C O R R E C T E D V E R S I O N

PORT OF MELBOURNE SELECT COMMITTEE

Inquiry into the proposed lease of the port of Melbourne

Melbourne — 9 September 2015

Members

Mr Gordon Rich-Phillips — Chair
Mr Daniel Mulino — Deputy Chair
Mr Greg Barber
Mr Damian Drum
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Witnesses

Dr Ron Ben-David, chairperson, and

Mr Dominic L'Huillier, acting director, transport and research and reviews division, Essential Services Commission.

The CHAIR — I reopen the hearing with the Essential Services Commission. I welcome its chair, Dr Ron Ben-David, and Mr Dominic L'Huillier, acting director, transport, research and reviews.

As you are aware, witnesses are not being sworn today, but questions must be answered fully, accurately and truthfully. Witnesses found to be giving false or misleading evidence may be in contempt of Parliament and subject to penalty. All evidence taken at this hearing is protected by parliamentary privilege as provided by the Constitution Act 1975 and is further subject to the provisions of Legislative Council standing orders. Therefore any information you provide today is protected by law. However, any comments made outside the precincts of the hearing may not be so protected. All evidence is being recorded by Hansard, and you will be provided with a proof version of the transcript in the next couple of days.

The committee has allocated an hour for this session with the ESC. I invite you to make an opening statement if you wish, and the committee will then proceed to questions.

Dr BEN-DAVID — Thank you, Chair. I will make a 1-minute opening statement about the ESC — who we are and where we have come from. I am happy to elaborate if required, and then I will hand over to Mr L'Huillier, who will run you through our functions with the port to date. Then I would like to make a quick statement about our role in the port transaction and then open to questions.

The CHAIR — Thank you.

Dr BEN-DAVID — The Essential Services Commission was originally established as the Office of the Regulator-General in 1994, with the privatisation of the energy sector, as the regulator of the privatised sector. Over the years we have been given a range of additional functions. These include water regulation, clearly the port, which came in in the late 1990s, freight rail we have had a small role in and various other transport areas more recently, such as taxis and tow trucks. We also administer on behalf of the Victorian government the Victorian energy efficiency target scheme, and from time to time we do inquiries on behalf of the Victorian government. For example, at the moment we are doing a large review into a rate capping and variations framework for local government. Our remit is broad. We are largely economists. We have accountants, we have engineers and a smattering of lawyers to help us do those functions, and of course we bring in consultants from time to time to help us with technical matters. That is in a snapshot who we are, and I will now hand over to Mr L'Huillier.

Mr L'HUILLIER — I will just run you through the ESC's current role in ports and give you some findings from our most recent review. The ESC's role in port regulation is defined by the Port Management Act, and the Port Management Act sets out a framework for the economic regulation of port services in Victoria. Specifically, section 49 of the act provides that certain services provided by the Port of Melbourne Corporation are prescribed services for regulation. So these are known as prescribed services in the legislation, and they are channel services, specifically the shipping channels in the port of Melbourne and the shared channels, which are used by all vessels entering or leaving Port Phillip Bay, including those accessing both the port of Melbourne and the port of Geelong.

Channel fees are levied once per ship visit and are levied on the basis of a ship's gross tonnage. To give you a brief example, to access the port of Melbourne channel, a typical ship would pay a channel usage charge of approximately 35 cents a gross tonne for using the Melbourne channel. So a typical mid-sized container ship of about 4200 TEU would have a gross tonnage of about 41 000 tonnes, which equates to a channel fee of around $14 500. Separate fees are also charged for the shared channels. In return for the fees paid, the Port of Melbourne Corporation provides channel services, and these include the vessel traffic services — that is, provision of shipping control services, the maintenance of channel depth, navigation aids and oversight and coordination of port emergency, safety and security plans.

The other key prescribed service is berthing facilities — that is, berths and other moorings, including buoys and dolphins — and short-term storage in cargo marshalling areas for the berthing of vessels carrying containers and motor vehicle cargo to the port of Melbourne. Wharfage fees are charged to cover the provision and maintenance of berths, and they are charged per quantity, volume or weight of cargo. Again they are set out in PoMC's reference tariff schedule. In return for payment of wharfage fees, PoMC seeks to provide a standard of landside facilities that allow reasonable berth availability.

So what is the current regulatory framework? The current regulatory framework in place is a price-monitoring framework. This framework is given effect through a regulatory instrument called the ports monitoring determination, and the ports monitoring determination sets out the requirements of the regime and the obligations on the port of Melbourne. Specifically, it requires the Port of Melbourne Corporation to publish its reference tariffs for port services each year, provide certain information to the commission for monitoring purposes, comply with a set of pricing principles and publish a pricing policy statement. In addition, the act requires that every five years the commission must undertake a review to determine whether the prescribed services are to be subject to private regulation, and if so, what form of regulation that should take.

