to do. It's a reserve power, if you like. It's not clear, I guess, to us why you would wish to do away with that or indeed whether governments would want to do away with that. It's not clear to us either, on the other hand, exactly why you'd want to keep it, but I think there's an issue there which is a slightly separate issue from the more general questions about the regulation of utilities and the sort of areas we're talking about today.

MR BANKS: Just on that, did you see that perhaps being satisfied if with a bit of a lag through the kind of inquiry process that they saw adding to the TPA to allow an assessment of an issue like that before undertaking any form of surveillance?

MR MUNDY: Yes, I think the best way through that may be for there to be some constraining capacity, if you like, very similar to what now exists in the PS Act - the capacity to restrain a price during the term of the inquiry.

MR BANKS: Of such an inquiry.

MR MUNDY: Yes, and that's essentially how the inquiries device within the PS Act works at the moment. Formal inquiries under the PS Act have been ordered so rarely anyway that I think the retention of that residual, and certainly from a public confidence in the overall rubric, may well be desirable. It's more a public policy proposition than an economic policy proposition.

I guess one of the reasons why we're keen to see the price monitoring arrangements rolled in to the general rubric of national access regime, Part IIIA or whatever it subsequently was called, is that it enables a greater deal of certainty. At the moment there is a clear potential, and it has happened, that firms such as ourselves who are regulated under the Prices Surveillance Act, having been through the processes of the Prices Surveillance Act, then find themselves exposed to further regulatory action in relation to in our case section 192 of the Airports Act but, in relation to the stevedores and others, conceptually under the more general provisions of Part IIIA. We see that simply as regulatory double jeopardy. It leaves gaming opportunities open to users who in our industry are typically well-organised and fairly well-heeled.

We would suggest, I guess, that the integration of the monitoring role - the prices surveillance role, if you like - within IIIA is a good idea. We see a lot of merit in the suggestion that it may become a sort of a de facto situation where you're not quite sure whether you need to declare so you'll monitor and carry on. The Airports Act as it's structured at the moment, particularly in Parts VII and VIII, will enable the federal transport minister to make regulations for the provision of financial information and quality of service information. So those monitoring provisions already exist within the Airports Act statute. They only apply to the leased airports that were formerly owned by the FAC, but the reality is there aren't any others that are going to cause you regulatory concern beyond that set anyway.

The information that is I guess formally provided under the monitoring arrangements of the PS Act could without any difficulty, simply by a rewriting of the regulations under the Airports Act, be collected that way. So the collection functions under the PS Act are essentially redundant for our industry as a whole. Whether you do it under one or the other I think doesn't make any difference. We furnish the information to the ACCC, they then publish it in due course and so on - not a dissimilar mechanism to what's predicated in these monitoring arrangements. We see that makes a lot of sense.

In relation to I guess our experience with the industry regime in section 192, the way it basically works is that within 12 months of sale airports had the opportunity of getting the ACCC to approve an access undertaking for airport and then if that was in place that served as an access undertaking for the purposes of Part IIIA. If it didn't, then airport services were declared for the purpose of Part IIIA, with the ACCC left to determine that any given service was an airport service. That was subject to two criterion, which I shall come to in a minute.

We went through the process of seeking to get an undertaking in place, and I believe Perth also went through a similar process. Ultimately we abandoned that

process because we formed a view that the level of undertaking that the commission appeared to be wanting to get from us would leave us in a poorer position than if we just chanced our arm with declaration as we went along. I don't intend to go into the details of it, but we just took a view that the process was really going beyond what we thought was commercially viable and we walked away. That was a decision that we took, and I don't think there's much point in hacking through the issues there.

