3 Structural reform of public monopolies

Protection of public monopolies from competition through regulation or other policies allows anticompetitive market structures to develop. Rectifying strategies include liberalising market access and ensuring public monopolies adhere to competitive neutrality principles. These strategies, however, will not always be sufficient to establish effective competition. Structural reform *may* be needed to dismantle an integrated government monopoly business. Such reform can involve separating the (potentially) competitive elements from the monopoly elements.

Structural reform is important where a public monopoly is to be privatised. Privatisation without structural reform could result in a private monopoly supplanting the public monopoly, with few real gains and potentially considerable risks. Clause 4 of the Competition Principles Agreement (CPA) sets out obligations of governments that aim to reduce the risks of such adverse outcomes. Governments agreed to undertake the following before privatising a public monopoly or introducing competition to a sector supplied by a public monopoly:

- relocate regulatory functions away from the public monopoly to prevent it from enjoying a regulatory advantage over (potential) competitors—CPA clause 4(2)
- undertake a review accounting for
  - the appropriate commercial objectives of the public monopoly
  - the merits of separating potentially competitive elements from the natural monopoly elements
  - the best way to separate regulatory functions from a monopoly's commercial functions
  - the most effective way of implementing competitive neutrality
  - the merits of any community service obligations (CSOs) provided by the public monopoly, and the best means of funding and delivering those CSOs
  - price and service regulations to be applied to the relevant industry
  - the appropriate financial relationship between the owner of the public monopoly and the public monopoly—CPA clause 4(3).

In its National Competition Policy (NCP) assessments, the National Competition Council has considered each jurisdiction's compliance with its CPA clause 4 obligations. Western Power (Western Australian Government) and AWB Limited and Telstra (Australian Government) were previously assessed as not complying with these obligations. Developments in these areas in 2005 are discussed below.

Western Power

In the 2003 NCP assessment, the Council reported that the Western Australian Government had endorsed the recommendations of the Electricity Reform Task Force, including the following relating to the state's CPA clause 4 obligations:

- the vertical disaggregation of Western Power into generation, network and retail entities in the South West Interconnected System, and a regional power entity in the North West Interconnected System and non-interconnected systems, by 1 July 2004

- the development of an electricity access code by 1 January 2004 and the operation of the new access framework and licensing regime by 1 January 2005.

At the time of the Council's 2004 NCP assessment, Western Australia's *Electricity Industry Act 2004* had implemented several task force reforms: it provided for the development of a wholesale market in the south west of the state, an independent licensing regime for electricity industry participants, a third party access code and consumer protection measures. The wholesale market is expected to commence in July 2006. An independent Economic Regulatory Authority commenced on 1 January 2004 to administer the electricity licensing regime. The establishment of the independent regulator is consistent with Western Australia's obligations under CPA clause 4(2).

However, the government had not disaggregated Western Power into generation, network, retail and regional entities. The Electricity Corporations Bill 2003, required to implement the disaggregation, was introduced in October 2003, but was withdrawn when it became evident that the Bill would not pass. The failure to implement this key reform meant for the 2004 NCP assessment that Western Australia was in breach of its CPA clause 4(3) obligation.

The government recently introduced the Electricity Corporations Bill 2005 into Parliament to split Western Power into four independent functional entities by 31 March 2006. On 22 September 2005, Western Australia passed the *Electricity Corporations Act 2005.*

The Council assesses that the Western Australian Government has met its CPA clause 4 obligations.

AWB Limited

Until 1999 the *Wheat Marketing Act 1989* prohibited the export of wheat by anyone other the Australian Wheat Board, a statutory authority, unless the board had given its consent.

In 1999 the board's commercial business and assets were transferred to a company, AWB Ltd, owned by wheat growers. The Act had been amended to reconstitute the board itself as the Wheat Export Authority (WEA) with the function of controlling the export of wheat. The WEA had also given the function of monitoring the performance of AWB Ltd's subsidiary, AWB International Ltd (AWBI), in relation to the export of wheat and reporting on the associated benefits to growers.

The WEA's power to control wheat exports was constrained however. The Act allowed AWBI to export wheat without the WEA's consent. Further, the WEA had to consult AWBI before consenting to the export of wheat by another party, and could not give such consent without the prior approval of AWBI, unless the wheat is exported in bags or containers.

In early 2000 the Australian Government commissioned an independent review of the amended Act under CPA clauses 4 and 5 (see also chapter 10). The review, released on 22 December 2000, found in relation to CPA clause 4 that the Act had not achieved a clear separation of the regulatory and commercial functions of the Australian Wheat Board and that the structure of the WEA board, set out in the Act to include two members nominated by the Grains Council of Australia, did not give the WEA sufficient independence. It recommended that the government amend the Act to:

- ensure the WEA is totally independent
- allow, for the three years until a further review already scheduled for 2004, the WEA to consent to the export of:
  - wheat in bags and containers without consulting AWBI
  - durum wheat without obtaining the AWBI's written approval.

The government responded in April 2001 by declining to amend the Act. The government argued that removing the AWBI's role in these arrangements would significantly change the balance between the operations of the WEA and the AWBI, which might have affected the AWB Limited's then proposed listing on the Australian Stock Exchange.

In 2003 and 2004 the Council assessed that the government had not met its CPA clause 4(3) obligation as it had not conducted a review before privatising the former Australian Wheat Board and, further, gave insufficient grounds for declining to implement the recommendations of the post-privatisation review conducted in 2000.

The Council has looked again at this matter and now accepts that the government did, prior to the privatisation of the former Australian Wheat Board, review relevant matters including the appropriate commercial objectives of AWBI, the ownership structure and the most effective means of separating regulatory functions from commercial functions, and that the government asked the 2000 NCP review to revisit some of these matters—particularly the separation of regulatory and commercial functions.