Just briefly, I will outline some features of the current regime, which is still in place. The regime was established with a number of objectives in mind, namely transparency, information provision and reporting and review.

On the transparency side, transparency is provided through the publication of reference tariffs annually — that is the port's prices. PoMC is required to publish a reference tariff schedule for all prescribed services by the end of May each year for the financial year commencing 1 July of that year. The reference tariff schedule is a standing offer of the terms and conditions upon which prescribed services will be provided. The reference tariff schedule must clearly indicate the services to which each tariff relates. While the reference tariff schedule forms a standing offer there is nothing to prevent port operators from negotiating different pricing arrangements with individual users where such arrangements are to the satisfaction of both parties.

In terms of information reporting, PoMC is also required to provide a range of financial and business information to the ESC. This information includes financial statements for prescribed services and is provided annually to us. We use this information to monitor the provision of prescribed services, and it is an input into our five-yearly reviews. Our most recent review, of June 2014, sets out our findings in relation to the Port of Melbourne's pricing over the last five years, and I will touch on that a little bit later.

The current regime also includes pricing principles that the Port of Melbourne Corporation must adhere to and a requirement for PoMC to develop and publish a pricing policy statement. PoMC's pricing policy statement explains its pricing strategy during the regulatory period, usually five years, how the costs of major investments are to be recovered and how PoMC calculates its tariffs.

An important part of the current regime is strong industry consultation. The Port of Melbourne is required to consult its users on its pricing policy statement and its annual reference tariff and also take into account industry feedback. The other important element of the current regime is the requirement for the commission to undertake its five-yearly reviews. The scope of the review is very confined; it is very narrow. It is only to the existing prescribed services, and we are only required to look at whether they should continue to be subject to price regulation and, if so, the form of that regulation. In other words, the last review was beyond the scope of considering possible future arrangements.

Generally our approach to reviews is that we assess the extent of market power held by the port only in the provision of prescribed services — that is, channel services, containers and motor vehicles — and we assess the available evidence to ascertain whether the Port of Melbourne Corporation has exercised that market power. This then informs our view on the appropriate form of regulation. Our assessment is a general economic assessment which takes into account barriers to entry, competition between ports for the prescribed services and the countervailing power of users. The current regime has been extended until the port lease transaction is complete. The current regime ends when the new regulatory regime, which is being designed and developed by the Department of Treasury and Finance, takes effect and when the legislation passes the house.

I will briefly touch on the findings from our review in terms of market power. In terms of the channels, we found that the Port of Melbourne does have market power in relation to its channels that it manages. This is due to factors such as channels cannot be easily economically duplicated. While customers could potentially use other ports, the cost of land bridging cargo from other ports would not make this feasible, and also the countervailing power of port customers is somewhat constrained. While the big shipping companies do have some negotiating power in deciding what ports to call in at, Melbourne is Australia's largest container port and is a major destination for imports from Asia and Europe and exports to South Asia, so bypassing is not a realistic option.

In terms of containers, we found that the Port of Melbourne does have market power in its prescribed services to containerised trade. This is due to a number of factors, mainly the significant costs associated with the construction of an alternative container terminal of a sufficient scale to be able to compete with the existing terminals, the availability of suitable sites and more importantly the need for supporting infrastructure and the regulatory approvals, environmental approvals et cetera, as it generally takes 10 years for a new port to be developed. We noted no other Victorian ports currently have facilities to compete effectively for container trade within the next regulatory period, so we looked at it within the five-year horizon. In addition, a high proportion of containers exported and imported through the port of Melbourne have their origin and destination either within Melbourne or within the broader catchment, meaning it is more efficient to ship containers through the port of Melbourne.

In terms of motor vehicles we found that the Port of Melbourne Corporation does have market power in relation to motor vehicle prescribed services. This is mainly due to the majority of motor vehicles shipped through the port of Melbourne being either sourced locally or distributed to local and regional car dealerships in Victoria in the case of imports. This gives the port a locational advantage as a port of entry into the broader Melbourne and Victorian motor vehicle market. I would suggest it is unlikely to be economically feasible at a high-volume scale for land bridging of motor vehicles through alternative ports. Also the current creation of substantial capacity for motor vehicle cargoes at the port of Melbourne and the lack of other motor vehicle terminal facilities being developed at other ports means it is unlikely that new market entry will occur, at least in the short to medium term.

Just turning to prices briefly, in our last review of 2014 we found that PoMC had followed their published pricing principles and their practice had appeared to have been to pursue price increases broadly in the range of 3.8 to 5.5 per cent. While some price rises have been above CPI, there have been significant ongoing capital works — that is, capital investment — and the need to recover investment so that these price increases were not seen to be unreasonable. In terms of wharfage, annual increases over the five-year period were generally around 5 per cent. With the exception of the port licence fee in 2012 and channel deepening project, the annual price increases have generally been below 5 per cent. For the 2014–15 year prices increased less than 1 per cent, and for the 2015–16 year there has been a price freeze on wharfage for loaded international export containers.

