PART II: ADDITIONAL POLICY ELEMENTS

8. Overview of Additional Policy Elements

In announcing the establishment of this Inquiry, the Prime Minister indicated that there was to be a specific emphasis on areas currently outside the *Trade Practices Act 1974* (TPA).[1] These were widely understood to include many government businesses (including public monopolies), statutory marketing arrangements for certain agricultural products and some professions.

The overwhelming majority of submissions received by the Inquiry argued that these sectors should be brought within a national competition policy, and concerns over a range of anti-competitive practices and arrangements were documented. A number of these submissions assumed that application of rules of the kind contained in the TPA would address their concerns and allow freer and more effective competition in these sectors.

While application of the Act has many benefits, much more is required if free and open competition is to be introduced to these and many other sectors of the economy. Regulatory restrictions on competition will often need to be removed or modified. The structure of public monopolies will often need to be reformed. Competitors may need to be assured of access to certain facilities that cannot be duplicated economically. Concerns over monopoly pricing may require attention. And the special advantages enjoyed by some government businesses when competing with private firms may need to be addressed. An effective national competition policy requires measures to respond to each of these issues.

Policies addressing these issues have important implications for Commonwealth, State and Territory Governments. It is their laws and their businesses that will be most directly affected. In some cases there may be wider implications for government revenues or the delivery of community service obligations, although these may, and in some cases should, be dealt with through alternative arrangements.

1 See Statement by the Prime Minister of 4 October 1992 (110/92).

The Committee is aware of the potential sensitivities in these areas. It has attempted to develop its recommendations in ways that respect the interests of sovereign governments, while ensuring vital national interests are not lost sight of. The Committee has also attempted to build on the lessons being learned in other Australian cooperative economic reforms, but is taking a bolder stance because of the importance of the reform task and the belief that precedents should be considered as steps towards effective national reform rather than as desirable models in and of themselves.

Implementation issues for these additional policy elements are considered in Part III of this Report. That Part includes details of the role of the proposed National Competition Council, the proposed Australian Competition Commission, and relevant legal, transitional and resource issues.

This Chapter presents a brief overview of each of the five additional policy elements the Committee proposes for inclusion in a national competition policy.

A. REGULATORY RESTRICTIONS ON COMPETITION

The greatest impediment to enhanced competition in many key sectors of the economy are restrictions imposed by government regulation or through government ownership. Examples include legislated monopolies for public utilities, statutory marketing arrangements for many agricultural products and licensing arrangements for various occupations and professions.

Compliance by a business (private or public) with government regulation is not prohibited by the TPA, however anti-competitive the consequences. Nor is imposition of the regulation. Application of the TPA will not be sufficient to overcome regulatory arrangements that establish monopolies, provide for the compulsory acquisition of crops, regulate prices, restrict the performance of certain activities to licensed occupations or a host of other regulatory restrictions on competition. Even if all exemptions from the TPA were eliminated — including the potential for Commonwealth, State or Territory laws

to authorise certain conduct[2] — these regulatory arrangements would be disturbed little if at all.

If Australia is to take competition and competition policy seriously, a new mechanism is required to ensure that regulatory restrictions on competition do not exceed what is justified in the public interest. Chapter Nine argues that all Australian governments should agree to adopt a set of principles aimed at ensuring statutes or regulations that restrict competition are justified in the public interest. This would involve increased scrutiny of new regulatory proposals and a more systematic review of existing regulations. An independent advisory body — the proposed National Competition Council — would support this process by undertaking and/or coordinating nation-wide reviews in specified areas and providing guidance on transitional issues.

B. STRUCTURAL REFORM OF PUBLIC MONOPOLIES

The removal of regulatory restrictions on competition may not necessarily, and perhaps even usually, be sufficient to foster effective competition in sectors currently dominated by public monopolies. Recent work by the OECD has highlighted the importance of creating competitive market and industry structures if effective competition is to emerge.[3] Structural reform of existing public monopolies may be required, as governments have recognised with reforms in place or underway in a number of sectors. Nothing in the TPA addresses concerns of this kind; an effective competition policy must include a mechanism to fill the void.

Chapter Ten identifies three main forms of structural reform particularly relevant to the introduction of competition to markets currently dominated by public monopolies. These are: (1) separating regulatory responsibilities from commercial activities; (2) separating natural monopoly elements of an organisation from activities which are contestable; and (3) separating the potentially contestable elements of a monopoly into several independent businesses operating in the one market.

---

2 See s.51(1) of the Act, discussed in Chapter Five.

3 OECD, *Regulatory Reform, Privatisation & Competition Policy* (1992) at 43.

The Chapter argues that all Australian Governments should agree to adopt a set of principles aimed at ensuring public monopolies are subject to appropriate restructuring before competition is introduced or substantial assets are privatised. While the implementation of these principles is left largely to individual governments, the NCC could be given references to advise governments when required.

C. ACCESS TO ESSENTIAL FACILITIES

Introducing competition in some markets requires competitors to be assured of access to certain facilities — referred to as "essential facilities" — that cannot be duplicated economically. Thus, for example, effective competition in electricity generation and rail services requires access to the electricity transmission grid and rail tracks respectively.

While the misuse of the market power provision of the TPA can sometimes provide a remedy in these situations, submissions to this Inquiry confirmed the Committee's own assessment that something more is required to meet the needs of an effective competition policy.

Chapter 11 argues that a special legal regime should be established under which firms could, in certain circumstances, be given a right of access to specified "essential facilities" on fair and reasonable terms. The regime would operate by declaration under a general law, provide safeguards for the owner of the facility and users, and have the flexibility to deal with access issues across a range of industry sectors. It could be applied to assets irrespective of ownership, although primary emphasis should be on consent of the owner when government-owned assets are involved. The NCC would play a central role in advising on when access rights should be created and on what terms and conditions.

D. MONOPOLY PRICING

In markets characterised by workable competition, charging prices above long-run average full costs will not be possible over a sustained period, as above-commercial returns will attract new market participants or lead consumers to choose a rival supplier or substitute product. Where the conditions for effective competition are

absent — such as where a firm has a legislated monopoly or the market is otherwise poorly contestable — firms may be able to charge prices above efficient levels for periods beyond a time when a competitive response might reasonably be expected. Such "monopoly pricing" is detrimental to consumers and to the community as a whole. Nothing in the TPA addresses this issue, and the Prices Surveillance Act has significant limits on its reach.

The Committee considers the primary response of competition policy in these markets should be to increase competitive pressures, including by those measures proposed in Chapters 9-11. Where these measures are not practicable or sufficient, some form of price-based response may be appropriate.

Chapter 12 argues that a national competition policy should include a carefully targeted prices monitoring and surveillance process. An independent inquiry into the competitive conditions of a market should precede the application of the mechanism to particular businesses. The mechanism could be applied to assets irrespective of ownership, although primary emphasis should be on consent of the owner when government businesses are involved. The NCC would assist governments in advancing pricing reform of public monopolies.

E. COMPETITIVE NEUTRALITY

Submissions to the Inquiry raised concerns over the special advantages many government businesses enjoy when competing with private firms. As competition of this kind is likely to increase over the next decade, there is a growing need to find some mechanism to deal with "competitive neutrality" concerns. Nothing in the TPA or other relevant legislation addresses this issue.

Chapter 13 argues that all Australian Governments should agree to adopt a set of principles aimed at ensuring government-owned businesses comply with certain competitive neutrality requirements when competing with private firms. The principles distinguish between markets in which the government business has traditionally operated — where some transitional arrangements may be appropriate — and new markets, where no such transitional arrangements are considered appropriate. The NCC would support the development of appropriate principles in this area.

9. Regulatory Restrictions on Competition

The competitive conduct rules proposed in Part I address restrictions on competition arising from the voluntary behaviour of firms. However, they do not address regulatory restrictions on competition, whether contained in statutes or subordinate legislation. Regulatory restrictions pervade the economy, ranging from government-sanctioned monopolies to licensing regimes and various restrictions on particular competitive conduct. In many areas currently at least partially exempt from the reach of competitive conduct rules — particularly government-owned businesses, agricultural marketing arrangements and the professions — removal of restrictions on competition will be the primary focus and means of implementing competition policy.

Government regulation will continue to be an important feature of our society, and there is wide community support for regulation to protect consumers, public health and safety, the environment and other significant interests. However, many of these laws were designed without explicit consideration of their impact on competition. Over the last decade or so, governments around the world have recognised that regulatory restrictions on competition impose substantial costs on consumers and society, through either cross-subsidies or reduced incentives for firms to innovate and improve their efficiency.

Proposals for new regulation are now subject to closer scrutiny to ensure they restrict competition no more than is necessary, and that the expected benefits to society outweigh any associated costs. Existing regulation put in place when there was greater confidence in regulation and less appreciation of its costs is generally reviewed as political priorities permit, with varying degrees of independent analytical rigour. Beneficiaries of the restrictions usually have powerful incentives to resist reform, with those advocating change bearing the burden of establishing that existing restrictions are not justified. While there have been important reforms, success has varied widely between sectors and different Australian jurisdictions.

The Committee believes that the time has come to progress regulatory reform more broadly, and to do so by reversing the onus of proof in considering the desirability of reforming particular regulation. Consistent with the principles already agreed between governments in relation to market conduct, the Committee considers that *there should be no regulatory restriction on competition unless clearly demonstrated to be in the public interest.*

This principle is the starting point for the Committee's proposals for more systematic review of regulations that restrict competition — including those relating to statutory marketing arrangements and the professions. A more rigorous review process of this nature was supported in many submissions to the Inquiry,[1] and can be an important and dynamic element of a national competition policy.

This Chapter comprises four sections.

Section A examines the impact of regulation on competition and outlines some of the key types of regulatory restrictions.

Section B outlines existing review processes and considers the case for adopting a more systematic, nationally-focussed approach.

Section C proposes a new approach to the reform of regulatory restrictions on competition as part of a national competition policy and considers alternative implementation options.

Section D presents the Committee's recommendations.

A. REGULATION & COMPETITION POLICY

In commissioning this Inquiry, Australian Governments agreed that "no participant in the market should be able to engage in anti-competitive conduct against the public interest". Where voluntary behaviour of firms is concerned, this principle can be implemented by application of the general conduct rules, with exceptions only granted where a business can show that the public benefit from engaging in the conduct outweighs its costs.

1 Eg, Dr R Albon (Sub 8); Treasury (Sub 76); DHHLGCS (Sub 84); NFF (Sub 90); BCA (Sub 93); Small Business Coalition (Sub 100); NSW Govt (Sub 117).

However, where anti-competitive consequences flow from government regulation, the public interest justification generally rests on policy judgements of elected governments and parliaments. These decision-makers are entrusted with defining and implementing the public interest, and must evaluate a range of competing considerations. While perceptions of public interest requirements evolve over time, regulations remain in place unless reviewed. Regulation that confers benefits on particular groups soon builds a constituency with an interest in resisting change and avoiding rigorous and independent re-evaluation of whether the restriction remains justified in the public interest.

Governments intervene in markets for many reasons and in many ways. At one level, all such interventions affect competition. Taxation policy, for instance, often deliberately discriminates between various classes of businesses or business activities, potentially affecting their relative competitive positions.[2] Similarly, regulation impacting on business costs affects the relative competitive position of Australia and its firms.[3] In this sense, almost no regulatory activity is neutral in its implications for competition.

However, there are two forms of regulation that impact on competition most directly: regulation that restricts market entry, and regulation that restricts competitive conduct. Both forms of regulation were the subject of numerous submissions to this Inquiry[4] and are considered separately below.

1. Regulatory Barriers to Market Entry

Regulatory barriers to market entry have the most direct influence over competitive conditions within an industry and, in the case of a monopoly, can prevent any competition. Other restrictions on market entry may be characterised according to whether they operate by reference to the number of suppliers, the qualifications of suppliers, or the origin of the goods or service providers. Extending the reach of market conduct rules will not affect these barriers to entry.

---

2 Examples drawn to the attention of the Inquiry are noted in Chapter 13.

3 Mr P J Boyle (Sub 5).

4 Eg, Dr R Albon (Sub 8); Shell (Sub 30); Mr R Sutherland (Sub 56); DHHLGCS (Sub 84); NFF (Sub 90); BCA (Sub 93); SBC (Sub 100); NSW Govt (Sub 117).

The importance of entry barriers has been highlighted by recent work on "contestability" — the idea that even the threat of potential competition can have efficiency effects similar to actual head-to-head competition.[5] Removing entry barriers can thus have an important impact on performance even if few or no new firms actually enter the market. Firms which were once isolated from competition realise that, unless they become more competitive, new entrants may seize opportunities and erode their market share.

(a) Barriers Creating a Monopoly

Government-sanctioned monopolies fall within four main categories.

- *Public Utilities*

Australian governments have largely entrusted the delivery of water, electricity, rail, road, postal and telecommunications services to public monopolies. Government-mandated monopolies were often justified on the basis that the activities in question were "natural monopolies". It was thought that a single producer was able to supply the service in question most efficiently, and that allowing additional suppliers would lead to "wasteful competition".[6]

At the same time, governments have used their businesses to ensure that communities have equal access to services irrespective of locations and different costs of providing the services. Monopolies have often been required to cross-subsidise between users or provide other "community service obligations". Monopoly profits have also been raised as a substitute for taxation, although not all monopolies have made profits, and fewer have made profits that exceed the cost of capital invested in them[7].

The costs to the community of monopolists' pricing and management practices are receiving increased attention. Inefficiency costs in the electricity sector alone were estimated at $2.2 billion per annum in

---

5 See Baumol W, "Contestable Markets : An Uprising in the Theory of Industry Structure", *American Economic Review* 72 (Mar 1982) 1-15; and Gilbert R J, "The Role of Potential Competition in Industrial Organisation", *Journal of Economic Perspectives* (Summ 1989) 107-127.

6 For example, in 1923 Alfred Marshall observed that "The supply of water, gas, or electricity to any locality cannot be distributed over several rivals:-for to say nothing of its wastefulness ...", *Industry and Trade* (4 ed, 1923) cited in Nowotny K, Smith D B & Trebing H M, *Public Utility Regulation* (1989) at 11.

7 See Box 12.4 in Chapter 12 for data on profits earned by Government Businesses.

1991.[8] At the same time, technological and other developments have eroded the extent of most genuine "natural monopolies" and eliminated others altogether. For example, while it is accepted that electricity transmission grids, rail tracks and local telecommunications networks probably continue to exhibit natural monopoly characteristics, electricity generation, rail and long-distance telecommunications services do not, and even local phone networks face competition from alternative technologies. Moreover, the natural monopoly element often accounts for only a small part of the range of activities carried on by legislated monopolies.

The recent introduction of competition to the telecommunications industry provides an example of the possible benefits. Although competition remains at an early stage of development, there is evidence that it is leading to reduced rates and improvements in productivity and service quality by the former monopolist.[9]

Some public utilities maintain their monopoly status without a formal regulatory barrier to new market entry.[10] In some cases the monopoly may be still be protected informally, however, such as through the exercise of discretions over various requirements relevant to the operation of the business, including development approvals and the like.

- *Monopolies over Budget-Funded Services*

A further form of monopoly exists where budget-funded government services are provided within government, without being subject to a competitive tendering process. Examples drawn to the Committee's attention ranged from road construction,[11] rail transport[12] and port services[13] to the delivery of welfare and community services.[14] In

8 IC, *Energy Generation & Distribution in Australia* (1991).

9 For example, over the period from June 1992 (when Optus entered the market) to May 1993, the STD peak rate on the Melbourne-Sydney route has fallen some 21%: AUSTEL advice based on published Telecom and Optus rates.

10 Eg, in South Australia there appears to be no legal impediment to new firms entering the electricity market: see NGMC, *Regulatory Framework Issues for a National Electricity Market* (1993) at 28.

11 AFCC (Sub 31).

12 IC, *Rail Transport* (1991).

13 IC, *Port Authority Services & Activities* (1993).

14 Mr A Greig (Sub 3).

these cases, the monopoly is supported by policy decisions rather than formal regulations, although the effect on competition is the same.

Studies indicate that average cost savings in the order of 20% can be expected from exposing government provided services to competitive tendering. In some cases, such as cleaning services in Sydney hospitals, competitive tendering has realised average savings of almost 30%.[15]

Progress is evident in most government sectors. At the Commonwealth level, most services provided by the Department of Administrative Services[16] and most legal services provided by the Attorney-General's Department[17] will be open to competition within the next few years. The NSW Government noted that its current reform program includes the introduction of greater competition in areas including schools and colleges, hospitals and health services and in community services.[18]

- *Rural Marketing*

Monopolies over the marketing of agricultural products have their origins in economic and institutional circumstances of several decades ago.[19] Governments have created quasi-monopoly marketing rights in a number of agricultural boards, sometimes accompanied by a power of compulsory acquisition of crops, controls over pricing and/or production quotas.

The rationales for domestic monopoly arrangements of this kind have varied over time, including increasing returns to farmers, stabilising prices or providing farmers with countervailing market power vis-a-vis buyers. The costs of these arrangements to the community have become apparent in recent years, with reforms in areas including domestic wheat marketing, domestic barley marketing in some States and egg production and marketing in most States.

---

15 A number of these studies are summarised in Domberger S, "Competitive Tendering and Contracting Out : Recent Experience and Future Policy" *Policy* (Autumn 1993) at 23-27.

16 DAA (Sub 83).

17 Attorney-General's Department, *Annual Report 1991-92* (1992).

18 NSW Govt (Sub 117).

19 IC, *Statutory Marketing Arrangements for Primary Products* (1991) at 1.

Providing rural producers with countervailing market power will only rarely be justified on efficiency grounds,[20] and the dangers of quarantining prices from market forces have recently been illustrated by the wool industry.[21] Providing income support to producers can generally be achieved at lower cost to the community by other means.

Governments have also conferred monopoly status on exporters of certain products, such as wheat[22] and sugar[23], where it is considered that the monopoly power will assist Australia to compete in world markets.

- *Other Government-Sanctioned Monopolies*

Australian Governments also sanction monopolies in other circumstances.

