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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 SYDNEY ON THURSDAY, 7 JUNE 2001, AT 9.39 AM

Continued from 6/6/01

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MR BANKS: Good morning, ladies and gentlemen. We resume our hearings into the commission's position paper on the National Access Regime and apologise for the delay in starting this morning. Apparently there was a confusion in the office of Spark and Cannon about the starting time. We have two hearings commencing this morning so I don't know what time the other hearing will now be commencing. Our first participants this morning are Network Economics Consulting Group or NECG. Welcome to the hearings. Could I ask you please to give your names and positions.

MR ERGAS: Thank you, chairman. My name is Henry Ergas, managing director of NECG, and I'm joined today by my colleague, Tony Warren and Anne Peters. Tony is a principal at NECG and Anne is our special counsel, and we're also joined by John Earwaker, who is on secondment to NECG from OXERA in the United Kingdom, OXERA being Oxford Economic Research Associates.

MR BANKS: Good, thank you. Well, thank you very much for attending today and the submissions that you've provided. I think this is probably the third submission. You provided two earlier submissions that were quite helpful to us. Why don't we, without further delay, let you make a presentation in relation to your submission and then we can come back and talk about it.

MR ERGAS: In the spirit of the proceedings and mindful of the time constraints, I'll attempt to optimise our presentation perhaps almost as drastically as some of the regulators have optimised the asset base of the regulated industry. I will therefore necessarily very much summarise the views that we've expressed in our submission and I hope that you and others who are interested will have the time to look at that submission in greater detail. Let me start by saying that we very much welcome the position paper that you have released and we share many elements of the direction that you set out in that position paper. We particularly welcome your focus on ensuring that the National Access Regime retains incentives for efficient investment and it's on that theme that I'll concentrate my remarks this morning.

To our mind, a central issue in respect of the impact of the National Access Regime on incentives to invest, the central issue is that of regulatory risk and the effect that regulatory risk associated with the National Access Regime has on the willingness of investors to commit funds to regulated industries. We believe, for reasons that are set out more fully in our submission, that there is emerging evidence that investors are reticent to commit funds to investment in regulated industries and in the infrastructure component of Australia's economy. We believe that such reticence to commit funds in view of major investment needs going forward could cause serious harm to Australia's long-term economic prospects and should therefore be a matter of significant concern for policy-makers and needs to be addressed fully by the commission in its final report.

To our mind, the key to addressing the question of regulatory risk is to reduce the uncertainty associated with the regimes that operate either directly under Part IIIA or are associated with Part IIIA of the Trade Practices Act. In saying that

the uncertainty associated with those regimes needs to be addressed, we certainly do not intend to imply that all uncertainty associated with regulation is harmful. We recognise that it is in the nature of regulation that you will have an element of discretion. Some uncertainty is simply the price of adaptability and a regulatory regime that attempted to eliminate all uncertainty, to eliminate all discretion would be as inefficient as it was ultimately unworkable.

Our focus therefore is not on eliminating uncertainty per se but rather on eliminating that component of uncertainty that is not essential to adaptability, that element of uncertainty, that component of uncertainty that imposes costs in excess of the benefits it brings in terms of greater flexibility and adaptability. We think that it is possible to go a fair way to reducing unnecessary uncertainty by confining the discretion that regulators have, and that one can do so without completely or harmfully impeding the productability of the regimes to changing circumstances. Our submission makes a number of specific recommendations, many in response to points that you have raised in your position paper, as to how this can be done.

Our approach starts off by trying to better define the coverage of the existing regimes. We think that if coverage can be better defined then the dangers associated with regulatory creep will be confined and some of the uncertainty about just the scope of regulatory arrangements will be eliminated. In terms of coverage, we support the commission's recommendation that Commonwealth access regimes be required to be certified. We share the commission's view that Commonwealth access regimes diverge significantly from the principles set down in clause 6 of the Competition Principles Agreement. However, we note that certification is unlikely to constrain the growth of regimes that are more intrusive or restrictive than Part IIIA, such as Part XIC or the Airports Act.

The main sanction associated with the failure to obtain certification for a regime is that the facilities that would otherwise be covered by that regime would be subject to or at risk of declaration under Part IIIA. To the extent to which a regime is more intrusive or wider in its coverage than Part IIIA, then that sanction in fact has no bite. So if certification is to be effective in respect of Commonwealth regimes, additional mechanisms need to be brought into play if they are indeed to confine or to reduce the harm associated with regimes that are too far-reaching relative to the criteria set down in Part IIIA. In our submission we suggest two such additional mechanisms and they are that where a regime departs from the principles set out in Part IIIA, there should be first of all a "show cause" clause, some mechanism that requires justification of the difference or divergence of that regime from the clause 6 principles.

Second, and perhaps most importantly, that the access provider at risk from that access regime should be capable of obtaining protection for the facilities that it operates by lodging a Part IIIA undertaking, and that Part IIIA undertaking would displace the regime that had failed to obtain certification. In addition to certification, we believe that coverage of the existing regimes could be better defined through

mechanisms for exempting investments ex ante. There is some merit, in our view, in access holidays. However, we believe that all potential investors should be able to obtain preliminary advice about whether a proposed investment is likely to be subject to access regulation. We suggest the incorporation of safe harbour arrangements into the National Access Regime which would provide essentially for binding opinions by the regulator about whether the criteria for declaration are or are not satisfied by the particular investment.

In addition to coverage, the greatest part of the uncertainty associated with the current regime relates to what happens to assets once they are brought within its scope and in particular the terms and conditions on which access to regulated assets is made available to third parties. In terms of those terms and conditions of access, ie the prices which are set for regulated facilities by regulators, we believe that a substantial part of the uncertainty associated with the current arrangements centres on attempts by regulators to optimise asset values, and in our submission we provide some data on the extent of optimisation of assets that has occurred in regulatory decisions and you will see from that data that the optimisation attempts by regulators have led to very significant write-downs in regulated asset values.

As a general matter, it is possible to construct an analytical case for some type of optimisation. However, what we do not believe can be justified is optimisation without appropriate compensation for the risk of asset stranding, and the greater the extent of the optimisation that is attempted, the greater the compensation that needs to be provided. Though the case can be made analytically for some type of optimisation, we believe that in practice optimisation as it is currently attempted by Australian regulators introduces so many uncertainties and is so likely to err in its results that the benefits associated with it analytically cannot exceed the costs that it imposes, and that as a result we believe that efficiency would be better served by having a simpler, more transparent, less discretionary approach to asset valuation than is currently implemented by Australian regulators.

In addition to the uncertainties associated with asset stranding and with optimisation, there are significant uncertainties that are introduced into Australian regulatory arrangements by regulator assessments of the efficiency of operating and maintenance expenditures. Again, in our submission we set out evidence of regulatory optimisation of operating and maintenance outlays which have had the effect of reducing those outlays well below what was thought by the regulated industries to be needed if the assets were to be maintained in a best in-service condition. Again, we wonder whether as a practical matter, even setting aside all of the theoretical debates that one can have as a practical matter, whether the information constraints that bear on regulators are not so great that the search for optimal Opex introduces uncertainties, the costs of which greatly exceed the benefits.

We therefore suggest in our submission that simpler, less informationally-demanding approaches be adopted which could set not the first-best but at least a tolerable second-best for estimates of allowable costs over a period of

time. The final area where great uncertainty is introduced by current arrangements into the terms and conditions of access is the determination of the cost of capital and we believe that there is scope to reduce that uncertainty by providing for regulators to establish cheap components of the cost of capital before investments are made and funds are committed. In particular we think it should be feasible to determine the risk premium associated with an investment before that investment is committed.

Now, those measures would in our view go a long way towards introducing greater certainty and confidence in decision-making with respect to investment in regulated assets. But the reality of it is that regulatory decisions like any decisions are subject to error and additionally to possible bias or the risk of bias and we believe that it is essential, given the significance of the decisions that are at issue here, that there should be scope for full review of those decisions on the merits. We welcome the recommendation that you have made that there should be full merits review by the Australian Competition Tribunal of decisions of the ACCC relating to undertaking applications. We don't support the proposal that is set out in your position paper to remove full appeal rights against decisions to declare services.

We would put to you that the recent decision by the Australia Competition Tribunal in respect of the coverage of the eastern gas pipeline highlights the value of having full review rights in respect of decisions that go to the scope of the regulatory regime. We think that the costs associated with the provision of review rights are likely to be greatly outweighed by the costs of allowing wrong decisions to stand. Finally, as far as the administration and implementation of the regulatory arrangements are concerned, again it's our view that those issues should be dealt with in a way that preserves checks and balances and minimises the risk of regulatory overreach.

We are strongly of the view that there should not be a single regulator under Part IIIA. We believe that the current division between the ACCC and the Competition Council is an important aspect of the checks and balances and has worked well to date. We are especially concerned about eliminating that distinction in a perspective where Commonwealth regimes would be required for certification. If Commonwealth regimes were required to be certified and that certification were to be the responsibility of the ACCC, which itself is the main body that administers those regimes that are being certified, we believe there would be a clear conflict of interest and that the certification process could not have the wide-spread confidence that it deserves and indeed must have.

As a result, we would urge you to reconsider any recommendation that would remove the current checks and balances. Rather the broad thrust of our submission consistently we believe with the approach that you set out and the goals that you set out is that of ensuring that checks and balances remain in place in every facet of the National Access Regime. Thank you, chairman.

MR BANKS: Well, thank you very much for that. I guess in responding just to

your last comment about reconsidering, in a way the role of the position paper is to float ideas and we will be reconsidering a lot but in particular the tier 2 proposals, which we felt were more speculative and where the issues to do with the costs of change may loom large apart from other issues, so we were grateful for your feedback on that and indeed we've received some other submissions today that are quite helpful on the same issues. Perhaps the best thing might be for us to engender the sense of optimisation, given that my colleague and I haven't 100 per cent coordinated our questions, is to just start at the beginning and work our way through and we'll confer and make sure that we each get an opportunity to ask you the questions that we have in mind.

The first one that I was really going to ask you related to about page 8 of your submission where you were talking about the dynamic inefficiencies in pricing too low. I mean you make the points we also make. This is page 8 of your submission.

MR ERGAS: Is it in the first submission, Gary?

MR BANKS: No, this is your draft submission, and you talk about regulatory risk and you lead in and say that in the initial submission the point was made that there is an asymmetry in the consequences of over and undercompensating investors. I guess the point that I was just wanting to raise there is whether you would concede that there are dynamic inefficiencies that could arise from pricing too high as well. Now, we ourselves in the position paper emphasise that if you price too low that can have an impact on investment, which clearly has dynamic implications. But pricing too high equally presumably could lead to a monopoly provided deferring investment to optimising in a situation of exploiting the market. Would you have any comment on that? In other words, that the situation, the monopoly is not just all about static allocative inefficiencies but also has some dynamic inefficiencies associated with it as well.

MR ERGAS: I think that in principle in industries where demand is very inelastic it's unlikely to be the case that the demand's pressing effects of pricing too high will be very great and so long as investment is essentially geared to meeting demand, the timing of investment will not be, in my view, greatly influenced by what would be slight errors in the setting of the price, errors which would set that price above the level that equates to the competitive rate of return.

That isn't to say that you could not get other dynamic effects associated with monopoly pricing. I think you could and you could get those both in the activity itself and in downstream activities or independent markets. But it's not obvious to me that they would be really terribly great. It's consuming which is not terribly obvious, whereas of course the costs associated with underinvestment include the loss of all of the consumer surplus that is not being met because of constraints on supply and, hence, those losses are likely to be quite large. I do hope that addresses your question.

MR BANKS: No, that does help actually.

MR ERGAS: It may be that I've misunderstood the question or that my colleagues would like to comment.

MR BANKS: I mean you're not denying that if we just take for example an unconstrained monopoly provider in a situation like this, that in that situation investment would be delayed beyond what might be socially optimal in an unconstrained situation. Are you saying that that is not an issue? In other words that you would have, you know, deferred investment from a social point of view occurring under unconstrained monopoly?

MR ERGAS: Well, I think there certainly are dynamic costs associated with unconstrained monopoly. I think it's a fairly controversial issue just what those costs are and how large they are and I'm sure you'd agree with me, just as a matter of economics, it's not a terribly obvious issue. Clearly a monopoly supplier will as a general matter have incentives to maximise profits and hence will by and large operate in a manner that is productively and technically efficient. Now, that won't be technical efficiency in the narrow sense because the level of output of an unconstrained monopolist will, if it's not perfectly price discriminating, the level of output will be wrong and so output will only be at the point that minimises average costs by accident.

So in that little text book sense it's correct to say that an unconstrained monopolist will minimise costs for the monopoly level of output but not minimise costs in the social sense relative to where costs would be in a first-best world. Will a monopolist have incentives that from a dynamic point of view are incorrect? Well, I mean, as you know there is long and rather inconclusive literature about whether monopolists innovate too slowly or too quickly or neither, and I don't think that there is an a priori statement that can be made about that at this stage of our knowledge. Will they in general invest too slowly? Well, they'll invest too slowly to the extent to which demand is constrained by monopoly pricing, and for that given level of demand the monopolist will invest in line with demand. And if the demand is very responsive to price then that will mean that the level of investment will adjust accordingly. I'm not sure that one can go sort of terribly much beyond that except in a rather text book kind of sense.

MR BANKS: Yes, okay. No, that's helpful and your colleagues may want to comment further on that.

MR COSGROVE: You present us with a table on page 11 of your latest submission. The table shows estimates of gross revenue according to proposals put forward by investors and the decisions provided by regulators. I mean, one would think, and it seems that a footnote on the following page of your submission, suggests that there could be some degree of ambit claim in the business proposals regarding revenue, simply because they know that the regulator is there and, you

know, is likely to be looking for ways in which it can prune potential revenues in the interests of - well, the users of the facilities. So I'm wondering what degree of importance we should ascribe to the percentage differences for example shown in table 1. It's difficult, I imagine, to make any clear-cut comment on the possible extent of actual ambit claim but I guess I'm simply seeking your view on whether you think it is a factor in explaining the differences that you're observing here.

MR ERGAS: Undoubtedly the regulatory processes are a process in which there is a sort of bid ask mechanism at work and it does create incentives of all kinds, incentives that themselves reveal the extent of information asymetries. I think that's the fundamental point that we take from this table. We're not suggesting that the decisions themselves were not in some instances correct. They may well have been so. Rather, the point that we make here is that the spread between what is sought and what is obtained, that that spread itself tells you a great deal about the uncertainty and information imperfections associated with this process.

MR COSGROVE: Yes.

MR ERGAS: And that a process which was in many respects more certain than predictable would be characterised, we believe, by a much narrower spread as there would be a great convergence of expectations about what the outcomes were likely to be. It's my impression, and perhaps my colleague can comment on this, that the spread that you see here is very great if you compare it to what experience has been in the UK where regulators have not engaged in optimisation on anywhere near the very aggressive scale that has characterised regulatory decision-making in Australia. John, would you like to comment on that?

MR EARWAKER: I think Henry is exactly right in saying that. I think that comes from two factors. One is that the regulatory regime in the UK is older than the Australian regime and so a lot of the debates have been worked out and there's a lot of certainty around certain key parameters in the pricing decisions that regulators make, say, cost capped or, say, asset valuation, is now quite mechanistic. I think the second point is that the operating cost side where it is the greatest degree of division between the regulator's view and the company's view. Again, that has tended to narrow over time as information has been revealed about the scope for efficiencies in these industries and regulators have to some extent been able to roll forward what has gone in the past so - yes.

MR BANKS: Where you talk about the spread or the gap, are you referring to the gap between the proposal and the decision or are you talking about the spread between how big that gap is for some proposals and how big it is for others? In other words, a variation from 14 to 33 per cent? To me that may be more picking up on John's point about a possible ambit prevention, that might be more revealing, a very significant variation in the difference across proposal but that's not the point you were making.

MR ERGAS: Well, I would say both. I mean, in a sense what these numbers suggest is almost sort of two random process; one random process that is generating the bids and the asks and then a second random process that is selecting amongst them, so you get a big variation in both of those and to my mind it's that that makes the current mechanism so difficult to predict. You go in there and you simply don't know whether - you don't know, (a) what theory the regulator is working to, and (b) how the regulator is going to implement that theory. So you can strike it lucky in a sense if you're the owner of regulated assets, that you hit upon a regulator who both has a theory that is moderately acceptable and implemented in a moderately acceptable way or at the opposite extreme, you can strike it sort of terribly unlikely. Like, this suggests EAPL with respect to the ACCC where both the theory and its implementation were seemingly rather at odds with whatever EAPL may have had in mind.

MS PETERS: Perhaps just another comment that may be worth making is that over time if you have certainty in respect of the regime, to the degree you accept that there are some ambit claims those would tend to diminish because there would be more critical review of the claims by market analysis and others to that eventually, you know, there was some element of ambitness and that would shift over time as well if you were able to have greater certainty at the outset.

MR ERGAS: I would say, just on the basis of our experience, which really in the context of these decisions has mainly been acting as consultants to Telstra, that we certainly didn't perceive the claims that were being made as ambit claims. On the contrary. There was a great amount of effort to try to be conservative in the perhaps mistaken belief that if one not only was conservative but also seemed to be conservative then that would increase credibility of one's argument with respect to the regulator and hence to not only a more favourable outcome but especially a more timely outcome than ultimately proved to be the case. In fact, the situation from my famous short story about an unfortunate Italian who attempted to be honest in his tax return - - -

MR BANKS: The only man in Italy.

MR ERGAS: Yes, that's right, found himself progressively bankrupted as the tax officials kept on scaling up his tax claims in the line that he could perhaps have been honest once but he would surely never be honest twice. So the learning process may in this situation be to some rather pathological behaviour.

MR COSGROVE: Is it possible for you to give us any information regarding similar differences in the UK now that there has been this period in which experience has been gained? I mean, for example, are there still differences there in excess of 10 per cent or are they significantly less than that?

MR EARWAKER: I wouldn't like to put a figure on it but I would certainly say I'm astonished to see 25 per cent and 33 per cent; that those numbers are extremely

big to my experience in the UK. As I say, I couldn't give you a precise number about what the mean difference would be in UK determinations there.

MR ERGAS: We do in fact have a paper that we're preparing and that I think is very close to completion which does provide fairly detailed comparisons for individual decisions between the UK and Australia, though the focus of that paper is primarily on comparisons of the allowed costs of capital, but it does take account of and provide some information on the extent of regulatory optimisation, be it of Capex or Opex costs.

MR WARREN: We'll certainly try and get you some comparisons.

MR COSGROVE: Thank you.

MR BANKS: Thanks. Just moving along, your submission in section 3 talks about coverage of the regime and makes a number of useful points; I think endorses the commission's approach to the objects clause but has a warning there that you can't just rely on an objects clause and the extra declaration criteria is quite important. I guess we would agree with that. The formula which you have welcomed the emphasis of the commission's proposed objects clause, to quote you on the bottom of page 16, is the emphasis on the promotion of efficient investment. I sort of put it to you - I mean, that was certainly the consideration in our mind. I mean, some have been saying to us that while that's important that's not in a sense the overriding objective of the access regime which is really about efficiency in use of these assets or services and that therefore perhaps a better emphasis would be to talk about promoting the efficient use of essential infrastructure services while preserving incentives for efficient investment. There's a nuance there, I guess, but I would welcome any reactions you had to that rather than as it is at the moment promoting efficient use of, and promoting efficient investment in essential infrastructure services. I mean, you can take that on notice if you want.

MR ERGAS: Yes. I think we would probably take that on notice but my immediate reaction to it would be that it's not apparent to me why one would phrase the relevant clause in the way it has been put to you, ie, suggesting that efficient use is the objective and investment is to some extent the constraint. It seems to me that you're attempting to promote efficiency both in the use of and the availability of the infrastructure at issue and that to prioritise them in the way suggested seems to me slightly artificial.

MR BANKS: Although what you seemed to be implying earlier was that efficient investment would take care of itself in a sense in an unregulated environment largely but the timing example of it wasn't likely to be too much of a problem, and therefore what arises as the problem is more the use of that, achieving efficient use, rather than investment.

MR ERGAS: That is, I think, correct but the difficulty to my mind is that one of

the main consequences of regulatory arrangements may be to distort investment and so it's important that in designing those regulatory arrangements proper attention be paid to the fact that in attempting to cure what may be the weakness of the entirely unregulated arrangements you don't create significant difficulties with respect to what might be the strength of those less regulated arrangements, namely the fact that they will not undermine or distort the incentives to invest.

MR WARREN: I think that would be a shame if that was accepted because I think one of the strengths of the position paper was that you really came out and said, "Well, we have to remember the investment side, not just the monopoly rent extraction side." I think that accepting a change like that in the objectives clause would basically say, "Well, let's go back to where we are," rather than - well, may send that signal which says, "Yeah, let's regulate its focus on getting those prices down, getting the consumption and the downstream market signals correct," and I thought one of the great strengths of the proposal objectives was that it said, "Well, you know, hold on here, there's a real issue with ensuring the longer term benefits to consumers, not just the shorter term benefits," and I think that's a nice point about your proposal.

MR COSGROVE: Does your view here depend in part on the way in which regulation has been applied to date or is it more a question of principle that regulation, even with the best means of implementation, would still produce a tendency to favour removal of monopoly rent to the maximum extent rather than having proper regard to the need for the investment?

MR ERGAS: It may be that one could construct regulatory regimes or imagine regulatory regimes which really did not have this problem to any significant extent. It's difficult to comment on that but what I think is important here is that we are looking at these arrangements in the light of their current history and in the light of their history this seems to be an issue where there would be gains to clarify what objectives those who are implementing the regime ought to pursue. It seems to me that in that context the issues associated with the investment are significant. Now, in saying that, I recognise that from an economic point of view investment is just a cost. If you look at it just at an Olympian height standpoint you might say, "Well, investment is a cost like any other cost, and there's no particular purpose that is served by promoting one particular form of cost." Really, the objective is all the benefits that are associated with incurring that cost and ensuring that that cost is carried out in the most efficient way. So from that standpoint it's not the mindless promotion of investment per se that is at issue here. It's ensuring that efficient investment is not unnecessarily deterred or harmed. That's really the thrust of the approach that we have taken.

At the same time it's worth noting, and I think it comes to the point you made earlier or the question you raised earlier about the optimitality of investment in an unregulated situation; that there are those who argued, and I expect this is really a matter on which you will have to come to a view, there are those who argue that

there are significant externalities associated with investment, and really the essence of that argument is to a degree both static and dynamic. The static component is that in anything other than perfect competition and perfect price discriminating monopoly at the margin of investment there is some consumer surplus that is associated with the marginal unit of expansion of supply. If there is any consumer surplus at that margin then that's not internalised by the investor, and hence in anything other than those polar cases of perfect competition and perfect price discriminating monopoly, you can argue that the optimal social level of investment is greater than the level of investment that you will in fact observe. That's the static argument.

The dynamic argument which I think is most explicitly put in the papers for the recent OECD ministerial conference on economic growth is that the evidence seems to be that investment is a very significant causal factor in growth. Even when you, as you obviously must, account for all of the interdependencies between investment and growth and the argument that is put in the paper prepared for that ministerial by the OECD secretariat on understanding growth performance in the OECD economies over the 1990s is that the single most important causal factor is the level of investment and the argument that was put by the secretariat, and again I don't know how much weight one would want to put on it, but the argument that is put there with a great deal of supporting econometric analysis is that the distinctive feature, particularly of the US economy in the 1990s, was the very high level of private sector capital formation.

Now, if you believe that argument which goes really to the dynamic impact of renewal of the capital stock, then the social costs of distorting or reducing incentives to invest go beyond the immediate loss of output or consumer surplus associated with that investment, and hence the weight to be given to policies that do not deter investment; to ensuring that policy does not prevent investment from occurring, that weight presumably ought to be quite substantial.

MR BANKS: Yes, that's the least one I'm saying, I suppose, as a policy implication from that.

MR ERGAS: Yes.

