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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO NATIONAL COMPETITION POLICY REFORMS

MR G. BANKS, Chairman
MR P. WEICKHARDT, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON TUESDAY, 30 NOVEMBER 2004, AT 9.04 AM

MR BANKS: Good morning, ladies and gentlemen. Welcome to the first day of the public hearings for the Productivity Commission's review of national competition policy reforms. My name is Gary Banks. I am chairman of the Productivity Commission. The commissioners assisting me on the inquiry are Philip Weickhardt on my right and Robert Fitzgerald. Unfortunately, Robert has had to undergo some surgery in the past week and won't be able to participate in the hearings but he will be back on deck in January.

The purpose of the hearings is to provide those who have an interest in the inquiry with the opportunity to present submissions and in response to, in particular, the commission's discussion draft which was released on 27 October. After these hearings in Sydney we have hearings in Melbourne next week; Canberra the week after; and then hearings scheduled for Toowoomba and Perth. We will then proceed to finalise our report to government which is due by the end of February 05. The public hearings allow anyone to have a say in person on the issues under consideration and for others to listen to those remarks and respond if they wish. We keep the hearings as informal as possible but the act does require that people be truthful in their remarks and a transcript is made of the proceedings which we endeavour to place promptly on the commission's web site.

I would remind participants, for the record, that all submissions need to be in by the end of the year to allow us to draw on them adequately in working through our final report. I should also take this opportunity to thank those participants who have assisted us this far in the inquiry. So I would now like to welcome AusCID and ask its representatives to give their names and their positions, please.

MR O'NEILL: Thank you, chairman. Denis O'Neill. I'm chief executive officer of the Australian Council for Infrastructure Development.

MR MUNDY: Warren Mundy. I'm a regulatory and economic adviser to AusCID.

MR BANKS: Thank you very much for attending this morning and being the first participants in the hearings. Thank you also for the submission that you sent us in June. I will leave it to you to provide an overview of the points you would like to make.

MR O'NEILL: Thank you, chairman. Firstly, I would like to just congratulate the commission on the excellent discussion draft that they have presented for further analysis and comment. I think the breadth of issues you have covered and the depth in a number of areas certainly dovetails well with the issues and the understanding of AusCID's members, particularly investor members, as to remaining reform activity that is required in the Australian economy, particularly in relation to economic infrastructure areas. A key issue which I would like today to bring to the attention of

the commission is something that follows from work which AusCID undertook in the middle of this year after we had first made our submission to the commission and that was to attempt to get some feel for what productivity gains might be achievable if Australia's infrastructure was right-sized and right-timed, if I can use those expressions.

You may recall that in 2001 Engineers Australia had commissioned an analysis of various economic infrastructure sectors in terms of their perceived adequacy, not only at the time but for future needs, and as a result of that scoring system, identified a range of infrastructure sectors which, from the perspective of fit for current and future use, were perceived to be substandard. In the middle of this year, AusCID reviewed that 2001 report and through a series of discussions with sector investors and operators with experts in the fields we looked at what was missing in the middle of this year in the areas of land transport, water and energy infrastructure which ought to have been in place to meet this requirement of fit for at least current 2004 requirements.

The result of that modelling exercise - firstly, the result of the analysis was that on a very conservative estimate there was possibly some $25 billion of under-investment across those three sectors. We took that conclusion which is the result of a series of projects which were then costed as to the investment required to put those projects in place. It included some projects currently under construction and had the Canberra economic modelling company, Econtech, model the results and the net effect was that were that 25 billion of investment in place and functioning in the Australian economy, GDP would perennially shift, move up, by .8 per cent.

We think that's a very significant result, given the conservatism of our estimates and also given the nature of your own review of just what further gains may be made to achieve productivity growth in the Australian economy. We have particularly in mind the federal or Commonwealth Treasury's own assessment, looking forward 40 years, that as a result of ageing and demographic change it is likely that the Australian economy will grow by some .75 per cent less than it has over the last 40 years and I understand, in the commission's own review of similar impacts of ageing, you have an even more pessimistic outlook for future growth and I guess the connection we would like to make in bringing the Murphy Econtech modelling results to your attention is clearly to indicate that a major step forward in addressing that shortfall in productivity growth going forward will be to get our infrastructure right-sized, right-timed and working efficiently. I'm happy to table and leave with you a full copy of that Econtech analysis.

A second dimension which we're very pleased to see you acknowledge in the discussion draft is the key challenge posed by achieving sustainability outcomes in relation to how the Australian economy works in future. In 2003, AusCID invested

some time and effort in putting together what it has called a sustainability framework for the future of Australia's infrastructure. This was predicated on the view that economic infrastructure as a very fundamental foundation of economic productivity and social amenity must be based on sustainability principles. By sustainability we mean triple bottom line and I'm again happy to leave the commission with a copy of that publication as well because from our point of view it forms the basis of articulating to all Australian governments the need to undertake longer-term strategic planning with sustainability outcomes as a key driver for how they identify urban growth; how that growth should occur; how urban areas should be interconnected and adequately supplied with water and energy on a sustainable basis.

Going to some of the key areas of recommendation in the draft, I believe one aspect where we might take some minor exception to the comments offered by the commission, relates to taxation. While I understand a key driver for the commission's recommendations was to identify areas for reform which could be taken up on a COAG basis rather than on a single jurisdictional basis - and, of course, when one thinks tax one tends to think exclusively of the Commonwealth. However, it has been the experience of infrastructure investors in Australia in the last 15 or so years since we have seen a tremendous growth in privately financed investment in public infrastructure, that the issue of taxation, if you like, and the need for ongoing tax reform to facilitate that private investment in public infrastructure, is not really one exclusively for the Commonwealth to resolve because it comes into an area of endless debate between all jurisdictions and the Commonwealth about cost shifting; as to which budget and which tax systems, state or federal, should be bearing the bulk of the responsibility for investment in public infrastructure.

We believe that there is unfinished business, from the Ralph review of business and taxation back in 1999, which goes to the heart of this series of endless debates - fruitless debates - about cost shifting. I think it has been made more complex by the introduction of the GST. I believe that some wise words could well be offered through the auspices of the commission as to the importance of putting in place some mechanisms. They may be black-letter law, but they may also be the need for institutional arrangements, whereby some political capital is invested on a regular basis in resolving through negotiation - as indeed recommended by the Ralph review - between the states, the territories and the Commonwealth as to how these cost-shifting challenges are finally resolved and there is a satisfactory financial outcome for all players.

Another dimension to the taxation issue plays very strongly into, again, the view of the impact of ageing on the Australian economy going forward. This is a perennial chestnut for any private investment when dealing with a Commonwealth-driven tax system but of course it's also increasingly coming out when we look at private financing, and how the state treasuries look at it. That is

what I call loosely the short-termism implied in a traditional "protect the revenue at all costs" mentality that we see in treasuries, ahead of a more expansive view of what total revenue gains may be achieved by allowing the economy to grow through well-timed and well-scoped investment. This entrenched protection of the revenue stream at all costs, I think, is something that mitigates against ensuring that there is timely investment in longer term large scale lumpy infrastructure projects in this country.

Another dimension which is more in the area, I think, of budgetary reform - again applying to all jurisdictions in this country - is the quite urgent need to treat capital expenditure and operating expenditure in support of the maintenance required by the assets acquired in that expenditure of capital, in a more coherent and whole of project life fashion. We are still seeing and still experiencing - perhaps even in some of the infrastructure dilemmas that have struck the community in the last few years - the consequences of the maintenance element of expenditures by governments being out of step with - or out of sync with - their original capital expenditure decisions of previous eras, previous years, previous decades.

To some extent, the public-private partnership procurement model, I think, is addressing this need, because it is able to package a whole-of-project-life view of how an asset and a service should be delivered, and how it should be supported for the life of that asset. But I think there's a very urgent requirement - given that PPP procurement is perhaps at best unlikely to be more than 12, 15 per cent of total capital expenditures by governments - that the disciplines implied in that PPP model, be retrofitted to the more conventional procurement methodologies applied to the other 85 per cent of government capital expenditure.

In that context, I would point the commission to some recent academic work which I can't immediately cite. I didn't bring the citation, but it's the Journal of the American Planning Association, I believe summer of 2002, which looked at some $US90 billion of transport infrastructure procurement in a range of countries over a series of decades, to identify why there seemed to be such a persistent cost over-run, time over-run factor in the delivery of those projects through traditional procurement methodologies. It came to various conclusions, but I just point to that document or that publication by way of identifying that I think we are now beginning to see some academic analysis of where there are inefficiencies, and why there are inefficiencies in the way governments go about acquiring major assets of this type. I believe an area for exhortation, if you like, for further reform and further efficiency gain certainly lies in that area for the commission to pursue through further analysis.

In relation to the road transport reforms that are cited in the discussion draft, AusCID is strongly of the view that if we are seriously to consider the enormous growth in private use of motor vehicles, particularly for commuter travel, and put

that in the context of desirable social and environmental objectives for a balance between public transport use and private car use, together with some moderation of just how much can be really invested in our road system to satisfy the logistics needs of the country, then we are going to need to move towards some form of road-pricing/congestion-pricing mechanism, and this should be undertaken by all jurisdictions, because it would need to be carried out in conjunction with a review of the fuel excise regime, as well as, of course, at state level, registration charges and the like. But frankly, achievement of neutrality in the road transport sector, vis-a-vis rail, would need to go quite broadly beyond just specific charges to the vehicle operators. I think it would need to include the whole fuel tax system as well.

The commission has made some comments about the need for ongoing monitoring of reforms that may be put in place. We fully support that call, but would add to it the suggestion that perhaps as a nation, we've arrived at a point in our economic history, where as in the early 80s, when governments decided to step back from direct political involvement in interest rate settings, and gave quite a degree of independence to the Reserve Bank, perhaps we have also arrived at a point now where certain key national essential infrastructure should be likewise independently assessed in terms of its capacity, productivity, efficiency, and that a statement of opportunities in relation to emerging or perceived emerging supply-demand gaps should be put into the marketplace in such a politically independent way as are interest rates set.

We are seeing elements of this, I guess, in the electricity sector, with the annual NEMMCO statement of opportunities, and AusCID would certainly like to suggest to the commission that it give some further thought to the NEMMCO model - with all its flaws at the moment, which hopefully are being ironed out as a result of the Ministerial Council on Energy process - being extended to include land transport opportunities and water sector opportunities and telecommunications sector opportunities - at least cover off on the key economic sectors. It could be that in time, social infrastructure might be required to fit into such a model, simply because of the current size and the huge growth rate of the health sector in particular, and likely to be exacerbated through the ageing population.

I mentioned earlier the PPP model. As you are aware, in the Australian context, the public-private partnership procurement model for public infrastructure, particularly when applied to social infrastructure, is not a full service model - that is, governments have decided - these are state governments in the main - that they would like to see separation of what I call loosely the bricks and mortar component of that infrastructure from the core service component, and have made it quite clear that the core service component is to be maintained as a government-delivered service, be it, for example, medical, nursing, education, teaching. Other jurisdictions, however, most notably the United Kingdom, have been more

venturesome in looking at full service PPP or PFI delivery of such infrastructure.

I believe it would be most worthwhile for the commission to undertake some further analysis and again, perhaps with the health and education sectors predominantly in mind, consider whether productivity and efficiency gains might reasonably be expected from promoting a move from a limited-service PPP model toward a full-service PPP model in those sectors.

As a last point, I would like to address the question of economic regulation of economic infrastructure. We have a multiplicity of regulators in this country and we have seen in recent times decision-making by individual regulators which has thrown up inconsistencies as to the signals that those regulators have been sending investors, particularly pricing signals which mitigate against the desire to expand or grow those regulated assets, the most recent example being the Dalrymple coal loader in Queensland, but with an outcome looking very similar to the analysis that was thrown up by the Western Australian regulator in relation to the Dampier to Bunbury natural gas pipeline. So consequently, AusCID believes that this inquiry would provide an excellent opportunity for recommendations in support of the need for nationally consistent economic regulatory principles to be applied by all regulators in support of common outcomes.

In conclusion, Mr Chairman, I believe it would be very, very important that governments, when receiving the final report, have some views expressed by the commission as to priorities between those various sectors that you've identified for ongoing reform. I realise time and opportunity may mitigate against the sort of modelling that might be required to tease that out, but with the challenges posed by growth in the health expenditures, with the challenges posed by the growth in logistics, but with the more immediate environmental and social dimensions of energy and water, I think it would be very important that governments have a feel for, if you like, the more immediate crises that should be headed off while working towards also achieving an absence of crisis from the longer-term issues. Thank you, Mr Chairman.

MR BANKS: **T**hank you very much for that. I guess that question of priority came up at the CEDA discussion yesterday, and I take your point; and certainly in terms of the agenda we've set up, as I said yesterday, I guess we've put those things in the basket that we think are a priority relative to other things, but also with the cut of the things that we thought were most appropriately dealt with through COAG. In terms of the modelling that Econtech has done, we'll certainly have another look at that in terms of what use we could make of that ourselves, but from having previously - I understood it was sort of predicated on an assumption that regulated prices have impacted on investment; or am I wrong about that? What is the link to pricing in this work that Econtech has done?

MR MUNDY: The nature of the work is essentially to identify a gap in the capital stock as we sit today. The analysis of individual projects, for example, we were very careful - and I mean we're all aware of the huge range of infrastructure gap expenditure that was there. We didn't seek to identify what the gap was. What we sought to do was to identify from third-party sources a significant range of projects; significant, by which I mean with enough value that if you increase the capital stock by that sort of amount you could expect to see some macro-economic outcome.

So the sort of range of issues we looked at, for example, it is our view - and I think the view of many - that basically every project that's in the AusLink white paper should in fact be in place today. The Hume Highway from Melbourne to Sydney should be duplicated today; the Pacific Highway should be duplicated from Sydney and Brisbane today. The current condition of interstate rail track is not what we need to have in five years' time; it's what we should have today. Now, a lot of those areas, the failure is not because of regulated pricing; it's lack of fiscal will.

MR WEICKHARDT: Lack of?

MR MUNDY: Fiscal will. There are some areas - for example, the major gas asset that we identified was missing surprisingly was the additional capacity in the pipeline from Bunbury to Dampier, and that is in our view demonstrably about regulatory failure. In electricity, for example, the lack of - well, it is our view that Basslink should probably be in place today, not currently under construction; and the delay in Basslink is actually a planning failure and difficulty getting planning approvals, particularly the debate about above and below-ground cabling through the Gippsland. So we weren't out to make a case that these things are because of economic regulatory failure. That is certainly one of the reasons.

I mean, you could argue that lack of assets in the water industry, particularly with the Services Sydney application currently before the NCC, is actually again - you know, the lack of water assets may well be because of failure to properly open up to private sector interest or because of some corporate conduct on the part of state-owned incumbent service providers to introduce investment in those. So the link to regulated prices isn't a strong one, and the bulk of the missing assets are probably in areas where you would expect the state to be the primary supplier. It's tempting to draw a link, for example, to underinvestment in the rail sector to the access regime that ARTC entered into at its establishment with the ACCC.

Now, the reality is that the prices that the rail track provider can charge are effectively constrained competitively on the interstate road system up and down the eastern seaboard, and that's the great challenge I think in land transport policy: that the rail industry will struggle to generate enough internal funds to invest in the assets

to get quality up, because it's price-constrained by its competitor. So why are we regulating an industry that's got a price constraint from competition?

This is an interesting question that the Victorian government is going to have to wrestle with as it looks forward to the regulation of Freight Australia assets acquired by Pacific National; not so much in relation to passenger services or perhaps grain haulage but in those areas of, you know, haulage of containers from Mildura to Melbourne, where clearly those containers can go by rail or road to Melbourne; they can go by road to Adelaide and they can find their way to Sydney or potentially, as time goes on, Port Kembla. The issue is not price regulation and its identification. We've tried to identify why these assets may be missing, but we haven't tried to draw a strong link back to make a note and say, "The reason for this is because of price regulators."

MR BANKS: Right. Okay. Did you want to follow up on that?

MR WEICKHARDT: Can I just ask a sort of supplementary question, and I guess we've got a couple of other submissions coming forward that bear on this subject; but that issue of the road versus rail intermodal issue. If it is true that the rail prices are being held down at the moment by, effectively, road competition, if the true neutrality - and I guess what true neutrality is is an arguable point - but if true neutrality meant that road prices went up for long-haul heavy freight, would it not follow that the rail prices would simply go up because they need to get higher prices to justify further investment? And if their prices simply go up, will there be any switch between road and rail, effectively?

MR MUNDY: We know that there is one corridor in Australia where rail dominates, and that's across the Nullarbor; and the dynamics and the logistics of road and rail are critically dependent on the sort of commodities where - I mean, road's great advantage is it can operate door to door. So the issues, I think, are what you would find - and we certainly see this, for example, in the US where there's a tremendous amount of short-haul rail operation; logs, things like that. I think what you would find is that there would be a capacity for - my sense - and this is just from someone who observes this industry and is not a participant in it - is that the capacity of the rail industry to innovate is actually constrained at the moment by its ability to price itself at a point where it can value-add properly.

The interesting thing about the dynamics of the land transport industry is that it has now essentially ceased to be a rail industry and a road industry. Some of the dominant road players have now become the dominant rail player and the integration of that, I think, is causing legitimate competition concerns. The statements over the last six months or so by the chairman of the ACCC, particularly around the time of the acquisition of Freight Australia by Pacific National, show the ACCC has a

concern about those things. There would be a shift up in price; there would be a shift in Mobil's share as cargo freight found its natural place, I think. What it would do would provide us with better signals, I think, for investment.

The fundamental problem with road pricing at the end of the day - and the fundamental dynamic problem - is that rail freight and rail track access is essentially a private good. You can exclude people from it. You can get at it. The problem with pricing long-haul road haulage is, of course, it's produced jointly and in common with other goods, one of which demonstratively in my mind is public goods. So thinking through the economics of this joint production and then the public good nature of the roads that we all drive on, the Commonwealth, for obvious political reasons, if no other, have spent a lot of money on roads between Newcastle and Brisbane over the last eight years. The bulk of the use of that is local communities but these are still incredibly important national transport assets. So how you separate out those pricing issues is, to me, not obvious and not trivial. Would the price of rail freight go up? Probably, but so would the quality and that would be the difference, I think.

MR BANKS: Okay, good. I think you made a point about fiscal will previously and I would just like to hear your comments on whether you think this aversion of the public sector to borrowing for worthwhile projects is still a really important problem.

MR MUNDY: For my sins, I was a treasury officer in the late 80s and we just used to wait for the Loans Council decision every year. It seems to me that the current position of governments is to fund their capital activities primarily out of recurrent expenditure. That, to me, is the public sector equivalent of saying, "All private sector infrastructure will be funded purely by equity and there will be no debt." If we advance that proposition, infrastructure users would be rightly saying, "This is forcing the cost of capital up and therefore charges are going to be too high and we won't use it." We seem to have formed the view that we don't want to encumber future generations with debt and that's initially appealing but it seems that we don't want to also give them the benefit of long-lived assets.

We've replaced the borrowing constraint that was imposed by Loans Council by perception of a borrowing constraint imposed by ratings agencies. But the ratings agencies quite openly say there is clearly sufficient debt capacity within state government and Commonwealth government balance sheets to keep their AAA ratings. I mean, why have a AAA rating if you're never going to borrow, is a question that should be addressed. Why not save the several million dollars a year it costs to get the rating and maintain it? But more than that, this infrastructure - be it the deepening of the channels in the Port of Melbourne, be it road infrastructure, be it rail infrastructure - if we want adequate, viable competition in downstream markets,

we're not going to get it if the infrastructure is inadequate.

We've seen, in Australia, what happens when infrastructure providers open up, provide additional capacity and invest prudently. We saw that with the entry of Virgin Blue and Impulse into the aviation industry which, if certain infrastructure investment didn't happen, entry could not have occurred in reality. So I think we have to accept - and it goes back to the point that Dennis made; that proper investment in these assets not only boosts productivity and presumably profitability in the private sector and increases quality and competition in what are essentially non-tradable services but support the trade of the sector. That's what NCP, to a large extent, was about. It was about reform of the non-tradable sector to raise their productivity to support the tradable sector.

Not only does all that happen but there's a general increase presumably in economic activity and a general increase in the tax base. It seems to us that governments have lost sight of the fact that when they invest in public infrastructure they're also investing to expand the tax base which they are the beneficiary of. As long as they resist the relentless run to the bottom on tax then these things actually, in the longer term, make a lot more sense.

MR BANKS: Okay. Good. I was just going to get you to elaborate a little bit on this NEMMCO model, the statement of opportunities, and its extension to these other areas of infrastructure. I'm not sure that I've got my head around exactly what you have in mind there. Will you elaborate on this in a written submission to us, Dennis? Is that feasible?

MR O'NEILL: We'll happily do that, chairman. Yes. Our thinking is still at an early stage in relation to this but I guess what we're feeling for here is the fact that with the NEMMCO model you've got an entity that is not politicised, identifying supply and demand, regional imbalances, looking at the distinction between generation transmission and distribution issues and consequently placing itself in a position to report to the market the state of play. In reading that state of play, both public and private sector participants can make appropriate decisions, either on a regional or on a whole-of-market basis in terms of investment response. That's not happening in a depoliticised way in relation to water and land transport.

We seem to wait until the squeaky hinge demands a drop or two of oil. Consequently if we're to look for a greater role for private investment to address a shortfall that seems to be evident in Australian economic infrastructure at least, then I believe a better informed marketplace could be a great starting point for that. If we selectively use the word "crisis", arguably there is crisis in a number of Australian cities in relation to urban water supply. Why that is so obviously has some natural causes in terms of rainfall. For example, in the Sydney region, in the 40 years since

the major storage was constructed and filled for the first time - Warragamba Dam - the stored volume of water, when full, has diminished from eight years of stored water per resident, in the greater Sydney region, to four years of stored water per resident.

My understanding is that engineering analysis back in the 50s, when Warragamba was first postulated, came to the conclusion that eight years was the desired storage amount because of Sydney, New South Wales, being on average in drought one year in four. What's happened in the ensuing 40 years? What has happened in terms of analysis of supply, demand and an investment response to address that situation? Clearly, the politicisation of the response mechanism, be it flight from debt by governments or be it lack of fiscal will and other aspects or other ways, or just a sheer concern about the whole complexity of the planning system to deal with whether a new storage - ie a new dam was required or whether pumping between basins was required or, as we're now hearing, a range of other alternatives, including recycling, reuse and desalination.

These new alternatives or these most recent alternatives have all come together in a climate of crisis. I don't think one needs to draw too long a bow to suggest that there must be tremendous productivity and efficiency costs in having allowed the supply-demand gap to narrow to such an extent, without allowing for an appropriate investment response. Therefore, if we could have a more public and a more objective mechanism for identifying those supply-demand movements, and even being able to commission modelling and perhaps even preliminary engineering studies as to what technology options are opening up, as well as, of course, identifying policy constraints because I think that's the tremendous benefit of the emerging NEMMCO model; is that if investment does not occur in response to that statement of opportunities within a reasonable time, it can lead to some public questioning of why that investment was not occurring.

What are the other constraints? Would they be policy constraints; be they pricing or economic, regulatory outcomes which are constraining the response by the market? I think we're at a point in our economic development where similar dynamics are required for other key economic infrastructure sectors.

MR WEICKHARDT: Can I just ask a sort of supplementary question to that and I'm sure that people do analyse every word that Alan Greenspan says and that Ian Macfarlane says. You gave this analogy to the Reserve Bank but they also look very closely because they actually have some lever that is - they control interest rates. It would appear that an independent body that simply said, you know, there's a problem that has no, if you like, other sanction or control mechanism, it might not actually make very much happen.

You quote in your submission assessments that were made by professional engineers back in 2001 which gave some infrastructure in Australia an F rating, I think. Certainly, you know, inadequate; not much has happened. So I can understand the desirability of an independent body making an assessment. The question is do they have any sanction now? In some of the electricity sectors around the world I understand that the regulators have the power to sort of suggest that if you have a licence to operate you have to have a certain amount of stand-by capacity but it seems to me you need some sort of teeth behind this independent body if they're going to make something happen, as opposed to simply informing the market.

MR O'NEILL: That's true. That would be ideal but a starting point might just be an informed market and then let's see what the market response is. But I could venture the suggestion - which I must say I haven't given a lot of in-depth thought but I'm happy to try and do that and put it in writing to you - could we not envision a future which links the mechanism for competition payments or competition dividends - including the Commonwealth, I might add - to be linked to demonstrable capacity for the market to respond. If the market is not responding then questioning why it's not responding and, if you like, resulting in pointing the finger at failure to reform in one or another sector or failure to move in one or another sector, would factor into some measurement of whether the competition payment would or would not be paid.

In other words, I agree with your observation. If you can have a carrot and stick operating, that would be a preferable outcome, but in absence of being able to create some element of the stick, frankly, in an era where we are looking increasingly to try and mobilise superannuation savings into some of our longer-term infrastructure investment opportunities, just having a better-informed market in itself would be useful because there's an implied stick, in terms of public opinion, and I think you have only got to look at the anger - the palpable anger - in this city when the trains started to fail and the mobilisation of community concern. That has been felt very strongly by the current government here and is causing a response. I think it's a less finely tuned response than perhaps the Reserve Bank's capacity to set interest rates but, nevertheless, it is a response.

MR BANKS: I think the connection between the two modes, rail and road, was quite evident in Sydney over the last few days in terms of the amount of traffic on Sydney roads.

MR O'NEILL: Indeed.

MR BANKS: If we could move just onto tax briefly, as you indicated, I guess we were looking for an agenda more for COAG and a number of the tax issues we have seen being more firmly in the Commonwealth domain, although I take your points

about some of the cost-shifting issues and so on. But I just thought I would get you to comment on the division 250 concerns you have and perhaps give us a sense of how important these are. For example, in relation to your concerns about price regulation - what impact that might be having on investment - just how important is the division 250 issue, given that I understand from what you're saying here that there are moves to address it but you're seeing those moves in themselves as being problematic.

MR O'NEILL: I think the key points to be made about division 250 as it appears to be emerging is that it is being drafted more particularly with revenue protection in mind as a priority outcome. I will bring you back to my introductory remarks in that regard. While it may, in that context, prove to be a black-letter law device for offering all parties more certainty about what the outcome will be for a particular transaction, I guess I would like to voice the concern that if the appropriate national development outcome should be instead a view about what is the right timing and the right sizing of appropriate infrastructure investment in the country, and that becomes the top priority, then I would look to certain changes being required in division 250 to achieve that priority ahead of the revenue protection priority.

