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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 FRIDAY, 8 JUNE 2001, AT 9.04 AM

Continued from 07/06/01

MR BANKS: Good morning, everyone. We're resuming our hearings into the commission's position paper on the national access regime. We welcome this morning the New South Wales Minerals Council Ltd. Could you please give your names and positions.

MS STREETER: My full name is Rosemary Susan Streeter. I am the acting executive director and I prefer to be called Susan, thank you.

MR BANKS: Thank you.

MR CLACHER: I'm Ken Clacher. I'm the coordinator of the Hunter rail access task force which is a body concerned with rail access in the Hunter Valley which operates under the auspices of the New South Wales Minerals Council.

MR BANKS: Thank you. Thank you very much for coming today and for the submissions. We've had two submissions from you and both of them were very useful and we've got some questions on your most recent ones at least, but we will give you the opportunity to make your main points.

MS STREETER: Thank you. We would like to make an opening statement and I will do that and then Ken will mostly respond to the detail questions. So, Mr Chairman, I thank you for the opportunity to appear here. The New South Wales Minerals Council in general supports the finding and proposals in the commission's position paper on the review of the national access regime. It does consider that some changes should be made to the content and priority of some of your proposals. These have been covered in our written submission to the commission. I don't intend to go over that ground again in detail. I would like, however, to emphasise to you today the experience which our organisation has had with the so-called negotiate and arbitrate regime for major infrastructure.

While the default provisions in Part IIIA provide for only negotiation and arbitration, almost all regimes established under Part IIIA for which certification or accreditation has been sought provide also for a regulator. That regulator's primary duty is usually to establish prices. When regulators are called upon to establish prices, they are typically empowered to require infrastructure owners to provide information sufficient for the regulator to determine appropriate pricing. If regimes without regulators are to provide any realistic prospect of genuine price negotiations, the infrastructure owner needs to provide the same information as a regulator would need in determining prices. This is clearly recognised in the Hilmer report on page 256.

Our second submission gave an account of our experience in seeking information needed to facilitate negotiations. We have recently sought information from the New South Wales infrastructure owner to facilitate access price negotiations for 2001 to 2002 with the same result we had previously. We have been offered actual backward looking cost information related to 1999-2000 financial year when the regime calls for prices to be established on forward looking efficient costs. Because there is no regulator, users cannot obtain the relevant information unless

they initiate arbitration. This is why we advocate that in regimes that have no regulator an independent auditor should be appointed to determine and provide the necessary relevant information to users seeking to negotiate prices.

Disclosure of relevant information should not harm the infrastructure owner's commercial interests because by definition it doesn't have any competitors. If an infrastructure user's commercial interests might be compromised by price transparency, it's likely that it's because it benefits from favourable price discrimination. The council's members have first-hand experience of this exercise in price discrimination in the New South Wales Rail Access Regime. They recognise that in theory price discrimination minimises efficiency losses. They consider though that those who seek to apply price discrimination should demonstrate in a transparent way that this discrimination is justified based on objective criteria.

The council supports price differentiation under which infrastructure users are given price signals that tell them how to minimise their impact on an infrastructure owner's costs. It would like price differentiation to apply to the rail access in the Hunter Valley but it is not. Instead we have price discrimination which has not been justified in any objective way. If price differentiation is practised, no-one's commercial interests would be compromised by transparency and pricing. We have provided in our submission a copy of a paper by ACIL Consulting on discrimination applied to the Hunter Valley rail network. That paper showed that the potential efficiency losses arising from perfectly applied discrimination are little less than those arising from pricing based on fully distributed cost which is far simpler and a potential loss if discriminatory pricing is imperfectly applied are high. Mr Chairman, we'll be happy to answer any questions.

MR BANKS: Thank you for that. That was a commendably brief overview. Perhaps what we'll do is go back through your submission. Your point about price differentiation I think is quite an important one because as you concede yourself, conceptually there's a case for efficient price discrimination or perhaps you'd call it efficient price differentiation. But your experience has been that it's been anything but efficient. I'm just wondering whether I could give you the opportunity to elaborate a little bit on that in terms of perhaps the adverse consequences of discrimination that you've been talking about or just raised then.

MR CLACHER: Mr Chairman, they were covered in the paper by ACIL which we appended to our second submission. Still after five years of operation of this regime we are still a little bit in the dark about the extent of discrimination because prices are still not transparent. The infrastructure owner still does not disclose who pays what so that we're still a bit in the dark. We know that price discrimination applies, we have no idea what criteria area used, although I recall Rail Access Corporation, as it was then, giving evidence to the inquiry into the Australian black coal industry some time in 1997 when they said that the degree of discrimination becomes apparent during the negotiation process and that appeared to be the only justification they could find for the price discrimination.