MR BANKS: Okay, thank you for that. Going to about page 22 where we talk about reform of the declaration and sort of (indistinct) criteria, NECG supports the broad thrust, you say, of the tier 1 and tier 2 proposals. I guess it wasn't too clear to me whether you had a preference; whether you thought some minor tinkering with the existing criteria, ie, the tier 1 approach, would be better than a more wholesale reformulation in tier 2. I thought I would just give you the opportunity - I mean, you have talked a lot about uncertainty and so on and that may well be a factor in deciding which would be the better way to go .

MR ERGAS: It seems to us by and large that the proper interpretation of the current criteria is a matter where there is now greater certainty as a result really of

decisions taken by the Australian Competition Tribunal. In that sense we believe that the inherent uncertainty associated with those criteria has to a degree been addressed by the development of precedent. We have an open mind about whether that precedent is entirely satisfactory in respect of the objectives that have been set out and that's an issue to which we are giving greater consideration and would hope to get back to you in greater detail in the very near future.

MR BANKS: That would be helpful, particularly in the context, I suppose, of those two alternative approaches; I suppose the minimalist and the maximalist approaches to it. That would be helpful. There's nothing you could foreshadow now in terms of whether there were aspects of the Duke outcome that worried you in relation to the declaration criteria?

MR ERGAS: It seems to me that the Duke outcome is a complicated one and it's one that has its pluses and minuses, so to speak. Let me put it this way: I believe that the Duke outcome, the outcome in respect of the EGP, is consistent with the criteria as they are set out in the act. In other words, I personally take the view that the tribunal came to an approach to those criteria which is not manifestly inconsistent with the plain words that are set out in the act. Whether that interpretation is consistent with the overall objectives of the act I think is the more arguable question, and really it hinges on the extent to which one views the uneconomic to develop test as a natural monopoly test in an economic sense. If one views that test as a natural monopoly test then I personally do not believe that the tribunal's decision is consistent with that interpretation.

The tribunal's decision is very heavily focused on - in practice I think - the term "service", the issue being uneconomic to develop another pipeline or facility to provide the service. It interprets the term "service" as being not a question of economics but rather, as it puts it, as a question of fact. It defines the service in essence as the menu that the facility owner posts. So if it were asked what the service being provided by an Italian restaurant was, they would say, "Well, it's a service of providing pasta, pizzas," while the service of a Chinese restaurant might be the service of providing - - -

MR WARREN: Shanton chicken.

MR ERGAS: Yes, I turn to my colleague who is more expert in these matters than I. It would then say, "Well, would it be economically feasible in essence for someone else to provide that service?" So what it would say, turning to perhaps a less facetious example, is that the services provided by the Port of Geelong are different services because of their geographical specificity from the services provided by the Port of Melbourne, even though in an economic sense you would think that the services provided by the Port of Geelong are services that would compete with the services that are provided by the Port of Melbourne, and would do so very directly. But the tribunal says, and the tribunal is quite right in that respect, that the concept of the market does not appear in that criteria, and so the fact that on

a competition analysis the Port of Geelong and the Port of Melbourne might be held to be in the same market, is not a factor in the interpretation of the criteria. So it goes to a rather narrow interpretation of that criterion which in my view is not consistent with the concept of the natural monopoly.

At the same time what the tribunal then does is it says, "Well, look, if you were addressing the situation of the Port of Geelong you would have to take account of the fact that Port of Geelong is in the same market as the Port of Melbourne." Hence in asseessing the impact on competition and whether declaring or covering the service would promote competition, you would need to take full account of that competitive constraint that the Port of Melbourne would impose on the Port of Geelong. So the tribunal would say, if you follow their reasoning in EGP and you apply it to my admittedly hypothetical situation of the two ports, that the Port of Geelong, not being a monopolist, the tribunal would say they would need to be convinced that there were strong reasons why declaration or coverage would promote competition, given that this port was in fact not a monopolist.

So the outcome of the EGP decision is to, relative to in my view what was done in SACL in the Sydney airport's decision, the outcome is to alter the balance within the provisions of the act by putting less weight on the uneconomic to develop a test making it do in a sense less work, and imposing more weight on the promotion of competition test which, in the tribunal's decision, is the one that does virtually all of the work. Now, the difficulty, and that's why I said we have, and I hope I speak for my colleagues too, an open mind in this respect, is that that is not necessarily a harmful outcome, and certainly our client in those proceedings is very happy with that outcome, namely Duke and EGP. So it's not necessarily I think, even setting aside parochial interest, necessarily a harmful outcome but it's certainly an outcome that merits close reflection and I think your deliberations are really a very timely opportunity to reflect on whether that is the balance that you want in the way those provisions work. Does that advance your - - -

MR BANKS: No, that's quite helpful. I guess in a sense you could think about this more in looking at our tier 2 proposals, you could argue that it's not inconsistent with the tier 2 sequence that we have got where the natural monopoly test is sort of at the screening stage before you get to the competition, and it could be interpreted as a - I know you don't like the concept but a natural monopoly technology which to some extent abstracts from the wider market circumstances of substitutes and competition. You could imagine other situations, for example, a rail infrastructure which had intermodal competition but under the narrow definition was a natural monopoly technology but wouldn't be declared because of, say, strong intermodal competition. That might be analogous to what happened in the Duke situation .

MR ERGAS: That is absolutely right; that what the Duke decision of the EGP decision would say is the railroad going from point A to point B would meet the criterion of being uneconomic to develop - either it would be uneconomic for an alternative to be developed. At the same time if you had intermodal competition it

would be the case that the competition test would not be met. I have reluctance to accept the concept of a natural monopoly technology because I believe that a natural monopoly is a form of monopoly so that to be natural monopoly you have to be a monopolist to begin with. Natural monopoly is simply a monopoly that is a monopoly because cost conditions are such that it's sufficient for only one firm to serve the market.

MR BANKS: Yes.

MR ERGAS: Whereas the only Italian restaurant in Aranda is undoubtedly such that it would pass at least that component of the test but I would be hesitant to say that it had monopoly power in any known economic sense.

MR BANKS: So I guess the only question then is in an administrative sense, whether that two-part assessment of natural monopoly is easier to administer or to grapple with than combining it and trying to assess in a sense the nature of the technology, the scale economies or whatever, and then the broader substitutions that occur within the market.

MR ERGAS: I believe that's right, and you have posed the question very well. What in my view was done by the present criteria was really to distil the perhaps conventional essential facilities test in the United States. That conventional essential facilities test had really two elements to it; that there's an upstream monopoly in an economic sense, and that then you assess the impact on competition in another market. So in that sense there are two markets at issue; first, in the upstream market are you a monopolist, and then if you are a monopolist are you distorting competition in the downstream market. But the objective of the assessment is really with respect to the downstream market. The upstream analysis is instrumental. It is a step in getting to the final point of whether some form of regulation, be it as in the United States, under anti-trust provisions in the context of essential facilities or here through Part IIIA, whether that regulation will likely promote competition in a way that serves the overall cause of economic efficiency.

You could argue that the same end point could be obtained by streamlining the assessment of the upstream situation and focusing more heavily on the assessment of the downstream impact. The one caveat that I would express in that regard is this: that the assessment of competition and of the way in which particular measures affect competition is a fairly uncertain process. It's clear if you read the tribunal's decision that they grappled, and grappled fairly mightily, with a wide range of indicators before coming to the view that coverage would not promote competition downstream, and equally if you look at the record of decisions under Part IV of the Trade Practices Act it's clear that the assessment of whether particular conduct either does not substantially lessen competition but that is a fairly complicated exercise from the point of view of determination of fact, determination of that likelihood.

It was, I think, relatively easy or easier in the context of the SACL decision

because in the context of SACL you had these access seekers who were at the gate and entry was being denied to them, and so the tribunal said in SACL, "Well, it's pretty clear that competition will be promoted," but even then quite a few reasons as to why it saw opening that gate or opening that door as they put it would in fact promote competition. So that assessment of competition and of competitive impacts is by no means a trivial task. It's by no means a certain task, and you must wonder whether the cause of administrative efficiency is best served by putting so much of the weight on that particular criteria.

It seemed to me, and this was the argument that we put in the context of the EGP proceedings, unsuccessfully put, that it was fairly obvious that the EGP was no monopoly. The tribunal accepted that. It actually texturally says, "The EGP is no monopoly," but when it came to the consideration of the criterion that the fact that it was no monopoly wasn't directly relevant, but it seemed to us so clear and so much easier that perhaps it would be better to have that criterion do some of the work rather than, as it is in the current situation, where the single Italian restaurant in Aranda would for this purpose be held to meet the criterion as it now stands.

MR BANKS: Yes. I just wonder though to what extent you can get away from this need to have a close assessment of the computer because if you go the other route you have to put the Italian restaurant in a market.

MR ERGAS: That's right.

MR BANKS: So you have to define the market, you have to look at the substitution possibilities and so on, so you can't escape it. What you're trying to do is do two at once and you just want return and - you know, the scale economies I guess of the Italian restaurant in that market which I just wonder to what extent it's avoidable.

MR ERGAS: True, and I'm not suggesting that it is entirely avoidable by any means but the upstream assessment is easier because to a degree you're just looking at direct substitution. In the context of the EGP the question with respect to the upstream is, are the services provided by the MSP substitutes in an economic sense for the services provided by the EGP. If they are, and if the criterion is read as a conventional natural monopoly criterion you stop there, right?

MR BANKS: Yes.

MR ERGAS: So the difficulty with the promotion of competition criterion is that what you are looking at is the indirect effect that the test is if I cover or declare the upstream service how does that affect competition in a distinct but dependent market. So that requires an assessment of competitive conditions in that dependent market and then of the link between those competitive conditions and the upstream market. That is quite a complex assessment. I think you can do it well. I think regulators are certainly familiar with that kind of assessment. We have a fair degree of experience of that kind of assessment because it's after all the essence of Part IV of the act but

it's always a fact intensive and quite costly assessment and so there's the issue then of whether you want to impose that burden on access providers.

Bear in mind that it's generally much easier for the access provider to identify the competitive constraints that bear on its own activity than it is for it to fully understand competitive conditions in a distinct but dependent market, and so if you're an access provider and you're worried about whether or not you're likely to be declared or covered, it's much easier for you to know whether there are substitutes for your service in the market and hence come to a reasonable view about that than it is for you to know how the imposition of a regulatory regime on the services that you supply might ultimately affect competitive conditions in another market; typically a market where you're not present.

MR BANKS: Okay. You have asked us to explore the potential for proposed changes to introduce additional certainty. If we put all of that to one side do you have any views on whether tinkering introduces less uncertainty than a wholesale change, given as you say that - well, there are some developing case law and precedent, it's still relatively early days. Some might argue that a small change is just as problematic because it raises questions about why the change occurred and whether there was some other changes and objectives or whatever, whereas if you provide the whole parcel it will be looked at in its merits as a parcel and therefore in some respects give rise to less uncertainty but that's an argument that has been put.

MR ERGAS: The approach we have taken is that of saying, and my colleagues may well to comment on this, that we believe the broad architecture of the regime is right. We don't believe that at the moment there is a need for wholesale change to the regime. What we believe is doable and worth doing is really to add to the existing arrangements, and our proposals, particularly those that go to terms and conditions of access and the manner in which they would be determined, are really aimed at adding to the current regime a greater degree of specificity than was introduced to it when the regime was first set up. In our view it is feasible to do this because we now have quite a bit of experience to go on, and that experience both highlights the difficulties that the current vagueness of the regime creates but also gives us the basis on which to provide greater guidance than it now has. So our proposals, particularly in respect of pricing and the manner in which those pricing decisions would be taken, our proposals are in our view certainly capable of sitting within the architecture of the regime as it now stands, and rather than create new uncertainties will generally, we hope, help to resolve them.

I agree that in terms of some other areas in the regime, for example the coverage criterion, it may be that minor tinkering would create more costs than benefits at this stage, and so if change was considered desirable it may be that it would need to be on a more significant scale. Anne or Tony, would you like to add to that?

MS PETERS: Yes. I don't know that I would go so far as to say a wholesale

change, particularly in relation to the declaration criteria, but to really use as you said, Henry, this opportunity to reflect on what we have learnt in the few decisions that there have been, and perhaps to expand upon the criteria, even the declaration context, to clarify what the regulator should be considering applying those decisions, but I agree probably at this early point in time to basically go and rip all the declaration criteria out and start again is not really going to be terribly helpful.

MR WARREN: Particularly in the context that we haven't had wholesale regulatory overreach under these criteria. Now, there is the issue of certification criteria and how that feeds through into the other regimes which may be more difficult but I mean, if you compare it to IXC, we haven't seen anything like the expansion there. There are a number of reasons for that but one of the reasons is the declaration criteria under IIIA are much stronger than they are under IXC so it's not like we have to raise the hurdle too much anyway.

MR ERGAS: I would say that that doesn't apply. As Tony put it, it certainly doesn't apply to all of the regimes that we have under the general rubric of national access arrangements, and even specifically under Part IIIA. For example, I think it is a matter of concern that the criteria for coverage under the Gas code are phrased in terms of another pipeline. Whether it would be economic to develop another pipeline to provide the service which excludes those considerations of intermodal competition. So there are some changes there but - - -

MR WARREN: That's the problem with the inconsistencies between IIIA itself and the certified regimes or the regimes that fall under its umbrella and that's where I think we should - - -

MR ERGAS: But a broad approach is to say that we think the overall architecture of IIIA is quite reasonable.

MR BANKS: Okay.

MR ERGAS: What we would like to see is the architecture preserved and its objectives clarified and then some important elements of its implementation clarified.

MR BANKS: Good, thank you.

MR COSGROVE: Time is getting by. We will need to move fairly quickly.

MR BANKS: Just on that, are you okay till 11.30, if we went through till 11.30?

MR ERGAS: Yes.

MR BANKS: Is that possible, okay.

MR COSGROVE: Just a quick question about table 2. Your request here for

fewer differences if you like between the declaration criteria and the certification criteria, what's the real substance in that request? Is it more than a matter of regulatory neatness? For example, do you think that under the existing certification criteria NCC might have been making some incorrect assessments of regimes? We need to bear in mind here that this is pretty much at the heart of the federal-state nature of the competition principles agreement and in efforts to introduce greater consistency, while desirable in themselves, might rankle some key participants in the whole deal. So how important do you see this need for greater consistency?

MR ERGAS: I take that point; that attempting to amend the competition principles agreement, would have costs, and difficulties associated with it. At the same time I, without wanting to criticise the council, I believe that the situation in which the council has been placed is not an entirely satisfactory one. I would say not entirely satisfactory from the council's own point of view in the sense that the council has had to read into the certification criteria in a manner that is perhaps a bit more liberal or interpretative than certainly some of the states and territories believe appropriate. I don't think the council has done so in an inappropriate manner and I additionally don't believe that the objectives that the council has pursued in that interpretation have been themselves inappropriate, but nonetheless the reality is that these differences do place the council in a difficult position.

They may also lead to unwarranted and ultimately inefficient forms of regulatory arbitrage as between state regimes and national or Commonwealth regimes and that there would be gains from having the greatest degree of commonality between them so as to ensure that access providers weren't artificially harmed or hindered by whether they were under the jurisdiction of the state arrangement or the jurisdiction of the Commonwealth arrangement.

MR COSGROVE: Thank you.

MR BANKS: Perhaps just moving on then to the section where you talk about mechanisms for exempting investments, I must admit when I first read the submission I wondered whether you were interpreting our proposal for access holidays as the next anti-measure or not, but in your presentation just then it seems more clear that you do recognise that the idea of an access holiday was to have an ex anti-provision.

MR ERGAS: Yes.

MR BANKS: So that's clear, yes. I guess I just wanted to explore with you, the way you have now expressed it is over and above access holidays you say, "All potential investors should be able to obtain preliminary advice analogous to the pre-notification procedures within the merger guidelines," and so on. Now, I first thought that you were seeing that as an alternative to access holidays and I was going to ask whether in fact that prenotification process could really be regarded as a safe harbour because I mean my interpretation of a safe harbour is a rule that is fairly

transparent that participants can understand and make decisions on the basis of it without having to go cap in hand to the regulator to get an interpretation, and that that has certain advantages to it.

The problem I saw with what you were proposing was all it did in a sense was bring forward the need for the regulator to go through the agony of deciding in advance and to what extent the regulator realistically would be prepared to lay himself or herself on the line in that respect. I mean, you may have had Duke in mind as the sort of case that would have been sufficiently clear but Duke didn't demonstrate that because the regulator actually went the other way.

MR ERGAS: Yes.

MR BANKS: So I just wondered in practical terms to what extent this would solve the problem and would actually reduce uncertainty relative to something like a safe harbour, and we could talk about it in a minute, involving say an access holiday where the rule is a more clearly established.

MR ERGAS: Yes. With respect to the Duke situation I am not entirely across the history of that to be honest but certainly Duke's own view of it is that they believed that their pipeline was not going to be covered and they were surprised when coverage was eventually determined, surprised and disappointed, and in that sense they believe that they would have been better off if they had been able to go to the regulator at the outset and get a binding commitment or at least a commit one way or the other which would then have guided some of their decisions. The goal here is admittedly a fairly limited one. It's simply to create the scope for that to occur. I agree with you that that's not a panacea. It retains the discretion that the regulator has. It doesn't materially bind or limit the discretion. What it does do, and perhaps the strongest arguments in its favour is that it telescopes that decision back to the time when the investment decision is being taken and that to my mind is helpful for two reasons.

The first is that it avoids some of the problems associated with possible opportunism where an access seeker in effect waits until the investment is sunk and then seeks declaration or coverage. Because it telescopes that decision back about the scope of the regime to the time when the investment decision is being taken it eliminates or at least reduces the asymmetry and bargaining power that exists between the parties because at that point the investor hasn't yet committed the hostage the fortune that the sunk asset ultimately represents. So that's the first in my view not insignificant merit of the proposal. The second - - -

MR BANKS: Also as you're saying, because it's a sunk asset, the risks are elevated precisely for that reason.

MR ERGAS: Exactly.

MR BANKS: So it doesn't diminish the uncertainty bearing on that decision.

MR ERGAS: No. The second in my view hopeful element in it is that if the regulator does say, "Look, I genuinely cannot at this stage decide one way or the other," then at least the investor knows that and can factor that into the risk assessment about the investment decision. You can take an investment decision which is consequently better informed. So it both has an impact on the dynamics of the coverage or declaration decision and can help guide the investment decision as it's actually made.

MR BANKS: Yes, okay. I think those points are right. I guess for us a question is to what extent you would need that if you had a properly constructed access holiday and that's something that we could perhaps explore. For example, one that essentially applied to all the new infrastructure that was contestable, so any new investment, whether as an extension to existing infrastructure or greenfields investment that was contestable, the onus would be on, say, the regulator to show cause why they shouldn't get an access holiday.

MR ERGAS: How would you define contestable for that purpose?

MR BANKS: There is a question, and we could think about that, but I mean in a simple minded way, you know, any investment that potentially could have been undertaken by more than one player. That doesn't depend on circumstances where the incumbent has a dominant position and can exclude anyone else from vying for it. We talk about pipelines. I think yesterday we were talking to APIA about this process and essentially - I mean, the point they were putting is that most pipeline development is contestable and fairly hotly contested at the development stage. One concern that you have voiced, and I think others have voiced, is that, "Well, if a holiday implies something of fixed duration, and if you give a holiday that's too short, then you're giving it at the wrong time, and at the very time when - - -"

MR WARREN: The blue sky arrives.

MR BANKS: " - - - when the blue sky comes then, bang, you get - the regulation sort of comes into play." So that's a question of the duration of that and I guess the pipeline people thought that, you know, 20 years would be appropriate from their perspective, at least 20 years I guess, to overcome that. But it might be something that you could get back to us on but this notion of contestability seems to us, as we indicated in the position paper, as a key to it, and you could almost think about the exceptions. You could put a circle around the exceptions rather than what's in, and you can think of situations like replication or the superseding of an existing network by an incumbent would be a situation which you wouldn't give a holiday because there would be obvious potential for market power there, or augmentations to infrastructure that's already accorded an access holiday where that augmentation is undertaken by the incumbent again using that position that has been established, and they might be exceptions. So in other words, the onus would be on the regulator in

other circumstances to demonstrate why an access holiday shouldn't be given.

Alternatively if an applicant didn't fall into that category and wanted to go for a holiday, the onus would be on the applicant to demonstrate why a holiday should be given which sort of equates to your pre-notification type arrangement, which would pick up the residual in a sense. I don't know whether you have any immediate reactions to that but I would welcome any - - -

MR WARREN: I just want to clarify. I think our comments on the access holidays here are predicated on the interpretation of the position paper which was that it was timed to limit it and focused it at greenfields. So our commentary was really on the basis of that point and I think we wanted to push back a limit on the time to limit problem which you had already raised. I would be a bit worried about adding in a new dimension where we can sort of stretch or shorten the holidays on some kind of regulatory basis. I think that would open up a whole new dimension of, "Well, how long are you going to give us," et cetera.

The other concern, and I think this is one you have picked up, was this idea that it was greenfields only and you're suggesting it's more augmentation. I think the point we wanted to make there was augmentation rehabilitation, the numbers just swamp greenfields' investment. I mean, it's just a huge factor and so really for many of the investor group that's really where the issues are at, not in sort of new greenfields pipeline but in the day-to-day upgrading, building, extending of their existing network, where the real money is at.

MS PETERS: Also the concept of risk doesn't lie only with new investment but rely on exactly that - - -

MR WARREN: Exactly.

MR BANKS: But if you think about augmentation, again in this contestability sense, you know, quite a bit of augmentation could be picked up. I mean, if it's augmentation by someone else other than the provider then that implies a contestable situation, where if it's augmentation of a facility that's already declared, then again that could have been done by somebody else presumably so there's a notion of contestability in that too. So I guess - - -

MR WARREN: I think the example we had in mind there was one that arose in the XIC context but - this is the digitisation of the Telstra HFC. So you have got, "Is that really greenfields or is that augmentation of existing investment," and some of the points I think we make in the document is that there's a real administrative issue, at what stage it flips from being simply, you know, day-to-day maintenance if you like to a substantial new investment. So those were the issues that were playing on our mind when we looked at your access - and that underlay our comments on access holidays.

MS PETERS: I would probably place it higher than just administrative issue.

MR WARREN: Yes.

MR ERGAS: We will certainly get back to you on the question that you have raised and the scope for such a mechanism. I can see many benefits to a mechanism of the kind that you suggest; that there would be two concerns in my mind. The first is the administrative clarity of the underlying concepts and hence the ease with which the transparency and predictability with which the approach could indeed be implemented and the second is that you would want to reflect carefully on whether the approach will on balance promote economic efficiency. By that I mean this: that undoubtedly there may be a race to be the first person to build the only bridge that crosses to the island but if the consequence of being the first person to build that bridge is that no controls can be imposed on that bridge, then that creates two risks, and without wishing to say that those risks are in any way determinative, they're worth noting, the first is that the bridge will be built too soon because part of the benefit of building the bridge is that you get the entitlement to the holiday.

So exactly like the patent race or the race associated with any system of first possession, investment decisions and the timing of investment decisions are distorted, and then the second risk is that once it's built, not only is it built at too high a cost because the timing decision is distorted, but also you get all of the static abuse associated with the fact of sole supply. So again it comes back to this, I think, incontrovertible - an uncontroversial proposition that the mere fact that you have an investment race to supply a particular asset will not as a general matter ensure that you get either efficient investment or efficient use. So that in considering a proposal such as yours, which strikes me as on balance likely to be a very good one, you would need to ensure that proper weight had been given to whatever risks it might create.

MR BANKS: Yes. I will have to think about that. You could argue - I mean, in a sense there's always an investment race to do things that are profitable. What we're talking about here is a situation in which a piece of infrastructure - I mean, that bridge doesn't become profitable until investors perceive that enough people are going to go across it and there's a bit of a risk about that. You don't know exactly how many are going to go across so they make judgments and some might make a better judgment or be less risk averse and they get in first. What you're saying is that the regime itself may then distort those incentives, but if the holiday was generally available in a circumstance like that, then whether they went later or earlier would be no consequence in terms of the regime of what applied. It's just one of those things for which there would be an access holiday.