To expand on that a little bit, to give an example, in the publicly available exposure draft of division 250, our reading of the drafting suggests that it would preclude the ability to introduce shadow pricing or shadow payment mechanisms for the provision of suboptimal infrastructure. For example, to explain further, when a project may have economic benefit but may not be financeable by a private investor, that private investor would look to some support from the government. There may still be user charges involved but it may not be conceivable that you can charge the end user the full price of delivering that service, be it a toll road, be it a water supply to a regional town, be it perhaps regional telecommunications where there is a community service obligation required.

What we have been proposing and what we are still proposing to the Commonwealth - and in fact I have only just today completed a letter that will go to the Prime Minister to address the Commonwealth's intention to put $2 billion of Commonwealth money in place to support water projects in Australia. They've already put quite a lot of money down in support of land transport projects through AusLink, and our message in that context is why limit the private investment component in those schemes only to projects where there can be 100 per cent private investment of the project in question, if it's a road necessarily that will limit the road to major arterials in and around our large cities?

Similar analysis probably would be concluded for many water projects, although perhaps some of the larger regional towns and cities could similarly benefit. When it comes to lack of critical mass in a market sense, then one has to look at the

moment only at 100 per cent government funding, or a stalemate because of the way the tax system operates, that you can't readily bring mixed funding together. You cannot bring public and private capital together into the one project, because the tax system will treat the government component in a way that disadvantages the private investor's view of that co-funding.

Another way of looking at it, apart from the equity injection side is to look at how the private funding, if it is 100 per cent private funding, is then supported by payments both from direct users - perhaps a direct toll, but maybe a direct toll that's capped and topped up by shadow payments from either Commonwealth Treasury or a state treasury. Again, division 250 - the way it's panning out - would not treat very favourably income streams that are coming from the government treasury. They would be deemed to be a low risk revenue stream, and would result in some punitive loss of deductions to the private investor.

MR MUNDY: What 250 effectively does is rule out the private sector involvement in any major extension to the urban public transport fixed infrastructure. That's the real problem with it, in regard to urban public transport, is that urban public transport cannot be developed solely on a user-pays basis, and nor should it be because of the significant externalities that are involved. So if the state quite rationally says to the private sector provider, "Well, you go off and capture the private benefits from the people on the train by charging them to be on the train, and we'll pay you for the externalities that you create, because they're public goods," the 250 as we understand currently is drafted, will blow such a project out of the water. It just won't work, because of the way that the payments from the state will be treated.

MR O'NEILL: This brings us back into this realm of the argument about cost-shifting, which in its current version, is complicated because of the introduction of the GST, so we are seeing very much a strongly-held view, particularly since the recent federal election, that at one level you've got a growth tax and the GST available to the states to invest in their infrastructure, with the Commonwealth saying, "Our tax system should not be used in support of your investment." So there's a them versus us element in all of this, which from an infrastructure investor perspective, we would like to see ironed out and instead merely a national economic benefit view adopted, with some accounting treatment or, if you like, some left pocket/right pocket treatment of any exchange of money that has to occur between a particular jurisdiction and the Commonwealth.

MR BANKS: I think you've probably succeeded in convincing me that this is a hard issue to address in this particular review, but thank you for that. Clearly it bears on the infrastructure investment issue, which is very important to the review.

MR MUNDY: It is an important issue for COAG to come to terms with, because

the benefits of infrastructure projects are not contained within the jurisdiction solely of where they - deepening of the channels in Port Phillip Bay will create significant benefits right around the country, and indeed in New Zealand, simply because it removes the bottleneck. So deeper draft vessels - because of the way shipping arrangements are - will then be able to profitably trade up the whole eastern seaboard, just not through Melbourne.

So if you thought you were going to fix up rail freight between Melbourne and Brisbane, most of the work is actually going to happen in New South Wales, but to the benefit of at least three jurisdictions, so this jurisdictional problem is a real issue that COAG, I think, really needs to come to terms with, and from the Commonwealth's point of view, they do get a growth revenue source from increased economic activity. It's called company tax, and company tax receipts don't appear to have been particularly sluggish of late.

MR WEICKHARDT: Sorry, what was that last point?

MR MUNDY: Company receipts have not been sluggish of late, as far as the Commonwealth revenue is concerned.

MR O'NEILL: I think, gentlemen, the issue of division 250 or the underlying philosophies that are driving the thinking about it, are not dissimilar to the concerns implied in the sovereign borrowing area. It's a timing issue, and if we're not going to - I'm not even going to say "accelerate" - right-time the investment in necessary infrastructure, it will be because of either the reluctance to borrow and invest, or the reluctance to resolve some of these residual taxation impediments.

MR BANKS: Thank you very much for that. Can we expect a written submission before too long?

MR O'NEILL: Certainly. Indeed.

MR BANKS: We would really appreciate that. We'll now break for a few minutes before our next participant. Thank you.

MR BANKS: Our next participant is Pacific National. Welcome to the hearings. Could I ask you please to give your names and positions for the record.

MR JEREMY: Robert Jeremy, general manager commercial at Pacific National.

MR CARSTAIRS: Jamie Carstairs, director of Firecone Ventures.

MR ERGAS: Henry Ergas from NECG-CRA.

MR TAYLOR: Angus Taylor from Port Jackson Partners.

MR BANKS: Thank you very much for attending the hearings this morning and also for the two submissions that Pacific National has provided to the inquiry. As we discussed, I'll let you go ahead and make the key points that you'd like to make.

MR JEREMY: Thanks, Gary. Well, I'll just make some introductory remarks and then I'll hand over to Henry and Jamie, who will make some further comments; then we can deal with questions. I'll just start with a brief introduction to Pacific National. We are the largest freight rail operator in Australia. We operate in the coal, bulk grain and intermodal sectors, and the focus here really is on the intermodal part of our business. Just to put our submissions in some context, I think it's worth pointing out and giving you a view about where we are today in the intermodal business and what we think the next five years hold.

The position today simply in terms of where we are today is that we are at capacity. Our trains are full. We have no more capacity for additional freight and the network is in the same condition, and that includes on the east-west corridor, so we are experiencing congestion on all corridors and there is little capacity for additional growth in the existing infrastructure. We have approved for investment $150 million in our intermodal business, which will be spent and delivered over the next 12 months, and we have plans for further investment. The east-west corridor is still growing and our focus in the next couple of years will be on the next long corridor, which is the Melbourne-Brisbane corridor.

If you go back 10 years to the formation of National Rail, which is now part of our business, about 10 years ago they started a $500 million investment program, between 5 and 6 hundred million dollars in new assets - brand-new assets: rolling stock, terminals and other assets. It was state-of-the-art equipment, and also some One Nation money came into the system as well, and that really took the old state rail freight systems out of the dark ages into the new age of modern technology. Over that 10 years, an enormous amount of progress has been made and I think it's largely due to that investment. If you go back, that was the visionary investment; it was the above rail investment, because if you look over the last 10 years, not much has really

been invested below rail in the network.

It was the best investment decision that's ever been made in this industry in the last 10 years, and it's time to do it again, because that investment is now fully utilised. The growth that we've seen in rail and the achievements that we've seen in rail, in my view, are really as a result of that above rail investment and the work that's been done by the above rail operators. It's not been achieved by the track owners; they've invested very little, and in any case the role of a track owner is to invest in order to supply capacity, and that facilitates growth by the operators. But on its own, track investment just for the sake of it is absolutely useless.

Over the next five years we're forecasting very significant growth in the rail sector, particularly in the north-south corridor. We don't see any reason why the north-south corridor shouldn't - shouldn't - be able to achieve the same modal share as on the east-west corridor; that is, in the order of 60 to 70 per cent over time. But over the next five years we want to double rail share to the sort of 30 per cent mark, which is a big call. In absolute terms that's a very big call. And in order to do that, our intermodal business has plans to invest - as I said, do it again: another 6 to 7 hundred million dollars in rolling stock and terminal improvements over the next five years. So we're very much working in a five-year time frame and I think the central underlying theme of our submissions is that we need an environment in which there is an incentive to invest, to make that sort of investment.

Those are long-term investments - they're 20-year investments - and we live in an environment, a regulatory and quasi-regulatory environment, which operates on sort of very short-term horizons. We often can only acquire five years of access rights, five years' certainty of access pricing. We need 20 years. We need guarantees of capacity, to grow into that market, of 20 years. So we need long-term capacity commitments; we need long-term pricing certainty; and we need, very importantly, a level playing field with road. The work that we've done, and you've seen some of it, I think proves what I think people intuitively know, which is that rail is the most efficient mode on all intercapital corridors. It's not hard to work out that one locomotive can beat 15 trucks in terms of fuel efficiency and so on and so forth, and we are talking about state-of-the-art equipment that is used on rail these days.

In the current environment, there is no future for rail on the short corridors; that is, Melbourne-Sydney, in particular, but also Sydney-Brisbane. There is a future on the long corridors, particularly with the track investment that we're seeing coming from the federal government now; the $1.8 billion will assist a great deal. It's not as bright a future on the long corridors as it could be, but the short corridors are dead ducks, and the reason for that is road pricing. The great tragedy of that is that the short corridors on the east coast is where all the volume is. That is freight land. Melbourne-Sydney volumes are huge, and we have an environment in which,

because of the price signals that we have in our system and some of the other distortions that we have, that volume will trend over the next five years to the wrong mode, and we believe that needs to be addressed.

We think there needs to be a real sense of urgency here. Talking over the last 10 years, I think knocking around the industry in the last 10 years, everybody has known what the issues are, and there's been some very slow, grinding reform to knock them over. The privatisations have been a key part of that but what's needed is a real sense of urgency because if we don't solve this problem in five years, not 10 - we're all working on five-year horizons now - then I don't think we'll be able to achieve what is achievable. So what we'd like to encourage the commission to do is really to emphasise the need for a very clear mandate from the policy makers to address these issues that we've raised, come up with the answers and give us the sort of competitive neutrality that we need so that freight moves to the most efficient mode for the task; and that will deliver huge benefits for the economy. That's the nub of it.

MR BANKS: Good. Thank you.

MR JEREMY: So I'll hand over to Henry.

MR ERGAS: As Robert said, there's no mystery about what is needed in the area of road reform. The fundamental goal here should be that of putting the price mechanism to work in signalling costs and allocating resources, and as matters now stand, charges for using the roads provide very poor signals for modal choice. They distort modal choice rather than sensibly directing it. Fuel use is a very poor proxy for road use and for the costs that are imposed on the road network, and it provides no price signal at all for time or location. Given that, the statement in the draft report that most of Australia's road network will remain unpriced for the foreseeable future is too defeatist.

The commission should be advocating in the strongest possible terms early moves to reform road pricing and put it on an economically more rational basis. It's technologically feasible nowadays and it's economically of great importance. Even short of a move towards economically rational pricing, for so long as reliance is placed on fuel excise and registration fees, at least measures should be taken to increase their effectiveness. That would require that the fuel excise charges and registration fees should better reflect the cost impacts that heavy vehicles have on the road network, and should allocate a sensible share of common costs to those vehicles.

Ultimately a move to economically rational road pricing must form part of a scheme - better governance - of the road network, and the key question that the

Productivity Commission should address in this context is how one can move in that direction. Clearly, in the Australian federal system, implementing road reform is going to be a very challenging exercise. After all, this is not one of those areas like health or eduction, where the solution itself is extremely complicated, and there's great uncertainty as to what the solution is. Here we've known for a long time what the solution is. The difficulty is in taking moves to actually implement it. It's important, in my view, for the commission in its final report to address the nature of those obstacles, and then to provide some direction - road map - as to how those obstacles could be addressed.

The obstacles themselves are clear. The first one is simply the fact that fuel excise provides very substantial tax revenue to the Commonwealth. If you had a move towards user charges for roads, those funds would accrue to the states. As a result, moves towards reform will involve an inter-jurisdictional arrangement, with respect to sharing of funds. A second obstacle is the fact that at the state government level, there have been very significant moves in recent years to securing private investment in road, on the basis of the toll revenues that those roads will provide.

The reality is that those toll revenues are currently being raised in a manner which causes significant efficiency losses, including because we are charging significant prices for the use of what are often uncongested facilities. There's inconsistent pricing of tolled and untolled roads, and diversion as a result of that, of congestion and of all the social costs that that imposes. There are also high transactions costs being imposed by the use of multiple tolling technologies and diverse back-end billing systems. A move towards sensible road user charges would require addressing the commercial commitments state governments have entered into, and that will be a complex task.

Another obstacle comes from the fact that the fuel excises lead to responses in terms of choice of vehicle stock. Purchasers of vehicles respond to the fuel excise charges by substituting towards more fuel efficient vehicles, and we know from the economic studies that have been done, that in fact a very large part of the response to the fuel excise is not to alter use of the roads, but to alter the composition of the motor vehicle stock. As that process continues, and as we move towards perhaps uneconomic shifts towards motor vehicles solely on the basis of the fuel excise distortion, the sunk nature of those commitments - the fact that investments will have been engaged by consumers in buying those motor vehicles - will create resistance towards a move to more sensible road user charges. That makes it important that one begins such a move early, and phases it in on a carefully, pre-announced basis over a period of time.

Last but not least, obviously a move towards sensible charges for use of the roads will affect those who have benefited from the pricing distortions to date, in

terms of the allocation of the transport task between modes, and hence will have an element to it of resistance from current beneficiaries. Those obstacles are undoubtedly significant, but all they do is highlight the need for political leadership in this area. The commission should, in my view, set out a clear call for that political leadership, and in particular define an agenda for COAG to start on that process, perhaps beginning with a conference on future directions in road pricing, and then an action plan to implement a nationally consistent system of road pricing over a period of five to 10 years.

Absent such a move towards road pricing, it will be difficult to get full efficiency in the transport task, and even more difficult to allow the rail system to play the long-term role that it can and should play. Obviously those moves need to be parallelled by changes in the way the rail system is managed, and on those Jamie will now set out some thoughts.

MR CARSTAIRS: Thanks, Henry. I would just like to take forward the points that Henry has made, and Robert. The argument has been that rail has significant cost advantages, but that inconsistent governance frameworks between rail and road mean that it's not enjoying the full benefit of those advantages. The desirable long-term position is to develop commercial frameworks that drive investment in both road and rail, and has been outlined. The key to that is to develop road user charges which enable efficient road pricing, rather than continue to rely on a poorly-structured and very blunt tool for the pricing of road.

We think that agenda should be advanced and carried out with greater urgency than has been suggested in the draft report, but until that is implemented, rail is going to continue suffering from being exposed to competition from road, with the governance framework from road being very different from the governance framework from rail. So that will require short-term protection, to protect the position of rail until a medium to long-term agenda can be implemented, of shifting both modes onto a more commercial footing.

I would just like to develop two points that were made in the submission, and suggest some practical steps that the commission could now think for implementing them. The first is around the AusLink white paper. In the submission of June this year, Pacific National welcomed the AusLink white paper, and in particular three aspects of it. The first was identifying a national network, consisting of rail, road and necessary intermodal linkage infrastructure, that could be the target of a comprehensive national plan for funding.

The second was to develop road transport and road corridor strategies around corridors within that national network. The third was to allocate funding on a neutral basis between modes, in order to respond to the priorities identified in the corridor

planning. That seemed a significant advance, and is a significant advance, in the way that public funds are allocated. However, there are further improvements which could be advocated by the commission, which would assist and improve the approach that has been taken to date.

The first of those is to seek some kind of output based funding of the funds that are being injected into the national network. To date, the Commonwealth government has indicated that it will develop transport strategies, but it has not yet indicated what form those strategies might take, what kind of outputs they might seek within a corridor, and so how they could ensure the funds were allocated to meet the desired outputs most effectively.

Rather, so far they've indicated a desire to develop strategies, but matched that with over $3 billion of expenditure which is targeted to specific inputs, and experience elsewhere suggests that if the Commonwealth identified the outputs it was seeking to achieve - whether in the form of faster transfer between capital cities, higher levels of capacity, greater reliability, or whatever form they took - and then sought to use its funds to address those desired outputs most efficiently, it would probably get from private sector and other providers greater innovation and get greater efficiency in the way in which the funds were used. So a move towards implementing the strategies set out by the Commonwealth of corridor based strategies, desired outputs and then funding the outputs - rather than funding a set of inputs - would be a significant improvement in the approach advocated in the AusLink white paper.

The second improvement that is necessary is that implementing AusLink will require a mix of funding by government and private bodies. At the moment, road funding can be channelled through government departments and some rail funding can be channelled through government-owned entities, through providing additional equity or some other form of funding for the government-owned entity. It will also be necessary to ensure competitive neutrality that there are mechanisms for delivering this additional funding through private entities. That will create complexity in the sense of determining what a reasonable price is when you're dealing with one party, determining what a reasonable allocation of risk is and implementing the project; and there are precedents elsewhere in the rail network for people developing contractual frameworks for open-book delivery of projects for appropriate risk sharing. We would encourage you to set out to the Commonwealth the way in which they could develop means of implementing projects, both with private as well as government parties, to ensure that the AusLink funding is neutral between ownership.

The third area where AusLink could be extended is to seek hybrid funding and to identify areas where public funds could be leveraged by private funds, and to

develop mechanisms for joint funding rather than simply the injection of public funds. All of those are essentially means of deepening the approach which was set out in AusLink and consistent with it. The second point I want to make, which again deepens submissions made earlier: in its June submission, Pacific National pointed out that the model being adopted in Australia for vertical separation of track ownership, which recovers full economic costs, is a model which the BTRE indicated had only been used in one other OECD country, which was the UK.

That model creates a number of difficulties which are illustrated by the difficulties experienced by Railtrack in the UK. We'd like to indicate just one possible practical response to those difficulties. One difficulty that arises is from the separation between above rail and below rail operations. That can create inefficiencies, as was indicated in the submission, and may create poor incentives for maintenance. In order to overcome those complexities, it's necessary to specify the obligations of the below rail provider with respect to the quality of the track they're providing. Looking around Australia and the world at the ability to write contracts which fully specify the condition of assets, and so enable the obligations of the below rail provider to be defined, monitored and enforced, it's clear this creates great complexity.

Perhaps the easiest source of experience is where there's separation between ownership and operations, so under long-term leases for track. Where ownership is separated from operation, there tends to be a reliance on a mix of instruments to ensure that the track is well maintained, so there may be attempts to monitor condition; there may be specification of inputs; there may be processes for agreeing and monitoring maintenance; and there may be false attribution regimes which seek to place a liability and then ensure that the parties are maintaining the track well. That illustrates the complexity and difficulty of relying simply on one instrument such as fault attribution or a condition index regime.

A further difficulty shown by the UK was the conflict of interest that may arise if the track-owning entity has a relationship with the capital market which leads it to seek to distribute profits in order to maintain a strong relationship with the capital market, and to have an ability to raise funds; which leads it to have a conflict between whether it should reinvest profits in the network or should distribute profits and maintain a strong relationship with the capital market. The experience in the UK is of concern in this regard because, to greatly simplify the Railtrack experience, one element of it was that Railtrack built up a substantial maintenance deficit and it was hard to monitor that deficit, although it became clear after major accidents raised concern; and that led to the insolvency of Railtrack.

That suggests to us that the difficulties of monitoring an efficient maintenance regime, combined with the conflict of interest that can arise when the owner of a

vertically separate track entity is seeking both to please the capital markets and decide whether or not to reinvest, creates a significant risk for this model. We'd argue one pragmatic step to reduce that risk might be to introduce an obligation on any vertically separate track owners that earnings and profits should be reinvested in the network rather than distributed, so as to avoid the added complexity that arises by trying to monitor whether their decisions to distribute are correct decisions, versus a decision to reinvest.

MR BANKS: Thank you for that. Just on that last question in relation to the UK, this aspect that you attribute to pleasing the capital market; I mean, I perhaps see it in a more simplistic way: that perhaps the regulatory environment - the prices in particular - weren't adequate to sustain the kind of maintenance that was needed, but you've not mentioned that at all. I mean, why would the capital market be more pleased by such a short-termist, ultimately destructive strategy than a longer-term one based on more sustainable pricing and so on?

MR WEICKHARDT: And indeed, if I could piggyback on that, why wouldn't - if that temptation applies to private sector investors in general, why doesn't it apply to a vertically integrated private-sector investor as well?

MR CARSTAIRS: Well, as you point out, we're not arguing that it is in the interests of a vertically separate track owner to drive themselves into insolvency, because I'm sure it's not; and I'm sure it's not in the interests of capital markets and lenders to them to see them drive themselves into insolvency. The argument is more that the complexity of the monitoring performance - which may also become a complexity between the owners of the entity and the managers, of ensuring that an efficient maintenance regime is being undertaken. Now, within the UK system, there was a subsidy being provided through the passenger train operating companies which then flowed through to Railtrack in order to undertake the necessary maintenance; perhaps with the benefit of hindsight people might argue that there was underfunding and there was insufficient maintenance being undertaken.

But the point wasn't whether or not there was insufficient funds; it was the difficulty and complexity of monitoring whether there was sufficient maintenance being undertaken. Now, that difficulty of monitoring creates a risk that capital markets may be ill informed, creates a risk that even managers, directors, of the entity may be ill informed about maintenance. That difficulty about information doesn't disappear by removing the ability to distribute profits, but an obligation to reinvest at least simplifies the regulatory task by removing one possible management choice which could lead to underinvestments.

MR BANKS: Okay.

MR JEREMY: Could I add a few words, Gary, just from our point of view? I think there's a lot to learn from the Railtrack example. The sort of underlying structure from Railtrack is different and more complex than the one we have here today but Railtrack hit the markets in the UK with a boom, you know. It was a share market darling, and you hear all sorts of war stories from people who experienced the Railtrack thing that it was a nightmare for everyone. The freight operators in the UK just took a dive during that period and they were very concerned about the levels of charging that applied at the time. The problem we have here is that we pay 30 cents in every operating dollar to the track owners for the privilege of running up and down their often fairly dodgy track. We have a regulatory regime in which they are able, overnight, to double that charge.

ARTC, for example, has a profit mandate. It is an ordinary company. It just happens to be owned by the Commonwealth. The conundrum for us is we have a billion dollars of investment to be made in the next five years. We can see the opportunity. We want to make that investment. What will we be paying for track access? Is it going to be today's rate or is it going to be 60 cents? What is it going to be? 60 cents is just too much. As we start to generate returns on our equipment, on that investment, and we start to grow, how much of that return is going to be withdrawn from us through track access charges? We don't know. How much is enough?

In an environment where we could be paying up to 60 cents but road is capped pretty much where it is today, all the signals are wrong. Which goes back to my point about needing certainty and the rail track - you know, my perception is that that's precisely what happened with rail track; that they charged everybody a lot of money. They have penalised people for being late and not doing the right thing. Apparently they had 400 people just writing tickets all day long to people.

But that profit motive is the wrong motivation in the environment that we have at the moment. If we had a level playing field; we had a good quality network; then maybe it would be different. Maybe you could start to operate in a more market-efficient point of view. We could all be listed on the Stock Exchange. Fantastic! But we're not in that climate now. Until we create that climate, I think Jamie's and Henry's point is that there are some short-term measures which need to sort of dampen things down a bit so that we can get to where we ought to be. I don't mind paying 60 cents in the dollar if I have got a level playing field with road and I am able to compete effectively. I can't do that now.

MR WEICKHARDT: If you had vertical integration, are you suggesting the profit motive would be an unsatisfactory one?

MR JEREMY: No. I think the dynamics are quite different. Let me give you - I'm

not able to answer your question precisely - but on the east-west corridor there is congestion. There's a very simple fix for it at the moment - it's passing loops, which are just - do you know what they are? They cost $3,000,000 each. That's nothing. Can we get them installed? You know, we can't do it. If it were our network it would be a no-brainer. They would go in and we would get all the rolled up benefits that go with that, in terms of improved utilisation of our assets; improved transit times and growth.

We enter into this bizarre sort of negotiation process and even when we offer to pay for them ourselves we get shown the door because track owners can't come to grips with us having some sort of ownership or investment right in their asset. It's particularly complex where it's a publicly owned asset. So I guess what I'm trying to say is that in a vertically integrated operation I think the dynamics between above and below rail are quite different than they are in a separated model and the inefficiencies are quite significant and there are conflicts of interest. In that scenario the track owner doesn't get much out of the passing loop. It spends $3,000,000. If you work out the access fees, it's nothing. There's no real incentive to invest, so why do it? Hold onto the money and pump it up. The dynamics are quite different.

MR ERGAS: Really what the issue is about is that, put in economic terms, there are externalities between the track network and track usage. When the owner of the rail assets invests in improving the quality of the rail assets and of the track network, part of the benefit - potentially a significant part of the benefit - flows to the above rail operator. To the extent to which the below rail operator cannot capture that benefit, then its incentive to invest appropriately in both the quality of the asset and in enhancing or augmenting the asset, those incentives will not be properly aligned.

On top of that externality distortion associated with investment by the below rail operator which will benefit the above rail operator, you have an externality that is running the other way and that is the result of the fact that current rail access charges in Australia - and particularly those that Robert was referring to in the example he gave of the ARTC, but not solely - are below the ceilings as determined on the basis of DORC type valuation of the assets. They're inevitably below those ceilings because you have the rail mode competing with the road network where the road network is in fact costed solely on a pay-as-you-go basis in a situation where road outlays are lower than they have been for many years historically, and where a relatively low share of those outlays is allocated to the freight task that competes with rail.

So that sets some type of cap on rail charges but the reality is that if rail usage were to rise then the below rail operators would be able, within the room for manoeuvre they have from current ceilings, to significantly increase their access charges. What that means is that when Pacific National is considering whether it

should invest in improving the rail share or increase in the rail share and enhancing the competitiveness of its service, it faces the threat of the returns on that investment in fact being expropriated by the owners or operators of the below rail assets.

So you get a situation where you have these incentives that are misaligned at both levels. The below rail operator does not have the right incentives to invest in enhancements that will go to the benefit of the above rail operators; and the above rail operators don't have the appropriate incentives to invest in all of those complementary activities that would make the below rail assets more valuable. What the proposals Jamie has just referred to attempt to do is to, within the constraints of the institutional structure, begin to address some of those incentive misalignments which otherwise will prevent the rail system from ever realising its potential.