MR BANKS: We'll certainly look through in detail the paper provided by ACIL

which is a very detailed paper. But is your perception that to the extent there has been price discrimination - on what has it been based, do you think? Simply a perception of capacity to pay or - what you're saying really is the differentiating between your members, all of whom are selling on to the same market and I can see why there would be concern about that. But on what basis have they chosen to do that?

MR CLACHER: As I say, we can only go on their statements and really all we have on that is the evidence that they gave to the black coal inquiry where they said that the discrimination that they apply on their perception of capacity to pay.

MR BANKS: Good, thank you.

MR COSGROVE: Is the price discrimination solely between the coal traffic and other forms of traffic or is it also applied between coal mines themselves?

MR CLACHER: As I said, we don't know because of the lack of transparency. There is a Rail Access Corporation - now Rail Infrastructure Corporation - did several years ago publish a pricing policy in which it said that in general it would tend to apply the same price to the same type of traffic with the same origin and destination. I suspect that this hasn't been fully applied and, of course, the problem with that is we think that they tried to charge the same on a per tonne basis, so that a short train which has a low ratio of payload to full tonnage will pay the same rate per tonne as a long, much more efficient train. Whereas we would like to see price differentiation applied in that case, similar to the ARTC pricing where it was just quite transparent; that was a flagfall and a rate per tonne kilometre.

We'd like to see something like that or a somewhat more sophisticated type of pricing applied to the Hunter which fully recognises all the significant cost drivers on the network so that people are pushed by the pricing towards applying efficient practices and operations. But that doesn't happen if you've got the same rate per net tonne, it doesn't encourage people to use more efficient practices.

MR COSGROVE: What's the present status of the New South Wales Rail Access Regime? It was certified only for 12 months and I know that period has now past.

MR CLACHER: Yes. The current status is that it is not yet quite fully finalised, even though it's been certified and that certification has lapsed. As part of that process of certification IPART carried out a review of the access regime and they reported on that on 28 April 1999. That review did not establish a process for the assessment of the asset value of the network but it recommended that it be carried out. Subsequently IPART was asked by the premier to carry out an asset valuation of the network. A final report on that was issued about a month ago by a contractor to IPART. That report was forwarded to IPART. We understand that IPART is considering that report and it will then make a - I'm not sure whether it's a report or a recommendation the minister and the minister will then make some decision on that report from IPART. So after five years of the regime it's still not quite finalised.

MR COSGROVE: But at the moment is access being arranged as though the certified agreement remains in place or - - -

MR CLACHER: Yes, there has to be a retrospective adjustment to the prices that were applied for the past two years one the final asset value is determined. Yes, we have been proceeding in accordance with the regime that was published on about 19 February 1998, I think it was - it might have been 99. But, yes, the outstanding issue was the asset value and there will be retrospective adjustment on that.

MR BANKS: Just on that - and excuse my ignorance about that particular regime - but what are the arbitration provisions then? You say there's no regulator.

MR CLACHER: That's correct, yes.

MR BANKS: But what are the arbitration provisions of the regime?

MR CLACHER: The arbitration provisions are that IPART is the arbitrator. If there's any dispute then IPART is the arbitrator.

MR BANKS: When you say there's no regulator, is that a semantic distinction in effect?

MR CLACHER: No, I don't think so.

MR BANKS: In effect isn't IPART regulated through arbitration?

MR CLACHER: No, I don't think it's a semantic distinction. For example, on the issue with these costs which apply for negotiation. In most of the regimes that I've looked at a regulator as a matter of course takes an interest in and is involved in the setting of prices and possibly other non-price aspects of access. The infrastructure owner provides information as a matter of course on its costs and other issues to the regulator. In the case of our regime, that doesn't happen. If we want to get the arbitrator involved at all, then we have to initiate an arbitration and the procedures for an arbitration are quite different from those of a regulator.

The arbitration under this regime is governed by the New South Wales Arbitration Act - I'm not quite sure if that that's the right name - or Commercial Arbitration Legislation which relates to commercial arbitration and there are some provisions in the IPART Act which refer to that Commercial Arbitration Act and the way it's applied in arbitration carried out by IPART and those would come into effect if an arbitration is carried out under this regime. I think it's really quite a different process compared to proceedings under a hearing by a regulator as to what price or other provisions should apply in an access regime.