I guess the thing about section 192 is that it's actually a terminating provision. The minister had to set the declaration for a finite period of time, as he did to 30 June 2002. There is no provision in the act for the minister to review the declaration, and this declaration applies to all leased airports. It raises interesting questions as to why this applies in Townsville and not in Cairns, why it applies in Launceston and not in Devonport and Burnie, and the list sort of goes on. But the 192 provisions do expire and that will, I sense, in a sense remove the less onerous tests in declaration from the scene, so airports will then just be subject to declaration like everyone else. That, from the point of view of Launceston, of course, would mean that the likelihood of declaration then would probably diminish significantly, but the reality is I think that it's pretty hard to argue that Melbourne Airport in a number of senses is not a nationally significant piece of infrastructure. So those provisions still remain there. So looking forward from the point of view of our industry, 192 will ultimately go away and we'll be left with the general issues in IIIA.

I guess we in our initial submission back in December of last year and at the round-table were proponents of the argument that with unintegrated facilities probably the access issues will be different - why would you deny access and so on - and the only issue there really is price. I guess our now, having done a lot more work on this and given it a lot more thought and seeing the propositions of rolling the monitoring, prices surveillance-type functions into the general access regime, a lot of our concerns there are accommodated by that sort of approach. The question then ultimately, I guess, is the scope of the services subject to declaration and how you work through those sorts of issues and the pricing issues.

The difficulty that we have I guess in our industry looking forward is that, because prices don't in any sense represent long-running efficient incremental costs, they don't generate a normal return on assets, there is a situation whereby for investment to occur prices have to be raised so that incremental revenue is sufficient to cover the costs of the investment. So the fact that there wasn't, if you like, a price reset at the point of sale has meant there's had to have been this other mechanism that's got revenues up to get prices on volumes, to get costs through, and that's what the necessary new investment arrangements are. It's solely a question of whether the prices are not the right prices to encourage investment. Whether they're fair or not is another question, but that's why the arrangements exist.

We were pleased to see the commission acknowledge in the position paper this issue about getting, if you like, the starting prices right and that if prices were too low there were going to problems the same as if the price was too high. We have that problem now. I guess the question is: how over time do you work to a situation that, when major investment is required, prices are such that that's sustainable?

We're at the moment starting to work both with our customers and putting some ideas towards the airport pricing inquiry.

It's probably helpful to just reflect on the two cases that have been brought under 192. The first one was Delta, where the issue in question was the rights of an off-airport car rental operator to conduct its business at the airport. That was the sensible question. There was a question of charging for that and there was a question about where they were going to operate that service form. They sought declaration, and the service that they sought was I guess one which would not have passed the test of section 192. The ACCC took - - -

MR BANKS: Of IIIA, do you mean?

MR MUNDY: Wouldn't have passed 192. It was too narrow in its scope. It was about them being able to drop off and pick up their customers. Having seen that, the ACCC broadened that. There's a test about "necessary for civil aviation" in 192. The ACCC broadened the scope of the service to essentially the road system as a whole and argued that that was necessary for civil aviation, which is a fair and reasonable argument. Subsequent to that Delta has continued to operate largely under the existing arrangements that they had. They've subsequently bought National Car Rentals, who were the privatised DAS fleet, and have subsequently largely ceased off-airport operations. So the matter has been and gone. There was never an arbitration under it so we never found out what was going on.

The other matter which I alluded to earlier is the Virgin question and the domestic express terminal. We do see this as a fairly clear case of regulatory double jeopardy, having been through the hoops at the PS Act and going through them again. The interesting question here - and we're still to see the ACCC's draft decision on it - in our view is that, there being already two domestic passenger terminals at Melbourne Airport and our having built a third, this is pushing up the economic "to duplicate" test. The ACCC has a view on the question of duopoly and so on and has taken a forward-looking approach. We submitted to the ACCC when we made our submissions that it was conceivable that one of at the time the two existing operators could cease to be, would go out of business and merge with one of their competitors and therefore would access terminal services in another way. That was fairly prophetic and is exactly what has come to pass.

So there's an interesting question there, and I know it's been raised by others, about this question of: if there are two, does that mean three is economic? If there's one, is two - if there's another one does that get you over the hoops? I think the NCC has provided some useful advice on this. It's about the ability to provide additional capacity reasonably augmenting existing facilities and so on. That's the approach that we're taking and, if you're interested in that line of argument, it's available in our submission which is on the ACCC's Web site.