MR BANKS: Okay. I'll be interested to see this written down so we can reflect on it a bit more. But some of the external issues you're talking about seem to me nevertheless to come back to this sort of intermodal problem that you've got; that if you could invest and charge for it appropriately and get a return on it then some of what you were calling externalities might disappear. I don't know. I mean, you still have a tussle between the above and below rail, I suppose, as to each entity's attempt to maximise its own profits. The reference was made before to the BTRE and I've not looked at this work but will do so. I understand they've done some work which raises some questions about the extent of this intermodal non-neutrality. I don't know, Jamie, whether you're familiar with that work?

MR JEREMY: Angus.

MR BANKS: Angus. Would you like to comment on that? We will have a look at it or you could get back to us if you like, once you've had the chance.

MR TAYLOR: I think, to put that work in context, there has been a belief for some time that the total road-funding pot, if you like, is being allocated too heavily towards cars or light vehicles and not heavily enough towards heavy vehicles. What the BTRE did was work through the current allocation mechanism and it came to the conclusion that not enough of that total was being allocated to heavy vehicles, and that was for several reasons. One is that there's a big slice of costs which they call non-separable. They are allocated on a vehicle basis, to a significant degree - not entirely but to a significant degree. That's very favourable to trucks and very unfavourable to cars.

There are several other aspects of the prevailing methodology which the NRTC has used - now the NTC is using - which, in the view of the BTRE bias, the funding is towards cars and away from trucks. Their view of the impact of that is somewhere in the order of 20, 25 per cent impact on charging. That's excluding any impact of

externalities caused by trucks through accidents in particular but also, to a lesser extent, pollution and so on. So that was the result of their work - there's a significant distortion. I think, when you look at other international studies that are emerging in this area - it's a very sort of hot area, if you like, worldwide, for research - there's an emerging view that that may even be - 25 per cent is probably very low and that there's significant more misallocation, if you like, or incorrect allocation towards cars and away from trucks. But the BTRE, I guess it was the first shot across the bows in the current debate that's going on.

MR ERGAS: I think it's also important to distinguish two slightly different things if I may. One is, in aggregate, do trucks about pay their way? - and you can argue about that. Secondly, when taking individual decisions, do pricing laws appropriately reflect marginal costs? So even though the aggregate may be about right, if it isn't signalling costs correctly then decisions won't be taken sensibly. A system that is based on an essentially fixed registration fee - which in turn means that you can reduce your effective charge by utilising the vehicle more - and a fuel excise charge that bears very little relationship to the marginal costs that road use entails, will not provide the right price signals at the margin and hence distort resource allocation, even if the total revenue it collects about matches total costs. Now, in reality we would believe that both of those issues at the moment are resolved in such a way that, in aggregate, trucks pay too little and the price signals are poor. But even if it were the case that the aggregate amount was right that would not, in and of itself, tell you anything about the marginal signals which are clearly very distorted.

MR WEICKHARDT: This probably displays my ignorance about the subtlety of that last point you were making, but just listening to this, it sounds to me that if you accepted that the aggregate was about right but it's tilted too heavily towards favouring lighter vehicles, if you altered this, there's the potential that first of all the truck owners will simply elevate their prices to extract more rent. So the price differential between large trucks and rail won't change very much at all, so will there be very much change in traffic between the two?

The second consequence might be that light trucks actually become more favourably priced. So rather than take more traffic off the road what happens is light trucks start increasing and taking more and more traffic which doesn't sound to me to be a very desirable consequence. The last thing, if I could just add to all this, is that it seems to me that this whole debate is about road versus rail. The whole issue of coastal shipping for long-haul routes doesn't seem to have entered into the debate. Yet if coastal shipping were truly efficient the question is how much more share might it take on the long corridor routes? Sorry, multiple question.

MR JEREMY: They're all good points and we don't have the answers. I think where I come from, just standing back from it, there's a policy question here. Do the

policy makers want the most efficient, lowest cost mode of transport to be used by people? If the answer is yes, when it comes to land transport - putting aside the ships - then, on the long corridors, the intercapital corridors, the numbers fall out for rail. If nothing is done, then we'll just keep trundling along. We'll have 70 per cent of the east-west corridor and 20 per cent of the north-south corridor and I suspect, over time, we'll be put on some sort of starvation diet by the track owners because they want to make themselves look good. It will be a very uneasy sort of relationship and there will be more and more trucks.

I think what we want to see is much more - we want this issue to be very much on the agenda and as Henry said we want to see an agenda for dealing with it. There's a lot of number crunching and a lot of analysis that has to be done to make sure the sorts of things you were talking about - we don't get unintended consequences. And, on top of that, to have a degree of urgency about it because otherwise we're going to see - and this is again, a policy question - do people want to just see more B-doubles, more B-triples, more road accidents, more congestion on the roads or are roads there for cars? So that's the nub of it. And as for the ships, that's an issue that's difficult in its own right and I don't have the answers for that either.

MR CARSTAIRS: If I could just add a couple of points. The first is on the point that Henry made about the signal. The current structure of the proxy for road pricing relies entirely on fuel but fuel efficiency increases with vehicle size so that the effective charge per GTK - the gross tonne kilometre - declines. The given wisdom seems to be that the impact of vehicles' on-road costs increases - I was going to say quadratically but I'm told this is the one word, quartically - so to the power of four with axle weight. So what looks like the marginal price signal suggests to users that their impact on the road declines a little as they increase in weight and is completely contrary to their actual impact.

That indicates, I think, the impossibility of relying on some tweaking of fuel excise and registration fees in order to give even correct signals on the impact on load, construction and maintenance costs. If you add it in - and I think you might have been suggesting this with your discussion of light vehicles and the suggestion of improved signals on road congestion - then clearly fuel excise barely provides that and certainly provides it with no adequacy whatsoever. So our argument would be that an adjustment or attempt to tweak the current reliance on fuel excise taxes and a fixed fee will not yield anything like an efficient signal.

The other point that you raised was if prices were adjusted so that heavy freight on the road faced a higher charge, would that simply lead to a transfer to the owners of rail track? It is, I think, a reasonable issue which it would be desirable to consider. It could be argued that that is simply a transfer. It delivers no benefit, and it's not

necessary to have incentives for new investment. Having that risk hanging over complementary investments is a deterrent to complementary investment in above rail.

MR ERGAS: If I can add a word to what Jamie has just said, the risk that improved road user charging would lead to increased charges for track access is not an argument against improving the pricing of roads. It's an argument for having better controls over track access charges. In the long run, what is at issue here is not to allocate the freight task to one transport mode or another. It is, rather, to have pricing rules in place which can ensure that the freight task flows to that transport mode which in the long run will deliver the lowest cost to the community.

MR BANKS: Okay. Good. I was just going to move from that a little bit to the question of the regulatory arrangements around Australia, which have always been interesting, coming out of our federation, just get you to make any comment on any problems you perceive still in the inconsistencies across jurisdictions, in terms of these regulatory regimes and access arrangements and so on, which you will see we've sort of picked up in the report as still being a remaining issue to try to get a kind of national regime operating. Are there any good reasons for these divergences? Would you care to comment on that?

MR JEREMY: There are none that we can think of. It's extraordinary the level of resistance to change, particularly in the state machinery that supervises rail, so that we still have - although this will be denied by some - extraordinary divergence in the administration and regulation of safety. It's not so much the regulations themselves it's the way in which they are administered and the practices that are adopted. We still have turf wars between safety regulators, particularly between the state and the federal regulators.

There are a lot of people applying a lot of time and effort to try and resolve these issues, but they seem to be intractable. Whilst we'll get national agreement at the ATC level that we should have national consistency, we'll get a state just running off and running its own agenda or writing its own regulations on a particular matter like driver health and safety. That has gone from being a national agenda to one that is being driven by Victoria, because they've just picked up the issue and they're running with it, and because Victoria says, "Drivers must meet these standards," it effectively becomes a national standard and that's a large problem.

In relation to track access, we've had ARTC take up the network in New South Wales, so the one-stop shop is closer than ever before. We have simplification in New South Wales, but when you stand back from it, to get now from Brisbane to Melbourne, before you dealt with two track owners; RIC and ARTC. Now you deal with three, four or five. I'm not sure. You deal with QR, because they've taken back

the track between Brisbane and Border Loop - 100 kilometres of track - so you need an access agreement with them. Then to get down to Sydney you need one with ARTC. If you want to sort of turn right anywhere, you have to deal with RIC. As you go through Sydney you've got to deal with RailCorp and then you get down to Victoria and you're dealing with ARTC again, so simplification leads to more complexity. To get around New South Wales, you need three access agreements. So it is getting more and more complex. Does that matter? I don't know. There's a lot of administration goes into dealing with all of this.

MR WEICKHARDT: Presumably, in the US if you're going from east to west you would have sort of multiple track arrangements too.

MR JEREMY: Yes, that's right.

MR WEICKHARDT: And it works there.

MR JEREMY: I think the Surface Transportation Board - I'm not close enough to this - has a basic sort of standard of what they call "trackage rights", and so there is a sort of protocol across the network as to what you can expect, whereas here, when you negotiate with QR for your access agreement, the operating standards and the environmental protocols and things that you've developed for ARTC are not good enough. You have to completely reformulate and reformulate them, and they've got a different format, and you get quite material misalignments between the bundle of rights and obligations that you negotiate with each track owner. You can also get misalignments of term, so you might get five years in Queensland but 10 years in New South Wales. It's quite messy, there's no doubt about it.

As I go back to my other point, that increases the problem about the lack of long-term certainty. It's very hard to get, and making the track access arrangements click - like sort of Lego - across every border is a real art form.

MR BANKS: Are there any solutions to this? What are your views about how we can move forward in that area?

MR JEREMY: I can't see any short-term solution. I think it's something we have to live with. I can't see the Queenslanders, for example, giving up their network any more than you could expect the ARG in Western Australia to give it up.

MR BANKS: Is it a problem that the sort of principles out of, say, the national access regime and so on are too loose? There's not sufficient higher level guidance? I know that NECG has talked about getting more national coherence in the regulatory framework generally. Would you comment on that?

MR JEREMY: On the one hand, yes. On the other hand, I'm wary of too much prescription in this area, I think, because one size doesn't fit all. We have a real problem, I think, in the system at the moment in that it's designed on the assumption that one size does fit all, so it's like the first to negotiate an access agreement sets the standard and what's good, for example, for intermodal traffic isn't necessarily any good for steel traffic or coal traffic, or what's good in the Hunter Valley is not necessarily going to be right for the Queensland coalfields. So there does need to be flexibility. They're more behavioural and institutional problems, I think, than problems with the access regimes themselves.

MR CARSTAIRS: Can I also repeat the point that Henry made very eloquently at the beginning, which is that there is a major regulatory design task here, which is to seek to move road out of a setting which looks 10 or 20 years out of date and which is a reform with a good deal of complexity and challenges in it, which the Productivity Commission is very well placed to think through and articulate how it could best be addressed. Perhaps that higher inconsistency in a regulatory setting and government settings is the priority.

MR BANKS: Good.

MR WEICKHARDT: I have one last one. Just going back to road pricing, I see a recent article talked about the German experiment with mass distance charging as being "one of the biggest industrial and political flops since the war", which is a big claim.

MR BANKS: The war was a pretty big flop for them too.

MR WEICKHARDT: And you quote the fact the New Zealanders have moved this way. I'm a bit out of date, but four or five years ago the last thing I wanted to do as a purchaser of freight services was emulate the conditions in New Zealand. I mean, are there any sorts of best practice examples where mass distance charging has actually worked?

MR TAYLOR: I have a couple of comments about that. One is, I would say, that full-blown mass distance charging is still in its infancy. By full-blown mass distance charging, I mean charging for both mass and distance, and the complexity with that is distance on its own is easier, because you can track a vehicle with satellite technology and all sorts of other microwave technologies and so on. Mass is a lot more complex, because you actually have to know how much is in the truck. So I would say it's evolving and it's certainly moving forward very quickly, with some successes and some failures. I can't talk to the New Zealand experience in particular, but certainly in Europe, in particular, there's lots of emerging experience in this area and that will unfold in the next 12 months to two years.

I think, though, that thinking of it as something that is introduced carefully and in a staged way is the way to look at it, rather than thinking that this is the panacea from day one, and perhaps distance charging is the place to start rather than mass charging. What I would say, though, is that rail has a very particular problem, which is that if you look at the trucks that are competing with rail they are heavily laden and they're highly utilised and so the problem of the undercharging of those trucks is particularly extreme, because they are able to amortise the cost of registration over very large volumes, very large distances, over a 12-month period. So ultimately mass distance charging is the solution. I think, though, it will need to be staged to be successful.

MR JEREMY: I would have thought too that you could make some assumptions on mass for a B-double or a B-triple that would be roughly correct. I mean, we know what the average mass per TEU that we carry is. It generally turns out to be X, and you can have weighbridges and intervention to sort of audit that from time to time. So I would have thought a rudimentary preliminary system is quite feasible, and the technology will develop. But we're not calling for an overnight change here. We're saying, step number 1, it would be very healthy to have a recognition that there is an issue here, because there are a lot of people putting their heads in the sand about this. There's an issue here. We need an agenda to deal with it, we need to do our homework about it and then we have to have a sensible transition into some sort of new regime for road and rail. So we're not talking about shocks to the system, but the end result should be a much more efficient transport system: use trucks where they make sense and use rail where it makes sense.

MR BANKS: I think that's probably a good note to end on. Thank you very much. We're going to proceed almost directly to the next participants, but I'll just break for one minute to meet them. Thank you.

MR BANKS: Our next participants this morning are the Railway Technical Society of Australasia. Welcome to the hearings. Could I ask you please just to give your names and your positions or the capacity in which you're here today, please.

DR LAIRD: Yes, Philip Laird, and I am chairman of the government relations committee of the Railway Technical Society of Australasia which is a technical society of Engineers Australia.

MR HONAN: My name is Andrew Honan. I'm a government relations committee member of the RTSA.

MR BANKS: Thank you very much for attending today, and thank you also for the submissions. In fact, we have a submission from Dr Laird as well as a submission from the society. So thank you for those. I'll leave it to you to make whatever remarks you'd like to make in support of those submissions.

DR LAIRD: As we said, under the national competition policy, as it touches on land transport, there is much unfinished business. If we look at it since its last almost decade, on the good side we have seen rail competition for freight help to improve service and cut costs. But the lessons seem to be that it works best when the infrastructure is strong enough and robust enough to support competition, and this is the case on the east-west corridor. It took about four decades to bring it up to its present condition going back to gauge standardisation in the 60s, Australian National's 25-year concrete resleepering, more recently the ARTC.

Now, from Melbourne to Perth, 96 per cent of the track has good alignment. There's only the bit over the Adelaide Hills with the tight curves and the steep grades. Most of it is concrete sleepered. West of Adelaide you can run double-stacked containers which improves productivity. By way of contrast, on the north-south corridor, between our three largest cities of Melbourne, Sydney and Brisbane, it's terrible stuff. It's rated F for fail by Engineers Australia in infrastructure report cards, and I'll say more about it later.

On the bad side of national competition policy, we see the use of tranche payments in 1995-96 to force New South Wales to adopt the National Road Transport Commission first generation charges. It's almost a travesty. The Industry Commission, your predecessor, in its 1992 annual report made it very clear that they thought of charges that relied only on fuel and annual registration charges, despite an intergovernmental agreement allowing for the option of a mass distance component, was really bad and it would distort the market as rail reform progressed. How true that was, whoever wrote that and signed it off in 92.

I think Fred Hilmer, in his 1993 report, with his co-authors, recognised that in

order to make these sorts of reforms work we would have to look at road pricing as well. In general, we suggest NCP needs a bit of a revamp and it also needs more of a triple bottom line approach and more consideration given to ecologically sustainable development. NCP has been given very strong support by our system of government but it does need finetuning to be a bit more environmentally and socially sensitive.

Coming to land transport again, we've done the sums, and here I've relied on the University of Wollongong research, supported by the Rail Cooperative Research Centre and Railway Engineering and Technology, and we counted up how much money the federal government has spent in today's dollars over the last 30 years. It seems that they've spent $58 billion on roads, of which about 24.5 billion was for the national highway system, and of that, just over 5 billion was for the Hume Highway; about 2.2 billion for rail and about 1.8 billion for urban public transport in today's dollars.

Our submission refers to externalities in some depth. We pick up on the ARTC track audits estimates and the study done for Queensland Transport. These estimates of externalities were revised and they appear in the main submission. Further work suggests that even those Queensland Transport estimates are conservative, and work published recently by Austroads, looking across externalities, shows that they're much higher than appear in the track audit. You're looking at 2 or 3 cents per net tonne kilometre for road and perhaps one-tenth of that for rail. But that's in urban areas because a large part of that is congestion, air pollution and noise. Move away into rural areas and they're lower, of course.

One of the problems of national competition policy is we are now conducting a giant experiment: does vertical separation of rail work? The presentation this morning was very revealing but I'd like to put some flesh and bones on it. Our submission refers to a Sydney freight bypass recommended by the Productivity Commission in 1999 and supported strongly in the 2001 track audit, but it's yet to start - five years later. But on 6 November 1998 the ABC's 7.30 Report went to air showing the antiquated safe working system requiring something called a staff between Casino and Acacia Ridge. That system is still there, six years later. It delays trains over half an hour. Every time a train costs - research for Queensland Transport showed a few years ago it cost $106 just to stop that freight train for four minutes and then get it rolling again. With the number of trains, it therefore adds up to over a million dollars a year.

And yet, this is still here, and because ARTC have the New South Wales section, Casino to border loop and QR, and the Queensland government have the northern section, how many more years before we finally bang enough heads together to get technology which a vertically integrated train operator would have had within 12 months. In 1995, in the rollout of the One Nation work, there was

going to be concrete resleepering near Maroona, near Ararat, as part of gauge standardisation. We went for the vertically separated model as of June 1995 and those sleepers sat by the track for four years.

Similarly, it was going to be putting in a triangle to allow Sydney, Cootamundra, Parkes, Perth trains, the preferred route of National Rail and now Pacific National, for most but not all of their Sydney-Perth trains, so it could turn left at Parkes rather than having to turn right and then bring in other locomotives and a whole lot of shunting to turn the train around. That stood there for four years. As I said, the freight bypass: over five years it has been recognised as crucial. It's the number one red spot in the country. The signalling system, six years. Going north into Queensland, Caboolture-Landsborough is the most heavily congested piece of single track in the nation. Yet Queensland had money in their budget in the 90s for it. They had option 2 duplication with deviations worked out last year. Politics intervened on 15 January this year. The Queensland premier and his outgoing transport minister said, "Stop, we won't build it because a few pineapple farmers are unhappy," and the local member, a government backbencher, was concerned.

Look at the wrangles with freight terminals. We're supposed to be an internationally competitive nation sitting on the Pacific rim and what are we doing to resolve these intergovernmental wrangles that go above and below? It just doesn't make sense.

So, to conclude, coal we move fairly well, but are we pushing down the freight rates so much that there is nothing there for the track upgrades that would give the true technical efficiency for the coal, let alone improve passenger services to the people who mine the coal and transport it? I think we've perhaps exported a lot of the benefits from the improved productivity and maybe we've gone just a bit too far that way.

Our iron ore - it's a real success story - the best in the world; over 220 million tonnes a year now get moved out of the Pilbara, some in trains over 300 wagons long, the most energy efficient trains in the world. This much diesel - less than a litre of diesel will move one tonne of iron ore from Mount Newman over the Chichester Ranges down to Port Hedland and bring the empties back. Nowhere in the world is it so efficient. But look at our grain. You know, we might in a bad harvest say 13 million tonnes noted in the ARA facts book, freight task of 5 billion tonne kilometres, but in so many mainland states our grain network is at risk. It's an unintended consequence of privatisation but it needs addressing, otherwise we can throw it all on the roads and it won't just be going to rural silos, super silos. Some of it will be finding its way into our capital cities or regional towns such as Port Kembla or Portland with all those externalities.

I've spoken about externalities. Greenhouse is one of them. We live in a time when oil prices are going to be going up and up. Rail freight is three times more energy efficient than road freight on average, for non-bulk freight. Surely to heck we should be getting some efficiencies built into the rail system and removing some barriers from the use of rail by subsidised highways. To conclude, before handing over to Andrew to look at urban transport briefly, we have a vision. Between Sydney and Melbourne track laid down in the 19th century, much of it between Cootamundra and Campbelltown, was rebuilt in the 1910s, easier grades but at the expense of adding a lot more curves, 20 K more of track. We could build 200 kilometres of new track today over the next five, 10 years, it would get rid of 260 kilometres of steam-age alignment where trains wander 30 circles to the left and then 30 circles to the right - alternated, of course - and save each standard freight train, two locos only, over 1300 tonnes of fuel; save as much in braking costs; save track maintenance. And the indicative cost? Well, who knows what it is, but the benefits are certainly there. It might seem a big ask - 200 K - but bear in mind Queensland, assisted by coal freight rates that are better than today - we built 160 kilometres of track between Brisbane and Townsville in the late 80s and early 90s, and the AusLink white paper provides for rebuilding of 120 kilometres of track between Maitland and Brisbane. Thank you.

MR BANKS: Okay, thank you.

DR LAIRD: And if I could ask Andrew to briefly address.

MR HONAN: Just a short comment on urban transport. I think one of the missed opportunities for the national competition policy was in fact in the urban transport area. If there's a review of it we'd like to see much more focus on urban transport and we'd commend the commission's approach to using COAG as the forum to address the issues.

There are many externalities, of course, in urban transport in terms of the private motor vehicle, so we see that there is an opportunity for rail and, in particular, public transport in general, to connect up between the different modes. We look at the system in Sydney where we have a bus system and a heavy rail system and in many ways they substitute one another. I think there is an opportunity to have a look at basically the operations of the public transport and the interplay of the public transport with the motor car to get a much more efficient outcome for Sydney.

I believe that one of the shortcomings of the system in Sydney is the lack of, I suppose, long-term planning and the lack of long-term investment for public transport. It seems that in an age when private motorists have been able to get increased capacity on the road system, new freeways, it's hard-pressed for rail and public transport in general to get either additional capacity or get improvements in

service performance. We believe that there should be a higher level of investment in service performance for public transport and probably a better mode shift, or a mode shift towards public transport.

We commend some of the statements by Pacific National in terms of urgency. We see it as a very urgent problem for Sydney transport. We have an action for transport plan which was put out some time ago and now that seems to be just gone by the wayside. There is no effective planning for Sydney transport. It seems to be just an ad hoc type of arrangement. One of the ways that I think public transport can be improved is in fact the using of intelligent transport systems, real-time transport systems. There is no-one in the private industry who will pick up real-time information systems for public transport.

We see that telematics for the motor vehicle will be motivated by motor vehicle companies and private motorists, but we see no appetite for governments to take on board real-time information systems for public transport. We think this is fundamental in actually connecting up the modes. For us, in the rail, we see an opportunity for rail to partake in much more of this passenger task. So we would commend that the commission takes this to COAG. We see that, as I say, as an urgent matter for us. Really, that's all I'd like to say on the matter.

MR BANKS: Thank you for that. We've got a number of questions and I suppose one is that you know, having sat through the earlier presentation, there are a couple of issues that came out of that to give you the opportunity to comment. One was, I guess, the overriding issue of the intermodal problem between rail and road, whether you have any comment on that, or further comment to make?

DR LAIRD: Freight terminals have been also subject - intermodal road-rail terminals have been subject to inordinate delay with the New South Wales government planning processes. National Rail wanted to build one at Enfield and in the end it gave up and further developed the Chullora one. There is a case here which I understand is subject to a dispute over who really owns it, whether it's Pacific National or Queensland government - but I think the comment most resonated from Pacific National was the urgent need to address road pricing, and I differ in only one respect - I think the New Zealand experience has been, since it was introduced in 1978 - by and large successful. It helps very much that it's single jurisdiction, compact country, but the road user charges are kilometre based on the configuration of the vehicle and the declared mass of the vehicle.

The technology has advanced enormously since then and I think the way forward would be hopefully that the National Transport Commission, in its third determination, will have a distance differentiation as well as a mass differentiation, as was provided for in the intergovernmental agreement it currently operates under.

But I think we're perhaps looking at need for further measures. The AusLink green paper at least floated the idea of a national transport advisory council to try and drive the reform a bit harder, a bit quicker, I think. The question of externalities does need addressing and yet the initial indication from the NTC is the third determination will probably find that not there, so we're losing valuable time there.

The other thing that we would support would be - and did support - the recommendation of the commission five years ago for an inquiry into road provision, funding and pricing. We really need, as a nation, quickly to lift the level - the public debate - on the way we fund our roads and the way we price them. I think an inquiry is a good way. So there are three options: there is the COAG, there's the inquiry process or a national transport advisory council.

MR HONAN: I'd like to just make a comment on the Port Botany expansion. It seems that in the lack of any state plan on how transport is to function, we have this approach that we have a proposed Port Botany expansion but there's no real mechanism - if you read some of the submissions by Pacific National and indeed the Sydney Ports Corporation - where they say, "We anticipate" or "We hope to have a 40 per cent mode share on rail," and yet there is no active policy that will make that happen. It's just an expectation or a hope. We say that we have high hopes for these things but low expectations for many of these inquiries. The Port Botany inquiry is one that sort of just sits around without any guidance as to where it fits into both an urban form and to a transport task.

MR WEICKHARDT: You talked about the grain network being at risk. I see the Bureau of Transport and Regional Economics recently said that there are some grain lines where the recovery is 7 per cent of operating costs. If it's as low as that it would seem to me, even if you did price road, allowing for mass and distance, it would be very difficult to justify a recovery at 7 per cent of operating costs. Are there parts of the grain network that just aren't economically viable even if they were priced at a competitively neutral level?

DR LAIRD: I think you'd have to look across each line individually. I think the figure of 7 per cent must be an extreme low case.

MR WEICKHARDT: Glen Martin from the Bureau is quoted as saying, "New South Wales grain lines recover 7 per cent of operating costs."