MR BANKS: But in the situation where IPART is called upon to arbitrate where there's a dispute, where you're unhappy with the outcome, they nevertheless would have the powers to get the sort of information that enabled them to make an adequate decision.

MR CLACHER: Yes.

MR BANKS: So in that sense it corresponds to the broad structure of the national access regime itself which is simply providing for arbitration in that same way.

MR CLACHER: Yes. In fact it's close to the procedures under Part IIIA where a declaration application has been successful, just required simply for negotiation and arbitration. We point out, as we did this morning and in our submission, that there's something about arbitration that people are reluctant to address it. They don't like initiating arbitration except under very extreme circumstances. In the case of a regime with no regulator, for example, to try and get costs relevant to the prices which are going to apply next year you would have to go to arbitration. The perception of arbitration is that it takes a long time to get going, it takes a long time to reach a conclusion and is very costly.

There has been an arbitration under the New South Wales Rail Access Regime which was in fact initiated by Rail Access Corporation and it related to prices to be paid by the National Rail Corporation in New South Wales. It happened right back in 1996 or 97 and it was at least six months before anything came out of that arbitration and in fact after only a couple of hearing days it was cut short and there was a settlement almost outside the arbitration which was endorsed by the arbitrator. The statement by the arbitrator which announced the matter had been settled gave absolutely no useful information as to what the terms were and that's been addressed in this position paper which says that this should be in a report by an arbitrator on any arbitration which has been carried out and which should provide useful information. This particular arbitration didn't provide any useful information but for the whole of the six months in which that - from the time the arbitration was initiated until the time it settled it was pretty well impossible to speak to anyone in the Rail Access Corporation. They were always working on the arbitration. So it's not something which people enter into lightly, and as I say, it's perceived that it's a long, lengthy and costly process.

MR BANKS: So essentially are you saying that you don't see the approach of the national access regime as being very productive in your circumstances in relation to rail; that negotiate, arbitrate, is not a productive way to go relative to just simply having a regulator setting prices?

MR CLACHER: One point we're saying is that if there's going to be negotiation and it's no good expecting the customer to be able to negotiate unless he has something to negotiate with, if he doesn't know what the costs are, the person he's negotiating with, then it's not a negotiation, and in fact some people go so far as to claim that any negotiation of a monopolist is an oxymoron.

MR BANKS: Yes. You included in attachment 1 the information package which looked pretty good to me.

MR CLACHER: Yes.

MR BANKS: But is your main concern with it its lack of currency rather than the detail of it?

MR CLACHER: We have two concerns; one is the lack of - or perhaps three. One is the lack of currency. One is that it doesn't really address the particular peculiarities of this regime under which there's a ceiling test and a floor test which has to be applied to all combinations in theory of access seekers who might want to operate on that railway and there are theoretically billions of those. Even if you break it down into just a few key ones there are still - you know, even a handful is very difficult to produce the information required to be able to carry out those tests on all the combinations which might apply to a very small area. For the Hunter Valley, for example, we're looking at perhaps nine key combinations which should be addressed. It has taken - Booz Allen is the contractor to IPART - are about 12 months to come up with an asset valuation for just one of those combinations. Different combinations have different asset values. Different combinations have different costs which apply to that particular combination and that schedule in the regime doesn't really address the issue.

MR BANKS: Yes, okay. I was going to go back to the beginning of your submission where you have got some suggested modifications. The first one is in relation to the declaration criteria which you see as meaning to be modified. I think you say, "To get to the heart of the intent of our proposals, eliminate their conditional problems."

MR CLACHER: Yes.

MR BANKS: I guess we were cautioned yesterday the Law Council, and you might be interested too - a representative of the Law Council anticipating a submission that's coming in. You might care to look at the transcript where I guess that person was saying that lawyers get very hyperactive as soon as there are word changes in legislation because they think those changes are there for a purpose and the purpose that they typically impute is that the intent has changed somehow, so it's very hard - I mean, this is something we'll think about but they sort of implying it's very hard to make changes which are sort of a catch-up variety or a reinforcement variety because there may be some unintended consequences in the way they're interpreted, so I just make that point. It might be something you would have a look at.

My second concern really is how easy that would be to administer that amendment. You have gone from looking at whether there would be a substantial increase in competition to attest which would have an assessment of the benefits arising from increased competition exceeding the costs of regulation which in some respects is rolling all the considerations into one. I just wondered about - I don't know, my colleague had the same reaction, just how workable that would be.