Temporary monopolies are given to protect the intellectual property rights of inventors and creators under the laws of patents and copyright. In the absence of such protection, there is concern that difficulties in controlling the use made of their ideas might diminish the incentives for socially-useful innovation.[24] The extent of monopoly required to achieve this goal is often open to debate.[25]

Most State governments reserve the transport of some commodities — including coal, timber, cement and petroleum — to rail. While monopolies of this kind may sometimes be justified on safety grounds, they also allow monopoly profits to be made which can be a significant source of State revenue in some cases (notably carriage of coal in NSW and Queensland).[26]

---

20 Eg, see ABARE (Sub 95); and IC (March 1991).

21 Eg, see DPIE (Sub 50) at 24.

22 See Mr V Kelly (Sub 110); Grains Council of Australia (Sub 134).

23 See Qld Sugar Corp (Sub 51); Canegrowers (Sub 67); Mackay Sugar Co-op Assn (Sub 70).

24 Eg, see Australian Information Industry Assn Ltd (Sub 40); AIPO (Sub 77); DITARD (Sub 101).

25 Eg, see PSA, *Book Prices* (1989); *Sound Recordings* (1990); and *Inquiry into Prices of Computer Software* (1992). Also see Chapter Six for a consideration of current exemptions from the competitive conduct rules for intellectual property.

26 For a discussion of the use of Qld Railways to raise monopoly profits, see Galligan B, "Queensland Railways and Export Coal", (1987) 46 *Australian Journal of Public Administration* at 77.

(b) Restrictions that Operate by Reference to the Number of Producers or Product

Competition in some areas of the economy is restricted by licensing regimes or similar arrangements that regulate the number of producers or the volume of production. Under these arrangements, competition is permitted, but only within a rigidly controlled industry structure.

In some cases, such as restrictions on the harvest of timber and fish, regulations may be supported on resource-management or conservation grounds.

In many cases, restrictions may be based more on an "orderly marketing" rationale, in the belief that "too much" competition might be disruptive. Examples of schemes that appear to fall within this category are production quotas or similar licensing regimes for eggs, milk[27] and potato[28] producers, taxis,[29] and intrastate aviation services in NSW and Tasmania. While restrictions on some agricultural products were traditionally justified on public health grounds, it is now clear that these standards can be maintained without quantitative restrictions.

Restrictions of this type are often connected with price regulation of various kinds, and are usually difficult to reconcile with the modern understanding of the benefits of vibrant competition to consumers and the economy generally. While domestically focussed arrangements have their primary impact on consumer prices, they may also undermine the development of efficient export industries by distorting input prices.[30]

The potential benefits of reform are significant. Deregulation of egg production and marketing in NSW led to a fall in average retail prices of 38 cents per dozen, with savings to consumers of $21m in a full year.[31] Deregulation of domestic aviation in 1990 led airfares to fall significantly; average fares are up to 29% lower than they were prior

---

27 See, for example, Australian Dairy Farmers' Federation (Sub 10).

28 See Pacific Dunlop (Sub 112).

29 See Aerial Taxi Cabs Cooperative Socy (Sub 102); Australian Taxi Industry Assn (Sub 114).

30 Eg, see Brass P, "Driving with a Destination – The Need for a National Vision" *Business Council Bulletin* (May 1993) at 78.

31 NSW Egg Corporation, *Annual Report 1990-91.*

to deregulation on virtually all routes and the range of discounts has greatly increased.[32] Welfare gains to the community from aviation deregulation have been estimated at $100m per annum.[33]

(c) Restrictions that Operate by Reference to Standards or Qualifications

Entry to many markets is restricted to goods or service providers which meet some prescribed standard or qualification. There are over 160 licensed occupations in Victoria alone, ranging from chicken sexers to boxing matchmakers and scrap metal merchants.[34] Other examples include product and building standards, and requirements for banks to comply with prudential requirements.

Such regulatory regimes may be more restrictive than necessary to protect the public interest objectives for which they were imposed. For example, the Prices Surveillance Authority (PSA) recently argued that the requirements for entry to the real estate agency industry went "way beyond what is necessary to protect consumers".[35] Similarly, the scope of the monopoly traditionally reserved to lawyers has been under intense scrutiny in recent years.[36] A number of governments have removed the lawyers' monopoly over conveyancing services, and accountants argue that other aspects of the lawyers' monopoly are too wide.[37]

Even if the standards are objectively reasonable, there may be concerns over whether they are administered or enforced in a way that unduly favours incumbents.

The recent agreement on the mutual recognition of regulatory requirements and occupational licensing is generating closer scrutiny of standards, particularly for occupations or products that are not regulated in all jurisdictions. While a mutual recognition regime offers the prospect of breaking down barriers between different

---

32 PSA, *Monitoring of Movements in Average Air Fares* (Report No. 5, July 1993).

33 Bureau of Transport & Communications Economics, *The Progress of Aviation Reform* (Report 81, 1993).

34 Victorian Regulation Review Unit, *Principles For Occupational Regulation* (1992).

35 PSA (Sub 97) at 53.

36 Eg, see Law Reform Commission of Victoria, *Restrictions on Legal Practice* (1992); NSW Attorney-General's Dept, *The Structure & Regulation of the Legal Profession* (1992); and TPC, *Study of the Professions : The Legal Profession* (1992).

37 Inst of Chartered Accountants/Aust Socy of CPAs (Sub 99).

jurisdictions, from a competition policy perspective there is a concern — whether justified or not — that standards may be harmonised at the level of the most restrictive standard, rather than the most appropriate.

(d) Barriers Operating against Inter-State Goods or Service Providers

Section 92 of the Constitution restricts regulations that discriminate against interstate trade and commerce and which have the purpose or effect of protecting intrastate trade or industry against competition from other States.[38] The provision has been used to challenge a range of discriminatory arrangements.[39]

Recent inter-governmental efforts have focussed on removing differences in regulatory requirements which restrict inter-state trade. The agreement on mutual recognition of product standards and occupational licensing is an important achievement in this regard.[40]

Impediments to the creation of a truly national market remain, however, including policies and laws not affected by s.92 or the mutual recognition arrangement. For example, it has been argued that different regulatory measures and infrastructure investment decisions in the various States have led to the sub-optimal use of Australia's gas reserves.[41] It has also been claimed that national policies, such as protection of domestic shipping, inhibit interstate trade by increasing its cost.[42]

---

38 Section 92 provides that "trade, commerce and intercourse among the States ... shall be absolutely free". The interpretation of the provision was recently settled by the High Court after many years of uncertainty: see *Cole* v *Whitfield* (1988) 165 CLR 360.

39 Eg, *James* v *South Australia* (1927) 40 CLR; *North Eastern Dairy* v *Dairy Industry Authy of NSW* (1975) 7 ALR 433. See generally, Coper M, *Freedom of Interstate Trade* (1983).

40 The Mutual Recognition Agreement was signed by Heads of Government in May 1992 and provides for the States and Territories to refer power to the Commonwealth to enable it to enact national legislation to provide the detailed conditions of mutual recognition. The *Mutual Recognition Act 1992* (Cth), which came into force on 1 March 1993, and at time of preparing this report applied to NSW, Qld, the NT, ACT and the Commonwealth; with Tas and Vic expected to proclaim the relevant legislation in the near future.

41 See DPIE, *A National Strategy for the Natural Gas Industry: A Discussion Paper* (1991) at 12-13; and Australian Petroleum Exploration Association Ltd (Sub 128).

42 Eg, NT Govt (Sub 91) and Tas Govt (Sub 115).

(e) Barriers Operating against Foreign Goods or Service Providers

Although restrictions on international competition are traditionally treated as part of trade policy, as distinct from competition policy, reforms in this area improve competition in the domestic economy and are consistent with competition policy objectives.

Examples of entry barriers that operate by reference to the national origin of goods and services include import tariffs and quotas, foreign investment and immigration controls, rules governing local content in broadcasting and shipping cabotage policies. Barriers of this kind are generally erected to protect some distinctive national interest such as a domestic industry or cultural values.

Traditionally, Australia imposed relatively high import barriers to protect its manufacturing sector. Since the 1980s there has been increased understanding of the costs of such policies to consumers and the economy generally, and the effective rate of assistance for manufacturing has been reduced from 22% in 1983-84 to 15% in 1990-91. The Government has set out a fixed schedule of reductions that will leave most manufacturing industries with little industry-specific assistance.[43]

The impact of increased import competition on industry efficiency is illustrated by developments in the motor vehicle industry. The abolition of import quotas and a program of phased tariff reductions has led to improved productivity growth since 1988 and to a fall in the average level of faults per vehicle by 39% over the same period.[44]

Barriers against foreign banks and foreign investment generally have also been relaxed. Increased international exposure is an important means of improving competition and efficiency in a relatively small economy like Australia's, both directly through import competition, and indirectly by allowing foreign firms to operate in Australia on the same basis as Australian firms.

As noted in Chapter One, this Inquiry has focussed on competition policy issues within the domestic economy in developing its proposals, and thus does not deal with policy addressing barriers operating

43 IC, *Annual Report 1991-92* (1992) at 268-269.

44 EPAC (Sub 126) at 15.

against foreign goods or service providers, many of which operate under, or are subject to, treaty obligations.[45] However, there are other important links between these policy areas. As well as their common effect in increasing competition in the domestic market, it is important to ensure that liberalisation of domestic barriers to competition accompanies trade liberalisation, so that domestic producers have the flexibility and incentives to enter promising markets, expand profitable operations, shift product lines and exit from shrinking markets.[46]

2. Restrictions on Competitive Conduct

Many sectors of the economy, including agriculture and many professions, operate under regulatory regimes which restrict certain forms of competitive behaviour. These regulatory restrictions range from price controls at one extreme to requirements to comply with generally accepted ethical standards at the other. Many of these restrictions may be justified as desirable for the protection of consumers, but the benefits to consumers of other restrictions are less obvious. For example, price regulation intended to assist favoured classes of producers or consumers restricts competition, and restrictions on advertising may serve to protect the interests of producers.

Where these restrictions are maintained by private agreement between producers, they would be subject to the competitive conduct rules proposed in Part I, but because they are imposed by government regulation, they are generally immune from the *Trade Practices Act* (TPA). Simple extension of the TPA, without removal of the regulatory restrictions, would often have a negligible impact because doing, or refraining from doing, an act in order to comply with government regulations is not usually conduct prohibited by the TPA.

3. Conclusions

The above review highlights the diversity of forms and possible rationales for regulatory restrictions on competition.

---

45 Submissions concerning international barriers included Dr R Albon (Sub 8); Australian United Fresh Fruit & Vegetable Assn (Sub 45); and Qantas (Sub 78).

46 See Frischtak C R, *Competition Policies For Industrialising Countries* (1989).

The recent reforms mentioned illustrate the benefits to consumers and the economy generally of removing unjustified restrictions on competition. Submissions to this Inquiry confirmed the Committee's assessment that there remains a vast amount of regulation that is perceived to be restricting competition without adequate justification. Examples given in submissions covered almost every sector of the economy, including agriculture,[47] the professions,[48] transport[49] and government monopolies.[50]

Clearly, much more needs to be done if Australia is to meet the challenge of building a more dynamic and efficient economy.

B. CURRENT REFORM & REVIEW PROCESSES

The determination of whether a regulatory restriction on competition is justified on public interest grounds largely depends on perceptions of the "public interest". In a democracy, this question is determined by elected governments and parliaments, though at times independent agencies are asked to make the judgement. In Australia's federal system, there are nine governments involved in this process.

Governments and parliaments accept that their judgements are not infallible. Increasingly, governments are implementing new procedures to assist in determining whether the benefits of a proposed regulation are likely to outweigh the costs to society. Similarly, there is an acceptance that perceptions of what the public interest requires will evolve over time, and that there is a need to bring existing regulations under scrutiny from time to time. Current processes differ between Australian jurisdictions.

1. Scrutiny at the Commonwealth Level

The Commonwealth has adopted a policy of "minimum effective regulation" which is applied by the Office of Regulation Review (ORR). This requires that proponents of new regulation demonstrate

47 Eg, Australian United Fresh Fruit & Vegetable Assn (Sub 45); Pacific Dunlop (Sub 112).

48 Eg, Mr P R Meatheringham (Sub 9); Australasian Dental Technician's Socy (Sub 14); Hospital Scientists Branch, NSW Public Service Assn (Sub 19); Assn of Hospital Pharmacists of Victoria/Medical Scientists Assn of Victoria/Victorian Psychologists Assn (Sub 26); Inst of Chartered Accountants/Australian Socy of CPAs (Sub 99); Chiropractor's Assn of Aust (Sub 137).

49 Eg, Aust Inst of Petroleum (Sub 22); ARTF (Sub 74).

50 Eg, Dr R Albon (Sub 8); AFCC (Sub 31).

that their proposals address real problems, that non-regulatory alternatives have been considered and that the expected benefits of the regulation outweigh the costs. Where regulation is considered justified, the ORR seeks efficiency in its design. The ORR is a formal part of the machinery of government and advises the Cabinet on submissions involving regulation issues.[51]

Scrutiny of existing regulations with significant economic impact is often undertaken by independent reviews, either by ad hoc public inquiries — such as the present one — or independent bodies including the Industry Commission (IC), PSA and TPC. The Australian Law Reform Commission may also be involved in this work.[52]

The IC and its predecessors traditionally focussed on import restrictions, where its independent analytical work has been an important impetus for reform. It has also focussed on inefficient industries where competition is weak for reasons other than import restrictions — such as rail, electricity, gas and water. More recently, it has been providing policy advice on industries considered to have growth potential.[53] It uses a public inquiry process and takes an economy-wide view of issues.

The PSA has also undertaken inquiries into areas where regulatory restrictions on competition affect performance, with recent studies on restrictions on real estate agents and on the parallel importation of books, records and computer software.[54] Like the IC, the PSA uses a public inquiry process and applies economic analysis with a nation-wide perspective.

Although the primary focus of the TPC has been on the conduct of firms, its recent work on the professions included an examination of regulatory restrictions on competition.[55]

51 See IC, *Annual Report 1991-92* (1992) at 159-160.
52 Eg, ALRC, *Designs: Issues Paper* (1993).
53 See IC, *Annual Report 1991-92* (1992) at 24.
54 PSA (Sub 97).
55 TPC (Sub 69).

2. Scrutiny at the State Level

Most States have units similar to the Commonwealth's Office of Regulation Review,[56] which are part of the machinery of government rather than independent, and advise government on regulatory issues and proposals. They can also investigate complaints about government regulation.

Some States have instituted automatic revocation or sunset programs, which provide for automatic repeal of regulation after a specified time frame (generally 10 years) unless retentive action is taken.[57] In Victoria, regulation may be enacted or retained only following an impact assessment process which must establish a net public benefit, and include a public discussion process.[58]

There are no State equivalents of the IC, although the Commission is increasingly involving the States in its work. The terms of reference for many of its inquiries are now agreed between the Commonwealth and State Governments, and many of its more significant reports in recent years have been on sectors dominated by the States (eg, electricity, gas, rail, and marketing of primary production). States also commission work and hold public inquiries.[59]

3. The Need to Move on a Broader Front

The last decade has witnessed a growing appreciation by governments and the community of the costs to society of regulation that unjustifiably restricts competition. Proposals for new regulation are now subject to closer scrutiny to ensure they are no more restrictive of competition than necessary, and that the expected benefits to society outweigh any associated costs. Existing regulation put in place when there was greater confidence in regulation and less appreciation of its costs is also being reviewed, albeit usually on an ad hoc basis and with varying degrees of independent analytical rigour.

---

56 Eg, Office of Regulation Review (SA); Business Regulation Review Unit (Qld); Business Deregulation Unit (NSW); Regulation Reform Branch (Vic); and the ACT Regulation Review Unit. Tasmania has passed legislation to establish a review of all subordinate legislation (the *Subordinate Legislation Act 1993*), and is reviewing all legislation that affects business activity.

57 IC, *Annual Report 1991-92* (1992) at 129.

58 The Subordinate Legislation Act (Vic) sunsets all regulations made prior to June 1982. Any proposed replacement regulations are required to meet "sunrise" assessment processes, including cost-benefit assessment. See IC, *Annual Report 1991-92* (1992) at 129.

59 Eg, Energy Board of Review, *The Energy Challenge for the 21st Century* (1993).

The challenge of reform is great. Restrictions in place for long periods usually have usually developed a constituency of interests. Other things being equal, a business would rather face less competition than more. While protected businesses generally have a keen appreciation of the implications of change, the benefits of reform to the wider economy are typically dispersed, reducing the constituency for reform. In this setting, protected businesses are often well-placed to resist change, with proponents of reform usually bearing the burden of establishing that existing restrictions are not justified.

Australia has begun to address this challenge but priorities and progress continue to vary between jurisdictions and sectors. In the meantime, the inefficiencies arising from unnecessarily restrictive regulations are disadvantaging consumers and businesses that rely on inputs from protected sectors to contend with international competition.

The recent inter-governmental agreement on the mutual recognition of product standards and occupational licensing is a significant achievement in adopting more coordinated and broadly based reforms. It recognises the reality that Australia is one market, and that regulation in one jurisdiction often has implications beyond State borders. That agreement will not reach all restrictions on competition, however, and its liberalising potential can be subverted by adopting uniform regulations that are themselves unnecessarily restrictive.

The increasing involvement of the States in the work of the IC is also an important step forward.

Existing reform efforts affecting State-based regulations are not coordinated but appear to have a "bandwagon" effect. When public concern arose over the effects of restrictions in the legal profession there was not one substantial review adopting a national perspective, but a series of studies including by the Victorian Law Reform Commission,[60] the NSW Attorney-General's Department,[61] the

60 Law Reform Commission of Victoria, *Restrictions on Legal Practice* (1992).

61 NSW Attorney-General's Dept, *Structure & Regulation of the Legal Profession* (1992).

Senate Standing Committee on Legal and Constitutional Affairs,[62] and the Trade Practices Commission,[63] covering substantially the same ground. While the result of such a barrage of reviews may be improved prospects of reform, it raises the question of whether the same or even better work might not have been pursued through a cooperative mechanism of some kind. Similarly, there would be benefits in pursuing coordinated national reform of agricultural arrangements.

An important first step is to ensure unjustifiably restrictive regulations are not imposed in the first place. While decisions on these questions are ultimately for individual governments and parliaments, it seems possible to develop a more consistent, national approach to scrutinising proposals to restrict competition through regulation or statute.

Where such regulation is in place, the challenge is to overcome the resistance of protected groups. This might be facilitated by governments accepting the principle that there is a presumption that competition is desirable, placing the onus on those proposing continuation of a restriction to demonstrate why it is justified in the public interest. Experience shows that improving the transparency of the costs and benefits of particular restrictions is usually a vital part of reform processes,[64] and a common commitment to such processes could expedite reform across the economy. Undertaking those analyses through an economy-wide, coordinated approach could reinforce the important national perspectives involved, while providing some economies of scale in resources and expertise.

