



COMMONWEALTH OF AUSTRALIA

JOINT COMMITTEE

of

PUBLIC ACCOUNTS

Reference: Internet commerce

CANBERRA

Tuesday, 16 December 1997

OFFICIAL HANSARD REPORT

CANBERRA

JOINT COMMITTEE OF PUBLIC ACCOUNTS

Members

Mr Charles (Chair)

Mr Griffin (Vice-Chair)

Senator Coonan
Senator Faulkner
Senator Gibson
Senator Hogg
Senator Watson

Mr Anthony
Mr Peter Baldwin
Mr Beddall
Mr Broadbent
Mr Fitzgibbon
Mr Georgiou
Mrs Stone
Mr Vaile

The terms of reference for this inquiry are:

The Committee shall inquire into and report on the impact of internet commerce on:

- (1) the administration of the Australian taxation system and the implications for Australia's tax base;
- (2) the international competitiveness of Australian businesses, particularly small and medium enterprises, with the emergence of the internet as a retailing medium; and
- (3) government industry assistance programs, Customs administration, and the quality and accuracy of Australia's economic and trade statistics.

In conducting its inquiry the Committee will consider:

- (a) the expected growth in internet commerce;
- (b) the findings of and solutions proposed by the Task Force on Electronic Commerce established by the Commissioner of Taxation;
- (c) the quantity, value and type of goods entering Australia under the duty and sales tax free limit, and the commercial entry thresholds, administered by the Australian Customs Service;

- (d) the appropriateness of the existing duty and sales tax free limit, and the commercial entry thresholds, referred to in paragraph (c) and the implications, costs and benefits of any alteration to these limits and thresholds;
- (e) the commercial opportunities (both domestic and export opportunities) afforded to Australian firms by the growth in internet commerce;
- (f) the current frameworks for consumer protection and the protection of intellectual property;
- (g) the opportunities for Commonwealth agencies to improve services to the business sector and to the general public arising from growth in internet commerce;
- (h) the extent to which the Government's potential responses to the growth in internet commerce are affected by international agreements or conventions; and
- (i) the policy approaches being taken by other countries and the scope for international cooperation.

WITNESSES

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WARREN, Dr Tony, Consultant, Industry Commission, PO Box 80, Belconnen, Australian Capital Territory 2616	471

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Present

Mr Charles (Chair)

Senator Gibson

Mr Beddall

Senator Hogg

Mr Griffin

Senator Watson

The committee met at 9.05 a.m.

Mr Charles took the chair.

CHAIR—The Joint Committee of Public Accounts will now take evidence, as provided for by the Public Accounts Committee Act 1951, in its inquiry into Internet commerce. The committee will resume where it left off yesterday. Today the JCPA will take evidence from the National Australia Bank, the Industry Commission, the Australian Music Retailers Association and the Commonwealth Law Enforcement Board.

Before swearing in witnesses, I will refer members of the media who may be present at this hearing to the committee's statement about the broadcasting of proceedings. In particular, I draw the media's attention to the need to fairly and accurately report the proceedings of the committee. Copies of the statement are available from secretariat staff at this hearing. I now welcome representatives of the National Australia Bank to today's hearings.

[9.07 a.m.]

CARR, Dr Roderick Marshall, General Manager, Asia-Pacific Payments, National Australia Bank, 500 Bourke Street, Melbourne, Victoria

DURRANT, Mr Michael Robert, Practice Leader, Electronic Commerce, National Services, Asia-Pacific, National Australia Bank, 500 Bourke Street, Melbourne, Victoria

McLEAN, Mr Ian Mitchell, Manager, Group Government and Industry Relations, National Australia Bank, 500 Bourke Street, Melbourne, Victoria

CHAIR—We have your submission and have read it thoroughly. Would you like to make a brief opening statement before we start to ask you our intense round of questions?

Dr Carr—Mr Chairman, first of all, on behalf of the National Australia Bank, we thank you for the opportunity to talk to you today concerning various matters related to E-commerce. The National Australia Bank has been engaged in various forms of electronic commerce for the last 25 years. While new and emerging technologies have substantially changed the public interest and scope of what is defined to be E-commerce, the banking industry has substantial investment in the technology infrastructure for conducting E-commerce. It continues to make substantial new investments in enabling technology and clearly wishes to participate with government in ensuring that public policy is such to facilitate the development of choices for the community in how it might conduct business both in the commerce forum and in the general business community. We would be very happy to discuss the specific issues from our submission that interest you most.

CHAIR—In your submission, you talk about the scale of investments required and the size of competitive economics on a global basis. You say that Australia will be disadvantaged as a provider of goods and services if we do not realise that we need access to a larger pool of purchasers than just those available in Australia. You say:

- * to achieve this, Australia must establish bi-lateral and multi-lateral relationships, particularly within the Asian Pacific region.

Whose responsibility is that?

Mr McLean—What we are really talking about there, since you are looking at the overview, are essentially privacy and security issues. We are now running smack bang into problems with what we want to do as a financial services organisation because of the differences in legislation among the various jurisdictions in which we operate. Probably the best example relates to our wanting to centralise Asia-Pacific processing. To do that, we need to transfer personal information out of jurisdictions into Australia, such as New

Zealand, Singapore and Hong Kong, all of which have privacy legislation. We do not, and that is of concern to them.

CHAIR—You are saying that these multilateral or bilateral negotiations are the government's responsibility?

Mr McLean—We do both. We negotiate with the governments with what we want to do.

CHAIR—Are you suggesting that it is industry's responsibility as well as government's?

Mr McLean—As well as government's. There is nothing we are suggesting in here that is not a joint responsibility, except for the legislative regime, if necessary.

CHAIR—In talking about barriers to investment and competition, you say:

- * taxation reform is vital, and this must include the removal of regressive and anti-competitive State and Territory taxes such as financial institutions duty, debits tax and payroll tax;

Can you tell us how important the NAB views each of those taxes and their removal as a growth incubator?

Mr McLean—Clearly, we think that FID and BAD are about the worst form of tax that anybody could have. They are unique in the world and regressive, and they are expensive to administer. They hurt both the bank, because we absorb quite a lot of that tax anyway, and individuals. They are regressive because of the way they operate. There are different areas of regressivity depending on which tax you are talking about. Basically, FID is an awfully regressive tax.

Senator WATSON—What is the cost of putting it on a bank statement? Sometimes you get \$2.35 and \$1.19 respectively. What would it cost the bank per month to put that on your statement?

Mr McLean—All I can say is that it costs more than that.

Senator WATSON—Could you give us a bit more information?

Mr Durrant—None of the IT systems that we purchase have provision for adding it. Most of the software, particularly with Internet commerce, that is applicable comes out of the US. Because we have these unique taxes that are assessed in a unique fashion, there is always a substantial effort to implement any sort of package and get it operational.

Senator WATSON—How did you change that package to put this function on your system?

Mr McLean—It was done some time ago. I am now dredging, because the same question was asked by the PSA in 1995. We gave a figure of about \$45 million to set up the systems, which we cannot recoup. That is just the set-up cost.

Senator WATSON—That is a lot for these two items, just to your bank alone?

Mr McLean—Yes. We estimated that it was \$100 million across the industry in 1995.

CHAIR—Last week, I think I recall seeing articles in newspapers indicating that at least three new financial service organisations are intending to set up Asia-Pacific headquarters. All three of them are going to Sydney. Why are they coming in and establishing regional headquarters here if FID and BAD are so bad?

Mr McLean—Under the regional headquarters policy, which includes both the Commonwealth and states, as I understand it—unless it has changed in the last six months—they get a tax holiday, if not a total tax rebate, which is very nice for them. They get both Commonwealth and state incentives to do that. Apart from the fact that that is a big help to them, it also puts us and anybody else who competes with them internally at a competitive disadvantage. It is a great policy.

Senator WATSON—In the implementation of it, does that amount of money have to go on their statement each month or, being given a tax holiday, is it not necessary that they incur the cost?

Mr McLean—They just do not incur the cost.

Senator WATSON—So, if it is a rebate, it is not a question of getting it back at the end of the year?

Mr McLean—No.

Senator WATSON—They have savings in implementation costs plus the monthly administration costs?

Mr McLean—Yes. It is a problem we have with the regional headquarters policy. It disadvantages those who compete here. Naturally, they compete here as well as offshore.

Senator GIBSON—In your submission on page 7 you say:

A particular problem for the National has been different regulatory regimes between States and Territories.

You say that there has been too much emphasis on local problems rather than on taking an international view of what needs to be done regulation-wise. Would you care to expand on that?

Mr McLean—There are quite a lot of those problems. If you look at FID and BAD, for example, the rates differ across states. That is the first issue. That causes quite a lot of problems because people tend to want to avoid certain taxes so they do things in certain jurisdictions. You will know that the recent reforms failed because Queensland did not want to come on board. The issue I was thinking about in particular was the ‘threats’, if you like—and they are more than threats—of states to introduce privacy legislation that differs between the states. The Commonwealth does not have it. That would affect us differentially as a global provider and not much less as a national provider.

Give me time and I will think of about a dozen state based problems—differences in stamp duty and the applicability of stamp duty, which caused us, for example, very significant problems when we were integrating BNZ Australia into the National. We had to negotiate with the jurisdictions in each state. We had to have legislation in each state. They applied FID and BAD and stamp duty differentially. It was a very expensive process.

Mr Durrant—The other point to note is that electronic and Internet commerce exacerbates that. Our core systems are largely automated now but we offer a range of peripheral products and services that we handle manually. We assess some of these charges manually and then just enter them as a cost. As you automate more and more to do Internet commerce you run up against this over a wider and wider range of products and services that you offer. So that is a major problem. You have to make a major up-front investment in an environment where you do not know what the returns are going to be.

Mr GRIFFIN—On that question of returns, I understand that you expect to introduce Internet banking next year. I note that in the report it also mentions that the impact of that cannot be underestimated. Can it be estimated?

Mr Durrant—Clearly, we have put together a business case and we have estimated potential revenue streams over the next five years. It is acknowledged within our own organisation itself that those estimates are fluffy. We have looked at the best research we can and we have come up with what we think the market take-up rate will be. However, it has to be understood that our current estimation is that it will just add cost to our bottom line and that we will derive very little new revenue from moving into this. Largely we are going to be faced with great difficulty taking cost out of our existing distribution structures through our branch network because of the migration issues—people

from that network. It is hard to build an attractive business case to do this. We are doing it largely as a defensive measure rather than to derive new benefit for the organisation.

Mr BEDDALL—If I take up Internet banking next year and want to pull all my various accounts up on the screen, how do you secure that from Mr Griffin pulling up all my bank accounts from the Internet?

Mr Durrant—That has been a major inhibitor to us moving into this. You will note that in the US a large number of organisations have already done this. In large part it is because the core software most of us use for the provision of this service comes out of the US, which has had significant export restrictions on the key technologies around encryption. They have only recently relaxed those restrictions so it is only recently that we have been able to provide sufficiently strong security to enable us to go out to the market. Advance Bank, for instance, has been out for something in the order of 12 months. They used a specialised solution that is expensive to deploy and maintain. We wish to avoid that. Basically the reason we are going out now is that we believe the security infrastructure is in place for us to go out to the market. It has been a prime focus for us. The last thing we want to be is the bank that goes out, has transactions running and somebody breaks the system.

Mr BEDDALL—You will all be using one home based computer, basically. That is the real problem, isn't it? It is not a series of computers interlinked, it is a master computer. Up until now they have been super computers in the United States universities all linking in. Therefore the data is available. We have the problem in Parliament House here just with ordinary computer services where they can actually pop up.

Mr Durrant—We believe we are using the best security technology that we can put our hands on. We are intending to manage the delivery of the security 'tokens', if you will, in the same way as we manage credit cards and PINs, using very similar processes. The onus will still be on the individual to protect those PINs and tokens they require to get access. The onus is still on the individual to manage that. We put in place the infrastructure.

Mr BEDDALL—With the PIN, you have physically got to have the card and a PIN number to access data. What will you have here?

Mr Durrant—A digital certificate. By the way, we are told that we are not allowed to call it a PIN because that has particular legal connotations, but let us call it a PIN for the sake of this discussion. You will have a digital certificate which will be issued to you. While it is, if you like, a virtual card, you will have to have that physically resident on your PC or the computer you wish to do banking from. You will also have to know the PIN. So it is the typical security system where you have to have something and you have to know something.