MR ERGAS: I mean, I think it would still have an effect on the timing of investment. Whether that's a significant effect, whether it's a material effect, whether it was a very costly effect, they're all things that you have to consider, and that you have to set against the obvious benefits that flow from that approach, but it does

seem to me that if I wanted to argue against it, and I assume there will be people who will argue against it, that would be the natural argument to run so you would probably be well advised to at least consider that argument and the weight you want to place upon it.

MR BANKS: Good, okay, thanks for that. John?

MR COSGROVE: I was going to jump onto a brief question on page 32 of the submission where you're discussing the proposed pricing principles in our position paper. You suggested that you have a preference for the phrase costs prudently incurred over efficient long run costs. There are a number of issues involved in either change but would you have any concerns similar to some we discussed earlier this morning about possible legal uncertainties there or is this a pretty well accepted phrase?

MR ERGAS: My colleagues are all pointing at me because - yes, they're cowards. No - - -

MR COSGROVE: For that reason as well. Perhaps a question best put to the Law Society but - - -

MR ERGAS: There is indeed a body of interpretation with respect to the concept of prudently incurred costs. That's mainly in the context of the US-style rate of return regulation where regulatory agencies in essence allow costs to be recouped unless it can be demonstrated that those costs were not prudently incurred. It seems to me that what can be said in favour of the concept of costs prudently incurred are really two things. First, that it to some extent shifts the onus onto the regulator of demonstrating as at times occurred under the US regulatory proceedings, that particular costs were indeed imprudent. Second, that it concentrates the assessment not on the ex post situation but rather on the situation at the time when the costs were being incurred. So it doesn't say, "With the wisdom of hindsight would you have built a smaller bridge," which tends to be an assessment that is terribly - heads, I win, tails you lose. If you have built the bridge then it's optimised down, no-one comes along and practice - says, "Really, we'll have to compensate you for a slightly bigger bridge. Compensate you for a smaller bridge." So it has the wisdom of hindsight in that the concept of efficient costs today, whereas the prudent cost approach says, "Was that a sensible decision to take in the light of the information you had when you took that decision?"

MR COSGROVE: Couldn't you conceive of a concept of efficient costs as of today just as you can for prudently incurred costs?

MR ERGAS: Do you mean a concept of ex ante efficiency?

MR COSGROVE: Sorry, the concept of?

MR ERGAS: I am not sure I understood the question. But are you saying could you conceive of an efficient cost concept that was also ex ante?

MR COSGROVE: Yes, indeed.

MR ERGAS: Yes. Well, you could, and what you would assume is that those would be the decisions that would be taken by a properly managed, ie, prudently run firm. So it may be again this is simply a question of terminology and the way it's developed in practice but in practice reference to efficient costs have been interpreted as meaning the costs that you would incur today if you were taking that decision rather than the ex ante concept of the costs that you would have chosen to incur at the time in light of a proper assessment of the information available to you.

MR BANKS: So you're seeing it as favouring or encouraging or allowing an optimisation approach? Is that what you're - - -

MR ERGAS: Sorry, which one, the efficient cost concept?

MR BANKS: Yes.

MR ERGAS: Yes. Well, we believe that the way that the term "efficient costs" has been interpreted in practice by Australian regulators is as the costs that would be incurred today in light of the for instance that is available today if you were constructing those assets.

MR BANKS: Yes.

MR ERGAS: So it's with the wisdom of hindsight, and although it penalises, even efficient decision making in a situation of inevitable uncertainty. I am willing to accept that you could have an efficient cost concept such as the one that you have set out but it seems to me that that has as its necessary consequence that you have to compensate firms for the more substantial risk of stranding that they face as a result of ex post optimisation. In a way that's a social cost benefit decision which, whether you believe it's better done ex ante or ex post - - -

MR BANKS: Yes. Good. One eye on the clock, we're moving, and we should move pretty fast. I won't detain you much longer but on about page 36 of your position paper following on from what you're saying here, I mean, you talk about the risk of stranding and you're talking I think largely about the risks of assets being marked down through an optimisation approach. We had BHP talking to us in Melbourne and also again yesterday where their perspective on it from a user's point of view was the opposite way. That is that optimisation approaches involve a DORC, involved assets being revalued upwards. I'm particularly concerned about transitional situations where that was providing a windfall gain and flowing through the higher prices which users were having to pay.

I mean, is your perspective more from a telecommunications perspective? I mean - - -

MR ERGAS: I haven't read, and hence you know it may not be doing justice to the argument that was put to you, but the way I have heard that argument in the past generally leads me to believe that it confuses two rather different things. Those two rather different things are the difference between accounting at historical cost and accounting at replacement cost. That's element A. Then B, the extent of optimisation. You could have, and indeed there is some experienced with, systems that are regulatory systems that are based on historical cost yet optimise costs out of historical costs, right?

MR BANKS: Yes.

MR ERGAS: As I have understood the argument that at least I heard presented on other occasions, what is of concern to those putting argument is that the assets have a value at replacement cost in excess of their value at historical cost, but that is - in a way there are two elements to that gap. Think about it this way: you have a set of assets that you have purchased, that period T equals zero or some set of prices, and so the value of those assets at period T equals zero is P zero times Q zero where Q is the quantity of the assets that you have purchased. Then you revalue them at some future period, say, T equals N, and there are two components to that. There's the PN and the QN. Now, the optimisation essentially bears on the QN that you allow at the second period but quite independently of that the price on revaluation of the total value of the assets more properly at revaluation may be higher than the depreciated historical cost because the P component has changed in the period.

MR BANKS: Yes.

MR ERGAS: The way some access seekers view that is that the P component ought to be treated as some kind of capital gain which, if it's provided to the facility owner, is effectively a windfall gain to the facility owner. Now, to my mind the difficulty with that - I mean, that's a very complicated argument I believe. I'm sure I can't possibly do it justice in a few moments but perhaps the simplest thing that can be said in respect of that argument is that if you were using the approach of depreciated historical costs in situations where relative prices had changed materially so that the P terms were very different from what they had been at the outset, if you were using that approach to set essentially uniform prices for the services then those uniform prices could not properly reflect long tun marginal cost. The reason they could not properly reflect long run marginal cost is because long run marginal cost would be a function of price today, not price at period T equals zero.

If you believe that the prices ought to reflect long run marginal costs, and if you're constrained to have essentially uniform pricing, then that objection is in my view pretty fatal with respect to that argument, but on the other hand if you either are not required to have uniform prices or are not particularly worried about whether

prices reflect long run marginal costs then the argument may have more substance to it.

MR BANKS: Okay. I mean, we would certainly appreciate if you had the opportunity earlier to have a look at that paper that Prof Johnstone talked to on Wednesday, we would appreciate that.

MR ERGAS: We certainly will.

MR BANKS: Good. All right. Let's just quickly scan to see what we really to detain you on before you go. I mean, the arguments you have made about the single regulator will certainly reflect on. I think you have given us - I pause there. I just wonder whether - had you made comment about the role of ministers in all of that? I don't think you had anything in your submission. As you know we had as our tier 1 proposals that ministers could well be removed from the process to the net benefit of all concerned but some have objected to that, particularly some state governments I think. I don't know whether you have any views on that.

MR ERGAS: I will take that question on notice. I'll put it to the minister.

MR BANKS: Which minister? Okay. Yes, again you have taken exception to our tier 2 proposal in relation to appeals by the facility owner in relation to declarations. I mean, I guess an element of our logic there was that - I mean, we were trying hard in a sense to find ways of expediting things. An element of our logic there which you berated us for I think was that - but we thought at least there was a second opportunity for the facility owner as opposed to the access seeker to appeal at the stage of the determination in relation to terms and conditions. I guess I might just get you briefly to comment on why you don't think that's good enough. It's implicit in things you said earlier I think about the importance of the coverage decision but would you just like to comment on that?

MR ERGAS: I think our view on that broadly, and my colleagues may have quite a bit to add to that, but our view of that is that the coverage decision is from the point of view of the facility owner a very significant one and it creates a new set of risks and obligations that bear on that part, and it is in our view appropriate that that decision should be open to review. It's appropriate because the stakes involved are really quite substantial, and it must also be said that even the best regulator can get that decision wrong. So that there is merit in having potential for review. In my own view the issues associated with review, if there are concerns there about timeliness, they're perhaps best addressed by imposing tighter time lines on the review process.

To the extent to which you get clarification of the criteria for declaration as an outcome of your consideration of national access regime, then that again should make all of the processes quicker including the review process but it's very difficult from, I think, the prospective of even a relatively simple cost benefit analysis to conclude that the cost of a bit more delay in what is in any event a fairly lengthy

process, but the cost of a bit more delay would swamp the benefits of being sure of getting it right when you're dealing with investment decisions that have lifetimes of 20, 30 or 50 years. Surely in the case of such very long-lived assets and very long-lived decisions it's worth ensuring that you get it right, and if the price of that is that a bit of time is spent in the Australian Competition Tribunal, and hopefully a bit of money is spent on excellent economists to argue the toss either way - - -

MR BANKS: And hopefully a better decision.

MR ERGAS: Yes, I suppose a better decision, then in the long run society ought to be a winner.

MR BANKS: You might have a look at the transcript in relation to what Prof Johnstone said about our profession, or your profession.

MR ERGAS: Well, coming from an accountant as Prof Johnstone is, a distinguished accountant, but nonetheless an accountant, that has to be - - -

MR .....: Your worst case.

MR ERGAS: No, it puts itself in perspective.

MR BANKS: Okay. Sorry, I - - -

MS PETERS: Sorry, I was just going to add to Henry's remarks that I suppose there seem to be a sort of underlying suggestion in the position paper that one could address those areas as you said through sort of the second order, ie, in terms of price, but I think some of those concerns are just so fundamental to the operation of the regime is certain to hear the flow-through effects on other investments, all those sorts of issues, that you can't really address that type of thing in that context of price alone. I think you will need to maintain those rights there and perhaps to question the sort of perception being created about delay and look at those other mechanisms that can - if that's right, if that's in fact a problem that we need to do something about them, we can do that in other ways, but particularly at this early stage I think of the regime too - I didn't realise it had been in place for a while now but it's still relatively early stages so I think to start peeling back some of those important review processes is not really justified at this time in view of the costs associated with it.

MR ERGAS: Might I say that I think some of that perception of delay was due in part to the SACL decision which did take an unnaturally long time. Tony and I worked with the applicant in that decision and it's true but unfortunate that the applicant had perished by the time its success was announced, not to mention by the time our invoice got sent, but in contrast it must be said in all honesty that the EGP decision and the EGP process was really quite expeditious and the timelines there were very tight indeed, and I think that there were some unfortunate, really coincidences as it were, or endogenous factors, that bore on the time it took for the

SACL decision - there were complications there. Those were in my view quite exceptional and in contrast in the EGP case which was a more normal case, the proper case management processes that the tribunal has ensured that a decision was come to in a matter of a couple of months.

MR BANKS: Okay. I propose ending it there unless you have any further remarks. We appreciate the effort you have put into submissions and participating today, and also if you are able to get back to us on those matters, that would be helpful to us. We put our transcripts up on the Web site within a few days and you may find it helpful to look there, you know, at some of the things that others have said as well. So thank you very much.

MR ERGAS: Thank you, and thank you also for what we thought was a very valuable paper and we will get back to you on those questions that we weren't really able to address in detail this morning.

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

MR BANKS: Our next participant is the Australian Chamber of Commerce and Industry. Welcome to the hearings. Could I ask you please to give your names and positions.

DR KATES: Yes. I'm Dr Steven Kates and I'm chief economist at ACCI.

MR SHIRLAW: I'm Matthew Shirlaw, economist at ACCI.

MR BANKS: Thank you. Thank you very much for attending and for the submission. I'm sorry for the delay which wasn't entirely our fault but I leave it to you now to make the main points. We only have a few questions that we will come back to at the end of that.

DR KATES: Yes, and thank you for giving us time to speak to our submission. In our view the national access regime should be focused on improving access to those essential facilities which are not commercially or economically viable to replicate but they should not, we stress should not, provide a means for a potential competitor to gain access to the capital assets of a provider simply because it would be commercially convenient so that there is a clear distinction in our own minds. We concur with the Productivity Commission's report that a review of Part IIIA and clause 6 should ensure that firstly the national access regime is given a tighter focus. Secondly, a greater emphasis is placed on incentives to invest. Thirdly, that clear guidance is given to regulators and industry. Finally, that measures are introduced to make the process more workable in general.

We just note that in regard to the incentives to invest, that the whole point of the access regime is that it has potential to deter investment, and in fact if there was a commercial outcome it would just happen automatically that you would get that automatically so obviously there are commercial costs involved for the provider. Despite the fact that access regulation does involve some cost, and the current framework has a number of deficiencies, it is ACCI's belief that a retention of the regime is warranted. A decision to a better national access regime on the basis of its limited practical experience would be in our view premature. It is clear that in order to introduce competition to markets at which there exists a high degree of monopoly power an appropriate access regime may be necessary. Business does, however, have a number of concerns as to the manner in which the national access regime would be administered.

We note here that while access arrangements are unlikely to succeed in promoting competition without some form of external regulation an external regulatory body must ensure that firstly the process of negotiation between an infrastructure provider and a third party is smooth; that owners are not - I think I should put into quotes the word "unduly" but unduly disadvantaged. Thirdly, future investment in infrastructure is not discouraged. I think that's a really crucial one. But we're also ourselves mindful of the fact that property rights, particularly in the private sector, are being infringed, and there is I think just an issue of serious

principle here that has to be considered because it's not, I think, in our view straightforward even if there are national economic benefits in the narrower sense in terms access to this particular infrastructure. There are wider implications in terms of how a free enterprise economy actually exists and the fact that these property rights are honoured.

In our view an external regulator should only be given power to set access prices when negotiations background a potential competitor and a facility owner do fail. We do not express a preference for any particular access pricing method but reaching the ultimate goal of increased competition. We think it would be essential to ensure that the cost to existing infrastructure providers are more than matched by the advantages to the community in general so there has to be that continuous weighing up.

In regard to the tier 1 proposals we agree that - well, firstly in regard to the objects clause we would be in favour of the inclusion of an objects clause within Part IIIA of the TPA. It is likely to clarify the objective of the regime and reduce the frequency of disputes. An objects clause would clearly or help to clear up to ensure a more consistent application of the natural access regime. Secondly, in regard to pricing principles, rather than the inclusion of a specific pricing principle under Part IIIA, a more appropriate proposal and one which is consistent with the findings of the Hilmer report, would be to recognise that there are a variety of access pricing methods and ensure that the most appropriate method is chosen on the specific merits of each case. (3) in regard to certification of Commonwealth industry regimes ACCI shares the Productivity Commission's belief that the same obligations that applied to private sector participants under a national access regime should also be extended to federal government and its agencies.

Furthermore it should be recognised that the implications for investment are much more severe when a private sector owner is forced to provide access. I think that's a really important crucial issue. In regard to ministerial involvement, which is the fourth point, ACCI recognises that the ending of ministerial involvement may improve efficiency with regard to reducing the delays which are inherent in the current system but that such a proposal would be unlikely to be accepted and moreover ongoing (indistinct) in our view would be necessary to ensure that the authority for decision-making is not given entirely to an external regulatory body such as the ACCC which has limited knowledge of the intricate work of the particular industry in question. So in regard to ministerial involvement we think it should continue.

In regard to tier 2 proposals firstly we speak to the efficiency objective. ACCI considers that it is essential to recognise the context with which the national access regime operates. The regime was developed out of the Hilmer competition reforms in the mid-1990s. The access regime gives effect to a large area of national competition policy and it is business's view that it should remain in this context. The underlying assumption of the national competition policy is that enhanced

competition leads to greater efficiency. However, ACCI does not accept that competition-based reforms are the only means for improving efficiency. ACCI is therefore unconvinced as to the need to modify the declaration criteria to focus more on efficiency.

Secondly, regard to the issue of a single regulator. Whilst the ACCC has clear expertise in competition law and policy matters, there is also a high risk of excessive concentration of regulatory power in a single agency. Moreover, it would be unlikely that the ACCC would have an adequate and detailed knowledge of each industry to which the national access regime has relevance. Specialist knowledge would be the proper basis on decision-making and ACCI would be extremely reluctant to see a shift from present arrangements. Moreover, an external regulatory body must not be given the power to interfere in the negotiation process but most provide a medium for negotiations. I think I'll leave that there. We will just turn to questions now.

MR BANKS: Thank you for that. The point you made in relation to pricing it wasn't clear to me from your submission whether in saying that you were opposed to the pricing principles we had or you accepted those but were wishing to have, you know, other provisions in there to allow greater scope to tailor the arrangements to the particular circumstances.

DR KATES: Yes. It wasn't that we particularly objected to the ones that were listed in the submission itself, but our view was that there should be more of a case-by-case approach so that you did not find yourself tied to an inappropriate single or multiple pricing mechanism that would not suit the particular circumstances. So I think it's better that there is an open goal on whichever pricing mechanisms are adopted.

MR SHIRLAW: The pricing mechanism might be adopted on the merits of each individual case, I guess. That's what we're sort of getting at.

MR COSGROVE: But drawing on a set of general principles to suit the needs of any particular case? I'm not quite sure what you really have in mind in terms of pricing principles.

DR KATES: In regard to that, as I say, I think the world has more variety than you can actually write down in advance so that while it's one thing to say that there are a series of principles that we would endorse in the abstract, there are always going to be real life situations that are going to find their way in between not quite what you expected. So while on the one hand hard cases make bad law, in this case as long as the intention is not to restrict yourself and then tie your own hands so that even though there might be a better approach that is identifiable by the regulator, that what ultimately becomes legislated does not prevent the decision-makers and the regulators at the time from adopting what is best in the circumstances.

MR COSGROVE: So essentially a discretionary approach in the application - - -

DR KATES: That's right, yes.

MR BANKS: You talk on page 5, I have noted down of your submission, about limiting the role of regulators to matters in dispute. In reading that I wasn't sure that you - it's not explicit there that you were necessarily supporting our own recommendation to that effect. I will just read what we had, and we had it as a tier 1 proposal, one that we are obviously more competent about. We say, "In arbitrating terms and conditions for declared services the ACCC should limit its involvement generally to matters in dispute between the parties." We go on to say, "Where matters agreed between the parties are subject to reassessment by the ACCC, it should be required to explain its reasons for doing so." Is that in the spirit of what you think is appropriate?

DR KATES: Yes, that's exactly our view; that the approach should be one in which - where do we have the - - -

MR BANKS: I think it was on page 5.

MR COSGROVE: It's spelt out a little more also on page 12 under your Business Concerns section. As I read the text there you seem to be saying that the regulator should only essentially arbitrate matters which are in dispute. It's not actually said in those words but I think that's what you were driving at?

MR SHIRLAW: Yes, that is what we're getting.

DR KATES: That's right. In fact, I think we were agreeing with both the spirit and the letter of what you said there, that - - -

MR COSGROVE: Yes, matters commercially agreed should not be interfered with by regulators.

DR KATES: That's right, absolutely, and I think if anything the fact that someone might come in over the top as an arbitrator and is something of a background threat that says, "Now, look, if you guys can't come to an agreement commercially, you never know what - this almost random agreement generator might end up doing to you," so that there is a kind of impulse to get together and come to a commercial agreement, but one that agreement is struck then the regulator just has no role. It should just simply be - it's there as a background as a kind of final - I guess the final - - -

MR SHIRLAW: Once a commercial agreement has been established between a provider and an access seeker then I guess what we're saying is that an external regulatory body shouldn't be able to come in over the top and say, "Well, I don't believe that negotiation is fair." I mean, it has been agreed commercially in the

market and that should stand.

MR COSGROVE: What about a situation in which a regulator might take the view that the parties were not necessarily colluding but sharing in the monopoly rents in a particular market to the detriment of other potential market players?

DR KATES: Yes. There is always that danger, and in fact of course if there is evidence of collusion then there is every reason for someone to come in on top of that, but without such evidence I think that you really ought to be looking for market solutions and with the regulator there as someone who will drive parties to reach a solution, once that solution is struck then that should be the end of the story. At the same time because both parties know that there is or there can be arbitration if they don't reach agreement it is always possible for someone just to wait on events but I think because of that particular circumstance, and the fact that they could wait on events, the fact that they have reached agreement should basically say there is nothing more to be said by a regulator.

MR BANKS: Did you have any particular circumstances or instances of that in mind in saying this or did you see it as a - - -

DR KATES: I suppose I always think of the airports on this as the kind of instance that - really, once decisions are made it just simply should just be left alone for the parties.

MR BANKS: Okay, thank you. Yes, jumping around a little bit here, I think you were in the audience, we had a significant discussion about the declaration criteria and the risks and potential benefits of making different changes. I think you have expressed on page 17 some concern about introducing the term "substantial". You say the definition may be unclear and in some circumstances - and be used by an owner of essential services to dispute the validity of access arrangements. Could you elaborate on that?

DR KATES: Yes. It's one of the things that was almost by a vote of two to one inside the organisation when we looked at this, that the word "substantial" seemed a potential impediment, that if you used - once the word substantial comes in then there's a whole new grounds for arguing the cost so that you say, "Well, there will be an increase in competition." That might just simply be stipulated and no-one will disagree with you but then you say, "But it is substantial." Then how do you quantify the substantial? Rather than making it something that will allow the process to occur there is that danger that it will actually be dragged out and perhaps you want it to be dragged out and maybe these are the kinds of issues that you really want to think through more carefully.

The word substantial had opened the problem area to us that it might actually be something that will slow the process and will be used to impede access rather than to actually create it. At the same time we agree with the concept; the idea that it should

be substantial not some trivial improvement in competition, but that it actually should be substantial. We actually agreed that should be in there. So we were worried about saying it in this way.

MR BANKS: I see. It's a definitional sort of - substantial.

DR KATES: But not about the idea itself which we actually accept.

MR BANKS: That's helpful and I guess we ourselves have agonised over these things and there's always scope for legal interpretation to produce an unexpected result. That's something that we would have foreshadowed and we may have the opportunity later, particularly with the Law Council to talk about the use of that word in particular and how it would be interpreted. Okay, that's good to clarify that. John?

MR COSGROVE: Just going back to the preceding page, 16, where you have proposed an amendment to the wording of the objects clause in our position paper. I guess my question here is twofold: one, why you seem to be concerned about a reference to efficiency rather than competition, and I read your point about all this being in the context of national competition policy framework but one would think that efficiency is legitimate and intended purpose of increased competition. But then on the actual wording it seems to me to be a little tautological to say that you would enhance competition by promoting competition. This is up near the top of page 16.

DR KATES: I suppose that is one of the things where there was some debate inside the organisation about that and the aim I guess - I mean, one always assumes that efficiency is going to build into any kind of competitive environment so that what you really are looking for is a situation in which, if you can enhance the competition then you will gain the efficiency. The efficiency itself is something that is almost impossible to say, is this the most efficient outcome that you could get? Are we there? What is easier to see is, do we have a situation where competition is taking place, so that where there is none it's quite evident. Where there is at least some that's also evident.

Whether you have drained all the efficiencies out of a situation, it's not that we disagree again with the notion that efficiency isn't what you're aiming for, because of course that's what your competition is aiming for, but it's whether you are creating the criterion that really isn't there to be monitored and to be tested, whereas the competition issue, which is where the framework that we're thinking about actually gives you some kind of a methodology in which you can actually understand what is the process there.

MR BANKS: Following on from what my colleague was saying, could you argue that the object clause is at a sufficient level of generality that you can talk about efficiency there without getting into trouble and where the use of the word competition as a proxy for efficiency perhaps is most administratively useful is more

in relation to, say, the declaration criteria. There I picked up you've made similar remarks in relation to the tier 2 proposals because you're concerned that one of those relates to efficiency. You said earlier there's many ways of gaining efficiency other than through competition. You saw it as being too broad. So one could argue that in the objects clause which is what this is about, is to sort of guide, to provide an overarching guide of why are we trying to increase competition? What's the real intent of this? That's what I think we saw the purpose of that was rather than talking both about the objective and the means of achieving it in an object clause which might have defeated the purpose of it.

MR COSGROVE: Our wording doesn't chase optimal efficiency. We're simply talking about enhancing. You would have heard the remarks made by NECG, Henry Ergas, mentioning how complex it can be to reach an assessment of competition in the market.