DR LAIRD: Difficult to comment on that. I haven't seen the figure. It strikes me as somewhat low. I'd add the point though that the road wear and tear is a lot more on rural roads of light construction than it is on, say, parts of the Hume Highway, which at great capital cost had rigid pavements with concrete. I think, secondly, each state is different. It appears to our Victorian chapter that there was a four-year

maintenance holiday going on before privatisation to American interests. The maintenance holiday took a different form with the operator who has just sold out becoming renowned as a distinctive above rail operator but really cutting costs on below maintenance. So now there's a question of whether even Australia could supply the wooden sleepers needed to rehabilitate the lines.

In WA there are different contractual arrangements which will change next year. I think the thing to do though is to avoid the situation that Mr Fischer, former deputy prime minister, said: "We'll one day live to regret some of these lines that we have closed." I think we have to be careful that we look at all the costs rather than just some of the costs, as tends to be the case.

MR WEICKHARDT: Just on those costs, the National Transport Commission is, I understand, deliberating on this third stage assessment. What is it that, if you like, in their constitution or remit or range of authority which prevents them from reaching a satisfactory outcome in terms of a competitively neutral pricing road?

DR LAIRD: I'd suggest it's very, very hard when you're an organisation that has done the first determination and the second determination. You've gone out and got the consultants and you've published the reports that say that the aggregate level is about right. It's very, very hard for you to have the credibility to come out and say, "No, we got it wrong in the first two determinations and it should be double that." But at the end of the day, it's a very assumption-sensitive area. There are huge data deficiencies out there to deal with, but the Bureau of Transport and Communications and Economics, as it was in 1988, produced a report, "Review of Road Cost Recovery" or a title like that, that found articulated trucks were underrecovering by about 1.2 billion a year.

At that stage, very broadly, the articulated trucks were paying about 400 million a year. The former Interstate Commission - which indeed ended up in the Industry Commission - felt that obviously it was somewhere between 400 - you know, the bureau was too high at 1.2 billion and the industry is not paying enough - and put a way forward with both externalities and mass distance pricing for the heavier trucks. Then to governmental agreement: the first one said, "The charges would be determined by an overarching group of officials," and then they walked into the special premiers' conference in July of 1991 and a funny thing happened on the way to the forum. Those charges were set aside and it was agreed that the new National Road Transport Commission would determine the charges. Surprise: they were revenue neutral.

They got consultants to say that parameters that had been attributed to equivalent standard axle load kilometres should be, you know, nice, easy, friendly passenger car equivalent units or vehicle kilometres and then your Bureau of

Transport and Regional Economics is now taking the view that, "Well, on aggregate, the charges are sort of okay," which in my book, contradicts their findings 16 years later. Probably the truth is halfway between. Again, the one in 1998 was too high and the current view, that in aggregate they are paying about right. You know, it should be somewhere between it but to expect the NTC to basically say, "We got it wrong the first time," and the second time, with the second determination, circa 2000, is a very big ask.

Maybe there is a role for the National Transport Advisory Council and there is, we believe, a role for the commission to highlight the issue and to try and advance the agenda, because whilst it continues we will continue to have the situation where over 10 million tonne a year of Sydney-Melbourne intercapital freight is carried mostly at night by an army of over 3000 heavy trucks. If we continue with business as usual, in 10 years' time you might as well close down the Maitland-Brisbane line, because it will only be having about half a million tonne a year on it, instead of the one it has got at the moment.

MR BANKS: All right. Well, thank you very much. As I say, thanks for coming along to discuss the submissions, as well as the submissions themselves. Had you planned to put in any sort of written response in response to the discussion draft? I mean, you're not obliged to, but just to get a sense of whether you intended that or not.

DR LAIRD: Yes, we were pleasantly surprised, I think, to find your interest in passenger transport. Material which we had directed to your concurrent inquiry into energy efficiency we would be happy to send to this inquiry as well, and we would be happy to make, on the freight one, just a brief one, but I think the bottom line is that we support the commission's draft recommendation that it is a matter to be taken up at a COAG-type level to get the quantum leap forward, just as in 1991. You know, we wouldn't have had a National Road Transport Commission with all the benefits of harmonisation of Road Transport Regulations, or a National Rail Corporation, had it not been taken at the prime minister and premier level. I think we have reached the point again.

MR BANKS: Yes. All right, thank you very much.

DR LAIRD: Thank you.

MR BANKS: Again, we will just break for a minute before the next participants. Thank you.

MR BANKS: Our next participants this morning are from the Association of Consulting Engineers Australia - ACEA. Could you please give your names and your positions with the association.

MS CHARLES: Therese Charles, chief executive of ACEA.

MS GRAYSON: Nicola Grayson, senior policy officer, ACEA.

MR RIDGWAY: John Ridgway, senior policy consultant, ACEA.

MR BANKS: Thank you for taking the trouble to appear this morning and also for the submission which we've received. As I indicated, perhaps you might like to just make the main points you'd like to raise in support of your submission.

MS CHARLES: Thank you very much. Perhaps I might just start off by saying a few words about what the Association of Consulting Engineers of Australia is. We are a business association representing the interests of consulting engineering firms, who offer consulting engineering design services in the market. We have most of the large consulting and medium consulting engineering firms in Australia in our association, but we also have a very large number of small firms. There are about 300 firms in total.

Our members have designed a lot of the major facilities and infrastructure in Australia including the 2000 Olympic Games Stadium Australia, Superdome, Olympic Village, Sydney Opera House, Darling Harbour, Star City Casino, motorways and international projects such as the Singapore Exhibition and Convention Centre, Hong Kong Airport et cetera. I might say that although our firms are both large and small, in terms of very large corporate bodies, such as governments, even our large firms are relatively small in terms of their capital holdings, and that will go to some of the points that I would like to make today.

In general can I say that we're very happy with the Productivity Commission discussion draft. Our organisation and the members of our organisation, our firms, are heavily involved in the production of infrastructure in Australia and we believe that the competitiveness of the development of infrastructure in Australia can be improved and we support in general those recommendations. The major point though that we would like to pick up today is a point that has to do with the competitiveness of government activities in the production of infrastructure, so perhaps I might go into that main point and that will be the major point we will make today. It is our intention to put in a more substantive submission in which we will express further the points I will make today, but we will also tackle a bit more in depth some of the areas of infrastructure that you have mentioned - for example, transport et cetera.

The public sector is a major client for our consulting engineering firms. It comprises approximately, we would say, about 50 per cent of our market and some particular firms who do particular kinds of projects - it constitutes the whole of their work - working for the public sector. Perhaps I might give an example of the kind of public authorities that our members work for, and we recently reviewed a sample set of client contracts in New South Wales and the larger clients involved included Department of Public Works and Services, New South Wales Land and Housing, Department of Transport, State Rail Authority, Sydney Water, Rail Infrastructure Corporation, Roads and Traffic Authority, TransGrid. They're just the big ones in Sydney. This list can be expanded through multifarious other New South Wales state agencies and all of the local councils throughout New South Wales who let projects of various kinds and, of course, you can multiply it by eight in every state, because we are a national organisation. I make that point to indicate that we have a very large interface with the public sector in the production of infrastructure in Australia.

The client organisations, by their nature, tend to have major market power in our area. In most cases they are monopolistic power because, for example, roads and traffic authorities produce roads in Australia and they tend to be a monopoly supplier. I will give an example of the departments of main roads. I should make the point that when I make examples I'm not suggesting that the departments of main roads behave any differently - either better or worse - than other authorities; it's merely an example so that you understand the points that we're trying to make. Departments of main roads are responsible for a network of national highways and state roads. The projects they let include minor works and discrete major projects that are significant in scope and cost, like freeways and motorways.

The work is mainly done for the DMR, the Department of Main Roads, as client, but they use private sector suppliers and they operate under commercial contract. They involve significant delivery of services, we would maintain, in the context of carrying on a business. In general, there are no competitive private sector clients for their service requirements - that is, they are monopoly clients. You can make similar remarks about the projects of Sydney Water, Department of Defence, state rail authorities, Energy Australia, Department of Education and Training Services, Health Commission and other departmental work.

The services that they require are either delivered by private sector service firms under commercial contracts directly to the client, the department or the agency as client, or under subconsultancies agreement through contractors that are engaged by the client. However, the point is that the kinds of conditions that are demanded of firms come down from the client; the control lies at client level. In contrast to such leviathans, the consulting engineering industry is generally characterised by

relatively small firms with limited market power and low capital bases, and that is true even of our largest firms. Consulting firms are heavily dependent on the clients for work and survival and the impact of withdrawal of business or termination of contract is potentially devastating.

Now I'd like to make some remarks on the crown as a business. The Trade Practices Act binds the crown insofar as it is carrying on a business and the objective was, amongst other things, to expose government agencies to competitive pressure; it was about competition. Our submission will have some argument, legal argument which says that the drafters of the TPA - their intent was not that some departments and authorities engaging in commercial activity would enjoy a degree of immunity from the act, they intended that the departments be covered. This is evidenced by the government's policy of competitive neutrality, that business activities don't enjoy competitive advantages over private sector competitors simply by virtue of the fact that they are public, that potential resource allocation distortions arising from public ownership need to be eliminated, and that there be fair and effective competition in the supply of goods and services.

However, competitive neutrality does not recognise formally in practice that the principles and requirements of the TPA should be applied when the government is procuring the services of the private sector, but only in circumstances where they are directly competing. We believe that both competitive neutrality and the TPA should clearly apply in procurement situations because of the significant market power that the public sector client holds. It's particularly important where such immunity contributes to a distortion in competition frustrating the intention of the national competition policy reforms.

We recognise that there are some problems. One is the lack of clarity of application of the TPA in Australia It doesn't include definitions in the way that the New Zealand act does, in a way that would reduce some of the anomalies in this area; and we talk a little bit about that in our submission. There is also the issue of public benefit, and we clearly recognise public benefit in the activities of government agencies. Our submission and our case is about those of their activities that are basically commercial in nature and that are, in our view, carrying on business.

An example which I would take from your own discussion draft is you mention the Olympic Games would be seen to be an act in the public interest, or for public benefit. We would agree with that in the overall management of such a great initiative as the Olympic Games. I guess we would say, though, that in the actual working through of the contracts that deal with the games, they involve delivery of routine services within the framework of the games - for example, the design of stadia, sports halls, environmental remediation, development of a mass transport system, lighting, road and rail development. All of that our firms do every day.

Other departments do it every day. In terms of those particular aspects of the games, we would think that they should be subject to competition principles and not exempted on the basis that a stadium for the Olympic Games is in some way in the public interest in a way that a stadium somewhere else is not.

Now, what are the impacts? What it basically means is that in the working-through of contracts, you'll have harsh and oppressive contractual terms. Basically, it's "take it or leave it" standard form contracts. Examples include requirements for excessive and unreasonable levels of professional indemnity insurance, which effectively shift the total liability and risk for projects to the consultants; unilateral variations of contract; very high standards of care, which in some cases are unachievable; responsibility for the information of the client lies with the consultant rather than the client; liquidated damages in the head contract; absolute fitness for purpose warranties; strict compliance with very complex and detailed specifications; certification of compliance of design; liability for consequential loss; and indemnities and duties of care of various kinds that the engineers just cannot comply with.

These infringe the principles set out in section 1 of the TPA, but the reason we are here today is we believe they also have a significant anti-competitive effect. Basically, the effect is that the contractual terms are so harsh and oppressive that it raises the height of the barrier of entry to the market. Smaller consulting engineers who have the skill and the capacity to participate in the market cannot enter the market because you have to have significant financial resources to be able to afford things like the professional indemnity insurance cover that is demanded. Where you have unilateral variations of contract you have a problem that only very large firms that deliver multiple services can in fact guarantee; that if there's a change in the contract conditions, they can deliver the service that the contract has been signed around. Therefore the market concentration has increased, because what effectively happens is the small firms are unable to compete.

We have a classic example - it isn't the only one but it's one which we felt was good enough to put into the document. We had a medium-sized consulting engineering firm with over 30 years of experience and a track record of award-winning bridge design. This is one of our best engineering firms in Australia. They're niche designers; they work through a medium-size firm. They were the initial successful tenderer to a government client for a $3 million bridge design project for which the consulting fee was $50,000. They were told that they were the preferred supplier. The PI insurance demanded by the client was $20 million. The firm had PI cover of $15 million.

They went to their insurer and said, "Look, I need another $5 million of cover to do this job." The insurers said, "Well, okay, but it's going to cost you X," and

basically the cost of the cover would have made nonsense of the fee. On this basis, although they had been notified they were the preferred supplier, they withdrew; they could not meet the PI requirement. I would say to you that this same client, a few months later, because of the complaints that were made about the high level of cover they wanted, actually reduced their standard cover to $10 million, so this consultant could easily have met that and could have done the job; but by the time that the reduction was made the tender had been awarded to another consultant who had the $20 million cover, and that was a major firm.

So there you have a clear example where small firms just cannot compete. We would like, therefore, the TPA to be able to apply to cases like this so as to try to promote a more competitive regime and in the long term a more efficient economy. We note the NT Power case, which has highlighted in the Northern Territory an incident that if a government authority is found to be conducting a business, a broad range of activities relating to the business are subject to the act, and it demonstrates market power; so we are somewhat encouraged by the fact that if that particular case is taken note of by the authorities, there might be a regime that takes more strength in applying the act to public authorities.

I think the only other point that I would make on this is that we are talking about infrastructure and supply here - that is, supplied by our firms - and if the infrastructure reform that you're talking about to make the nation more competitive and the economy more competitive is to occur, most of it is done with public sector suppliers and we would see that - this point we are making - that there should be much heavier application of the act to public sector clients in the commercial environment - tougher. If that doesn't happen, the delivery of infrastructure, we believe, will be not in the interests of competition, or at least not as in the interests of competition as it could be. Mr Chair, I have mentioned that when we make a formal submission to you we will be talking a little bit about other areas of infrastructure, particularly transport; we've done some work on transport. I think, though, the main point we want to make is the one that has to do with the Crown as exempt from the TPA. So I will finish my comments there. Thank you for listening, and we're happy to answer any questions.

MR BANKS: Thank you. I guess just one sort of slightly - well, a related question from what you've just been talking about: I'd be interested in your views as to why in effect the public sector entities operate in that way, because in some respects they're denying themselves services that would well suit their needs, and perhaps better suit their needs. I mean, what's the explanation for the manner in which they're seeking these kinds of harsh provisions and so on?

MS CHARLES: Well, I could make a comment and I think John could make a comment too. I think - and I'd have to say to you this is opinion rather than fact -

that there is quite often a lot of bureaucracy involved in procurement and the departments and agencies are not necessarily averse to a small pool of clients as opposed to a large pool. It's much easier to select. Secondly, I think that particularly on the issue of insurance the public sector tends to be very risk averse and its answer to problems of risk has not been to find a model of risk for public sector clients that is realistic. Its answer has been to cover every hole everywhere and protect the public everywhere, but in such a way that we contend they're not actually protecting the public. It certainly has an anti-competitive effect. John, you may have a comment on that.

MR RIDGWAY: Yes, Mr Chairman, I think one of the other issues here is that over the years the nature of the consulting engineering industry has changed in terms of its relationship with clients and certainly in its relationship with public sector clients, whereas two decades ago public sector clients were very well educated in terms of understanding the technicalities of consulting engineering. In other words, they knew and understood the services that they were buying.

The situation has changed and whereas most public sector organisations have now shed their engineering divisions and rely fairly heavily on the private sector to provide engineering services, there isn't the level of understanding in government of the nature of the services they're procuring. What they're doing is protecting their patch, in effect, by ensuring that the risk and the conditions of contract are such that risk and liability passes from them to the consulting engineering organisation.

MS CHARLES: An example I might give of that was we had a visit a few months ago from one of the foreshore authorities in New South Wales and they told us that something like about five years ago they had 400 engineers. They now have four. So when contracts are written now, they tend to be driven by the lawyers rather than the technical people, because they don't have technical people.

MR WEICKHARDT: You quoted the Northern Territory Power and Water case and said, "If notice is taken of this." As I understand it, that was a High Court decision. I'm not a lawyer, but it would seem to me that people can't refuse to take notice of the High Court. It can't go any further than that, can it?

MS CHARLES: You'd have to be confident, just as we are sitting here saying that you have to take notice of that, that all the authorities in Australia will also take notice of it and say, "Gee, we could be sued under the Trade Practices Act, we'd better change our ways." I am not so confident that that will occur. I think what is far more likely is that one of our firms, or us, would have to take a case on the basis of the Northern Territory case under the Trade Practices Act to make the point. We can't afford it. They can't afford it. I guess what we would like is for the Productivity Commission to make the point in cinemascope and technicolour so that

the public authorities know that there's an issue there which they do need to take account of, without us having to take them to court.

MR WEICKHARDT: I don't wish to demean our authority in this regard, but I would have thought the High Court probably in pretty technicolour had made the point. However, I'm not legally proficient to judge that.

MS CHARLES: Nicola might have a point there.

MS GRAYSON: Yes, Mr Chairman. I just want to add that, while that case took us some way forward in terms of broadening, the court said that it broadens the application. It still didn't specifically deal with our point about government procuring the services of the private sector. That bit still remains fairly unexplored. That's really the heart of what we're trying to put across to you in our paper.

MR BANKS: Thank you for that. I understand that you'll be making this as a formal written submission. We look forward to receiving that and thank you very much for coming today. We'll just break for a moment before our next participant, thank you.

MR BANKS: Our final participant in this morning's session is the Australian Telecommunications Users Group Ltd. Welcome to the hearings. Could I ask you, please, to give your name and your position.

MS SINCLAIR: Rosemary Sinclair, the managing director of ATUG.

MR BANKS: Thank you for attending today and also for the submission which you have sent in response to the draft report. Perhaps you might to like to give us an overview of the points you want to make.

MS SINCLAIR: Okay. I thought I'd make my remarks in four sections. Firstly, just to take a moment to explain who ATUG is and why we're interested in this whole discussion and particularly to just make some points about the e-economy and productivity for business and the connection we see between that rather large agenda and competitively priced connectivity for telecommunications services, then spend a little time explaining why we support the Productivity Commission's draft recommendation on telecommunications and then to perhaps outline where we'd like to wind up in the industry, very broadly. I should just make the point that the submission that is before you is a preliminary submission, and we'll be taking the opportunity to update our thoughts and make a further submission by 17 December.

MR BANKS: Good. Thank you.

MS SINCLAIR: Firstly, just on ATUG, we are a member subscription funded lobby group, essentially, which is focused on telecommunications services for business users. We don't receive any government funding for our work in this area. So our point of view is independent but partisan, in the sense that it represents the interests of our members. Those interests increasingly take us not only to business use of telecommunications for its own sake but to the availability and affordability of services to residential end users, because of the use of this technology increasingly by business and government agencies to deliver services to consumers. We started life representing medium to large business in a very clear way but over the last few years we've become very interested in consumer end issues, because of the importance of communication services to all players.

So we have a set of focus policies that we work out each year and core in those focus policies is competition and the effectiveness of competition, the role of innovation and infrastructure and, flowing from that, a set of issues around the access regime and anti-competitive behaviour. Then we go into some specific areas of broadband mobiles, regional services and so on. But at the core of our interests are the very same subjects that have been canvassed in the competition policy review, which is the reason we were interested to participate in this discussion.

My next set of comments is really about why we care, in a specific sense. I'm not going to spend a lot of time on this, because I think that the essence of any of us having an interest in competition policy and national competition policy goes to the effectiveness of infrastructure services and the role in competitively priced available infrastructure to the health and wellbeing of the economy. We'd like to put particular emphasis on the e-economy and communications in the context of that debate about where the next quantum, if you like, of productivity benefit or outcomes is going to come from that increasingly commentators are arguing is necessary as a response to the sorts of issues raised in the intergenerational report.

One of the responses to that is improved productivity, and we see communications services playing an important part in that. We keep an eye on various reports from the OECD which continue to make the point that ICT pervasiveness - use in economies - is correlated with productivity benefits and growth, and that really is the central issue for us here. We want to make sure that Australian businesses and Australian end users are enjoying the kind of business productivity and productivity in government services and so on that are being enjoyed by our competitors around the world.

Over the last ten years or so, that has been an item of increasing importance on the agenda of the economy. The role of ICT and communications connectivity for us is a critical component, especially in a business world that people describe as a networked world or a world of web services. You can talk about all of that, but if you can't get access at reasonable prices then you limit the effectiveness of those initiatives. Then I wanted to go perhaps more specifically into why we support the recommendation in the draft report that the matter of structural separation ought to be looked at in the context of the 2007 review and the suggestion that that review ought to be brought forward, given the agenda of privatising Telstra, albeit that we've not yet got a date on that particular activity. It seems that the policy imperative is definitely taking us in that direction.

In that context, could we go to the submission that I sent, starting on page 8. Rest assured I won't read through this, but I do just want to make a couple of comments for the record. The most relevant part of this submission is our assessment of the current state of competition in telecommunications. We base this on a number of sources, attempting to use robust and factually based evidence for the policy positions that we put. It's very easy, on this particular subject that I'm talking about, for people to develop all sorts of positions over barbecues, but the position that we're taking is coming from an analysis of quite a significant amount of data that the ACCC puts out in its market indicator report.

It paints a picture of market share of various services, and we think that that market share picture demonstrates very well the point that the commission makes

that we've still got a very dominant player in this market after a number of years of open competition. A number of other people go on to make the point that those market shares translate into a very significant profit share for the entire industry, variously put at between 90 to 95 per cent. I think it is important to make that point, because even in the commission's report we have reference to the number of licensed carriers having gone from three to 100. It's very important to understand that those other carriers are sharing a very small percentage of the overall industry profit, the point of that being that you need companies to be making profit to invest in the sort of infrastructure that we would want them to invest in, to make sure that we get to a very robust base of competition.

We think the access regime is going to play a role for some considerable time to come, because of the nature of telecommunications that you require any-to-any connectivity. Even if we get a lot of infrastructure competition in this industry, we're still going to require an effective access regime. The ACCC also reports on price changes. Our concern about the last report there is that, if the industry were as competitive as we would have hoped after this time, we would have expected to see continued price decreases, particularly given the role of the price control regime in this industry which is to allow rebalancing of the fixed access service.

So those prices are going up under a controlled path, but they're going up. So we would have expected all the other prices to be coming down as a consequence of that. The detail in the ACCC report indicates that that is not the case. I refer to some work we did ourselves some time ago now, focused very much on the corporate sector. The other piece of work that I looked at in this context was to try get some comparison with international prices, and I know the commission did some work some time ago on international benchmarking.

We look at the OECD's Communications Outlook, which comes out every couple of years, to see whether Australian users of telecommunication services are in the ballpark we would expect in terms of prices for baskets or services, and our assessment is that we're in the middle ranking rather than where we think we should be, which is in the top 10 - paradoxically in terms of the best prices - so not the highest prices but the lowest prices. Again, we think that's an indicator that the market isn't as competitive in Australia as in some other places. So that's ACCC and OECD.

The other thing that I have referred to in here is work that the ACA - the Australian Communications Authority - does. I think this is an important contribution because, whilst I understand that most of the argument is based fair and square in the discipline of economics, it seems to me that robust sampling of what the end users think about all this is a relevant contribution to the debate, and their perception is that fixed line rentals are too high and that there is some decreasing

satisfaction with the amount of competition in the industry, with 50 per cent of households being only satisfied with the level of price competition and only 54 per cent of small businesses. So I think that there is a role for that information to be part of our deliberations on all of this.

We would say that all that shows that competition is not yet effective, so there's a continuing role for regulation. As the Productivity Commission's draft report points out, regulation has been adjusted over the last couple of years to try to make it more effective in dealing with the issue of market power, I guess, in summary. But our assessment of those changes is that they're proving rather more difficult than we perhaps all hoped when they were introduced and, in particular, the accounting separation regime is not proving as effective as we would have hoped in terms of providing, I guess, a substantial finding that wholesale customers of Telstra are being treated even-handedly.

I find it very paradoxical that we have information from the ACCC which, on the face of it, indicates that there is equivalence there and yet, amongst the competitors, a higher degree of dissatisfaction. Recently, of course, there's the matter of the broadband wholesale pricing vis-a-vis the broadband retail pricing and the fact that competition in broadband, which was once described as a born competitive market - I mean, we were on a journey from the fixed telephone service through to mobiles, where markets were more competitive and ideally broadband would be even more competitive than mobiles.

It seems to us that the role of the fixed network in DSL-delivered broadband has taken us back to square one again, and to think that the competitiveness of that market is, from our point of view, being managed by a competition notice that was applied in April of this year - that's still standing - is a very strong statement that competition isn't effective and that the regulatory regime isn't working the way we would have hoped. We think that the fixed network - the copper network - is going to remain a very important technology for some considerable period of time to come. I think when the regime was introduced there were thoughts that that might not be the case; that mobiles may take over the role of the fixed network and that perhaps in time wireless services and other services would do so.

We think it would be interesting to have a look at that in, say, five years' time, but the amount of technology development around the copper network would suggest to us that that infrastructure is going to be relevant to our discussions on this industry for a considerable period into the future. So we're not seeing new technologies perhaps as the panacea that we might have hoped once and, at any rate, we would still then have the access regime issue, because of the any-to-any connectivity problem. Even if I'm connected via a wireless access service, I need to talk to you and you're connected by a fixed-line service, so we're still going to need that access

regime.

The outcome that we want, just to conclude, so that we can perhaps take some discussion, is really a regulatory regime that's very focused on encouraging infrastructure competition. We think the regulatory regime that we've got is competitively neutral and we're looking for something rather more positively pro-competition in terms of infrastructure development. We think the issue of market power is not being effectively addressed by the regime and, thirdly - and this is very much from our point of view - where markets fail, in the sense of not being large enough to attract commercial investment sustainably - such as in some regional markets and remote markets - then we see a role for direct government subsidy to assist the development of services in those markets.

I think we've got much more clarity now than we did seven years ago on where those markets are and the role for government subsidy in addressing those markets and not expecting the competition regime to extend into places where there simply isn't enough demand to make an ordinary commercial model work. Perhaps if I stop there.

MR BANKS: Yes, thank you. That's been very useful. I guess the three things that you've ended up on - and, in particular, the question of market power - you've supported our call for review of Telstra's structure prior to the sale. We'd be interested in your views on what the right answer is. Certainly, in our report we indicated that there are pros and cons either way.

MS SINCLAIR: Yes.

MR BANKS: We're not starting with a clean sheet of paper; at least not any more.

MS SINCLAIR: No.

MR BANKS: Therefore, it is a complex business.

MS SINCLAIR: Yes.

MR BANKS: But do you have any views? Have you had an opportunity to think through those?