CHAIR—When do you intend to launch?

Mr Durrant—It will be mid next year. We expect all four majors to be in the home Internet banking market by mid next year.

CHAIR—Just to finish this off because it is of real interest, one of the groups that appeared before us yesterday said, ‘This all sounds very interesting, but why don’t you do something innovative like allow the user to determine what their account’s balance would be if unpresented cheques had been presented?’ Having seen your proposed system, I do not think it does that.

Mr Durrant—There is a range of options there. We intend that people will be able to connect to the bank over the Internet to download statement information to personal financial manager software such as Microsoft Money or Intuit’s Quicken, which is software that is resident on your PC. On that PFM software you can also enter cheques that you have written but have not been presented yet and it will give you your balance. As those cheques are presented, they will be automatically reconciled on the next statement download from the bank. So that is the PFM software, if you will. The other approach we are providing is web banking where you will basically be able to see the state of what has been presented at that time.

Senator HOGG—What sort of market are you trying to attract in Internet banking—the younger market or the older market?

Mr Durrant—Like every other bank, we are trying to attract the young professionals with lots of money.

Senator HOGG—This is important because it really gives us an insight as to how you expect the market to expand. We had evidence yesterday that it was not necessarily an age profile, it was really an income profile, that determined the marketplace. We were told yesterday by one witness that incomes of \$60,000 and over a year are being targeted. Do you have a target income as such, given that invariably people with that sort of income can afford the computers and everything else?

Mr Durrant—It is intended that the service will be offered to the broad market. Anybody who wants to use the service will be able to use the service.

Senator HOGG—I understand that, but the issue is how many people will be able to make use of the service given the availability of a PC or some other piece of hardware to access the service. It is nice to say it is going to be available to everyone, but you must have some idea out there of what numbers of people—

Mr McLean—Can I correct one thing: we do not actually collect people’s income data, except if they are borrowing. We can make assumptions if they put their salaries and

income into their accounts, but we do not know what people's income are. We can make only assumptions about that.

Senator HOGG—I would expect you would have done some market research that would give you some indication as to what group of people are most likely to use the service. It is not much use saying the NAB has, say, 100,000 customers when in reality about only 5,000 may be able to use it.

Mr GRIFFIN—To put it another way: you have got your business plan, it is whether you can discuss it or not.

Dr Carr—There are a couple of points. One is clearly that people have to be connected to the Internet. I think something like 18 per cent of Australian households are connected, but something in the order of 85 per cent of Australian businesses are either connected or connectable today to the Internet in the sense that the business has a PC with a modem. The issue we do not know is to what extent people will do private personal banking from work which would fundamentally change the accessibility of PC Internet banking for the mass market. We have got a lot of unknowns in a business case that says: people go to work; will they do their banking from work?

CHAIR—You are encouraging people to moonlight. Is that correct, Dr Carr?

Dr Carr—We would not encourage them to moonlight. It is for their employers to determine what services they make available.

Senator WATSON—What will it cost to join the NAB network if you have got your own computer? Is there an up-front cost and an annualised cost?

Dr Carr—I do not believe we have finalised pricing for that.

Senator WATSON—What range is it likely to be in?

Mr McLean—We still cannot tell you that because we do not know yet.

Mr Durrant—I can tell you that the experience of the US banks has been that they attempted to charge for it and they got very little take-up. Typically the way they do it now is that you have the first six months, three months or some period free and then there are minimal charges—something in the order of \$2 to \$5 a month—for use of the service.

Senator WATSON—So it will cost more than normal banking?

Mr Durrant—We have not as an organisation determined that yet.

Senator WATSON—Is it likely to cost more than normal banking?

Mr BEDDALL—If people conserve balances, there will be inducements, as there are now.

Mr Durrant—Typically, it will be part of the marketing matched to a particular segment and we will price it accordingly for that segment.

Mr GRIFFIN—Can you talk about what sort of take-up rate you expect or is that commercial-in-confidence?

Mr Durrant—We have projected take-up rates based on experience that we know from Advance Bank, for instance. Certain banks in the US have had penetration in the order of 60 per cent of their customer base, but those banks are focused on certain market segments where they have a very high likelihood of access to the Internet. The typical experience in the US of home banking is in the order of 10 per cent of the customer base and that is growing at 20 to 30 per cent compound per annum. You can look at that and probably say that that is very similar to what we would expect in the Australian marketplace.

Mr BEDDALL—What would you envisage the service being able to provide besides access to balance? What about generation of payments? How would that be done through the system? If I wanted to pay my American Express card from my National Bank, can I generate that payment?

Mr Durrant—Yes. A broad outline of the services that we will provide mid next year will be account balance, statement information and the last 90 days transactions. You will be able to transfer funds from one National Bank account to any other National Bank account. There will be various levels of security. With the initial level of security, you will only be able to do it between your accounts. That is very similar to telephone banking, as it is now.

With another level of security, with further authorisation, you will actually be able to generate payments or transfer funds between your account and other accounts, including accounts in other banks. There is also the intention to enable bill payment—the B-pay initiative that you can currently do through the IVAU, through telephone banking—to also be available on the Internet. Those are the core transactional banking services. As well as that, we are intending to look at the provision of sales of things like term deposits. There are some issues around that to do with how you identify and authenticate somebody in the virtual world. There are Austrac issues and things around that that really need to be resolved over the next six to 12 months.

Senator WATSON—I want to go back to this question of security. If I draw an account on the National Bank and I mark that account ‘not negotiable’, there are certain

protective measures. Will I have that same level of security if I pay accounts through Bill-pay, if it goes into the wrong hands, et cetera?

Mr BEDDALL—If the old Bills of Exchange Act existed, would that still apply?

Senator WATSON—Would that still apply?

Mr Durrant—I cannot answer that question exactly.

Senator WATSON—Could you take that on notice because I think the level of customer security is one of the foremost questions that we really need to address our minds to.

Mr BEDDALL—I think this is an area where there is enormous potential. I am one of those people who would never use a telephone to do anything because it drives me nuts to press button 1, 3 and 7 and then start all over again. It seems to me that, because it is going to be visual on a screen, it is much easier and much more friendly. Is that what your research would show, that more people would be likely to use electronic banking rather than telephone banking? What is the take-up rate of telephone banking? I cannot find anyone who ever uses it.

Mr McLean—Only 15 per cent of those people who have telephone banking actually use it at this stage.

Mr BEDDALL—Of those who have it, but most people do not have it, do they?

Mr McLean—About 85 per cent of customers have it, but only 15 per cent use it. There is a big effort to try to push them up on that. What should be recognised—and this is a fairly interesting outcome for deregulation from new channels—is that, with the introduction of new channels such as the Internet, it is not a necessary outcome that existing channels will be used less. Our experience, for example, with EFTPOS and ATMs is that people in Australia still use the same number of cheques that they did 10 years ago. They just have not increased. What people have is a far greater choice, which means they have more transactions. So instead of just using cheques and cash, they now use cheques, cash, ATMs, EFTPOS, telephone banking and the Internet.

It is a major problem for your cost base—and I think Rod alluded to this earlier—because it actually adds to your costs quite considerably. You cannot take the costs out the back end. So we still have people wanting to use cheques, people wanting to use cash, and they want to use branches. They also want to use all the new mechanisms, or the majority of them, so they want the lot. It is an issue then of what you are going to charge. You mentioned earlier about what we are going to charge. That is a major problem, of course, because we used to give away everything for free under various forms.

Mr BEDDALL—No, you did not. I used to pay for it through my home loan. You cross-subsidised, and you cannot do that anymore.

Mr McLean—Quite. You cannot do that anymore. It is nice to hear David Beddall say that, but it is not something that we hear very often from politicians and various other people.

Mr BEDDALL—I am a retiring politician.

Mr McLean—And you were the minister for small business, as I remember. That having been said, it is a truism. When we went to the PSA back in 1995, we actually showed quite strong graphs about the usage of these mechanisms. The same thing is going to happen here.

CHAIR—Could I go on to some more generic issues. On page 4 of your submission, you had a terrible sentence. I do not really know what it means. It says:

The actions of the Australian Competition and Consumer Commission (ACCC) in relation to the criteria under which new entrants to the electronic payments system are particularly concerning.

Something must be concerning. What are the concerns that you have?

Dr Carr—Following on from the Wallis inquiry and report, you will recall that the National Bank was strongly supportive of opening up the payments system to non-bank participants under rules which would ensure appropriate prudential supervision to manage systemic risk. It appears that an additional agenda has emerged in the various forums concerning not only the specification of standards within the payment system to ensure open access but also a proposal about the regulation of pricing, particularly interchange agreements. The proposal is that, unless an efficient pricing regime—which is economist speak for marginal cost pricing—emerges, then various regulatory devices may be used to enforce a pricing regime on the interchange arrangements between banks and the electronic clearing streams.

Mr McLean—At the moment those arrangements are bilateral, so we negotiate them bilaterally. The proposal is to enforce a price regime over the top. Rod has carriage of this, so it is quite an interesting exercise.

Dr Carr—This is not the forum to delve right into that. The bank will be taking that up with the APCA and a number of other industry groups, including the ACCC itself. The issue for this forum is clearly future investment in electronic commerce, which is, in part, dictated by the expected returns. If past investments are essentially treated as public utilities, then it is likely to change the nature and extent of expected future returns from new investments in these technologies. That is obviously an issue for us going forward and making plans for additional investments such as where we do it and how much we do

of it.

CHAIR—On page 5 you talk about problems which have occurred through a lack of understanding about the nature of competition and the need to accurately assess costs and benefits. You go on to say:

However, a significant problem is the paucity of acceptance among certain individuals and groups in the community, and confusing government policies and responses.

Which ones?

Mr McLean—I think we have just alluded to that with David Beddall. For example, we have an inquiry into alternatives into banking in regional and remote areas. A fair trading report came out of the—

CHAIR—Industry, science and technology committee?

Mr McLean—Yes, that is the one. That has given us quite a deal of angst. Our belief is that it stems from an unwillingness of certain people to actually change. It probably stems from a lack of knowledge about how to change. It stems from our inability, if you like, to be able to alter behaviour without significant price signals. Those price signals that we give are not strong enough at this stage to really influence behaviour. It is still a very significant problem for us in trying to move into the new electronic age—still being hampered by not only a regulatory response but also, if you like, a persuasive response to allow people to maintain what they did in the past at the same price that they did in the past.

CHAIR—But then you turn around in your submission and argue for government regulation over privacy.

Mr McLean—That is a different thing.

CHAIR—Oh!

Mr McLean—It is a moot point. We have had a lot of angst in looking at that. Why we came down on privacy was not because it is a national issue; for us, it is becoming an international issue. It is much easier for us to point to a regulatory regime and say that this is in place than to point to a self-regulatory regime that may not be in place across the board. As a bank, it is not a real worry for us. We have negotiated a position with Hong Kong. We will negotiate a position with New Zealand. We could not negotiate a position with Singapore. We now have some interesting responses coming out of the US and the European Community. So it is quite an issue. On balance we would prefer to have a self-regulatory regime. We are not sure that that will meet all the requirements going forward of our international trading partners. That is really where we

came from.

Dr Carr—As Ian alluded to, the risk is that this apparent vacuum will be filled by states introducing state based privacy legislation which will fragment entirely the prospect of a sensible resolution to a policy.

Mr McLean—We already have a privacy regime mooted in Victoria for a multimedia Victoria. We have New South Wales preparing their legislation. We do not quite know where that is up to. Each of those is quite different. Victoria's is a light touch legislation and the New South Wales legislation, what we know of it, is not. We have Queensland also talking about it. It really will cause us a great deal of difficulty. Our self-regulatory regime is not necessarily going to be accepted by all. I am heavily involved with Moira Scollay's exercise at the moment. It is a good exercise which is likely to be quite successful, provided everybody signs up to it, but to sell that outside of Australia is not necessarily going to be an easy job.

Senator GIBSON—How far away is completion of this private code?

Mr McLean—Quite a long way away.

Senator GIBSON—Months?

Mr McLean—You would have to ask her. I would say months, perhaps six months.