C. REGULATORY REFORM UNDER A NATIONAL COMPETITION POLICY

A mechanism to facilitate the reform of government regulation that unjustifiably restricts competition should be a central plank of a national competition policy. The starting point should be acceptance by all governments of the principle that there should be no regulatory restrictions on competition unless clearly demonstrated to be in the

62 Senate Standing Committee on Legal & Constitutional Affairs, *Cost of Justice* (1992).

63 TPC, *Study of the Professions : The Legal Profession* (1992).

64 Eg, see Derthwick M & Quirk P J, *The Politics of Deregulation* (1985).

public interest. This Section proposes a set of principles and recommends a cooperative implementation approach.

1. Policy Principles

The Committee's review of regulatory restrictions on competition supports the following broad principles as a basis for a national policy.

I *There should be no regulatory restrictions on competition unless clearly demonstrated to be in the public interest. Governments which choose to restrict consumers' ability to choose among rival suppliers and alternative terms and conditions should demonstrate why this is necessary in the public interest.*

This principle is unexceptional but gives formal recognition to the new consensus over the proper role of competition in building an efficient and dynamic economy capable of delivering improved living standards. The principle recognises that while it may be appropriate to restrict competition in some circumstances, this should not be done lightly. The principle would apply to proposals for new regulations and statutes, as well as the scrutiny of existing restrictions.

The principle is directed at "regulatory" restrictions, and does not address situations where monopolies are maintained or competition restricted through government decisions on sourcing budget-funded goods or services. Decisions in this area are commonly regarded as management prerogatives, as they are in the private sector. However, contracting-out and competitive tendering have been seen to offer substantial cost savings in many areas, and governments are encouraged to continue exploring opportunities for creating new competitive markets in this way.

II *Proposals for new regulation that has the potential to restrict competition should include evidence that the competitive effects of the regulation have been considered, that the benefits of the proposed restriction outweigh the likely costs, and that the restriction is no more restrictive than necessary in the public interest. Where a significant restriction on competition is identified, the relevant regulation should be subject to a sunset provision deeming it to lapse within a period of no more than 5 years unless re-enacted after further scrutiny in accordance with Principle III.*

This principle is aimed at ensuring that the costs and benefits of regulations which have the potential to restrict competition are considered in a transparent process before being put in place. Some jurisdictions have already adopted this approach. The sunset provision places the onus on those wishing to maintain a restriction on competition to justify that such a restriction continues to be in the public interest.

The Committee envisages a pragmatic interpretation of "significant restriction on competition", focussing on barriers to market entry and prohibitions on competitive conduct. The Committee is not prescriptive as to the methodology for assessing costs and benefits but notes that existing agencies are developing experience in this area which might be harmonised between jurisdictions.

III *All existing regulation that imposes a significant restriction on competition should be subject to regular review to determine conformity with Principle I. The review should be performed by an independent body, involve a public inquiry process and include a public assessment of the costs and benefits of the restriction. If retained after initial review the regulation should be subject to the same requirements imposed on new regulation under Principle II.*

This principle involves governments adopting a pro-active, systematic and rigorous approach to the review of existing regulation that restricts competition. It also recognises that both existing and new regulation should be subject to the same scrutiny regarding their net public benefit.

The requirement that the body undertaking the review be "independent" excludes not only the industry subject to the regulation but also the government agency responsible for creating and administering the regulation.

IV *To the extent practicable and relevant, reviews of regulation undertaken pursuant to Principles II and III should take an economy-wide perspective of the impact of restrictions on competition.*

This principle reflects the necessity to account for impacts beyond a single State or Territory border. While individual governments may not be well placed to adopt such a perspective in all cases, cooperative mechanisms such as those set out below can assist in ensuring larger national interests are given due weight.

These principles are not exhaustive and could be further refined and be supplemented by more detailed principles governing particular forms of restriction or sectors, such as agricultural marketing.

2. Implementing a National Policy

The Committee considered several options for implementing policy principles of the kind proposed above. While favouring cooperative and decentralised approaches, it proposes that a new institution — the National Competition Council (NCC) — play a role in coordinating reforms and facilitating the cooperative process generally.

(a) Implementation Options

The main options in this area distinguish between the treatment of the regulation review activity and the possible role for a legal regime to over-ride regulations found to be inconsistent with the principles.

- *Review Activity*

Assessment of the costs and benefits of new regulatory proposals is clearly a matter for each jurisdiction. However, there may be benefits in collaboration to develop consistent methodologies.

Reviews of existing regulations present more options. A single national body could be given jurisdiction to review all existing

Commonwealth, State and Territory regulations, including through inquiries with compulsory information gathering powers. At the other extreme, each jurisdiction could be responsible for reviewing its own regulations, subject to conforming with the agreed principles. A middle course would see each jurisdiction primarily responsible for its own regulations, but providing a mechanism to facilitate cooperative nationally-focussed action where appropriate.

- *Implementing Review Findings*

Where a review of a regulation concludes that the costs to the community outweigh its claimed benefits, the question arises as to how that finding might be carried into effect.

One option would be to have a single national law that would over-ride the regulation in question. Although the Commonwealth's constitutional powers are not unlimited, it may be possible for the Commonwealth to over-ride State and Territory laws by effectively creating a "right to compete" or a "right to buy", qualified as appropriate to take account of other social goals. The operation of such a law might be triggered by the finding of a national review authority, or by some process agreed by governments.

Alternatively, individual governments could retain responsibility for reforming their own laws.

(b) Consideration & Conclusions

As in other areas, the Committee starts with a preference for respecting the prerogatives of sovereign governments unless there is a clear national interest at stake that could not be resolved cooperatively. There are two main issues: the review process, and a power to over-ride State and Territory regulations as a possible response to the findings of that review.

- *The Review Process*

Evidence of Commonwealth-State cooperation on matters such as interstate rail, the waterfront, road transport and mutual recognition suggests that cooperation in this area is likely to be successful, though the pace of such cooperative effort is at times of concern. However,

given the experience that is developing with cooperative arrangements, the Committee supports this approach.

Under the Committee's preferred approach, each government would be responsible for implementing the principles within its jurisdiction, but could call on a nationally-focussed, independent advisory body — the proposed NCC — to facilitate cooperative efforts.

Thus, for example, each government would be responsible for applying Principle II — relating to scrutiny of new regulatory proposals — in its own jurisdiction. In many cases, this task is already being performed by a specialist agency, and this work would continue. However, the NCC could assist in working towards more consistent approaches between jurisdictions, including on methodological questions.

In relation to the review of existing regulations, each government would be primarily responsible for implementing the agreed principles within its jurisdiction. However, where particular regulations that were of concern to more than one jurisdiction were involved, the NCC could be given a reference by governments to coordinate or undertake economy-wide reviews of the regulations in question. Such a process may present economies for individual jurisdictions and could be used to accelerate reform across targeted sectors of the economy. While the areas of early interest may be those constraining competition in the infrastructure industries, agricultural marketing and the professions, the NCC's work program could be agreed between governments.

At present, the TPC and PSA undertake some work on regulatory restrictions on competition, and have taken a national view of State and Territory regulations in areas such as real estate agents and the professions. Their activity does not appear to have intruded unduly into State prerogatives in this regard, and the Committee supports a continuing role in this area for the proposed successor to these bodies, the Australian Competition Commission. To avoid duplication it would be important for the work program of all reviewing bodies to be coordinated, and the NCC should undertake this task. Moreover, it would important that the ACC's work be seen as complementary to the work of the NCC, and that any reviews the ACC initiates are genuinely economy-wide in focus or significance.

In view of the cooperative nature of the envisaged regulation review process, the Committee does not see a need for review bodies to have powers to compel the disclosure of information, although powers of these kinds might be conferred on these bodies for the purposes of specific reviews where such powers were considered essential.

Although the proposed process would see a number of bodies involved in reviewing regulations that restrict competition, there may be fewer inquiries than under the current, more ad hoc approach in each jurisdiction. The NCC should assist in avoiding unnecessary duplication.

A further task is to develop and refine the broad proposition reflected in Principle I, including by developing more detailed principles governing particular forms of regulatory restrictions or particular sectors of the economy. For example, it should be possible to develop more detailed guidelines governing the reform of particular restrictions in the agricultural sector, or for removing regulatory impediments to competition in infrastructure industries such as electricity and gas. While decisions on what principles should apply in these areas are for governments, the NCC should be well-placed to assist them in developing and refining appropriate principles.

- *Over-Ride Power*

In view of its preference for a cooperative approach to the review of regulations in this area, the Committee does not recommend that the Commonwealth enact a law to over-ride relevant State or Territory regulations which do not comply with agreed principles. Nevertheless, an approach of this kind should not be ruled out as a possibility if the cooperative approaches recommended by the Committee prove inadequate to meet the national interests at stake.

D. RECOMMENDATIONS

The Committee recommends that:

9.1 A mechanism to promote reform of regulation that unjustifiably restricts competition form a central plank of a national competition policy.

9.2 All Australian Governments agree to abide by the following principles:

I *There should be no regulatory restrictions on competition unless clearly demonstrated to be in the public interest. Governments which choose to restrict consumers' ability to choose among rival suppliers and alternative terms and conditions should demonstrate why this is necessary in the public interest;*

II *Proposals for new regulation that have the potential to restrict competition should include evidence that the competitive effects of the regulation have been considered; that the benefits of the proposed restriction outweigh the likely costs; and that the restriction is no more restrictive than necessary in the public interest. Where a significant restriction on competition is identified, the relevant regulation should be subject to a sunset period deeming it to lapse within a period of no more than five years unless re-enacted after further scrutiny in accordance with Principle III.*

III *All existing regulation that imposes a significant restriction on competition should be subject to regular review to determine conformity with Principle I. The review should be performed by an independent body, involve a public inquiry process and include a public assessment of the costs and benefits of the restriction. If retained after initial review the regulation should be subject to the same requirements imposed on new regulation under Principle II.*

IV *To the extent practicable and relevant, reviews of regulation undertaken pursuant to Principles II and III should take an economy-wide perspective of the impact of restrictions on competition.*

9.3 An independent, nationally-focussed advisory body — the proposed National Competition Council — be charged with assisting governments in developing and implementing the agreed principles, including by:

(a) undertaking and/or coordinating economy-wide reviews of particular regulatory restrictions, in accordance with a work program agreed with governments; and

(b) developing for the consideration of governments more detailed principles governing the treatment of particular sectors and forms of regulatory restrictions.

9.4 The national competition authority — the proposed Australian Competition Commission — continue to be able to undertake reviews of regulations restricting competition. Activity in this area should complement that of the National Competition Council, focus on matters of economy-wide significance, and be consistent with any work program agreed under the auspices of the Council.

10. Structural Reform of Public Monopolies

The introduction of effective competition into markets traditionally supplied by public monopolies will often require more than the removal of regulatory restrictions on competition. Where the incumbent firm has developed into an integrated monopoly during its period of protection from competition, structural reforms may be required to dismantle excessive market power and increase the contestability of the market.

From a competition policy perspective, questions about the most appropriate structure for public monopolies arise in two main contexts. First, there is the concern that reforms involving the introduction of competition to former monopoly markets should result in effective competition, with minimal need for ongoing regulatory intervention. Pro-competitive reforms of this kind have already been undertaken in the Australian telecommunications industry, and are being pursued in sectors such as electricity. The second setting is where a public monopoly is being privatised. While the Committee recognises that privatisation may offer efficiency benefits, there is a risk that privatisation without appropriate restructuring may entrench the anti-competitive structure of the former public monopolies, making structural reform even more important.

In either setting, establishing the conditions for effective competition may require the structures of public monopolies to be reformed to ensure they are compatible with more competitive markets. Responsibility for regulatory functions may have to be separated from commercial functions. Natural monopoly elements may need to be separated from potentially competitive activities. And in some cases it may be desirable to separate potentially competitive parts of the enterprise so that it becomes several distinct businesses.

While issues of this kind are of particular concern to owning governments, the structural reform of businesses owned by State and Territory Governments increasingly also has a national significance. This Chapter proposes that a national competition policy should include a mechanism for enhancing cooperation and coordination on such matters, including inter-governmental agreement on a set of

principles which would be supported by appropriate institutional arrangements.

Section A examines the role of structural reform of public monopolies in competition policy and concludes that it should form part of a national competition policy.

Section B considers the policy content and implementation approach for dealing with structural reform of public monopolies in a national competition policy.

Section C presents the Committee's recommendations.

A. THE STRUCTURE OF PUBLIC MONOPOLIES & COMPETITION POLICY

The structure of a market is one of the key determinants of competitiveness and hence efficiency. In competitive markets, the structure of firms and the industry as a whole evolves over time in response to changes in market conditions. In the case of many public monopolies, however, protection from market forces through government regulation or other government policies has often allowed enterprises to develop structures unlikely to be found under normal market conditions.[1]

While questions of the most appropriate structure for public enterprises may be of interest from a public management perspective generally, competition policy concerns come to the fore when government decisions are being taken that may affect the competitive conditions, and hence efficiency, of markets.

This Section considers the dimensions of the task of structural reform in terms of the three main forms of structural separation that may need to be considered to facilitate effective competition, and notes some of the reforms already in progress. It then considers the different contexts in which structural reform issues arise and argues

---

1 Several submissions noted the key role of structural reform in introducing competition into markets hitherto dominated by public monopolies. Eg, IC (Sub 6); Dr R Albon (Sub 8); Esso Aust (Sub 21); Shell Aust (Sub 30); Vic Gas Users Group (Sub 47); DPIE (Sub 50); DOTAC (Sub 58); Trade Practices Committee of LCA (Sub 65); Treasury (Sub 76); BCA (Sub 93); Queensland Govt (Sub 104); NSW Govt (Sub 117); BHP (Sub 133).

that the privatisation of public monopolies raises special concerns. The Section concludes that the increasing national significance of these issues warrants the inclusion of appropriate policy measures in a national competition policy.

1. Dimensions of Structural Reform

The primary focus of competition policy in this area is to dismantle excessive market power that may impede the introduction of effective competition into markets traditionally supplied by public monopolies. This may require structural separation in three main areas:

- the separation of regulatory and commercial functions;
- the separation of natural monopoly and potentially competitive activities; and
- the separation of potentially competitive activities.

Each dimension of structural separation is considered separately in relation to its rationale from a competition policy perspective and recent experience in considering or implementing the necessary reforms.

(a) Separation of Regulatory and Commercial Functions

Reflecting their origins in departments of state, many government agencies were responsible for regulating technical aspects of a particular industry, as well as providing services that were subject to or affected by those regulations. Telecom provides an example, where it remained responsible for technical regulation of the telecommunications industry until these functions were transferred to an independent regulator, AUSTEL, in 1989.

In a competitive environment, such a dual role creates a potential conflict of interest between advancing the commercial interests of the enterprise and advancing wider public interests through the exercise of regulatory powers, presenting opportunities for incumbents to misuse control over regulatory standards to frustrate the actions of actual or potential competitors.[2] The rationale for separating the

2 The potential difficulties that may arise where such separation is not carried out before the introduction of competition are illustrated by the New Zealand telecommunications market. New

regulatory and commercial functions of a public enterprise is widely appreciated, and was acknowledged by a number of submissions to the Inquiry.[3]

There are a number of options for dealing with the regulatory functions hitherto performed by a public monopoly. In some cases it may be possible to replace government regulation with industry codes of practice, which can be vetted by the competition authority if appropriate.[4] Where the regulatory function is to continue to be exercised through a government agency other than the incumbent, there may still be a need to consider the potential for conflicts of interest. For example, placing these responsibilities in a government department may create concerns that regulatory discretions will be exercised to the benefit of the government-owned business — and hence maximise government revenues — rather than in a more even-handed manner. A technical regulator at arm's length from the government will generally be preferred.[5]

(b) Separation of Natural Monopoly Elements & Potentially Competitive Activities

A number of industries currently dominated by public monopolies involve an element with natural monopoly characteristics, in the sense that a single firm can supply the entire market most economically — examples include electricity transmission grids and rail tracks. In many cases, these natural monopoly elements have been integrated with potentially competitive activities (such as electricity generation or rail services). Integration of this kind may be through a vertical

---

Zealand Telecom continues to perform various regulatory and quasi-regulatory functions, and this appears to be one factor which has hampered the achievement of effective competition in that market. For example, problems have arisen in relation to numbering and directory access, where New Zealand Telecom has retained control of the numbering plan. See NZ Commerce Commission, *Telecommunications Industry Inquiry Report* (1992).

3 Eg, AUSTEL (Sub 41); DOTAC (Sub 58); ESAA (Sub 89); Govt of Victoria, (Sub 122). The Victorian Government recently announced that, as part of the proposed restructuring of the SECV, regulatory responsibilities would be separated from the SECV : Office of the Treasurer and the Energy Minister (Vic), "Major Restructuring of Electricity Industry Commences" (News Release, 10 August 1993).

4 A code of practice agreed between industry participants may constitute a "contract, arrangement or understanding" for the purposes of s.45 of the TPA, and would thus be prohibited if it substantially lessened competition unless it was authorised by the TPC.

5 This approach is consistent with the telecommunications reforms (where the regulatory functions were given to AUSTEL), and with the conclusions of the Carnegie report into the structure of the WA energy industry: see Energy Board of Review, *The Energy Challenge for the 21st Century* (1993) at 74.

relationship — so that one activity is upstream from another — or a horizontal relationship — where there are no essential links between the two activities. There are two main competition policy concerns.

First, irrespective of whether the natural monopoly element is integrated vertically or horizontally with the potentially competitive element, industry structures of this kind present opportunities for cross-subsidisation.[6] Monopoly returns made in the monopoly market may be used to finance otherwise unprofitable prices in the competitive market, potentially driving out or disadvantaging competitors. Indeed, even the prospect of such conduct may deter competitive market entry unless appropriate safeguards are in place.[7] This concern will be more pressing where the potentially competitive market is itself not highly contestable.

A second concern can arise where there is a vertical relationship between the two activities, particularly when access to the natural monopoly element is essential for effective competition in the downstream or upstream market. For example, effective competition in electricity generation requires access to electricity transmission grids. In this case, integration of the natural monopoly element (transmission grids) and a potentially competitive activity (electricity generation) raises concerns that control over access to the monopoly element may be misused to stifle or prevent competition in the potentially competitive sector. Even if access is not actually misused, the potential for such behaviour may deter new entry to, or limit vigorous competition in, markets dependent on access to the natural monopoly element.