MR CLACHER: It is a very difficult area, Mr Chairman.

MR COSGROVE: It's very difficult to measure the cost of regulation for example.

MR CLACHER: I agree. I think also though it's difficult to say what a substantial increase in competition - how that might be identified. As I understand it, the reason for wanting a substantial increase in competition was to make sure that the benefits of this competition outweighed the costs of applying - - -

MR COSGROVE: Yes, to get rid of trivial situations.

MR CLACHER: Which is why I suggested that wording to get to the intent of the change.

MR COSGROVE: Yes.

MR BANKS: Okay. I think it's a useful suggestion and I guess we have to balance - I think with a lot of these things we're really looking at rules of thumb so that the end result hopefully will be one in which the benefits do exceed the costs but whether you can get around it by just simply asking them to calculate that. I mean, as an economist it has an appeal and we know how to go about it but whether the regulator would look at it in the same way. The next - - -

MR COSGROVE: A competing facility rather than a second facility.

MR CLACHER: Yes.

MR COSGROVE: What are you driving at there?

MR CLACHER: It occurred to me that a second facility might be duplication of a current facility which is perhaps owned by the same monopolist in that what we're really looking at there was something that's in competition rather than just a second unit of what's there already.

MR COSGROVE: Yes.

MR BANKS: Yes. The other question actually I had there in relation to proposal 6.2, you say that in the case of the Hunter rail network downstream coal markets are highly competitive which is undoubtedly true yet the provider of rail access has exercised substantial market power by charging monopoly rents and some mines have closed down; where normally one would see that as irrational, commercially irrational behaviour in that they would have an interest to try to maximise use and profit from the rail line. I mean, does this come down to a point that you're making later about competing objectives in the mind of the service provider, and in particular the lack of an explicit support for a CSO in the regime?

MR CLACHER: In at least one case I can think of a mine shut down. Well, typically what happens with coal mines is that normally as they get older, or perhaps because they run into tough or adverse geological conditions the costs of production increase and so the margin between revenue and costs decreases. Now, you know

that for many years up until last year monopoly rent was charged on railways and this was - you know, in the case of, say, Mid-Hunter Valley Coal Mines, perhaps 2 or 3 dollars per tonne. Now, that would have been a very attractive margin to a lot of mines at that time but I think the - no, I don't really know. I really can't total in the minds of the access provider but it seemed to be an attitude on the part of the access provider that mines could - you know, they could afford to pay 2 or 3 dollars a tonne in monopoly rent. What happens of course is that as the conditions - or as a mine goes on and its margins reduce there comes a time when a margin is just not big enough and it has to shut down.

There have been cases where they have been paying $2 a ton, say, for monopoly rent for rail and they have had to shut down. If that monopoly rent hadn't been there they would have been able to go on for some time longer before they had shut down. You can't avoid shutting them down eventually because, you know, they run out of resource, they have fully mined the lease that they're mining. Geological conditions get to be such that it's not economic under any circumstances to continue mining but there is no doubt that the access provider did not appear to fully appreciate the effect that this monopoly rent had on the operating margin of these mines and that it advanced the closure of some of the mines in some cases.

MR BANKS: Yes. Is this the problem of government ownership or simply a commercial error?

MR CLACHER: It's hard to tell whether a non-government monopolist would have produced the same result.

MR BANKS: Do you think so?

MR CLACHER: I think there might have been a greater willingness to consider particular cases.

MR BANKS: I mean, the situation described in there would have been a marginal benefit presumably in allowing this to bring in reducing prices and allowing the traffic to occur.

MR COSGROVE: Is it also possible though - you mentioned further down this page that a single track between Antiene and Muswellbrook is approaching capacity.

MR CLACHER: Yes.

MR COSGROVE: So might the service provider here be charging what the market will bear? It can't get another non-coal customer on the line so why would it have any reason to reduce the price for a coal mine which was experiencing reduced margins on its production?

MR CLACHER: I'm not sure that I understand the question.

MR COSGROVE: They have reached the point at which their capacity - maybe -

I'm not sure from what you have said here but in a situation where a service provider simply has no capacity to take additional wagons on the track, it has no reason, at least in the short term to reduce its prices because it's not going to generate any more revenue through extra volume of traffic. I'm not sure whether that's the actual situation. That seems to me to be how a service provider operating at full capacity would set its charges. It can't get any more volume so why not keep the prices where they are?