Just in conclusion, we see that there may well be some merit in industry-specific regimes which deal with the peculiarities of the cost structure, the peculiarities of the nature of competition, the downstream markets, whatever -

international treaty arrangements, which are issues which impact on us, security - dealing with those particular industry-specific arrangements. We think there's some merit in that, but they shouldn't involve when it gets to the questions of declaration and so on weaker tests than arise out of Part IIIA. They should be a recognition of the operational issues rather than a diminution of the standards of declaration, and that's the problem with section 192. Our view is that neither the Delta declaration nor the Virgin applicant would cut the mustard under IIIA, largely because of the competition test but also because of the national significance test.

We have thought long and hard about the question of ministers. This is probably a philosophical point, but ministers are accountable at the end of the day, and in our industry, which is so bound up with safety issues, with environmental issues, with international treaty issues and so on, the imposition of other areas of government policy on our business is quite profound. We think there needs to be retained a residual role for ministers to make sure that those other public policy issues are properly recognised and dealt with by the regulator. We don't think ministers should do that in private, we don't think they should do it in the dead of night, but they should be in a position where they are able to direct the regulator in a public way somewhat similar to the treasurer's directions under the Reserve Bank Act or perhaps even one step further, that these directions can be given and they can be disallowable instruments. But I think there needs to be again that reserve power retained to deal with the impact of wider public policy issues on regulatory outcomes. Again, I think they're powers that would be hardly ever used but I think they need to be there.

MR BANKS: Would this introduce an element of sovereign risk? You've cited some examples there, I think, where you feel the minister has done the right thing.

MR MUNDY: Yes.

MR BANKS: You could probably think of situations in which from your point of view might do the wrong thing. To what extent would that create an element of - - -

MR MUNDY: I think part of the reason why there has been ministerial involvement in these matters, both in relation to the Sydney decision and its pricing proposal overall and in relation to multi-user domestic terminal decision to a large extent arose out of the deficiencies of the PS Act. There are no effective appeals mechanisms. You've got two options. You can stare it down, say, The emperor has got no clothes. We actually know the PS Act has got no teeth," and go to war and then basically hope that the minister then won't order and inquiry and the whole thing will go away. That's simply not an acceptable regulatory process, in our view. I guess anyone who's ever been subject to notification under the PS Act, the first thing they do when they get a decision from the ACCC they're not happy with is mumble darkly into their coffee and consider that course of action.

It also is the case that part of the conditions of our lease from the Commonwealth is to comply with the government's pricing policy, and it's not clear to us what that actually means in relation to the exercising of whatever rights we

have under the Prices Surveillance Act. In those two instances it was a way of the government dealing with the fact that the regulator was taking decisions I think which could be demonstrated, at least to some extent, were contrary to what government policy was. In relation to the Sydney matter, the government had a fairly clearly-stated policy on the single till and felt it was necessary, for whatever reason, to make that more explicit to the commission in direction 22, which the minister was entitled to do and he did so under the act.

In relation to our matter, there was a very real chance that, having seen the draft pricing decision from the ACCC, we would have not proceeded to develop that terminal, and the government was concerned and the deputy prime minister was concerned that in such a circumstance that would significantly impact on the development of competition in the downstream market. It's interesting with hindsight to say perhaps it didn't need to be there at all, but I think we need a lot more hindsight before we can form that view. Certainly, at the time we had a customer who was happy to pay the price that we were wanting to charge and we ultimately got a commercial outcome from that process, but it goes to the more fundamental question of the government being able to ensure that its wider public policy outcomes are given, if you like, due attention by the regulator.

There are other issues here - screening issues, treatment of environmental issues, all those sorts of things. You could conceive of issues in relation to foot and mouth in a similar sort of way. So I think there just needs to be a reserve capacity there. I don't see it as a device by which you need to go to the minister and get an ACCC or whoever the regulator is decision corrected, but I do see it as a device by which the government can make very clear its policy needs, and indeed in our industry, sometimes its treaty obligations in relation to ICAO agreements and such.