Mr BEDDALL—But you can have the best of both worlds. You can have a self-regulation code underpinned by the Trade Practices Act which is only then enforced in the breach.

Mr McLean—That is of some concern to us. The self-regulatory code—this is the fair trading outcome—can now be enforced but that is not necessarily going to meet the requirements of the people we are talking to. The outcome we are really looking at is a national privacy regime that allows codes to fit underneath it according to the nature of the industry. It would not be a prescriptive regime; it would just have a set of principles. They already exist. We are negotiating those at the moment.

Mr Durrant—There are implications here. We were involved in the formation of an Asia-Pacific consortium. It was looking for a home to do its data processing. There was a preference that it be in Australia because of the infrastructure that we have. However, in the end, I believe that that consortium is likely to go to Singapore. The reason is that you cannot export data out of Singapore because there is not the privacy regime in place. While it is not the intention—I am sure it is not the intention of the Singapore legislation—it almost has the effect of a non-tariff trade barrier.

In data processing and software you have a lot of personal data. It can be data mined. You can draw all sorts of conclusions from that. Unless you have a privacy regime which is negotiated on a multilateral basis with other jurisdictions, you will end up with either these islands of processing or, for those jurisdictions that do not have those requirements, they will naturally gravitate to a centralised processing point where they can actually do all the processing. We are actually starting to see that happen. Singapore has a thriving data processing industry on the basis of the fact that they are a natural point to do that in Asia. There are significant issues for Australia in terms of the growth of data processing and outsourcing in the software industry.

CHAIR—Mr McLean, you mentioned the Victorian legislation. I think you used the word ‘lighthouse’.

Mr McLean—‘Light touch’.

CHAIR—Do you support the Victorian legislation?

Mr McLean—No. We do not support state legislation at all.

CHAIR—No. Forget about the fact that it is state legislation. If it were national legislation, would you support the approach?

Mr McLean—I have not given huge consideration to the actual details of it. Our concern is that it is state legislation. We will look at the details later and whether there is something in there that could be exported to a national level.

CHAIR—You are proposing that there be federal legislation to address the issue of privacy with respect to Internet commerce. Would you be willing to advise the committee now what you think a proper regime should be for Australia or is that too complicated?

Mr McLean—It is a big ask because I do not make those decisions. That is the bottom line. We certainly do a lot of work on it, but I could not give a guarantee to the committee that we could advise the committee on what we would like to see in it. The other complicating factor is that we are not the only ones that this would be applicable to. We are working closely with the industry in developing a set of standards. While the industry is pro self-regulation and we have set ourselves a little bit apart from that, the principles would be the same regardless of whether legislation or self-regulation applied to our industry which, as you are probably aware, is already under quite significant privacy constraints anyway as a result of common law and the code of banking practice.

Senator WATSON—What you have said to us, though, is that the proliferation of growth of privacy legislation amongst the various states may well send some data processing offshore.

Mr McLean—It may. I did not actually say that, but it is certainly possible. From a systems point of view, it is just extraordinarily difficult to have state based systems when we are an international organisation. It is bad enough with FID and BAD, which caused us all kinds of trouble. Once we start getting into this and we have a different way of looking at individuals' information, a different way of storing it, a different way of destroying it for each state—

Senator WATSON—To take that a bit little bit further without going quite as far as the chairman, perhaps there may be a role for the Commonwealth to at least coordinate what is happening to ensure that this data matching industry is not lost to Australia.

Mr McLean—The Privacy Commissioner has a large project going at the moment which is attempting to do just that. We are negotiating with her all the time. At the moment it is confined to negotiations with industry groups. That does not mean she does not talk to us individually. She is attempting to come up with a solution for that. It is a non-legislative solution; nevertheless, it is a potential solution. At the moment I can tell you that we do not like what she has come up with in the last draft because it is very prescriptive and causes almost as many problems as state based legislation.

Senator WATSON—Is there enough stick as well as carrot in the Privacy Commissioner doing it as opposed to federal government agencies doing it in a more formalised way?

Mr McLean—We tried that one with the Attorney-General's Department. That was basically a lift of the Commonwealth privacy legislation in the private sector. That had a pretty horrific outcome.

Senator WATSON—What do you mean by that?

Mr McLean—It was very restrictive and very limiting and extraordinarily expensive for us and in fact would not have allowed us to do a great deal of what we wanted to do internationally.

Senator GIBSON—Are there any international models that the banking industry supports?

Mr McLean—We have certainly been looking at the Canadian model. We have been quite attracted to the New Zealand model. As I understand it—I really have not read all the papers that have just been given to me—the Hong Kong model is not too bad either. So there are a number of models around, but it needs to be looked at in terms of our requirements in going forward.

Senator GIBSON—Can your association give us some information about those models?

Mr McLean—Yes.

Senator WATSON—Including your preferred model.

Mr Durrant—Paired with the privacy issue, although they are somewhat separate but they are closely related, is the issue to do with the regulation of encryption technology and the effect that that has in distorting our ability to deliver solutions on a global basis—in particular, the US export regulations on security technology but also the various regimes that are starting to develop around the world. The UK has quite onerous proposed legislation on encryption technology. There are a whole lot of areas here.

In order for us to deliver service and sales of financial services on a global scale, we actually need to see multinational agreement on some of these areas. I do not know how that is going to come together. The Internet is starting to push the boundaries of jurisdictions in ways they have not been pushed before and there just aren't the coordination bodies there to do some of this stuff. But, certainly, for us to be able to deliver strong encryption to a customer that we might have in Singapore for banking transactions, we are into a huge morass of regulations—about how we do that and will they allow that strength of encryption. If we are exporting stuff out of Australia, do we have to get export approval for some of that encryption, even though we have imported it from the US? These are things that we are trying to work through, and at the moment there is not a lot of clarity around a lot of this.

CHAIR—I note that you said:

The number of government and government sponsored inquiries which relate to electronic commerce is significant, as presumably is the total cost. Again, this is evidence of the need to better co-ordinate government policies in this area.

Did you propose that we butt out?

Mr McLean—No, it was a comment that we made to the Wallace inquiry and it is a comment we make here that it appears to us that there are an awful lot of agencies involved in the exercise, in one form or another.

CHAIR—It does to us too.

Mr McLean—Yes. The parliament has a particular role, but there are an awful lot of agencies involved—not only government agencies but also semi-government agencies: state governments, some local governments, universities—all of whom have got an agenda to push, all of which causes business a great deal of problems in following it. You would not believe the amount of paper I have from all these; it is probably over a metre high.

I made the comment about the smart card code of conduct and what we considered

to be some ill-informed comments on the banks' role in that. The smart card is one small mechanism, as a channel. It is no good to us at all to have product-specific codes running around our bank and having to comply with them—apart from the fact that we have already got privacy. Yet there were some pretty uninformed comments about the banks not supporting privacy. We have electronic commerce, of which smart card is just one mechanism; it is electronic commerce we are looking at. It is not only privacy but how you deal with your customers. If you have a look at the EFT code of conduct, which we are looking to expand, it deals with how we deal with customers in cases of fraud, in cases of mistaken identity and so on—quite irrelevant to us. Yet there was this uninformed comment that came out, both from government and elsewhere.

CHAIR—I am forming a view that it is the size of the problem in the marketplace. I think I can fairly say, on behalf of the committee, that we commenced this inquiry thinking that Internet commerce was really quite significant in Australia—we looked at this \$3 billion figure worldwide, expanding to \$100 billion to \$150 billion by the year 2000. Yesterday we, perhaps more realistically, came to grips with the size of the market: an estimate perhaps as low as \$32 million in real trade on the Internet in Australia this year. If that is right, then your comment about the number of agencies, the number of inquiries and the perceived amount of regulation perhaps has some practical, on the ground relevance.

Mr McLean—Yes it does.

Dr Carr—I think one of the things about electronic commerce is that it is ultimately all-pervasive. So almost any individual, business or organisation can rationalise having to become involved. It is as big as *Ben Hur*, to quote the story. But, to a large extent, the reality is about doing stuff that we already do, in a slightly different way.

CHAIR—Sure.

Dr Carr—The concern that we have is, as I said in the opening remarks, that we have been doing electronic commerce in one form or another for 20-some years. We will continue to do it. It evolves at a different pace and on a different scale. The last thing we need to do is to create an extraordinary regulatory environment for this particular way of doing business—which is not to say that there are not some issues surrounding privacy that we have discussed this morning which are significant—which have the ability to fragment, impede and create barriers to the evolution of this way of doing what we already do.

Mr McLean—I think the best policy is one that removes the barriers to technological development as opposed to one that produces positive outcomes—subsidies and so on. We have tax barriers; we have fragmentation of government policies across Australia, which is a constitutional issue. The removal of those is likely to enhance the ability to go forward, to actually deal with this. As Rod said, this is an all-pervasive

mechanism with quite a few opportunities for Australia but also a few threats.

CHAIR—Gentlemen, thank you very much, both for your submission and for your comprehensive answers. If you can put together some more information on a couple of those issues that we asked you about, we would indeed be most appreciative.

[10.07 a.m.]

COSGROVE, Mr John Henry, Commissioner, Industry Commission, PO Box 80, Belconnen, Australian Capital Territory 2616

RIMMER, Dr Stephen John, Director, Office of Regulation Review, Industry Commission, PO Box 80, Belconnen, Australian Capital Territory 2616

WARREN, Dr Tony, Consultant, Industry Commission, PO Box 80, Belconnen, Australian Capital Territory 2616

CHAIR—Thank you for your submission. Do you have a brief opening statement you would like to make before we ask you deeply interrogative questions?

Mr Cosgrove—Thank you, Mr Chair. I appreciate the opportunity we have had to make a submission to your inquiry and to appear before you today. I will make some brief remarks directed at presenting to you what we see as the main elements of our submission. I think our submission relates mainly to the second of your terms of reference, although we also touch on the first.

As you probably know, the commission has a strong general interest in the allocation of resources within the community. In addressing that general issue, the key principle that we keep in our minds is that providers of goods and services should meet the needs of users and consumers at the lowest possible real resource cost. Pricing of Internet access to reflect real resource cost seems to us vital for the provision of a sound basis for growth of Internet commerce in Australia and the associated opportunities for Australian businesses to use this medium to increase their international competitiveness.

In very general terms, one can say that pricing Internet access too far above cost will discourage consumers from purchasing access to the Internet and hamper its adoption as a medium for electronic commerce. On the other hand, if Internet access is priced too far below cost, that will jeopardise the willingness of providers to supply the infrastructure which is needed to support growth in Internet commerce. I think it is mainly that supply side element which our submission seeks to draw attention to. There is often a lot of interest naturally in the demand side, but we think there are some important supply side considerations that need to be borne in mind.

The first issue which our submission raises concerns the current pricing arrangements for Internet access calls. As you will know, the capped charge for those calls of 25c per minute for residential and charity users means that in most cases the cost of the local call component of an Internet session is not met, and we have presented some estimates of those costs in our submission. The losses made on those Internet access calls are likely to be borne disproportionately, it seems to us, by lower income households. That is because the greatest demand for Internet access calls is among higher income, better

educated households. So that group is likely to be the largest beneficiary of untimed or at least less than fully costed Internet access calls, and the losses made on Internet access calls are likely to be covered by users of basic telephone services, including of course lower income households. So the outcome that we see is one in which low income households under the present arrangements for pricing subsidise the calls made by higher income households. In other words, we may have a situation which is neither economically efficient nor equitable.

The losses made by carriers on these calls also may undermine incentives to upgrade the technology of the local call network to provide higher quality Internet access for Australians. In fact, the current pricing of Internet access calls may even encourage the development of a separate network to carry data at high speeds at a timed charge, even though an upgraded local call network may have carried both voice and Internet calls at a lower total network cost.

So it is against that background that we have recommended in our submission that carriers be allowed to charge on a timed basis for the cost of providing the Internet access call service. This would remove the need for those calls to be subsidised by the provision of other telephonic services. It also should ensure that investment incentives are not distorted and that inefficient proliferation of networks is avoided.