There are two broad alternatives for addressing concerns of these kinds. First, the natural monopoly element can be separated from the potentially competitive elements. Alternatively, the integrated structure could be left intact, and reliance placed instead on more intrusive regulatory controls to guard against cross-subsidisation and, where a vertical relationship is involved, the potential misuse of control over access to the natural monopoly element.[8]

---

6 Eg, see Ordover J A & Pittman R W, *Competition Policies for Natural Monopolies in a Developing Market Economy* (1992).

7 Although s.46 of the TPA is potentially applicable to pricing conduct of this kind, the delays and uncertainty associated with judicial proceedings may still have a deterrent effect on competition.

8 A possible regulatory response to access issues is proposed in Chapter 11.

In each case an assessment of the relevant costs and benefits is required. Structural separation involves some immediate costs of transition, and possibly some additional transaction costs on an ongoing basis. However, these have to be weighed against the benefits of developing a more efficient and dynamic industry structure, and of avoiding the costs of ongoing regulatory intervention. Regulatory approaches involve costs for the parties and for the regulatory authority, and will rarely be as dynamic as market-driven outcomes.

It is sometimes suggested that the degree of separation required is merely "accounting" separation, so that the financial relationships between two parts of a business become more transparent. While separation of this kind may place some practical constraints on cross-subsidisation, and facilitate regulation of the natural monopoly element, it will not be sufficient to remove potential incentives to misuse control over access to a vertically integrated element. Full separation at the level of ownership or control is required.

While full separation of ownership or control should facilitate the emergence of effective competition in the potentially competitive element of the business, it does not exhaust the competition policy interest in such firms. The natural monopoly element will still be in a position to use its market power to charge monopoly prices, which may itself warrant some form of response.[9]

- *Recent Experience & Studies*

The Victorian Government has recently announced plans to restructure the State Electricity Commission of Victoria (SECV) by separating the generation, transmission and distribution elements of electricity supply.[10] Also in the electricity industry, vertical separation of the natural monopoly and potentially competitive elements was supported by the Industry Commission,[11] the National Grid

9 Chapter 12 discusses possible responses to monopoly pricing concerns. In some circumstances it will be appropriate to address these concerns in tandem with access issues as part of the access regime outlined in Chapter 11.

10 Office of the Treasurer and the Energy Minister (Vic), "Major Restructuring of Electricity Industry Commences" (News Release, 10 August 1993).

11 IC, *Energy Generation and Distribution* (1991).

Management Council,[12] and the Carnegie report into the Western Australian industry.[13]

Separation of the natural monopoly and potentially competitive elements has also been recommended for the rail industry[14] and for the Western Australian gas industry,[15] but not for the water resources and waste disposal industry.[16] The pro-competitive reforms to the telecommunications industry did not include vertical separation due to a concern that AOTC, at least for the 5 years from the introduction of competition, required the economies of scale and scope of an integrated business to compete effectively in global markets.[17]

Based on a survey of experience in member countries, the OECD has also recommended that, wherever possible, potentially competitive activities should be separated from those of a monopoly.[18] Experience in the UK gas industry is considered above in Box 10.1.

- *Consideration & Conclusions*

The Committee strongly supports structural reforms over more intensive conduct regulation. While particular structural reform proposals need to be evaluated carefully on their merits, the Committee is sensitive to the difficulties in demonstrating the longer term dynamic benefits of creating a more competitive industry structure. The Committee is also mindful that incumbents — and sometimes owning governments — may have strong incentives to resist wide-ranging structural reform.

Against this background, the Committee considers that these issues should be subject to a rigorous, open and independent analysis of the costs and benefits of various reform options. Moreover, where the natural monopoly element is vertically integrated with the potentially competitive activity, the Committee considers there should be a presumption in favour of full structural separation, leaving those who

12 NGMC, *Structure of an Interstate Transmission Network for Eastern & Southern Australia* (1993).

13 Energy Board of Review,*The Energy Challenge for the 21st Century* (1993) at 86-87.

14 IC, *Rail Transport* (1991)

15 Energy Board of Review,*The Energy Challenge for the 21st Century* (1993) at 86-87.

16 IC,*Water Resources and Waste Water Disposal* (1992).

17 For a critical discussion, see Corones S G (ed), *Competition Policy in Telecommunications & Aviation* (1992).

18 OECD, *Regulatory Reform, Privatisation and Competition Policy* (1992).

support some lesser reform to establish why this is in the long term public interest.

Box 10.1 : Structural Reform in the UK Gas Market

British Gas (BG) was privatised in 1986 without separation of its natural monopoly and potentially competitive elements, and BG retains control over the transmission, distribution and sale of gas in the British market. BG currently has a monopoly on the domestic gas market, but is subject to competition from independent suppliers in the industrial gas market.

As a result of this industry structure, independent suppliers in competition with BG must rely on access to the pipeline — a natural monopoly — owned by BG. BG has also been permitted to re-enter the production of gas, an activity from which it had previously been required to withdraw. This situation has raised concerns that BG may be in a position to use its control over the gas pipeline to shelter other elements of its business from competition or disadvantage its competitors.[19]

The UK gas regulator — OFGAS — has made a submission to the Mergers and Monopolies Commission (MMC) arguing that the gas purchasing and gas supply activities of BG should be separated, and that the gas supply activities be separated into twelve separate companies. The results of the MMC's investigation of the gas industry are expected to be announced shortly.

(c) Separation of Potentially Competitive Activities

Under the protection of government ownership, many public enterprises developed into large, integrated businesses meeting requirements across an entire State, or in the case of Commonwealth businesses, across the country. Even where no element of natural monopoly is involved, there are a number of circumstances where effective competition may be enhanced by separating such enterprises into a number of independent businesses.

Where there is no element of natural monopoly involved, there are less concerns over cross-subsidisation or misuse of control over access

19 See Bishop M & Kay J, *Does Privatisation Work? Lessons from the UK*, (1988) at 17; *The Economist*, "British Gas — Better Broken Up" (8 August 1992) at 44; and "British Gas - Under Fire" (24 July 1993) 51-52.

to a vertically integrated element. Nevertheless, structural separation may be a useful mechanism for dismantling the market power of the incumbent, for facilitating new market entry and for creating competition where there was none. These issues can arise in three main contexts, depending on the balance of private and public activity a government wishes to support.

First, where a government intends to privatise a hitherto publicly-owned monopoly, restructuring of potentially competitive activities may be necessary to reduce concern over monopoly abuse by the privatised entity, and will ease the burden on conduct regulation. In many cases it is quite feasible to establish a more competitive industry structure as a central feature of the reform process. Where a substantial business is involved, reducing its size through restructuring also increases the probability of takeover if management fails to perform, providing another spur to management efficiency.[20]

Second, where it is intended to keep the business in public ownership, but to open a market to new entrants, restructuring the incumbent may reduce its capacity to dominate new entrants, and thus encourage competitive entry and ease the burden on conduct regulation to guard against predatory behaviour. In this case, optimal results require a clear separation of management and control between the new entities.

Finally, even where no private ownership or new market entry is envisaged in the immediate future, horizontal restructuring of an enterprise will permit "yardstick" competition between what were previously parts of a single business. In this case, even separation at the accounting and management level may lead to greater efficiency and limited competition if managers are provided with sufficient incentives to perform — for example, by means of the remuneration process.

The potential benefits of separating potentially competitive activities will depend in part on the contestability of the market. The case for such separation will be stronger where there are substantial barriers to new market entry. The economies of scale and scope of each industry also need to be considered, as do the costs of transition, although these should not obscure the assessment of the longer term benefits of creating more competitive industry structures.

---

20 See Bishop & Kay, *Supra*, n 19, at 17.

Ultimately, structural reform in this area leads to questions over how many business units will serve the market most efficiently, taking account of both static and dynamic efficiency considerations. In some cases, the creation of only two entities has been found insufficient to ensure vigorous rivalry — the UK experience in electricity is discussed below in Box 10.2.[21] There are no simple or universal answers to this question, however, and the costs and benefits of alternative reform options need to be evaluated carefully in the context of each industry.

Box 10.2 : Structural Reform in the UK Electricity Market

Structural reform in the UK electricity industry included the creation of two thermal generation companies, and a third state-owned nuclear generating company. While the restructuring of the industry has been far-reaching — with electricity generation and distribution separated from transmission — some have argued that the monopoly thermal generating company should have been separated into more than two businesses.

Prior to the restructuring, Robinson questioned whether competition would arise in generation, as the established generators would have a strong incentive to collude and restrict entry into the industry.[22] Green and Newberry have recently argued that a competitive industry structure should have been put in place prior to privatisation, as the existing duopoly (in effect) does not sufficiently subject the incumbent generators to competitive pressures.[23] The UK electricity regulator, OFFER, has also concluded that the structure of the industry has enabled the two major generators to influence and control prices.[24] The lack of competition in the generation aspect of the industry appears to have been a key factor influencing the amount of ongoing regulation required in the industry.[25]

- *Recent Experience & Studies*

The Industry Commission has recommended horizontal separation of electricity generating companies,[26] and the NSW government has

21 See also Axelrod R, *The Evolution of Co-operation* (1984).

22 Robinson C, *Competition in Electricity?* (1988).

23 Green R & Newberry D, "Competition in the British Electricity Spot Market", *Journal of Political Economy* (1992) 100, 5, 929-953.

24 UK Office of Electricity Regulation (OFFER), *Report on Pool Price Inquiry* (1991).

25 Eg, see Commonwealth Treasury, "Electricity Reform in Australia: Some Lessons from the UK Experience", *Economic Round-up* (July 1993) 49-60.

26 IC, *Energy Generation & Distribution in Australia* (1991).

restructured Pacific Power into three generation profit centres.[27] The Victorian Government has announced that the electricity generation and distribution elements of the SECV will be separated into a number of different bodies to facilitate competition,[28] and is also examining options for structural reform in a number of industries currently dominated by public monopolies.[29] It has recently been argued that the gas supply operations of British Gas — a privatised public monopoly — be restructured into twelve separate companies.[30]

- *Consideration & Conclusions*

While the potential benefits of separating the potentially competitive elements of public monopolies can be considerable, judgements ultimately turn on an analysis of the costs and benefits of particular proposals. Unlike situations where natural monopoly elements are vertically integrated with potentially competitive elements, the Committee was not persuaded that there should be a general presumption favouring structural separation in this setting.

Nevertheless, the potential benefits of reforms of this kind are sufficient to warrant a more systematic exploration of options in this area, at least where competition is being introduced or the public monopoly is being privatised. As with the structural separation of natural monopoly elements from potentially competitive elements, however, reforms of this kind may be resisted by incumbents or, in some cases, owning governments. Accordingly, any more systematic approach to this question should place emphasis on rigorous, open and independent analysis.

2. Contexts for Considering Structural Reforms

From a competition policy perspective, structural reforms of these kinds can arise in two main contexts; pro-competitive reforms generally and privatisation. The latter context raises special considerations from a public policy context.

---

27 NSW Government, *Performance of NSW Government Businesses* (1992) at 47.

28 Office of the Treasurer and the Energy Minister (Vic), "Major Restructuring of Electricity Industry Commences" (News Release, 10 August 1993).

29 Victorian Govt (Sub 122).

30 See Box 10.1.

(a) Pro-competitive Reforms Other than Those Involving Privatisation

Owning governments may seek to restructure their enterprises for a range of reasons, although achieving improved efficiency has clearly been the most pressing goal in recent years.[31]

From a competition policy perspective, structural reforms will be particularly relevant where traditional monopoly markets are being opened to competition, and it is desired to ensure that effective competition can be established with minimal need for ongoing regulatory supervision. Reforms of the three kinds noted above may all be important parts of that process.

(b) Privatisation

In recent years there has been a world-wide trend in favour of transferring ownership of hitherto public businesses to the private sector.[32]

The ownership of a business is not of itself a matter of direct concern from a competition policy perspective.[33] Nevertheless, there is evidence that privatisation may increase the efficiency of many businesses,[34] which is consistent with the overall goals of competition policy.

However, privatisation is less likely to offer significant public benefits if appropriate structural reforms are not carried out before or concomitant with the privatisation, possibly entrenching the monopolistic structure of the industry.

The concerns in this area are pronounced when one considers that privatisation may be driven by budgetary goals as well as efficiency objectives, and that businesses with a substantial degree of market power may attract premiums on sale. These concerns have led

---

31 For example, structural reform is an integral part of the Queensland Government's corporatisation policy, as enshrined in s.19(d) of the *Government Owned Corporations Act 1993*.

32 See OECD, *Regulatory Reform, Privatisation and Competition Policy* (1992); and Shirley M & Nellis J, *Public Enterprise Reform - The Lessons of Experience* (1991).

33 Of course, government ownership may be relevant to the application of competitive conduct rules under the current regime (see Chapter Six) and may give rise to special "competitive neutrality" concerns (see Chapter 13).

34 See Shirley M & Nellis J, *Public Enterprise Reform - The Lessons of Experience* (1991) at 67-68; and OECD, *Regulatory Reform, Privatisation and Competition Policy* (1992).

commentators to warn of the dangers of trading "cash for competitiveness" when privatising government enterprises.[35] Governments considering privatisation must often choose between short-run revenue objectives and longer-run costs to the economy associated with transferring the ownership of a business which has not been properly restructured to the private sector, where there are fewer constraints on profit-maximising behaviour. Of course, those costs would be exacerbated if the relevant market was poorly contestable by reason of regulatory restrictions on competition or long-term supply contracts entered into as part of the privatisation.

Moreover, unless appropriate structural reform is accomplished before or at the time of sale, the only means of addressing industry structure is through divestiture, with implications for the shareholders of the newly privatised entity. The TPA does not currently contain a general divestiture power, and the Committee has not proposed that such a general power form part of the general conduct rules of a national competition policy. The question remains as to whether some special divestiture power may be desirable to deal with this special setting.

These considerations reinforce the need for a national competition policy to place special emphasis on structural reform issues in the privatisation context.

3. A National Approach

Questions of the appropriate structure of public assets have traditionally been seen as a prerogative of ownership for the government concerned. While reports by the Industry Commission have contributed to the debates in sectors such as electricity, gas, rail and water, decisions on whether to pursue any of the Commission's proposals, and if so by what means and over what timetable, have until recently been regarded as a matter exclusively for the individual governments concerned.

The recent work by the NGMC on the structure of the electricity supply industry is an important milestone. Governments have recognised that the structure of a public monopoly in one state can have important consequences for the development of national markets and the conduct of inter-state trade and commerce.

---

35 Eg, see "Greiner has doubts about coalition privatisation plan", *Australian Financial Review*, (25 February 1993) at 2.

Much of the work in the electricity sector thus far has focussed on the structure and ownership of the transmission grid, which is an interstate asset. This work is clearly of vital importance if national markets are to be developed. However, even questions of the structure of the generation sector may have potential implications for interstate trade if vertical or horizontal linkages, or control over technical regulation, create possibilities for the misuse of market power. While the general conduct rules proposed in Part I may offer a remedy in some circumstances, structural approaches will always be the "first-best" solution.

The Industry Commission has provided timely advice as to where Australia's public monopolies should be heading. However, there is scope for greater coordination between governments on key questions associated with the implementation of reforms in individual sectors. The more detailed structural work being performed by the NGMC in relation to electricity could usefully be done in other sectors where an interstate or national dimension exists or is likely to evolve. And even in sectors where the interstate links are less substantial, the importance of the government business sector to the international competitiveness of the national economy suggests opportunity for greater coordination and cooperation between governments.

There may also be a role for a coordinated process to ensure that structural reforms in particular industries proceed as rapidly as is feasible.

As discussed above, a special issue arises in relation to proposals to privatise substantial public monopolies without appropriate restructuring. In addition to direct interstate impacts, there is a clear national interest in ensuring that the economy does not become encumbered with private monopolies, with costs in terms of efficiency and more intensive conduct regulation. The national interests in this setting are increasingly recognised; for example, the Victorian Government recently asked the Trade Practices Commission to monitor competition policy aspects of the privatisation of one of its businesses.[36]

---

36 Victorian Govt (Sub 122). The Victorian Government invited the TPC to monitor the proposed privatisation of Heatane, the LPG division of the Gas and Fuel Corporation of Victoria. The TPC will consider whether any of the parties bidding for Heatane will be in danger of breaching the merger provisions of the Act.

The Committee is satisfied that questions associated with the structural reform of public enterprises are an important element of a national competition policy, albeit one that may be of primary significance during a transition period when more competitive industry structures are put in place. The desirable content and implementation approach for such a policy is explored in the next Section.

B. STRUCTURAL REFORM UNDER A NATIONAL POLICY

There is increasingly a national element in many questions associated with the structural reform of public monopolies. This Section considers how a national competition policy might best contribute to Australia's goals in this area, and proposes the establishment of a new mechanism to facilitate cooperative action on structural reform issues.

1. Policy Principles

The Committee's review of the competition policy aspects of the structural reform of public monopolies supports the adoption of a set of relatively simple principles. These are:

I *Before competition is introduced to a sector traditionally supplied by a public monopoly, any responsibilities for industry regulation should be removed from the incumbent. The location of regulatory functions should place special weight on the need to avoid conflicts of interest.*

Acceptance of this principle would be especially important for situations where new entry into a market is being encouraged, as potential industry participants will often need assurance that control over regulation will not be used to anti-competitive ends.

The principle is not prescriptive as to the most appropriate means of handling the regulatory functions previously performed by the public enterprise. In some cases, voluntary codes of practice may be appropriate, with the competition authority vetting arrangements that might substantially lessen competition. In other cases, an independent technical regulator — possibly based on the telecommunications model — may be appropriate.

II *Before competition is introduced to a sector traditionally supplied by a public monopoly, there should be a rigorous, open and independent study of the costs and benefits of separating any natural monopoly elements from potentially competitive activities. Where the natural monopoly element is vertically integrated with potentially competitive activities, there should be a presumption in favour of separation at the ownership or control level.*

This principle distinguishes between situations where the natural monopoly element is integrated horizontally or vertically. In the former case, concerns over cross-subsidies may warrant close examination. In the latter case, the coincidence of cross-subsidy concerns and potential incentives to misuse control over access to the natural monopoly element are considered sufficient to warrant a presumption in favour of separation, although that presumption can be rebutted by appropriate evidence.