MR CLACHER: Yes. Well, on the part of the Hunter rail network between Dartbrook and Bengalla in the north and Newcastle at least in the south the infrastructure owner is obtaining its ceiling rate of return on that part of the network so it's getting its full 8 per cent on the asset value. The coal traffic is paying all of that capital charge, right, even though some non-coal traffic uses that part of the network it's all the capital charges and all the fixed costs we believe are being paid by coal traffic. In the case of the - the line is a double line at least from Newcastle all the way to Antiene and there's only a single line then from Antiene to Muswellbrook which is about, I don't know, 10 or 15 kilometres I think. Now, on the single line from Antiene to Muswellbrook there is about half of the train pass, half of the slots available are used by coal traffic and about half by non-coal traffic but the coal traffic is paying all the fixed costs and the capital charges.

MR COSGROVE: Yes.

MR CLACHER: If traffic keeps on increasing then unless there is to some rationing on that part of the line it needs to be duplicated. Now, the difficulty is that the infrastructure owner seems to want coal traffic to pay for a duplicate - if the line is duplicated and the coal industry is seen to be the person who should pay for it because the theory is it's the increases in coal traffic which is causing the duplication of this line but if coal traffic were the only traffic on that line only one line would be needed so really the extra line is needed to accommodate or the duplication is needed to accommodate non-coal traffic.

MR COSGROVE: Yes. That, if I have understood you properly, is a separate issue about who should pay for new capacity when it's being put in place. But I was just wondering whether short of that point, in other words, simply looking at the existing capacity, a reason why a marginal coal mine who is being driven out of business seemingly by having to pay a still high rate of freight charge and access to the line, then I don't really see why that doesn't make sense from the point of view of the track owner's perspective.

MR CLACHER: I can only agree with that.

MR COSGROVE: Okay.

MR BANKS: What you're saying in this section, coming back to the point earlier, is that, and I quote you, that the reason is not seen as being economically feasible to provide this extra capacity as the owner is applying commercial principles and social welfare principles to the same line. Does this come back, as I said earlier, to the lack

of an explicit CSO? In other words, it's embedded in a cross-subsidy that the government provider wants to provide?

MR CLACHER: Yes. CSOs apply to the tracks beyond Dartbrook, say, and they were running at about $170 million a year for the past few years. Last year as a result of the extra effort which became - which it was apparent was needed as a result of the Glenbrook accident, that went up to about 230, 240 million dollars of explicit line CSOs but I think the perception in government appears to be that, you know, this is on the coal network, coal users, so coal should pay for it.

MR BANKS: Okay.

MR COSGROVE: Just a point of clarification, I think I know what's intended here. In your discussion at proposal 7.4 you go on to refer to some other of our proposals, 6399. That section ends with this sentence, "It would be desirable for this to be a tier 1 proposal." I assume what you're referring to there is 7.4?

MR CLACHER: Yes.

MR BANKS: You then look at the pricing principles and make, I mean, some useful observations. The first I guess what we saw as the potential virtue in a generic regime you see as a deficiency from the perspective of the user of rail. You say that the first one would not prevent cross-subsidisation of one part of the network by another. I guess we had in mind conceptually, you know, the scope - not stymieing the scope for efficient price discrimination but your view on that is that it's a rare beast.

MR CLACHER: Yes.

MR BANKS: Would that be right? So you would want to preclude, but nevertheless would you want to in a general regime like this to preclude the scope for efficient price discrimination?

MR CLACHER: No, I didn't intend to say that but it seemed that this first point, to generate revenue across to facilities regulated services as a whole. The way I read that was to say that the whole of the revenue shouldn't exceed the whole of the cost. It just leaves enormous scope for cross-subsidisation between various parts of the regulated services.

MR BANKS: Yes. I guess what we had in mind there was perhaps avoiding the situation of sort of a requirement for almost a uniform pricing regime in relation to each of the components of the service but it's something that we - - -

MR CLACHER: No, I didn't intend to say that.

MR BANKS: Okay. You say that the second one which relates to costs, to quote what we say, "prices not being so far above costs as to detract significantly from efficient use of services", we raised a question of what the word "significant" might

mean. Is your concern there that it could be interpreted too liberally?

MR CLACHER: Yes.

MR BANKS: Okay. There's a fair case history in relation to the word "substantial" I think in trade practices law. I will have to check perhaps on the use of the word "significant". In fact, you commented earlier, I think, your concern about the use of the word "substantial". The lawyers don't seem to be too worried about it because of what they see as a fairly settled legal interpretation through the Trade Practices Act. They didn't see that as posing too many problems although they were quite concerned about use of some other words.