Our second main point in the submission is that we believe the inclusion of Internet access in the universal service obligations for telecommunications could result in cross-subsidisation also from low income to high income households. Providing Internet access to all Australians on the basis of existing technology would necessarily involve cross-subsidisation benefiting high income users. The cross-subsidy may be paid for in part by other Internet users in high density areas, but some of the burden is also likely to fall on users of the basic telephone services, typically including the low income users.

Another area of concern that we have mentioned to you is the cost of Internet capacity between Australia and the United States. Most of Australia's international Internet capacity is to the US, and Australian Internet access providers currently pay the full cost of that capacity. So they are paying not only for Internet traffic coming from the United States web sites to Australian Internet users but also for Internet traffic from Australian Internet sites to US users. That represents a subsidy to those US Internet access providers by Australian access providers and, ultimately, by Australian users of the Internet. Ideally, the cost of Internet capacity would be shared by Australia and the US on the basis of traffic flows, as is the case with Australia's other direct Internet links.

We have suggested that the committee take note of the cost impost imposed by the current arrangements and their potential impact on the growth of Internet commerce in this country. It may also be useful for the committee to consider the potential role for government in advancing discussions between Australian and US carriers on this issue.

The final section of our submission discusses taxation and Internet commerce. We have noted that this issue has been the focus of many of the submissions and hearings put to your committee to date. In particular, there appears to be concern regarding the current tax-free thresholds for goods purchased over the Internet and delivered by other means into Australia.

Our submission concluded that, with Australia's currently low tax-free threshold and the presently low volume of Internet commerce, it is unlikely that electronic ordering will present a quantum difference in the volume of goods delivered by other means as compared with existing methods of ordering those goods. We have noted, for example, that according to Australia Post, the volume of parcels and packages entering Australia has remained quite static over the past five years. In 1991-92 there were 11.6 million such parcels and packets entering Australia. In the last financial year, 1996-97, that level reached only 11.8 million—almost no growth.

Accordingly, we doubt that electronic commerce of this type will have a significant impact on the competitiveness of Australian retailers or on the revenue base in the short to medium term. However, given the level of concern regarding this issue which has been raised by others, we offer some additional comments on the matter. We have noted that the Australian Retailers Association recommended a lowering of the tax-free threshold for goods entering Australia—in fact, to zero. It seems to us that reducing that threshold would involve greater administrative and compliance costs which are likely to outweigh the increase in revenue collected from such a lowering.

In its submission to the committee the Australian Customs Service claims that the current costs of processing import documentation and collecting revenue on a cost recovery basis are \$22.80 plus 20c per line after 10 lines for an electronic entry and \$44.55 plus \$1 per line after the first line for a manual entry. It is on the basis of those calculations that they do not collect sales tax and duty if the combined value of the taxes is less than \$50. It is simply not worth while to do so.

Another proposal which was put forward by Mr Webb of the Australian Fishing Tackle Association to impose a flat fee on all goods entering Australia seems likely to result in a substantial loss of revenue. Replacing the existing sales tax and import duty rates with a flat entry fee may discourage small purchases—in fact, it probably would—but it is likely to have the unintended effect of encouraging the bundling of purchases into commercial sized lots to minimise the average incidence of the flat fee. It seems to us that neither of those proposals have merit.

Less attention has been paid in submissions and hearings to date to taxation issues for goods purchased and delivered over the Internet. That is not surprising given the range of technical difficulties involved in monitoring this type of Internet transaction and the current relatively modest value of goods purchased and delivered in this manner. At the present time, the cost of monitoring and enforcing the taxation of these transactions could

easily outweigh the benefits, although any rapid growth in Internet commerce could alter the situation some time in the future. In our submission, with that in mind, we have recommended that a regulatory cost benefit analysis, including preparation of a regulation impact statement, be undertaken before introducing tax measures which would potentially stifle Internet commerce. Nonetheless, we note the government's recent decision in its Investing for Growth statement that goods ordered and delivered electronically will remain, we understand, tax free.

In summary, our submission has raised several issues which we think are important related in particular to the pricing of Internet access. We believe that these need to be addressed adequately to ensure that Australian businesses and consumers are able to capture the opportunities that would be offered by an appropriately priced, well developed Internet environment.

CHAIR—Thank you very much. I know my colleagues have a number of detailed questions, but I would like to start with something a bit more generic which we have been trying to come to grips with. On page 3 of your submission you comment that the ATO estimated in 1996 about \$10 million of Internet commerce. Mastercard said that in the 12 months to June 1997 it was about \$15 million. Your submission further states:

The ATO quotes projections for the year 2000 of about \$500 million in internet commerce sales by Australian businesses.

Yesterday www.consult gave us an estimate for the current year to date—that is, the last 12 months—of about \$32.5 million in total and a more flat growth profile for the expansion of Internet commerce and Internet access than has been true of the last couple of years. Do you think the \$500 million is realistic?

Mr Cosgrove—It is very difficult for us to help you with that question. We at the commission are not by any means experts on Internet commerce as a sector of the economy. We really intended in our submission to set forth some essential principles related to the pricing of these services which might be useful in the guidance of policy formulation. How the sector might develop I think is a matter on which you would be more likely to gain authoritative advice from some of your other participants.

CHAIR—Would you not agree, though, that the quantum of that sector of industry is important to these considerations? You have talked about certain items of tax and regulation, and so have others. The NAB was just here talking about a range of issues from privacy to government regulation to taxation.

Mr Cosgrove—Yes, it is certainly relevant.

CHAIR—If the quantum is very small, are these things of major significance?

Mr Cosgrove—As we have indicated, because our impression at present is that some elements of electronic commerce are not very large, that is a reason for not going over the top in terms of seeking to impose rather rapidly regulatory measures which might have higher costs than benefits to the community at large. Again, we have indicated that if that situation should change the balance of benefits and costs may change. So one would want to have a pretty thorough assessment in the event that some significant take-off in growth of this area was involved.

I do not think, though, that we have done more—or want to do more—than indicate that there are some potential impediments to the efficient growth of this type of transaction, which we believe should be taken away. It is with that in mind that we have directed most of our comments in this submission to the pricing arrangements. In other words, it makes sense to us to remove those existing impediments—one in particular—and to allow the sector to grow. Whether it chooses not to grow or to grow very rapidly thereafter would seem to us not to be a matter of great concern, except possibly on the taxation side. It is better to approach the issue that way than to predetermine a particular level of activity which requires certain policy actions.

Mr BEDDALL—I find the proposition that you have come up with about cross-subsidisation quite strange. It is completely at odds with all the evidence we have had to date. If you know anything about the telephone network, you would know that the greatest problems we had in determining policy for it were the lack of competition and the fact that the network was never used to capacity—nowhere near capacity.

What happened with Telstra and Optus was Telstra got smarter, its capacity was upped and, even though it had only a small percentage of the market, it made more money. We had evidence yesterday from the technical people at Telstra that the quantum leap in the core capacity, carrying capacity, of the network—not by increasing the size of it but by increasing the technology—has meant the amount of data being transferred is, by factors of X, substantial.

I do not know how you could possibly believe there is a cross-subsidy, because there is only additional capacity. That is what is being utilised by the Internet—additional capacity. It is not replacing current capacity and, therefore, a cross-subsidy is not taking place.

Mr Cosgrove—Some estimates which the commission has done indicate that the average long-run marginal cost of providing what are estimated average length calls through Internet data services is about 75c.

Mr BEDDALL—Have you talked to the carriers about that? Why would Optus go into the Internet now when it is going to lose 50c a call?

Mr Cosgrove—That is the cross-subsidisation element.

Mr BEDDALL—It has not got a local network.

Mr Cosgrove—No, but Optus are not operating purely in a local network environment. They may well be making a decision to subsidise their involvement in Internet access provision through higher prices charged to other parts of their operation. That is what we suspect is actually happening.

Mr BEDDALL—The argument put forward is that the maximum local calls—not anything else—are 25c and Optus does not have a local network, yet it has gone into the Internet—

Mr Cosgrove—It has some local network, not a very extensive one.

Mr BEDDALL—It really is a good local network—it cannot handle more than 600 calls. That is its problem: it falls over. Another government instrumentality—the ACCC—is trying to correct that through a backdoor mechanism, which is an argument we should have with the ACCC. This is about increased capacity. With the capacity that is not being utilised there is no revenue.

Mr Cosgrove—But they still need to cover their marginal cost.

Mr BEDDALL—Have you talked to the carriers? It would be nice to get some information. Do they agree that the marginal cost is 75c?

Dr Warren—As you well know, this data is not easy to come by, of course. This data comes from the carriers. We are not going to cite it, but that is where it comes from.

CHAIR—Didn't Telstra yesterday talk about being able to price on quality of service rather than on quantity?

Mr BEDDALL—That is the other point. You are worried about downgrading of the service, which is the second point I wish to make. That is going to happen anyway. They have already indicated that they are going to provide two levels of service and you will pay more for the other. If you want to transmit high quality data internationally through the Internet or any other means, you will pay a premium for it. There is no need to have that sort of quality just for normal, voice telephone calls. They will use satellites rather than landlines, et cetera. That is going to happen anyway: you are going to have a two- or three-tiered system.

Dr Warren—That is true. The business users at the moment do not have the cap and they use ISDN links anyway. The point we are trying to make, which gets back to your earlier Optus example, is that Optus is involved in the carrying from the ISP on to the Internet. Optus is not in the local call component of the Internet.

What we are suggesting may happen given the timed local call constraint is that there will not be a lot of incentive for the local network to be upgraded. For example, extension of ATM technology to the local loop may not happen, because you cannot recoup that cost. Given that your average Internet local call component goes for half an hour and on average it costs the carrier 75c, the most they can get for that is 25c. So there is not a lot of incentive for them to upgrade residential networks. What they will do instead, as you have mentioned, is focus on business and ISDN.

Mr BEDDALL—But that is not right. The focus for them to upgrade the residential network is interactive services. It is not necessarily just the Internet. It is the next stage. It is why Telecom has laid fibre optic to the corner and, in some cases, to the household and laid coaxial even in small streets like mine. It is about upgrading the network to get to the next stage. It is not just about telephone calls or even the Internet. It is about movies on demand and all those sorts of things. That will upgrade your network.

Dr Warren—Charged by that process.

Mr BEDDALL—Yes.

Dr Warren—So we get further duplication of the networks?

Mr BEDDALL—No, you get an upgraded network. What you are talking about will mean that the network will not be upgraded. It will be upgraded because they have to provide a better grade of service to provide the next range of data transmission to the home. Data transmission to the home will come along with the information superhighway. That is what will happen. But it will not happen just because of the Internet.

Senator GIBSON—I was just wondering whether the Industry Commission could have a look at the information that was given to us yesterday by the carriers, particularly by Telstra, with regard to David Beddall's point about huge increases in capacity by new technology over the existing lines which they were foreshadowing is going to happen in the next 12 to 18 months. I think if you could give us advice about what impact that is going to have on long-run marginal costs and give us a bit of guidance as to what is going to happen in the future, that would be most useful so that we can put what you have said to us today into perspective. Would that be possible?

Mr Cosgrove—I think we could do that. We have not, of course, seen what was put to you yesterday.

CHAIR—Well, we understand that because it has not been transcribed yet. I would also like to note that British Telecom, as I recall, commented that their pricing concern was more about being able to price the quality of the service provided rather than the quantum—that is, quality rather than time. That is what I understood them to argue.

Senator GIBSON—They were basically arguing with Telstra about access to the Australian network. But none of them raised the concerns you have with regard to this timed call business. It is interesting that it was not raised.

CHAIR—I do not recall it.

Senator GIBSON—Nor did anyone raise the other issue which you have raised; that is, the connection between here and the USA and the imbalance of it. I am surprised.

Dr Warren—Telstra is running a case against the Federal Communications Commission in the United States currently on this issue. So it is a matter of concern.

Senator GIBSON—That is interesting. We should chase that up then.

CHAIR—Did you have another question?

Senator GIBSON—Just a general one. Earlier this morning we had NAB here expressing grave concern about the privacy rules and the lack of privacy legislation here in Australia. They said that they are facing a disadvantage in shifting processing of data here to Australia out of Singapore, Hong Kong, New Zealand or wherever—part of their empire—because of strong privacy legislation. While they are going down the route of negotiated privacy rules with the Privacy Commissioner, they are concerned about the way that is going. Has the commission looked at this at all? Are you aware of this problem?