In terms of profits over the last regulatory period, in terms of the rate of return on assets on its prescribed services, it has been around 5.5 per cent, so we have not seen any issues of excess market power with that indicator.

In terms of service quality we monitor a range of indicators, but the two most influenced by the port are the proportion of vessels that are draught constrained — which is a function of channel construction and deepening — and the proportion of vessels delayed from the scheduled berthing time or advised arrival time. We found that there were no adverse movements over the five-year period in container ship delay indicators. That is my opening statement.

The CHAIR — Thank you. Dr Ben-David, do you want to add a concluding comment?

Dr BEN-DAVID — Yes. For the avoidance of doubt I wish to make it clear that at no time have we, the Essential Services Commission, been involved in determining or advising on the form or substance of the port transaction. Consideration of these matters has rightly been managed from within the relevant policy department. As the regulatory agency, we would not have expected to have been involved in these deliberations. Our role in effect will be determined by the pricing order envisaged in the legislation.

Over a number of meetings — perhaps three or four; I have not tried to count them — the port transaction team and its advisers have met with us to guide us through progressive drafts of the order, typically on a page-turn basis. At each meeting we were provided with the latest draft of the pricing order. During those meetings we were invited to provide feedback on any matters we wished to raise. In large part the advice being sought pertained to matters of practicality — that is, what issues did we see in the latest draft of the order from the point of view of having to implement the regime as outlined in that draft?

While we were not restricted from doing so, we were not generally invited to give, nor did we offer, our views on the overall architecture of the regulatory model for the pricing of port services. These matters of policy design were largely treated as external to the purpose of those consultations. I am unaware of whether the

pricing order has been finalised or at what stage it currently rests, nor am I aware of the process by which it will be finalised. Our last meeting with the transaction team and its advisers took place two weeks ago.

At the end of each meeting with the transaction team and its advisers we were requested to return our copies of that draft of the pricing order. Under these circumstances we have not undertaken any independent analysis or modelling of our own. The feedback we have provided to the transaction team and its advisers has been limited to what may be called our first impressions of each successive draft. I wish to place on record my appreciation of the willingness of the transaction team and its advisers to meet with us and to attend to any concerns we raised in those meetings.

The CHAIR — Thank you, Dr Ben-David, and thank you for the more substantive presentation. I must say at the outset I am somewhat surprised by your concluding comments with respect to the pricing order and its development. It was my understanding from earlier interactions we have had with the Department of Treasury and Finance that the ESC would be in a position to run through how that regime was to work, and indeed I must say I had the impression that the ESC had been involved in the development of that regime. But you have made it quite clear that has not been the case and that you will implement it rather than being involved in its development. So I take it you are not in a position to talk to the pricing order today either?

Dr BEN-DAVID — Not in any detail, no. As I said, we were invited to comment on drafts. They took on board our comments, but we were not involved in any further detailed work on the development of the pricing order.

The CHAIR — Can I ask you then: with respect to the work that has been undertaken by the ESC and the port in relation to the prescribed services, you have found with each of those that the port had the capacity to exercise market power. There has been raised with the committee concern about those elements of, or those revenue items which are not going to be subject to oversight — approximately 14 per cent on the government's estimate of current revenue base will be outside the scope of the future proposed regulatory framework. Is there any reason for the committee to believe that the Port of Melbourne will not have market power with respect to those excluded functions? In particular I highlight the issue of rents.

Dr BEN-DAVID — The way the current regime works is that it is a one-way review mechanism, meaning that once a service is no longer prescribed, we do not go back and review whether it ought to be prescribed. Certainly in my time and in Mr L'Huillier's time the rents has been outside of the regime, so we have never actually looked at whether there is a capacity for the port to exercise market power in relation to that service.

The CHAIR — But given your knowledge of the prescribed services, is there any reason to believe the port would not be in a position to exercise market power on rents?

Dr BEN-DAVID — Well at face value only. It is dealing with sophisticated commercial operators who have recourse to other forms of address if they are dissatisfied with the arrangements being proposed by the port. I make that comment at face value; as I said, we have not done any analysis on that matter.

The CHAIR — Is that not the case with the prescribed services, in terms of the counterparty?

Dr BEN-DAVID — Well there are other tests that we have looked at, and we were satisfied that there was market power in those prescribed services, but it does not necessarily follow that the same findings would be found with respect to other services. It may or it may not; I cannot comment.

The CHAIR — Has the ESC formed a view on the scope of services which should be prescribed as opposed to what are currently prescribed? Again I go to the issue of rents, which has been raised by a number of witnesses who have sought their inclusion within a regulatory framework. Does the ESC have a view on that?