MS SINCLAIR: Frankly, we agree with your perspective that it's a very complicated issue. The thing that has been frustrating us is the fact that this matter has not even been allowed on the agenda in the Productivity Commission's own review in 2001. There was no term of reference and, in fact, a direction not to look at this issue. Perhaps it was too early in 2001 to think that the regulatory regime

might not be working.

Since then, of course, we've had the ACCC's emerging market structures report and, after what I thought was a pretty careful deliberation on the subject, they expressed concern that market power from existing markets could be parlayed into new markets, so that the kind of competition that we're expecting from new infrastructures isn't going to emerge. They called for consideration of the topic, and that's where we stand. We want this topic considered. We're not, at this stage, saying that this is the only answer - structural separation - but it seems to us that what we've tried to do, with information and record-keeping powers in the current regulatory regime aka the accounting separation reports and tools and so on, doesn't seem to be getting us anywhere.

My understanding is that the ACCC has some concerns about the clarity of the information between retail and wholesale because Telstra's business is not organised that way. So maybe the separation we're looking for is a next step from accounting separation to some more internal separation. Then, some of our members will argue robustly for the network retail - the services infrastructure separation model - but if you want to argue that then you've really got to spend some time figuring out how we get from here to there and that's a difficult call. But on the other hand, the value of an effective telecommunications market to the whole country is very significant.

Our position, of course, is that the relevant stakeholders are the users of telecommunications services who are trying to run businesses, who are trying to deliver government services, health education, Centrelink, so on and so forth, and consumers who have social and personal lives to lead, for whom communications is absolutely critical. So, in the context of national outcomes and the national economy, then we think where we're up to with telecommunications is not far enough. Certainly, the further privatisation of Telstra would seem to create a situation with market power that the ACCC has expressed reservations about.

We, as a user group, take a lot of notice of that. If the independent regulator says, "We don't think we're going to be able to cope with this," then that's something we really listen to because of the impact of this industry on telecommunications users. That's what they're saying and they've been saying that for quite some time and every time you read their annual report they're still saying, "We think there's an issue of industry structure." They're very careful to nail the problem - industry structure - and call for, I think, a careful analysis and consideration of an appropriate next step. That's why we're very interested in the recommendation but we wouldn't be prepared at this moment to say, "We think that Telstra should be structurally separated and that's the only answer."

MR BANKS: Thank you.

MR WEICKHARDT: Yes, it's sort of interesting and somewhat relevant that we had submissions this morning from very different technology - probably 19th century versus 20th century technology - where an industry rail which has been structurally separated is saying, "This is wrong." We got a submission this afternoon from NECG who have argued that there are potential losses of efficiency by structural separation. So it's not clear what the real benefits might be, to me, anyway.

MS SINCLAIR: No, although one of the things I did want to say is your draft report talks about additional transaction costs, moving from internal to external contracting. I'd make the point that there's a lot of external contracting going on, on the basis of efficiency gains. So it's not simple and certainly, as a rail user, I watched that debate from a layperson's perspective to find the separation of infrastructure from retail has, it seems, led to poor reinvestment. That is an issue in this industry - in telecommunications. Nobody wants the copper network to fall over, least of all the telecommunications users of Australia. Nobody wants that outcome but what we do want is an outcome that says, "Okay, that is going to remain bottleneck infrastructure for a considerable period of time, through generations of technology to come."

An access regime which puts all the parties on an equal footing and says, "Negotiate commercially," when one player in the industry is so dominant in terms of market share and profit, is not an access regime that's working. I think what we're doing is trying to make it work whereas what we actually need to do is to go back and have a fundamental look at whether, given the level of market power, there is an increased role for the regulator. Perhaps the collection and provision of information doesn't include end users. Perhaps we don't need to understand what the network costs are but I think individual competitors, one-by-one, trying to have this debate, is not effective when the other side of the negotiating table is very powerful.

So the philosophical approach we've had of light-handed regulation - let the market work, competitively neutral level playing field - I think it's that set of issues that we need to really look at for telecommunications and if we have experience from other industries to say that structural separation results in efficiency losses, then I, for one, would say, "Well, let's not go there but let's do something else."

MR WEICKHARDT: And do you have any idea of what something else might be?

MS SINCLAIR: We've made various suggestions in various places, like, to the senate inquiry looking at the privatisation of Telstra. We made some quite specific suggestions about the role of the ACCC in, frankly speaking, just setting prices. We say, if you've got bottleneck infrastructure then do away with commercial

negotiation. Let's not pretend that we're on a level playing field here. We'll declare that there's significant market power and I'm talking about all sorts of powers and processes that don't exist but you say, "Okay, that's bottleneck so we're going to set prices for that elsewhere," because you just can't get to a commercial incentive despite all the chat about valuing our wholesale customers, to then go down the broadband track.

That just makes a nonsense of all that, to have just dropped retail prices ahead of any consideration about wholesale prices. It lingers longer with us because we're supposed to be on a journey towards more competitive markets and more competitive behaviour and bingo, we get into the brave new world and how do we get competition there? With a competition notice. It has been in place from the 4th to the 11th and not a whole bunch of happy, competitive campers that we can see. I haven't come with an answer. I've come to support the proposition that we actually need to talk about this and we certainly need to talk about it before the further privatisation of Telstra.

I note with interest that this debate is going on in the UK. Ofcom has put out a series of what we regard as very worthwhile contributions and reflections on the same set of issues. They have different processes but it's interesting that other people around the world, in markets that we would say are much competitive than our particular market, are struggling with these same issues of going forward; how do we make sure we get the competitive outcome that we're looking for. In that market, the dominant player doesn't own the cable network and hasn't for some time owned a mobile network so there's not the degree of vertical integration in that market that there is here. The cable network infrastructure gets discussed with much enthusiasm.

We say that the OECD, who has, frankly speaking, little commercial interest in what's going on in Australia, has a very clear position that the ownership of the cable network by Telstra stifles competition in broadband; a very clear position, and from our point of view a pretty rigorous analysis of why that's the case. In that context we were really concerned when people started talking about having to have access holidays from a regime that we don't think is particularly effective now for building up the fibre network. Well, you know, we just think that those kind of suggestions really ought to be nailed, stopped dead in their tracks, because the last thing we want is another updated new technology bottleneck infrastructure.

MR BANKS: You mentioned the OECD, but they've been quite ambivalent on the question of vertical separation.

MS SINCLAIR: Yes, they have.

MR BANKS: As well, haven't they?

MS SINCLAIR: Very, very.

MR BANKS: Again, from a fairly independent perspective, so it gives one pause - - -

MS SINCLAIR: Yes, it does. It does. That's why I'm not in here to sort of - ATUG's position prior to open competition - we argued very strongly that there should be network co and services co. That was our position. We argued up hill and down dale and in all the corridors in Canberra and it was a very heartfelt position. It didn't go that way. We can 't easily see how you get back to it, but we think it's important to have the debate because if the right questions are asked and the right skills are applied to the topic, then perhaps there are solutions that the user group can't see in terms of financial structures and processes and hybrid securities. There may be other ways of getting to that point, if a proper review decides that that is what is needed; that there is no other solution for this particular industry.

MR BANKS: Good, thank you.

MR WEICKHARDT: And wireless technology, your members aren't optimistic about?

MS SINCLAIR: No, very interested - and very recently we've come back from visiting 21 regional centres all over Australia looking at broadband and it's a good example of how we work on issues. We got to a point of saying, "Okay, we've got policy, we've got programs, now what we need to do is go and stimulate demand." Because there's nothing like a bit of demand to bring competition in and in certain regional markets competition will fix it. Well, what we discovered with wireless is that there are some interesting niche opportunities in conjunction with DSL or satellite. So you get satellite to a point and then wireless, or you get DSL to a point and you get wireless. But you've got that interconnection all the time. There is not the kind of wireless solutions all by themselves existing independently as infrastructure from other forms of infrastructure.

We're very keen about wireless and in fact the ACA's been looking at spectrum allocation for broadband wireless access. We're very supportive of the direction that they're going, which is very pro-competitive in terms of the ownership outcomes: who is going to own this spectrum. In our submission to that inquiry we said the ACCC ought to look at whether there should be competition limits to make sure - if we're going to use an auction based system, you see, you run the risk that the person with the deepest pockets can turn up and buy all the auction. If we want wireless to be seen to have any role as a competitive infrastructure then we need to make sure that there are competitive owners of wireless infrastructure, and then we need to

make sure we've got an access regime and an anti-competitive conduct regime that deals effectively with the interconnection of those wireless networks with the main network. Little, regional wireless ISP negotiating interconnection arrangements - it's a case study of what's not working with the current arrangement.

MR WEICKHARDT: Thank you.

MR BANKS: All right, thank you very much again for attending. Did you say to us that you were going to provide us something more?

MS SINCLAIR: Yes, I am.

MR BANKS: All right, we'll look forward to receiving that in due course.

MS SINCLAIR: Yes, thank you.

MR BANKS: We'll now break for lunch. We're scheduled to resume at 2.15. Thank you.

(Luncheon adjournment)

MR BANKS: Our first participants this afternoon are from the New South Wales Council of Social Services. Welcome to the hearings. Could I ask you please to give your names and positions?

MR MOORE: Gary Moore, director.

MS THOMSON: Maz Thomson, deputy director, administration.

MR BANKS: Thank you very much for attending this afternoon. As we discussed, perhaps you could just raise the main points you'd like to make and we can take it from there.

MR MOORE: Firstly, thank you for the opportunity to come to today's hearing. Our comments are mainly going to be made in the context of lower income Australians. We believe, in looking at the draft report, that the evidence is still not clear that the introduction of NCP has bought far greater benefits than cost to low-income Australians. We think that is especially true for those in those urban and rural communities that have very high levels of social disadvantage. Although low-income households income has risen over the decade since 95, we note that the inequality gap with higher income Australians has widened. It is certainly arguable whether price increases in a basket of essential goods and services such as housing, utilities and health care costs have been addressed by the income rise that those low-income Australians have had. We do believe that social disadvantage and exclusion has been reinforced for many locations and some population groups during that 10-year period, or almost 10-year period.

Turning to the four headline conclusions in the report, in relation to productivity surge and increasing incomes, we would note that economic restructuring and improvements in productivity have of course occurred, but have also seen we believe longer working hours with impacts on work/family balance; a degree of compulsory unpaid overtime becoming a norm in several industries; the major elements of job creation over the decade have been in part-time and casual employment; we note that women still earn approximately 70 per cent of wages that men do and we also note a growth of working poor, full-time jobs in some service industries particularly in some elements of the declining manufacturing sector.

In relation to your conclusion about NCP reducing the prices of some goods and services, especially for business users, we would ask you to note - but I think as you also in your own report have - that average real prices paid by households for services such as electricity, water and urban transport, have in fact risen over the last decade or so, and we know from our own work in relation to greater Sydney that in 2003-04 prices for items such as energy, water and public transport have all risen at 5 per cent or more, whilst prices for out-of-pocket health expenses, child care fees

and certain insurances have all increased well above 5 per cent.

In relation to your conclusion about expanding the range of products available for consumers, it is certainly true in many areas but we would urge you to note the affordability impacts, particularly for higher quality products - for example, energy efficient whitegoods and their impacts on lower income households. We'd also ask you to note the current levels of personal debts in Australia and the greater vulnerability of low-income groups, through competition, driving poorer lending practices within the banking sector - which we believe the governor of the Reserve Bank made some comment on a few weeks ago.

In relation to the conclusion about helping to meet some environmental and social goals, we would agree that there are certainly some positives, as you've noted in the report, but we would ask you to look at the following: there is and remains a significant inconsistency in terms of concessions policies across Australia, and we also believe a significant inadequacy. Of course, the Senate poverty inquiry tabled earlier this year relates specifically some recommendations to that. In human services, there are examples of market funding practices that are leading to poor results for clients and a concentration of ownership and control of services by a few large agencies. So, in fact, the adoption of some market forces in some areas with government funding is having a reduction of consumer choice and a concentration of ownership.

The lack of application of a robust public interest test, we believe in cases - and particularly true in this state, such as alcohol retail and gambling products - creates concern for us. Of course, we note with alcohol retail a further concentration of ownership. In New South Wales we have a form of deregulation of the taxi industry which is in fact producing a two-tier system without significant price decreases or improvements in standards. We should note that 14 per cent of taxi users in Sydney are in fact low to modest income earners because of the poor lack of public transport in a number of areas. We also would note that private motor vehicle use imposes much higher costs on low-income people. Some Victorian research recently suggested up to 28 per cent of total income of lower income groups is used, plus the general environmental costs on the community.

So having said that, in terms of forward actions the sorts of things that NCOSS would like you to explore - and certainly we will go into some detail in our formal submission in response to the paper - is to look at reforming the public interest test to make it more comprehensive and meaningful. We do support the proposal for a COAG-auspiced review of health and we do believe that's significant and important, but we also think there is scope to look for review of concessions and passenger transport provision, and that needs to be on a national basis.

With health we think it's critical that in terms of looking at any such review, there needs to be firstly a mix of adequate, acute primary and community health care benchmarks which can be set for any community to receive; that all options in the Commonwealth-state financial relations are assessed if transfer of responsibility to one jurisdiction are suggested, and that the relationships - and we note, of course, your other report on economic impacts of ageing population - between health care, community care and residential care systems are reviewed.

We think with the national electricity market that we should be looking at establishing national benchmarks for community service obligation payments in that market, and we are concerned that we're not very - we don't seem to have made, in our view, very much progress in that direction.

MR WEICKHARDT: Sorry, I missed that last point.

MR MOORE: We don't feel very much progress has been made in that direction and we think that's a key feature of the NEM, or should be a key feature of the NEM. Can we also say, in line with your other report on economic impacts of ageing, we don't assume necessarily that greater productivity gains will create the GDP growth required to fund services for our ageing population, in the same way that you don't - or certainly make comment in that. So it is very important, we think, that we should be looking at tax reforms, including intergenerational transfers in that area. So in conclusion, we endorse a number of things that the draft report says. The comments I've made relate specifically, we think, to either areas where the draft report hasn't looked, or hasn't looked firmly enough at impacts for low-income people, communities, and those are some of the forward actions we think should be looked at for being potentially recommended in the final report.

MR BANKS: Good, thank you. We can give some reactions, I guess, to what you've said, but we'll look forward to seeing your written submission. I take the point that you've made in relation to the perspective that you've got on the distributional side of things and anything further that you can point to in your submission where we need to do more work, we'll certainly do that. I should say that at the level of modelling - which has its limitations and we found the limitations are most extreme when you try to model distributional effects - we have tried and, in fact, there's work ongoing to do that. I guess the purpose of that work is to show, or to understand to what extent some of the direct price effects may be ameliorated by indirect price benefits from business getting lower cost inputs.

That's very hard to work through, but the old Industry Commission did some work some years ago that showed that there were some indirect effects there, so we'll try to get that work together. That's one bit of work in progress that we've got going there. I don't know about Philip but you've mentioned concessions a number of

times and you've talked about the need for national benchmarks. Would you like to just elaborate on how you see that being operationalised; what your vision would be for the way that might work?

MR MOORE: We actually think it needs to occur through a COAG process. It can't occur really in any other way. There are questions and obviously our experience is mainly from a New South Wales level but I'm sure our colleagues in the other state and territory COSS's will concur with this, that we have to have a proper discussion about the level and scope of income support into the future in Australia, delivered by the Commonwealth. At the same time, we have to look at how we get some equity across the country in terms of even if we just look at the basic essential goods and services. So through utilities, through transport - those ones in particular. If we don't, we simply have the situation of huge differences experienced by lower to modest income people continuing.

Of course we also have the issue of price rises being differential, depending on different housing markets, different capital cities, different locations, and we do need to look at things in that sort of equation. For example, at that level, about rent assistance - and I know we've talked about this in another place, in terms of different markets. The only way it can be done, in our view, is through a COAG process. From NCOSS's perspective we would think there needs to firstly be some agreement about what the Commonwealth and what the state actually offer in concessions. Then, moving from there, try and get some agreements about some benchmarks which also reflect differential prices in different locations, and starting small; concentrating on two or three key areas and trying - we think, unless that process gets followed, we'll just have a continuation of what we've got.

MR BANKS: The other question I was just going to ask was in relation to the public interest test. I guess it struck us - one of your colleagues, I think, came to a round table we had in Wagga in New South Wales and Robert Fitzgerald kept asking the assembled throng questions about the public interest test and kept getting blank looks. It dawned on us after a little while that most of the people there who are quite interested in the issues and have been following things, didn't really know about the public interest test or how it worked, which seemed like a bit of an indictment to us. You will see in the report, we've laid out some of the problems, but I'd be interested in whether you had any particular suggestions in relation to how it might be improved. Indeed, we've talked about, in terms of a forward program, whatever that might be, that a public interest-type test would be an important part of that. So any suggestions you have would be helpful in that context.

MR WEICKHARDT: Can I just sort of ride on the back of that? You said in your submission actually that there were unrealistic expectations of community involvement in the public review exercise. I guess I'm not sure what is a realistic

expectation but how do we make this work as it was conceived in theory?

MR MOORE: Obviously, in our submission, we will go into some detail about this but I guess one of the first things is, it seems to us - and also now from my own experience of working in the New South Wales government in recent years and doing legislation reviews under NCP - the public interest test is sort of right at the bottom of the concern. You kind of do everything else and then you worry about this benchmark down here. So the first thing is somehow or other that you actually get it sitting in the core as it was originally envisaged in the 95 principles, et cetera. It seems to us that there has got to be an element of independent assessment. One of the things we'll explore in our submission to you is the relationship between public interest and social impact assessment in planning laws and other things in cabinet submissions, et cetera.

Once again, we think it would be good to have headlines of five or six - or probably a few more - an agreed set of benchmarks that are measurable - or as much as possible measurable - that everyone understands and operate in the same sort of way - because I think that's one of the other problems in this - that measure up to a range of what we could call social factors and consumer protection factors. I understand they are laid out in 1.1.3 originally. There should be a bit of a best practice guide about - there are a range of different consultative mechanisms with consumer and community interests that might be relevant or proportionate to the sort of thing that you're looking at doing, and giving some guidance about that.

So they're some of the things that we'd like to explore in terms of trying to elevate the importance, talk more about a consistent approach and a set of kind of benchmarks, almost like pulling from a suite - the benchmarks that kind of reflect the different things in 1.1.3, and then consultative practices which are proportionate to what you're actually doing. Is it my understanding it's the National Competition Council that would promote presumably - or COAG - in terms of this? So we will explore that a lot further in what we give you in writing.

MR WEICKHARDT: You started off your presentation saying the evidence is still not there that national competition policy has brought benefits to lower income people.

MR MOORE: No. We said we're not sure whether the benefits outweigh the costs, as you've said generally in terms of lower income Australians, and the reasons that I gave are that we acknowledge that the bottom has moved up, income wise, but the gaps between lower and higher income Australians during 10 years of growth - we believe the evidence is there to suggest it has become greater. We believe the price increase is cumulative over that time for essential basket of goods and services and may well outweigh that income increase.

MR WEICKHARDT: May?

MR MOORE: Yes, and the problem there, in part, goes to the question of inflation, how you calculate it, and the discretionary income that lower income people actually have. We argued this before IPART in New South Wales. When they talk about water pricing or energy pricing now, you've got to look at the collective effect on lower income people; the things they can actually afford, put together, because discretionary spending just doesn't exist on other factors that go into the calculation of CPI. That's why we say, "may". I can't say to you I don't think there's any evidence to say one way or the other that, for us, what we get through our member organisations, clients' experience from the field would suggest that that's certainly tenuous. So that's why we make that statement for lower income Australians.

We also acknowledge - or should acknowledge - that prices in greater Sydney, of course, are highest in some of those baskets of goods and services in the country and their rate of increase, particularly those that have something to do with housing-related inputs into the economy are greatest.

MR BANKS: The question I was going to ask you is, we raised the question of consumer protection policy as something that may be worth looking at - and as we indicated in our report, from two sides, one is in a more competitive environment. Are they still doing their job in terms of protecting consumers' interests and from the other side, are they equally operating in a way that's not impeding business-producing income and so on, which will also benefit ourselves. Do you have any views about whether it's worth doing that?

MR MOORE: Can I say in some of the areas that affect us or our constituency, and if I go to the example of gambling - for example as one - I think there is some real virtue in having a look at that, because once again, we have a set of regulatory regimes across the country which consumer protection and harm minimisation sitting somewhere as one of the objectives, which we suspect doesn't deliver nearly enough on those particular objectives. We have in this stage a regulatory regime in gambling which is antiquated and ridden, we believe, with a conflict of interest. It doesn't measure up to modern industrial regulatory consumer protection practice, no separation of powers, no independent consumer complaints and it may arguably be, in the future - and you talk in chapter 10 in the human services arena about some of the reforms - well, if the market reforms continue to the extent that we believe that they in some parts are, we do need to be perhaps looking at independent probity advisers, at other forms of appeal mechanism in the market sort of sense which we don't currently have.

So probably the way I could answer it is for some of the areas that we are

interested in, which kind of verge on market mechanisms and have some relationship with NCP thrust, the answer would be yes, I think it would be important to look at what would this consumer protection mechanism look like. In relation to some of the utilities areas, I think we would probably say in New South Wales that IPART has performed a very important job in that area, and I guess we do remain a bit concerned in terms of the national electricity market and if we were to have a national water market, in terms of whether in fact New South Wales particularly residential consumers - that they may in fact experience a downgrade to what they currently have.

MR WEICKHARDT: A downgrade in?

MR MOORE: In terms of assessment of the social impacts of pricing, pricing reform and change. I guess also I should say with the energy and water ombudsman scheme in New South Wales, the important role that that scheme has played in terms of changed corporate behaviour amongst the distributors and retailers in terms of their activity with residential consumers in particular. That is a concern for us. I know that - yes.

MR BANKS: You made the point that as long as price signals remain a prime mechanism to manage energy and water consumption, that low-income Australians will continue to be disadvantaged by that, but do you think with a properly designed CSO scheme that you can get the best overall effect, or have you got an alternative to that sort of concept fundamentally?

MR MOORE: I think the two things need to happen: a properly designed CSO scheme that is adequate, and the second thing is demand management assistance to lower income people.

MR BANKS: The?

MR MOORE: Demand management assistance, so by that I mean - for example the group that is most vulnerable in New South Wales are large low-income households in private rental. In more medium-term senses they are the group that has less chance of getting retrofitting to their properties, and less chance of ever being able to afford the five-star energy and water appliances, rather than the guzzlers. So, sure, one thing dealing with bills and transfers through CSOs, but another part of the CSO thing is how do we make low-income people participate in energy and water efficiency and demand management. It seems to us that there are little pilot schemes operating around Australia out of - depending on the jurisdiction CSO approach, but it's really ad hoc, it's spread everywhere. Those sorts of things, we think are really important if long term.

MR BANKS: You make a comment - no, actually that's the ACOSS one which I'll save for Melbourne. Just getting back to the CSOs and the concessions and so on, you talk about inconsistencies. I think you raised that around the jurisdictions. One of the great things about a federation - it has its downsides but one of the upsides is I suppose you get to compare what different governments will do. Some will do things better than others.

MR MOORE: Yes, sure.

MR BANKS: But are there any jurisdictions which you would want to identify where this has been done better?

MR MOORE: Yes, in terms of energy concessions, I think Victoria is leading very strongly there in terms of having a more universal rebate approach than elsewhere. I am probably not in the position to say with water and transport where else. I think one area where nobody is doing very well, which is a very difficult area, is that group of Australians who are non-health care card holders, non-Centrelink beneficiaries, but are very low waged workers, you know, with average household incomes, well below the sort of state average male weekly earnings. We still haven't worked out - I mean, I know there's a policy question about whether they should or shouldn't be in CSOs, but we don't have a simple administrative regime.

I mean, certainly other countries do through taxable income and using the tax system and the tax information. There are downsides with that in terms of people's movement in and out of employment and this occurs, and I suppose we think if we're liable to see a continuing growth and I'm not saying we don't have the evidence about where that would go to, but if the mixture of people in sort of part-time employment and very low-paid full-time employment continues to grow a bit, we've already got a significant number of those people - they're probably almost the most marginalised in this sort of area. Sure, they earn more than people on benefits, but once again, particularly living in cities like Sydney are massively disadvantaged in terms of some of these costs and can pick up no assistance through formal CSO policies.

MR BANKS: Okay. The other area that you've raised is the question of - you just talked about it then, human services and to what extent reforms there have been helpful or not, and I think ACOSS has also raised questions about that. I guess I'd be interested in any views you have on that and in particular how things could be done better. You know, what are the areas where particular attention has to be given in order that some of these competition-related reforms will generate maximum benefits, or minimise the costs?

MR MOORE: I guess NCOSS itself has become a lot more involved in the past couple of years with what we would call sector development, or industry support

activities. We all know we have thousands of small to medium-sized organisations, a number of which are becoming increasingly unviable, and in a sense some of the market reforms in fact are accelerating that process. We think a big area in the human service that must be focused on is the area of pool purchasing and share back of the services. Those things need to be - and government, we believe, needs to think about that in an investment strategy way, in its role of funding often in human services, and working in partnership with the peak bodies in the sector, because we don't want to see 15 big organisations running 70 per cent of the service outlets in the future.

Part of the reason for that is that a lot of services can much more deliver far better results that are locally focused, locally responsive, locally owned as well, too. So we don't want to lose that side of the equation in Australia. There is a question about what we would call the role of government in working with the sector in structural reform, particularly in the back office. We are facing big issues of skill shortages into the future and we already see it within parts of the allied health area, parts of residential aged care and children's services, and part of that is also the atrocious money that people get, too.

But if you assume, once again going to the ageing population side of things - and I think you make the point or the commission makes the point in a report about the importance of community care, but the concern about the availability of skilled carers into the future - that's a big issue we should, in our view, be starting to address in a workforce development sense right now. So they're some of the things which are - - -

MR BANKS: The point you made about pooling and shared back office - can you give me a tangible example of how that might work?