Mr Cosgrove—There may have been some—I suspect, not great—effort devoted to it. Dr Rimmer might be able to make some comments.

Dr Rimmer—As we understand it, the state of play is that the Privacy Commissioner has released a draft self-regulatory regime in this area and is soliciting comment. So, in that sense, a legislative regime is not in place. What the final regulatory regime will be and whether that has a legislative component, it is probably a bit too early to say. The government has yet to respond. But clearly there are various views amongst commerce and industry and other community groups about the best way to develop privacy regulations.

Senator GIBSON—Essentially, this morning the bank was saying that their consideration of trying to bring processing out of Singapore here to Australia will basically fail because there is not a principles based privacy legislation, or set of regulations, backing up the system here and so people will not take the risk to shift the data here. So Australia could miss out on the processing of information by the likes of NAB as a consequence.

Mr Cosgrove—I could perhaps make one final remark in connection to a point made by Mr Beddall. The cross-subsidy which we do see in the current arrangements,

relating, as our submission indicates, only to residential and charitable organisation users, is still a clear disincentive to upgrade the infrastructure underlying the servers. But that may not stop upgrading related to other elements of service such as multimedia type arrangements or interactive facilities. But I do not think one can entirely leave out of account the disincentive to carriers and suppliers presently resulting from this clear excess of cost of provision over price earned.

Mr BEDDALL—I would like to see evidence of that in the current network. We often forget how good our telecommunications industry is. We are the eighth biggest telecommunications market in the world. We are not a small player. We have more telephones per household than any country, including the United States. There has been no evidence that, even as a monopoly, there has been any lack of looking after the upgrade of the network. Certainly, evidence since competition came into effect—with Optus and all the other players—is that a vast amount of money, maybe too much, has been spent on the network. Something like \$4 billion has been spent on the cable roll-out.

Mr GRIFFIN—It might be fair to say that it is not an incentive to actually upgrade.

Mr Cosgrove—Certainly not.

Mr GRIFFIN—But, to get back to the point that David made about why there is an upgrade occurring anyway, the evidence that we have had so far, I would say, is this: Internet services for most players, whether they be industry, business or carriers, is essentially an adjunct to other activities. It is not the principal activity. So if you are looking at it in this situation I think it is fair to say that people are looking at the Internet and saying that there are some opportunities here that could be significant, but they are not significant right now. They might be in the future but it is a bit of a ‘how long is a piece of string?’ argument. So it is an add-on that we have there. It is not central to our decision making about what we do on the issue of networks and upgrades. It is an adjunct to that, so it is peripheral—at least that is the way I read it, anyway.

In relation to the volume of Internet trade or trade coming through the Internet, you mentioned the figures from Australia Post regarding parcels, et cetera. I understand that that is the case, but some people—you mentioned the Fishing Tackle Association—have raised whether it is having an impact on particular niche industries, if you like. That of course is very difficult to get data on, but do you have any comments on that particular point?

Mr Cosgrove—I am afraid I do not have any information on that particular point. I do not know whether my colleagues do.

Dr Warren—We do not have that data.

Mr GRIFFIN—It is a hard ask. You also referred to the downloading of data directly through the Internet in terms of exchange of goods. Again, it is extremely hard to get any real idea of what is going on there, but do you have any thoughts beyond what you said earlier about that? What is interesting is that we may not be talking about high volumes of items but we are generally talking about things which are quite expensive items as such. The music area is possibly where there is significant evasion of duties and so on.

Mr Cosgrove—Yes, there may be some possibilities there. I suppose the most obvious case one would think of is the downloading of literary material. That does not present a substantial problem, I think, because those products are already free of customs duty and sales tax for the most part. The next area probably is the music area, broadly defined. I understand technology already exists for downloading through computer facilities onto an individual consumer's own blank compact disc—although, so far as I am aware, that is not being done on an extensive scale right now.

Apart from those areas, I guess you are into the general area of service provision, more or less advice, which could be transacted through electronic commerce in a tax and duty free environment. One could imagine some significant possibilities there, I would imagine. As we have indicated in our submission, we see this as the more important of the two areas where one might have concerns about taxation loss. It is very difficult, though, to make an informed judgment as to when that potential loss becomes of a sufficient level to warrant some counteraction. It is for that reason we are suggesting that, before any such action is taken, people with access to more information about these possible transactions than we at the commission do look quite seriously—as seriously as the data permits—at the balance of benefits and costs associated with tighter regulation in this area.

CHAIR—On the last page of your submission you comment on the ATO 1997 *Tax and the Internet* report, which of course led to this inquiry. With respect to that report, have you done any work on potential recommendations—I understand it is only a draft—that would have serious competition implications? In other words, those recommendations might limit our ability to grow our business in Internet traffic and commerce and therefore cause Australia to lose potential advantage.

Mr Cosgrove—I do not think this is really what you were intending to say, Mr Chairman, and I do not wish to imply that you were, but presumably all providers would be treated equally under whatever taxation regime was in place. So it is more a question of whether there are elements of proposals which have been advanced in the ATO report that would constrain the growth of the service. Is that how I should interpret your question?

CHAIR—Certainly a number of organisations—including banks, the Internet traders association and some individual firms—have said that ATO recommendation X, Y, Z would be highly restrictive and would inhibit trade dramatically.

Mr Cosgrove—Restrictive of Internet commerce per se or restrictive of competition between different providers?

CHAIR—Would tend to restrict Internet commerce activity in Australia and our take-up of Internet commerce—in both ways. I just wondered whether you had reviewed ATO's recommendations and you could give us your view of those. Do you intend to make a submission to the ATO?

Mr Cosgrove—I do not think that had been our intention.

Dr Rimmer—We have not sought to quantify or measure the potential costs that extension of the taxation regime to electronic commerce would generate. The point we are making is a more in-principle point, and that is we are exploring whether the taxation regime should be extended to electronic commerce and how that regime may be extended.

But it is important to look at both sides of the ledger, if you like—the costs and the benefits of doing so. We do so as a point of principle, but we do so in terms of the government's broader regulation review and reform policy, which is outlined in *A Guide to Regulation*, the document I have here which was released in October. This document requires all new regulatory proposals to undergo essentially a cost benefit analysis, which is called a regulation impact statement. In addition, when taxation policy proposals are developed they now require a regulation impact statement that should be published in explanatory material of any legislative change. That regulation impact statement, in part, needs to look at compliance costs and the cost that a taxation policy will impose on taxpayers.

The point we are putting across here is really just in principle. The fact that some organisations that have come to the committee have argued that the costs are considerable I think reinforces the importance of really trying to come to terms with the pros and cons, the costs and benefits in this area.

CHAIR—Mr Cosgrove mentioned the Australian Fishing Tackle Association and their submission to this committee. Their argument essentially is that, because they have a high wholesale sales tax component plus a duty component that they must meet in Australia to retail fishing lines, fishing reels and fishing rods, which they largely import from overseas, individuals can purchase these items directly over the Internet after coming into their shop to see which ones they want and they do so duty and sales tax free. While you can argue absolutely correctly on efficiency grounds that a cost benefit analysis will show it is not worth while to collect the duty and the sales tax on one of those items coming in, nonetheless what do we say to that group of retailers who are being unfairly disadvantaged because of a taxation system that operates in two different spheres? What do we say to them?

Mr Cosgrove—I suppose they are to some extent in a position where they are

obliged to compete with the individual consumers who are able to benefit from these thresholds. One would need to look at the facts of the matter and try to ascertain what proportion of total sales of fishing tackle in this country was being supplied through personal imports under the thresholds relative to those being sold through the retail stores providing fishing tackle. I do not know what the facts and figures on that are, but clearly one would imagine there is some degree of growth in the former category—that is the personal importation under the threshold category. We do not know, as we indicated earlier, what the breakup is of particular imports of this kind across different sectors of the total market in Australia for fishing tackle books and compact discs and what have you. I think one needs that kind of study to be made, though, before one would want to put forward recommendations for substantial change in the thresholds.

It is natural, and I am not trying to cast aspersions in anyone's direction in making this comment, that people who feel under a degree of competitive pressure will want to seek to see that alleviated. But the degree of pressure that may be there is something that I think needs to be tested. There are, of course, other ways in which people are able to acquire items such as fishing tackle less expensively than through Australian retail stores. Many Australians travel abroad and this is within the total duty free entitlement of overseas travel. This is another opportunity which is there. For all I know, it may well be that that is as important an area of competitive pressure for this particular type of transaction as is imports of these items ordered over the Internet and delivered physically under these tax free thresholds.

Senator GIBSON—Back on the Australia-US interchange, do you think that we should be recommending to the government that it take up the matter at a government to government level to try to sort out that?

Mr Cosgrove—We think there is a case for doing so. It does seem as though we have in place an arrangement which no doubt was established at a time when the flow of traffic was much more one way than it now is. In the light of changed circumstances, why shouldn't our negotiators seek to take that matter up. If I may seek your indulgence, Mr Chairman, Dr Rimmer wishes to add to my earlier remarks on the fishing tackle issue.

Dr Rimmer—I think what the fishing tackle people are essentially saying is that the rate at which the wholesale sales tax, et cetera pushes up the price is greater than the transport cost of bringing in goods from overseas.

CHAIR—That is not fair because they import it too.

Dr Rimmer—Indeed; they do so in bulk, though. For most individuals who would import fishing lines and things, they would pay a much higher unit cost, if you like, for transport. The next question one would ask is that there are a lot of items that are taxed at the same rate as fishing tackle, so is this problem just affecting fishing tackle or is it affecting other goods with a similar taxation rate that are mobile across borders and, if

not, why not? That seems to me to be the next question that one would ask. The third point is that, in addressing this concern, the government has announced a very fundamental review of taxation, and indirect taxation reform is part of the focus. Any changes as part of that broader taxation reform process may well result in a change in the indirect tax rates which will affect this issue and may well resolve some of the concerns.

Mr GRIFFIN—They may well compound them too.

Senator HOGG—On that Australia-US link, what are the potential cost savings for the consumers in Australia? Do we know?

Dr Warren—We do not have a figure. It used to be that 100 per cent of the traffic was Australians downloading information from web sites. Now about 70 per cent of the traffic is Australians downloading information; so it is a 30 per cent reduction. If we were to share it on the basis of traffic, you could presumably suggest that costs would drop by about 30 per cent. But, again, we do not have that data, and we would require the carriers to provide us with that before we could get more detail.

Senator HOGG—So one would then assume that, if there is to be an equitable share of the cost, whether it be 70:30 or 60:40, that would be passed on to the consumer?

Mr Cosgrove—If there is sufficient competition, yes.

Dr Warren—If not, they will pocket it.

CHAIR—Thank you very much, gentlemen. We appreciate your submission and your coming to see us. If you can advise us further, we would appreciate that as well.

Mr Cosgrove—Thank you, Mr Chairman. We will look at the points put to you by Telstra yesterday and get back to you on that.

CHAIR—Thank you.

[10.56 a.m.]

GENGOS, Mr Ross William, Deputy Chairman, Australian Music Retailers Association, PO Box 6306, St Kilda Road Central, Victoria 3066

WALKER, Mr Robert Stephen, Executive Officer, Australian Music Retailers Association, PO Box 6306, St Kilda Road Central, Victoria 3066

CHAIR—Welcome. Is there anything you would like to add about the capacity in which you are appearing here today?

Mr Gengos—I am a music retailer with a store here in Canberra.

CHAIR—Thank you for your submission and thank you for coming and talking to us today. Would you like to make a brief opening statement before we ask you questions?

Mr Gengos—I would like to say how happy we are to have this opportunity to discuss our concerns and the concerns of our members. I think that this is a very significant issue facing music retailing in Australia today. We are confronted by two very significant issues that affect the economic viability of this industry. One is the government's recent decision to remove current arrangements on parallel importation of compact discs, but I think that is a separate issue from what we are here to discuss today and we do not wish to dwell on that at this time. It is rather with Internet trade that we are concerned.

I should clarify a couple of things. The Australian Music Retailers Association represents both chain and independent stores throughout Australia. This amounts to a little over 700 retail outlets and between them those retail outlets employ over 10,000 people. So we represent both the big and small players in the field. The second thing is that under particular circumstances many music retailers do actually import CDs. We are experienced with overseas ordering and with overseas prices.