MR BANKS: Normally when you think about a good regulatory design the legislation would set the standards that reflected what government policy was and it was up to the regulator to apply that. In a sense you're saying that there's more going on than just that and that there may be broader either international or public policy concerns that would require additional intervention?

MR MUNDY: Yes, which may well be dealt with - rather than having to reinvent the regulatory system all the time, there needs to be some way in which the broader public policy context and public policy issues which develop over time can be given to the regulator and told, "These are the thing that we've got. Please do these things with them." I think that needs to be done in a transparent way.

MR BANKS: Are you saying, though, in the context of this inquiry that this is something that needs to be embedded into IIIA, or are you saying that's an argument for having an industry-specific - - -

MR MUNDY: It may well be an argument that's peculiar to our industry's regime. They're not industries in which I practise, but there may be other policy issues that governments wish from time to time to deal with and that they want the regulator to take note of. All I'm saying is I think there needs to be a transparent formal

mechanism by which these things can be communicated rather than a few quiet phone calls. I don't think that's good regulatory practice at all. I guess leaving it at that, Mr Chairman, we are aware of the submissions made by Qantas and by Avis in this inquiry, and I think BARA has made one too - - -

MR BANKS: To this inquiry or - - -

MR MUNDY: Yes, to this one.

MR BANKS: You have a reference in there to Qantas, and I wasn't quite sure what that meant, in terms of confidential submissions. I'm not conscious of any confidential submission that - - -

MR MUNDY: The impression I got certainly from your Web site was that there was confidential material attached. I may well have misread it, but the Qantas - - -

MR BANKS: Was this from the IIIA Web site?

MR MUNDY: Yes. I may have misread it.

MR BANKS: I'm getting a nod that there may be some, but the question of what that bears on we'd have to check.

MR MUNDY: My reading of Qantas's submission is that there were some I guess examples or instances that they wished to draw to the commission's attention about access being denied. That was the impression that I formed, and I guess my passing observation on that was that if access was being denied it's curious that Qantas hasn't sought to use its right under section 192 of the Airports Act to seek redress of those matters. That was just our passing observation.

MR BANKS: Okay, good. We'll check. It's clearly not something that was in the forefront of our minds when we were writing this report.

MR MUNDY: Just in response to those two submissions, I guess the question that we'd simply ask would be this: why are airports different? Why should those access-seekers need to have further protection than rail access-seekers, people seeking access to pipelines and so on? It's just a question of why it's different. That's about all we really wish to say.

MR BANKS: Thanks. Perhaps just going back to where you started, in a way, in talking about feeling happier with a IIIA regime that in sense would integrate the potential for monitoring, if we could just explore that a little bit. The scope that we saw there was essentially in what you might call borderline decisions, where there was an opportunity to have monitoring rather than going through the full - - -

MR MUNDY: Yes.

MR BANKS: It would still in a sense by up to the regulator to decide whether an

airport, for example, was simply subject to monitoring or nothing at all or the full IIIA regime, the negotiate, arbitrate regime. You'd still see that better probably than section 192 because of the fairly permissive, as you see it, coverage rules.

MR MUNDY: Yes. I guess the question is ultimately: do you want to be able to retain somewhere a prices surveillance function? The problem that we see with the general application of IIIA - and I think Qantas also recognised this - is that you don't want to have an arbitration arrangement every time you've got a blue, basically. If you accept the argument or accept the proposition that the principal issues in access disputes between airports and airlines - not all of them in their entirety but the principal issues - are going to be about price, given that there's relatively little competition-based reason to knock it over.

Then a monitoring device may well be, perhaps with some sort of reporting against CPI minus X or whatever that might be, in the absence of an access arrangement or indeed in place of an access arrangement. You could conceive of how an access undertaking would contain a price cap without any difficulty at all. But if you wanted that sort of arrangement, that was an alternative, in our view, to the more general arbitration provisions, which really wouldn't be desirable because you end up having to deal with them on a case - we have 28, 30 airline customers. You wouldn't want to have the ACCC having to deal with 28 to 30 individual arbitrations.