DR KATES: I suppose it's something in the eye of the beholder here that it may actually be the reverse of how we think about it. Certainly the aim is efficiency and the competition is the means to the end. We don't take a strong position on that but we were actually in our own way trying to assist rather than to disagree with what you were doing. It's something that we thought might make it work better but if it doesn't turn out that way it's not something we would have a hard time with.

MR BANKS: Certainly I think it's a particularly helpful comment though in relation to us trying to juggle the tier 1 versus tier 2 declaration criteria where competition is much more explicit and used as the proxy in the first arrangement which is essentially the status quo, than it is in the second as you point out. I guess what you're saying is you prefer that kind of formulation to one that has in the declaration criteria more of an emphasis on efficiency rather than competition per se. Is that the - - -

DR KATES: Yes, that's probably a fair interpretation of what we had in mind there.

MR BANKS: Good. You also just referred earlier to concern about removing the role of ministers. I may not have understood properly what you were suggesting there but I think what you said was, and it's in your submission, that the ACCC - in fact I can quote. Bottom of page 18 you refer to it and you say that:

> Ongoing ministerial involvement will be necessary to ensure that the authority for decision-making is not given entirely to an external regulatory body such as the ACCC,

and then you say,

> which has a limited knowledge of the intricate workings of the particular industry in question.

I think that is true and it's a point we refer to in terms of the limits of any regulator and what they can achieve. There's an implication in there that somehow the minister has more knowledge than the regulator.

DR KATES: No, I think we were talking about the authority making sure the lines of authority are right; that there is no roving bureaucracy that makes decisions but that because we're not talking about something at the bottom end of the scale, but something as important as property rights and ownership, that this should be political from the start. It should actually be an issue that is ministerial rather than from just a bureaucracy. So our substantive point here is that if we're going to have a situation where access is being forced into an industry then there has to be a situation where ministerial involvement is simply assumed always to happen. It makes the process more legitimate but it also makes the process I think - it puts the responsibility in the right sort of place rather than wending it down into who knows where, and who knows why.

MR BANKS: Would you see the fact that there is still recourse to appeal to the Australian Competition Tribunal above and beyond a minister, that that reduces the force of that? I mean, in the current arrangement it's not the minister who has the final say necessarily. The Duke case is a very recent illustration of that where the final ruling came from the tribunal, overturning the decision of the minister, on advice from the ECC.

DR KATES: That to some extent troubles us, that once there is a process in play in which almost you would say - like with the Reserve Bank, where you hand over the authority - the minister hands it over and says, "You do what you like because we think it's important that you do it independently of me," then I can understand that. In this case there isn't a serious reason to have a hands-off ministerial distance and rather than actually opening that distance further I think our view would be that we should have serious consideration about closing it. Ministerial veto almost might be part of what that process should involve. If a minister is not prepared to stand behind something like that then perhaps that's a reason not to go forward after that at all.

While I understand that the council can have or take different views and end up with different conclusions it is I think a serious risk in terms of the operation of the free enterprise system, rather than just in terms of individual access regimes. Just on that, the amendment to Part IIIA, that final line, point 5, "arrangements to remove provision for merit review of accepted declaration applications," that is also something - I'm not sure, but we would have some misgivings about that as well, and similar kinds of considerations.

MR BANKS: Did you have any other questions, John? I think that is all the questions. The other two questions I had you actually answered in passing previously. Do you have any other comments you would like to make? Again, I apologise for the truncation of time but I think we managed to cover the issues that

we wanted clarification on and your submission will be generally available on the Web site. Thank you very much for that. We appreciate your participation and the submissions and I hope you get your taxi.

DR KATES: And thank you very much. I appreciate the time.

MR BANKS: We will break now, ladies and gentlemen, till 1.30.

(Luncheon adjournment)

MR BANKS: Our next participants today are AusCID. Welcome to the hearings. Could I ask you please to give your names and the capacities in which you're here.

MR O'NEILL: Thank you, commissioner. We appreciate the opportunity to offer comment to the commission on its position paper and to back up the earlier submission which we made in support of our views on the paper. The team is headed by myself, Dennis O'Neill, chief executive officer of the Australian Council for Infrastructure Development. On my left is Linda Evans, partner with Clayton Utz. On my immediate right, Tony Warren, principal of Network Economics Consulting Group. Two on my right, Warren Mundy who is the manager, strategy for APAC, and on my far right, Matthew Crocker, who is a research associate with our organisation, AusCID.

MR BANKS: Thank you. As we discussed, I will let you provide an overview of your submission.

MR O'NEILL: Thank you very much. I would just like to provide the commission with a short opening statement outlining the council's position in relation to the inquiry. By way of background which you may be aware of from our earlier submission, AusCID is the principal industry association in Australia representing the interests of investors in Australian public infrastructure as well as the other organisations which finance, construct, operate, maintain, and otherwise service infrastructure businesses. The council was formed in 1993 and currently has 95 members. Membership is drawn comprehensively from all economic infrastructure sectors including electricity generation, transmission, and distribution, gas transmission and distribution, roads, rail, telecommunications, water, airports and ports. Details of membership have previously been provided to the commission.

As a result of this very broad membership base AusCID is in a unique position to consider the views of infrastructure investors and debt providers and to combine them with the views of infrastructure operators. More specifically our membership is concerned about the impacts of access pricing on investment incentives in respect of regulated assets and declared services. This membership base enables AusCID to bring an important perspective to this inquiry; one which we believe is at the heart of the commission's concerns, that is, the importance of ensuring that investment is promoted by, and is not discouraged by, the pricing of access to regulated services. We note that this issue is also at the core of the commission's concurrent telecommunications regulation inquiry.

Chairman, adequacy and time limits of infrastructure investment is a key foundation stone to any modern, globally competitive economy. Increasingly AusCID expects the wider community also to understand and value the critical role of modern infrastructure in delivering sustainability in the true bottom-line sense of that expression. The amenity of Australian communities, their connectedness, their social and physical health, as well as their economic capacity, are intimately bound to the adequacy and quality of their infrastructure, both economic and social.

Infrastructure investment is therefore somewhat different. One ought not relate availability of infrastructure to other garden variety business investments. Its strategic nature and the hierarchical way in which it drives economic and social interactions mean for example that a gas explosion in regional Victoria can disrupt social and industrial activity in several states. A water scare in Sydney can influence tourism outcomes in several states.

In short, the nature of infrastructure and its inadequacy or over-supply generally has national significance. In an era of increasing reliance on private investment to ensure infrastructure adequacy regulatory and policy prudence is necessary lest we frighten the investment horses. I say this not as special pleading, nor as a rent seeker. I say it as the representative of companies operating in a global market which is dynamically competitive and in which capital is increasingly mobile. The 1990s have seen Australia move away from a century-old system of government planning and delivery of virtually all infrastructure services to a new competitive world involving greater private sector direct investment and delivery in a growing range of infrastructure services. In the last half decade all new gas pipeline developments have been private. Most, if not all, electricity generation and much of the transmission and distribution investment has been private. Other than Sydney Airport's pre-Olympic upgrade, all major airport development has been private.

There have also been significant private investments in road and rail with possibly only the water and port sectors falling behind on these measures I have just mentioned. Even considering the sort of halfway house status commercially of Telstra, or ownership status of Telstra, one may suggest that all recent telecommunications investment has essentially been private sector driven. Other than roads, electricity generation and some ports, Australian infrastructure is heavily regulated. Many companies already involved in Australian infrastructure delivery are poised to put many more billions of dollars into the ground in the interest of national and corporate development.

Negative perception is sufficient to influence investor behaviour. A current investor perception of Australian regulation is negative. I can recite examples from a number of institutional investors of their reluctance to consider investment in Australian regulated businesses. I can refer here to comments, for example, from Deutsche Asset Management to us and made publicly that Deutsche has not invested in regulated businesses for three years other than the Port of Geelong. There they were given a guarantee by the regulator not to regulate the income. Hastings Funds Management, where while they will look for high value regulated business opportunities in their financial modelling when looking at those opportunities they introduce a very high discount rate into the models to take account of regulatory uncertainty.

In the press for over - well, not over a year, about 10 months now since October last year - several times have been repeated references to a comment by a senior executive of AMP Henderson Global Investors that they would find

investment in regulated businesses in India more attractive than similar investments in Australia. So unless a different balance is struck in Australian infrastructure regulation the investment horses may shy completely and key national opportunities will be lost or significantly delayed, particularly the completion of critical energy, telecommunications and transport networks.

If I could just digress for a brief moment. There is a current live issue which is not related specifically at the regulatory mechanisms of the Trade Practices Act or the role of the ACCC but nevertheless in a broad policy sense's regulation and that is proposed changes to the depreciation schedule available for investors in businesses such as infrastructure where for example in relation to gas pipelines the previous accelerated depreciation that was available over some 12 or 13 years as a transition measure as a result of the business tax changes was to move to 20 years but as we are now aware as of a discretion available to the tax commissioner as of 1 July is very likely to move to 50 years, and that move from the transition 20-year write-off to a 50-year write-off is going to - or very likely will imperil a number of significant gas pipeline projects currently in the planning stage and which have been providing for a 20-year write-off. That's the type of uncertainty, the type of risk if you like that is in the broadest possible sense ascribed as regulatory or political risk; that investors in these categories of businesses are currently having to face up to.

To win investor confidence over the longer term it will be essential that Australia's regulatory framework delivers consistent rulings which, if they are to err in favour of prudence, do so in favour of investment prudence not pricing prudence. Australia's competitiveness and the amenity of its communities cannot afford to endure the punishing consequences of any major deterrence to increase investment in our infrastructure base. More specifically, to offer some comments on the commission's position paper, AusCID is generally supportive and welcomes the views that have been expressed in the commission's paper. While there are some improvements that we would like to see in the commission's final report, AusCID's membership generally expresses strong support for the commission's paper and congratulates the commission on its robust analysis to date.

Our key concern is about the impact of regulation on investment in regulated services. We believe that much of the current policy debate about regulation is concerned about the short-term impacts of regulated pricing. In our view longer-term investment issues are generally not analysed with the same level of interest. In this respect the paper heralds a welcome change to the general direction of policy debate on these issues. It does consider the longer-term implications of pricing of regulated services. We believe that it is at the earliest stage in the process the investment decision that issues with regulation and regulatory risk have the greatest impact.

What is important from the investor's perspective is risk. When an investor looks at a potential investment it has to model the expected outcomes of the investment making adjustments in its model for the risk that is faced from the market

from construction and from the regulatory regime. I just earlier offered the view (indistinct) from Hastings in terms of how it handles regulatory risk in its modelling. Risk itself is not a bad thing. There is always some risk associated with an investment. Investors face what might be called market risk when making an investment, and this is not itself socially harmful. It merely reflects the ordinary uncertainty associated with market forces. However, AusCID believes the current environment is characterised by an unacceptable level of regulatory risk. If regulatory risk can be minimised or even just reduced then it is more likely that a project will be attractive and go ahead, and I might say we will be pursuing similar arguments to government in relation to tax policy to take up the depreciation issue I just mentioned.

One reason regulatory risk may tend not to be accorded a high priority in policy debate is that the costs of such risk can be difficult to measure. For example, how does one measure the cost of an investment that has not occurred? How can one be sure that there were not other factors at work affecting the decision not to invest? In any case doesn't a pattern of consistent investment in regulated services undermine the credibility of any claim that regulation is harming investment? These are difficult questions to answer. However, in considering a third of these questions policy makers ought not to make an a priori assumptions about why investment occurs. For example, investment may be commercially unattractive but may nevertheless be mandated by extraneous regulatory requirements such as government imposed social obligations or quality performance standards with penalties for noncompliance, that require constant upgrades in infrastructure and therefore demand ongoing investment in the regulated assets.

Moreover, in an industry such as telecommunications not only are these obligations imposed but many of them are also substantially underfunded. Notwithstanding the difficulties of quantifying these costs we believe that there are instances in which regulatory regimes in Australia and the risk profile that goes along with those regimes has meant the difference between an investment going ahead or not. In such instances the costs are at least possible to identify intuitively. Once such example is that of the Melbourne Ports Corporation which although not a member of our council is illustrative of the problems faced by regulated businesses.

Melbourne Ports is planning to build a third container terminal and expand railway infrastructure as part of its expansion of the facilities at the Port of Melbourne. However, it's business is regulated by the office of the regulator general, ORG in Victoria. Under these arrangements Melbourne Ports is subject to an average revenue cap. The ORG disallowed recovery of the investment in the railway through an increased charge because it was not deemed to relate to the provision of prescribed services. However, such expenditure has historically been funded by way of wharfage charges, therefore investment and funding to other areas will be cut to develop the rain infrastructure. Melbourne Ports did not include the investment plans for the container terminal in its submission to the ORG due to the fact that the investment would only occur late in the regulatory period and details needed to be

finalised.

Melbourne Ports asked to have the next review moved forward to accommodate the investment which the ORG refused. We believe that this clearly illustrates the direct link between regulators' decision-making and the impact of such decisions on investment decisions by those who own or invest in regulated assets. We have provided other examples in our submission. So where to err? High or low? In AusCID's view one of the most important considerations raised in the commission's position paper relates to the costs of erring on the high side versus the low side in respect of pricing regulated services.

In its position paper the commission recognises that the cost of underpricing regulated services is greater than the cost of overpricing in terms of the damage that is done to investment and the long-term investment incentives in infrastructure. In our view not only does this threaten national and regional development, given the foundation stone character of infrastructure, it obviously impedes the development of competition in downstream markets. We agree with the commission's assessment. However, it is important that our position not be misinterpreted as wanting regulators to deliver up monopoly rents to asset owners and investors.

This is not what we are talking about. What we are seeking to ensure is that regulators do not systematically underestimate the costs associated with the provision of regulated infrastructure. When that occurs the social costs of underinvestment in such services can be enormous, albeit as we have already noted, difficult to quantify. It is for this reason that the effects can be, to use the commission's own words, "insidious." Indeed, we would say that this particular issue is so important that it should drive everything that the commission decides in regard to this inquiry. It was suggested to the commission in a number of initial submissions that there are strong economic reasons in many regulated industries to place particular emphasis on ensuring the incentives are maintained for efficient investment and for continued productivity increases.

The dynamic and productive efficiency costs associated with distorted investment incentives and with slower growth in productivity are almost always likely to outweigh any allocated efficiency losses associated with above cost pricing. AusCID therefore welcomes the fact that the commission appears to have accepted these important points. In view of these considerations AusCID believes that the key aim of the commission's inquiry should be to recommend a framework that can be put in place that will ensure that the costs of such regulatory errors are minimised. Since regulatory concession is the key contributor to regulatory risk we strongly support the commission's proposals to introduce measures to limit the discretion provided to the regulator, introduce an objects clause in Part IIIA, and introduce pricing principles into IIIA.

We also recommend the following measures: introducing a mechanism for testing if a natural monopoly service falls within the scope of access regulation and

introducing a pre-investment framework undertaking which would provide a mechanism for agreeing with the Australian Competition and Consumer Commission the parameters for the terms and conditions of access under a regulated scenario post-construction. In summary, we believe that the commission should recommend these further specific measures to ensure that the regulatory framework does not hinder investment in infrastructure.

Chairman, our detailed recommendations are outlined in our submission and my colleagues would welcome the opportunity to discuss these issues with you. Thank you.

MR BANKS: Thank you very much for that. We have both got questions and we'll have to confer from time to time to make sure that we're proceeding in order. I have one on page 5. It may be one that might be useful just to start with because it sort of raises a number of other issues or a number of other issues are related to it. That is mentioned on the bottom of page 5 and I quote you:

> While it is fundamentally important that the hurdle to be satisfied before infrastructure is subject of access regulation is sufficiently high so as not to lead to inappropriate coverage, the detail of the terms and conditions of access would be the actual key determining feature of incentives in many cases.

I would just ask you to elaborate a little bit on that, particularly in the context of some recommendations we've had about appeal rights and so on and whether having appeal rights at the stage of determination of terms and conditions would do the job sufficiently and how important it is to have appeal rights at the declaration stage for the provider. This seems to imply that most of the action in practice, in relation to uncertainty and incentives is at the latter stage in terms of the determination of terms and conditions.

MS EVANS: Perhaps if I could lead off. It's not intended to suggest by that that the declaration criteria and the process or indeed merits review from that process are not important and AusCID would actively support retaining merits review from a declaration decision. What however I think has been critical in terms of the experience once you're within a coverage process is that there has been a lot of dissatisfaction with the way in which the terms and conditions of access have been determined. That both goes to the processes that are used, the sort of information that is required to be provided by the service provider as to a whole range of aspects of their business which may not seem very relevant, and the outcomes that are achieved at the end of that process, because it's not the decision that it be subject to some form of regulation in and of itself that will necessarily have a catastrophic effect in terms of incentives. That effect will be directly related to the outcomes of the terms and conditions process and the very consequence of the form of regulation that follows.

Whilst Part IIIA is modelled on a negotiate/arbitrate-type outcome, which is intended to be quite a light-handed approach and we haven't had arbitrations coming out under Part IIIA directly, but the experiences that have happened in the more prescriptive provisions in the gas code and the experiences which have happened in the telecommunications regime have caused - and also in the airports area - have caused a lot of concern amongst service providers about the sort of pricing and other terms and conditions that are emerging from the process. That's why AusCID considers that getting what some people regard as the back end right is critically important.

One of the reasons I think we've seen a lot of focus on the declaration criteria is because there is so much concern that if a particular service or particular infrastructure falls within this regime then I know that the returns that I would expect to get are going to be completely or significantly diminished and I will therefore devote all the resources I can to staying outside the scope of this kind of regime. So I think we have seen that focus on the declaration criteria but I think that's the underlying reason.

MR BANKS: Can I just say, interpreting that, that if there's questions about the back end then it's even more important to get the front end right, because that's the initial filter or the initial step that leads to this further set of questions or uncertainties?

MS EVANS: I think the back end and the front end are equally important and particularly in terms of Part IIIA working as a framework or architecture for other regimes and that in terms of good policy then each of those components is equally important. If IIIA is to be a framework not only in terms of specific issues about the declaration criteria but also more broadly in terms of things like pricing principles and processes then I think it is very important that those two are dealt with with equal importance.

DR WARREN: I would just like to say I think you've hit the nail on the head. There is undoubtedly the major concern about declaration, is what's going to happen to pricing? I think it's important - these things can be to some extent divorced. You can think about declaration in a world in which let's assume the regulator was perfect, and you were going to get the perfect price outcome at the end. I think the experience is that once you get declared the game changes automatically and the dynamics of the bargaining process change very automatically. I think as Linda mentioned much of this is predicated on a negotiate/arbitrate model.

If we look at the experience of other regimes it's really an arbitrate/arbitrate model. It's declare/arbitrate model. It's very hard I find to think of a situation in which after declaration arbitration will not almost inevitably follow because one presumes one side of the other would feel they would get a better - particularly when you've got a regulator with runs on the board as to how they set prices. I tend to suspect that declaration is important in and of itself, not solely because of the way

prices are set but because it changes the way the bargaining goes between the access seeker and the access provider.

MR COSGROVE: Might the access provider not have an incentive to negotiate?

DR WARREN: I accept it's a very complex thing and yes, if you had a situation where the regulator was very pro the access provider then presumably - - -

MR COSGROVE: Access seeker?

DR WARREN: No, the access provider, then presumably the access provider would always be going for arbitration. It can go either way. We in practice tend not to see it like that but, you know, I don't see why it's not symmetrical.

MR MUNDY: Mr Chairman, someone who's got an access declaration hanging for services that have been declared and one hanging over his head, we've fought both of these - the Delta matter and the Virgin matter quite strongly because we know if we can knock the declaration off that's where it ends. Once we've got certainty, if we can defeat declaration, so you'll always fight it in the first instance. The problem and the issue then, if you're declared you're just not declared in the matter, the dispute, you're declared for the full duration of the declaration. We have a declaration in place for certain road systems currently in place around the terminal complex and use of roads around Melbourne Airport is a bit of a controversial issue at the moment.

The people who sought declaration are now no longer in business, in the business for which they sought access for, but the existence of that declaration not relevant to the dispute for which they - - -

MR BANKS: This is the Delta one?

MR MUNDY: This is with respect to Delta - remains, and therefore immediately distorts, the presence of that declaration, immediately distorts all subsequent negotiations vaguely related to the services in question, not necessarily of the parties who are in dispute. You sit there and you're sitting there and you say, "This thing's going to be with us for say three or four years." We don't know in what instances this is going to be brought back against us. We don't know what set of consequences are going to arise from subsequent declarations. Why don't we know that? Because we have absolutely no idea of what the arbitrator is going to do when the arbitrator gets his hands on this.

We have got no precedent. We have got a set of principles set out in IIIA at the moment which could mean anything, and quite frankly it also, because of the very broad question of terms and conditions, it could go to issues like where cars and traffic move which would not be beyond the scope of the commission to determine, and in fact that was one of the matters in dispute in Delta, was where vehicles would go. So it opens up a Pandora's Box in which you - and even if you had a robust set of

pricing principles you are never going to be able to bolt down all those terms and conditions issues. So that even if you had a lot more certainty about what outcomes were going to be then at the moment who knows? All we're led to rely upon is the received wisdom of the potential conduct of the regulator which, I guess, "beauty is in the eye of the beholder".

MR BANKS: Okay, good, thanks.

MR COSGROVE: You have supported the inclusion of the objects clause that we proposed but you want to use that in a wider manner. I'm not quite sure exactly what you had in mind. This is the material on page 6 and the top of page 7 of your submission. You say on page 6, "Even greater utility would be derived if the objects clause were not simply an underlying statement of policy intent, but also something to which the relevant decision-maker, the NCC, the minister, the ACCC, must have regard in applying the criteria." Then you subsequently talk about the objects clause guiding each step. What does that really mean? Do you think the documentation of, say, the declaration criteria and the pricing principles should be restating the objects clause at the outset? What's the practical intent of this?

MS EVANS: Practical intent really arises from the rule of statutory construction; that you would ordinarily only have regard to the objects of legislation if there is some ambiguity in interpreting a particular section. So that you will start from a proposition that if a court or a tribunal or a decision-maker takes the view that something is clear on its face they will simply not have regard to the objects clause. So to eliminate that it's really to set out as a preliminary matter these are the objects of this part, and in considering each of the criteria and in considering in terms and conditions of access the relevant decision-maker must have regard to those so you would probably have a series of subsets to pick up each of the decision-makers but just to actively say that these are something to which regard must be had in applying whatever the - - -

MR COSGROVE: And that would be set out in the - - -

MS EVANS: In the section itself which has the objects.

MR COSGROVE: Dealing with the objects clause, I see, thank you.

MR BANKS: You wouldn't have an example of that that we could use? Get back to us with a form of word that would make you happy.

MS EVANS: I can get back to you, yes.

MR BANKS: Okay. We had some discussion earlier, and you may or may not have been there, with NECG about the form of the objects clause. We have got overlapping representation here. I guess what I was putting to that group was whether the objects clause should properly be phrased the way it is which has equal

emphasis of promoting efficient investment and promoting efficient use or whether one of those in a sense should come before, ie, promoting efficient use while preserving, for example, as incentives for efficient investment. Reflecting over lunch on that discussion I think that while Dr Ergas thought it was better to have it in the form we did have it with the kind of equal emphasis, the subsequent discussion, and I'll have to look at the transcripts, sort of seem to come out the other way, where he was putting emphasis on achieving efficient use but without in any way comprising efficient investment, but I don't know whether it's something you would want to comment on or again get back to us on. Maybe have a look at the earlier discussion.

MS EVANS: It might be - - -

MR WARREN: I'll have a word with Henry about that.

MS EVANS: It might be of benefit if we have a look at the transcript of the discussion which occurred and then come back to you.

MR BANKS: Yes, I think that's the case. It would be an interesting point to look at because Gareth - I mean, as I said in the earlier thing, the view is that really these things should be of equal, not one over the other, either way really, and I think that may have been the point he was saying about - you don't want to put investment up on a pedestal either. I mean, what you want to do is do both and then make sure you're getting efficient outcomes in terms of both consumption and investment.