The requirement that the studies be rigorous, open and independent should be axiomatic. If studies of this kind are to be of value, they must reflect a disinterested view of the issues. The findings of industry participants or others with a stake in the outcome, however altruistic and public spirited, may always be open to suspicion. For example, there has been criticism of the work of the National Grid Management Council, largely because an ostensibly inter-governmental process appears to be dominated by industry participants.[37]

III *Before competition is introduced to a sector traditionally supplied by a public monopoly, there should be a rigorous, open and independent study of the costs and benefits of separating potentially competitive activities of the monopoly enterprise.*

This principle is not prescriptive as to the outcome of such studies, but does require that governments more systematically explore options in this area as part of other pro-competitive reforms. As with the preceding principle, the studies in question should not be performed by the incumbent or any other interested party, and should place due weight on the dynamic benefits of establishing more competitive industry structures.

---

37 Eg, see "Pulling the Plug on the Power Lobby", *Australian Financial Review* (18 November 1992); and "Power Council Rejects Vested Interest Claim", *The Australian* (2 March 1993).

Although the operation of the principle is limited to situations where governments have already decided to introduce competition to an industry, studies of this kind may usefully be undertaken before that time so that governments and the wider community have a greater appreciation of the various considerations involved in introducing competition.

IV *Where privatisation of a substantial public monopoly is proposed, there should be a rigorous, open and independent study of all related structural issues. There should be a presumption in favour of vertical structural separation.*

This principle, including the creation of a general presumption in favour of structural separation, reflects the special problems raised in the privatisation context discussed above. Further details concerning the implementation of this principle are considered below.

2. Implementing a National Policy

The policy principles outlined above are capable of being implemented in a number of ways. The discussion below canvasses some of the broad options and, while supporting cooperative approaches, distinguishes between situations where privatisation is involved and other settings.

(a) Broad Implementation Options

The main options in this area distinguish between the treatment of the inquiry into structural matters and the possible role of a divestiture power to enforce the findings of such an inquiry.

- *Inquiry*

There are a variety of ways in which the requirement for an independent inquiry into structural reform matters could be implemented. One option would be a national law establishing an enforceable mechanism for conducting certain reviews, including designation of a national body that would have primary jurisdiction over these matters. At the other extreme, compliance with the requirement to conduct relevant studies could be left to individual governments.

- *Role for Mandatory Divestiture*

Where review of a particular public monopoly situation concluded that structural reform was appropriate, the question arises of how these findings could be implemented if the owning government resisted reform. Several submissions argued against widening the divestiture power within the TPA,[38] although some suggested that the current divestiture power may need to be broadened.[39]

One option would be to have a divestiture power, possibly limited to cases where there was an adverse finding by a review body. The divestiture power could be exercised, say, at the initiative of the competition regulator or the Minister, and would probably require supervision by the courts. Although the Commonwealth's constitutional powers are not unlimited, there may be ways the Commonwealth could support such a law under its corporations power or its powers for interstate trade and commerce. A variation on this approach would be for exercise of the divestiture power to require, say, a majority vote of Commonwealth, State and Territory Governments.

(b) Consideration & Conclusions

As with other areas of its work, the Committee starts with a preference for respecting the prerogatives of sovereign governments unless there is a clear national interest at stake that cannot be resolved cooperatively. Its recommended implementation approaches differ between the privatisation context and other settings.

- *Pro-competitive Reforms Other than Those Involving Privatisation*

The Committee considers implementation of its proposed principles should generally proceed by a cooperative process, rather than unilaterally by a Commonwealth or a national body.

Under a cooperative approach, governments would formally adopt a set of principles along the lines proposed. Such a decentralised approach would allow each government to determine its own reform agenda — subject to meeting the broad requirements of the principles

38 Eg, IC (Sub 6); Trade Practices Committee of LCA (Sub 65); Treasury (Sub 76); BCA (Sub 93); Qld Govt (Sub 104); BHP (Sub 133).

39 Eg, TPC (Sub 69); Mr R Copp (Sub 107); Mr C Sweeney, QC (Sub 119).

— and to sponsor its own studies to meet the requirements of the principles.

In some cases there will be advantages in governments pooling their resources to examine structural reform issues of common concern in a particular industry. The recent work by the NGMC illustrates the potential benefits of such approaches. There may be more detailed implementation issues arising out of Industry Commission reports that could be considered, as well as a host of other structural reform issues which have national or interstate dimensions or implications.

The Committee proposes that a national competition policy should include as a key institution an independent and expert body — the proposed National Competition Council (NCC) — capable of examining these issues at the request of governments. The Council could receive references from any government and would generally adopt a public inquiry approach.

The Committee has not recommended that a more general divestiture power be included as part of the enforcement regime for generally applicable market conduct rules.[40] In that context, however, the primary focus was on means of dealing with firms that emerged in a competitive environment and which were found to be persistently misusing their market power. By contrast, most public monopolies developed their anti-competitive structures while sheltered from competition through government ownership or government regulation.

Another of the Committee's concerns with a divestiture power is the difficulties traditionally experienced in deciding through judicial processes which parts of a firm should be separated.[41] This issue is simpler where administrative approaches can be used to add more expertise to the adjudication. The use of administrative processes would also overcome the delays and uncertainty often associated with court-ordered divestiture.[42]

---

40 See Chapter Seven.

41 Because of concerns like these, Posner argues that "structural" remedies such as divestiture should be confined to the divestiture of assets recently acquired in an unlawful merger: Posner R A, *Antitrust Law: An Economic Perspective* (1976) at 78.

42 For example, the *IBM* case was abandoned by the US Department of Justice after 14 years of litigation. The delays in cases such as this can often be accompanied by fundamental changes in the market structure, and thus make the original reasons for bringing the case irrelevant. For example, two new generations of computers were developed while the *IBM* case was pending.

Overall, the Committee is persuaded that its preference for cooperative approaches should generally extend to decisions of governments on whether or not to implement the findings of the review process. Accordingly, it does not recommend that any legal regime put in place to implement its recommendations should include a general divestiture power directed at government businesses.

- *Privatisation of a Substantial Public Monopoly*

As indicated in Principle IV, the Committee considers that where privatisation of a substantial public monopoly is proposed, there should be a rigorous, open and independent study of all related structural issues, and that there should be a presumption in favour of vertical separation.

While the Committee considers that a decentralised and cooperative process is most appropriate for implementing the other principles, it believes that the privatisation of a substantial public monopoly without appropriate restructuring raises a number of special considerations. These include:

- the likelihood that, once privatised, the monopolist would be subject to fewer constraints in exercising its market power;

- the possible incentives for governments to increase the proceeds from a privatisation by not sufficiently dismantling the market power of a monopoly before sale;

- the absence of a general divestiture power able to effect structural reforms after privatisation; and

- the consideration that, whatever its status while in public ownership, there is no persuasive argument for treating a former public monopolist with greater deference than any other private firm.

Against this background, the Committee proposes that its fourth structural reform principle be supported by a special mechanism intended to encourage appropriate reforms before or concomitant with privatisation.

The Committee proposes that any government — including the privatising government — should be able to give a reference to the proposed independent advisory body, the NCC, to investigate the competitive impact of a proposed privatisation involving a substantial public monopoly. The reference could be made before a privatisation was effected or, if insufficient notice of the intended privatisation had been given, within a reasonable time after the privatisation.

In making its assessment, the NCC would take into account relevant market characteristics as well as any long-term contracts or regulatory restrictions that might serve to perpetuate or extend an anti-competitive structure in private hands.

The inquiry process would be designed to be as unobtrusive as possible consistent with the protection of the national interests involved. Where appropriate, inquiries could be fast-tracked; the Trade Practices Commission currently has 45 days to consider applications for a merger authorisation, and a similar period should be feasible in this context. To the extent possible, the inquiry would avoid duplicating the detailed analytical work undertaken by the privatising government as part of the privatisation proposal. However, in many cases there would be no duplication, for a competition analysis is typically very different from the financial analyses characteristic of pre-privatisation studies. The NCC's findings would be made public, although it would be directed to protect commercially-sensitive material obtained through the inquiry process. Although it need not have powers to compel the disclosure of information, the process of which it is part encourages cooperation from privatising governments.

If the NCC identified no competition policy concerns arising from the proposed privatisation, no further action would be taken. The sale could proceed without concern over subsequent structural intervention from other levels of government, although the privatised entity would remain a candidate for the national prices oversight mechanism outlined in Chapter 12 and, if appropriate, declaration under the general access regime outlined in Chapter 11. It would also remain subject to the competitive conduct rules proposed in Part I of this Report.

If the NCC recommended that particular structural reforms be undertaken before or concomitant with the privatisation, any action on

those recommendations would be a matter for decision by government. If the privatising government did not agree to amend its privatisation proposal in line with the NCC's recommendations within say, 45 days of the report, the matter would be referred to other Australian Governments for consideration. Within some further specified period, they would be required to either "clear" the privatisation notwithstanding the NCC's report, or to indicate what specific action was proposed. That action might include the passage of specific legislation (probably by the Commonwealth Parliament) to prevent the privatisation; to prevent it except on certain conditions (eg, that regulatory restrictions or long-term contracts be amended); or ultimately, to effect a divestiture of the privatised monopoly.

A process of this kind should assist governments in developing their privatisation proposals and to bring to early resolution any issues of possible divestiture or other structural intervention that might impact on the sale price of the asset. If the proposed privatisation were "cleared" by the NCC, the sale could proceed with greater confidence to shareholders. If the proposal were the subject of an adverse finding by the NCC, these issues could be ventilated publicly, allowing the privatising government to reconsider its plans. If the privatising government declined to act on the recommendations, other governments would be required to come to an early view on their response. If they express an intention to intervene in the situation, prospective shareholders in the privatised monopoly would be on notice of possible future action. Indeed, the very threat of such action should diminish the incentives to privatise a substantial public monopoly without appropriate restructuring, thus reinforcing the likelihood of appropriate structural decisions in the privatisation context.

In most cases it will be desirable for governments to undertake structural reforms at an early stage prior to privatisation. This permits initial judgements about the appropriate degree of structural reform to be tested through experience in a more competitive market, and allows further reform to be undertaken, if necessary, without adverse effects on private shareholders.[43] Strategies of this kind are consistent with the development of more competitive and efficient market

[43] For example, the Victorian Government, which has stated that it may further privatise elements of its electricity industry, has recently announced a major pro-competitive restructuring of that industry: Office of the Treasurer and the Energy Minister (Vic), "Major Restructuring of Electricity Industry Commences" (News Release, 10 August 1993).

structures and in many cases would avoid the need for vetting of privatisation proposals by a process of the kind proposed by the Committee.

Threats of divestiture or other intervention from other levels of government are clearly only appropriate in extreme circumstances, which the Committee hopes would never arise. It is for this reason that the Committee proposes that specific legislation to effect structural remedies of these kinds be introduced into Parliament only if and when required, rather than providing a more general power of intervention to deal with the contingency should it arise. While the Committee is mindful of the potential difficulties associated with divestiture after privatisation, including the impact on shareholders, this is a matter to be considered by the privatising government in arranging the sale of its assets.

C. RECOMMENDATIONS

The Committee recommends that:

10.1 A mechanism to facilitate the pro-competitive structural reform of public monopolies form part of a national competition policy.

10.2 All Australian Governments agree to abide by the following principles:

I *Before competition is introduced to a sector traditionally supplied by a public monopoly, any responsibilities for industry regulation be removed from the incumbent. The location of regulatory functions should place special weight on the need to avoid conflicts of interest.*

II *Before competition is introduced to a sector traditionally supplied by a public monopoly, there be a rigorous, open and independent study of the costs and benefits of separating any natural monopoly elements from potentially competitive activities. Where the natural monopoly element is vertically integrated with potentially competitive activities, there should be a presumption in favour of separation at the ownership or control level.*

III *Before competition is introduced to a sector traditionally supplied by a public monopoly, there be a rigorous, open and independent study of the costs and benefits of separating potentially competitive activities of the monopoly enterprise.*

IV *Where privatisation of a substantial public monopoly is proposed, there be a rigorous, open and independent study of all related structural issues. There should be a presumption in favour of vertical separation.*

10.3 An independent, nationally-focussed body — the National Competition Council — should be charged with assisting governments to progress cooperative reform in accordance with these principles.

10.4 Any government be permitted to give a reference to the NCC to investigate the competition implications associated with privatising a substantial public monopoly. If the inquiry recommends that structural reform be carried out before or concomitant with the privatisation, and those recommendations are not acted upon by the privatising government, other governments should consider the matter and may consider remedial action including the passage of specific legislation to prevent the acquisition; to prevent it except on certain conditions; or ultimately, to effect a divestiture of the privatised monopoly.

11. Access to "Essential Facilities"

In some markets the introduction of effective competition requires competitors to have access to facilities which exhibit natural monopoly characteristics, and hence cannot be duplicated economically. For example, effective competition in electricity generation and telecommunications services requires access to transmission grids and local telephone exchange networks respectively. Facilities of this kind are referred to as "essential facilities".

An "essential facility" is, by definition, a monopoly, permitting the owner to reduce output and/or service and charge monopoly prices, to the detriment of users and the economy as a whole. In addition, where the owner of the facility is also competing in markets that are dependent on access to the facility, the owner can restrict access to the facility to eliminate or reduce competition in the dependent markets. Mechanisms to guard against potential abuses of this kind are expected to play a vital part in pro-competitive reforms in network industries such as electricity, gas and rail.

This Chapter proposes the establishment of a new legal regime under which firms can be given a right of access to essential facilities when the provision of such a right meets certain public interest criteria. The regime is general in nature and has the flexibility to deal with access pricing and related issues in designated essential facilities irrespective of ownership. In designing the regime the Committee was conscious that almost all cases of essential facilities identified for the Committee were in the public sector because of the history of government ownership of infrastructure. While the public interest rationale for providing an access right is the same irrespective of ownership, the proposed regime takes account of the special considerations that can arise when the facility is owned by a State or Territory government.

Section A examines the nature of the "essential facilities" problem in more detail, and considers some of the broad alternative approaches to dealing with this issue in a national competition policy. It concludes by proposing the creation of a new access regime that operates by Ministerial declaration.

Section B considers the general rules that should apply to the access regime, including the circumstances in which a right of access might be conferred, pricing arrangements and possible additional safeguards.

Section C considers the application of the proposed general regime to facilities that are owned by governments. It concludes that while the general regime should be applicable to such facilities, some special considerations need to be taken into account before a right of access is granted to assets owned by State and Territory Governments.

Section D presents the Committee's recommendations.

A. "ESSENTIAL FACILITIES" & COMPETITION POLICY

This Section considers the nature of the "essential facilities" problem, reviews some of the alternative means of guaranteeing access to those facilities and argues that a new access regime should be the preferred response for Australia.

1. The "Essential Facilities" Problem

Some economic activities exhibit natural monopoly characteristics, in the sense that they cannot be duplicated economically. While it is difficult to define precisely the term "natural monopoly",[1] electricity transmission grids, telecommunication networks, rail tracks, major pipelines, ports and airports are often given as examples. Some facilities that exhibit these characteristics occupy strategic positions in an industry, and are thus "essential facilities" in the sense that access to the facility is required if a business is to be able to compete effectively in upstream or downstream markets. For example, competition in electricity generation and in the provision of rail services requires access to transmission grids and rail tracks respectively.

Where the owner of the "essential facility" is not competing in upstream or downstream markets, the owner of the facility will usually have little incentive to deny access, for maximising

1 See IAC, *Government (Non-Tax) Charges* (1989) Vol III, Appendix J.

competition in vertically related markets maximises its own profits.[2] Like other monopolists, however, the owner of the facility is able to use its monopoly position to charge higher prices and derive monopoly profits at the expense of consumers and economic efficiency. In these circumstances, the question of "access pricing" is substantially similar to other monopoly pricing issues, and may be subject, where appropriate, to the prices monitoring or surveillance process outlined in Chapter 12.[3]

Where the owner of the "essential facility" is vertically-integrated with potentially competitive activities in upstream or downstream markets — as is commonly the case with traditional public monopolies such as telecommunications, electricity and rail — the potential to charge monopoly prices may be combined with an incentive to inhibit competitors' access to the facility.[4] For example, a business that owned an electricity transmission grid and was also participating in the electricity generation market could restrict access to the grid to prevent or limit competition in the generation market. Even the prospect of such behaviour may be sufficient to deter entry to, or limit vigorous competition in, markets that are dependent on access to an essential facility.

As discussed in Chapter Ten, the preferred response to this concern is usually to ensure that natural monopoly elements are fully separated from potentially competitive elements through appropriate structural reforms. In this regard it is important to stress that mere "accounting separation" will not be sufficient to remove the incentives for misuse of control over access to an essential facility. Full separation of ownership or control is required. In fact, failure to make such separation despite deregulation and privatisation is seen as a major reason why infrastructure reform in the UK has been disappointing.[5]

---

2 See Areeda P & Hovencamp H, *Antitrust Law* (1990 Supp) at 779-780.

3 Whether the issues arising in relation to a particular facility would be best addressed under the access regime or prices oversight process would be considered on a case-by-case basis.

4 The main cases where the owner of a vertically integrated monopoly will have an incentive to deny access to an essential facility are where the owner is price regulated in the essential facility market and where providing access might undermine a profit-maximising price discrimination strategy in the dependent market. See Note, "Refusals to Deal by Vertically Integrated Monopolists" (1974) 87 *Harvard L Rev* 1720 at 1727-1728; and New Zealand Ministry of Commerce, *Guarantee of Access To Essential Facilities: A Discussion Paper* (1989) at 4-5. Cp. PSA (Sub 97) at 19.

5 For a discussion of the UK reforms see Vickers J, "Government Regulatory Policy", *Oxford Review of Economic Policy*, 7 (1991) 3, 13-30; and Bishop M & Kay J, *Does Privatisation Work? Lessons from the UK* (1988) at 17.

Where such structural reforms have not occurred, the challenge from a competition policy perspective is to provide a mechanism that will support competitive market outcomes by protecting the interests of potential new entrants while ensuring the owner of the natural monopoly element is not unduly disadvantaged. A mechanism of this kind seems likely to play a pivotal role in a national competition policy as competition is introduced to areas previously reserved to public monopolies.

2. Guaranteeing Access to "Essential Facilities"

As a general rule, the law imposes no duty on one firm to do business with another. The efficient operation of a market economy relies on the general freedom of an owner of property and/or supplier of services to choose when and with whom to conduct business dealings and on what terms and conditions. This is an important and fundamental principle based on notions of private property and freedom to contract, and one not to be disturbed lightly.

The law has long recognised that this freedom may require qualification on public interest grounds in some circumstances, particularly where a form of monopoly is involved. Thus, for example, the natural monopoly character of certain transport functions gave rise to the common law notion of "common carriers", where such carriers have an obligation to carry certain goods.[6]

The law has developed two broad alternatives for creating obligations to deal in the "essential facility" area. First, persons seeking access to such facilities may rely on the general competitive conduct rules governing a misuse of market power. Secondly, special legislative regimes can be created to guarantee access to such facilities. Both approaches are reflected in current Australian law.