As we have argued to the airport pricing inquiry, we actually think the case for continued regulation of airports is weak for major airports and bordering on non-existent for smaller ones. If you were to accept that sort of argument but you had some residual doubts about Melbourne and Brisbane and whatever, then you could slip them into that monitoring arrangement as a transmission mechanism. Particularly I think if you had concerns that the current pricing structures, for whatever reasons, were in some sense inefficient, that would be a more sensible arrangement under which transition to more sensible pricing arrangements and structures could occur.

It's always been the policy of the government that airport pricing would go onto a more commercial basis. The problem that has occurred - and this isn't a criticism of the ACCC; it's actually a criticism of the people who designed the policy - is that the existence of the regulator and the structure and the necessary new investment arrangements and the nature of the Prices Surveillance Act meant that there was little incentive on the part of the users to ever come to commercial terms. So an arrangement that allows some sort of stepping back and the continuing of the monitoring function, which is essentially no different to what exists in Parts VII and VIII of the Airports Act or under the monitoring provisions of the PS Act, would enable you to go forward that way, with the capacity for the regulator to have a look at these things and decide whether there is a real need for declaration at some point down the track.

It's a question of do you regulate because of concern or do you regulate because of conduct, and at the moment there is very little experience in this country

about what sort of conduct you're likely to see if you take the regulator away from the table. There are some experiences in Scotland and Prof Forsyth has sort of argued that that's not really deregulation because the CAA is really sitting there at the table; you just can't see him. But that process does actually work quite well.

The threat of regulation is omnipresent for everyone, including the guy who runs the corner store. It's there. I mean, there's the conduct provisions of the Trade Practices Act as well. So I think we see that as a better way and, if integrated with the IIIA thing, I think that solves a lot of the problems and the concerns that we had originally with this approach. That's the real issue with the unintegrated provider of services with market power: the fact that the disputes will be about price and quite often the service will be being provided to a range of companies who are competitors with each other. I think that's what makes it different. The question is: does that mean you don't apply IIIA? I don't think that matters so much, but now the commission appears to be moving to a situation where we're going to get all our economic regulatory tools in the one place and integrate them, and I think that will get you most of the way there. That's why I'm certainly less concerned about it than I was.

MR BANKS: Okay. Part of your concern is obviously the transaction costs of the negotiate, arbitrate IIIA approach, and that could be another reason for having, I suppose, an industry-specific regime.

MR MUNDY: Yes.

MR BANKS: As in electricity and other areas where you've got otherwise myriad transactions.

MR MUNDY: What also worries us is the ability of parties to use these arrangements to delay investment, which may delay entry. Clearly it's an undesirable situation to have large amounts of surplus capacity sitting around. When we bought the airports, we bought them as they were. For whatever reason, there was surplus capacity in some assets and not in others. We've got a fair amount of surplus capacity on our runways. We didn't have a common user domestic terminal, so our ability to develop that facility when it was required - we could have, I suppose in principle, built it in 1997 with no-one to use it. The multi-user facility in Brisbane sat vacant for a decade basically. What concerns us is our ability to respond to the sometimes fairly rapid-moving changes in demand for our services and not have a set of processes which, particularly when entry is occurring, can be used by incumbents to slow that process.

That's one of the reasons, and in fact it's the primary reason, why the parliament made sure that airlines could never control airports in Australia. We continue to bear the costs of the legacy of the domestic terminal leases, which were essentially a fiscal fix in 1988. Our research indicates that if we had been able to provide capacity through those terminals at Melbourne Airport we would not have needed to build a new terminal. There was enough capacity there - and for entirely understandable commercial reasons, if not the reasons under Part IIIA of the Trade

Practices Act or 192 of the Airports Act. It's entirely understandable. I mean, we understand why Virgin and Impulse didn't want to use the Qantas and Ansett terminals. Whether that constitutes a reason for declaration is another question.