MR O'NEILL: As a non-economist I stand to be corrected, but if I just may introduce the observation here that one of the points that has been made to me about the shift towards greater private investment and infrastructure is that unlike traditional infrastructure investment out of the budgetary sector, it is arguably more difficult to get over-investment because you have other parties standing as gatekeepers, particularly the banks, the providers of debt. Their standards of analysis of the robustness of projects from a commercial point of view is such that while you might get marginal over-investment it's very difficult to envision gross over-investment, for example, as we saw commented on by EPAC in its analysis of electricity generation over investment in the 70s and the 80s. I just make that as an observation; that I think we have different checks and balances operating in an infrastructure market which is going to be dominated more and more by private investment drivers than by government budget drivers.

MR COSGROVE: The latter point is one you could argue about. We have had a fair bit of public assistance thrown at some infrastructure projects which has got them over the line.

MR O'NEILL: This is why we promote depoliticising our infrastructure definitely.

MR BANKS: Obviously taking due account of externalities and social benefits.

MR O'NEILL: Indeed, indeed.

MR BANKS: Nation building.

MS EVANS: That's right.

MR COSGROVE: In this area of evidence on the costs of regulation I think what we are being given is pretty much the same sorts of cases as have been mentioned previously. You mentioned in your opening remarks, Dennis, that Deutsche Asset Management, Hastings Funds Management and AMP Henderson had all sort of to some degree other put down the shutters but there are other financial institutions of some importance which we haven't heard similar statements from. I wonder how representative the companies that you have cited are as an indicator of the seemingly increasing reluctance to introduce private money into infrastructure projects. You don't hear from Macquarie for example. I have been trying to think of others but - - -

MR O'NEILL: I was just actually going to use Macquarie as an example in response to your point. For a start Macquarie, other than - I'm just tyring to think. Other than some airport investment, but very limited, they have really the substantial money that Macquarie has invested in infrastructure is in roads, some in electricity generation, and that's it. And predominantly overseas now in terms of incremental opportunity, and indeed, very large investment in either existing or prospective tolerated operations overseas. So Macquarie is, without saying anything specific into this, is just moving quietly to avoid regulated business opportunities.

MR COSGROVE: But more broadly, I mean, I don't know what proportion of the financial resource is going into this type of investment is provided by the three firms that you mentioned, it would be very substantial, but more generally are you able to say that other firms to your knowledge are taking a similar view to that you have reported to us from these - - -

MR O'NEILL: Quite honestly you can obviously look at some of the large foreign utility investors who clearly have adopted a contrary view to the position expressed by those large institution investors so you have your Duke Energies, you have your China Power and Light et cetera, Singapore Power, who have bought the electricity transmission assets in Victoria, but if I can express this quickly, they have not been the initial investors in those assets. They have bought as part of a second round transfer from the initial purchasers of those assets, and one is not to know exactly to what extent there have been some fire sale types of opportunities in that to make the opportunity particularly attractive from them, notwithstanding the regulatory risk that is implicit in how those businesses are regulated.

If I go back to my Hastings example, they are not saying that they are absolutely out of the regulated businesses market. They're just looking for damned good bargains.

MR COSGROVE: Yes.

MR MUNDY: Can I just add to that. We from time to time encounter people who have an interest in investing in the Australian airport sector in general, and the sale of SACL at the moment is sort of focusing minds on that question. I guess the first question they sort of want to go to, and the one that seems to be exercising their mind most strongly, is the question of, "What are the regulatory outcomes? What are the regulatory issues? Where does the regulatory risk lie?" After that comes, "What's the potential for volume growth and what's the potential for business expansion?" It's the first issue off the rank. This actually is quite different to my experience with the phase 1 and phase 2 airport sales in the previous life where the first interest was, "What's the potential for business development? What's the volume growth likely to be, and oh, by the way, what this thing called direction 13 actually mean?" So the order of priorities in people looking at the sale of Sydney now seems to me to be very, very different to what we saw four or five years ago when the rest of the FAC was on the block.

MR COSGROVE: Some of those potential investors are domestic companies?

MR MUNDY: Yes, and some of them are international, and indeed - - -

MR COSGROVE: Yes, it might be understandable with international companies because they are coming in anyway - - -

MR MUNDY: There is no domestic international bias in this. Indeed, it's interesting to reflect on even the change in the priority for consideration of people who are already in the industry. That may well be a reflection of once bitten, twice shy, but if that is the case then that should be of concern.

MR COSGROVE: Okay. I was interested too in the quote that you provided in connection with the Melbourne Ports Corporation's troubles. The final quote there on page 9 says in part, "As the timing and magnitude of such projects becomes clearer the consequence of ORG's decision may be a deferral of expenditure." I was interested in the significance of the word "maybe" as distinct from "is" or "will be". Do you know any more about their intentions following this decision? No.

MR CROCKER: I think it probably related to - I have done a bit of research on the Melbourne Port Corporation as an example and the fact that due to the regulatory time frame that the investment, when it was mooted to be taking place, was still in a sense a little up in the air so there was a little bit of room to move in terms of the investments, but I guess if you're an investor from a private sector perspective that time to move obviously has costs as well.

MR BANKS: Just looking at these examples, and we don't want to focus too much on them, it sort of underlines the point that we haven't had a lot of examples and I

think your point earlier was right; that we don't really know the counterfactual and therefore it is a tricky area for us but the Perth one for me raised a question that was discussed again in the discussion with NECG and that was - and with Tony Warren here maybe it should be directed to him but we were discussing there about the use of the term "prudent" or "prudently incurred costs" for the pricing principles rather than efficient long run costs which he saw as being problematic, but this seemingly is an example where the regulator has taken a particular view about costs which would suggest that in his view these wouldn't be prudently incurred. I just wondered whether that would give you pause about how robust that kind of criterion would be.

MR WARREN: Yes. I think Warren will talk a bit more authoritatively than I will on the necessary new investment-type criteria which is unusual in the airport situation as you would know.

MR COSGROVE: Yes.

MR WARREN: Really that there is a tick-as-you-go type process which makes it unusual, and pre-investment so an ex ante process. The process from an outsider's point of view is that it's not terribly robust and it's not working terribly well. Do I see it - I think we live in a world though of alternatives and if the alternative is you get what you put out then the necessary new investment criteria obviously looks bad from a regulated firm's point of view but if the alternative is optimisation once you have sunk the investment, so in other words, no discussion to Perth at all ex ante, but once they have laid down the overlay we can write that off at any stage down in the future, or write it down, strand that investment, then I think it's that context in which we saw the necessary new investment or if the prudency-type test working it. Now, I don't believe a prudency test, if you have got a regulator sitting there giving a tick or a cross is a substantially brilliant process, I think it's better than optimisation and gets rid of some of the problems that optimisation pretends to get rid of but I think if you ask me what's the best way of determining whether or not that's sufficient or you give the airport operator incentives to be efficient and then rather than you as the regulator trying to second-guess whether or not that's something that should be done at this stage because that strikes me as being a very difficult position to put a regulator in, but maybe Warren can talk about the - - -

MR MUNDY: Mr Chairman, there's no issue of prudence here. There is no issue here from what I understand, at least privately, the airlines believe this should happen. They don't like the idea that they can only use 737s on this runway at all. They don't like that. They want to be able to continue to use 767s on a runway which was originally not designed for their use, and by the way that's why the problems have occurred. The problem is not whether the expenditure, and I think we need to sort of - this word "investment" has special meaning in the mind of the ACCC because it clearly relates to, as they say, a change in the fixed durable inputs. It is not simply replaced to the natural degradation of capital. I'm curious, and I always have been, of what does that mean if you decide to put 18 new passenger assistance officers in a terminal to assist people to find their way? That clearly

doesn't count for investment because it's not an increase in durable inputs.

Similarly perhaps the replacement of software systems which may or may not be argued to be durable. But the point here is not whether it is prudent or not; it's whether it's new. The question here is not a differentiation initially about prudence. It's a question of essentially is it maintenance or not. I don't know whether I have made the observation to this inquiry or not but the reason why the necessary new investment arrangements exist in the airports regime is that the starting prices were wrong. Perth Airport I think earns about 3.1 per cent on its regulated assets so that's the best part of 2 and a half to 3 per cent below the riskless rate. So we have a situation here is, if this firm had sensible prices that reflected long run incremental costs or whatever you might think that should be, it is likely that this firm would have just overlaid the runway.

The problem here is there is so little cash around in these businesses that they can't do it. It is not prudent from their management's point of view to invest in this asset because it generates no new revenue and because the returns on the services if you like that they provide as opposed to the assets is so low. They would prefer to take what may well be a company that's capitally constrained and invest it in property development or somewhere else. Now, at some point the prudency test will be met here and prudency will cause this investment to occur because CASA will threaten to withdraw their aerodrome licence. That will be the point, or the Commonwealth may well come along and say, "You're getting pretty close to the constraints of your lease here, guys. You had better do something about it." This is gaming by the airlines. They want this work done. They're simply playing the game with the rules of the MMI arrangements.

MR BANKS: Your comment there about users, I got the opposite impression from this quote where the regulator seemed to be saying that there were no comments from users on it. In other words, no interest.

MR MUNDY: I would invite you to have a look at the - or perhaps the commission staff would like to scan the ACCC's investment decisions and find how often users support anything. I think it's a fair rule of thumb to say as a general proposition, particularly in the earlier days of these arrangements where this case arose, was that silence can usually be construed as consent. If they're not happy you will hear about it real quick.

MR BANKS: Yes. Okay. You have a section there, section 3, I think, on regulatory risk and ways of reducing that by getting some signals up front ex ante decision-making. I think we had a reasonable discussion about that earlier. Perhaps we could move on from that. I mean, the only thing, perhaps just to re-emphasise from my point of view, in terms of this proposal to have a pre-notification arrangement in place which I think is what has been said on about page 16 and 17, just to what extent the - you know, how effective that would be. We had a bit of a discussion about it but I guess I have got some doubts as to what extent the regulator

would be prepared to precommit in a situation of confidentiality when the proposition is being put by the service provider, couldn't be transparently tested. I could imagine a risk averse regulator really not wanting to do too much. So I guess I just wonder - I mean, I can see the logic of having something like that but in practice, you know, how effective or used it would be. I don't know whether any of you would like to comment. Perhaps apart from Tony Warren who was involved in the earlier discussion - I won't rule him out.

MS EVANS: I suppose there are two issues that I see with that. The first is that it is quite important in terms of the decision for the reasons that we have already discussed earlier but secondly, I think that it need not be a confidential process. There is scope for a transparent process to occur, particularly because what you're talking about here is an assessment of a project against the declaration criteria rather than more detailed consideration of pricing issues. There may be some information for which a commercial confidentiality claim would be made in the way in which those issues are ordinarily addressed in the context of declaration. So that that would provide it seems at least to me that level of transparency which would be important, and, yes, it may represent a slightly different approach from the way in which regulators have traditionally dealt with these things but I understand it to be the case that the council has had several requests for advisory opinions in relation to matters arising under the Gas code. I'm not sure about the detail of those but I understand that has arisen to date and therefore may be of some utility.

MR BANKS: Yes.

MR COSGROVE: Just towards the end of that section you argue that it's important that there be a separation between the roles of determining the assets subject to regulation and determining the terms and conditions that should apply. I wonder how essential that might be. I mean, I can see, and we had a long discussion on this with NECG earlier in the day, that there is a kind of an important property right issue involved here, but at the same time if you think about what the regulators have required to do, a determination or forming a view about possible coverage needs to involve and assessment of the degree of market power that the service provider might have, and in making that assessment you are, at least to some extent I think, involved immediately in thinking about pricing power, terms and conditions issues, so I'm asking this in a devil's advocate sense because I do see some strong reasons why you might want to have them separate, but isn't it the case that it's not a really a tidy distinction, that one can be done without having any implications for the other?

MS EVANS: I think it's true that they are not unrelated issues in that sense but I think it's precisely for the reasons that you articulate, that it is very important that they are separate because if you consider the position of an organisation which is making an assessment about a particular service should be declared, and that organisation will have regulatory control if it is declared, and it looks at questions of market power and considers some issues about pricing, the inevitable issue is, "Oh, I

can see how this would be dealt with appropriately," or, "I have some ideas about how all the terms and conditions generally should operate." No matter how disembodied that might be notionally within the one regulatory organisation, a regulatory mechanism shouldn't, even of itself, provide some incentive for the regulator to make a particular decision, and I think that there is great risk of that happening simply because of the very nature of the processes that are involved.

MR WARREN: Can I make a point on that too about the overlap. At least in the experience that I have had on these issues, there is obviously overlap but the issues to do with declaration are much more to do with substitution effects, a competition assessment. So in other words, you're looking at between firm - you know, in a market level. When you're going to pricing often you're going to in firm, within firm cost, long-run cost assessments, and you know, obviously these things can't be divorced. I mean, they are very different sets of questions and I think even if you look at XIC within the ACCC, the people in Telecom's division responsible for declaration, are not necessarily the people responsible for the pricing. It's a much more specialised set of skills, the pricing process, and so the overlap may be greater than what you - I mean, it's not true to say there's no overlap but I don't think it's as great as you're perhaps suggesting.

MR COSGROVE: How about a Chinese wall? Could the be effective for a single regulator? I'm prompted to ask the question by what you just said.

MR MUNDY: We find ourselves in the bizarre situation of having been through the hoops on the PS Act, now being subject to declaration by the - who effectively carried out a pricing assessment, and given that there is no issue of access denied, they have looked at price. They're now having a look at declaration and if they decide there's declaration they'll come back and have another look at price. Now, I've got a pretty fair idea what the second look at price is going to be, except I'm not sure how worse it gets. The only problem is if they want their rate of return model they're now in a lot less volume than they were before because they can't find the second airline because they have not been able to stop it from being gobbled up, but, look, I think it goes back even to a more fundamental theory of bureaucracy if you like in that, you know, they want to make work for themselves. It's a way of securing resources.

I mean, these modes of conduct are - I mean, if you believe in those theories of bureaucracy and what motivates people exercising the administrative function, and I probably put the commission to one side on this of course - - -

MR COSGROVE: Of course.

MR MUNDY: - - - but one can see that there has been a significant extension in the agreement and the resources being devoted to this function and if you were to marry the NCC and the ACCC together I wonder why you wouldn't believe that that sort of bureaucratic conduct wouldn't continue in a way that has arisen. I mean, it's a natural

thing. People who lead organisations want those organisations to become more powerful and more influential.

MR BANKS: Yes. We have in our draft report on telecommunications competition regulation a sort of summary treatment of different forms of capture that can apply to a regulator and I mean, I think there is an interesting issue there I think where you might get some scope for crossover, they have both roles, but it's certainly an area that we're obviously looking at and it was a tier 2 proposal which signalled that. Moving along, you've got a section on safe harbour options. Did you have any other questions, John?

MR COSGROVE: I'm not quite sure I understood some of the distinctions here in the ways in which problems you've cited for new investment might be addressed. Access holidays, okay, we know there's some questions about how you would actually do it but we know what that's meant to involve. Scope for a pre-investment undertaking in accordance with the process currently used for undertakings under Part IIIA, and then the next one, a particular type of undertaking which may be called a framework undertaking. I'd like a little more explanation of what that might comprehend. I think you go on subsequently, I can't remember where, to talk about setting the parameters for such a framework undertaking. Again, I would like to know what sort of parameters you have in mind and more generally I guess why is the present undertaking route under IIIA not sufficient for the sorts of purposes you have in mind?

MS EVANS: Perhaps we might divide that into a couple of parts and I might talk about the nature of the undertaking and Tony might talk about the sorts of things that might go in the undertaking and then probably Warren will have some comments on his experience in relation to the undertaking processes. Reading the undertaking parameters that are set out in IIIA, you would expect that it would provide for precisely the sort of approach which we've outlined in the submission and that is that an undertaking is designed to provide the framework or parameters within which specific terms and conditions for individual users of the service will be set.

However, it has been the experience of the membership of AusCID that that is not in fact the way in which the ACCC has implemented the undertaking process and one of the fundamental reasons for the lack of use of undertakings has been that those organisations which have approached the ACCC with a view to submitting an undertaking have been told that an undertaking must effectively amount to a specifically enforceable contract between the infrastructure owner and any particular person who seeks access.

That involves a very high degree of prescription of the undertaking and effectively means that there is very little difference between having an undertaking in place and subjecting yourself to an arbitration process post-declaration. So if the undertaking mechanism was originally designed to be a proactive step by a service provider to establish a framework which would encourage a negotiated outcome it hasn't played

out in that way. As an adviser to infrastructure owners it's very difficult, particularly if they are not subject to a declaration but in examining and managing their risk portfolio they're thinking about how they would deal with these and they would like to put an undertaking in place, given the response we've had from the commission it's very difficult to say that would be a good idea because the alternative is simply to remain not subject to a declaration and simply to see how matters progress.

That seems to AusCID not to be really the way in which it was intended undertakings would operate and it's very difficult to see what incentives there are in that kind of a scenario for an infrastructure owner to submit an undertaking.

MR COSGROVE: If I may interrupt that seems to be an implementation problem. If you were able to set the declaration criteria and some pricing principles in such a way that the regulator would be obliged to make an undertaking a bit more in the nature of the beast it was intended to be, as you were just describing, would that still be inadequate?

MS EVANS: I think to achieve that it would require, given the indications and the way in which it's been implemented to date, that would require some explicit recognition of how an undertaking was to operate in the context of the legislation and that would need to be contained in the legislation. I agree it is an implementation issue but it is such an implementation issue which arises because of the broad discretion that the regulator has that the only way in which it can be addressed is by some change to the nature of the process or some explicit indication in the legislation about what is expected from an undertaking process.

DR WARREN: I think the way I see this process working if it was possible would be that you would go to the NCC and you would say, "Is this the class of assets that are likely to be regulated, yea or nay, before I'm investing." The reason, as Henry suggested this morning, we do it before the investment is because that evens up the bargaining position. If the NCC says, "Look, no guarantees but this does look like the kind of thing we would normally consider declaring," or it's likely to fall within the provisions of this code or whatever, you then say, "Okay, I'm going to take this advice and go round to the ACCC or whoever the regulator is and say I want to" - the extent to which this is possible depends a lot on whether it's a commercial in-confidence process or something the regulator can market test, fully accept.

You go to the ACCC and say, "Okay, the NCC has told us if we invest in this we will likely be regulated." We want some certainty that we can plug into our models about how you're going to regulate us. We accept that there needs to be legitimate discretion down the path. Things change and you need to be able to factor that in. We're not in most cases asking for a pattern of prices over the 35 year life of the asset. What we're asking for is what kind of risk premium are you going to add into the whack. Or even more generally, what kind of regulatory pricing model are you going to apply upon us? That's not even known at the moment. In telecoms are you going to use TS Lyric, are you going to use retail minus, you know, what from your

bag of tricks are you going to pull out here to use as your regulatory model?

Let's assume you use something; within your whack what kind of risk premium are you going to impose upon us? You would then ask other questions which would go to non-price terms and conditions, for example, what do we do with spare capacity? If we've built spare capacity into the network for our future interest, for our future use, are we allowed to lock that away or are you going to force that to give us first in, best dressed kind of approach. A whole lot of those things I think could be easily pinned down in an ex ante world. They have to be dealt with ex post and it seems to me it's only really a bargaining power issue that people resist doing them ex ante. Ex post they've got complete hand, almost complete hand.

MR MUNDY: I think when we discussed these issues in Melbourne I think I briefly touched on this issue of undertaking so I won't labour the point but it's mainly along the lines of what Linda said, is that it seems to me that the scope of the issues that should be in the mind of the commission when it's considering an undertaking should be those issues where there is a clear potential for abuse of market power. My view is that doesn't extend to things like normal credit conditions. It doesn't extend to a whole range of issues. I think it's quite explicit from the ACCC's published documents in relation to our access undertaking that they are quite explicit that this thing has to be enforceable. Their view is that if this goes to the Federal Court it must have the capacity of enforcement by the Federal Court.

The experience that we found was that in relation to I guess a set of customers where you may be concerned about market power the issues that got addressed draw down very low: credit terms and conditions and all those sorts of things. There was also a tendency to widen the scope of the range of services or the people to whom the services might be provided as well. For example, they were particularly concerned about the rights of access to private light aircraft pilots. Five minutes down the road there's an airport where you can land essentially for free and that's called Essendon. If we collect $100,000 a year revenue from private pilots I would be surprised, in a regulated asset income base of 50 million-odd.

It was the sense in which every contingency for every possible provision of service that might be vaguely related had to be covered and it got to the point where we just said, bugger this, we'll cop the general declaration and if things get really bad at least we can get an appeal in the ACT.

MS EVANS: Another example might be the experience which the Duke group of companies had in relation to the eastern gas pipeline. They lodged a draft undertaking with the ACCC and that was rejected by the ACCC on the basis that they didn't have sufficient information to determine it and whilst there are reasons for decision published they don't go into a lot of detail but I understand there was a material dispute between the Duke group of companies and the ACCC about what was sufficient information for the ACCC to make a determination. I suspect it has a lot to do with precisely these kind of issues.

MR COSGROVE: If I could come back to Tony briefly, the indication of the sorts of parameters that you might be looking for in this framework undertaking, let's take the risk premium one. I assume you would see that as being case specific so would that not involve the regulator already in a fair degree of investigation about the nature of the investment and market risk and all those sorts of things?

DR WARREN: Yes, it would.

MR COSGROVE: I'm just wondering how easy this - - -

DR WARREN: The timeliness is that which you're concerned about?

MR COSGROVE: How easy it would be for the regulator vis-a-vis consideration of a standard undertaking route, to sign off on these parameters.

DR WARREN: The thing is they do it already.

MR COSGROVE: Ex post?

DR WARREN: Ex post. That's really the problem, if you like. It's the ex post nature of it when the sanctions or the potential sanctions on them are very limited. Whereas if you do it in an ex ante world - that's why I asked the question is there a timeliness issue: these things do take time. They are difficult. That's why I tend to have a predisposition towards, "Really, is this the kind of thing they should be doing or should they at least try to the greatest extent possible to have a more simple approach?" Let's assume that's not possible for the moment. Then they have to do that anyway and if they do that ex post there's no real sanction on them, no real - if they get it wrong there's no - in terms of withdraw on investment - and so that's - - -

MR COSGROVE: So you're not so much distinguishing the extent of the parameter information that you would want. It's more a question of ex ante versus ex post?

DR WARREN: There are two separate questions here and I take Warren's insights and experience on board in this and this is consistent with a whole range of industries where the need for a binding contract type undertaking is - that's one set of problems. I think that has to be dealt with. The other thing that I think the point we're making is that in a framework agreement you don't really need to go into that extent. You don't need to have a bottom-line price and then importantly all you need to do is pin down the regulatory discretion. If you like there is sort of subjective and objective aspects to any regulatory decision and what you're trying to do is pin down the subjective ex ante.

MR BANKS: If you look at the question of access holidays, under the heading The Role For Access Holidays, question mark, which shows that you're not convinced

either. There may be some misunderstandings and indeed the commission's own thinking is developing as we're talking to people on this. On page 25 one of your concerns is the need to involve an ex ante assessment by the regulator of the likely profitability of the project. I think the ACCC or one of commissioner's has indicated that they don't want to be picking winners and I guess we wouldn't want them to be either in this respect. That's why we're thinking about some rules. We talked this morning to NECG about one that, you know, relates to the contestability of the project. When we talked to the pipeliners yesterday, or the APO representing them, they made the point that most pipeline projects are contestable and quite hotly contested in advance so that's a situation which you would expect ex ante factoring in risk, you know, for them to go ahead when they're normally profitable. I thought that that was left out.

On the bottom of page 25 you envisage two possible reasons why you would get a situation of a natural monopoly-type infrastructure being only marginally profitable ex ante. It doesn't seem to pick up this point that essentially if these investments are constestable they will go ahead as soon as they become profitable to do so, taking into account a risk, and not any earlier than that and not any later than it. Therefore you could almost categorise that whole class as a class that should be exempt from an access regime. I don't know whether people would like to comment on that.