(a) Reliance on the General Competitive Conduct Rules

- *Current Australian Approach*

As discussed in Chapter Four, s.46 of the *Trade Practices Act 1974* (TPA) prohibits the taking advantage of a substantial degree of power

6 See Gorton L, *The Concept of Common Carrier in Anglo-American Law* (1971) at 20-33. For a statement of current Australian law see *Halsbury's Laws of Australia* (1992) 3 at 121,149-121,152.

in a market for the purpose of (a) eliminating or substantially damaging a competitor; (b) preventing the entry of a person into a market; or (c) deterring or preventing a person from engaging in competitive conduct in a market.

Section 46 is potentially applicable in essential facility situations. If a facility is truly essential, its owner will always have a substantial degree of market power within the meaning of s.46.[7] There should also be little difficulty in establishing that a refusal to deal in an essential facility context constitutes a "taking advantage" of that market power, given that in the absence of such market power access to the facility would be available.[8] A refusal to provide access to an essential facility could conceivably occur for any of the three proscribed purposes.[9]

There have been suggestions that the US essential facility doctrine, discussed below, could be imported into Australia through judicial interpretation of s.46. However, the High Court has not embraced such a doctrine and the Federal Court has specifically rejected it.[10] In these circumstances, unless s.46 were amended in some way, access would only be available where a firm was able to prove that it had been denied access, or access on reasonable terms, because of a proscribed purpose.

In addition to the difficulties in demonstrating a proscribed purpose, there may be difficulties in courts determining the terms and conditions, particularly the price, at which such access should occur.[11] The courts do have the power to make orders varying contracts, including the power to vary prices,[12] and the provisions of the Act are probably wide enough to permit courts to fix prices where there have

---

7 On the meaning of "substantial" in the phrase 'substantial degree of power in a market', see L'Estrange P, "'Substantial' Definition" (1992) *Law Institute Journal*, at 654.

8 The test for deciding whether a corporation has used its market power is whether it could afford, in a commercial sense, to engage in the conduct only by virtue of its substantial market power, or alternatively, whether it could achieve its anti-competitive purpose other than by virtue of its substantial market power: see *Queensland Wire Industries Pty Ltd* v *BHP* (1989) 167 CLR 177.

9 Cases involving refusal of access to products or facilities include: *Queensland Wire* — (refusal to supply Y-bar to a rival in a downstream market); *Pont Data Australia Pty Ltd* v *ASX Operations Pty Ltd* (1990) ATPR ¶41-007 (refusal to supply "Signal C" wholesale to a rival in a downstream market); and *Dowling* v *Dalgety Australia Limited* (1992) ATPR ¶41-165 (refusal to permit a potential rival use the Goondiwindi Saleyards).

10 *Queensland Wire Industries Pty Ltd* v *BHP* (1988) ATPR ¶40-841 at 49,076 - 49,077.

11 See Wright R, "Injunctive Relief in Cases of Refusal to Supply" (1991) 19 ABLR 65.

12 See s.87(2).

been no previous dealings between the parties.[13] However, as discussed in Chapter Seven, Australian courts are "slow to impose upon the parties a regime which could not represent a bargain they would have struck between them".[14] Although the courts have been prepared to grant injunctions requiring one firm to deal with another on the basis of previously agreed prices,[15] they may decline to order supply because of the difficulties in calculating a reasonable price.[16]

- *Overseas Approaches*

Courts in the US have developed an "essential facility doctrine" through interpretation of the Sherman Act. One statement of the principles involved in this doctrine[17] requires:

(1) control of the essential facility by a monopolist;
(2) a competitor's inability practically or reasonably to duplicate the essential facility;
(3) the denial of the use of the facility to a competitor; and
(4) the feasibility of providing the facility.

The limits of the US doctrine are not yet clear, and it has been observed that "the doctrine has not developed with clarity, coherence or consistency, let alone with strong economic foundations".[18] Decisions which have relied on the doctrine have found essential facilities in situations ranging from local telephone networks[19] to football and basketball stadiums.[20]

---

13 See s.80 and s.87(1).

14 *Pont Data Australia Pty Ltd* v *ASX Operations Pty Ltd* (1990) ATPR ¶41-109, at 52, 666.

15 *Pont Data* v *ASX Operations Pty Ltd* (1990) ATPR ¶41-007. Note that at first instance the court was willing to set new prices which reflected the cost of supply and a margin of profit similar to that charged by competitive suppliers. Two interlocutory cases in which the court has been prepared to order access, and to fix prices on the basis of previous dealings are: *Maclean* v *Shell Chemical (Australia) Pty Ltd* (1984) ATPR ¶40-462; and *O'Keefe Nominees Pty Ltd* v *BP Australia Ltd* (1990) ATPR ¶41-057.

16 In *Berlaz Pty Ltd* v *Fine Leather Care Products* (1991) ATPR ¶41-118, one of the reasons given for refusing an injunction was that " ... the hearing produced no satisfactory explanation of how the court should perform the task of setting the prices and other terms of trade if an injunction were granted."

17 *MCI Communications Corp* v *American Telegraphic & Telephone Co* (1983) 708 F.2d 1081 at 1132.

18 See Vautier K M, *The "Essential Facilities" Doctrine* (1990) at 65. See also Areeda P, "Essential Facilities: An Epithet in Need of Limiting Principles" (1990) 58 *Antitrust Law Journal* 841.

19 *MCI Communications Corp* v *American Telegraphic & Telephone Co* (1983) 708 F.2d 1081.

20 *Hecht* v *Pro-Football Inc* 570 F 2d 982 (DC Cir 1977); *Fishman* v *Wirtz* 1981-2 Trade Cas (CCH) ¶64,378 (ND Ill 1981).

New Zealand deals with essential facility situations under the misuse of market power provision of its Commerce Act, which is similar to s.46 of the TPA. Although an early court decision suggested that situations of essential facilities, as identified in accordance with the US doctrine, might raise a presumption of proscribed purpose,[21] this suggestion was subsequently rejected.[22]

The New Zealand Government chose to rely on the provisions of the Commerce Act to resolve access disputes arising from the introduction of competition to its telecommunications market.[23] The need to negotiate interconnection agreements with NZ Telecom has proved to be a significant barrier to entry by new competitors,[24] and the Commerce Commission has suggested that the general provisions of the Commerce Act are unlikely to be fully effective in removing obstacles to competition where an essential facility access issue is involved.[25]

(b) Creation of Special Access Rights

In order to overcome the uncertainties and delays associated with reliance on the general competitive conduct rules, a number of jurisdictions have developed specific access rights to particular essential facilities.

- *Current Australian Approach*

The *Telecommunications Act 1991* (Cth) illustrates one means of creating and administering special access rights on an industry-specific basis. The Act creates a right for any carrier to connect its facilities to the network of any other carrier, and to have its calls carried and completed over that network. The pricing principles that must be applied in determining access charges are determined by the Minister. Interconnection issues are determined by agreement between carriers, but where agreement cannot be reached an industry-specific regulator,

21 *Auckland Regional Authority* v *Mutual Rental Cars (Auckland Airport) Ltd* (1987) 2 NZLR 647.

22 *Union Shipping NZ & Anor* v *Port Nelson* [1990] 3 NZBLC 101-618.

23 The *Telecommunications (Disclosure) Regulations* provide limited assistance in the resolution of such disputes, by requiring the disclosure of certain financial information by NZ Telecom.

24 There has been considerable lengthy litigation by Clear to obtain access to certain facilities held by NZ Telecom, which has not always been successful.

25 NZ Commerce Commission, *Telecommunications Industry Inquiry Report* (23 June 1992) at 7.

AUSTEL, may intervene and arbitrate.[26] In view of the vast market power of the incumbent, the Act also includes various additional pro-competitive safeguards.[27] Supplementary access rights can also be created in respect of customer billing, operator assistance, listing in published directories, and access to facilities such as radio-communications masts and antennae as conditions of carriers' licences.[28]

The *Petroleum Pipelines Act 1969* (WA) provides another illustration of an industry-specific access regime.[29] Upon application from a person seeking access to a petroleum pipeline, the Minister may give directions to the applicant and to the owner, permitting the applicant to use the pipeline, subject to the owner's right to convey its own petroleum through the pipeline in priority to any other petroleum. The Minister's discretion in making directions is largely unfettered, and includes the ability to specify the price to be paid for access.

In relation to gas, the Commonwealth Government has recently announced that it intends to legislate special access arrangements to facilitate access to inter-state gas pipelines.[30] In addition, a Code of Practice for access to inter-state gas pipelines has been announced by various industry participants.[31] While the Code is an important contribution to the development of open access regimes, it does not provide any legally enforceable rights; it provides for a "right to negotiate" rather than a "right of access"; does not give guidance on pricing principles; and has no binding dispute resolution mechanism.

In the electricity sector, the Council of Australian Governments, with the assistance of the National Grid Management Council, is

26 Section 137(2)(b) *Telecommunications Act 1991* (Cth).

27 Discussed in Section B (below).

28 Section 187 also provides essential facilities rules for some services markets.

29 Section 21 *Petroleum Pipelines Act 1969* (WA).

30 News Release from the Minister for Resources, "New Arrangements for Interstate Gas Trade", (June 2, 1993). The Carnegie Report into the WA gas and electricity industries also proposed the establishment of access rules governing gas pipelines: see Energy Board of Review, *The Challenge For the 21st Century* (1993).

31 See Australian Gas Association, Australian Petroleum Exploration Association Limited, Australian Pipeline Industry Association, "Pipeline Access Code" (Joint Media Release, 23 July 1993).

considering arrangements to provide access rights for generators to electricity transmission grids.[32]

- *Overseas Approaches*

Notwithstanding the wide reach of its court-based essential facility doctrine, the US has recently introduced a new legislative regime to facilitate access to inter-state electricity transmission grids. The new regime requires a finding that an access order is in the public interest and sets out relevant pricing principles and other terms and conditions of access, with individual applications settled by a regulator.[33]

The UK also provides industry-specific access regimes in relation to industries including telecommunications and gas. Licences granted under the *Telecommunications Act 1984* may include conditions requiring the licensee to connect to particular telecommunication systems, or permit the connection of another telecommunication system or apparatus, and requiring the licensee not to show undue preference to, or undue discrimination against, such connected systems.[34] Under the *Gas Act 1986*, there is an administrative discretion to direct the owner of a gas pipeline to carry the gas of an applicant, including the ability to specify prices, terms and conditions.[35] Such direction will not occur where the pipeline is already running at full capacity. Prices are determined having regard to principles which apportion costs and permit an appropriate return on capital.[36]

Submissions

The majority of submissions to the Inquiry on this issue indicated a lack of confidence in the ability of the general misuse of market power provision, s.46, to deal effectively with essential facility issues in the context of introducing competition to markets traditionally supplied

32 NGMC, *Network Service Pricing: An Information Paper* (1992); *National Grid Protocol* (First Issue: 1992).

33 See Title VII of the Energy Policy Act of 1992 (PL 102-486), which inserted new provisions in the Federal Power Act (16 USC 824j).

34 Section 8 *Telecommunications Act 1984* (UK).

35 Section 19 *Gas Act 1986* (UK).

36 Section 19 *Gas Act 1986*.

by public monopolies.[37] As well as difficulties of demonstrating the proscribed purpose, submissions pointed to the difficulties of courts determining appropriate access prices.

Several submissions supported an additional mechanism for guaranteeing access to certain essential facilities on fair and reasonable terms.[38] One submission argued that access rules should not require legislatively forced inter-connection to gas pipelines.[39]

Consideration & Conclusions

The Committee is conscious of the need to carefully limit the circumstances in which one business is required by law to make its facilities available to another. Failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment.

Nevertheless, there are some industries where there is a strong public interest in ensuring that effective competition can take place, without the need to establish any anti-competitive intent on the part of the owner for the purposes of the general conduct rules. The telecommunications sector provides a clear example, as do electricity, rail and other key infrastructure industries. Where such a clear public interest exists, but not otherwise, the Committee supports the establishment of a legislated right of access, coupled with other provisions to ensure that efficient competitive activity can occur with minimal uncertainty and delay arising from concern over access issues.

Importantly, the Committee is not convinced that access regimes of this kind need be legislated and administered on an industry-specific basis. While each industry has its own peculiar characteristics, there are also important similarities between access and related issues across the key infrastructure industries. The development of a common legal framework offers the benefits of promoting consistent approaches to

37 Dr W Pengilley (Sub 11); AUSTEL (Sub 41); DPIE (Sub 50); DOTAC (Sub 58); Mr Michael Corrigan (Sub 72); Treasury, (Sub 76); Dr S Corones (Sub 86); Optus Communications (Sub 87); Mr B Akhurst (Sub 94).

38 Eg, Shell (Sub 30); Vic Gas Users Group (Sub 47); DPIE (Sub 50); DOTAC (Sub 58); Treasury (Sub 76); ESAA (Sub 89); SECV (Sub 92); PSA (Sub 97); DITARD (Sub 101); TPC (Sub 69). BHP Ltd argued that if s.46 was considered inadequate, any more stringent regime should be quarantined to particular industries, rather than apply to all businesses (Sub 135).

39 AGL Ltd (Sub 24).

access issues across the economy. It also permits expertise and insights gained in access issues in one sector to be more readily applied to analogous issues in other sectors. For similar reasons, and as discussed more fully in Chapter 14, the Committee considers that an access regime of this kind should be administered by an economy-wide body rather than a series of industry-specific regulators.

The Committee recognises the important industry-specific work undertaken to date on facilitating access to various essential facilities of national importance. Some of this work may provide a useful foundation for access declarations under the Committee's proposed access regime, should the decision be made to provide a right of access in the relevant industries.

The Committee considers that any legal framework providing access must be national in scope and operation. State-based regimes are incapable of dealing effectively with access issues affecting inter-state or national facilities, and different approaches or pricing principles adopted in different States have the potential to impede the development of efficient national markets for electricity, gas, rail and other key industries.

A general access regime of the kind recommended by the Committee requires some flexibility to be adapted to differences between industries and within an industry over time. The following two Sections consider the detail of such an access regime as it might apply to infrastructure industries across the economy.

B. GENERAL RULES GOVERNING ACCESS TO "ESSENTIAL FACILITIES"

This Section looks at certain general rules governing the creation of a legislated right of access, and considers six questions:

- When should an access right be created?;
- How should access prices be determined?;
- What other terms and conditions might be required to protect the owner of the facility?;

- What additional safeguards might be required to protect the competitive process?;

- What remedies should be available for failure to comply with requirements of the access regime?; and

- How should the proposed regime interact with existing access regimes?

These rules were designed recognising the fact that in Australia, whilst the majority of "essential facilities" have traditionally been owned by governments, there are many examples of privately owned facilities of similar nature. The general rules proposed are intended to cover essential facilities, irrespective of ownership, where certain public interest and other criteria are met. The need for additional adaptations in the case of government-owned facilities is considered in Section C.

1. When Should a Legislated Right of Access Be Created?

As the decision to provide a right of access rests on an evaluation of important public interest considerations, the ultimate decision on this issue should be one for Government, rather than a court, tribunal or other unelected body. A legislated right of access should be created by Ministerial declaration under legislation.[40] At the same time, the existence of a broad discretionary regime may create pressures on the Minister to declare an essential facility to advance private interests.[41] Accordingly, the Committee proposes that the Minister's discretion be limited by three explicit legislative criteria, and by a requirement that the creation of such a right has been recommended by an independent and expert body — the proposed National Competition Council (NCC).

---

40 The Minister would be a Commonwealth Minister. The role of State and Territory Governments is discussed in Section C (below) and in Chapter 14.

41 Concerns of this kind led to a reluctance to adopt a broad access regime in New Zealand, where it was observed that: "Ministers are ... likely to face considerable pressure to declare an essential facility to advance private interests. These situations do not necessarily coincide with the promotion of the competitive process or the overall public interest": NZ Ministry of Commerce, *Review of the Commerce Act 1986 : Reports & Decisions* (1989) at 8.

Unless the owner of a facility consents to access being declared, the Minister could only make such a declaration where:

I *Access to the facility in question is essential to permit effective competition in a downstream or upstream activity;*

Clearly, access to the facility should be essential, rather than merely convenient.

II *The making of the declaration is in the public interest, having regard to:*
   (a) the significance of the industry to the national economy; and
   (b) the expected impact of effective competition in that industry on national competitiveness.

These criteria may be satisfied in relation to major infrastructure facilities such as electricity transmission grids, major gas pipelines, major rail-beds and ports, but not in relation to products, production processes or most other commercial facilities.[42] While it is difficult to define precisely the nature of the facilities and industries likely to meet these requirements, a frequent feature is the traditional involvement of government in these industries, either as owner or extensive regulator.

Moreover, when considering the declaration of an access right to facilities, any assessments of the public interest would need to place special emphasis on the need to ensure access rights did not undermine the viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects. Accordingly, wherever possible the likely obligations to provide access should be made clear before an investment is made, whether that be through licensing requirements of a new facility or the acquisition of an asset formerly owned by government. Where this is not possible, due account of the likely impact on incentives to invest should be made in determining whether or not to create a right of access, and if access is declared, through the declaration of appropriate pricing principles and other terms and conditions.

42 Eg, in the US case of *Berkey Photo* v *Eastman Kodak Co* 603 F 2d 263 (2d Cir 1979), a small photographic company sought (albeit unsuccessfully) to obtain access to the products of Kodak's research and development before Kodak could market its own innovations. This case illustrates the need to ensure that the proposed access right does not deprive investors of the fruit of risk-taking investment.

III *The legitimate interests of the owner of the facility must be protected through the imposition of an access fee and other terms and conditions that are fair and reasonable, including recognition of the owner's current and potential future requirements for the capacity of the facility.*

Pricing and related issues are considered below.

IV *The creation of such a right must have been recommended by an independent and expert body.*

An affirmative recommendation of the NCC on whether or not the three previous criteria are satisfied should be a prerequisite to the creation of a legislated access right, although the Minister could decline to make a declaration notwithstanding the recommendation of the body. The recommendations of the Council would be based on an investigation of the facility and markets in question and would take account of submissions from interested persons. The recommendations would be made public. Inquiries could be triggered by references to the Council from any government — Commonwealth, State or Territory.