MR BANKS: So we've had a bit of a discussion about how IIIA might be integrated with monitoring. We saw it, as I said, very much as a kind of tool that would be used in the borderline cases. That still leaves the question of the declaration criteria and to what extent that would throw up an airport as being borderline or not, I suppose. You haven't addressed this directly in your submission, but we would value any feedback you could give us on the tier 1 versus tier 2 declaration criteria that we've got there. We've made some minor amendments to the tier 1 by talking about substantial increase in competition and so on, but tier 2 we've got more of an efficiency focus but also an explicit recognition that we're talking about denial of access as well as the terms and conditions of access. Would you like to comment on that?

MR MUNDY: As I mentioned in my introductory comments, we're participating with AusCID, who are going to put in a fairly lengthy submission that will cover those issues. They probably won't directly address airport-related issues and I haven't given those particular thought in relation to those parts. I'm happy to do so and just send you a line. Yes, that's fine.

MR BANKS: Yes, we'd find it quite valuable. It could be just brief, any brief perspectives you had on those two sets of declaration criteria - from your perspective.

MR MUNDY: Yes. Part of the difficulty we have is that we provide the same service into different markets, and the degree of competition in those markets and the ability to substitute in those markets is very different. The example we use is, if you define the service to be the provision of runway services for 747 aircraft within 30 kilometres of the Melbourne CBD, then the market power position there is very different to the facilitation of travel between Australia and Singapore but it's the same 3.8-metre strip of runway that's doing the job. It's the old Trade Practices question of - - -

MR BANKS: What's the market.

MR MUNDY: - - - what's the market, and that's I think why the service definition approach rather than the facility definition, the thing - it's the "What are you buying?" rather than "What's providing it?" I buy a Ford, I don't buy the use of a factory down at Geelong. It's that sort of issue, I think, that's in play there.

MR BANKS: All right. We'll leave you to have a look at that.

MR COSGROVE: Could I ask you a question about a few points we had in the position paper about possible disadvantages of price monitoring. We referred to a possible third umpire effect, by which we meant that, in situations where an application for declaration was not at all clear-cut, the administrating agency,

presently the NCC, might in that situation with the price monitoring option available say, "Well, I'm really not sure and it's going to be very difficult to decide whether to recommend declaration or not, so I'll pass this across to the ACCC for some monitoring for while." From the point of view of a service provider would that be seen as a significant drawback? Would you rather, in other words - - -

MR MUNDY: I'd see it as a vast improvement to getting declared.

MR COSGROVE: Okay. The other option, of course, is that you might not have been declared and instead you're subject to price monitoring.

MR MUNDY: I guess it comes to the question of what is the inclination or the bias in declaration. If it is to err on the side of the access provider because we're concerned with long-run investment opportunities and we're persuaded by the NECG arguments about where the long run welfare losses are going to arise from and that that's properly enshrined in what the NCC is doing, then maybe the need for the monitoring arrangements is not there. You have confidence that, if the NCC is declaring you, the NCC has weighed the facts and is compelled by them to declaration rather than the other way. If you didn't know that, you'd probably take some comfort in the fact that the monitoring provisions were there. So I think it depends on what the bias in declaration is. At the moment - - -

MR COSGROVE: That comes back to the objects clause, I suppose.

MR MUNDY: Indeed it does. At the moment I think we have so few declaration decisions, it's quite difficult to ascertain what the NCC's bias is, because a lot of the action that's going on is happening under codes elsewhere or 192. It's very hard to get a sense of what the NCC's institutional bias on declaration is because it does it so rarely. It's quite hard to ascertain. But if that's the case, you would have thought that good public policy would seek to tell the NCC what its bias should be, and if there were appropriate appeals mechanisms you'd probably take some comfort in that.