MR WARREN: Thinking about this morning's discussion, and I'm sorry to be overlapping on this, but isn't that then an issue rather of an access holiday than getting the declaration criteria right? I mean, if you have a service that's contestable it should be ruled out at the access declaration style level so - - -

MR BANKS: No, because it's like competing for the market. Once you're in the market providing the service you have got a monopoly.

MR WARREN: I see. So it's not a contestable within the market?

MR BANKS: No.

MR WARREN: It's competition for building the bridge.

MR BANKS: Exactly, yes. So in that sense - I mean, there will be situations in which it wouldn't be contestable and they're the situations in which we imagine that you would reverse the onus and you wouldn't provide an access holiday unless the applicant could show good reason why they would have one but, look, it might be something that you would take on notice. I would appreciate having a legal perspective on this in terms of what we're proposing. We had a more elaborated discussion this morning which will be in the transcript which you might care to comment on. I guess the other point, just to clarify, on the bottom of page 26, you say, "In addition to an access holiday, if not a de facto exemption, will be followed by regulated terms and conditions."

I guess what we envisage, and you can argue about what the appropriate duration of an access holiday would be and how that should be determined and so on, but what we envisaged was at the end of that all that would happen is that that facility would be in a position where there could be a declaration. Some could seek to have it declared so there wouldn't be any automatic regulation of it and they would take their chances. Now, it could well be that at that point, you know, the declaration criteria could be such that it still wasn't declared, so there would be no automaticity about having terms and conditions imposed.

MR WARREN: The length of time really then does become crucial, doesn't it? I mean, as the API and a whole lot of people's argument, that if you have got a particularly risky investment you really want the holiday at the end when the investment has been proved and you're starting to get some payback in terms of your expenditure rather than at the beginning when access seekers are much less likely to want to ride on your risk.

MR COSGROVE: That's a question of the duration of the holiday really.

MR WARREN: Yes. But it's a really hard question I would have thought because you don't want to - there must be an optimal length in determining that - - -

MR BANKS: It might be different for every project.

MR COSGROVE: Yes, indeed.

MR BANKS: I mean, the other thing on my mind there is that - I mean, if it was unlimited you could imagine potential for gaming there to keep those assets sort of operating, spending a hell of a lot on maintenance and try to keep them operating so there is something to be said for a defined period of time. Then you could say, "Well, instead of 10 it should be 20 or 25," but then you start to wonder, you know, at any sort of positive discount rate, you know, dollars earned 25 years down the track are pretty small in present value terms. What you might be saying is, "Yeah, but there are a lot of dollars at that point because that's when the thing really becomes profitable," but I mean, any views that you had on what a rule might be, a viable rule for the duration as such an access holiday would be useful. Okay? Could we leave it that you would get back to us on that. We would appreciate that. John, have you got - - -

MR COSGROVE: As we come to section 5, proposed changes to the declaration criteria, a general impression we have from your submission is that while you have got substantial concerns with the system as it's presently operating, you're not very keen on the types of proposals that we have put forward for tightening the declaration criteria and pricing principles and that rather you would prefer to go down this route we were just discussing about ex ante arrangements to give degrees of comfort to potential investors. Is that a fair reading of the overall ways in which

you would prefer to go?

MS EVANS: Save from one - I think quite supportive of the idea of pricing principles. I think pricing principles are endorsed by AusCID - - -

MR COSGROVE: With some changes.

MS EVANS: With some changes, yes, but the notion of that I think we regard as being quite important.

MR COSGROVE: Declaration criteria though, you don't seem to favour most of the things we have put forward. That's my impression.

MS EVANS: I think the position that is probably now been reached largely as a result of the eastern gas pipeline decision which came after the commission's position paper, and if this were being written before the eastern gas pipeline decision then the outcome may be slightly different. I think if you were starting with a blank sheet of paper you would probably write the declaration criteria quite differently. Living with what we have, we have now had a couple of decisions which indicate that we're not getting bad outcomes and not a bad approach to the thresholds that should be applied in determining whether or not particular services fall within the criteria. From the lawyers' perspective any changes which are made will assume to achieve a different purpose from what which currently exists. So it's difficult to effect a sort of tidying up or increased clarity because that will be assumed to mean a change from what is now been set down in the various.

MR BANKS: But is there sufficient precedent to justify that?

MS EVANS: I think in relation to what are quite significant aspects of the criteria I think that probably is the case. Some of the criteria which - the first two criteria, the promotion of competition test and the criteria B have been quite well enunciated. Some of the other criteria, particularly the public interest issue, hasn't really been addressed very much in any of the decisions to date. One of the issues that I think is inevitable with criterion A is there will be very qualitative assessments about the nature and extent of competition which exists in upstream and downstream markets and the likelihood and the ways in which competition may be promoted, that I think is in many respects inevitable because of the very nature of competition, and also because the nature of the processes means that those making the decisions at various stages are heavily dependent upon the material which is put before them by the parties, and as time progresses different factors can emerge and you might at a later stage in a process be seeing actual evidence of competition when it was speculative previously, and you can never - there's an important distinction too I think between the way in which the criteria are interpreted and the application of any given set of facts to that interpretation and that goes to the sort of qualitative or subjective assessment that is inevitable with a human decision-making process.

MR MUNDY: Gary, you mentioned the sort of the voracity of the precedent. I mean, the tribunal and the Duke decision has turned its mind, at least in passing, of this question of uneconomic to duplicating criteria B. The ACCC has certainly to date maintained that this is a forward-looking concept and therefore if there are N of them already in existence we're only concerned about the construction of the N plus once facility. This is the matter that they have clearly in their issues paper in relation to the Virgin application said that, "Well, we see that there are two terminals, domestic passengers at Melbourne airport at the moment," but that's not of concern to us. What we're concerned about is the ability to duplicate this third one. Now, I probably don't have as much faith. I am probably a bit old-fashioned and this is probably a reflection of my background, I have more faith in statute than courts and it will be very interesting to see the extent when the ACCC comes to consider that Virgin application, whether it's going to be mindful of what attention it pays to this decision.

The declaration criteria in section 190 of the Airports Act is slightly different be it says "another" which may want you to lead to the belief that it's the next one rather than an alternative, but - - -

MR BANKS: We thought we had solved that for you and you didn't like a second facility.

MR MUNDY: Yes, but I think the question of the robustness of the precedent will I think be exposed fairly soon so I guess time will tell.

MR BANKS: Yes, time will tell. Just on that question of a second facility is my understanding correct that on page 33 your main concern with is that it may be taken to imply an identical facility rather than testing for substitute services. Is that - - -

MS EVANS: The concern is that it focuses on technology specific facilities.

MR BANKS: Yes, because we're still using the word "facility". Is that it?

MS EVANS: The notion of second facility, and this may be an isolated view, but it seemed to have a much greater notion of identicality with the first facility than the notion of another facility, and I suppose it harks back to the lawyers' approach which says, "If this is a change it must be for a reason. Therefore perhaps the reason means it needs - it is a technology specific issue."

MR MUNDY: I think the tendency to want to rely upon facilities rather than services is just inherently dangerous in my view.

MR BANKS: Yes. So leave well enough alone if it's already there. Is that what you're saying?

MR MUNDY: This really should be, and I guess it's sort of raising the issue of - I

mean, it's sort of all associated with how you might think about pricing as well. The real issue here should be about the provision of services, not about the provision of facilities. You know, one of the arguments that we have in relation to the ACCC in Virgin is that we didn't need to build this third terminal because there was sufficient capacity within the other two, and even if there wasn't, couldn't you have extended either of those to make that capacity available at a lower incremental unit cost? The answer to that is yes. So this whole notion of facility leads almost to some consideration of engineering outcomes rather than the issue of provision of services which is really what the focus of it is.

MR BANKS: Yes. But the fact is that in the current declaration criteria the word "facility" is there. What I think you're saying is that if you substitute the word "second" for "another" then you go backwards.

MS EVANS: There is some risk that that might happen.

MR BANKS: So if you're risk averse you leave it as it was.

MS EVANS: Yes.

MR BANKS: You're not so risk averse in relation to the word "substantial". I think that's interesting because with a legal perspective you might reassure us because others have told us that "substantial" could open up some avenues for uncertainty. Would you like to comment on that?

MS EVANS: My personal view I suspect is that because of the qualitative nature of the assessment of competition if you insert the word "substantial" in practice it's probably unlikely to have much of a material effect on the way in which the criteria is interpreted or the range of options that you're likely to get out of the relevant decision-makers, and that's because of the qualitative nature of the whole assessment process. So that where you see "substantial" being used at the moment in the context of the substantial lessening of competition in Part IV you do get a range of descriptions of what "substantial" means from being not insignificant to being material and you see slightly different applications of it in the various cases. I think that's something which simply can't be avoided.

MR BANKS: Okay, thank you. Look, we won't hold you much longer. Just a quick look through to see if there are any other points. Yes, perhaps just on page 39 my colleague referred to the question of pricing principles and I think you said that you were broadly happy with what we had but you wanted to add some. That's on page 39 I think that you provide some suggestions there. Could I get you just to - or someone - to elaborate on the additional principle A, namely that:

> Regulators should be required to respect the principle of financial capital maintenance.

DR WARREN: I think the best place to get more detail on this is the Telstra submission under Part XIC where this was discussed. That might be a quick answer if you were after one but the idea is very much here that - and I think this goes very much to the point about optimisation - that if you're going to essentially strand some assets you have to compensate for that process within a regulated environment. Of course there's a great distinction between a regulated environment and a free market because in a free market firm you would price higher because it fears it's going to be stranded in five years time anyway. That doesn't happen generally in the regulated environment.

What we're basically saying here is if regulators are to be constrained by pricing principles and I think that's not a bad idea - I think it's a very good idea - then you really need to build into the constraint there that they have to maintain the financial capital that the investor put in place or at least protected against regulatory takings essentially; against them stranding those assets without any compensation. We can give you chapter and verse on the bottom line if that's the case.

MR BANKS: So you elaborated on that point in the Telstra - - -

DR WARREN: Telstra elaborates on that point.

MR BANKS: In the communications' submission. But your submission to the commission on telecommunications?

DR WARREN: Yes. We're actually writing an NECG submission that will go in there as well. That will be more elaborated, on that point.

MR BANKS: Okay. Sorry, that was Telstra's submission to that inquiry?

DR WARREN: Telstra's initial submission which is in there in front of you has something on this. We can get more to you.

MR BANKS: Good, thank you. We will look at that. Yes, your others I think are ones that we've covered in relation to regulators being required to include strong incentives for producers to achieve productivity improvements and I think in terms of our reference to the use of productivity benchmarks and so on in incentive-based regulation, we've got some references there. Are you saying that we should strengthen them? I think at the moment they're not in there as proposals but rather findings.

DR WARREN: Yes. I mean, the existing principles are very much, as I read them at least, within the efficient cost building block-type model and they're not inconsistent with other models. I just think that's the sort of way they can be read, as very much within that mindset. I think the idea we were saying here is, let's try and push people to be - I think the words in your report were - a little less ambitious and just say, "Come on, let's step back and try and use the incentives as much as

possible," because really regulators shouldn't be sitting there working out whether the fence pickets should be painted in four years or five years time. That's really just not a sensible use of community resources.

MS EVANS: I think the other point is - the point you make - there's a number of these issues that are addressed in findings in the commission's position paper but not necessarily picked up in terms of the precise recommendation. I think we would suggest that some of those findings should be incorporated into the actual recommendations.

MR BANKS: Certainly our final report will contain recommendations rather than proposals and different tiers. It may have some options in it but they will be firm recommendations. I propose - - -

MR COSGROVE: I just might say that the Energy Users Association in their submission to us in Melbourne last week raised what they saw as some substantial practical difficulties in going down that particular road on the productivity incentive benchmarking arrangements. As a reader of foot notes, there's one missing. It's on page 26. You refer to a joint industry submission to this review, foot note 37. Is that the previous AusCID submission that you have in mind there?

MS EVANS: That's the submission which has been prepared by NECG as the joint industry submission.

MR COSGROVE: This morning's paper? Okay, thank you.

MR BANKS: Any last comments? I would propose ending now and I'm sorry we detained you so long.

MR O'NEILL: Not at all. We have been very pleased to hopefully - been able to address all of the issues that you've raised. We've got a number of points on notice and we will revert to you as soon as possible in response to those. Thank you very much.

MR BANKS: Thanks again for participating and I'm sorry that we delayed you. I hope no-one misses a plane. I'll just break now for a couple of minutes.

MR BANKS: Welcome back. Our next participant is Mr Ian Tonking. Welcome to the hearings. Could I ask you perhaps just to clarify your name and the capacity in which you're here today.

MR TONKING: Yes, thank you, Mr Commissioner. My name is Ian Tonking, T-o-n-k-i-n-g. I appear in two capacities. Firstly I appear as a representative for the Trade Practices Committee of the business law section of the Law Council of Australia which is a committee comprised of practising lawyers and academic lawyers and a small number of economists from all around Australia who are involved in competition matters at various levels. I also appear in my own capacity, having made a submission to the commission's inquiry.

MR BANKS: Thank you. Perhaps as I said you might just care to very roughly outline the points that you were making on the submission.

MR TONKING: Thank you. I think I can say this, that with respect to the Trade Practices Committee there will be a short submission which will be similar to the short supplementary submission that I made following the position paper. I think that broadly speaking the committee members have been pleasantly - I won't say surprised but have received the position paper with a degree of pleasure and comfort in that they perceive the commission to have advanced a long way towards a number of the fundamental matters or points that they were making in their submission. For that reason the supplementary submission is not likely to be very extensive or touch on very many matters.

I think I can reasonably say that the matters that perhaps will be touched on, and they're the ones that are in my own submission plus an additional one that I will mention, are as follows: the first relates to proposal 5.2 and this is the one about whether there should be an express statement that Part IIIA of the Trade Practices Act applies to vertically integrated facilities and non vertically integrated facilities. I think the view that the committee takes and certainly the view I take is that having regard to the decisions that have already been made there is no need for that clarification. There is a difference of view within the committee as to whether it should apply in both cases.

The second comment on the position paper is in relation to proposal 6.1 and that was one which attracted some comment in the last session, that is the proposal to change the words, "another facility," to "a second facility." The comment that the committee make here and that I make is I think very much in line with what was said by Ms Evans in the last session and that is that it's a peculiar characteristic of lawyers I suppose who are fixated on language to assume that any change must be made for a purpose and if particular language has been interpreted in a particular way and it's then changed then those changing it must intend that it means something different from what it's been interpreted to mean even if what it was interpreted to mean wasn't apparent on the face of the language before.

That sort of catch up change, in other words, will be interpreted not just as a catch up but as trying to make some change in some other direction. For that reason I think the counsel from the committee would be perhaps leave well alone. I think the other point that's made about that really is that the difficulty that's been experienced in interpreting criterion B has been more in relation to the word "develop" which seems to have a prospective meaning rather than an all-encompassing meaning and so that where you do have an existing facility it might be thought that you disregard that. That's not been the approach taken by the tribunal or indeed the NCC and therefore despite the perhaps awkwardness of the use of that word I don't think we would suggest that any change ought to be made to it.

The next comment is in relation to proposal 6.2. This again I think addresses criterion B and the comment we would make in relation to that is that the greatest amount of controversy I suppose to date in the cases has been in relation to the meaning of the word "service" in that criterion, in different contexts. It was the subject of course of argument in the Robe River litigation in the Federal Court in relation to production facility, and whether that was part of the service. It was the subject of debate in the Sydney Airports' case where the commission will recall there was some comment by the tribunal about different understandings amongst the parties and amongst the witnesses as to what was meant by the service there, whether it was the service that the airport provided or the service that was provided after one had access to the facility.

It has also been the subject of comment in the recent Duke decision in another context again and that is in the context of the gas pipeline access law which is based on Part IIIA where there is - where perhaps it has a particular meaning because the law obviously is dealing with pipelines which tend to go from point A to point B and the view that was taken by the tribunal in that case was that another facility or another pipeline meant a pipeline going from A to B, not a competitive pipeline, and that a competitive or market analysis wasn't necessary or appropriate to determine the scope of the service that's being referred to in criterion B.

If I can just leave my own hat on for the moment and discard that of the committee's and make a disclaimer, I appeared as counsel for Duke in that matter and Duke was arguing a contrary interpretation of criterion B, namely that one did take into account competing pipelines and one looked at the competition both at the source and at the end of the pipeline and therefore in the particular case it was argued that the eastern gas pipeline which comes from Bass Strait to Sydney was a substitute for the Moomba to Sydney pipeline. However that was not the decision that the tribunal reached and that may I think surprise some people. However, that is the way the law has been applied.

Further point which the committee will I think make in its submission ultimately is that the question of whether the functions of declaration and arbitration should be fulfilled by separate bodies. The committee's view is that they should. The committee is not in favour of there being a single regulator in the sense of a merging

of the roles of the NCC and the ACCC or whichever other regulator happens to be involved as they stand at present. If I can just make an addition comment on that which I think is made in the primary submission by the committee, the committee's view is that if any role should be dispensed with of those that are presently deployed in this area it is the role of the minister, although recognising that the role was given to the minister for a good, sound policy reason and stems back I think to the Hilmer Committee report itself, namely that these decisions may well be contentious when they're taken and while they should be based on sound advice from an expert body such as the NCC, ultimately the decision may verge on the political and should be seen perhaps to be taken in that arena.

Now, the experience of course has been that the federal minister tends to have simply adopted the NCC's recommendation without the extensive reasoning. State ministers have either done the same or not followed the recommendations; simply let the time lapse. One is left wondering whether in fact there is a need for that particular role. I don't wish to say any more about that but simply to emphasise that the committee would see and I would agree that there are different roles at the declaration stage and at the regulation stage and we're of the view that those two roles ought to be kept in separate hands.

I think the final area was one that arises out of what we understood to be a recommendation in tier 2 and that is that the scope for an appeal from a decision to declare a service where an appeal presently lies to the competition tribunal should possibly be dispensed with, as I understand it on the basis that this would streamline the process. That is a recommendation which the committee would not endorse. The reasoning behind it seemed to be that there hadn't been any need for it in relation to Part XIC, but as the submission will I hope make clear, it is seen to be a different basis for Part XIC and it shouldn't be used as the model for Part IIIA. Those I think were the only matters that I wish to comment on but I would be happy to deal with anything else the commission may wish to raise.

MR BANKS: Thank you for that. Perhaps just coming back to the first point. We were conscious in the first submission by the Law Council that there was a division of opinion on the question of the coverage in relation to vertically integrated or separated facilities. What you are proposing here is essentially you're taking the view that because it's been interpreted as covering both there's no need to do any more. Does that come back to your point that you made subsequently that once something is made more explicit it raises questions?

MR TONKING: Yes, it's the same point really. Yes, there is a doubt when you read the legislation perhaps, particularly having regard to the fact that the Hilmer report and I think the competition principles agreement was really only talking about vertically integrated facilities that the legislation appears to apply to both, but it's been made clear that is the interpretation that has been adopted by the tribunal. Now, unless one wants to alter that, again why the need to change the language? I personally have some doubts about it applying to non vertically integrated facilities

although I can see there may be an argument in the case of network facilities and I can also see the difficulty in trying to define what is vertically integrated and what isn't. We can all recognise it but it is extremely difficult I think in a legal or a statutory context to try and define it.

MR BANKS: Would that be another reason for not being explicit about coverage?

MR TONKING: Yes. I mean, if you're going to spell it out then you're going to have to say what you mean by vertically integrated and not vertically integrated and there is a problem.

MR BANKS: Is there any - you referred to the question of Hilmer. In fact Hilmer is - depending on which parts of Hilmer you read and whether you're like my colleague and you read all the footnotes seriously - you'll find that the Hilmer committee seems to have two opinions in its head at the one time and in the footnote it seems clear that they're envisaging the possibility on a case-by-case basis that if we separate the facilities being encompassed within the regime, but if we take it that the general view is that Hilmer really was confining the proposed regime to vertically integrated, that still could be a problem in the future, to the extent that it became an issue in dispute. Or do you think that the precedent already now established means that what Hilmer had to say is now - would never be relied upon in any future dispute on this matter?

MR TONKING: I think the latter. Indeed, the tribunal said in the Sydney Airport case that one had to approach the application of the Hilmer report with caution for the very reason that you've mentioned, that it hadn't necessarily been entirely adopted or embodied in the legislation and therefore I think that while it will continue to be drawn upon for general principles it cannot be binding in terms of interpretation of what is relatively clear language.

MR COSGROVE: I had a question relating to the earlier submission we had from the Law Council. It was this issue of whether or not Part IIIA should focus on access provision only with pricing matters left to be covered by another means. I think you mentioned the Prices Surveillance Act. We've had some difficulty ourselves in making such a clear distinction because access could be provided or offered but on terms and conditions which clearly no seeker would find acceptable so the two are intertwined. It's difficult to separate them. Have you reviewed your approach to that?

MR TONKING: I don't think the committee has discussed it formally and I may be speaking at cross purposes because I haven't reread the original submission for some time but my clear understanding of what was being said in that, and tell me if this is not the point that you're dealing with, was that it was the committee's view that if at all possible a decision in relation to declaration or determination, call it whatever you will, ought to include within it some pricing principles. Now, it was recognised that has difficulties and that they may have to be very general or at a very general level,

particularly if they're in the legislation itself. In other words if the legislation says, "Well, if you're declared then you can expect the following broad pricing principles to apply," given the fact that this applies to a variety of different industries then it would be difficult to make those specific.

However, despite that limitation and reservation the committee was still of the view that there would be greater certainty and there would be - it would be an improvement on the present structure if that approach could be adopted. As I understand it that's the approach that's pointed towards in the position paper.

MR COSGROVE: We have raised the idea of price monitoring as, if you like, an intermediate way of dealing with some services where you might not be feeling that it's necessary to declare but at the same time you're not sure that you want to take a decision not to declare so you would subject the thing for a certain period to price monitoring. Have you given any thought to that proposal?

MR TONKING: No, I can't say that I have, no.

MR BANKS: I might come back just to your third point in relation to proposal 6.2 and you talk about the question of service which I take - which you then I think extend into a more general caution about the tier 2 declaration criteria that we're putting forward there. I just thought - I don't know whether you have any further thoughts on that alternative regime that we put forward. We put it in tier 2 because it is a more wholesale change and maybe you would just like to comment, perhaps building on your earlier comment, about the way lawyers interpret change to see whether this would be worse than a marginal change in tier 1 or not, and then perhaps get any views you had on particular terms. If we could sort of just go through it together if you like.

MR TONKING: Look, I haven't given it any detailed consideration. I think the only comment I would really want to make at this stage is that there are about twice or three times as many words there as there are in the present set of criteria and that lends about two or three times as many opportunities for lawyers to take different views as to what those words mean. I'm not trying to be flippant but - - -

MR BANKS: There are some economists laughing in the audience.

MR TONKING: They always do. Seriously, if you introduce additional refinements or gradations of meaning to criteria then obviously people will again say, "Well, that must be there for a purpose. How does it apply to me? What arguments can I advance?" So the issues perhaps become more complex or more attenuated. That, as I say, is a comment at a general level. It doesn't necessarily mean that there shouldn't be an attempt to rework the language at some stage but I think it is something that would need to be exposed for quite some time for debate, not simply by the commission and I don't mean any disrespect to the commission, but I mean in the form of draft legislation so that it can be looked at: parliament or the government

has decided to go down this road and it wants some input as to the consequences of doing so, rather than just embracing it at a conceptual level and putting it forward in a report. I haven't given the particular language consideration for the reason that it would open up a number of possibilities I think.

MR BANKS: Perhaps the only one I might just seek any comment you've got now or later, and that is in relation to criterion D in that proposal 6.2 where we talk about improving overall economic efficiency significantly. I guess we would particularly appreciate, or I would at least, any response you had from a legal perspective on the hazards or other perhaps benefits of using a term like that.

MR TONKING: I think that the decision particularly of the tribunal in the Eastern Gas Pipeline case and the approach it took to promotion of competition in the context of the existing criterion A would not be likely to change very much by the introduction of that as an additional criterion because I think on my limited reading of the economic literature in this area that tends to be advanced by lawyers and by economists arguing in this area, the sort of improvements in competition based on economic efficiency tend to go hand in hand.