MR CLACHER: The lawyers may well be happy to have those sorts of things tested in court. It gives them something to do.

MR COSGROVE: You have suggested at the top of page 5 that the IIIA pricing principles which we proposed should incorporate the principle that pricing is based on efficient costs.

MR CLACHER: Yes.

MR COSGROVE: I thought we had that but does this get back to the point you were discussing with my colleague a moment ago, as we have said, generating revenue of a facilities regulated services as a whole, because apart from that potential snag from your point of view, it does go on to say that the revenue is at least sufficient to meet the efficient long-run costs of providing access. I wasn't quite sure - - -

MR CLACHER: We have had a history on the New South Wales railways where costs aren't necessarily efficient costs. You may be aware that when - I think this came up - it certainly came up in other Productivity Commission inquiries in that when the New South Wales government rail entities were split up in 1996 into four separate entities there was an infrastructure owner, a freight train operator, passenger train operator, and a track and rolling stock maintainer. When that was done the infrastructure owner said that it was going to carry out a procedure whereby it was going to divide up the New South Wales network into about 12 or 13 different areas and make each of those areas - or put the maintenance of each of those areas out for tender on a progressive basis. Every three months there was going to be a new area put out to tender.

They started on that process and no sooner had the group who won the first contract started work than it was suspended but it was too late to, as I say, prevent the first one from being let and starting work and I think the second one, if you go onto - the reason for suspending it was that Rail Services Authority which was the maintainer was an authority rather than a corporate body and it was deemed that it needed to be corporatised in order to compete effectively with private enterprise. Now, at the time that was done we complained and said, "Well, this means that the coal industry," which is the only one which was paying the full cost anywhere on the

New South Wales rail network, "was going to have to meet the inefficient costs which had been quite openly identified by infrastructure owners being about 30 per cent above efficient costs and so the coal industry was having to meet those inefficient costs on the Hunter rail network."

We said, "Well, if the government wants to protect, maintain, that's fine as long as we don't have to pay for it. They should identify and establish a clear CSO for that." It was said at the time there would be benchmarking to efficient costs and that the coal industry wouldn't be any worse off. Benchmarking would be carried out by IPART and that was about four years ago and we're still waiting. Anyway when Rail Services Australia, and it was formed out of Rail Services Authority, the tendering competition for maintenance on the network was resumed, the Hunter network was the first off the mark. Tenders were called. They were evaluated and a recommendation was made to the Rail Access Corporation Board. Before the contract could be awarded the government decided that the process would not proceed; that all of the maintenance would continue to be carried out, except for the two that had been let, continued to be carried out by Rail Services Australia. So that we're still faced with actual costs rather than efficient costs. And then as a result of the McInerney reports Rail Services Australia has been re-amalgamated with Rail Access Corporation and they're now called Rail Infrastructure Corporation. So that's our sensitivity about efficient versus actual costs.

MR COSGROVE: Yes. I understand that but what I was wondering is why you don't think that our first pricing principle meets your concern about efficient costs.

MR CLACHER: Yes. I recognise that it specifies efficient costs but it has got the problem of the possibility of cross-subsidies between various parts of the services.

MR COSGROVE: Right.

MR BANKS: Your concern about - I mean, normally a business wouldn't want to run any of its activities at a loss. I mean, is your concern again non-commercial behaviour by government owner?

MR CLACHER: What, on the issue of efficient costs?

MR BANKS: Yes. No, your concern about cross-subsidies there. I mean, are you essentially saying that they would run a loss on some activities or with some customers and ask others to make up for it?

MR CLACHER: Well, they do. As I say, they had a CSO of $170 million which has gone up as a result of the McInerney - - -

MR BANKS: Well, in a sense the CSO compensates them for that so it shouldn't be disadvantaged and it doesn't involve a cross-subsidy.

MR CLACHER: That's right.

MR BANKS: It's a direct subsidy.

MR CLACHER: Yes, but still it doesn't necessarily mean that there are still not some cross-subsidies which would otherwise mean that that's identified. CSO might be higher.

MR BANKS: Okay. I will perhaps just come back to the points that were made about monitoring and how you see that. We envisage monitoring in the context of the access regime Part IIIA as an alternative to declaration under the regime and the regulator felt that it was line ball but something that was more light-handed if I can use that word, might nevertheless be appropriate, and having that option might lead the regulator to avoid declaring where declaration wasn't really called for or necessary. Could I just get you to explain how you see monitoring operating in relation to the rail regime in New South Wales?