As I said, we're subject to statutory reporting anyway. You could construct all this monitoring under the existing Airports Act and you wouldn't need the declaration provision. You wouldn't need the monitoring provision for us because that's the way our act is structured. To be honest with you, it's costly, it's not cheap, but we don't feel that we are overburdened with reporting compliance costs. We use them ourselves. We use them for marketing and things like that. A lot of the quality of service stuff we use for our own internal purposes, our own business purposes - business unit design and all that sort of stuff. So a lot of what we're asked to do we would probably do in some way, shape or form anyway.

I guess the other question and the issue that we raise in relation to monitoring is that, if you accept the issues about regulated firms running down quality and so on, I think you have to ask yourself whether you want to just monitor financial things or prices or whether there's an issue of quality as well, and the nature of services being provided and those sorts of things. I actually think that's quite important. While I've got some criticisms in detail, I think the reporting arrangements that we have for

airports in Australia are pretty good. They're vastly superior to the UK and in the US they're virtually non-existent. So we don't have a particular problem with those sorts of issues.

MR BANKS: Your comment earlier on Scotland - I thought I'd just get you to just reflect on to what extent are we simply talking about degrees of either second-guessing or hand pressure, if you like, because it could be argued, and some have argued, that it doesn't matter very much because at the end of the day what the regulator does in domains where explicit price controls are used conditions everything else that happens throughout the system.

MR MUNDY: Well, Scotland is different. Scottish law is different. I think that's probably an example of a situation where there are three airports which are owned together, which are all fairly close to each other - Aberdeen, Glasgow and Edinburgh. I've recently had the opportunity to go back through the minutes of pricing meetings for a number of years in Scotland and it's a robust dialogue, is the best way to describe it, and there's an agreement at the end, and both sides give. There's a reasonable provision and exchange of information.

The Scottish airports have a voluntarily imposed price cap, if you like, which they agree with their customers, and they often don't price up to it. Certainly in the case of Heathrow, Heathrow hasn't always priced up to its price cap, and that's largely because it hasn't been able to get the airlines over the line. Does that condition everything else? Only if the most profitable outcome is beyond the constraint. In a sense, I think a lot of what's going on in Scotland is that the optimal commercial outcome for the parties concerned is within the perceived set of constraints that the regulator would provide.

But the Department of Environment, Transport and the Regions, I think it's now called, has looked at declaration in Scotland and they've declined to do so. They've looked at Luton and declined to do so. I think they've even at one stage had a sniff around Birmingham. They just find that there's no need, and I think that's because largely there's a lot of potential airport capacity in the UK, so that's what conditions it. Similarly, there's a lot of international airport capacity in Australia. The question is the extent to which it's substitutable. Tasmania is a class example. There are four airports down there within two and a half hours' drive of them all. It's an interesting question in that there's almost certainly an inefficient oversupply capacity, but the thing that oversupply capacity does, given it's all there and it's sunk, is it significantly degrades the market power of the individual airports as long as you can substitute between them.

That depends on the nature of the markets for the services. If it's tourism services, a classic example in Tasmania is that one of the very common package marketing ploys is fly into Launceston, fly out of Hobart. So circumstances order case in most of these things.

MR BANKS: The other question I was just going to ask you - and it certainly is an issue that the companion inquiry into the airport pricing is looking at most closely -

in the submission, in talking about the PSA on about page 8, you make reference to relatively inelastic demand and therefore relatively small welfare losses from higher pricing. What would you say to the proposition that in a sense the facility or the service would try to price up until demand started to become elastic, in other words, the inelasticity of the demand in itself was a signal of unexploited profit opportunities and therefore by implication an unregulated entity like Melbourne Airport would simply price up until it started to bite?

MR MUNDY: It's not clear to me what the robust answer to that question is. I guess the question is, its partly got to do with strategic behaviour and it's partly got to do with the fact that we're talking about a small part of a wide range of services provided to any given customer. This conundrum has confronted me on other occasions, and I think the answer to it lies in the value of incremental services to the bottom line where there's surplus capacity around. If we were to price up 10 or 15 or 20 per cent - and indeed Sydney Airport is significantly pricing up at the moment - if we're ever going to see a demand response, we're probably going to see it in Sydney. But I think the root of this lies in the fact that a third of my business, roughly a third of my revenue, comes from those charges; the other two-thirds doesn't. In particular, my major customers who are going to bear the brunt of that are also the people who are going to deliver me new freight facilities. They're the people who are going to deliver me maintenance lease bases and all those sorts of things.