While these requirements focus on the policy underpinnings of the regime, it may also be necessary to ensure such a regime falls within the Commonwealth's heads of legislative power. This requirement will be readily met where the owner of the facility is a trading corporation, or where access relates to an inter-state transaction. It may also be sufficient if the beneficiary of the access right is a trading corporation, on the ground that the creation of such a right would be a means of protecting that corporation's trading activities.[43]

Where these requirements are met the Minister could declare an enforceable right of access to the facility described in the declaration. The declaration might be expressed to apply to a particular user or a particular class of users. Thus, for example, access to an electricity grid might be provided to all generators over some minimal output requirement. However, any restrictions of this kind should be clearly justified on efficiency or other grounds, and reflect the findings of the NCC inquiry.

43 These issues are examined in more detail in Chapter 15.

It may often be appropriate to apply such an access regime to a particular facility or activity within an industry as an integral part of reforms intended to introduce competition to a hitherto monopoly activity. This approach would provide a transparent and predictable regulatory environment within which competitive trading arrangements could evolve, with increased certainty facilitating efficient investment decisions by potential new entrants. In other cases it may be appropriate to allow private parties to come to their own arrangements, and only declare such a right if experience shows that access is being abused. A declaration under the regime could be reviewed at intervals stipulated in the access declaration that are appropriate to the circumstances of each industry. A declaration could be revocable on the showing of a material change in circumstances.

The general regime could apply to a range of facilities and does not require industry-specific regulation. The access declaration would reflect particular considerations relevant to individual industries or facilities, the details of which are considered below.

2. Determination of Access Prices

Access to a facility should only be declared if the legitimate interests of the owner of the facility are protected through a requirement for a "fair and reasonable" fee for providing access, and other appropriate terms and conditions.

Neither the application of economic theory nor general notions of fairness provide a clear answer as to the appropriate access fee in all circumstances. Policy judgments are involved as to where to strike the balance between the owner's interest in receiving a high price, including monopoly rents that might otherwise be obtainable, and the user's interest in paying a low price, perhaps limited to the marginal costs associated with providing access. Appropriate access prices may depend on factors such as the extent the facility's existing capacity is being used, firmly planned future utilisation and the extent to which the capital costs of producing the facility have already been recovered. Decisions in this area also need to take account of the impact of prices on the incentives to produce and maintain facilities and the important signalling effect of higher returns in encouraging technical innovation. For example, relatively low access prices might contribute to an efficient allocation of resources in the short term, but in the longer term the reduced profit incentives might impede technical innovation.

An indication of the range of possible policy judgments in this area is reflected in some of the pricing rules already in place. Examples include:

- Under the Australian *Telecommunications Act 1991*, the new entrant, Optus, is being permitted access to the interconnection network of the incumbent at an initial price based on directly attributable incremental costs, with this relatively low price intended to assist the new entrant overcome the competitive advantages of the incumbent.[44]

- In the New Zealand telecommunications market, it has been held that New Zealand Telecom is entitled to charge an access fee which allows it to recover the opportunity costs of providing access — the so-called "Baumol Willig" rule.[45]

- Under the US regime governing access to interstate electricity transmission grids, the overarching goal is that prices will "promote the economically efficient transmission and generation of electricity". It permits owners of transmission grids to recover: "... all the costs incurred in connection with the transmission services and necessary associated services, including, but not limited to, an appropriate share, if any, of legitimate verifiable and economic costs, including taking into account any benefits to the transmission system of providing the transmission facilities."[46]

- In the UK, charges for access to gas pipelines are based on principles which apportion costs and permit an appropriate return on capital.[47]

An access regime capable of application to several sectors in the economy requires the flexibility to respond to circumstances peculiar to particular industries and facilities, as well as changes in industry

---

44 See Leonard P & Waters P, "Regulating For Competition : The Telecommunications Act 1991" in Corones S (ed), *Competition Policy in Telecommunications & Aviation* (1992) at 81-86.

45 *Clear Communications Ltd* v *Telecom Corporation of New Zealand Ltd* (1992) (unreported). See TPC (Sub 69); Farmer J A, "Competition Law" (1993) NZ Recent Law Review 14 at 20.

46 See s.212(a) of the *Federal Power Act* (US).

47 Section 19 *Gas Act 1986* (UK).

conditions over time. No single principle or rule of any degree of specificity is likely to meet the policy concerns of every market.

The Committee considered two broad responses to this issue.

First, a broad discretion could be entrusted to an independent regulator, leaving it to decide where the balance should be drawn in particular circumstances, perhaps guided by some broad and general guidelines as to the factors to be taken into account. An approach of this kind was supported by the Prices Surveillance Authority.[48]

A second approach would be to require the relevant Minister to stipulate more specific pricing principles in the context of declaring a right of access to particular facilities. Once those principles were established, the parties would be free to negotiate access agreements, subject to a requirement to place those agreements on a public register. If the parties could not agree on an access price, either party could insist on binding arbitration in accordance with the declared principles. This approach is similar to that adopted under the Telecommunications Act.[49]

The Committee favours the second approach under which the key policy issues relating to pricing principles are more transparent and are made by an elected representative. Once principles are in place the parties have a greater degree of certainty over their respective rights and obligations. This approach is also less interventionist than regulated outcomes and should facilitate the evolution of more market-oriented solutions over time.

While the Committee believes the ultimate determination of an appropriate pricing principle for any given facility should be made by the Minister, he or she should be required to seek independent and expert recommendations on this issue from the NCC. That body's advice would be based on an assessment of the industry and would take account of submissions received from interested parties. The recommendations of the Council would be made public and would be

48 PSA (Sub 97).

49 See ss.140-172. Under the Telecommunications Act, access agreements must comply with the Ministerially-determined pricing principles (ss.140-143); under the Committee's proposed regime this would be primarily a matter for the parties, and if need be the arbitrator, although additional pro-competitive safeguards may be declared in appropriate circumstances (see below).

binding on the Minister unless the owner of the facility agreed to an alternative arrangement.

If, despite the existence of an access right and declared pricing principles, the parties could not reach agreement, binding arbitration would be available under the auspices of the competition authority — the proposed Australian Competition Commission. The Commission could appoint independent commercial arbitrators or itself provide the arbitration function. In some circumstances the access declaration might specify that arbitration should only be conducted by the Commission. Whether or not the Commission is the arbitrator, the arbitrator's determination would be binding and appeals would be limited to matters of law.

To facilitate negotiation of appropriate access agreements once a facility has been declared, the owner of the facility should be required to provide relevant cost or other data to the party entitled to seek access and, if need be, to the arbitrator.

3. Other Terms and Conditions Required to Protect the Owner

In some cases it may be appropriate to qualify the right of access, such as by imposing quality requirements on the gas or water put in a pipeline, the minimum or maximum volumes of throughput or other conditions.

With privately-owned facilities, in particular, it would be appropriate to ensure that an obligation to provide access does not unduly impede an owner's right to use its own facility,[50] including any planned expansion of utilisation or capacity. It may be appropriate to require that access be provided on a "non-discriminatory" basis, although what this is intended to mean in a particular setting should be spelt out. For example, it may be appropriate for the owner of a private facility to give priority to its own requirements in determining access to the facility in some circumstances. Similarly, discrimination between different third-party users should not be prohibited where the discrimination relates to objective efficiency-related considerations, including different costs associated with providing access to different users.

---

50 For example, under the UK gas regime, access will not be ordered at all where the pipeline is already running at full capacity: see s.19, *Gas Act 1986*. See also *Petroleum Pipelines Act 1969* (WA), which gives priority to the owner of the pipeline.

The relevant terms and conditions will tend to vary between industries and between facilities and should be subject to Ministerial determination under the same declaration process used for determining relevant pricing principles, including the role for advice from the NCC.

4. Additional Safeguards to Protect Competition

In some situations there may be concern that the assurance of access on fair and reasonable terms will not be sufficient to protect competition in a newly competitive market, and that some additional safeguards are required to ensure that an incumbent does not misuse its market power to damage emerging competition.

Under the *Telecommunications Act 1991* (Cth), for example, the new entrant was given access to the interconnection network at what is regarded as a relatively inexpensive price to help offset the competitive advantages of the incumbent. In addition, the Act includes:

- prohibitions on the dominant carrier engaging in price discrimination;[51]

- prohibitions on the dominant carrier favouring its own operations in the setting or applying of terms or conditions for the supply of its own basic carriage services;[52]

- practical constraints on cross-subsidies through requirements to maintain accounts in prescribed forms and scrutiny of such records by the regulator;[53] and

- extensive administrative scrutiny of pricing and marketing practices.

51 Section 183.
52 Section 187.
53 Part 5, Division 5.

These safeguards are designed to become less prescriptive and intrusive as competition develops, and are expected to be phased out as certain predetermined market shares are achieved by the new entrant.

The circumstances of the emerging Australian telecommunications market are relatively unusual. The incumbent dwarfs the new entrant; a regulated duopoly limits the contestability of the market; and the large number of different products in that industry presents the opportunity for the incumbent to exploit its market power in less contestable market sectors to resource cross-subsidies in sectors where competition has commenced or is expected to emerge.

The same conditions appear unlikely to exist to the same degree in other infrastructure industries that may be subject to an access regime. In most of these industries, there is often only one relatively homogeneous product (such as electricity or gas) and appropriate regulatory and structural reform should increase the contestability of the market. Accordingly, the Committee considers that any concerns over predatory or unduly discriminatory behaviour will generally be met by requirements to provide cost data relevant to the application of the pricing principles; to place access agreements on a public register; and to ensure all parties are subject to the general competitive conduct rules proposed in Part I. Additional safeguards that intrude into the rights of the owner are even less likely to be appropriate in the case of private facilities, as the costs of pro-competitive policies ought to be borne by the public, either via its ownership of the facility or otherwise, since the beneficiaries of the policy are consumers generally.

If additional safeguards are considered necessary in a particular market, they could be specified by the Minister as part of the process of declaring a particular facility. Examples might include a requirement that any arbitration be conducted by the Commission itself rather than simply under its auspices; that access agreements be subject to scrutiny by the Commission to ensure they conform with declared principles; or more detailed requirements tailored to the circumstances of the particular declaration. Any such additional measures should be transparent and kept under regular review to ensure they are not unnecessarily interventionist and in particular do not become a prop for inefficient competitors. Importantly, the

decision as to whether to provide such safeguards should be based on the advice of the NCC.

5. Remedies

The proposed access regime relies on negotiation between parties to settle access disputes. Where agreement cannot be reached between the parties, an arbitral process is proposed. The arbitral award would be binding in the usual manner of a commercial arbitration, and non-compliance with the determination could be addressed through civil actions for injunctions or actions for damages.

In some cases, however, the prospect of normal civil remedies may not be considered sufficient to ensure full and timely compliance with the requirements of the access regime. Additional remedies — such as pecuniary penalties of the kind proposed for the competitive conduct rules of a national competition policy[54] — might be declared as part of the access declaration where this is recommended by the NCC.

6. Relationship with Existing Access Regimes

As noted above, there already exist some examples of legislated access regimes.[55] Where such a regime provides access on fair and reasonable terms there will usually be no need for declaration under the proposed general access regime, as effective competition in upstream or downstream markets will already be possible. If the NCC were given a reference to inquire into whether or not an access declaration should be made under the proposed general regime, it would be required to have regard to existing arrangements in framing its recommendation.

If the Council considered that an existing industry-specific access regime was unduly restrictive or discriminatory, had a detrimental effect on inter-state trade or otherwise adversely affected Australia's international competitiveness, it might recommend a declaration under the new general regime. In such cases the proposed general access regime would prevail over the existing access regime.

---

54 See Chapter Seven.

55 See eg *Telecommunications Act 1991* (Cth); s.21 *Petroleum Pipelines Act 1969* (WA).

Upon declaration of a facility, the proposed regime should provide an exhaustive statement of access rights. It would thus also operate to exclude any claims under s.46 of the TPA, to the extent that they relate to allegations of a refusal to provide access to a declared facility.

7. Conclusions

The Committee proposes the establishment of a new access regime potentially applicable to any sector of the economy. In practice, however, such a regime should be applied sparingly, focussing on key sectors of strategic significance to the nation. Concerns over access to facilities that do not share these features should continue to be addressed under the general conduct rules. The key elements of the Committee's proposals are summarised in Box 11.1.

C. ACCESS TO "ESSENTIAL FACILITIES" OWNED BY GOVERNMENTS

Many of the facilities potentially subject to an access regime are currently owned by Commonwealth, State and Territory Governments. This is particularly so of key infrastructure assets such as electricity transmission grids, rail tracks and the telecommunications network, and the Committee was cognisant of this fact in designing the general rules outlined above. Indeed, as these assets are held on behalf of the public, the benefits to the public of improving the efficient use of those assets, and improving the competitiveness of the economy generally, will usually be additional factors supporting the creation of an effective access regime.

A number of concerns were raised in submissions and discussions with States that might arise from the application of an access regime to State-owned assets. In the Committee's view, none of these concerns provides a reason for excluding State assets from an access regime, although these special considerations should be taken into account.

Box 11.1:	General Access Regime — Summary of Key Elements
WHEN:	The designated Commonwealth Minister could only declare access to a particular facility if: (a) the owner agrees; or (b) the Minister is satisfied that: (i) access to the facility in question is essential to permit effective competition in a downstream or upstream activity; (ii) such a declaration is in the public interest, having regard to: (1) the significance of the industry to the national economy; and (2) the expected impact of effective competition in that industry on national competitiveness; and (iii) the legitimate interests of the owner of the facility will be protected by the imposition of an access fee and other terms and conditions that are fair and reasonable. Where the owner of a facility has not consented to a declaration, the Minister may only make such a declaration if recommended by the independent advisory body and only on terms and conditions recommended by that body or on such other terms and conditions as agreed by the owner of the facility.
ACCESS PRICE:	Each access declaration would specify pricing principles that provide for a "fair and reasonable" access fee. The principles would be determined by the NCC, but declared by the Minister. They could be altered by agreement with the owner of the facility. The parties are then free to negotiate their own agreements, subject to a requirement to place them on a public register. If the parties cannot agree, either party may seek binding arbitration by or under the auspices of the Australian Competition Commission.
OTHER TERMS & CONDITIONS	Each access declaration would specify any other terms and conditions relating to access designed to protect the legitimate interests of the owner of the facility and which were "fair and reasonable". The terms would be declared by the Minister and be based on the recommendations of the NCC.
ADDITIONAL SAFEGUARDS	As a general rule, the requirement to place access agreements on a public register should suffice to protect the competitive process. Where recommended by the independent body, the Minister may also declare that other safeguards should apply aimed at protecting the competitive process.

1. Potential Concerns

State and Territory Governments raised three main concerns about pro-competitive policies that might relate to the Committee's access proposal. These were potential revenue impacts, potential implications for community services obligations and more abstract sovereignty concerns.

(a) Potential Revenue Impacts

Profits derived from government-owned businesses are often regarded as an important source of government revenue. Although requirements for government-owned businesses to make a commercial rate of return on investments are consistent with economic efficiency, there have been suggestions that some governments rely on the monopoly status of their businesses to charge monopoly prices and hence achieve returns in excess of what might be possible in a competitive market.

The extension of a legislated right of access to government-owned assets has the potential to impact on monopoly profits at two levels:

- application of an access regime to a government-owned facility (such as an electricity transmission grid) would limit the potential for that facility to charge monopoly access prices to new entrants (such as private electricity generators); and

- application of an access regime will permit competition in dependent markets, such as electricity generation, and thus limit the potential for any government-owned generators to charge monopoly prices.

The actual impact on the profitability of a business would depend on the extent to which current returns relied on monopoly pricing behaviour, and were thus inconsistent with competitive market outcomes. Normal commercial returns on assets are consistent with competitive markets and would not be affected. While some governments have been taking increasing dividends and other payments from their business enterprises in recent years, the Committee was presented with no material that would allow it to judge to what extent, if any, those profits exceeded a commercial rate

of return.[56] Indeed, many government businesses are earning returns below the commercial level. The introduction of competition into many sectors may not have any impact on profits, but it could allow similar profits to be earned more efficiently, and hence at lower costs to consumers and the economy generally.

If there are indeed profit implications associated with the application of an access regime, the revenues in question will have been obtained at the expense not only of consumers but of a more efficient economy generally. From a national interest perspective, therefore, the issue is one of ensuring appropriate transitional arrangements rather than permitting the status quo to continue. In this regard the NCC would have a specific mandate to advise on transitional issues associated with its recommendations.

(b) Implications for Community Services Obligations

Many government businesses are required to perform community service obligations (CSOs) of various forms, at least some of which may be funded from cross subsidies between different classes of consumers.

Application of an access regime to government-owned businesses would facilitate the introduction of competition, which in turn may threaten the viability of CSOs funded through cross-subsidies. Unless alternative funding arrangements are put in place, new market entrants would be able to target the customers that have been charged higher prices to fund CSOs.

This issue is common to other pro-competitive regulatory and structural reforms discussed in Chapters Nine and Ten, and can be addressed by using alternative funding arrangements for CSOs. Options include direct budget funding and, as is being done in the telecommunications regime, funding via levies imposed on all competitors in the market, based on their respective market shares. The issue is thus one of appropriate transitional arrangements. In some circumstances transitional concerns of this kind could be accommodated by the imposition of appropriate terms and conditions of access under the proposed access regime. For example, a condition

56 See Box 12.4 in Chapter 12 for an indication of the earnings, before income and tax, of various government businesses.

of access might be imposed requiring beneficiaries of the access right to contribute to a fund to meet community service obligations.

(c) Sovereignty Concerns

A third consideration peculiar to assets owned by governments are the constitutional and other considerations arising in a federal system. Necessarily, the issues vary as between Commonwealth, State and Territory Governments.

- *Assets Owned by the Commonwealth*

There are no constitutional impediments to the Commonwealth dealing with its own assets, and no other circumstances that might be used to justify the exclusion of Commonwealth assets from a national access regime. Indeed, the Commonwealth has already exposed AOTC to an access arrangement through an industry-specific legislative scheme, and has experience in dealing with CSOs and like matters in a competitive environment.

- *Assets Owned by State & Territory Governments*

Although the Commonwealth's constitutional powers are not unlimited, it seems that there are a number of circumstances where the Commonwealth could validly create access rights to assets owned by State Governments.[57] This is clearly so in respect of facilities that are owned by trading corporations or where the facility or the proposed access arrangement has an inter-state dimension. It may also be possible to create such a right in respect of State assets irrespective of the legal form of ownership or interstate character of the facility or transaction if creation of an access right would protect a trading corporation from possible restrictions imposed on its trading activities. The Commonwealth's legislative powers in respect of the Territories are plenary.