Getting to the third point, we are here today for the main reason of sales tax on CDs and the nature of its application. Sales tax is at a relatively high rate such that we believe that it is attractive for consumers to avoid payment of this tax by purchasing compact discs over the Internet. This indeed has repeatedly and widely been publicised by the media over the past year or so. As retailers, we have no choice but to trade in accordance with Australian law, and Australian law requires us to pay wholesale sales tax on every CD we purchase, whether that be purchased from an Australian wholesaler or under certain circumstances directly imported from overseas. We are disadvantaged directly versus our international competition because we are paying sales tax at the rate of 22 per cent. What tax is paid on net purchases? Nothing at all. I think that is the real starting point for discussion. We cannot be competitive when we are expected to trade in an environment where we have one hand tied behind our backs and our international

competitors have an open playing field.

CHAIR—In your report you have talked about the size of Internet trade in the music industry. Could you tell us where you got the numbers that say that Australia's Internet trade in CDs is 30 per cent of the worldwide market?

Mr Walker—Yes. The study was done by Jupiter Communications of New York and that was an overall study of the American market. They use an example of the biggest provider called CD Now, which represented some 33 per cent of the Internet market. Their figures in that study indicated that Australia was approximately 30 per cent of their customers.

Mr GRIFFIN—What is the breakdown within that? Thirty per cent of their market was Australian. How much was US?

Mr Walker—They say that 30 to 40 per cent of the Internet trade comes from outside of the US into it.

Mr GRIFFIN—So you are talking about 60 to 70 per cent of their overall being US?

Mr Walker—Yes.

Mr GRIFFIN—And 30 per cent of the remaining 30 to 40 per cent is Australian or all of it?

Mr Walker—Thirty per cent of the 40 per cent, we believe, according to CD Now, to the best of our knowledge.

CHAIR—Thirty per cent of the 40 per cent?

Mr Walker—I am sorry.

CHAIR—You said in here it is 30 per cent of the whole market.

Mr Walker—No, I am sorry.

Mr GRIFFIN—Is that right?

Mr Walker—The worldwide market outside of the States.

Mr GRIFFIN—So, taking away the US domestic market, that is international sales, with the US being the origin point. That is what you are talking about. The way it is written there is a little bit misleading. In fact, we are talking about 30 per cent of the maximum 40 per cent that are actually overseas sales. It is too early in the morning for

me to do that sort of maths. What is the size of that market in terms of volume?

Mr Walker—To the best of our knowledge, about \$18 million to \$20 million constituted the Net purchases last year.

Mr GRIFFIN—In Australia?

Mr Walker—No, worldwide.

Mr GRIFFIN—Including the domestic market in the US?

Mr Walker—We presume so, yes.

Mr GRIFFIN—You are saying that \$18 million worldwide is the entire market. About 60-plus per cent of that is US, so you are down to around \$8 million or thereabouts that are actually international sales and about 30 per cent of those are Australian sales. We are talking about \$2.5 million or \$3 million, maximum.

Mr Walker—No. We are talking about 30 per cent of the \$18 million.

CHAIR—Could you make that information available?

Mr GRIFFIN—Could I clarify that. My understanding is that what you are saying is that the 30 per cent figure in the submission is actually 30 per cent of the non-domestic—

CHAIR—That is not what he is saying.

Mr GRIFFIN—That is what he is saying now or I thought he was saying that now. Can I get a clarification. The submission reads:

It is estimated that Australia is currently 30% of the world market in Internet sales—the biggest market outside the USA.

That 30 per cent is of the world market, taking away the domestic sales within the US. So it is 30 per cent of the world non-US sales on CDs?

Mr Walker—Yes.

Mr GRIFFIN—I thought you said that the figure of \$18 million includes the domestic sales on the Internet within the US. Does it include that or not?

Mr Walker—Yes. We believe so, according to this study.

Mr GRIFFIN—According to this study, the \$18 million is total Internet sales at

the moment for CDs, including the domestic US market and the international market. Is that correct?

Mr Walker—As I read our study quote, the global music industry report on selling CDs on line was prepared by Jupiter Communications of New York and their report is available. It points to one on-line CD seller, CD Now, as controlling 33 per cent of Internet CD sales in 1996, which were valued at \$18.2 million.

Mr Gengos—Can I clarify that. That is just one provider.

Mr GRIFFIN—So the \$18 million is actually CD Now sales as such?

Mr Walker—Yes.

Mr GRIFFIN—Which is about 30 per cent of the overall market. Is that right?

Mr Walker—Yes.

Mr GRIFFIN—I think it is important definitionally to make sure we are clear what we are talking about here in terms of the volume and size. One of the big arguments that has come through in the other hearings that we have had is the question of some people saying that this is a significant issue and others saying it is not.

Mr Walker—Yes.

Mr GRIFFIN—Volume questions are important with respect to that. We can say that \$18 million is about 30 per cent of the world market in this situation, given that CD Now represents about 30 per cent of sales.

Mr Gengos—In 1996.

Mr GRIFFIN—On 1996 figures, yes. Then we go on from there. I might have a little play with that and come back to it, if I may.

CHAIR—It is our understanding that in an overall sense Australia participates only in about one per cent of the worldwide Internet marketplace in terms of Internet commerce. These sorts of numbers would indicate that, when it comes to compact discs, there is a huge disarrangement of the normal Australian marketplace for some unexplainable reason.

Mr Gengos—You mean that it is higher?

CHAIR—It seems very high.

Mr Gengos—I think it is and I think there are good reasons for that. As I mentioned in my opening comments, one has been fairly extensive and unremitting media publicity regarding the sale of CDs on the Internet. We see in the Sunday press repeatedly popular articles that give the actual Internet addresses of American providers of compact discs. There is a media education program for the public there leading them beyond any other commodity towards American suppliers. Why that may be is open to question. It may be the publicity of the whole history of PSA hearings, the ACCC and so on, but nevertheless I think that it is indeed the case.

CHAIR—Could you make available to the committee the research available to you that indicates the past and current size of the Internet CD marketplace in Australia?

Mr Gengos—I think the problem is that nobody has done specific research. We are reliant upon a number of sources for our information.

CHAIR—But there seems to be a good deal of confusion about the numbers and the quantum, so if you could give us what you had—

Mr Gengos—We could certainly clarify what we have in terms of that study that my colleague has mentioned, but the important point to note is that anecdotal evidence from our members—and we must rely upon our members' experience—is that we have customers every day talking about the price differential between the Internet and what is available in Australia.

CHAIR—Under 'Recommendations' you said:

That the government institutes policy which ensures that sales tax is collected in the same manner as domestic sales tax. The same would apply to a GST (unless the domestic GST is applied at a lower rate).

Are you talking about applying a sales tax to a downloaded CD?

Mr Gengos—No, we are talking quite specifically about the bringing of the physical object of the CD into the country. We believe that the downloading of music is a complex, difficult and evolving issue, which we are aware of and are monitoring. It offers opportunities for retail in this country as well as threats, but we are not talking here about the totally electronic commerce; we are talking about the ordering of an item electronically which is then physically shipped into this country.

CHAIR—If the average value of a shipment of CDs for personal use in Australia was such that the cost of Customs collecting the duty and sales tax was greater than the duty and sales tax collected, would you stick with the same recommendation?

Mr Gengos—We are simply faced with a situation where government policy, as I

said in my opening statement, leaves us, in competitive terms, with one hand tied behind our backs. We are having to pay 22 per cent; our competitors are offering the same goods with absolutely no sales tax whatsoever.

I write a cheque once a week for my employees. Mine is not a huge store, but I employ six full-timers and five part-timers, they are reliant upon me for their living, I am reliant upon my operation for my living and my house is on the line, and I have government policy actually compromising my ability to compete. It is saying to me I have got to add that 22 per cent at wholesale level. Once it is added at wholesale level, I have got to factor in my margins so that a \$3.20 wholesale sales tax ends up being about \$4.50 of the final price of a \$30 CD or in some cases a little more. I have got to factor that into what I am charging the consumer. I can only answer in my experience as a retailer, and I am being forced into a situation where I am uncompetitive because of the non-collection of sales tax on exactly the same item.

CHAIR—Is it in fact government policy or is it in fact a change in the marketplace that is causing you problems? Before people started buying CDs over the Internet, they could go overseas and buy CDs, which I am sure they still do. You come back with a few in a suitcase when you go on an overseas trip. Was it a problem before people started buying on the Internet? The policy has not changed since then.

Mr Gengos—It was infinitesimal before the Internet.

CHAIR—Then is it a change in technology or a change in the marketplace rather than in government policy?

Mr Gengos—It is a change in awareness. I might just add that overseas travellers who go to Europe and look for their CDs come back and say, ‘I didn’t buy anything because you’re cheaper.’ That is in fact the case. But when they go to America it is different. Sure, everything is cheaper in America ranging from shoes to cars, but I do not want to get off into that. I take the point that you are making—that there is an increase in accessibility to these goods and an awareness that one may escape the net of sales tax if one orders in reasonable quantities out of the United States and thereby evades what the consumer is having to pay in this country going through traditional retail channels.

Mr GRIFFIN—Go to ‘Statistics’ on the first page of your submission after the summary where you say:

The current value of the CD market in Australia is according to the Australian Bureau of Statistics	
Wholesale Sales	\$607.50m
Plus Sales Tax	\$133.67m
Total	\$741.17m
Retail Value (using standard mark up)	Up to \$1 billion

At the top of the next page, you say:

90% of records sold in Australia are made here. Of the 10% which are imported a rapidly increasing proportion are imported via the Internet with no sales tax paid.

Looking at that figure, I would have said that 10 per cent is imported, so a component of that is what we are talking about in respect of Internet sales. But 10 per cent of which figure—the \$741.17 million or the \$1 billion? I am asking that because I see that you say in the third paragraph on the second page of your submission under ‘The Value of the Internet Trade in the Music Industry’:

1996 Studies show . . . that legitimate global CD sales via the Internet passed \$US25 million, with Australia representing some 30% of this market.

That would seem to suggest that the value of global CD Internet sales to Australia is about \$7.5 million, being about 30 per cent of that \$25 million. I am a little intrigued. Taking that \$7.5 million figure, if you just go off the total figure in ‘Statistics’ of a value of \$741 million and you go on with the fact that 10 per cent of that figure is what we are saying is the value for imports, I get a figure of \$7.4 million. I must have mucked it up somewhere. I am getting a value of \$7.4 million for all types of importation, yet I am getting a value from the next paragraph on from that of \$7.5 million solely for CD sales. Can you explain to me what I have done wrong?

Mr Gengos—We have been unintentionally confusing in the top sentence. What we meant to say there—I do apologise—is that of retail sales in this country 90 per cent of the CDs going through retail channels are manufactured in Australia and 10 per cent are imported, usually by the record companies. What we should have said was that, in addition to this, a growing volume of sales is coming in through the Internet. The 90:10 breakup is related to the retail industry itself. I apologise for that confusion.

Mr GRIFFIN—Rather than going into tortuous cross-examination, which you guys do not deserve, is it possible for you to look at the figures again and determine whether there are some things that might lead dummies like me to reach the wrong conclusions?

Mr Gengos—We can undertake to clarify that absolutely.

Mr GRIFFIN—If you have the original statistical information that it was based on, we would also be interested in looking at it.

CHAIR—When you do it, can you tell us, amongst other things, the total retail sales dollars for CDs in Australia, the dollar value of those produced in Australia, the dollar value of those coming in from overseas and what you think comes in over the Internet and through Australia Post?

Mr Gengos—The last figure, as I have said, is a problematical one.

CHAIR—I understand that, but you will get closer to it if you work through those

other issues rather more logically, I suggest.

Mr Gengos—Certainly. We could also obtain more up-to-date figures for companies such as CD Now in 1997 and apply some of those study factors in there.

Mr GRIFFIN—I stress from an earlier comment I made that this is one of the real issues which is coming up in this inquiry. A lot of people are saying that this is not something to worry about at the moment and may never be something to worry about while particular industries are saying that it is a real concern. Being able to show that is an important aspect of what we need to know.