In other words, it's not competition for competition's sake but it's competition with an efficient objective. Therefore I think to the extent that I can anticipate what the committee might say about that I think they would be in favour of it as a welcome clarification perhaps of the overall objectives of declaration. I don't think it would be likely to be interpreted to make a major change to the thrust of the legislation as it is at the moment, although if one goes back perhaps to the Sydney Airport case where it seemed to me at least that a fairly low threshold of promoting competition was adopted, if this criterion had been required to be satisfied in that case there may I suggest have been a different outcome. So it may be case specific.

MR BANKS: I guess that was the case that was before us when we produced the position paper and since then there's been the Duke's case which as you point out gives some reassurance in some areas although some see it as perhaps posing questions in others. You referred yourself to criterion B, the declaration criterion. Okay, that's helpful.

MR TONKING: Can I just go back to your previous question, Mr Cosgrove, in relation to price monitoring as an alternative for declaration? This is purely off the cuff but it just occurs to me that there might be a degree of alarm I suppose by a facility owner or operator who was faced not just with the possible alternative of the facility being declared and therefore subject to some sort of regulation or the need to put in an access regime but to a completely different regime, namely surveillance by presumably the ACCC under a regime similar to that under the Prices Surveillance Act. I don't suppose the facility owner could do very much about it but it would I think result in a more lengthy process of submissions and consultation and so on where those two options were being considered rather than just the option of declaration.

Equally, if you then take that to the appellate level and somebody is opposing a recommendation of the minister that their facility be declared or subject to monitoring and then that is taken to the tribunal, would those two options be open also to the tribunal? Presumably they would and so again you would have a debate about two possible scenarios rather than one. It's a process thing perhaps that needs to be given some additional consideration.

MR BANKS: That actually raises an interesting point.

MR COSGROVE: There was one other proposal in the council's original submission which we lent some support to. That's captured in our proposal at 10.1 which is a tier 1 proposal, about exempting certain access arrangements under Part IIIA from Parts IV and VII of the Trade Practices Act. We did however go on to ask for some assistance about the best way to implement such an exemption and we mentioned in that respect the possibility of affording the relevant terms and conditions and automatic authorisation under Part VII. Has the council given any thought to that implementation issue?

MR TONKING: No, I don't think the Trade Practices Committee of the Law Council hasn't. I myself didn't, I must confess, give it a lot of consideration. I don't know that I fully understood what was being sought to be achieved. Perhaps it's just that it hasn't come up in practice but of course one is aware at the moment that a facility which might have natural monopoly characteristics is exposed both to the possibility of being declared under Part IIIA and to the possibility of a claim under section 46, whereas again I think the Hilner committee had recommended that it should be taken out of 46. So that's at the early stage.

I take it that what is being suggested here is that once a declaration had been made and an access arrangement was in place then that should stand in substitution for any possible claims under Part IV. I'm sorry, I don't really know that I can say anything usefully about that. It hasn't arisen certainly in any context that I'm aware of. That's not to say that it couldn't. I don't think I can make a useful comment.

MR BANKS: I think we first heard at a symposium at Melbourne Business School, and I think some lawyers had said there was a double jeopardy and that we needed to ensure that IIIA was more integrated with the rest of the Trade Practices Act to ensure that it didn't remain another major area of uncertainty. Well, if you had any thoughts on that in reflection that fit into that submission by the Law Council that would certainly be - - -

MR TONKING: I will certainly pass that on and if there's something that we can usefully add we will do so.

MR BANKS: Right. Anything else? Thank you very much, Mr Tonking, for that. We appreciate it and we look forward to getting the Law Council's submission.

MR BANKS: Our final participant today is the Energy Markets Reform Forum. Welcome to the hearings. Could I ask you please to give your names and positions?

MR DOBNEY: Thank you. I'm Peter Dobney. I'm a member of the Energy Markets Reform Forum. I work for Amcor and represent them on the forum. I work for Amcor as their national energy manager, negotiating electricity and gas contracts.

MR BANKS: Thank you.

MR LIM: My name is Bob Lim. I'm a consultant and adviser to the Energy Markets Reform Forum.

MR BANKS: Thank you very much. Thank you for appearing. You've made two submissions and you have another one I think that's nearly ready but we'll get an advance presentation on that so I'll hand over to you two to make the points you want to make.

MR DOBNEY: Thanks for your time this afternoon. As well as just making our presentation we've got a bit of factual evidence we feel of exercise of monopoly power by regulated businesses and we'll bring that to your attention as well. The Energy Markets Reform Forum comprises representatives from companies who are major energy and energy infrastructure users. The members are Amcor, Tomago Aluminium, BHP Petroleum, Onesteel, Insotech, BHP Steel and Visy Paper. As you see we've previously lodged two submissions to the inquiry. These focus mainly on the extent of regulatory gaming, possible in access reviews, and the consequential costs which consumers have to bear, that is extensive delays to access - in access to terminations and the anti-competitive outcomes arising from such delays, such as higher costs and discouraging retail competition and inefficient regulatory process which fails to equitably balance the interests of consumers with the access arrangement applicant.

The first point we would like to make is about the access regulation and that it deters investments. We say that there's no evidence to say that it does and in fact the contrary is true. We observe that there's no evidence that has been provided by asset owners or even by your position paper and that there's no empirical evaluation been undertaken to establish that the investments in essential infrastructure has been deterred. Having said that it's surprising that the position paper states that, "There's a strong in-principle case to err on the side of investors." That's page 73 of your submission.

MR BANKS: 71.

MR DOBNEY: Sorry, 71 of your submission, yes. You would be aware that the ACCC commissioned NERA report on international comparisons of utilities and regulated post-tax rates of return in North America, the UK and Australia. The NERA report points to higher Australian regulated returns than in the other countries

that were examined and that Australian regulators have provided incentives to invest. We would also like to point out that there are a number of regulatory practices in Australia that show that the system of regulation actually supports rather than discourages investments.

Regulators and access regimes have drawn a distinction between greenfield investments and established investments, thus the national third party access code for gas pipelines permits an asset owner to place a proportion of its capital investment in new facilities into a speculative investment fund which is indexed at the new facility's weighted average cost of capital - higher rate of return. As demand grows the relevant assets are drawn down and added to the asset owner's regulatory asset base and we know that the ACCC in its decision on the central west pipeline provided a 10 year access arrangement and the placement of a significant proportion of the project's capital base into a speculative investment fund.

Regulators have approved access arrangements that will reward asset owners for our performance against efficiency benchmarks. For example, regulators have allowed asset owners to keep gains in efficiency, that is the X factor, within and across access periods. The trigger mechanisms that allow for the access arrangements to be revisited when the access period is - if specific events occur, and the capital asset pricing model that's used to calculate average weighted costs of capital which incorporates risk premiums.

Regulators appear to be sensitive to access applicants' capital expenditure proposals within reasonable prudence requirements. In our experience regulators have normally approved the majority of capex proposals and it's useful to point out that in 1999 the New South Wales distributors network pricing review, the regulator, following a report from its consultants, actually encouraged some distributors to substantially raise their capital expenditure proposals. In our experience the system of regulation in Australia would tend to encourage access arrangements applicants to overforecast their capital expenditures. In the UK experience has shown that actual capital expenditures by UK utilities, that is electricity and gas, are consistently below capex proposals.

The incentives to gain capex are very strong; the higher the regulated rates of return are. The use of DORC asset valuation and the indexation of regulated asset base also provide strong incentives to invest. We've got some exhibits we would like to share with you. Could you put on the overhead, Bob? Exhibit 1 shows between 250 million to 300 million in new gas distribution pipeline investments by three gas distributors in New South Wales between 1997 and 2000. That excludes the 350 million for the eastern gas pipeline. This is following the advent of third party access in 1997. You can see there there's a number of projects that have been proposed and brought forward and AGL are also planning to construct a $96 million Central Ranges pipeline project to Tamworth once they've established base load contracts.

Recent press articles suggest that the AGL network's plan to reticulate to the Upper Hunter - that's about a $3 million project - with a low pressure pipeline and also it appears that they might be putting forward a high pressure pipe as well. Great Southern Energy of course are going to construct a $5 million gas network to Cooma and gas has already started - well, they have constructed a gas pipeline to Cooma and that's already flowing gas to about 600 customers in Cooma. Integral Energy is spending about $4 million to reticulate gas in Nowra where there are about 2000 gas customers.

Just as a way of contrast if you look at what's happened in the Victorian gas transmission system which is owned by GPU Gasnet and operated and managed by Vencorp in Victoria, Vencorp have the responsibility of transmission system planning in Victoria and this ensures that all GPU's capex budget has come under scrutiny and very close scrutiny in fact and we haven't seen a major increase in capital expenditure in gas assets in Victoria because of that. I'm not a great proponent - we're not a great proponent of Vencorp in particular but it seems like that the scrutiny that they apply is putting some rigour into the assets and the capex expenditure of GPU Gasnet.

Exhibit 2, which I won't read out in detail, but it's a report on various new pipeline investments that are planned including the APT proposal to transmit from the Timor Sea to Moomba and it spells out that there are a number of major projects in the pipeline, so to speak - pardon the pun - and they're obviously not being deterred by access arrangements.

MR BANKS: I might just ask you to have a look at the submission from APIA, the pipeline industry association, who've made points that while these proposals are in play how they turn out will still be affected by the perceptions of the regulatory outcomes. They are essentially making the opposite point to you in these areas. They also make the point that there's been no new pipeline commence since the regime has been in place. We've had some discussion of that on the transcript which you could have a look at as well.

MR LIM: But I guess, Gary, a quick response to that really is that it's competition happening in the sense that the access is encouraging different companies to come up with different proposals. How a particular proposal is worked out, what particular companies actually get to build their pipelines, depend on a whole host of commercial factors including the ability to get commercial customers to sign on. That's not to say that I don't think there could be a linkage to access arrangements actually deterring investment in that sense. It's just basically that the environment has changed given access arrangements and that competition is bringing forward those competing proposals. No new pipelines: I guess they would continue to exclude the eastern gas pipeline as a pipeline that has never happened but I think there would be other comment papers that would point to that pipeline as actually happening. I guess the exhibit number 1 actually shows quite a number of additional pipelines.

For example, the reference to the Integral Energy, that's using Bass Strait gas, that wouldn't have happened without the eastern gas pipeline coming up and bringing in new sources of gas and of course that means all those additional customers or consumers can use gas in those particular areas too. I guess my immediate reaction was to bring up those examples in response to the APIA submissions.

MR DOBNEY: The other pipeline that's also happening shortly is the origin pipeline between Victoria and South Australia. I don't think that's been deterred by access arrangements either. Turning to exhibit 3 then, that shows about 5.5 billion in electricity network capital expenditure proposed for South East Australia over the next five years. It's a very large sum of money and you can see what it will do to the asset bases of some of these organisations. Another thing to add just in here is that Vencorp in Victoria has proposed the upgrade of the New South Wales-Victoria interconnect, electricity interconnect, by about 400 megawatts at the cost of about $40 million. This is a very cheap and efficient way of getting additional electricity capacity into Victoria you would think. It will alleviate power shortages in Victoria in the years ahead.

Transgrid are not very keen on this project and under questioning by ourselves and others it seems that why they're not keen on it, is it's really not adding a lot to their capital base and they would prefer to have some congestion pricing on the interconnect rather than allow electricity to flow to another part of the national market. This sort of raises the question of have we really got a national market when we've got constraints like this that are occurring and people not willing to invest in relieving those constraints.

MR LIM: I guess what Peter is saying that there are pull and push factors. On the one hand you might get a lot of new proposals like the $5.5 billion that he mentioned in terms of augmentation of electricity network systems that have come under access reviews in the main, but on the other hand there are also push factors which might constrain investments coming forward for any number of reasons; preferences by some asset owners to have congestion pricing, create congestion, or perhaps interferences by state governments that wish to preserve the value in some of their businesses by preventing, for example, building of bigger interconnections between New South Wales and Victoria. So there are pull and push factors happening all the time.

MR DOBNEY: So we would therefore conclude that there is no evidence of access regulation leading to investments being deterred or that there are a lack of incentives. On the contrary, there are risks that - are erring on the side of investors - regulation in Australia through generous incentives could well be perverse and result in over-investment in some areas. We feel that so far as electricity infrastructure goes NEMMCO should actually be required to prepare a statement of opportunities in much the same way as they do for generation for transmission systems with a five-year outlook to advise where opportunities to relieve constraints within the

system. That would provide some sort of oversight in this matter as well as providing signals for investment rather than what we're seeing at the moment. Unfortunately we don't have the same sort of organisation to provide similar information on gas network planning.

The next point I wanted to take up is - actually, I think we might just come back there. There are a couple of instances that we wanted to refer to about regulatory gaming and monopoly power that I sort of mentioned before. The first one is this sheet here that you have got a copy of which is the TXU tariffs in Victoria. I just wanted to talk to that for a moment. Basically what it is is a fairly crude but I think effective analysis of what happened under a light-handed regulatory regime in Victoria. What you will see there are all the network distribution tariffs for all of TXU's customers in Victoria. If you pick for example the small customers, NEE11, the small tariff for householders, 2000 gives you an indication of what - it tells you exactly what the tariffs were in dollars per megawatt hour for small customers, that is, apart from the standing charge. Sorry, it's cents per kilowatt and dollars per megawatt out. The standing charge you can see at $59.40. The peak price was 6.295 cents and the off peak price was 6.295 cents, okay?

Then we move through to what their draft tariffs that they advised the ORG and published them on the Web site, is what they would be post-2000, 2001 or for the start of 2001. In their draft submission you can see there as a slight reduction across all those tariffs. The line draft percentage decrease shows that the standing charge went down 7.41 per cent. The peak price went down 9.9 per cent and the offpeak price went down .94 per cent. If you then move back up to their final submission which was after the ORG, and their final determination, ORG approved, you can see that there has been a substantial further drop in the standing charge, a substantial further drop in the peak charge, and a substantial further drop in the offpeak charge. So if you look at the bottom line under that tariff, that per cent, final decrease, and standing charge came down 18.1 cents, peak came down 25.37 cents, and offpeak came down 18.5 cents.

Then when you work through all the other tariffs you can actually see where the money is moved from. What has actually happened is the large consumers, and it's not just high voltage, it's all large customers and even medium-sized customers, are virtually cross-subsidising the small customers in the TXU franchise area now because they have actually received a negative - this is all meant to be CPI minus X regulation, mind you. They have actually all incurred increases in costs and the small customers have received reductions out of all proportion. This seems to me to smack of cross-subsidisation and I would suggest that it's probably because - well, the reason behind this is for retail contestability and I would say that this company wants to try and retain a lot of customers in the domestic level.

MR LIM: But according to that is that under price cap regulation, once the regulator determines a price cap or a revenue cap the business could actually do what it wants within that cap.

MR DOBNEY: Within that cap, yes, that's right.

MR LIM: So what TXU has done is to move all the costs across to the larger customers and therefore we say that you offer the smaller customers a lot of higher discounts and cross-subsidy is being paid for by the larger customers.

MR DOBNEY: That's right.

MR COSGROVE: Could that be an efficient reflection of elasticity of demand of the different customer groups?

MR LIM: It tends to happen when elastic demand customers are asked to pay as high a price as they can because they can't move their plant somewhere else.

MR DOBNEY: That's right, yes. If we look at the last sheet which is the summer profiles, system summer profiles, this is a graph that United Energy and other distributors in Victoria presented to me a week or so ago to tell me why they have provided now a summer incentive demand charge they call it. Well, it's really a certain incentive, it's a penalty for large customers actually consuming power during their afternoon peak over summer because if you look at the top dotted line you can see that United Energy have a very large afternoon peak. It's quite substantial. What they're trying to do is address that peak, smooth it out, so they can get some more capacity out of their system. So that's the first arrow that points towards that one.

The second arrow points towards the load of the non-franchise customers during a very hot day. You can see how that dotted line has a picture in the middle of the day but it tapers off in the afternoon, and it follows very closely the other curve for non-franchise customers during non-cooling months, so there is only a slight shift there between summer and winter basically. If you then look at the third arrow of the graph, that dotted line, that shows you what the franchise customer load looks like during summer and you can see very clearly who is causing the afternoon peak. It's the smaller consumers. So here again is another cross-subsidy between customer classes. When I asked the question as to why the non-franchise customers were having to wear this they said, "Well, we can't really charge the others because we don't know when they're using the power because they don't have sufficiently intelligent metering, so that we can bill them for it so we're billing you guys instead because you do have the metering that enables us to do that. So there again is another form of cross-subsidisation. It's not a very efficient pricing segment, and as Bob said, for the companies with an elastic demand it hurts, it really hurts bad. There's nothing you can do about it.

Okay, so if we move to access pricing monopoly - - -

MR COSGROVE: Sorry, just a moment, the customers with an elastic demand don't have much opportunity to substitute, say, gas as their energy source rather than

electricity?

MR DOBNEY: No. A lot of major manufacturing - - -

MR COSGROVE: Over time the opportunity would increase I guess.

MR LIM: Over time, yes.

MR DOBNEY: Over time, possibly, but it basically means you have to shut down and send people home; shut down your operations and send people home. That's all you can do to combat something like that.

MR COSGROVE: Yes. I guess you have to make a judgment about whether that's worthwhile or not.

MR DOBNEY: You do but - that's right, yes, but as you can see you're not the cause of the problem in the first place, and you wonder why you're being penalised. So you either take the hit and wear the costs or you shut down and go home.

MR COSGROVE: Yes.

MR LIM: I think one critical factor here is that the household market that uses airconditioners in the summer peak are not getting the price signals to eitehr switch off or to ration their demand or the responses are being pushed through to industry. Some industries can switch off over time, switch to different fuels, or they can basically switch off and go home as Peter mentioned or they can sell back some of their energy requirements into the market but the key thing I guess is that the small customer market is not facing that pricing signals to respond. This happens with the revenue cap or price cap arrangements where the distributor can have that flexibility to move prices within those caps. That's an example of some of the diverse outcomes that come out.

MR DOBNEY: Why don't you talk to some of these - - -

MR LIM: Okay. Peter is flagging so perhaps I could take over. The second big issue I guess we want to mention is the issue of access pricing and monopoly rents. The energy markets with forum notes the discussion in the PC's position paper abouat the benefits and costs of excess regulation and notes with some surprise the following statement, and I quote from it. It's on page 52. I quote, "It is important not to overstate the extent of market power in the provision of essential infrastructure services. Various competitive pressures would limit the scope for providers to restrict access and for raised prices. This reinforces the need for the inquiry not to dismiss the no regulations option, particularly given the potential costs of remedial intervention."

I guess the forum is a little bit surprised by the commission's summing up

statement in that area. It seemed to us that it seems to basically completely ignore what Part IIIA regulation was supposed to do in the first palce and we believe that this might send unfortuante signals to downstream industries. It seems to ignore that prior to Part IIIA the natural monopolies or the monopoly sector were able to incur monopoly rents and to deliver inefficient services to downstream industries and that statement might suggest that there might be some preference to go back to pre-Hilmer or pre-IIIA regulation. We may be wrong in that interpretation but - - -

MR COSGROVE: It is followed by another paragraph of course.

MR LIM: Okay.

MR BANKS: Perhaps if I could just - this is a generic regime with potentially wide applicability and maybe you missed the word "technology" in that paragraph. "A number of those services rely on natural monopoly technology." We had a bit of discussion earlier. Henry Ergas doesn't like the term "natural monopoly technology" because he thinks it's a monopoly by definition in relatoin to a market, not in relation to a technology, but for example, you could think of a rail line from A to B involving a natural monopoly technology having absolutely no market power whatsoever because there's a big fat new highway with B doubles on it going right along from A to B next to it. I mean, that's the sort of - in a general statement like this it's saying, you know, "Where you have got a general provision you need to be able to accommodate different situations." I mean, clearly if - and we come down to the declaration criteria which were intended to capture those essential services that do have power. I guess it's just not wanting to rule out the possibility that some won't have, even though they may appear from some perspectives to have a monopoly position, at least in relation to their technology. So I don't think there's a great difference between those.

MR LIM: Okay. We might have misunderstood what you are driving at because our initial reading was that it might have been a proposal that turned the clock back and that was a little bit worrying from our point of view.

MR BANKS: But in any event the paragraph you lighted upon is only one part of the summing up.

MR LIM: Okay.

MR BANKS: The second paragraph presents the other side of the possibilities, ending up saying that the competitive forces that might be expected to constrain the exercise of monopoly power and/or provide offsetting benefits might not yet be fully effective so I don't think we have really been one-sided here.

MR LIM: Okay. That's good. The main point I wanted to make I guess from this paper is that the energy markets reform forum wants to point out that without excess regulation, for example, in the gas pipeline area in New South Wales, there wouldn't

be that interbasing producer competition that we now see happening between Bass Strait gas and Cooper Basin gas. We wouldn't see the pipeline augmentation that has been going on. We wouldn't see new retail players coming in to being and we probably wouldn't see country customers getting access to gas. I guess that's really the main thing we wanted to add and that was to defned the fact that access regulation has actually helped to create investments and also helped to create competition at the retail level, and also has helped to create more customers for the consumption of gas.

I guess that's really the main thing we want to do and that was to defend the fact that access regulation has actually helped to create investments and also helped to create competition at the retail level and also has helped to create more customers for the consumption of gas. So that's really the main point to make. The third set of comments we wish to make concern some of the position paper's suggested pricing principles. In proposal 8.1 there was a suggestion that there should be allowance for some price discrimination, and I quote "when it aids efficiency" and to allow pricing above the cost of providing service if it does not, and I quote "detracts significantly from efficient use of services and investment in related markets".

Perhaps again we might have misunderstood what the PC might be alluding to but we thought that perhaps proposal 8.1 might be again a return to a pre-Part IIIA, either when monopoly is able to price above a long-run margin of cost by pricing in monopoly runs or to even price discriminate between users with users paying above long-run margin of cost. So if you just like to flag that, we have some concern with that particular proposal. There is a little bit of concern with proposal 8.2 which - and I quote - "would place an onus on the regulator to demonstrate why productivity based approaches would not be feasible" if a building block approach has been adopted.

I guess in relation to 8.2 we just want to seek clarification on proposal number 2. In a sense we believe that the building block approach that the regulators have adopted up to now provides for greater transparency and greater certainty in understanding the real cost of business. It tries to get to grips in the real world of regulatory gaming and cost-padding and strategic behaviour. So we are quite defensive of the building block approach. All we're asking is to seek some clarification as to whether that particular proposal - proposal 8.2 - might seek to diminish the role of building blocks in favour of productivity based approaches. Again we might have misunderstood the commission's intention there, so there were just two comments on the pricing proposal 8.1 and pricing proposal 8.2.

The rest of the paper we have are basically things that we agree with the commission, you'll be glad to know. The next issue really concerns information disclosures, and the forum supports propose a 6.3 which requires the provider of a declared service to give sufficient information to an access seeker to enable the access seeker to engage in effective negotiation. In our experience with a lot of regulatory reviews, information disclosures and transparency are absolutely critical

for better, efficient outcomes from a user's viewpoint and that disclosures would in fact reduce the impact of regulatory gaming and strategic behaviour and we think maximise efficient outcomes. So we think the information disclosure provisions of the national gas pipeline code could provide a useful model. I think you may have heard others make the same remarks, I suspect, because the information disclosure provisions of the gas code actually help regulators to come to grips better with the costs of the particular business.

There are a number of reasons why we would support information disclosures. They could obviously help in better informed regulation. Obviously it keeps regulators more honest because they have got to make decisions based on public information which everyone or most people would have access to and of course information disclosure would minimise disputes. So it might also avoid regulatory capture on the part of the regulators, so a number of good reasons and we are suggesting that perhaps the information disclosure provisions of the gas code might be a good model to work on.

The next issue concerns consumer funding issues and this is another sort of issue which the commission's position paper sought some information on. We support proposals to assist consumers to participate more effectively in access reviews. We believe that access reviews are often time-consuming and resource intensive. They can involve very complex and very technical issues. Asset owners are usually pretty well resourced and pretty well equipped to participate in regulatory reviews. For example, they use lots of consultants to help in their work.

MR COSGROVE: Some access seekers I would think are pretty well resourced.