Dr BEN-DAVID — The short answer is no because the reviews that we have done are only on the remaining prescribed services, so we have had no reason to form a view on that particular question — and in fact, had we, we would have been operating counter to the remit of the legislation.

The CHAIR — Can I ask you with respect to clause 69 of the legislation — —

Dr BEN-DAVID — Sorry, we did not actually bring a copy of the act.

The CHAIR — This is the clause which provides the carve out from the Competition and Consumer Act 2010 and the competition code of the commonwealth.

Ms SHING — A carve out under certain circumstances, the ACCC.

Dr BEN-DAVID — Yes.

The CHAIR — Is the ESC in a position to offer the committee a view on the impact of that carve out on pricing behaviour at the port — that is, what the impact of that exclusion will be on service delivery?

Dr BEN-DAVID — No. We have not actually reviewed this particular carve out of the legislation.

The CHAIR — That was not something that the ESC was consulted on in the development legislation?

Dr BEN-DAVID — No.

The CHAIR — Okay. Thank you.

Mr MULINO — Even though we will not step through the pricing order line by line today — Have you had a chance to look at the DTF submission?

Dr BEN-DAVID — Yes.

Mr MULINO — it is clear from the DTF submission the broad approach that is going to be proposed for pricing regulation. I would appreciate it if you could just explain to us how the building block method applies and what the rationale for it is.

Dr BEN-DAVID — The building block model is a standard form of economic regulation that is used across many industries. We use it in other industries, most notably in the water sector, and it relies on probably three basic components. One is operating expenditure — and I will go through each of these briefly in a moment — another is capital expenditure and then financing.

On operating expenditure, under a building block model we would look at the cost of operating an infrastructure facility such as the port. The important point here, without going into a lot of detail, is that we do not necessarily look at actual costs; we look at benchmarked costs. What we are trying to do is identify the costs of the efficient operator of a facility. For example, in the case of the water industry, which we also regulate, the water industry is a very heavy user of energy, particularly around pumping. While we will gather information on their energy use and indeed their energy cost, in developing our view as to what prices should be, we will actually use a benchmark price of energy, which is the price that we think they should be paying, not necessarily the price that they are paying. The reason for doing so is to give them the incentives to pursue the most efficient means of operating.

On capital, we essentially would operate two tests; one is around prudency, and the other is around efficiency. Different people have different definitions of these things. In my mind at least prudency goes to the decision. Was the decision to invest in a particular piece of infrastructure the appropriate decision at the time that it was made, given the information that the operator had at that point in time? Efficiency goes to the matter of whether that infrastructure delivers outcomes and outputs at the most reasonable and lowest possible cost compared to other options.

In terms of finance, this is an arcane art and people write whole tomes on this, again it is based on working out what is a reasonable rate of return for the investment made by the operator in the facility. Again it is not about that individual's required return on equity or that particular individual operator's cost of debt; it is around using benchmarks as to what might be an appropriate cost of debt for an operator of, in this case, the port and the risks entailed in that operation.

Mr MULINO — Thank you for that. That is a very clear explanation. Just to clarify, because the allowable tariffs or charges are going to be based upon judgements around efficient costs or benchmarks, that will provide protection against any gold plating or what one might consider unreasonable charges being imposed over the course of the lease.

Dr BEN-DAVID — All that stuff I just discussed around the building block, that is about identifying what revenues the operator requires. That is then translated into a pricing schedule, and there are constraints within the pricing order around how those prices would be struck, how they would be changed and how they might be rebalanced between different services. Our role will be over five years to assess whether the prices as charged against the volumes as put through the port return the revenue as the building block model would suggest is required.

Mr MULINO — If one were to compare that proposed regime to the current regime, it is a stronger regime, if anything, in relation to the kinds of protections it is going to offer for port users.

Dr BEN-DAVID — It is certainly a much broader regime both in terms of its reach and in terms of how prices are set. As Dominic explained, currently the prices are set by the port against a set of principles. Under the new regime it will be under a set of very clear rules, and our role will be to monitor that they have adhered to those rules.

Mr MULINO — I just have a final question going back to the question around rent. You have not undertaken an explicit review of market power in relation to rent, but as you observed, what we see in rental agreements is a situation where it is common practice — in fact, uniform practice in major ports — for those kinds of agreements to be subject to contractual negotiations and for there to be contractual dispute resolution processes. As you observed, that appears to be a situation where in the ordinary course of commercial practices between large organisations it plays out in a sensible way.

Dr BEN-DAVID — That is right.

Mr MULINO — Thank you.

Mr BARBER — My question is: can you explain to me the pros and cons of a building block approach?

Dr BEN-DAVID — I am not sure whether to start with the cons or the pros. On the pro side, it is well established. It has been in practice now for a couple of decades in various industries. The rules of the game are generally quite clear, and it does provide a degree of certainty to operators or owners of infrastructure which are subject to the building block. I can go into more detail if you wish. On the con side, it can be very technocratic. It can be very black box, particularly to the customer side of the equation. Now that is not necessarily always the case, so where you have maybe a few large users who are well resourced, the black box can be opened. In other areas it cannot be.