MR MOORE: All right. We've been doing work with SACOSS through 30 NGOs that employ between one and five people that are locationally based outside of Sydney in a region at the moment, getting them to look at all of their inventory supply, how could they pool a contract with local providers so they keep the work in the region? Then, with shared services, how could they share an accounting service, a legal service, a strategic planning service - that kind of thing. So it's about keeping the business in the for-profit sector in the area, reducing the unit costs and keeping the viability. It's commonsense, I suppose, in that sense, but for our sector we've not been in that arena ever, and we've had an explosion of small to medium-sized organisations. We'd far rather see that approach than simply unfettered market forces at the end of the day creating a human services funding situation where, in fact, the 15 big ones just get bigger and bigger and bigger all the time.

MR BANKS: Okay. Good, anything else?

MR WEICKHARDT: No, nothing.

MR BANKS: All right, thank you very much. We look forward to seeing your submission.

MR MOORE: Thanks a lot.

MR BANKS: Thank you. We'll just break for a moment before the next participants, thanks.

MR BANKS: The next participants are from NECG. Welcome to the hearings. Could I ask you please to give your names and positions?

MR ERGAS: Thank you. I'm Henry Ergas from NECG-CRA and I'm joined by Paul Paterson, also from NECG-CRA and also with us is Trevor Lee, who is group general manager, regulatory, from ENERGEX.

MR BANKS: Thank you very much. Thanks, Henry, for appearing twice today. We have your submission which is a very substantial one and we'll give you the opportunity to speak to it.

MR ERGAS: Thank you. What we intend to do is to simply pick upon on a few points that emerge, not so much from our submission, as from the draft report that you issued and, in particular, I'll address the questions to do with structural separation vertical integration, then touch briefly on the issue of mergers in the power sector - ie, in electricity - and at that point I'll hand over to Trevor Lee, who will discuss the issues concerned with the regulatory framework, in particular the framework for the energy industries, but also for the other regulated parts of the economy.

Thank you for this opportunity to address those issues, and I'll go through them as quickly as I can so that we can then have a bit of time for discussion. Let me start with the issues associated with structural separation and vertical integration. As you know we discussed those issues at some length in our submission. The essence of the view we adopted was that there should not be a presumption in favour of structural separation or vertical disintegration. In particular we noted that while there may sometimes be benefits associated with structural separation there are also substantial costs. Ideally the structure firms should be determined by market forces, including market forces in the market for capital, and that intervention should only occur after thorough review of the merits.

In taking those views, we accept that there is always a risk that firms with substantial market power that are highly vertically integrated, may seek to leverage the market power they have into competitive markets. However, economic analysis shows that the incentives for that type of leverage to occur are highly ambiguous, that whilst leverage may allow the firm to gain profits from increased sales by downstream affiliates, it has an opportunity cost in terms of the lost profits from upstream input sales. So even in terms of the leverage argument, any benefits of separation are ambiguous and will inevitably be highly case specific.

We equally don't believe that there is a well-established case that separation per se promotes competition. The reality is that there are many vertically integrated industries that are relatively highly competitive and there are some cases where

vertically related, but not integrated markets are not competitive. Generally the intensity of competition depends not on vertical integration per se but on factors such as demand conditions, barriers to entry and exit. The mere fact or act of separation does not alter those underlying factors which shape competitive conditions across markets.

We note the argument that has been put by the ACCC on a number of occasions that separation may make regulation easier or more effective, however, our view of it is that it is not the goal of policy to make the regulator's life easier. It is the goal of policy to promote an efficient economy. Additionally, the experience to date isn't so readily consistent with the argument that separation per se has a substantial effect on the ease or difficulty of regulation. Following separation, the noncontestable components will still need to be regulated. Equally, where activities need to be coordinated across the separated components, more regulation may be required than was the case in a vertically integrated content.

We have looked for evidence that might substantiate the position the ACCC has adopted on numerous occasions in this respect. In particular we've examined whether in fact in the Australian experience regulatory decisions are easier to reach, in structurally separated cases relative to those cases where the regulated entities are vertically integrated. To this end, we examined 42 regulatory decisions in gas, electricity, water and rail. 23 of those decision involved firms that were vertically integrated at the time of decision, and 19 involved instances where the relevant firms were structurally separated.

What we found was that quite in contrast to what has been asserted by the ACCC the average decision time of Australian regulators is longer for structurally separated businesses than for vertically integrated businesses. On average it took 22 months for a regulatory decision in instances of structural separation and 16 months in instances of vertical integration. The difference was statistically significant between those cases.

It is fair to say that the longer decisions have been especially prevalent in gas transmission, where the average duration of the regulatory process is 37 months. We therefore looked at whether the hypothesis that the ACCC had advanced might hold if one excluded gas transmission from the relevant sample and what we found was that when you exclude gas transmission there is no difference between vertically integrated and structurally separated instances.

In short, the Australian evidence - similar to the evidence in the United States - is that vertical integration or structural separation does not in and of itself affect the ease of regulation at least insofar as it can be measured by ordinary proxies such as the time required for decision. Where does that leave us? We believe that at least in

some cases there are significant costs to separation and those costs of separation - "breaking up" - in the words of the famous song - "is hard to do" - involve the loss of economies of scale and scope, serious problems when there are externalities between the different phases in the vertically related chain and, additionally, difficulties in risk management where the returns to investment depend on coordinating assets along the vertical chain.

As a result we believe there is an overwhelming case for being at least a questioning of the conventional wisdom in favour of structural separation as a precondition for regulatory reform. This makes us somewhat concerned about the recommendation that is advanced in the draft report in favour of review of structural separation of Telstra. We accept that it's possible to have an argument about whether there is continuing market power and the extent of that market power in telecommunications markets, but we don't think that that argument, or the outcomes of that debate, in and of themselves, tell you a great deal about the efficient vertical structure of the market.

What we have seen is that no developed economy has recently required structural separation for entities such as Telstra and, wherever that issue has been debated - and it has been debated extensively in many jurisdictions - there have been serious concerns about the technical feasibility, much less economic desirability of moving in that direction. Even in the United States - which is the only country in the OECD to have mandated structural separation - that policy has been very largely reversed, suggesting that the policy itself was not a success. As a result, we don't see what useful purpose would be served by instituting a process which could get a momentum of its own. It would encourage all types of rent-seeking to occur when the presumption must be that there is no case for the policy proposal.

Let me just move from that to say a few words about electricity mergers before handing over to Trevor. We are concerned that the commission in its draft report recommends a review that assesses the need for electricity-specific merger regulations. We understand it does so in response to concerns that have been raised by the ACCC, but we have no reason to believe that there are any issues associated with electricity mergers that could warrant a departure from the economy-wide framework in respect of electricity markets.

It seems to us that the commission, were it to recommend such a review - and we believe that such a recommendation would carry weight - would be rewarding the ACCC for complaining about the decision in the AGL proceedings and, in so doing, creating uncertainty about the robustness of Federal Court rulings. As you will recall, in the AGL proceedings the Federal Court decided that the relevant geographical market for the supply of electricity in Victoria was broader than Victoria alone and covered the NEM; ie, the National Electricity Pool.

The court also found that a occasional price spikes are not an indicator of substantial market power nor are prices that merely exceed short fund marginal costs. Additionally, the court found that vertical integration does not in and of itself raise competition concerns. Now, the ACCC disagrees with each of those propositions and argued vigorously against them in the proceedings, as both Trevor and I, who were witnesses in those proceedings, well know.

However, they had both the opportunity in those proceedings to present evidence that was inconsistent with the findings ultimately made, and they also had both the right and every opportunity to appeal from that decision; an opportunity the ACCC chose not to take. Since those proceedings closed the ACCC has presented no evidence or analysis that suggests that there is a substantial problem with mergers in electricity that the current economy-wide merger test cannot adequately handle, nor does the commission in its draft report point to any such evidence or have any reason for believing that there is such an inadequacy.

In those circumstances we question why the commission would recommend setting off a process which experience tells us is likely to acquire momentum of its own, particularly when that process is going to be conducted by an essentially industry-specific body. We would expect that the commission in its analysis of this issue would abide by its long-held view that industry-specific regulation should be very much the exception rather than the rule and that there would need to be a very substantial case made out before a move towards industry-specific regulation or a further move for industry-specific regulation occurred. That seems like a convenient point at which to hand over to Trevor Lee, who will look in a bit more detail at the issues associated with the regulatory framework.

MR LEE: Thank you, Henry. I don't have too much to add to what Henry has said about the question of structural separation. As he said, I was a witness at Loy Yang and I am really here to help answer any questions that you may have, except to say that in my view French J examined the case thoroughly and has come out with a proper interpretation of the law and, if the ACCC or anyone else disputes this, they could appeal. They have not done so. Some of the criticisms, I have to say, of the ACCC appear to be much more of a structural bent, whereas French J in my view, in his findings, concentrated more on behavioural and other matters, than structure alone. I'll leave it there and answer any questions.

On the general regulatory framework I'll keep my comments very short, but in essence I think it's fair to say that most regulated companies are pretty unhappy with the way regulation has continued, particularly in gas and electricity since 95. We've think the big residual problem of that first wave of reform was the way the businesses are being regulated. ENERGEX and Allgas have put in many

submissions to the Productivity Commission already and I don't want to reiterate all the problems we see in regulation. To summarise those very briefly, we believe that the building blocks approach, cost of service approach that is being applied to us, is certainly a case of gas - case of being incorrect under the law; it's against what we would deem to be the economic theory underlying national competition policy. As the UK review of the blackouts found, that approach undermines security of supply and also it hampers the companies when blackouts and other catastrophic events do occur, in recovering our position.

Those are the problems, but I think the solution the Productivity Commission has already come up with frankly, and that is that the template that it's put out for - in its final report for the gas access regime - energy companies believe that is workable and deliverable, not only for gas but also for electricity, and we deal with other regulated industries as well including telecommunications and the general feeling that I get is that that template will be suitable for all regulated industries. For the audience here, I'll just outline in essence, its basic focus is to transition companies that are performing well from what we might call heavy-handed regulation, under what the Productivity Commission calls tier 1. Eventually there was transition to a level called tier 2, which would be - rather than cost of service heavy-handed regulation - monitoring of performance in terms of trends in costs and prices and profits, and eventually, given passing a couple of tests, there was a possibility of being uncovered - that is, unregulated.

I'd just like to go back to tier 1 for a moment. Under tier 1, the commission recommended that alternatives could be proposed by businesses to the present building blocks model - in other words, something other than rate of return regulation. Secondly, if companies proposed a rate of return regulation then it could propose a model other than the one that is currently applied, what we call a KAPM model, or some other alternative, and if companies proposed plausible values in that financial model, then that would have to be accepted by the regulator. We applaud all those matters. We believe there are better alternative ways of dealing with cost of service regulation than building blocks and we have no confidence in the KAPM model whatsoever.

I think the Productivity Commission has accepted those technical deficiencies and under tier 1 the Productivity Commission has called under recommendation 711, for a study on perhaps finding a more robust way of dealing with this. I'm pleased to announce I think we've got the answer. Ergon and ENERGEX have employed KPMG and the Queensland University to come up with a method of dealing with those inherent technical deficiencies of KAPM. In essence, what they do is take the variability - on each variable that goes into the WAP calculation, use a Monte Carlo analysis to multiply those out to get a probability distribution, so that you have an idea of the probability or the degree of uncertainty if you like of whether you are

covering the true cost of capital.

When you then apply the principles such as the objects clause or decisions by the Australian Competition Tribunal on gas or whatever to that probability distribution, you can then decide what level of WAP, at what risk you have of covering the true cost of capital. So we think that is a first off way of dealing with those inherent technical deficiencies. On the tier 2, which is the monitoring option, we note that the Productivity Commission has said that the assessment by the regulator would not include an assessment of prices, and we agree with that. We also agree that the NCC and the minister should decide transition between tiers or uncoverage and not the regulator.

So in essence what we have is flexibility in the system to transition companies to an unregulated state - this gives us hope of something better instead of what we've had for the last almost a decade of going backwards. Hope of something better, rather than fear of something worse. It gives us flexibility and it gives us some control over regulatory discretion in the sense that under tier 1 we propose - businesses propose and regulators compare proposals against a criteria. The Productivity Commission has also supported merits appeal, which we do as well. That third element of limiting discretion is having decisions about transition decided by the NCC and the minister and not the regulator. So we are very happy with the Productivity Commission's suggestion and we think it should apply to all regulated industries. I'll leave it there. Thank you for your time.

MR BANKS: Thank you for that. I suppose any response on our gas report shows that the commission is not predisposed to always reward the regulators. I guess the question in this one is whether there are arguments on their merits that would require review and indeed - well, perhaps take you back to your initial submission where I think you argued at that time that there was a kind of logic to structural separation in the context of the Hilmer reforms at the time, which you clearly don't see evident any more - and I might just get you, Henry, to comment on that. You seem to be saying, if I recall your submission right, that the presumption at that time was fair enough, but by implication it's not any more.

MR ERGAS: I'm not sure we said or meant to say that; that presumption in favour of structural separation was necessarily warranted at that time. What I think is correct is that there were some better arguments for structural separation at that time than there are today, and in particular at the time of the initial Hilmer reforms there was a need to shake off incumbent management structures, shaped over very long periods of time under public ownership, usually in the context of entities that were run almost as ministerial departments. Splitting them up, giving more focused objectives, clearer accountability - that all made sense at that time. That shake-up has occurred and the arguments in favour of sticking by that policy have accordingly

weakened.

Additionally I think it's important to note that at the time of the Hilmer reforms, perhaps the crucial issue was not inefficiency in the use of labour - although that was certainly an issue at that time - but inefficiency in the use of the capital stock. We had a capital stock in many of the regulated industries that was over-dimensioned and reflected some degree of laziness in the management of capital assets by the regulated entities. As a result, one didn't need to worry too much about investment issues. The instances such as generation in New South Wales where it's taken quite a while for the legacy of excess capacity to be worked through and, since one didn't need to worry so much about excess - sorry, about investment - about ensuring that there would be adequate renewal and expansion of the capital stock - the risk-management difficulties associated with vertical separation were not as pressing a concern.

However, the reality now is that in a wide range of regulated industries we're approaching a point in the cycle where substantial additional investment is required and, if that investment is to be not underwritten and guaranteed by the public sector, but rather is to occur in a competitive context, even if you still have some degree of public ownership - if it's to be investment which is at real risk of stranding - then the risk-management problems associated with the inability to coordinate investment between functionally related activities; those problems are much more acute. One of the ways of interpreting what AGL was attempting to do in its partial ownership of Loy Yang was to precisely secure better risk management than it could obtain by any contractual means and that issue will be a pressing one not solely in electricity, where it has arisen first, but also in rail and in telecommunications, and if we in those circumstances - which are different circumstances from those that we faced at the time of Hilmer - persist in mandating structural separation, or even in having a presumption in favour of it, then we will inevitably pay some cost for that in terms of a higher risk associated with investment.

MR BANKS: In terms of the arguments for and against - I mean, is it true to read what you're saying as that in the case of Telstra in particular that there is no case - I mean, the case is so clear that there is no case effectively for review? Is that what you are saying?

MR ERGAS: I believe that to be the situation. Take what might be polar opposites - and my colleague Paul Paterson may want to leap in at this point, but if you take the rail network: in the rail network, at least conceptually, we know how to structurally separate. We know that there is something that you can roughly call "below track" and something that you can roughly call "above track" or "below rail" and "above rail", and we can define fairly stable functional interfaces that separate the below rail activities from the above rail activities, and though coordinating technically below

rail and above rail is in fact quite challenging, in rail at least it's feasible and indeed occurs every day in Australia.

But even in rail, where the technology is relatively stable, where you have clear functional interfaces, there are very substantial difficulties associated with coordinating not day-to-day operations, but asset maintenance and renewal - ie, the investment cycle - in a structurally separated context because the below rail operator has to engage substantial investments, the profitability of which will depend on the conduct of above rail operators and above rail operators equally have to engage substantial sunk investments, the profitability of which depends on the conduct of the below rail operator, and the difficulty of writing contracts which will cover those contingencies and align incentives creates even today fundamental problems with, for example, getting adequate capacity on the main north-south rail links.

When you go from that to telecommunications - in telecommunications anyone who tells you that they know how to define a stable functional interface between something that you can refer to as "the network" and something that you can refer to as "services" is, in my view, severely misguided. Perhaps the best evidence of that is if you look at what happened in the United States when the Bell system was divested and you had structural separation, albeit on a simpler model than has usually been proposed in Australia because the essence of it was some distinction between local and long distance and between basic and enhanced services.

What happened in the US was that by the end of the 80s it was taking two years or more to make what were relatively simple functional modifications to exchanges, so you had a new piece of software - a generic type of software. You wanted to implement an exchange which would enhance the functionalities of that exchange and there would inevitably be debates about whether that was serving local or long distance, whether it was basic or enhanced, and all of those issues had to go out to Judge Green and Judge Green - who undoubtedly was a very capable man, but not an expert on the engineering of telecommunications networks - would hear experts on one side and on the other, discussing whether a particular generic for an exchange should be classified as basic or enhanced. Then there would be an appeal against that decision and it was only once that was resolved that you could then actually implement the new functionalities.

The result of that was that you got inevitably pretty substantial delays and, when you project that ahead into a world where the pace of change in telecommunications is, if anything, accelerating - it's certainly no less than it was in the 1980s - and where the nature of the network is such that the boundary lines between what used to be called "basic network functionalities" and the intelligent network on the other side - those boundaries have become ever more blurred, so in an IP network it's very difficult to say what lies at one end or what lies at the other.

The very notion that you can find some even technically meaningful, much less economically efficient, dividing line, seems to me to not be readily supported by analysis or experience and, in those circumstances, when I look at the different proposals that have been put as to how this would work, either by the ACCC in its most recent documents, or in the study they did on convergence - when I look at those proposals I don't see any that make technical sense, much less economic sense going forward.

MR PATERSON: Yes. I think a useful additional point to make there, as well, is that even if there was a technical view as to an appropriate cut point for telecommunications - and you might think, for example, a split between contestable and noncontestable parts of a network - and the classic example given there is the customer access network as being the noncontestable part and the trunk network being contestable, and even where that split might take place it shifts over time. I think a useful current example there is DSL technology, which to my mind really has shifted where reasonable people might come down as a sensible split point back in the old telephony days, then the shift point was migrating towards the customer as fibre was pushed out further towards the customer and the point of aggregation in the network changed closer to the customer.

So you might think, well, where does the noncontestable start, do you think, at the end of those aggregation points where fibre finishes and other people's network finishes? But with the advent of DSL technology, which is essentially enlivening the copper to carry high bandwidth traffic, in fact you would see a shift back to the local exchange from those remote aggregation points, because that's essentially where that electronic equipment is best housed, and certainly the electronic equipment of competitors is best housed. So over time as well there is a dynamic there which complicates that issue of the cut.

MR ERGAS: Finally, we ought to bear in mind that it's not merely a question of finding a boundary point that is technologically feasible and sufficiently stable that it can actually be implemented, but it's also an issue of looking at whether it's economically sensible, and the reality is that there are so many chicken and egg effects in telecommunications now, so many complementarities between investing in the infrastructure and developing the services that will make use of that infrastructure, that even if you could effect that separation, it would have relatively high economic cost.

A good example to my mind is the Foxtel network, because there is a sense in which you could argue that the HFC network which is used to carry pay TV by Telstra - and Optus of course has its own HFC network, hybrid fibre co-ax network - is a separate network in part from the copper loop network. You can identify

network functionalities that sit in the hybrid fibre co-ax network and network functionalities that sit in the copper loop are now increasingly fibre-optic network. But even though you could do that, if you go back to the early days of pay TV in Australia, the reason we have an industry structure both at Telstra and at Optus that has that horizontal integration of the network ownership with the programming activity, the service delivery activity, is because if you are going to invest in building the network, you need to ensure that there will be the services that will make use of that network.

When Telstra began the rollout of the HFC it began that rollout on the basis of a product that was called the Visionstream product. Visionstream was an open access HFC network. The underlying idea was that Telstra would dig up the streets, put HFC to people's homes and then Trevor Lee would come along and say, "Well, now that the HFC is there I'd like to provide some pay TV programming." That way Trevor Lee would cover the cost he incurred, and Telstra would get some contribution to the network costs of the HFC.

Well, what happened was that Telstra announced Visionstream, built some HFC, had a party and no-one came along. The reason no-one came along was - and it comes back to the simple network externalities that economists carry on about at such length, and rightly so - that each Trevor Lee looked at the situation and said, "Well, if I go in at first there's going to be no customers" - which is right, or very few customers - "so I'll make very large losses and I'll bring my programming, incur those losses, but then the service will grow. Once it grows, what happens? Will I be able to then recoup my losses? No, I won't, because Gary Banks Pay TV Services will come along" - it's an open access platform and Telstra will say, "Of course, the more the merrier, because we don't want to be stuck with only Trevor Lee on our network who would have some degree of market power, so we'll welcome you to come in once Trevor Lee has sunk his costs."

Knowing that, the only way Trevor Lee will incur those costs is if he has some assurances about the future. But how can you write a contract that will have all of those assurances in it and be credible? The only way you could do that, as it turned out, was you had to go to specialist pay TV providers or broadcasters, firms who had expertise in that, and say, "Let's structure a joint venture whereby we will share the costs and share the benefits of developing the service." It's taken 10 years and that service is still to break even, but at some point it stands a much better opportunity of breaking even under that structure than it could ever have done under the Visionstream model.

When you look at the experience that we've had in telecommunications in Australia, the HFC case is by no means alone. The Telstra - or Telecom as it then was - videotext service was a failure in part because it was a complete open access

model and no service providers were willing to engage the investments necessary to make it work. You have to solve those problems, and one of the most effective ways of doing so is by having some form of even partial vertical integration. If you don't have that then it's very difficult to see it will ever be feasible to roll out fully broadband optical networks to the home.

MR BANKS: Just thinking, talking about gas, and you have foundation customers in the gas environment, don't you, but there's no analog to that in this sort of environment. I suppose you could do contractually in a sense what you're arguing you would need to do through an integrated ownership arrangement.

MR ERGAS: That's right, and you do have that to some extent in telecommunications. I mean, you could look at Foxtel as a foundation customer for the HFC and, like foundation customers in the case of pipelines, it would get preferential terms and have a claim on the future income stream associated with the service. But the realities of it are that telecommunication services are much more complicated than fuel transportation services, or gas transportation services. The range of technical contingencies that you would need to cover is much greater and you need much greater adaptability.

That adaptability, that ongoing adaptation to changes and technological and commercial opportunities is difficult to build into foundation-like contracts. It requires ongoing joint decision-making, and that's what the joint venture form provides albeit with its own limitations.

MR WEICKHARDT: Can I just clarify, if I'm understanding you correctly, because I think I understood you to say that - we started off with Hilmer who had a view, for reasons you've explained and perhaps appropriate to the circumstances at the time, that a presumption in favour of structural separation made sense. Our recommendation was, at least in the case of Telstra, that before if you like the opportunity to even consider the issues has passed, that you should have a look at it.

You've said, "Well, there's no good evidence that structural separation is either technically possible or indeed that it's desirable, and that you shouldn't start an investigation because once you start the hare running, you know, it's out of control." On the other hand, however, for electricity and for rail, you've argued that vertical integration actually might be beneficial. So it seems to me that, in terms of where the meter on the dial is pointing, we started off with Hilmer sort of saying structural separation was probably the presumption, the default presumption.

Rather than being at neutrality it seems to me you're now moving to the default presumption should be that vertical integration is a good thing, because I don't hear you saying in the case of the reintegration of rail and electricity, "Well, we shouldn't

have an investigation there, because once we get the hare running, maybe we'll go back to integration." You're not at a neutral point, it seems to me. You're at a point that favours integration. Is that exaggerating the position?

MR ERGAS: Well, I don't know if it's exaggerating the position, and it may just be the different ways of interpreting it, but to my mind the sensible approach is that one should not presume either in favour of or against structural or some degree of vertical separation. I think it needs to be dealt with on a case-by-case basis, looking at the circumstances that are involved.

MR WEICKHARDT: But in Telstra you're saying, "Don't even open the can and look inside." You're not saying that in the case of electricity or rail. If you weren't sure, you might say, "Well, let's just let the status quo continue in both cases."

MR ERGAS: My view of it is that, by and large, the boundaries of firms should be determined by markets, in particular by capital markets. It should be up to the investors in firms to determine what range of activities firms should undertake, and hence, if there is a presumption, it should be a presumption in favour of allowing corporate boundaries to be determined by market forces. Obviously, though, there are circumstances where public policy alters those outcomes.

One circumstance which I believe is fully justifiable is where there would be competition issues associated with, for example, vertical acquisition or a vertical merger, and clearly section 50 of the Trade Practices Act should apply in those contexts, and if the ACCC believes that a vertical merger would result in a substantial lessening of competition, it has the power under section 50 to seek to prevent that merger from occurring.

In the context of the regulated industries, my view of it is that it may well be sensible to allow some degree of reintegration of activities that were structurally separated at the time of the Hilmer reforms, but the firms at issue would need to take the initiative and then justify that. In the case of Telstra, my concern is this: that having an inquiry into structural separation would be a highly politicised process which would unleash, I believe, very powerful rent-seeking forces of every kind. It would also be a costly process, not merely in terms of the resources immediately devoted to it but in terms of diverting attention from commercial activities to the outcomes of that process.

As a result, unless there is some prima facie case for it, I don't understand why one would impose those costs. If there were a compelling prima facie case, even if it was far from being established but yet there was a cogent argument that could be put in favour of the policy, admitting that then some aspects of it should go to closer empirical investigation - if there were such a cogent argument, then it might well be

worth considering, but at the moment no such cogent argument has been put and, as a result - and it may be that there are good reasons, but they haven't been clear to me - I don't see why the community should bear the costs that unleashing the kind of process that that inquiry would involve would necessarily force the community to bear.

MR WEICKHARDT: What's the UK situation, because you talked about the US situation, but I understand in the UK the network has been in a separate management.

MR ERGAS: The UK situation is that BT is essentially a vertically and horizontally integrated entity. It has, for essentially commercial reasons, had different business units that deal with different parts of its operation, and that's not that unusual a model. For example, perhaps a more significant case would be Telia in Sweden, where you do have a separate company within the Telia group which is the network company. However, in cases such as Telia, that was a commercial decision that was made by Telia management, and it's Telia that decides what goes where, and so as circumstances change, it shifts operations and responsibilities around.

Similarly, when Telecom New Zealand was privatised, initially Telecom New Zealand had a regional structure at the time; immediately post-privatisation, they moved towards a regional model, and that had some efficiency, particularly in the area of achieving cost savings for outside labour or plant-associated labour, operations and maintenance staff, but also had some pretty severe limits, for example, in terms of how you served national clients.