MR LIM: Yes, indeed. The important thing to note here is that the asset owners could actually recover the costs of regulation. For example, with the AGL gas network's access review in New South Wales in 1999, I think AGL gas network's claim is $1.3 million in regulatory costs which the regulator gave back to AGL in the maximum revenue. So in a sense the asset owners are already well resourced but they can spend the money for regulation and claim it back by the way of regulated revenues. On the other hand the users then not have that sort of financial strength, if you like, or financial support.

MR BANKS: Sorry, just to be clear on that, what are they claiming? Are they claiming, in a sense, the costs of self-regulation? Are they compliance costs that they're claiming?

MR LIM: It came under the heading of Regulation Costs and I would imagine it's the use of consultants, it's the use of the costs incurred in putting together an AA - access arrangement or access arrangement information document. It's the costs of having dedicated regulatory executives to handle regulatory reviews. I would imagine that's the sort of costs that they are reimbursing but $1.3 million was claimed and what was given. So I guess what we are saying is that in the interests of

informed economic regulation there should be some provision for consumer funding. We have two suggestions: there is a possibility of perhaps having some specific funding requirement in all the access codes, like the national electricity code or in the national gas code or perhaps even raise it up to about 3.8 in terms of putting it up there.

In our experience with access reviews - and we've been to lots of them - you usually find a small household market absent from the reviews. You find the farmers are also absent from the reviews and you only find the occasional major companies being involved in the reviews or using consultants like myself to argue their case. When you have access reviews that stretch over 22 months, as we have pointed out in an earlier submission to the commission, that takes a lot of resources and funding requirements and time commitments on the part of consumers to stay engaged in the process. So consumer funding would help to alleviate the - if you like, put a more level playing field in terms of the regulatory processes. If the commission were to think in terms of regulation, the regulator in a sense cannot assume that he understands the views of consumers. He has to make a decision on the basis of the information that has been submitted in reviews. So absent consumers from the review, the regulator will be less able to make an informed decision.

To assume certain interests in the regulator's determination could easily be tossed out in the appeals by the asset owner to the Australian Competition Tribunal, that's my guess. So in a sense the regulator has to be very careful and very even-handed. So absent a particular segment of opinion I think informed regulation would be the worse for - as a result. So we would support consumer funding in that sense.

MR BANKS: Could I ask you to have a look at the submission by Alan Moran from the Institute of Public Affairs who provides a contrary view. There are two arguments that he makes. One addresses the point you just made. He would at least in making that argument see the regulator as having a remit to look at the interests of consumers. Indeed that's been a concern that some providers have expressed. The other point he made was that at least in a more mature market you would expect the retailers in serving their own interest to simultaneously meet the interests of consumers and if you've got sufficient competition between retailers that takes care of itself. The transaction costs in the course of consumer representation and who should represent consumers and how representative consumer groups are, are a whole swag of other issues.

MR COSGROVE: How to allocate the funds, yes.

MR LIM: Well, I don't know whether the commission is aware of some code change proposals which the ACCC is currently coming to a final determination on - and that is the issue of user's funding - to actually provide some funding under the national electricity code to enable users, if you like, to be able to participate in national electricity code changes or national electricity issues, but not in access

regulatory reviews, just on the national electricity code changes. I guess what we're arguing here is that access regulatory reviews are also pretty time-consuming and contain complex technical issues and again there ought to be some assistance, if you like, to consumers to participate.

Just picking up the Alan Moran point, in particular the second point about retailers getting more involved in the mature market, I guess from my own experience the retailers have generally been absent from the debate on national electricity code changes and generally absent from regulator access reviews of network businesses. They are not there and why should they be there, because in a sense they are owned by the same - I'm talking about Energy Australia retail business as opposed to Energy Australia distribution network businesses. The retail businesses wouldn't be participating in the access reviews - - -

MR COSGROVE: But the distributors would?

MR LIM: The distributors would because they have to put in their access arrangements, so whether they like it or not they have to put in proposals. But Energy Australia's retail business would not be putting in submissions or participating on behalf of consumers or putting forward any views. So in many ways the retailers are absent from the regulatory debates or the debates over the code changes that might come forward.

MR COSGROVE: Pass through the costs, don't they?

MR LIM: Yes, they do pass through the costs, so they don't really have to be too concerned about the incidence of transmission use of system charges or distribution use of system charges or even NEMMCO fees. They all pass through to the end consumer. So in a sense there is a need to draw a distinction between retailer interest and end user interest. You would imagine that in mature markets they might have a coincidence of interest but in reality at this stage and in the foreseeable future I don't think the interest of end users and retailers necessarily coincide. It's a cost busting exercise.

MR BANKS: So they're not competing with each other.

MR LIM: Sorry?

MR BANKS: The retailers are not competing with each other.

MR DOBNEY: They are competing with each other, but they're not - they only pass through the distribution and transmission charges, so they're not competing on that basis. They're competing on the basis of the energy charges, whatever they can purchase the energy for, pass that through, and whatever their retail margin is. That's where they have their elasticity in their price, where they don't have - as the other items that are passed through, as Bob said, the NEMMCO charges and the

distribution transmission prices; they really don't care. To them it's just - it doesn't matter who's your retailer, those charges are exactly the same.

MR LIM: The next issue which again we support the commission's position on that, on the issue - is the issue of a single regulator. We certainly support the move towards a singular national energy regulator, but we just have a question mark over why second tier, in the sense that we would like the move to happen more quickly. I know that might be wishful thinking. For realistic and empirical reasons, that sort of thing might not be able to happen quickly. But the costs are increasing day by day, unless we do have a more national and consistent approach. I think we have about 11 regulators or quasi regulators in the electricity sector. We are starting to see inconsistencies in regulatory decisions.

We are seeing the growth of multi-utilities and that really cries out for better consistency in how regulators approach key issues on gas or electricity, and more importantly, I guess, government's arrangements are quite different as between different sets of regulators. Let me explain a little bit more, if you are interested. I suppose I would say that by way of example, the ACCC would have a better government arrangements than some of the newer regulators, or some of the regulators which are regulating in states where the states have big equities in government businesses. So the government's arrangements are different in certain areas, versus, for example, the ACCC.

So in a sense, for those sort of reasons, we would like to see a quicker move, if you like, towards a national single regulator, because the transaction's costs, I think, or the costs of not doing so are rising as time goes by, because of inconsistencies in decisions. I think, chairman, we had in another forum talked about the evaluation of easements. ORC comes up with a zero valuation of easements. IPART comes up with an actual cost valuation, and ACCC, somewhat like DORC, but maybe less than DORC. So they are the sort of inconsistencies coming up which cry for some arrangements to pull them together.

MR BANKS: Could I just perhaps clarify there that - I think what we've proposed in relation to IIIA, again, the generic regime, is - again as a tier - to having one regulator. But we haven't, in a sense, necessarily recommended that the industry-specific regimes that sit alongside or under IIIA would necessarily have one regulator. We see, for what residual activity IIIA has got to do, that, you know, there could be advantages in that.

Now, on that question, there has actually been quite a lot of feedback; in fact, predominantly people saying to us, "No, there are traps in that", and they prefer the protections, the due process associated with having two regulators making different sorts of decisions, one which they see as being inherently more as a policy decision, being the responsibility of the NCC, and the ACCC having the nuts and bolts, you know, responsibility for terms and conditions and so on. In fact, I'd value any comments you might have on what people are telling us there. Probably the key

submissions on that might be NECG - - -

MR COSGROVE: AusCID.

MR BANKS: AusCID, Law Council of Australia, in a forthcoming submission. But on the broader question - I mean, I have sympathy for the point you're making about the proliferation of regulators around the country. I mean, think about that; it's not something that we've explicitly addressed so far.

MR LIM: And I guess we are trying to encourage you to address and be - the government's arrangements in the national electricity market institutions, an area of concern. There is a need for greater transparency and accountability of the operations. Transaction costs are rising, and so I guess we are trying to encourage you to have a little bit to say about some of these issues.

MR BANKS: Perhaps what we need is a review of the energy market forms.

MR COSGROVE: Could I just - - -

MR BANKS: See what COAG says tomorrow, yes.

MR COSGROVE: Could I just clarify exactly what you're proposing here with this single regulator? I can see that you'd rather have a single regulator of terms and conditions in the market, rather than, you know, the 11 and 12, whatever you have at the moment there. Are you also proposing that if - to put it simply, that NCC and ACCC move into one body at the declaration or undertaking stage?

MR LIM: No, we haven't ventured an opinion on that issue.

MR COSGROVE: That's what I thought might be the case.

MR LIM: If you - - -

MR COSGROVE: You're really concerned about the regulations of terms and conditions only.

MR LIM: We're more on the energy - yes.

MR COSGROVE: Thanks.

MR DOBNEY: Can I just add there, Bob, I think we're also concerned that from the ACCC down, some of these regulators appear to be undermanned, and it's because you've got this multiplicity of regulators, all with their own little bits of expertise, doing different things. If we had one common regulator, you'd have adequate resources to do everything properly, and within - finding a lot of things falling through the gaps, because they are undermanned, and they just say, "We can't

address it. We just haven't got the resources to do something about that." So it's becoming quite a significant problem.

MR LIM: Chairman, just if I could move on to another issue, which is appeals mechanisms, now. It's an area which, from memory, I don't think the position paper had a lot to say in connection with appeals on the part and by end users, to access arrangements or access determinations. You will find in the National Gas Code that users actually have no rights of appeal. Again, it's a regulator's decision, and in the sense there is an unlevel playing field there. There are some provisions under state legislation for electricity, which allows for users to appeal, but again, it's a very fuzzy area, and perhaps in Peter's NEMMCO experience, not very helpful at all. I guess what we are suggesting is that for access reviews to go well, allow customers and users the same rights of appeal against a regulator's determination as they are already available to the access arrangement's applicant - in other words, the asset owners can appeal, but users cannot appeal against a regulator's determination.

Now, it does have some psychological influences on the regulator's decision-making processes, and I think in our first submission to the commission, we pointed to an example in the AGL gas networks case study, in which the regulator, despite efforts on our part to point to the fact that many major customers have a lot of information on capital contributions by customers, and therefore the regulator had to take that into account in making its determination in terms of the revenue for AGL gas networks, the regulator chose not to deal with that particular issue and said that the end users could actually go to the - the end users could actually go to arbitration. In fact, we did try to go to arbitration but in looking at the gas code, the access to arbitration only applied to prospective users rather than to existing users, so in a sense, that locked out the existing users who actually made capital contributions which were not being taken into account by the regulator, but the way the provisions were written, existing users can actually go to arbitration as well.

So I guess, without wanting to go into too much detail on that, the case that we're trying to put forward is that perhaps end user's customers should have the same sort of appeals mechanisms, same sort of access to appeals as the asset owners do have, vis-a-vis the asset - regulator's decision.

MR BANKS: Okay. We'll look at that. I mean, I was under the impression that if anything, we took the balance more in favour of the access seekers than the facility owners in this position paper, and if you look perhaps at the bottom of page 239 in our position paper, there we're talking about extending appeal for merit review decisions on undertakings, and ensuring that the access seeker as well as the provider has that opportunity.

MR LIM: Well, we have no quarrel with that and we indeed support that, but I guess we are saying, extend it further, say - - -

MR BANKS: Beyond the access seeker, are you saying, to users generally?

MR LIM: Yes.

MR DOBNEY: It's a very interesting case. I'd perhaps like to - if we can hark back to the TXU tariffs again - - -

MR BANKS: You don't see the access seeker as, in a sense, again having coincident interest with other users? I mean, the access seeker is a user - prospective user, and not always a - - -

MR LIM: A prospective user is not an existing user.

MR BANKS: Existing users - - -

MR LIM: In the AGL gas networks case, on the capital contributions difference of opinion with the regulator, the court provisions only gave access to a prospective user to appeal to an arbitration, to appeal to arbitration on capital contribution issue but not to an existing user. It may be - - -

MR BANKS: Well, we'll have a look again at that.

MR LIM: Michelle would probably know a bit about that issue, but - - -

MR BANKS: Well, perhaps we won't - but we'll have a look at - - -

MR LIM: Those are matter of detail.

MR BANKS: This is in your first submission, where you cite that case.

MR LIM: Yes, we cite that case.

MR BANKS: We'll have a look at that, and if we've got any further questions, we could perhaps - you wouldn't mind if we got back to you?

MR DOBNEY: Yes. I can give you some very clear examples of how end users have been sort of not given the right of appeal. It's spend a day in court and get nowhere, basically - tossed out.

MR LIM: Chairman, I know time is pressing, so I'll put on my express skates and get onto the next issue, which is state government intervention. It probably may not come as a surprise to the commission and the commissioners here that state governments do intervene in many of the access reviews that we are familiar with. For example, in the national electricity code, the ACCC has to use the deprival value or, as the ACCC has chosen to do, use the DORC asset valuation method for valuing transmission assets. They have no choice.

In a case of distribution networks, the code requires the regulators to have, and I quote, "To take into account" - and I quote - "pre-existing policies of governments", and that has been interpreted as a green light for the New South Wales regulator to raise the asset value of the five New South Wales distributors in their 99 pricing determination by $2.2 billion, which translates to about 150 or 100 and something million dollars more in the cost of electricity prices per year in this state, as a result of that $2.2 billion increase in asset value.

So I guess what we're trying to do is to make it more transparent, the fact that governments have intervened in writing the national electricity code, by ensuring that certain things happen in their interest, and that whatever the commission can do to highlight that would be useful, and that governments may also be therefore capturing some of the benefits of the regulation, to the manipulation of asset values in the businesses of that they do owned. It also is related to some of our earlier comments about the government's arrangements involving some of the regulators concerned where when it comes to government assets, regulators are perhaps not as transparent or as rigorous in some of the work that they do so there are some concerns here. It may not be the appropriate place for the PC to be making any comments here. It may be something for the National Energy Reform Inquiry when it does take place. Of course, I should mention too that governments have imposed levies although lately the electricity distributor's levy in New South Wales has been suspended for a couple of years. Of course in Victoria we have the smelter's levy as well as as the franchise fee so governments have been in a sense taking some of the benefits of the deregulatory process and there are some concerns here. I think we did put on our fast skate - unless you want to - - -

MR DOBNEY: No, well, my only last remark is that I guess it's a bit of a concern sometimes when we see that government - when I say "government" I mean particularly the federal government - producing reports that say N users have had all these windfall gains and we're reaping all these huge benefits from deregulation. The information that the government is basing this on is about 18 months to two years out of date. It's a concern that the AB reports and the ACCC - they're behind the times. If they took a market survey right now, they'd find out the true picture. But this information is not coming to light right now. We still get ministers talking about the gains that are being made in the electricity market, so forth when we're now faced with prices in the electricity market that are above what they were before deregulation. I think that's - - -

MR BANKS: We've got a project underway at the moment on international benchmarking of electricity prices which you may some interest in.

MR LIM: In fact, chairman, we brought to you some time ago suggesting you might extend it to gas as well because it's been some time since gas distribution had been benchmarked in a, sort of, international benchmarking study. I think the last one done by the former BIE was back in 1994 perhaps, 95. So it's been a while since - and since then most of the gas distribution businesses would have been through

ACCESS reviews so it might be a timely - timely time to have a look. In fact there might be scope to look at some of the possible productivity based measures that might be used to do some of the benchmarking which might help the regulators in their next round of ACCESS reviews.

MR BANKS: Thank you. I guess I wanted to go back to a couple of points just briefly but partly to seek clarification because I think you had a discussion about what evidence there is about impacts on investment. Your position is there aren't much and the other side's position is there's quite a lot but, you know, a lot of it you can't see. You know, there are impacts that are more subtle than ones that you can actually empirically determine. They're things that we have to look at and you should look at each - both camps should look at what the other's saying and it helps us perhaps further on that. But I think that's one issue. But then you go on to say, I thought leading from that, that therefore there could be no in principle case as to why ACCESS could determine investment. I thought that was a huge lead and I just wanted to clarify with you. I mean, do you deny any conceptual possibility of an ACCESS regime having an impact on investment?

MR LIM: Conceptually we have no difficulties at all that access regimes could. I guess we were turning the tables over to you and to others and say if you think there is, apart from the conceptual question - if empirically you've done an evaluation to actually proves either it happens or it did not, let's have a look at it - I guess, in a sense we were telling - conceptually no problems at all.

MR BANKS: What I'd say to you is that in relation to the question of empirical evidence I think it's pretty hard to make a judgment call there with things being said on both sides. So if we - we're inevitably going to come back and think conceptually because I think that part of it is quite important particularly in relation to greenfield's investments I think where - I mean, if you have a look and I'd perhaps encourage you to have a look at the transcript of our discussions with NECG and also with AusCID previously where we talked about - in the context of possible access holidays, we've talked about the circumstances in which, you know, were contestable or implicitly contestable. Greenfields investments, you know, would in an ex ante sense take any risk into account and so on - only be expected to get a normal return. They're the ones we could - you could see this conceptual possibility realised. If you wanted to - I know with an earlier submission actually with Terry Dwyer I think you addressed some of these issues.

MR LIM: Yes.

MR BANKS: But any further thoughts you have on that , we'd appreciate. As I say, perhaps looking at the transcript where we talk about access holidays as focusing particularly on contestable investments which could mean contestable extensions or extensions or augmentations of existing - - -

MR LIM: That's an area we did not focus on in this particular group.

MR BANKS: Well, perhaps with one of your hats, you might think about that and, as I say, any further response to the discussion that you'll see in the transcript there, we'd appreciate.

MR COSGROVE: Incidentally the AusCID transcript also contains some discussion among us about possible empirical effects of ACCESS regulation on investment intentions or willingness to put up equity capital, that sort of thing. You might also have some reactions to that.

MR BANKS: Again I don't - it's semi-anecdotal. I don't think we've received a submission from AMP or from - - -

MR COSGROVE: Deutsch Asset Management.

MR BANKS: - - -Deutsch Asset Management.

MR COSGROVE: But they were companies mentioned as now being very reluctant to participate in the infrastructure financing.

MR LIM: Yes, I recall that in one of my earlier submissions. We made reference to - an AusCID reference to an AMP person saying that they haven't made any investments in two years. We, sort of, just drew the attention to - of the commission that there's a difference between primary investment and secondary investment in the sense that I think that AMP person - Mr Latham I think from memory - was referring to investment in equities as opposed to - in securities as opposed to actual primary investments in the infrastructure area. We thought that distinction should be drawn out in actually making that general statement that AMP had not made an investment for two years. I think there's a big difference and we thought the distinction ought to be recognised.

MR BANKS: Given that these institutions are having their names taken in vain, you may well approach them directly and see what they have to say.

MR LIM: We did draw to your attention I think in exhibit 4 Soloman Smith Barney's(?) assessment of the stock market reaction to investments in some of the (indistinct) imposed businesses and the performance by - what - 20-25 per cent in the year 2000 between those businesses and the all ordinary index. Again if you look at the infrastructure and utilities index, you'll see in our performance there. In a sense share holders are saying monopolies and monopolies are good investments outcomes to - good investment entities to put in capital. I would certainly agree with them too.

MR BANKS: Perhaps all consumers should become equity holders. Just perhaps going on from what I said earlier. I mean, doesn't it follow from the fact that conceptually there is a case that access regimes can impact on investment - that in a situation where it's very hard for any regulator to exercise surgical precision in terms

of identifying the rent and extracting it in a situation of uncertainty and information gaps and so on which is pretty pervasive that - in those circumstances there are potential down sides for investment from too ambitious an approach, if I can put it that way. Would you like to comment?

MR LIM: Yes, and I guess that is one reason why our regulators have tended to err on the side of caution by - and I think the NERA study does show by giving better returns than regulators in say North America or the UK would have done. That is one point I would make.

MR BANKS: Just on that, how valid are those comparisons? I mean, I suppose I've been involved myself in enough international benchmarking to know that comparing like with like is also the - - -

MR LIM: Apples and apples et cetera.

MR BANKS: Also particularly in the energy area.

MR LIM: Again, that is one study and obviously others - benchmarking studies could be done to improve on that. Like all benchmarking studies, you need to do a couple or two or three more all the time to really get a better flavour of it. But nevertheless that was a first good attempt to try to come to some grips on that. The second issue I would - the second point I would make is that in our experience of access reviews, the regulators tend to err on the side of caution with capital expenditure proposals that the access applicant would put forward. I think my feeling is that regulators are very, very cautious about saying no on capital expenditure proposals if only because they don't want to be caught in the position of actually causing a breakdown in a system or in - or whatever. So that's my assessment. The third point I would make - - -

MR BANKS: Just on that one - - -

MR LIM: - - - which is related to that is the example of APAT in New South Wales where they actually asked the distributors to raise their capital expenditure proposals because they felt that they were too low for system security. I would - these are anecdotal examples but in the absence of anything else, these are worthwhile examples to note that in general regulators are very loathe to say no to capital expenditure proposals or augmentation.

MR BANKS: Again we've had counter points put by I think AusCID who provided a few concrete examples one of which was Perth - in relation to Perth Airport where the regulator had not allowed an expansion proposal. But - - -

MR LIM: No, I wouldn't be familiar with airports. I would be more familiar with gas and electricity.

MR DOBNEY: One project, of course, that is going ahead is the Tasmanian pipeline so not all projects have been deterred.

MR BANKS: Yes, we made that point yesterday to APRA.

MR LIM: That's to be a regulated one too.

MR BANKS: In relation to the question of productivity benchmarks and trying to get perhaps truer incentive based regulation, I guess you're implicating building block approach - - -

MR LIM: I think it's - could I come in - - -

MR BANKS: Sure.

MR LIM: - - - without cutting you short unintentionally. I guess it's very early in the life of access reviews to actually get away from building blocks. I think personally I would like to see the regulators look at building blocks and come to a better grip of what the actual cost levels are - 15, 10 to 20 per cent of what a real business is - before actually getting to productivity based indicators for the reasons that I've said in other fora the ability to inflate the regulatory asset base has risen and the use of the DORC asset valuation method has mean that the regulatory asset basis has been pretty well padded. I guess we would like to - I guess I would say that it's too early yet. Let's try to get to a better handle of what the real cost of the businesses are before we start applying that.

MR BANKS: Get the cost base to what you think is a more realistic or appropriate level.

MR LIM: Yes, or to a better level, whatever that level is but - - -

MR BANKS: Well, yes. I mean, we have some discussion on that in there and you may wish to comment further but I thought - Stephen King is often quoted in these proceedings by both sides.

MR LIM: Both sides. Well, he's a flexible man.

MR BANKS: All three sides sometimes.

MR LIM: Three sides.

MR BANKS: And he's criticised the building-block approach by saying that, "It's brought together the worst aspects" - I'm quoting him - "of overseas experience to create a sterile framework that threatens to undermine the benefits of micro-economic reform."

MR LIM: Yes.

MR BANKS: So obviously - I mean, there are downsides or I guess what you're saying is perhaps we're not in a position yet to be more adventurous with more incentive based approaches until we get a better sense of the cost.

MR LIM: But certainly no harm in trying to start developing the indicators that could be used. I think overseas experience shows that you probably need a number of years' experience with productivity-based indicators before you can actually be very confident about applying that. I mean, the information intensity is quite huge in terms of getting that information and also getting to the businesses concerned to obtain that information.

MR BANKS: Well, yes, I guess from one perspective it would be less information intensive but I suppose - are you saying that there's currently not the basis to provide appropriate comparisons in terms of - - -

MR LIM: I think you would take some time to be confident that the data would be reliable and useful.

MR BANKS: Any other comments?

MR DOBNEY: No, I'm done, thank you.

MR LIM: Well, I'm surprised that you are so patient with us.

MR BANKS: No, we're grateful for your participation in it, and we're struggling to get from a position paper to a final report so the more robust the discussion we can have on these various issues, the better. As I say, if you have the opportunity to look at some of the counterclaims being made and in turn comment on those, we'd find that very useful. So thank you very much for your participation.

MR LIM: Thank you for your time.

MR DOBNEY: Thank you very much.

MR BANKS: We'll adjourn the hearings now. We'll resume tomorrow morning at 9 o'clock.

AT 5.15 PM THE INQUIRY WAS ADJOURNED UNTIL
FRIDAY, 8 JUNE 2001