Mr Gengos—If you are a retailer behind the counter dealing with members of the public every day and listening to the number of comments you get, comparing Australian prices with Internet prices, I do not think you would be led to state that this is not a problem to be worried about.

Mr GRIFFIN—That is why I am not trying to carve you up on the figures.

Mr BEDDALL—You just mentioned a 10 per cent price differential. The Australian dollar buys a lot less than it used to. How many of your customers differentiate between US dollars and Australian dollars? Do they do the conversion?

Mr Gengos—A lot of them are not quite smart enough to do that. Nevertheless, they see the end result on their credit card. I often talk to customers who discuss this with me. A lot of my customers are computer and Internet literate, as you would expect in Canberra, where we have a lot of public servants with a lot of access to the Internet. I repeatedly ask them, 'Would you still be doing the same thing if I were charging \$25 for that item rather than \$30?' The habitual answer is, 'It wouldn't be worth my while. The differential would be so small that I wouldn't be doing it.' That \$5 gap is, as I have said, accounted for by sales tax and its effect upon the final retail price. It is a serious problem.

Mr GRIFFIN—I do not think this is in the submission, from what I can see. What percentage of your sales are of top 40 modern music versus classical music and stuff like that? I would have thought that, given the way that stores are generally designed, sales are mainly of modern music aimed at a younger market. That obviously involves a more computer literate segment of the population that is more likely to be au fait with the Internet and, therefore, more likely to utilise it. Is that a fair comment?

Mr Gengos—Are you talking about the industry?

Mr GRIFFIN—Retail sales. Retail music stores are aimed at the top 40. That is where I imagine a major component of your sales are. Classical music is always off to one side. I do not know what the percentages in sales are. Most sales appear to me to be, given the design of stores, aimed at a younger segment of the population.

Mr Gengos—It depends on the store. Not my store.

Mr GRIFFIN—Can you provide any figures on what sales there are for each segment of the population according to the type of music? If younger people tend to be the ones buying CDs, they would also be much more up to speed on things like the Internet and, therefore, would be utilising it in order to save on sales. Do you get my point?

Mr Walker—Yes.

Mr GRIFFIN—If you have any figures that show or rebut that, I would be interested in them as well.

Mr Gengos—We could provide them for you. They would be general industry figures. The problem simply is that these proportions vary dramatically from store to store. In my case, for example, over 50 per cent of my operation concerns classical music whereas the national average is probably less than five.

Mr GRIFFIN—That is the sort of stuff that I am interested in looking at.

Mr BEDDALL—Is your industry seeing the opportunities as well as the disadvantages? Someone like you, who probably has a much broader range of classical music, with a web site would be in a position to have people from other parts of Australia come to you.

Mr Gengos—Yes. We had a national convention at the end of September last year. We had a whole morning devoted to the question of Internet. There are certainly Australian retailers with web sites. The message seems to be that if you are relying on that you had better keep your day job. The reason is, again, that price differential caused by sales tax. Even those people who are selling at a discounted rate from garages and lounge rooms—there are a number of operations—and who do not have the conventional retail costs are above the American price because of the sales tax component that they have to charge. There are certainly opportunities there but, getting back to this one crucial factor, they are limited.

I have just one final comment. I was in the room when previous parties were giving evidence and talking about the downloading of music. This is something that, as I have mentioned previously, we as an association are carefully monitoring. It would be a mistake to say, 'Let's not deal with the current sales tax issue because it might all go away if everything is downloaded.' First of all, that ignores the strong cultural and social place of the shopping experience in this country. It also ignores the fact that in the foreseeable future by no means everybody will have a computer of the size and technical complexity necessary to do it. We also have the question of the quality of lines needed to allow the physical downloading of music onto computers.

So it is an alternative delivery system, it is something that is coming in future years and it does represent a market challenge for record companies and retailers. I can foresee retailers having download capacity direct from record companies to supply consumers from within their stores—complete with properly printed brochures, slicks and so on. As an industry, we are prepared to meet this challenge. We are not afraid of competition, just as we are not afraid of competing with the Americans on the Internet—if only we did not have that metaphorical hand tied behind our back. I go back to that point. It is important that what is set up is a commercial framework to allow us to compete. This whole question of differentials in sales tax—applying it in some cases to us and our consumers and not to our competitors and their consumers—is a fundamental and important part of that.

CHAIR—Thank you very much for your submission and for coming in to talk to us. We look forward to the receipt of some updated numbers.

[11.35 a.m.]

MONTANO, Ms Elizabeth, Member, Commonwealth Law Enforcement Board, 111 Canberra Ave, Kingston, Australian Capital Territory 2600

CHAIR—I welcome the representative of the Commonwealth Law Enforcement Board to today's hearing. We have received your submission. Would you like to make a brief opening statement before we ask you questions?

Ms Montano—I would like to say something that is not new but that I think is very important in terms of the processes that this committee and government are facing in relation to electronic commerce, of which the Internet is only part of the picture—that is, to do this properly, we really need to adopt a truly holistic approach to the issues. Law enforcement, revenue laws and administration, telecommunications infrastructure and financial systems do not operate in vacuums; they interact. They are set up under the same basic set of assumptions, even though sometimes we do not see that, and therefore it is fairly important that, if we are trying to take the advantages of the new world, we also very carefully look at what we like about the way our systems work today and try to ensure that as far as possible we translate them into a new environment.

Where we find that we cannot translate them, then let us do that and face that in an educated and informed way and look for other ways to do things. That is why we think there is a very important role for both law enforcement and revenue in being part of the bigger picture so that we can actually keep delivering what we already deliver.

CHAIR—Thank you for that. On page 2 of the ECTF report you commented that the erosion of Australia's revenue base by the decrease in relevance of concepts such as residence, source and nationality should be of great concern to all Australians. We, of course, know about these kinds of concerns, but could you give us some idea of the quantum of the current problem or expected problem, and outline some of the critical challenges that we face?

Ms Montano—The idea of people moving outside standard systems—for example, conducting their taxation affairs in such a way as to avoid geographic nets or conducting criminal activities in ways that are designed to outsmart the systems—is not new. But what we are seeing now is a difference in the scope in the way in which it is going to be done. The availability of technologies to do those things is far wider than historically was the case.

The other issue is that, unlike many of the other times in which we have faced changes, we are now facing changes which go beyond domestic issues. Probably every witness you talk to will tell you about the way in which we cannot deal with domestic problems with domestic responses only. So we introduced the element of other societies and international issues which historically work very slowly. Tax treaties and international

law enforcement arrangements all take a very long time to put into place. That reflects the systems which historically did not need them to move very fast. That is going to have to change. So there will be change too in the way in which the government is going to undertake the processes.

I think the challenges are to do this very carefully and cautiously and to not concede issues before they have been fully explored. There are a lot of people saying things like, 'Encryption means the death of some kinds of revenue collection. It means the death of some kinds of law enforcement strategies.' I do not think that is true. Certainly it will impact on the way in which those strategies are used and the kinds of activities that those strategies are used on, but there will always be a place for them. The challenge we have is to look at what is being offered and to look at what is going to happen and, before it is too late in terms of systems being put into place, build into those new systems ways in which the government can achieve its objectives, whether they be revenue objectives or law enforcement objectives.

So I think the real challenge is not in the specific issues, although they will be challenges along the way. The threshold challenge is to make sure that, when we are running ahead to do all these things, we actually do it systematically and take into account everything that the government wants to achieve out of these technologies, not just the commercial issues in terms of open markets.

CHAIR—Is it fair to say, as someone said to us, that certainly the vast majority of Australian businesses are honest and keep their tax records properly and will do what they can to minimise their tax but not to evade it as such? Would you expect some decrease in the percentage of Australian companies meeting their obligations as a result of the capabilities of electronic commerce, particularly the Internet transactions?

Ms Montano—I think you are right. I think most Australians, in the sense of how they run their businesses, are honest. I think some of them are honest because they fear being caught. That is human nature; that is not being overly pessimistic. Certainly, in having strong compliance cultures—whether you are talking about stealing an apple from the barrow down the road or you are talking about major tax evasion—a big factor when you decide whether you are going to do it or not is whether you think you are going to get caught. If there are lots of systems in place which make you think about the possibility of being caught and you factor that into your decision making process and decide that it is not worth it, then there are lots of things at the moment which contribute to that.

In my agency, I get every international funds transfer instruction that comes into or out of the country. Taxpayers who realise that and who would otherwise have opportunities to move lots of funds offshore in that way or who, for some reason, might take advantage of geographic limitations, might well think that that is in fact a pretty good deterrent to some kinds of activities, and it is.

The question is: how are we going to deal with the issue of moving that compliance culture into an environment where there is certainly the perception—and I think it is promoted widely by the entrepreneurs in the area—that the old world is dead, anarchy rules and all that sort of rhetoric? That is not correct because at the end of the day, whilst the entrepreneurs may have hot ideas, the people who are going to make the systems work and get them to the stage where they are commercially viable are very careful business people.

So all the people who say things like, ‘We are going to have lots of high value, anonymous smart card transactions zipping around cyberspace,’ are kidding themselves. The reality is that people who maintain and operate and carry the risk in relation to those systems need to know things like: what is my exposure on day X? What do I have to do to back up my prudential arrangements? What liquidity ratios do I need to have in place? How am I going to prove to my partners in this process—and there will be lots of partners in the context of distribution and so forth—that they are dealing with someone who is financially credible?

If I, as a stored value entrepreneur, want people to have confidence in my system, I have to have pretty good systems in place to deter and then detect things like counterfeit value. You might well say, ‘Okay, we put in as many protections as possible in relation to a unit of value to stop it being counterfeited,’ but smart people never assume that something will never happen. Therefore, they will always have systems in place so that risk will be reduced and minimised. You have to have systems in place to detect when the counterfeit unit goes around and the alarm bells flash and you know something is wrong and you need to either close down a particular value or you need to do something. The systems will be there. The challenge for tax and law enforcement is to know where in the process to intercept with low cost, minimal inconvenience and greatest effectiveness. That is something we will only know over time, but we have to be in the process from the beginning.

Instead of government and business playing ‘20 Questions’, which I often find happens, in relation to what people will be told and what they will not be told, it is really an education process to say, ‘We have just as much interest in these things working as you do, entrepreneur; let’s work together to make sure the systems do work and that, in a couple of years time, you are not knocking on law enforcement doors saying, “We have an amazing fraud. Come and help us.”’ And then when investigators go in to do what they have to do, they find that there are no systems infrastructures there to help them do their job—not sufficient audit trails or they are all held overseas or they happen to be held overseas by someone you suspect is part of the fraud and all those sorts of issues. It is really a question of people being a bit smarter than the short term.

Mr BEDDALL—You touched on one of the things that I have been trying to grapple with. All the people who are now in this industry say, ‘No regulation. It’s got to be free market.’ Yet I think regulation can be of assistance. For example, the Taxation

Office says that if you have a web site it should be registered as a company is. Maybe there is a little flag that says 'Registered in Australia'. If I am going to be a purchaser, I probably think that prudentially it is better to deal with a company registered in Australia or the United States rather than the Cayman Islands. Do you think they are not focusing enough on the fact that some of this regulation will give them credibility and bring business?

Ms Montano—Exactly. If you talk to the responsible systems developers, they know full well that to do what they want to do—that is, to achieve mass market penetration—they have to convince people that it is worth while doing it. Why should I trust a stored value card or electronic currency or units if I do not have any reassurance that I am going to be able to rely upon the contract I have entered into in relation to how that happens? You also have to distinguish between high value and low value. There are a lot of low value risks that people will take. Buying CDs over the Internet is a classic. People say, 'I'm at the shopping mall in Texas and I am buying my CDs. The web site looks really cool. I love the graphics. It looks great.' But if it is run out of a crook's backyard and they are going to get the credit card details and they are going to flit, then it is not worth my trouble to pursue the \$30 purchase.

I am a banking and finance lawyer by background. I am not talking about \$30 any more; I am talking about \$30 million. I am talking about you settling a financing deal over the Internet without an enormous number of safeguards being put in place—not only contractual safeguards between the parties but also systemic safeguards, forcibility of contracts, the ability that you can have contracts recognised in jurisdictions, that once they are there you have the ability to go in and seize assets and enforce judgments. I am talking about all those sorts of issues. They need it and the smart ones know that. It is people who are in there for the quick buck to sell the technology who do not think about the long-term health of an industry.