I am expressing a personal opinion here, but one that does reflect the growing literature in this area. Maybe one of the weaknesses of the building block, because of its technocratic nature, is that in the past it has left out customers. It is very much an engagement between the regulated entity and the regulator, and customers kind of just sit over there. Certainly in every area that we regulate, at least in my time, we have tried to change that. So even within the building blocks model, or in any other regime we administer, there is a much greater onus on the provider to consult with customers, not just at the end of their planning processes but right up at the front of their planning processes — around the services they deliver, how they will be delivered, when they will be delivered — so that the services being delivered are reflective of the requirements of customers and not the requirements of the provider.

Mr BARBER — So it is possible, is it not, for a regulator entity to come in all guns blazing saying, 'This is all the investment we're going to need to make over the next while; we're going to do it very efficiently', and then just sort of downplay the amount of traffic that they are going to have coming through their utility or whatever it is. The result is they get a per unit revenue — I think this could be a per container charge — and then magically they decide that they do not need to do all that investment over the next five years, or they can do it a lot cheaper than they thought, and guess what? There are a lot more containers coming through, and so now we have got all this extra money and we have dipped out of an investment. I am not suggesting anybody would sneak that past you, but in your observation of other regulators is that a risk?

Dr BEN-DAVID — It is even a risk with this regulator. With regard to Mr Mulino's question, I was saying how the building block model is about developing a picture of their required revenues based on things like throughput or the service delivery. Then it is translated into prices, and the way it is translated into prices is around forecasts of future demand. I think most of my colleagues in the regulatory community would read that

as probably one of their most contentious areas when it comes to economic regulation, because it is often very, very difficult to forecast demand, and that happens even in those areas where we regulate. There would be nothing surprising in that, but we also have our tricks to counter those ambit claims, perhaps, on demand. Depending on the design of the framework, if there is imprudent investment or inefficient investment, that can be clawed back in later regulatory periods. It could end up being a short-term gain for the regulated party to try and game the system in the way you have suggested. Do you want to add anything to that?

Mr L'HUILLIER — Yes. Generally in regulatory regimes regulators do look at the capex that is put forward by the regulated business, and ask questions about the scope of the investment, the standard of the investment — is it gold-plated? — and the cost. It is not a matter of it just goes straight in, but if a case can be demonstrated that it is prudent and efficient and there is forecast demand and it is needed, then usually the regulator does let it go into the asset base.

Dr BEN-DAVID — If I could just add one more thing, and then the current regime in our five-yearly reviews will be required to look at whether there has been significant sustained non-compliance with the regulatory framework, and that is where we would look at imprudent or inefficient investment.

Mr BARBER — We have been sitting here for two days, and no-one can tell us how many containers are coming in in the next five years, except for the VU who are pretty confident they know what is going to happen. Everybody else said they have no idea and they are not experts and all the rest of it. So how do you know what is going to happen with the China free trade agreement or the Aussie dollar?

Dr BEN-DAVID — This regime is what could be called an ex post regime, as opposed to an ex ante regime, so in this case we will not looking at any stage in forecasting for future demand. At the end of five years we will be looking at how and what the port has done and delivered. At the end of five years we will have to ask the question: did they make prudent, sensible decisions on the basis of what they reasonably could have known at the time? I agree with you that there will always be a point of subjectivity in that. The onus will be on the port to demonstrate that its modelling of future demand was reasonable at the start or during the regulatory period.

Mr PURCELL — The ESC has been involved in the regulatory framework for a number of privatisations, whether it be the electricity industry, whether it be gas, whether it be the water. As I would read this, it is a different industry but the principles are the same: if you regulate and you write into your legislation your role is to basically consider those and to make the issues. There is nothing new in this that would scare you, after the ESC being through all of those privatisations. Is that a fair comment?

Dr BEN-DAVID — Scare is a pretty high benchmark. The first point is on public versus private ownership. Clearly the rules are set by the government through legislation, pricing orders and other instruments, but as far as the regulator goes, we are blind to ownership, and I think that is the way it ought to be. In terms of 'are we scared about anything in this framework?', I think this framework will require quite a lot of us. It is an area where the port, given the very light-handed nature of the regime we have administered up till now, we will have to spend and invest quite a bit of time and effort in building the systems to administer this. But that is not a fear, that is just a reality of the input we will need to make to make sure this works and works well.

Mr ONDARCHIE — Ron, given the primary objective of the ESC is to promote the long-term interests of Victorian consumers with regard to price, quality and reliability for essential services, and this 70-year unregulated monopoly — —

Ms SHING — Fifty. Lease.

The CHAIR — Order! Mr Ondarchie to continue.