Following the 2000 NCP review the government has not reduced AWBI's role in the regulation of wheat exporting. This reflects the government's policy of allowing wheat exports by parties other than AWBI only where these complement those of AWBI, protecting AWBI from any significant direct competition in the export of wheat, in contrast to the recommendations of the 2000 NCP review that the government trial direct competition in certain areas of the wheat export trade. As noted in Chapter 10 the government has not shown this restriction on competition is in the public interest and therefore has not met its CPA clause 5 obligations.

The government has also not directly addressed the recommendation of the 2000 NCP review that it amend the Act to ensure the independence of WEA. With the continuation of the export monopoly, the monitoring of the performance of AWBI in exporting wheat for the benefit of growers is particularly important, and the independence is necessary for such monitoring to be effective. However, the government acknowledged concerns about the independence of the WEA when it removed responsibility for conducting the 2004 performance review from the WEA, assigning it to an independent panel, and widening the review to consider the performance of the WEA itself.

The implications for the Australian Government's compliance with its CPA obligations are that:

- the government continues to restrict competition in the export of wheat—a breach of CPA clause 5

- the obligations under CPA clauses 4(2) and 4(3) arise from the introduction of competition, which the government has not yet done in any significant way

- the government has privatised the monopoly—a trigger under CPA clause 4(3)—but there is no meaningful competition in exporting, so regulatory separation has no real role to protect competition.

The Council finds that the Australian Government has met its CPA clause 4 obligations arising from the privatisation of the former Australian Wheat Board, albeit that these obligations have been reduced by the government's determination to continue the restriction of competition in wheat exports (a breach of CPA clause 5).

Telstra

Legislation in 1997 and 1999 provided for the part privatisation of Telstra which triggered commitments for the Australian Government under CPA clause 4 to review 'the merits of separating natural monopoly elements from potentially competitive elements of the public monopoly' before privatising a public monopoly. In regard to this obligation, the Council reported in its 1999 NCP assessment that:

> *This examination should have been undertaken prior to the partial privatisation and should have involved considering the merits of structurally separating the local fixed network from the non-monopoly elements of Telstra's business, or alternatively, arrangements for ring-fencing the local fixed network and Telstra's business units.* (NCC 1999, p. 338)

The Australian Government advised the Council that it considered that it had satisfied this requirement through related reviews. Moreover, it contended that it preferred, rather than pursuing structural separation, to prohibit anticompetitive conduct through part XIB of the *Trade Practices Act 1974* and to facilitate access to telecommunications services under part XIC of that Act.

In 2000, the Australian Government asked the Productivity Commission to review telecommunications regulation, but instructed it not to inquire into options for the structural separation of Telstra. The Commission made recommendations to improve the efficiency of the regime regulating access to the telecommunications network. Taking account of these recommendations, the Australian Government made legislative changes requiring Telstra to prepare separate accounts for its wholesale and retail operations (accounting separation). The Australian Competition and Consumer Commission introduced changes to the record-keeping rules that it applies to major telecommunications companies, to complement the introduction of accounting separation by Telstra. These reforms somewhat mitigate concerns about the market power of Telstra.

Through the Productivity Commission's review and the subsequent legislative changes, the Australian Government has made efforts to meet its NCP obligations. Nevertheless, to have complied with its CPA obligations, the Government should have considered the structural separation of the network in a formal way. At the time of the 2004 NCP assessment therefore, the Council reaffirmed its finding that the Australian Government was in breach of its CPA clause 4 obligation.

In 2005, the Productivity Commission released its *Review of National Competition Policy reforms*. It stated that full vertical separation of Telstra's network and retail services would involve substantial transaction costs that 'tip the balance' against full separation. The commission concluded that:

> *The … discussion of structural separation options highlights the difficulties of 'unscrambling the structural egg' in the*

> *telecommunication sector. Significant vertical or horizontal separation options may have been feasible or desirable when the company was still in full public ownership or before new investment … However, partial privatisation and the impending full privatisation have significantly increased the likely costs and difficulty of major structural changes.* (PC 2005a, p. 246)

The commission recommended that the Australian Government bring forwards (from 2007) its scheduled review of telecommunications regulation before the sale of Telstra, with the terms of reference providing for an assessment of whether further *operational separation* of Telstra's wholesale and retail arms would yield net benefits (PC 2005a, p. 247).

In response, the Australian Government brought forward its review of telecommunications regulation which found that operational separation was warranted. In September 2005, the government introduced legislation (subsequently passed) for an operational separation framework imposed on Telstra through a licence condition in the *Telecommunications Act 1997*. Under the licence condition Telstra will develop an operational separation plan for approval by the minister (subject to matters set out in the legislation). If it becomes apparent that Telstra is not complying with its obligations under the licence condition, the minister will be able to direct Telstra to provide a rectification plan. If Telstra fails to comply with its obligations under the rectification plan, the Australian Competition and Consumer Commission or the Australian Communication and Media Authority may take enforcement action.

The Council has no evidence before it to question the validity of the Productivity Commission's recommendation for a review to consider the merits of operational separation rather than structural separation. However, it does not consider that the commission's analysis of this matter—which constituted one element of a broad ranging review on the impact of the NCP and candidates for a new reform agenda—is a substitute for the structural review called for under CPA clause 4.

The potential benefits of full vertical separation of Telstra's wholesale and retail arms might not be sufficiently large to override the efficiency and transaction costs that would be entailed. Nevertheless, the CPA clause 4 obligation is clear. To comply, the Australian Government needs to undertake a review that definitively establishes the potential costs and benefits of structural separation relative to less stringent structures such as operational separation. The Council thus assesses that the Australian Government has not met its CPA clause 4 obligations.