Mr BEDDALL—But, if I am someone who American Express thinks is a valued client and they give me an American Express gold card or platinum card and I use that on an Internet site, all of a sudden the risk for me using that on an Internet site without relevant safeguards is also very large, isn't it?

Ms Montano—Yes, it can be. Historically, though, a lot of entrepreneurs—for example, credit card companies—because they want to encourage usage of their systems, by contract agree to bear the risk if something goes wrong. They are quite willing to bear that as a normal business cost up until a point where it becomes uneconomical to do it. That is when, all of a sudden, you will find risks being reversed. If you go and talk to any of the big law firms that are holding lots of seminars for clients at the moment in relation to things like setting up your electronic payments system, if you look at the terms and conditions they are suggesting for stored value card systems and so forth, they are just as comprehensive and as detailed as anything in any other kind of financial transaction, because they have to be.

They have to be because, firstly, they are not sure of what the law will imply into their contracts and what it will not and, secondly, they have to get over the fact that at general law everything is in the favour of the consumer. Courts will construe things against institutions, so the institutions try to even that up by the contractual arrangements. They are all into regulation in a big way. Some of it is self-regulation, and that is exactly what that is, or some of it is regulation which still needs an underpinning of government regulation, because at the end of the day they still have to be able to enforce those contracts.

If you look at the whole issue calmly and quietly and ignore the hype, there is a lot of scope there for government to play a very responsible role. The fact is that we are going to have to change the way the role is performed. Governments traditionally know a lot about what it is you are trying to regulate. That really helps. Here we are talking about something different. Learning what it is we are trying to regulate is a very big task in itself and an ongoing one. Presuming you can get that interaction going, then it is a question of what is the role for government.

We took the view in the report I did, and the subsequent work we are doing, that government's role is to look at what sorts of outcomes and what sorts of effects you want the systems to have and to say, 'Okay, market, you go out there and do it in the most cost-effective, efficient way you can. But at the end of the day there is a safety net of requirements here which we want our society to have. How they go about it is their business.' So you try to stay technology neutral, but you look for the outcomes.

There are lots of ways in which that has already been seen, like interception capability for telecommunications companies. They have general obligations in relation to things like providing interception capability. They have a lot of leeway as to how they actually do that. It has to be practical, effective and work, but at the end of the day you do not tell them how to do it. You work with them so that it works for everyone. I think that is a really big challenge for government. Everyone talks about consultation but this is about really getting in each other's pockets and working fairly closely together. That is what we are trying to do with the groups we are forming.

CHAIR—One thing we were interested in is your recommendation on page 113 of the ECTF report. You recommended that Australia review its decision not to become a signatory to the OECD Multilateral Convention on Mutual Assistance in Tax Matters treaty. Would you mind taking us through that and tell us why we did not want to sign that particular treaty?

Ms Montano—I am glad there are some tax officers here because it is probably their area rather than mine. That recommendation was devised by the officers of the tax office who were on our committee. My understanding of the situation, and I am quite happy to be corrected, is that Australia decided not to be a signatory to that treaty because it did not quite suit the way in which we thought the carve up should be made

internationally. But we have always maintained an interest in the issues and the desire to step in and participate when we need to.

The point is that all those treaties are based upon geographic nexus with tax paying systems. If you are going to change the basic assumptions then they are going to have to redo the treaties anyway, and that may well be a time for Australian revenue authorities to get back into the picture. There are lots of games, I suppose, that are played internationally about how you go about carving up tax pies. This is going to be another example of that. I think we are reasonably well placed in the sense that if you look at the work the tax office has done and the work we have been doing and various other areas of government, we are actually pretty well advanced in terms of looking at the issues and trying to understand the issues.

I have to say that, from my experience trying to deal with counterparts overseas for whom electronic commerce is not an issue domestically because they have different kinds of cultures and economies in terms of whether electronic commerce is seen to be a big issue or not, as long as it remains peripheral, a lot of those countries will not necessarily do the hard yards in terms of working on the issues. We are already there because we have worked out its imperative and we have an amazing technology friendly society. They are going to have to watch that very closely, and I know they are.

CHAIR—So those issues surrounding that particular treaty relate to domesticity. Is that right?

Ms Montano—All those international tax treaties, at their core, have issues about who is going to tax what and when, and what are the criteria that will be used in applying how they do that. If you look at residency, source, permanent establishment—all those sorts of tests—often you find that people satisfy those tests in a number of jurisdictions. That is when you get into tax sharing, tax credits and so forth between jurisdictions. It is all very orderly in the sense of there are quite detailed rules about when it applies and when it does not. It is a real art form, I understand, negotiating around that issue. But they are going to have to go back and it is going to be renegotiated totally.

All the positioning is about the role that America sees itself having, the position it has taken on cryptography—all those sorts of issues. Underneath all that is the quite human wish to be ‘top dog’. There are lots of areas in which you can be ‘top dog’ that come out of electronic commerce, whether it be in terms of your ability to market your products, whether you are a smart country, how you are going to get your share of the tax pie—all those issues. They are all intertwined. None of them is separate.

CHAIR—By way of example, because we have Mondex coming some time in the first half of 1998 and if we take Mr Beddall’s Cayman Islands situation, is that the kind of issue bound up in those sorts of negotiations?

Ms Montano—Undoubtedly. There are a lot of tax havens that have taken advantage of lots of circumstances to position themselves. They are most certainly positioning themselves in terms of providing nice places to have your web site so that you fall quite neatly even within existing jurisdictional rules within their boundaries rather than somebody else's. There are lots of ways in which they are going to be putting pressure on countries that play the game properly. That is then a question of: what is everyone going to do about it?

Senator GIBSON—Turning to the effectiveness of Austrac in chasing major financial transactions, currently today one can do electronic banking with banks offshore. Do you think you are missing out on much now or not?

Ms Montano—They do not in a technical sense. I can go to the Advance Bank web site and I can do things, but what I am doing there is communicating instructions. I am not actually effecting the transfers. It is just an alternative to telephone banking, standing in the queue, using the ATM. For example, in relation to that particular way of transferring value, every international funds transfer instruction that a bank effects for a customer in Australia is reported to me. The vast majority of them are done electronically so we do not have high compliance costs. Therefore, we have a very time sensitive record of those transactions.

The big challenge the tax office has as a user of that system and law enforcement has as a user of that system—and that is very effective for lots of other people who like to move their money offshore very quickly after the deal is done—is how do we translate that capability into the new environment. At the moment we look at the way the banks conduct themselves in relation to their commercial needs. They do bank to bank instructions under international clearing arrangements. We just take their messages straight. We do not take anything else. We do downloads off their messages. It is very efficient for them. We actually provide the software that they do it with. We make everything very easy. So it is a very efficient way of getting intelligence for Tax and Customs and so forth.

Senator GIBSON—But I was thinking of the other problem: of Australians, say, keeping accounts in Hong Kong—it does not matter where.

Ms Montano—We do not deal with those. They are outside Australia's domestic arrangements.

Senator GIBSON—No, I know you do not. But I would have thought, with the explosion of the Net and a lot more people getting used to it, there must be more people actually keeping their assets offshore and doing the transfers via the home computer—in other words, doing that outside the jurisdiction.

Ms Montano—Yes, but what are they doing? They are not doing anything

different from how people for 100 years have been writing to their banker elsewhere in the world saying, 'Please do X, Y, Z.' What they are doing now is doing it quicker. More of them can do it because more people know about it. It is really a question of scale. That is when it becomes an issue for a society. You can have a little bit of leakage and no-one worries about it in the sense that to stop it is too onerous.

Senator GIBSON—Do you think there is much now?

Ms Montano—I think there is, but I think it has always been so. That is the challenge: for us to change our capabilities. It has not been a big issue, simply because the mass market did not use it. The same system that will give you pay TV and the match of the day is then going to give you access to payment systems and to encrypted messages. This means it will not only be tax related transactions but also be criminals conspiring over the Net rather than in the pub.

Mr BEDDALL—Can I take you to that brave new world. Michael Carmody said yesterday that he does not set policy so he cannot comment on a broad based consumption tax. It seems to me that you are right about the top dog. The United States wants to be—and already is—the top dog on the Internet; 90 per cent of sites or whatever are located in the United States. If we move to a broad based consumption tax in Australia, which will affect financial services—for example, insurance policies—is there not an attraction then for the average householder to insure with a very reputable insurance company in the United States and to pay that by Mastercard or whatever? That transaction is offshore; it does not attract a broad based consumption tax in Australia. How do we address those tax issues?

Ms Montano—I think I have to give the same preliminary comment as Michael Carmody did, and that is I don't set policy either.

Mr BEDDALL—The point is that the United States does not have a broad based consumption tax. Not only does it have the advantage of having 90 per cent of the web sites but it now has a huge advantage, in terms of financial services, over the world that does have a GST or a VAT.

Ms Montano—I would have thought that any taxation system would have its advantages and its disadvantages. The question is how much you are willing to bear of the disadvantages to get the advantages. If you are talking about cash economies, there are lots of things to be said for a lot of different kinds of tax systems. Is it not a question of someone sitting down and very carefully working out where the swings and the roundabouts are and making a decision, on balance, what to do?

Mr BEDDALL—This is a new swing, is it not?

Ms Montano—Yes.

Mr BEDDALL—When the Europeans set up VATs—and they have got a great concern about this as well—there was no electronic transfer of this scale contemplated. My point is that we could actually disadvantage ourselves because we are looking at old reasons for doing new things.

Ms Montano—I cannot comment on a consumption tax, but it seems to me there are lots of tax systems and ways to do it. The question is to make informed decisions.

CHAIR—It is true, is it not, that if Mr Beddall's insurance policy—because it was a financial service—were zero rated it would have a zero effect?

Mr BEDDALL—But it won't be zero rated.

CHAIR—I think we are out of questions. Thank you very much for coming and thank you for your submission. These are important issues and we take them seriously. It seems that if international solutions are not forthcoming, if we try to impose unilateral decisions in Australia that act to disadvantage industry, most of the players say that we will suffer trade loss as a result. I think that bears out the kind of things you were saying.

Ms Montano—Can I say one thing. Whether you are talking about securities regulation, tax regulation or anything else, some people will play the regulatory arbitrage game. That is, you front up to every regulator in every country and you say, 'If you impose regulation, we will desert your market and you will suffer.' Fine. That assumes that regulators do not talk to each other. It also assumes that regulators and governments cannot enter into meaningful and practical international arrangements. In a sense, they are calling people's bluff.

Yes, we have to be very careful not to do things that will destroy our markets or make them uncompetitive, but that does not mean it is total hands off. I think it means working with our international counterparts to get a better understanding of what is needed and trying to have consistent action and building up networks of countries that can rely upon each other in those contexts so that you actually end up isolating the countries that will not enter into those sorts of arrangements. I do not mean isolating in a negative sense. It is just a matter of fact that if people want to trade in credible, honest markets which have the same sort of standards as they do then there are certain countries one will choose to trade with and countries one will choose not to trade with. The reputable players in those excluded countries will soon start making noises about joining the club. Those who do not join the club will always have a niche, but that is life. I do not think you can avoid that.

CHAIR—The NAB came and talked to us this morning. One of their recommendations is that we have national privacy regulation. At least with respect to their dealings in their Singapore operation, they maintain that they cannot transfer data because the Singaporeans believe that their privacy regulations are superior to ours or our lack of

them. Through your understanding of the banking industry, is that a reasonable request?

Ms Montano—They certainly have an interest in streamlining their requirements to an extent where they minimise their costs and it is simple. If they have different requirements for different jurisdictions, then they have some compliance headaches. I would have thought the international movement is such that there are pressures for everyone to be fairly consistent in the way in which they approach a number of issues, not just privacy. So it is really going to be a question of whether you are in the tent or outside the tent.

Mr BEDDALL—I think they were even more terrified of the state government's movement to privacy legislation. In Australia you have six different jurisdictions—railway gauge arguments again.

Ms Montano—That is probably not a bad concern.

CHAIR—Thank you very much for coming. We really do appreciate your input.

Resolved (on motion by Mr Beddall):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 12.09 p.m.