Mr ONDARCHIE — This 50 plus 20-year unregulated monopoly.

Mr MULINO — Regulated.

Mr ONDARCHIE — Some of it is unregulated, if you have not read all this.

The CHAIR — Order! Mr Ondarchie.

Mr ONDARCHIE — What are you worried about in terms of the economic effect and impact on Victorian consumers through this?

Dr BEN-DAVID — We have certainly had articulated discussions with the transaction team and its advisers, and we were certainly very keen that customers in the ports — so that is not quite the Victorian consumer — —

Mr ONDARCHIE — Ultimately.

Dr BEN-DAVID — Ultimately it is, of course — have their interests pursued through the regulatory regime. So we certainly raised in those meetings the need to ensure good consultation around the planning and delivery of services. We are reasonably comfortable that if that works well, the port will deliver — and of course it is in the port's interest to deliver good services — and that that should flow through to consumers, all of us.

Mr ONDARCHIE — You are not worried at all that the port rents will not have a price shock ultimately on consumers?

Dr BEN-DAVID — That is outside the scope of what we will be responsible for. For the bit that we will be responsible for, I am comfortable that once we have geared up we will be well-placed to promote those long-term interests of Victorian consumers.

Mr ONDARCHIE — Within that constraint.

Dr BEN-DAVID — Mm?

Mr ONDARCHIE — Within your purview.

Dr BEN-DAVID — Yes.

Mr ONDARCHIE — Yes. I will pick up Mr Barber's example, and I think Mr Purcell touched on this as well. When the electricity distribution was privatised — and there was debate about the asset value and there was a lot of debate around the WACC, if I remember.

Dr BEN-DAVID — There still is.

Mr ONDARCHIE — Yes, indeed.

Mr BARBER — Weighted average cost of capital, for the benefit of Hansard.

Mr MULINO — And Mr Ondarchie.

Mr ONDARCHIE — Thank you. I am happy for you to learn along the journey, Mr Mulino. Ultimately there were some determinations around the rate of return. But what did happen in the monopolised part of the business is consumers did see a price shock. Is it possible through the legislation that has been presented to the Parliament with regard to the port of Melbourne lease that ultimately consumers could see a price shock through this?

Dr BEN-DAVID — I just need to reflect on the energy scenario for a moment, as you have raised it. I think there are two broad reasons why we saw the price shock in energy. One was the New South Wales and Queensland governments changing the reliability standards with those networks, which maybe opened the door shall we say for a little bit of extra investment. The other reason goes to my earlier point around the role of customers. In the energy regulatory framework, up until recently there really has not been a very big role in the way of consumer consultation. I know it sounds odd, but the interests of consumers did not figure in the regulatory framework for network infrastructure. What was the second part of your question?

Mr ONDARCHIE — It was in regard to this, is it possible, using the energy distribution business examples, that as this is worked through, consumers — buyers of products, imported products — ultimately will see a price shock through this?

Dr BEN-DAVID — I think there are pretty strong safeguards in here. I cannot say to you that there might not be a short-term price safeguard, but I think it would be a high-risk strategy for the operator to overinvest in

capital in this facility, given the five-yearly reviews we will be doing and the reserve powers that the minister will have in terms of re-regulating the port in the event of significant sustained breaches by the operator of the regulatory framework.

Mr ONDARCHIE — But it is possible.

Dr BEN-DAVID — As I said, I cannot say to you in the short term that there might not be overinvestment, but it would be a high-risk strategy.

Mr ONDARCHIE — That is a decision for them, really, is it not?

Ms SHING — Thank you, gentlemen, for your presentation and for the oral evidence that you have given to the committee today. In light of what Mr Ondarchie has just referred to, can I ask you to comment on the CPI increase and the price cap for 15 years, to the extent that that will provide certainty and predictability for port users and the extent to which you have a view on that within the remit that you have?

Dr BEN-DAVID — It certainly will. One of the sometimes written, sometimes unwritten principles of economic regulation is price stability and price certainty for users, so certainly a CPI cap as envisaged will provide that. The regime does provide for some rebalancing between prices, and our role will be to monitor that that rebalancing overall does not mean that prices do not increase by more than CPI, and even the rebalancing will be constrained within certain boundaries. I think overall the net effect of the regime is to provide quite a degree of certainty and transparency where prices do change.

Ms SHING — Thank you. My other question relates to the statement you made at the conclusion of your opening remarks, which I note the Chair picked up on as well. If I am understanding this correctly, you were involved in a number of meetings with the transaction team whereby you were given an opportunity to comment on various drafts of the pricing order. Did you provide comment and/or feedback in relation to the provision of information to the Essential Services Commission as part of that structure and, if so, was that then incorporated into subsequent documents that you were in a position to comment on?