MR CLACHER: Yes. As I understood your proposal it was that someone would - well, that the access provider would advise the monitor what prices were charged and that the monitor would satisfy itself that these were consistent with whatever principles had been established.

MR BANKS: No, we weren't really going as far as that. In fact, there is a question. I guess you're saying that that's what we should be proposing because in that regime - I mean, you could say that that's fairly - well, somewhat more heavy handed monitoring in the sense that, you know, the regulator is monitoring with a view to ensuring that some particular price outcome relative to costs is being achieved whereas we saw it more as simply an informational role that would create greater transparency and at some point may well lead some users to seek a declaration of that facility. You also seem to be saying that really the facility should be providing on an ongoing basis to users detailed information about costs and so on. Is that - - -

MR CLACHER: We will be very keen on anything that promotes and increases transparency. Sorry, I have just forgotten your second question.

MR BANKS: I was just trying to get a sense of what you were really proposing. I mean, it just seemed to be a very high transaction cost regime. You seem to be - ours was very selective in that it would be a situation in which the regulator decided not to declare but to impose a monitoring regime under another provision of the Trade Practices Act and that would be focused on that particular service for a particular period of time.

MR CLACHER: So you're saying that in response to an application from a customer - - -

MR BANKS: Yes, so it would be specific to a particular application and in fact what we envisage was an alternative in a sense to declaration.

MR CLACHER: I see, okay. I didn't pick up that meaning.

MR BANKS: How would you see monitoring operating from your point of view?

MR CLACHER: I just come back to the point I made before; that customers can't negotiate with a monopolist if they haven't got any idea of what the monopolist's costs are and they don't have any idea of whether they're being discriminated against or in favour of and if so what is the extent of that discrimination. It's not a negotiation under those circumstances. As you read the Hilmer report which talked about negotiation and arbitration he seemed to me trying to promote light-handedness and regulation by saying, "Well, let the customers regulate the monopolist and not get other regulators involved," and that's fine as long as the customers get the same sort of information that a regulator might get so that they can do the - if they're going to do the regulator's work for them they need the same sort of tools that a regulator has.

MR COSGROVE: As I understood this part of your submission it's really a request for information disclosure rather than for price monitoring.

MR CLACHER: Yes.

MR COSGROVE: It's on the basis of information disclosure that you feel that the customer will be able to monitor effectively. Is that - - -

MR CLACHER: Yes.

MR BANKS: Okay. Just a clarification on the bottom of page 7, you say, "The council is of the view that monopolist selling prices should not be considered commercially sensitive." I'm not too sure whether that's exactly what you meant or whether you're talking about costs there. Do you mean selling prices to particular customers?

MR CLACHER: Yes.

MR BANKS: Should be available to other customers?

MR CLACHER: Yes.

MR BANKS: Yes, okay. You comment on page 8 in relation to final offer arbitration which was a speculative thing I guess that we thought was of some interest and had been raised with us but you say that if a dispute were to involve complex technical matters it's unlikely this type of arbitration would work satisfactorily. Could I just give you the opportunity to elaborate on that a little bit?

MR CLACHER: As I understand the final offer of arbitration - well, I think it became well-known in this application to baseball players' salaries which as I understand it was a fairly simple matter, as to how much they got paid, and on the matter of flexible rail access pricing where, for example, if prices were to be set which took into account a fairly large range of cost drivers and the things like train priorities and how access prices might differ depending on priorities and those types

of issues, then it might be just a bit too sophisticated to be dealt with by this type of arbitration.

MR BANKS: Yes.

MR COSGROVE: I guess the negotiators would have developed their positions though on all of that detail. Is the problem that the arbitrator would then find it difficult to adjudicate or to choose between the two?

MR CLACHER: There might be a problem with my understanding of this final offer arbitration. As I understand it's a matter of choice between only two - - -

MR COSGROVE: Yes, the arbitrator chooses one and that one is put into effect.

MR CLACHER: Yes, and where there is a large number of inter-related technical issues it could be that the answer is somewhere in between and not one or the other.

MR COSGROVE: I see. I hesitate to get into the somewhat arcane world of DACS and DORCS but there were a couple of comments in your submission about this. I wasn't quite sure I followed what was really intended. The first one is on page 5 where you cite the report prepared for IPART as I understood you by Booz Allen and Hamilton. That seems to be saying that from the point of view of the access provider, RAC in this case, use of DORC as the valuation methodology will lead to lower investment. I'm not here asking you to say whether that's the case or not but that's how I read that quote; that from the point of view of the service provider DORC is going to be adverse.