They then shifted to a model where they had essentially a network division and a services division, and that model where they had a network division and a services division worked relatively well within a highly integrated structure of overall governance, worked relatively well in terms of providing incentives for reductions in network costs, which was really what was being driven by that process. They'd entered the period with substantial excess capacity and they wanted to drive unit cost production.

What they then found, though, was that by the end of the 90s, that model was breaking down because they had to go into a new investment cycle, and when they moved into a new investment cycle issues of vertical coordination became quite significant, and that separation was no longer the best way of managing those issues, so there was a change in the structure.

As a result, if you look at those experiences - and obviously there's a wide range of them internationally - I think the point is that, yes, within an integrated

management and governance structure, you can have more or less separation but that will only work sustainably if it's a governance decision taken on commercial grounds and is subject to being changed - the circumstances themselves change.

MR PATERSON: If in that regard the perspective was one of a regulator and really regulating in such a way that the incumbent firm doesn't act to in some way give itself an advantage in how it deals with competitors who need to access its network, it's interesting to note that in fact competition policy itself drives that behaviour. In competition policy, one of the issues often considered, including by the ACCC, is that of vertical price squeeze.

MR WEICKHARDT: One of what?

MR PATERSON: Vertical price squeeze.

MR WEICKHARDT: Yes.

MR PATERSON: That is the downstream or the retail customer facing parts of the business, setting their prices relative to wholesale prices such that there's not sufficient margin for a competitor to make a go of it in the market. To police that and in fact to provide the right incentive for the company to act in that way, does there need to be separation? Quite frankly, no, because the sorts of trade practices tests that are applied there in fact simulate that separation. They say, for example, if Telstra Retail or BT Retail was to buy from the network part of the business at exactly the same terms and conditions as the rest of industry does, would it be able to live with the prices that it's setting in the market at the retail layer? So in effect you get simulated or quasi separation in that sense coming out of the sort of trade practices testing that occurs.

MR ERGAS: And it's true that in the UK Ofcom, the industry regulator, has recently moved to seek from BT greater equivalence of the services it provides to itself relative to the services it provides to competitors, and BT has, with considerable fanfare, appointed a director of equivalence to ensure that that happens. We have had similar conditions in Australia since 1991 and then in 1997 legislation - there are what are called "the standard access obligations", which impose non-discrimination in the provision of the relevant services.

Obviously, you can argue about whether those provisions are fully effective and whether the treatment is identical or whether it's identity that should be at issue or equivalence. Those are all issues for argument and I accept that but, at the end of the day, you have to come back to - well, perhaps, structural separation would be one way of ensuring such equivalence, but would the benefits outweigh the cost?

MR BANKS: How do you respond to the argument that the move from public to private ownership brings some sort of additional dimensions to this in terms of incentives for the private entity to exploit whatever market power opportunities might be afforded by integration relative to a non-private entity?

MR ERGAS: I don't fully understand why that would occur in the sense that I'm not sure that Telstra at the moment would be viewed by its rivals as not a profit-maximising, benevolent entity - at least I have never heard its rivals characterise it in those terms, but perhaps in their quieter moments that's what they're thinking. But that said, as a general matter of economics, one would think that the move from public to full private ownership would be more likely to be beneficial than harmful in that respect.

The reason for that is that - again these are matters for argument - there is at least a case to be put that publicly-owned firms will be managed to goals of expansion and of size to a greater extent than to goals of profitability and providing economic returns to shareholders and, as a result, it is at times argued that government-owned firms are more likely to engage in output-maximising behaviour relative to profit-maximising behaviour.

Indeed, John Lott, in a book which got a fair bit of attention a couple of years ago on predation cases, found that on his data set publicly-owned firms were much more likely to engage in predatory pricing than privately-owned firms and he argued that this was because they were maximising their output rather than maximising their profits, so if you accept - and clearly whether that's true or not goes also to the efficacy of the corporatisation and other frameworks that have been put in place for government business enterprises in Australia - that view of the world then you would say that a fully privately-owned Telstra would pose less risk of the type of anti-competitive behaviour associated with foreclosure because it wouldn't be so concerned about maximising or retaining its current output levels relative to the goal of operating as profitably as possible.

MR WEICKHARDT: It's a sort of related question, I suppose, given the fact that you said it's not clear that a vertically integrated firm will behave in a certain way or not. I accept that point and I also accept your argument that government policy is not just to make the life of a regulator easier, but given the fact that there are people who are nervous about this - you don't like the idea of having an investigation to see whether or not separation is sensible - do you have an alternative that would make people sleep more comfortably, that would give greater security which didn't involve the regulator being heavy-handed and spending all their time pouring over every activity that Telstra were involved in, and yet would give some comfort that they weren't in some way inappropriately using their market power?

MR ERGAS: We have very extensive protections against misuse of market power which are already in place across a wide range of regulated industries, but especially so in respect of Telstra. It's important to bear in mind that, even relative to other entities that have very significant market power, Telstra has special requirements imposed on it in terms of disclosure of information to the regulator and also that the regulator has special powers in terms of prevention of anti-competitive conduct through an industry-specific competition regime in Part XIB of the Trade Practices Act. So we have a very wide range of requirements that are already in place and which go to the prevention of anti-competitive conduct.

Do they make the regulator's life an easy one? Well, again, I don't believe that the goal of economic policy should be to make for easy regulation. I think it should be to make for efficient regulation and, in my view - and this echoes the themes that Trevor raised a few moments ago - many of the problems with our current regulatory arrangements come from their being too intrusive and heavy-handed. You take telecommunications: the ACCC's consideration of Telstra's prices for PSTN originating and terminating access is about to enter its eighth year. It's true that doing that kind of analysis is complicated - there is no doubt about that - but it's also true that eight years is internationally unprecedented for that type of exercise. Why is that? Well, the answer I suspect lies outside the area of competence of the economist, but there are elements to it of what one might call "political economies" that need to be considered.

MR WEICKHARDT: The good news is that if you took your total sample, at least they're doing it faster as a vertically integrated unit than if it was structurally separated. It might be taking 10 years if they were separated.

MR ERGAS: Very true. One shudders to imagine. I must say, from a narrow consulting point of view, of course we applaud the commission's efforts at transferring income from consumers to economists. The commission - not solely the Productivity Commission by any means but particularly the ACCC - is also very fair minded in that respect because virtually every economist in Australia, as I understand it, has been engaged directly or indirectly in those proceedings and many a holiday home or a beach house has been built that ought to be named after a particular day in those proceedings' now-lengthy history.

However, it's difficult to believe that that is the best way of ensuring that - to use your words - consumers can sleep well at night because if they're trying to sleep at night, what they should be thinking about are the very large sums that are being transferred from them into - I hate to say - unproductive activity but activities that perhaps are not as socially valuable as other uses of those resources might be.

MR BANKS: In our report, we talk a little bit about the dynamics of the

telecommunications market and this morning we had ATUG appear, casting doubt on the scope for the market to evolve in a way that enhanced the competition, basically, either through mobile phone usage or broadband or through wireless technologies. I'd be interested in your comments on that about the extent to which the market will naturally evolve in a way that would become more competitive.

MR PATERSON: Well, perhaps I'll lead off and then see where we go from there. I mean, my view is, quite frankly, the technological development and product development emanating from that, in fact, has very clearly worked to enhance competition, rather than restrict it. One example is mobile technology where we're seeing around the world and in Australia a clear fixed mobile shift, both in terms of the access technology itself and also in terms of calling volumes. It's occurring to a fairly dramatic extent in terms of - - -

MR BANKS: Including mobile-to-mobile traffic.

MR PATERSON: Indeed. Indeed, yes. So really bypassing the fixed network to a partial or complete extent. In the fixed network world, one of the critical developments staring telecommunications companies and incumbents in the face around the world is voice over IP and the scope for those service providers to, in fact, offer to customers very low-cost voice calls; either riding on closed networks that they establish or riding on the public Internet - again, to my mind, a real drive for competition and a real driver for lower prices for voice calling services. So a number of drivers there.

I guess the other good example to mention is wireless local networks and it's something that, for anyone who observes telecommunications, has been talked about for a long time as perhaps the great hope of cracking the supposed incumbency bottleneck around access to the customers. In fact, what we're seeing in the market is that is becoming a reality, you know, really driven by broadband considerations and wireless broadband and the number of advantages that offers customers that now are seeing a robust role out of wireless local loop in that regard. So a number of technologies, to my mind, are pushing down the path in a demonstrable way of greater competition and greater competitive forces in the telecommunications market, rather than the reverse.

MR ERGAS: I would agree with that. Ofcom, the UK telecommunications regulator, recently released a survey of telecommunications in the UK. It began with what I thought was the somewhat striking fact that in 2004, the average Briton spent considerably longer talking on a mobile phone than talking on a fixed line and that was the first time that that had happened. In that sense, in the UK as in Australia, you now do have two fully redundant alternative networks. You have a fixed line network and a mobile network. Now, that doesn't mean you get immediate

substitution, that the competitive pressures are necessarily as intense as they might be in other markets, but it is certainly a move towards much greater competitive discipline on telecommunications providers.

Looking to the future, those competitive pressures will only increase and the question to my mind is what is needed to make those competitive pressures fully effective. I believe that whilst the orientation of our telecommunications policy is fully understandable, that there are some respects in which it is pointing at perhaps the wrong issues. I would say mainly, in this respect, that much of the current focus of policy is on allowing competitors to make use of Telstra's existing assets and to compete with Telstra through the use of those assets and of course, that's sensible and understandable as such.

However, the real issue in the long run is providing the incentives that make both for efficient use of shared assets but also for the provision of alternative assets, where those alternative assets can be efficiently provided. That requires a suitable policy framework, both in terms of the fixed network and in terms of the wireless network. In terms of the fixed network, the reality is that our copper pair network needs to be renewed and, over the course of the next 15 to 20 years, needs to be replaced by fibre to the home. So the real issue should be providing incentive for competition in the wiring up of the next generation of telecommunications network, ensuring that the investment incentives and the price signals are right for that type of competition to occur.

In the wireless area that Paul was referring to a moment ago, a great deal hinges on having efficiency in the allocation of spectrum, which is the scarce resource in respect of the wireless network. It was, in my view, telling in this respect that Ofcom recently decided to move towards full tradability of spectrum entitlements so that the market could allocate spectrum as between uses and not merely as between users. What we would need for wireless to really develop and to have a cost structure that would be really competitive is to have a system whereby if new uses of spectrum become competitive, that that spectrum can be available and reallocated to those uses in a timely manner. That also goes to some of the important recommendations that you made in your broadcasting inquiry, where there is enormous scope to make more efficient use of the very large quantities of spectrum which are currently devoted to that purpose. An example is mobile use.

MR BANKS: I just pose this for you because you've raised the question of merger regulation and a kind of economy-wide regulatory approach as being the preferred way to go, and I guess the commission - this commission, anyway - is on the record as seeing that as being broadly desirable; and you participated in our review of the national access regime, where we nevertheless saw a role for what Richard Snape used to refer to as a root and branch kind of approach, whereby you had an

overarching regime like the national access regime that would kind of inform and provide some guiding principles, that then would be picked up in industry-specific regimes. Now, I'm sort of springing this on you, but just thinking about it, why would you rule that out - that kind of approach - in relation to, say, merger regulation; in other words, if there was an industry that had specific characteristics that warranted a somewhat different approach, even if the principles were broadly the same?

MR ERGAS: It seems to me that there's a compelling argument for having both a single set of principles in the form of legislation that inform merger decisions - ie decisions about whether mergers are consistent with a competition test - and for having unified administration of that single test. My concern would be that if we had an electricity-specific or energy-specific test, we would both get a variant of those general principles and we would get fragmentation of administration. The reason that that would be of concern is because it seems to me that the issues that arise in respect of mergers are the same issues in every sector, fundamentally: whether in that market the merger will or will not effect a substantial lessening of competition.

That assessment goes back to some common, underlying tests: it goes back to issues of defining the scope of the market where that's relevant, defining market power, looking at what market power there will be, with and without the merger at issue. So it's the same analytical framework that you're implementing in each and every case when you're dealing with merger regulation. As a result, what you want to be able to do is to have the maximum precedential value associated with merger decisions, so that a merger decision in respect of one industry will give guidance to participants in other industries about what is and is not within the scope of the prohibition.

If you look at the Australian experience, perhaps the most significant merger case in Australia was the QCMA case in the 1970s, and I would be surprised if many people today even knew what markets were involved in the QCMA decision. But that really isn't important, because what practitioners would know is what the core principles that emerged from the QCMA decision were, and they could use those core principles in advising about mergers in electricity or in telecommunications or in the supply of green velvet hats, for that matter. If you had an industry-specific test for electricity mergers, what would happen? You would inevitably fragment that body of case law and as a result there would be much less guidance about how mergers in electricity ought to be handled. There would be much greater uncertainty in that respect.

That in turn would bias the allocation of effort in capital markets between looking for profitable opportunities to find mergers in electricity and profitable opportunities to find mergers in the green felt hat business. But there's no economic

reason why you would want to induce such a distortion. As a result, unless there was some compelling case that made section 50 ineffective with respect to electricity, it's difficult to see why you would even contemplate moving in that direction. You look internationally, and internationally - the same type of laws as we have in section 50 under the Trade Practices Act - internationally it's those same laws that apply to electricity mergers as apply to other mergers. I'm not aware of issues arising in other jurisdictions with competition regulators saying we need special powers to deal with electricity mergers as against mergers in other industries.

Now, of course, I'm biased in this, as are the three of us, because we're all economists and we're all minded by that famous statement about Alfred Kahn. When Alfred Kahn became chairman of the Civil Aeronautics Board in the United States, before he abolished the board of which he had become chairman, and he was being questioned in the US Senate confirmation proceedings for his appointment, and a particularly aggressive senator said to him, "Professor Kahn, why are you qualified to be chairman of the Civil Aeronautics Board? After all, what do you know about airplanes?" he turned to this senator and said, "Senator, as far as an economist is concerned, airplanes are just marginal costs on wings." Exactly the same principles apply to airplanes as apply to the supply and demand of sliced bread, and until one can find compelling reasons not to believe that, I think that's a pretty good presumption in respect of electricity too.

MR BANKS: Well, we'll contemplate the green felt hat market.

MR ERGAS: With an industry-specific rule.

MR PATERSON: I'll perhaps make a further point there, a point of practical experience, and that is in fact I think it's often found quite refreshing to have someone with a particular set of skills concerning competition issues, market definition, changes in degrees of market power from hypothetical moves, et cetera, or proposed moves; someone who has got a general set of skills to be brought to bear on a particular market without any baggage, if you like, of preconceived positions as to where the power might lie in a market and what a particular proposal might mean. Certainly that's been my experience in what work I've done with the merger people in the ACCC, for example, who range across all industries, and they, to my mind, very often bring a degree of incisiveness to a particular industry that people who are well rehearsed in a particular industry may no longer be seeing quite so clearly because of an accumulation of positions over time.

MR BANKS: That almost sounded like a compliment to the ACCC. Probably we'll stop there. We've kept you in the seat a long time. We appreciate all of that and indeed, I don't know whether we can expect anything further written down. I hesitate to say that because I don't want to look as though I'm trying to push more work your

way, Henry, but I suppose in particular the arguments against even proceeding to have a review of structural separation, to the extent that they're not articulated in this submission, I think it would be useful to have those on paper.

MR ERGAS: We will look at that and thank you very much for your patience today; with me in particular, you've suffered twice.

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

MR BANKS: Our next participant is the Grain Growers Association. Welcome to the hearings.

MR CAPP: Thank you.

MR BANKS: Can I ask you please just to give your name and your position.

MR CAPP: My name is Damian Capp. I'm the research and developments and policy manager with the Grain Growers Association.

MR BANKS: Good. Thank you very much for attending the hearings today. Also thank you to the Grain Growers Association for the submission that was provided in the lead up to our presentation of our discussion draft. So I will hand over to you to make whatever comments you want to make in response to that draft.

MR CAPP: I would just like to place on the record my apology for not being able to provide this information before today. It's actually being printed up into another format, in a bigger font. The document you have is actually the latest newsletter from the association, but what we did include in that document to our members was this grains review matrix which goes back over the past five years, over a number of review documents specific to the wheat industry, but some of them more general to the wider grains industry.

The purpose of tabling that is its relevance to this report's findings that there is unfinished business, essentially, in the review of wheat marketing legislation in Australia. The document you have in front of you is relatively simple. Running down the left-hand side matrix are the key factors in grains marketing that are repeatedly identified in these different reports. So running down that left-hand side matrix are transparency, competitive tendering, corporate governance, complementary sales channels and industry representation.

As you can see the first report cited there is a Productivity Commission staff research paper from July of 2000, and the different quotes that are cited, running down the column, are relevant to each of those highlighted areas. It goes on to the national competition policy review of the Wheat Marketing Act of 1989 that was carried out in the year 2000. Once again the relevant sectors of concern cited back to the relevant areas - transparency, et cetera - and running right through. The point of listing all these different reviews are the fact that these fundamental areas of concern are repeatedly identified but the reform has not been apparent.

I would just like to also place on the record the Grain Growers Association - we have 17,000 members - grain grower members in Queensland, New South Wales and Victoria. We support the retention of single-desk marketing for the wheat

industry. Our concern is regarding the administration of the monopoly export powers under the Wheat Marketing Act of 1989 and the lack of transparency around a lot of the administration of the wheat single desk by the AWB Ltd group of companies.

MR BANKS: Good. Thank you.

MR CAPP: That is essentially it. Yes, thank you.

MR BANKS: In a way you have answered my question which was going to be - you seem to have made a very good case for getting rid of the single desk but on the other hand you seem to be supporting it. The point you made in the earlier submission that where deregulation had occurred the sky hadn't fallen in and indeed there were a lot of positive features of that, but perhaps you can take me back through the subtlety of your position in the sense of, I think, finding good reasons for deregulation and benefits where it has occurred, but nevertheless wanting to retain the single desk for wheat.

MR CAPP: The majority of our members support the retention of the wheat single desk. We are a member-driven organisation. What many of our members are receptive to are, for example, complementary sales channels to the wheat single desk. Some of the reforms that have been proposed over the years have cited a possibility of the Wheat Export Authority, the relevant federal agency, to have the power to issue bulk export licences, for example, for wheat for alternative exporters, other than AWB (International). In the original submission we cited the progress that had been made in Western Australia under a Grain Licensing Authority that was established under the Grain Marketing Act of 2002.

The Grain Licensing Authority mimics the Wheat Export Authority in many ways. However, it has the power to issue bulk export licences. When it commenced doing that in October of last year for canola and lupins and barley it injected contestability to the market in Western Australia. There were very good cash prices available. There has been good reports from the growers that chose to sell to the alternative exporters and what that essentially meant was the incumbent exporter, Grain Pool Pty Ltd, simply had to start competing more strongly. That kind of incremental reform hasn't been available in other states in Australia for various reasons.

Just getting back to the complementary sales channels, certainly there has been a lot of evidence from many potential exporters and other companies active in the grains trade about the possibility of exporting wheat in a complementary manner to AWB (International), whether it be smaller tonnages, whether it be niche markets, whether it be durum wheat. There are a number of different possibilities.

MR BANKS: I think there was some confusion about the most recent review of wheat - the Wheat Marketing Review Panel, which produced its report just before we put our discussion draft out, I think, where it was being said that this had been a review of the single desk, which clearly it hadn't been, but when I tried to find the report I found that there was a public summary of some eight pages.

MR CAPP: Yes.

MR BANKS: But I note you say here that there was a 350-page report that was confidential.

MR CAPP: That's correct, yes. That's the actual report that went to Minister Truss from the 2004 Wheat Marketing Review Group.

MR BANKS: What would be the reason for that being confidential? Because of the commercial in-confidence - - -

MR CAPP: Largely commercial confidentiality is cited, but I find it hard to believe that all 350 pages would be subject to confidential information. That's a weakness we have seen over recent years - the Wheat Export Authority which was set up to be the watchdog of the industry, if you like, the first growers report it put out covering its first two years of operation extended to nine pages, if my memory serves me correctly. The fact that growers are not privy to the workings of the company they own, AWB Ltd, and the wholly owned subsidiary, AWB (International), which was set up to look after their interest. The lack of information and transparency current in the industry at the moment is - well, many growers find it very galling and the fact that that has been repeatedly identified and the most recent review, the 2004 review, has called for greater transparency and contestability of services.

MR WEICKHARDT: Can I just try and understand better what your members see as the overriding logic as to why a single desk should be retained in the case of wheat and yet in the states that have abolished the single desk for barley - where our global market share is slightly higher than in wheat, as I understand it - as Gary said, far from the sky falling in, in fact it appears that people are voting with their feet and accepting - in the case of South Australia, as I understand, there is a reasonable amount of South Australian barley that actually is grown near the border where people choose to sell across the border in Victoria, using the non-single desk route rather than the single desk route that prevails in South Australia.

As I understand it, the evidence is that if you look at the states that have the single desks in barley and those that don't, there is no evidence that the, if you like, FOB level at the port there is any real significant price difference. But at the farm

level in terms of innovation, of when the farmer gets their cash, when they can sell their crop, how they can mitigate risk, how they can use that to finance future ventures, how they can hedge against things. There are all sorts of innovations that have grown up where the single desk has been abolished and no evidence that market power has been conveyed by retention of the single desk.

So here you've got a living experiment in barley that seems to sort of fly in the face of this passionate belief that the growers have; that the single desk maintains some form of market power. I think our global share in wheat is 4.5 per cent of the world market in wheat. I've come from industries where, quite frankly, 4.5 per cent global share gives you absolutely zip power. I find it difficult to believe - apart from the fact that people keep saying it until they believe it - that it gives you any power at all. So why is it that you don't even want to have an inquiry to actually look at this?

MR CAPP: You've correctly identified the contradictory nature of that position, yes. You've got to look at it with 70 years of history. A lot of these farmers have spent their lives working in a regulated system; moving into a less regulated business environment frightens many of them. The incremental change that is required; yes, it doesn't make sense at times. I agree. But of course the case studies going on around the country show that the process is manageable, growers can be upskilled. That is one of the intentions of the organisation I work for: to help growers equip themselves with the skills they need, moving into a new business environment.

MR BANKS: That is an interesting aspect of it all; adjustments are a significant issue in any reform process. What is your perception of how the adjustment has occurred where the single desk has been deregulated in, say, Victoria and barley? Did the growers have great difficulty in adjusting to the new arrangements in the more liberalised market?

MR CAPP: No, that's not my understanding. You must remember that the incumbent marketer, ABB Grain Ltd in Victoria, retained a large share of the export barley market and domestic barley market. Pools are still available; there are voluntary pools. Many growers make the mistake of believing that if there's no regulated system, pools won't be available. That's been shown to be untrue in Victoria, for example. The growers that wish to avail themselves of forward pricing, contracting - contracting two years ahead for their production - many of the farm advisers in Western Australia, for example, that do the annual plans with their clients, recommend that their growers try and forward price 30 per cent of the expected production and start putting in simply those price hedges. In Victoria the evidence shows that growers are able to adjust with a minimum of fuss.

MR BANKS: Would there be features in particular jurisdictions that would make them special cases though in terms of those sorts of benefits? For example, if you

compared South Australia to Victoria, where I suppose there's a bit of a debate raging across the border there?

MR CAPP: No, I think examples of special cases or arguments made for special cases are largely illusory. For example, in Western Australia, last harvest, the incumbent exporter, the Cooperative Bulk Handling group which has GrainCorp as a subsidiary, initially resisted some of the alternative exporters coming in that were granted bulk export licences by the Grain Licensing Authority. There were large tonnages that had to be exported; the Cooperative Bulk Handling system was the only storage and handling network effectively able to handle that grain. Cooperative Bulk Handling came to the party and largely started recognising that there was a new business environment in place - these exporters are going to be our clients for many years. Actually some of the exporters I spoke to spoke very highly of the logistics staff they dealt with at Cooperative Bulk Handling.

Initially it was unclear about how the Cooperative Bulk Handling group would react, for example, to these other exporters coming in. When you've been on top of the pile for 70 years you're not going to relinquish that position easily but they saw the bigger picture and made it much easier for these alternative exporters to come in and start doing business, start providing services to growers, start competing and lending that competition to the market.

MR WEICKHARDT: I understand one of the issues that has arisen in the barley area is that the single desk concept has lots of grain in stores around the country whereas the commercial operators who have grown up have tended to try to move stuff from farm out to export very much faster. So the amount of product actually in store has reduced significantly; of a particular bit of grain from grower to export, has reduced significantly. So the amount of stock that is actually in place in the barley market, in the deregulated areas, has reduced significantly which I guess you'd say, in logical terms, has got to be good for growers. Somebody has got to finance the cost of huge quantities of product being stored around the country.

MR CAPP: So you're saying ownership of that barley has changed hands or - - -

MR WEICKHARDT: As I understand it, a commercial operator, fairly logically, doesn't want to finance a product for long whereas effectively, I guess, the single desk works on a process of doing everything it does and then finally passing the difference back to the farmer. The commercial operator tends to be acquiring product out of the farm gate and getting rid of it and their motivation is to get rid of it as fast as possible. So it has reduced the amount of stock around, as I understand it - the amount of grain in the system - which fundamentally you'd have to think was a more efficient way of product being marketed.

MR CAPP: Well, certainly, it sounds to me like a lot of that grain would still physically be in the system but would be priced and already sold. For example, in Western Australia last year there were bulk barley sales made by one of the alternative exporters very early in the marketing year so that grain was actually physically being moved out but the logistics of the system means that obviously it can't all be moved at once. The nature, of course, of statutory marketers tends to be a pool being sold over 12 to 18 months and so that grain can - that's the nature of pooling: once the grower tips it down the hole he loses ownership but he maintains pricing risk. So 12 or 18 months later, his final pool realisation is made and it could go either way.

It may also be the increase in warehousing in the bulk handling systems in recent years when a grower can deliver but not nominate a buyer. So they retain ownership of the grain for weeks or months after harvest - they pay a fee for that - but then they can conduct or finalise their marketing plans after harvest when they've got more time to concentrate, look at the market, look at the cash market, look at the pools, that kind of thing.