Dr BEN-DAVID — Yes, we did provide information. We did provide commentary on the information we required as well as some clarification around, you know, definitions, and around, clause (a) says this and clause (b) says that, they do not quite seem aligned. So it was around information and clarification, and also on consultation, as I have already mentioned. While we did not have an opportunity to keep a log of what we had raised and what was done in return or in response, I think it is fair to say that many of the issues were addressed to our satisfaction.

Ms SHING — You are satisfied then that in relation to the process of engagement, which included seeking comment and views from you, that it was not lacking in any way in the context of taking your views into consideration?

Dr BEN-DAVID — Not at all. I am not suggesting that at all.

Ms SHING — Okay, great. Thank you, gentlemen.

Mr DRUM — Are you of the opinion that this transaction, which effectively sets up a monopoly with compensation payable on any additional port, effectively locks in the port of Melbourne as our main port site for 50 years plus a potential 20-year extension? Is that how you see this transaction?

Dr BEN-DAVID — As I said, Mr Drum, in my opening comments, we just have not done any work or given any thought to the nature, design and indeed the objectives of the transaction. I am simply not in a position to answer that.

Mr DRUM — But you did say that you would effectively be hearing alarm bells ring if the purchase price for the lease was too high, because it would then signal market repercussions that the return on that investment has got to come from somewhere. So that would be a worry for you if the purchase price was, in your opinion, exceedingly high.

Dr BEN-DAVID — That would never figure in the regulatory model itself, because the asset will be valued by the government as part of the transaction and that is what we will take into account and what the regulated

entity itself will take into account when setting prices for service. The price of the transaction does not feed back in any way into the regulatory model.

Mr DRUM — As economists, you tend to work purely within the numbers, as opposed to looking at all the practical doubts, risks, unclear elements surrounding this whole industry at this particular location. Those other external issues effectively do not really concern you.

Ms SHING — He has not said that at all.

Mr DRUM — I am just asking.

Dr BEN-DAVID — I am not quite sure I understand the question.

Mr DRUM — Okay, so if there are a whole range of risks about this site associated with the height of the ships that are seemingly on the way. Larger ships will be unable to get through within five years. The bigger ships will have bigger draughts and will need what they were calling yesterday capital dredging, and there are going to be some serious issues around that; and there is the uncertainty around capacity and where that sits. So if we have all of these risks associated with taking this port through to a 50 or maybe 70-year time line, that does not affect you at all?

Dr BEN-DAVID — Where it will affect us is when we do our five-yearly reviews in assessing whether the port's decisions during the past five years were prudent and efficient. We would be looking at its planning and whether the assumptions it has in its planning are reasonable in light of what it could have possibly known. What could it have known about China? When we do our first review in, say, 2021 or 2022, we would be saying, 'What could the port have reasonably known about ships coming from China over the last five years?'. That is how it would feed through into our decision, but it would be in terms of their planning, not in terms of our modelling, if you like.

Mr DRUM — In the same breath we have a government that is hearing all of this evidence coming before this committee in the last two days, which effectively has thrown all of these risks at the site that we currently call the port of Melbourne, having a 70 year — potentially 50 or 70-year future — at that site, yet it is progressing with a monopoly arrangement with a lessee that is going to have no competition because they are going to have compensation payable if a second port needs to be developed. Yet you do not see any issue with that at all?

Dr BEN-DAVID — Not from a regulatory perspective. I think that is a transactional issue rather than a regulatory issue.

Mr DRUM — If they are prepared to pay the money for it, good luck to them — or bad luck.

Dr BEN-DAVID — I think that is what we saw in the energy sector; particularly those American funds originally were very gung-ho and paid a lot.

Mr DRUM — Fair risk.

Dr BEN-DAVID — They ended up having to sell the businesses at a loss and that was their call.

Mr DRUM — Thank you.

Dr BEN-DAVID — It was not a matter for the regulator.

Mr MULINO — Thank you for your evidence. We have had some useful discussion around the strengths and weaknesses of this approach, and any approach is going to have some weaknesses. I think it is good that they are on the record and government takes those into account in setting up a framework, but I want to also go back to the broader context, which is that this is an approach that is used right around Australia and right around the world when it comes to assets that are natural monopolies right across a whole range of sectors — water, energy utilities. Noting that you have talked about some cons to this system, it is important to note that this is the standard approach that regulators around the world use and it is an approach which investors around the world are very familiar with.

Dr BEN-DAVID — Yes. I confirm those comments that the building block is well established, well understood, and I do not think one could say there is anything contentious whatsoever in applying it in this context.

Mr MULINO — Some of the issues that have been raised as potential risks, for example, the difficulty in making long-run forecasts, and everybody, I think, in this industry and indeed in just about every industry, acknowledges that making 50-year forecasts is extremely difficult, and that is one of the reasons why I think the building block method has evolved to the point where it is based around a five-year review. Five years is seen in many contexts as balancing the need for certainty so that the operator of the assets has a period of time in which they know roughly what kind of tariff they will be able to apply, and indeed use — —

Mr ONDARCHIE — Is there a question, or is this just a statement?