MR CLACHER: Yes.

MR COSGROVE: The second reference is on page 8 under the heading The Advantages and Disadvantages of the Key Methodologies for Valuing Infrastructure Assets. Then at the end of the first paragraph it's said that for the New South Wales Rail Access Regime DORC is the basis most consistent with the pricing principles. So on the one hand DORC seems to be adverse for investment. You say, "DAC is not going to be appropriate for many groups of users and DORC is most consistent for the pricing principles." I didn't follow all of that. DORC seems to be - it's again a question of perhaps of short term, long term issues. If DORC is likely to have the effect of deterring investment that may not be good for the reasons we were talking about earlier for people such as your members who want additional capacity yet this statement is most consistent with the pricing principles. How do you reconcile these statements?

MR CLACHER: I think what it points to is that the pricing principles in this New South Wales rail access regime are not user friendly and we have always argued against them for that reason; that in applying the common - - -

MR COSGROVE: So the regime itself seems to be internally inconsistent, does it, in these respects?

MR CLACHER: Not necessarily internally consistent but extremely difficult to apply in practice, and as it has been applied by Booz Allen and Hamilton on behalf of IPART, it has discouraged RAC from investing.

MR COSGROVE: Yes.

MR CLACHER: Now, I think it is true to say that for the pricing rules in this regime really it's hard to say that you could use anything other than DORC but it's not so much the DORC valuation but it's the optimisation of the process which has the effect of discouraging investment, not so much that it's the DORC or whatever else is used to value the assets. It's the optimisation process which encourages the investment because for example if we were to, say, forecast it over the next five years, there's going to be an extra 10 million tonnes of demand on the Hunter network, you spend $100 million in investment to accommodate that extra demand; five years' time that demand has come and gone and you have had a peak and it's entered a long-term decline, that $100 million is no longer needed and so it's optimised out of the DORC. That's the problem the infrastructure owner has.

MR BANKS: Again, I'm still sort of confused about your position that there's no regulator. I mean, we're now talking about a situation in which IPART is imposing a DORC valuation that's impacting adversely.

MR CLACHER: Well, they're not - - -

MR BANKS: You're saying that IPART is not a regulator in a sense.

MR CLACHER: IPART is carrying out this valuation in response to a reference from the premier and that reference arises out of the report that IPART tabled or finalised in April of 1999. It did that because in the certification process the NCC saw a need for rate of return asset valuation and cost definition or definitions of the things which relate to pricing and costs to be clarified. So that this is all arising out of the process that was part of the certification process. It is not doing this as a regulator, it is not doing it as an arbitrator. In fact, it's doing it as an adviser to the government and I believe that some legal advice has been sought on exactly what legal status this report from Booz Allen to IPART and from IPART to the minister has. It was certainly not either as a regulator or as an arbitrator.

MR BANKS: Yes. I'm just wondering whether again we're getting back to an issue to do with the fact that we're talking about a government owner here so these things - otherwise if it were just an advisory capacity the infrastructure provider could just simply ignore it if it wasn't being enforced through regulation, but you're saying that it's advice to the government which is in a sense enforcing it. Is that - - -

MR CLACHER: Well, it's yet to be seen whether the government will accept this valuation report or not.

MR BANKS: Okay, all right. I didn't have any more questions.

MR COSGROVE: No, nor do I.

MR BANKS: Did you have any more points to make?

MR CLACHER: I don't think so.

MR BANKS: Thank you very much for that. As I say you may just want to have a look at the list of submissions. There will be other submissions I think where discussions of rail have come up and if there is anything there that you wanted to comment on we would be happy to give you the opportunity. All submissions have to be in by the end of June so there is still a little bit of time but we put our submissions and our transcripts up on the Web site, although someone seemed to be implying yesterday that it wasn't all that user friendly. We will have to check that out but I believe it is quite accessible and hopefully - - -

MR CLACHER: I have used it many times and I haven't had too much trouble.

MR BANKS: Good, okay. Thank you very much.

MR CLACHER: Thank you.

MR BANKS: Just for the record I ask if anybody here in Sydney would like to appear. I think I know the answer. There being no-one, we adjourn the hearings in Sydney and our hearings resume in Brisbane on Wednesday, 13 June at 9 o'clock. Thank you.

AT 10.07 AM THE INQUIRY WAS ADJOURNED UNTIL WEDNESDAY, 13 JUNE 2001

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