So I think they're probably more elastic in the sense of the total range of services but less elastic at that point. I think it also depends on who they are and what their alternatives are, and I think it varies from customer to customer. I don't have an easy answer to this, Gary, but what I do know is that as soon as you go and try and undertake any pricing activity you're resisted heavily. This is essentially all going to the bottom line. Certainly in the case of our business we've got a relatively large amount of surplus capacity and additional capacity is relatively easy to get your hands on to augment. The airlines, similarly, I guess from their point of view, certainly at the margin, they can substitute away, and they do it all the time. They restructure their schedules and they do it all the time. The extent to which that's an action of airport pricing is an action of something else, but I guess the loss to them is in a sense the net margin to the next most profitable route.

I think the reason why you don't want to do it as an airport is the substitution opportunities for them, and that dollar difference for them is probably quite small because they'll just deploy the aircraft somewhere else. We've seen this from Virgin. Virgin have indicated quite publicly that, if we had priced the domestic express terminal differently, they would have operated through Melbourne more extensively. We made a commercial judgment. That's fine, we'll live with that. So they can substitute those aircraft away. We can't substitute runways away. We've only got one use for them. They're all sunk to us. We can't use them to supply other things; we're just going to supply runway services. So I think that's where the problem, that conundrum, is. We're not quite there yet, but I think it is certainly an issue that we're trying to come up with a robust answer to which has some theoretical underpinnings but also reflects some stylised facts, if you like. It's essentially a game theory problem, and I think the answer lies in the peculiar nature of the pay-offs within the

game. But game theory is something I've never really quite got my brain around, so I'm busily trying to do that.

MR BANKS: I think as you indicated earlier, selling it to the community is another matter again, and selling a proposition on the basis of a game theory set of considerations is quite hard.

MR MUNDY: Our view is that we think the most profitable thing for us to do with our business is to expand utilisation. We think that's where the most profitable business strategy is. Why wouldn't we do it? Because we don't think it's profitable. That's why we won't do it and that's why we wouldn't do it. We've got unregulated business streams that we could have priced up significantly, and we haven't. We could price carparks up, we could price office rents up. We're not constrained in any way and we haven't done so. So I guess the answer is we don't find it overall to be a profitable business strategy in the medium to long-term. Whether that's because of commercial issues or because of fear or regulation of unregulated business streams - in the two years that I've been in the business I haven't detected it's regulatory fear. That's just a passing observation on internal business conduct.

MR BANKS: All things considered, I think that's a brave comment. Thanks for that. John, did you have - - -

MR COSGROVE: No, I don't have anything further.

MR BANKS: I'll just have a quick look. I may have had some other quick points. I don't want to keep you much longer. I think that's about all, and it just remains to thank you again for your contribution. It's been useful. We'll look forward to the NECG submission. Is it coming to us under the banner of NECG or is it a joint - - -

MR COSGROVE: You mentioned AusCID.

MR MUNDY: Yes. No, there are two, and if they haven't come to you now that means they're in the next day or so.

MR BANKS: Yes, they should be, because I know NECG at least is appearing in Sydney and I think AusCID is also.

MR COSGROVE: On the same day.

MR BANKS: The same day, yes, okay.

MR MUNDY: They're both in very final - I certainly saw the final final and nodded at it yesterday.

MR BANKS: Good. Thanks very much.

MR MUNDY: Thank you.

MR BANKS: If there's no-one else wanting to appear briefly to make any comments today, I'll adjourn the hearings. We resume in Sydney next week. Thank you.

AT 12.24 PM THE INQUIRY WAS ADJOURNED UNTIL
WEDNESDAY, 6 JUNE 2001