Ms SHING — You have had your chance to editorialise as well, Mr Ondarchie.

Mr ONDARCHIE — It sounds like a second-reading speech, that is the only problem. We are just waiting for him to actually get — —

The CHAIR — Order, Mr Ondarchie!

Mr MULINO — A second-reading speech is 15 minutes. On the one hand there is that certainty, but on the other hand, as you say, when circumstances change, you can reset after five years and set a new benchmark if technology changes or forecasts change. Is that the rationale for that five-year period?

Dr BEN-DAVID — Yes. That is right. There is nothing magic about five years. It is more a convention that has been adopted probably in most industries. Again, we need to separate the role of the regulator and the regulatory regime from the role of the owner, and the owner should certainly be planning, I would have thought, 10, 15, 20, 50 years out.

Mr ONDARCHIE — Seventy, maybe.

Dr BEN-DAVID — We just look at that window of five years for the very reasons you outlined, so I will not repeat them.

Mr MULINO — There are a number of checks which you can apply, both during the course of the five years and at the five-yearly review, and you have already referred to a few of those. One is, for example, the rate of return that you have observed on the regulated assets, and others would be various quality-of-service measures. They provide you with some confidence, and also some warning, as to whether or not the benchmarks that you are setting are appropriate.

Dr BEN-DAVID — That is right, so we would be monitoring services at the port or at any regulated entity. It is never just about prices. Prices are for something, and so the price-service mix is what the regulators are interested in. We would be monitoring that continuously.

I would expect, though this will depend on the final form of the regulatory model, that we will be providing guidance material as to how we will be conducting our five-yearly review well in advance of the review, so that all parties — the owner, the regulated entity, as well as customers — will see that. In providing that material, and again, I do not want to be too pre-emptive, I would imagine it would always go out and there would be drafts of it, consultation with users as well as the operator, before finalising it. So there would be a well-informed community of interest as to how we would be going about our role.

Mr L'HUILLIER — I think it is fair to say there are information powers in the pricing order that allow us to seek the information that we need to be assured that the new owner is complying with the tariff compliance order or the tariff order.

Mr MULINO — Thank you. A final question: observing these rate-of-return measures and other quality-of-service measures over the period of the five years will be a very good way of informing you, amongst other consultation mechanisms, as to how you might reset whatever benchmarks might be appropriate in that following five-year period?

Dr BEN-DAVID — Yes, the point of this reporting is to ensure that there is a lot of transparency around what is being delivered against what is being paid for.

Mr MULINO — This is the final question. You have made the observation in a previous interaction that it is fair to say that the proposed regulatory regime based on the building block method will be stronger and broader than what is currently in place. Would you also make the same observation in comparing what is proposed to what is currently in place in other jurisdictions?

Dr BEN-DAVID — Without having done any sort of detailed analysis of what is done in other jurisdictions, and just having a broad working knowledge of those, I would say the answer to that is, yes, it is stronger and broader than those regimes.

Mr BARBER — This one is a little bit novel, though, isn't it, in that they have got this other revenue stream, which is the compensation or the rebate of revenue from their future possible competitor — another port being built, that in itself being triggered by port capacity — but you have all sorts of interactions through their investments and operating costs? How robust do you think the amazing building block model — accepted worldwide by everybody except me apparently — is going to hold up when that interaction starts to come into play?

Dr BEN-DAVID — I am not sure I can have an over-strong comment on that. The framework will require that the operator, in terms of their prices and their required revenues, will acknowledge the return on any investment, either over the life of that investment or over the remaining life of the port. So it is not immediately obvious to me how the compensation comes into it.

Mr BARBER — At some point this competitor kicks in. We have been told it is going to cost twice as much to build a new greenfields port as possibly continued asset enhancements, we do not know, on this site. At some point they have got a choice between investing in more capacity to compete with this new port versus simply sitting back and collecting their cheque — the revenue compensation measures that Mr Mulino has mentioned several times.

Dr BEN-DAVID — I am just not in a position to comment on the interaction between that compensation mechanism and the regulatory framework. What I would say, though, is from a regulatory perspective, we would welcome a second competing port, because competition always makes the life of the regulator easier. The question is: can the market sustain that competition?

Mr BARBER — This is a bit odd, because the operator might welcome it, because they start getting a cheque at that point.

Dr BEN-DAVID — Again, I cannot comment on the interaction between the compensation and the regulatory framework.

The CHAIR — Gentlemen, thank you for your attendance here this afternoon. The committee appreciates the input of the ESC to this hearing. When we eventually see the pricing order, we may have some follow-up matters that we wish to discuss with the ESC, either by hearing or in writing, but we appreciate your input and your participation today. Thank you.

Witnesses withdrew.