MR BANKS: In the earlier submission there was a comment about, again, going back to that review of wheat marketing - the 2000 review - and you conclude that little section by saying, "An opportunity was lost through that review period," and you say, "A number of structural problems in the wheat industry have since become apparent." Could you just elaborate a little bit on that? There's an implication that future opportunities for reform are going to be somehow diminished because of what has happened since. I might be reading that incorrectly.

MR CAPP: The structural problems that submission was referring to are specific to the wheat industry and the company structure of the AWB Ltd group, the business rules that AWB Ltd impose on access to the national pool and the exclusivity of services supplied to the national pool. So there is the service agreement between AWB Ltd and its wholly owned subsidiary, AWB (International) - so AWB (International) running the national pools - the AWB Ltd group are the exclusive supplier of many services to the pools in a non-competitive arrangement. That's certainly the structural problem we're referring to.

The competitive tendering: that has been repeatedly identified as an area needing reform in the wheat industry. The latest review talks about the transparency and opening up some sectors of the grain supply chain - for example, between farm and port - potentially to tendering by other companies to supply to AWB (International), rather than currently the parent company, which is AWB Ltd, exclusively supplying those services. The 2004 review document refers to opening up and allowing the market to find the right or the appropriate charge for each service within the chain. It was actually revealed in the Senate inquiry, which is

referred to there, that there are up to 77 different services supplied to the national pool by AWB Ltd but growers are not permitted to know what they are. It has never been disclosed what those 77 different services are. Certainly, the incremental change would be opening up some contestability for services between the farm gate and port.

MR BANKS: I suppose the only other thing, just to get any reaction you might have is, as you know, in the report we identified a number of areas of probably any competitive regulation which we thought needed to be reviewed rather sooner than later, and I mean you have got a whole matrix here of reviews in relation to grains. However, we did include wheat amongst that. I don't know whether you have any reactions to the desirability or otherwise of having another review sooner rather than later of wheat marketing.

MR CAPP: No, the review fatigue that has been referred to in the wheat industry, there is one solution: start acting on the recommendations of these different review documents. AWB Ltd have announced that they intend acting on some of the recommendations made in the 2004 wheat marketing review document. The problem we have with that is these reforms are largely on AWB Ltd's terms. There's no other way of forcing them through. Largely, it has been indicated by the federal government it's unlikely to be major legislative change. It will only be minor, and it's my understanding in the area of bagged and containerised wheat exports. So essentially at this point it leaves the reform on AWB Ltd's terms.

That was borne out by an announcement they made last week that they intend to change slightly the board membership of AWB (International), the pool operation. They will appoint two independent directors to that board, but they will be vetted by AWB Ltd and appointed by AWB Ltd and the growers will be asked to agree to those appointments at the annual general meeting in March. Growers don't get to vote on who it will be. They will be presented with two candidates, take it or leave it. They're the kind of Clayton's reforms that we believe are continuing to hold the industry back.

MR BANKS: Thank you very much for coming along this afternoon.

MR CAPP: Thanks for the opportunity.

MR BANKS: We will now break just for a minute, please, before our final participants for the day.

MR BANKS: Our final participants today are from the Maritime Union of Australia and the Australian Institute of Marine and Power Engineers. Welcome to the hearings. Could I get you to give your names, please, and your positions.

MR MANNING: Manning. I'm a consultant for the Maritime Union in this position.

MR SUMMERS: My name is Dean Summers. I'm the coordinator for the Maritime Union of Australia.

MR BYRNE: Martin Byrne. I'm the assistant federal secretary of the Australian Institute of Marine and Power Engineers.

MR BANKS: Thank you very much for coming along today and also for the submission. It's also a relatively short submission which we value actually, given so much reading that we have to do. So I'll give you the opportunity to go through the main points.

MR SUMMERS: I suppose I'll kick it off in that the Maritime Unions would support a wide-ranging review into intermodal transport which would include coastal shipping, road, rail and domestic aviation. We think that the review would need to include a broad investigation and analysis of the environmental impact of sustaining a strong merchant navy. Of course probably most topical is the benefits that are derived from having the security benefits from a merchant navy.

The Jones Act in America is their cabotage and goes a long way to describing just how efficient and effective a strong merchant marine can be in times of war and conflict. We have documented a number of times when in Australia's time of conflict they've needed to rely upon the ability to pick up Australian tonnage, not the least in the recent dispute in East Timor where they sought to enlist the assistance of Australian tonnage to take supplies and were found wanting. The only vessels that were available were flag of convenience vessels.

I think another way to identify some of the problems is the ammonium nitrate whereby we understand there is a bill before parliament which would encourage state governments to regulate the storing, the development, the transport of ammonium nitrate - one of the most dangerous cargoes - up until it comes to the leg of the shipping part of the distribution link. That seems to be left to the cheapest possible tonnage with the cheapest possible crews in the world. So we can do all the background checks and everything we see necessary to secure this trade in Australia, but when it comes to shipping a load of ammonium nitrate from Newcastle to Sydney, and that entire link is left is out due to the fact that we don't have a reliable shipping industry. It is now before a senate hearing into maritime security.

We were able to give evidence that on that day there was a vessel called the Henry Auldenbolth that really articulated and identified the issues in that she had a crew of 20 with 11 different nationalities, with no way of background checking, with very, very low-paid wages and coming from what this government calls the Arc of Instability. So we just wanted to really underline the security risks that transporting a dangerous cargo would present. John Anderson himself really understood this when announcing a review into maritime security. He said that the potential for a catastrophe with a ship carrying ammonium nitrate being ignited or exploded under the Sydney Harbour Bridge in peak hour traffic had all the elements that a terrorist could possibly want. So we keep on coming back to the very, very important provision that a merchant navy would provide for a safe and secure Australian carriage of cargoes.

I just want to briefly touch on a paper. I can hand this up or we could deliver this later on. It's a paper called Rebuilding the Australian Merchant Navy. It's by D.W. Leach, D.R. Leece, P.N. Dent and D.W. McDonald of the Royal United Services Institute of New South Wales where they give a very very strong argument in support of rebuilding the Australian Merchant Navy. They also outline the dangers that we have put ourselves in by letting it run down to the position where it is. But from the economic argument they say:

> With Australia's maritime exports and imports of 541 million tonnes and 62 million tonnes respectively in 2002, 2003 now exceeding 600 million tonnes of cargo per annum, with freight charges paid to international ship owners now estimated to exceed $10 billion per annum with freight charters of large bulkers which cost less than $20,000 a day in 2002 costing more than $100,000 a day in some trades in 2003 and 2004, our evidence is now that the freight rates are at unprecedented high prices and high insurance costs.
>
> There are both economic and trade security imperatives for rebuilding the Australian Merchant Navy. Without a substantial merchant marine capability of its own Australia is effectively at the mercy of international mercantile marine cartels which could disrupt its trade either by refusing service or by setting unacceptably high prices. Australia further is both paying overseas interest to transport its freight by denying itself the opportunity to accumulate this revenue within the national accounts. This is already a major cost to the national economy and it is likely to increase and compound along with the predicted increases in maritime trade globally.

So that sort of gives us a general outline of where we're going. Perhaps over to

you, Martin?

MR BYRNE: Thank you. Thanks, Dean. The essence of the submission that we've put jointly to the Productivity Commission is that there is an inconsistency between two parts of the draft discussion paper. There is the freight transport section of the paper on the one hand and there is the cabotage section which is in the legislative review infrastructure; a former legislative review section. In relation to the freight transport section there is a recommendation that COAG should sponsor the development of a longer term strategy for achieving a national freight system that is neutral across transport modes. I think you'll have seen from our paper - if you've had a chance to read it - that we support that. Dean has just indicated again today our support for that overarching review, covering the various freight transport modes, including road, rail, shipping and aviation.

However, we see it as inconsistent with such a long-term strategic overview approach to engage at the same time in the review that is proposed of the cabotage legislation at page 202 of the draft report. Although cabotage is a word that is shrouded in a certain amount of mystique, the reality is that road and rail enjoy 100 per cent cabotage in their operations and that aviation enjoys virtual 100 per cent cabotage as well. The term "cabotage" has generally been applied to shipping. It obviously, as you would be well aware, applies to the reservation of coastal freight trades to operate as operating within the domestic economy. That is our basic assertion.

We say that the current operation of the permit system is indeed a corruption of the cabotage provisions of the Navigation Act. However, be that as it may, if there is to be a truly neutral freight transport policy adopted by Australia, then it is logically inconsistent from our point of view for any review of one sector to expose that sector to further and additional external competitive pressures, and at the same time argue that the other modes should compete against that particular competition. Obviously foreign competition has been used as a lever - as a driver - of cost reductions in many sectors and we've seen significant cost reductions in the Australian transport industry; certainly in shipping there have been major cost savings and in stevedoring there have been substantial productivity improvements.

We can't argue against that. It's obviously there on the record. But we do exist in the Australian economy and in the Australian society. We're not all just economic units. We're also members of a society and a community and we're bound by both the social norms and the legal requirements of this economy and this country and they are diverse. We've enumerated some of them in our submission as being cost factors for the Australian industry which are not cost factors for competitors who are able to utilise the permit system, whether those are single voyage or continuing voyage permits. Some of those costs are on the second page. They include the

taxation that is levied by the Australian government on Australian corporations. Obviously also there is the taxation levied on individual Australian workers.

There are the legislative requirements - superannuation, compensation insurance - down to the minutiae of annual leave, long service leave; all of those types of requirements, which are norms in the Australian society. They're all costs for Australian transport operators, whichever mode they operate in, but - and this is the key factor - are not costs for a permit ship operating in competition with all of those other modes and with the Australian ship operator.

We could have a lot to say if this were a review of the permit system about what we see as the imperfect competitive nature of the permit system. There is in our view - and has been - extreme manipulation of the permit system to the disadvantage of Australian operators, such that it can in no way be seen as a tool of fair competition. There is for instance no general tendering of specific freight tasks, such that Australian operators could tender for the delivery of those freight services.

There is simply a manipulation of the system whereby certain operators predetermine that they will take advantage of the permit system to achieve low freight rates. Those low freight rates are, as I say, built on the fact that the operators of those vessels do not have to comply with the Australian regulations and taxes that are enumerated in our submission and which do apply to the Australian flag and Australian incorporated operator of shipping.

To reiterate the key point: we do support a modally-neutral review of freight transport in Australia. We have no problems with that; in fact we think shipping stacks up very well. It obviously does very well in relation to the movement of bulk commodities, bulk goods, whether they are dry or liquid bulk goods. The environmental efficiency of energy costs for instance in the movement particularly of heavy low-value goods over long distances is clearly the preserve of shipping. It is only done by other modes when shipping is not able to carry out the task; that is, when the movement is from an inland location to another inland location or from an inland location to a coastal location, but around the coast - and obviously internationally - shipping is the only option and it stacks up in all types of analyses.

We would be ecstatic if we had the kind of federal government support - or even one-tenth of the kind of federal government support - that other modes, particularly road and rail, get off the federal budget. Shipping gets next to nothing. In terms of the billions that are referred to in the freight transport section of the draft paper there is simply no comparison. There is no equivalent federal funds going into the maritime sector.

One of the major maritime regulators, the Australian Maritime Safety

Authority, is virtually entirely self-sufficient; in fact I think it runs at a profit for the public sector. It levies shippers, both Australian and international, of course, because it is dealing with both interstate trades and international trades. It levies for safety and navigation levies for pollution matters. It levies all of those operators, such that it covers all of its costs and more. There has in the past obviously been some public sector investment in port facilities. That has been done off the state budgets, not the federal budget, generally speaking, and that has historically been carried out really as part of regional development. Separate from that there are those private facilities - primarily export facilities - around the coast which are privately owned and operated - referred to as "private ports" or "private export facilities" - and they of course involve no federal government monetary contributions at all.

We say that shipping generally has been the least drain on the public purse of any of the transport modes. We say it is a fuel efficient and economic method of transport. It is obviously not the quickest mode of transport and that's why the interstate coastal passenger services of the first half of the 20th century died out. They still were able to survive for a while after the interstate rail system was up and running of course - variations in the width of rail gauge has helped shipping in that regard - but obviously aviation killed the interstate passenger trade, but for goods that are not quite so time-sensitive then coastal shipping still has the capacity to deliver great benefits to the Australian economy.

The diseconomies of congestion, both on the road and rail systems of our major cities and of our interstate transport routes, land transport routes, are significant and I think work is being done towards the costing of those things, although I think that is still embryonic but, by comparison, the shipping lanes are totally uncongested around Australia. The amount of traffic around Australia could be doubled and doubled again. It could be increased tenfold without causing any significant delays or congestion.

There may be problems in relation to berth availability and berth availability has been an issue at times in some locations, although where it is worse in Australia at the moment - it has got to be said - is in relation to bulk export facilities, which just have limited capacity and are constrained by the amount of capital that has been invested in them over the years, but I say again the diseconomies of the other transport modes - road and rail - in terms of congestion of those respective systems is significant and coastal shipping - expansion of coastal shipping - would provide a means at very low cost by which those diseconomies could be avoided and those congestions could be circumvented.

We don't have the inland waterways that the United States has unfortunately. They have vast numbers of vessels involved in interstate trade under the Jones Act, transporting goods through their river and canal systems, the Great Lakes and the

St Lawrence Seaway, the Mississippi River, and all those things. Thousands of barges and flat-bottomed ships move through those waterways, carrying a very significant proportion of - I think one estate by the Transportation Institute in Washington is something like 12 per cent of their interstate cargoes go on what they call their "inland waterways".

We don't have those opportunities. We are the driest continent in the world. We don't have the ability to navigate through the Murray-Darling system or anywhere else these days, but we do still have a very much coastal orientation to our economic development. All our capital cities bar Canberra are in coastal locations with port facilities nearby. All our major markets therefore are coastal and most of our major resource developments are linked to coastal outlets via rail lines, whether they are privately or publicly owned.

Movement of freight between all of those various locations around the numerous ports of the Australian coastline would certainly be in the interests of our economic development as a nation and we say that that is part of the domestic economy and part of the domestic transport task and that the proper analysis should be an analysis as suggested at page 185 or 6. That is a national freight system that's neutral across all of those transport modes. We would be happy to support and participate in such a review, but we think that a review of cabotage legislation through the legislative review process is a distraction, and one which is intellectually inconsistent with the former reference.

MR BANKS: With?

MR BYRNE: The former reference - the page 185 recommendation for a neutral review across the modes.

MR BANKS: Thank you. Are there any further comments?

MR MANNING: Perhaps just to add that, in support of the across the modes assessment, coastal shipping is very much an intermodal type of transport. Not everything is actually on the wharf, and therefore its merits and demerits cannot really be considered properly except in conjunction with the modes with which it integrates, and with investment in intermodal facilities.

MR BANKS: There's certainly a strong logic there and, indeed, I think we even have a parenthetic comment in that later part of the report, where we acknowledge that neutrality, or taking into account coastal shipping as well as the other modes, does make sense, so we'll certainly give that some further thought.

You caused me pause with your comment about cabotage applying to road and

rail as well as air, and I'm just trying to think my way through that. I can see it certainly for air, but in a sense the capacity for a foreign provider to actually compete in road and rail, I mean, has to occur through foreign investment, which to some extent has occurred particularly in rail, rather than when you can bring a boat over or a plane, and in that sense you can extend your network to another country.

MR BYRNE: When you're talking about ownership of transport operations, the Australian shipping industry is not immune from foreign participation.

MR BANKS: That's true, yes.

MR BYRNE: Various sectors of the Australian maritime industry, broadly defined - whether you're talking about shipping for freight, or offshore oil and gas for exploration and extraction of oil and gas offshore, or indeed whether you're talking about harbour towage - each of those sectors has foreign ownership participation at some level, to some degree within the industry, and as far as I'm aware there have been no barriers to entry of those foreign operators to those various sectors - - -

MR BANKS: In equity terms.

MR BYRNE: - - - of the maritime industry. In fact, you would be aware from the harbour towage review of the entry of a Hong Kong backed operator into towage - the Australian Maritime Services based by Hong Kong United Dockyards - Hong Kong Towage and Salvage has provided tugs to that operator: no barriers to entry; immediate start-up; Sydney, Melbourne, Brisbane operations currently. I mean, this is off the track of the freight transport issue, but just by way of particular demonstration, there was no barrier to entry of that player into this market, but that player plays by the rules that every other player in this whole economy plays by. They play by the Australian corporate law. They play by the Australian tax law. They play by superannuation requirements, occupational health and safety requirements. They play by all of those laws. Those laws cannot and do not apply to a permit ship.

In fact, in that sense, we would say that there is very little difference from a dumping, in relation to the permit ship. It is a virtual dumping of shipping freight services into the Australian market, because they do it without having to comply with all of the other provisions that are explained, that every other operator within that system - they have a massive cost advantage that is delivered by the fact that they are noncompliant with every other requirement of every other operator in this country.

MR BANKS: Yes. You could see it as dumping or you could see it as trade, because all of our imports are equally produced in countries that have different regulatory regimes as well.

MR MANNING: To some extent that's where the conceptual difficulty arises. I suppose it arises because ships have accommodation, so therefore it is possible to steam into Australian waters, bringing your overseas crew, and they are accommodated. Provided the government gives the necessary visa requirements and all that, they can then steam up and down the coast. You can, in fact, relieve them by fly-in fly-out. You can work the same way with an aircraft, after all. Garuda can fly in and then do intercapital flights and then out again, and they can relieve by fly-in fly-out.

Conceptually, I suppose, if you're in the mining industry, they work out a way to run the trains fly-in fly-out. That's the equivalent of breach of cabotage on land transport. Now, obviously that has an entirely different set of visa requirements, but you could work out how to do it.

MR WEICKHARDT: I guess the big dilemma is, as Gary was saying, the Australian economy has become much more efficient by exposing large sections of it to international competition, and there are manufacturers throughout Australia who have had to learn to survive, despite all these cost burdens that Australian companies go through, and disadvantage that they go through. It is to me incredibly ironic that we're a country with all our major manufacturing operations around the sea, and yet very little of our material moves round by sea, despite all the advantages you referred to. The reason for that is that moving by sea has traditionally simply not been competitive. Our question is, "What is the coastal shipping industry going to do to make itself competitive in the same way as, for example, the ports have become competitive?" It's just at the moment prohibitively expensive to move product around by coast.

In my old industry, we could move product out of one port in Australia to Singapore and move it back to another port in Australia more cheaply than we could sail it round the coast. The man from Mars would say, "There's something wrong here." It just doesn't compute.

MR BYRNE: Obviously you would move that by an international flag vessel, again with a far lower cost structure, because they don't have to comply. Just about every major international trading nation around the globe now has introduced a tonnage tax. President George Bush signed a tonnage tax into effect on 22 October this year for the United States Merchant Marine for their international fleet. That effectively waives the US flag company from the payment of US corporate taxes, and the reason that he did that was because every other operator in and out of the US of A is extracting similar benefits from the flag state that registers those ships.

There is a reason behind the cost differential, and it's not just because my

members and our predecessors have been greedy bastards all these years. There is a multilayered cost structure that is imposed upon Australian shipping, which just does not apply to international shipping. The independent review of Australian shipping, the Morris Sharpe review, last year recommended that, as a matter of urgency, the federal government should investigate tonnage taxes and a range of other mechanisms which are commonplace, absolutely commonplace, in international shipping, the basis upon which cost structure of those international flag vessels is predicated.

It's simply no good - it's not fair - to say that, "All of those people over there are fantastic. They can do it much cheaper," when the fundamental critical reason that they can do it much cheaper is because they don't have to comply with the laws that we have to comply with here. If those laws were all waived for Australian shipping, then maybe there would be an answer to the man from Mars.

MR BANKS: But given that they're not, and if you sort of reclaimed the coast for Australian vessels entirely, and you didn't have any permit system or whatever, given the cost problems that you've just talked about and the alternatives - and by the way, I think the alternatives are starting to pay their way more than they have in the past, and we had some participants this morning talking about that, and so I agree; there has been a pretty extensive subsidisation going on. But assuming that they get to the point where they're paying their way, do you see in that world that coastal shipping could hold its own against those other modes?

MR BYRNE: Well, they need to be free to do so, to attempt to do so. One of the elements of the Navigation Act coasting trade provisions was that a licence to participate in the coasting trade should not be issued to any foreign operator. You see, there's basically no barrier to a foreign operator participating in the coastal trades under the Navigation Act cabotage provisions, but there is a prohibition on a foreign operator who is in receipt of a subsidy from a foreign government. They were put in 90-plus years ago, into the act, as far as I understand, because that's generally accepted as not being reasonable competition.

But what has in effect happened is that the subsidies have been hidden by lifting all of the normal regulatory imposts, and so it's a subsidy by another name. It's not a direct government subsidy that these competitors are enjoying. But to get back to the issue, Australian-flagged coastal shipping, or indeed Australian-operated licensed shipping - which may not necessarily carry an Australian flag but it may be operated on the Australian coast by an Australian company - doesn't get the chance to compete against the permit ship because the permit application can go into the minister and be approved in 24 hours.

Now, with the need to position ships around the coast in order to facilitate

trade, obviously the applicant for that permit has positioned his ship many weeks in advance and is manipulating the permit system by being able to put that ship into the port the next day. Another operator of a bulk carrier or any other type of vessel is unable to get their ship there because they have a commitment to carry another cargo between two other locations that conflicts and, unless they get a reasonable lead time and there is an open process of information, there can be no real competition about it: it is just a manipulation of an opportunity to avoid all of those Australian regulations.

MR SUMMERS: I might add that we've never maintained the abolition of the permit system because we know that it does serve a purpose; simply, we think there are huge inconsistencies and abuses of the permit system. Something that Martin just touched on has been coined by Peter Morris as "manufactured requirements for a permitted ship", so that they do their plan and very carefully, and then right at the last minute apply for a permit, because the Australian ship has just sailed over the horizon. Classic examples exist where heavy machinery that you wouldn't think needed to be delivered the next day, has sat on the wharf for months beforehand, have fallen into this trap.

A clear example of the competition that the permits can supply is the Wallarah, a former Australian-flagged vessel owned by ISM that traded on the east coast between Newcastle and Sydney. It was taken out of the run. They said there was no more work for it. They took it out of the run, reflagged it, set up a business in Kent, used the flag of convenience system - something that's pretty well known - and used Tongan seafarers on there, and they are currently - I've spoken to them - I've seen their wages down to $288 a month, working on the Australian coast almost exclusively, with a trip to New Zealand every now and then. If anybody is suggesting that Australians have to compete on a level of $288 a month, I'd be surprised. It's a really, really difficult issue to get across.

Just back to the permit system again, we believe - and we've been told by investors - that if there was a clear understanding of the lead-in time to apply for a permit, either a CVP or an SVP, then they would be encouraged into investment into Australian tonnage, under those conditions that currently exist for Australian seafarers. They see the biggest impediment - and it was echoed through the Sharpe Morris report - as a lack of transparency in that process.

MR MANNING: So that you never know when your investment will go sour because permits are issued just when your cash flow is at critical point. I think I'd add as a footnote to that that we are not in any way objecting to the national competition policy procedures of cost-benefit analysis and all that sort of thing. We acknowledge that the industry does have to be competitive; that's the reason for talking about the review of all modes. It's just that it needs to be seen in context, and in fact acknowledged that coastal shipping is actually receiving a fair amount of

rather ill-coordinated overseas competition that's on-off in an investment-discouraging way.

MR WEICKHARDT: Can I just try and understand the point you were making at the start about security. You talked about dangerous cargoes and said as a footnote, "ammonium nitrate has sailed into Sydney Harbour". I'm four years out of date, but in my time running the chemical industry that moves a bit of ammonium nitrate around, it wasn't possible to sail any ammonium nitrate into Sydney Harbour at all, let alone under Sydney Harbour Bridge. But put that to one side, I guess what I don't understand is that there's lots of dangerous cargo that moves into Australia from overseas, so what's the security difference between that product moving into Australian ports from overseas versus dangerous cargoes moving around the coast?

MR SUMMERS: We absolutely agree, and the unions, along with their global affiliate, the ITF, have been calling for the Australian government to pick up on international convention 185, for foreign seafarers to have some sort of identity checks. Now the biggest thing in Australia for the maritime industry and the trucking industry is the proposed introduction of maritime security identification cards, roughly based on the TWIC system, which is up and running in America, or being trialled and prototyped in America. The Australian government has refused to support that convention and so it leaves that whole issue open.

Recently I was asked to visit a vessel that had come from the very very small ports of Indonesia, the ones that weren't regulated under the Maritime Transport Security Act, which came into Newcastle. We were very concerned. The crews were extremely low paid, a flag of convenience vessel again, bringing in cargoes from an unregulated port. But of course the act provides for that and makes sure all the checks and balances were put in place. What we're saying is that maritime security in coastal Australia can be enhanced by Australians carrying those cargoes, and by the support for an Australian industry to carry dangerous goods. We just use ammonium nitrate because that has been proven to be the weapon of choice for the terrorists, if you like, and to hook into the topical issues that are going on; and that example of sailing under the Sydney Harbour Bridge was from the deputy prime minister, so we can check the veracity of that with him, if we want.

MR MANNING: If you do an overall cost-benefit on this, security is not an easy thing to put into a cost-benefit analysis, but using that methodology, you're into probabilities and changes in probabilities, just as you are into changes in probabilities in running flag of convenience vessels that are less well maintained up and down inside the Barrier Reef, as to probability of environmental damage; but I think the methodology can handle it some way or other.

MR SUMMERS: I might also add that one of the key features of the flag of

convenience system, the system that takes away all of the requirements for regulation and for extra costs - and so that is the cheapest way to ship cargoes, either coastally under permits or around the world - one of the key features, and the most attractive feature for some, is the ability for the ship owner, for the beneficial owner, to be completely anonymous. This is accentuated by the American security identifying al-Qaeda as owning up to 20 ships, and with all of their security resources, cannot identify 18 of those 20 ships. So they know they're out there but they don't know which ones because the flag of convenience system provides this curtain.

MR BYRNE: Far more effectively than the Australian corporate veil protects Australian companies.

MR BANKS: Well, that's saying something. Thank you very much. You've given us food for thought. We appreciate you coming in and talking about these issues with us. There being no other participants today I'll close the hearings here in Sydney. We resume in Melbourne at 9 am on Tuesday, 7 December. Thank you.

AT 5.37 PM THE INQUIRY WAS ADJOURNED UNTIL
TUESDAY, 7 DECEMBER 2004

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