While it seems likely that the Commonwealth has power to create access rights to many of the more significant infrastructure facilities, the principle of comity between governments in a federal system suggests that the Commonwealth Government should generally respect the prerogatives of a State government unless an important

57 For a further discussion of these issues see Chapter 15.

national interest is at stake. The Committee supports this principle, and encourages the use of cooperative processes wherever they will meet the national interest.

2. Consideration and Conclusions

The Committee sees no reason why the access regime it proposes should not apply to relevant assets owned by the Commonwealth.

In principle, the same should be true of assets owned by State and Territory Governments. In this respect the Committee notes that the proposed scheme is constrained in its potential impact on State-owned assets in a number of ways. The most important limitation is the requirement that access only be granted if to do so would be in the public interest having regard to the significance of the industry to the national economy and the expected impact of effective competition in that industry on national competitiveness. There is a requirement that the legitimate interests of the owner of the facility be protected by imposition of an access fee and other terms and conditions that are fair and reasonable. And access rights could not be created without the affirmative recommendation of the NCC which, as discussed in Chapter 14, would be established jointly between Commonwealth, State and Territory Governments.

The proposed regime provides for the owner of a facility to consent to a declaration, and this should be the primary mechanism for bringing State-owned assets within the regime. The NCC could still furnish advice, but could do so to assist relevant governments reach agreement, and to provide guidance on any associated transitional arrangements.

The Committee considers that cooperative approaches of this kind should be the preferred method of making progress in this area, and governments may wish to establish informal inter-governmental arrangements to facilitate the obtaining of agreement. Where agreement is not forthcoming, however, the Committee considers the important national interests at stake in some circumstances may be sufficient to justify possible unilateral action by the Commonwealth, albeit subject to the safeguards outlined above.

D. RECOMMENDATIONS

The Committee recommends that:

11.1 Concerns over access to "essential facilities" be dealt with under a national competition policy by a new legal regime that creates a right of access in prescribed circumstances.

11.2 The legal regime underpinning access rights be general, rather than industry-specific.

11.3 Access rights be created by a process of declarations made by the designated Commonwealth Minister.

11.4 A right of access to a facility only be created if:
- (a) the owner agrees; or
- (b) the designated Commonwealth Minister is satisfied that:
  - (i) access to the facility in question is essential to permit effective competition in a downstream or upstream activity;
  - (ii) such a declaration is in the public interest, having regard to:
    - (1) the significance of the industry to the national economy; and
    - (2) the expected impact of effective competition in that industry on national competitiveness; and
  - (iii) the legitimate interests of the owner of the facility will be protected by the imposition of an access fee and other terms and conditions that are fair and reasonable.

Where the owner of a facility has not consented to a declaration, the Minister may only make such a declaration if recommended by the National Competition Council and only on terms and conditions recommended by that body or on such other terms and conditions as agreed by the owner of the facility.

11.5 The access regime have the following features:
- (a) an access declaration should indicate:
  - (i) the facility or facilities subject to the declaration;
  - (ii) the user or class of users benefiting from the right;

(iii) the pricing principles governing access to the facility;
(iv) any other terms and conditions to protect the legitimate interests of the owner of the facility;
(v) any additional safeguards required to protect the competitive process;
(vi) whether arbitration is required to be conducted by the Australian Competition Commission, or whether it may be conducted by others acting under the auspices of the Commission; and
(vii) what, if any, specific penalties should be available for non-compliance with an access right.

(b) if the parties cannot agree on particular terms and conditions, either party may seek binding arbitration by, or under the auspices of, the Australian Competition Commission;
(c) agreements, whether achieved through negotiation or arbitration should be placed on a public register held by the Australian Competition Commission;
(d) declarations should be subject to periodic and open review at periods appropriate to the circumstances of the industry, and should lapse automatically unless renewed following a review; and
(e) firms party to an access declaration should be provided with a formal mechanism to petition for revocation or modification of a declaration based on a material change in market circumstances.

11.6 Where a facility is declared under the proposed general access regime, the resulting access rights should constitute an exhaustive statement,
(a) taking precedence over access rights created under existing legislation; and
(b) excluding any right to bring an action in relation to an allegation of refusal to provide access to a declared facility under the misuse of market power provisions of the competitive conduct rules.

11.7 The proposed general access regime be capable of application to facilities owned by State or Territory Governments. As a measure of comity to other governments in a federal system, the Commonwealth should place primary emphasis on cooperative approaches to the the declaration of access, based on the agreement of the owner of the facility. Where that cooperation is not forthcoming, however, the Committee considers the important national interests at stake in some circumstances may be sufficient to justify unilateral action.

12. Monopoly Pricing

As a general rule, "high" prices lead to increased competition. They provide the signal that spurs innovation and risk-taking investment. In markets characterised by workable competition, charging prices above the level of long run average costs will not be possible over a sustained period, for higher returns will attract new market entrants or lead customers to choose a rival supplier or product. Consequently, the general conduct rules proposed in Part II do not seek to regulate "high" pricing directly, relying instead on the competitive process.

Where the conditions for workable competition are absent — such as where a firm has a legislated or natural monopoly,[1] or the market is otherwise poorly contestable — firms may be able to charge prices above the efficient level for periods beyond those justified by past investments and risks taken or beyond a time when a competitive response might reasonably be expected. Such "monopoly pricing" is seen as detrimental to consumers and to the community as a whole. The primary goal of competition policy is to increase the competitive pressures in these industries, and some of the mechanisms for achieving this were discussed in earlier Chapters.[2] Where those measures are not practicable or sufficient, however, some form of price-based response may be appropriate.

This Chapter proposes the establishment of a prices monitoring and surveillance process for a national competition policy. The process would be applied sparingly and only after proper investigation of the underlying market circumstances, and would not directly control prices. In principle, the same process is applicable to all firms regardless of ownership, although the process takes account of the special considerations that can arise with Government owned-businesses.

---

1 A natural monopoly can be defined as a market where the entire output can be supplied by a single firm at a lower cost than by any combination of two or more firms (IAC, *Government (Non-Tax) Charges*, Vol III, (1989) at 79). Major natural monopolies have been held to include some electricity transmission grids, rail tracks, gas pipelines, parts of the water industry and local telephone networks.

2 Means of enhancing competition were canvassed in Chapter 9 (Regulatory Restrictions on Competition); Chapter 10 (Structural Reform of Public Monopolies); and Chapter 11 (Access to "Essential Facilities").

Section A examines the nature of the monopoly pricing issue and reviews some of the alternative means of dealing with this issue in a national competition policy.

Section B outlines a general prices oversight process, including the circumstances in which it should be applied and other aspects of the process.

Section C considers the application of the proposed general prices oversight process to government businesses. It concludes that while, in principle, the same process should be applicable to all businesses, greater emphasis on cooperative approaches will be appropriate for State and Territory government businesses.

Section D presents the Committee's recommendations.

A. MONOPOLY PRICING & COMPETITION POLICY

This Section considers the nature of the "monopoly pricing" problem, reviews some of the alternative responses to the problem and concludes that a national competition policy should include a limited prices oversight process.

1. The "Monopoly Pricing" Problem

Where a firm is not subject to effective competitive pressure — including both actual and potential competition — it may be able to restrict output and charge higher prices than would be possible in a contestable market. This behaviour is known as "monopoly pricing" and can result in higher prices to consumers and a misallocation of resources.

There are two situations where "monopoly pricing" may occur. The first is where firms enjoy a legislated or natural monopoly over a particular activity and thus are typically in a position to monopoly price. In many of these cases, governments have responded by regulating prices. However, economic efficiency has seldom been the sole or even principal criterion in regulating prices, with governments often choosing to regulate to favour particular categories of consumers or to achieve other social or political objectives. Price regulation of this kind may come at a cost to economic efficiency. "High" prices

provide an important signal to potential competitors that finding ways to "crack the monopoly" are worthwhile. For example, many of the recent innovations in telecommunications were undoubtedly spurred on by the high profits of the industry during the 1970s and 1980s. Regulation of prices for social ends can slow this type of innovation. Another cost of price regulation, particularly cost-based regulation, is that it may often reduce a firm's incentives to increase efficiency. While a number of other pricing models are being tried (eg, price capping or CPI-X regulation), there has historically been a tendency for price regulation to foster a "cost plus" mentality in regulated firms.

The second situation where "monopoly pricing" may occur is in poorly contestable, though largely unregulated, markets. In markets comprising only a few firms, and where barriers to entry are high, there may be concerns over monopoly pricing behaviour. In these cases, in assessing whether prices charged by firms are "too high" it will be important to understand the underlying industry characteristics. What appears a "high" price may reflect no more than a competitive return on capital, given risk factors and pay-back periods. Firms without a legislated or natural monopoly rarely enjoy the capacity to charge excessive prices over a sustained period.[3] Intervening to restrict prices can deter new investment, constrain productivity growth and dull the signal to new firms to enter the market. Nevertheless, there may be some poorly contestable markets where there is reasonable concern over potential monopoly pricing behaviour.

In either monopoly or poorly contestable markets, the nature of the intervention will be important. Regulated solutions can never be as dynamic as market competition, and poorly designed or overly intrusive approaches can reduce incentives for investment and efforts to improve productivity. There are costs involved in administering and complying with pricing policies. Finally, from a government's perspective, resort to price control might be seen as an easy and popular way of dealing with what is in reality a more fundamental problem of lack of competition in an area. Since price control never solves the underlying problem it should be seen as a "last resort". For all these reasons, regulatory responses to monopoly pricing concerns must be approached with caution.

---

3 For example, the IC (Sub 6) noted that firm profitability in the short to medium term is generally a poor indicator of whether there is sufficient competition in a particular market.

2. Possible Responses

Given the risks associated with regulatory responses, the "first best" solution is to address the underlying cause of monopoly pricing by increasing the contestability of the market. This might be achieved by removing or reducing regulatory barriers to entry; restructuring public monopolies; or providing rights of access to certain "essential facilities".

Where measures to improve the degree of competition *within* the market are not practicable or sufficient — such as where an industry has natural monopoly characteristics — it may be possible to create competition *for* the market, also known as franchising or competitive licensing. For example, firms could compete for the right to operate a natural monopoly for a certain period, with the firm tendering the lowest reasonable supply price being awarded the monopoly right (subject to quality of supply and other considerations). This form of competition may generate some of the efficiency gains which arise where competition within the market is possible. While measures of this kind have attracted considerable attention in the literature, they have been applied only in a limited number of cases.[4]

Where none of these measures is practicable or sufficient, some form of limited price–based response may be justified. The following Sections outline a proposed prices oversight process for a national competition policy.

B. GENERAL PRICES OVERSIGHT PROCESS

This Section proposes the basic features of a targeted, economy-wide prices oversight process. It argues that the application of prices oversight should be restricted by explicit legislative criteria and transparent and independent processes; that oversight should be limited to monitoring and surveillance; and that the bases for assessing prices should be confined to efficiency and competition considerations.

---

4 See Demsetz H, "Why Regulate Utilities?", *Journal of Law and Economics*, 11 (1968) 55-65; Tasman Economic Research Ltd, *Harnessing Competition in the Provision of Electricity and Water*, (1992); Schmalensee R, *The Control of Natural Monopolies* (1979); Dnes A, *Franchising and Privatisation: Issues and Options*, (1989); and IC, *Energy Generation and Distribution* (1991).

1. When Should Prices Oversight Be Applied?

Any form of prices oversight will involve costs for the firm subject to the process and the regulator. The Committee proposes that firms should be subject to prices oversight in only limited circumstances defined by statutory criteria and after an independent inquiry has investigated the market situation, alternative pro-competitive reforms and recommended that prices oversight is appropriate.

Current Approach

Although there are a number of prices oversight and regulatory arrangements currently operating in Australia, the system with the widest coverage is that provided by the *Prices Surveillance Act 1983* (PS Act) and administered by the Prices Surveillance Authority (PSA), an independent body. There are around 50 firms operating in 18 industries currently declared under the Act, including ACI Ltd, Arnott's, Australia Post, BHP Ltd, Carlton and United Breweries, Colgate-Palmolive, the Federal Airports Corporation, National Brewing Holdings and Nestles.[5]

The PS Act provides that the Commonwealth Treasurer may declare firms under the Act, which, in turn, requires those firms to notify the PSA of proposed price increases.[6] There are no criteria in the Act governing when a firm can be declared, although the Second Reading Speech of the Act canvassed criteria including the pervasiveness of wage and price decisions, in combination with a lack of effective competitive market discipline.[7] While the PSA often holds an inquiry into the competitive conditions of a market before firms in that market are subjected to prices surveillance, this is not a statutory requirement.

A second generic kind of price regulation is that administered by the NSW Government Pricing Tribunal (GPT), under the NSW *Government Pricing Tribunal Act 1992*. This body investigates and reports on the determination of maximum prices for government monopoly suppliers and the pricing policies (including the pricing structure) of

5 PSA (Sub 97) contains a list of declared companies.

6 A firm may be declared for the purposes of one or more of the goods or services that it supplies.

7 *Ibid.*

such suppliers. The GPT has a standing reference covering, inter alia, electricity, rail and water authorities in NSW.

Submissions

A number of submissions claimed that current PSA declarations were inappropriate for particular firms and industries, essentially on the ground that effective competition existed in relevant markets.[8]

Consideration and Conclusions

There will usually be scope for debate over whether a particular firm is in a position to engage in monopoly pricing and, if so, whether the costs of a prices oversight process outweigh the potential costs of monopoly pricing. While not in a position to pass judgement on individual markets or firms, the Committee considers that the application of the pricing mechanism of a national competition policy should be subject to more explicit statutory criteria than at present and should be guided by an open inquiry process. The Committee expects that the effect of these recommendations would be a more focussed, analytical and transparent approach to price oversight.

Importantly, the Committee considers that, unless a firm agrees to administrative prices oversight, the responsible Commonwealth Minister should only declare a firm where that firm has a substantial degree of power in a substantial market,[9] and an independent body, the proposed National Competition Council (NCC), has examined the market and concluded that the conditions for effective competition are lacking and that prices oversight is appropriate. The market examination would comprise a public inquiry and involve an assessment of barriers to entry, and other factors bearing on the contestability of the market. The NCC could recommend reform of regulatory barriers to entry or other pro-competitive reforms where these were adjudged to be desirable. The Minister would not be bound to declare a firm if it was recommended by the NCC.

---

8 Eg, Australian Institute of Petroleum (Sub 22); Caltex Aust (Sub 27); Shell Ltd (Sub 30); Carlton & United Breweries (Sub 34); Coopers & Lybrand (Sub 42); BP Aust (Sub 46); Pioneer Ltd (Sub 81); BHP Ltd (Sub 133). Treasury argued that "while it is often difficult to assess the case for price regulation in oligopolistic markets, it is arguable that surveillance in a number of areas currently covered may not be warranted on monopoly pricing grounds" (Sub 76). The Trade Practices Committee of the LCA (Sub 65) argued that price regulation should be imposed only in markets which are natural monopolies or have unusual barriers to entry.

9 Accordingly, the mechanism need not be limited to monopolies.

These requirements should be set out in the legislation itself, and could be supplemented by guidelines issued by the Minister or the NCC.

Declarations under the Act should also be subject to periodic and transparent review to ensure that prices oversight remains justified and responsive to market conditions. In particular, declarations should lapse automatically after a period of no more than three years, and should be renewed only after a further inquiry. In addition, a formal procedure should exist to allow firms that are subject to declaration to petition for a revocation on the grounds of a material change in circumstances.

Existing declarations should lapse automatically within two years, but relevant firms, goods and services might be subject to declaration under the new process.

In some cases, firms may derive substantial market power by owning so-called "essential facilities" to which other firms require access to compete in upstream or downstream markets. In such circumstances, it may often be appropriate for a firm's facility to be subject to the access regime outlined in Chapter 11, rather than prices oversight.[10]

2. Intensity of Prices Oversight

Where it is considered that some form of prices oversight is necessary in the public interest, that oversight could include powers of prices monitoring, prices surveillance and prices control.

Current Approach

Firms declared under the PS Act have their prices surveilled but not controlled. Surveillance involves the PSA examining (usually) each proposed price increase of declared firms and products and indicating whether it has any objection to that increase. Firms are not obliged to comply with the PSA's findings but have always done so to date. The PSA also engages in prices monitoring, although this does not have any statutory backing and therefore requires the consent of the monitored firms. Prices monitoring requires firms to provide certain

10 Whether the issues arising in relation to a particular facility would best be addressed under the access regime or the prices oversight process would be considered on a case-by-case basis.

price and cost data to the PSA at regular intervals, but those prices are not subject to notification, recommendation or control.

The PSA has powers under the PS Act in relation to public inquiries and the administration of the prices surveillance arrangements, including the power to obtain information and the power to summons persons to attend inquiries.[11] Confidential information is required to be maintained within the PSA.

The NSW GPT has the power to set maximum prices for services supplied by NSW government monopolies.

Submissions

Some submissions considered that the PSA's monitoring function should be given a more formal basis.[12] The PSA also argued for a prices control power, on the basis that this would be necessary to restrain the prices of natural monopolies and other firms considered to have a high degree of market power.[13]

Some submissions argued that the costs of compliance with PSA processes were a substantial problem, consuming significant corporate and government resources.[14] The PSA noted, however, that it strives to reduce the costs of its surveillance by accepting data from companies which is in line with their existing information systems and by accepting the different ways in which companies account for cost and revenue items.[15]

Consideration and Conclusions

The Committee supports formalising a prices monitoring power as a less intrusive form of overseeing pricing behaviour in carefully specified situations.

A surveillance power in a simplified form to that currently exercised by the PSA may be an appropriate response in circumstances where prices monitoring may be insufficient. The Committee considers there

11 See s.32 of the Prices Surveillance Act.

12 Caltex Australia (Sub 27); PSA (Sub 97).

13 PSA (Sub 97).

14 Eg, Carlton & United Breweries (Sub 34); Coopers & Lybrand (Sub 42).

15 PSA (Sub 97).

may be opportunities to streamline the operation of the current prices notification and assessment process. For example, it may be possible to fast-track prices surveillance arrangements where the administrator of the prices oversight process[16] considers the proposed price increase is clearly justified. Other measures to reduce the compliance burden of surveillance should also be explored. With refinements of this kind, and providing its application were more limited and focussed, the Committee considers it may be appropriate for a surveillance power to continue under a national competition policy.

The Committee was not persuaded of a need to include a price control power. Regulated prices increase the risk of deterring efficient business activity. Moreover, firms have accepted all price recommendations of the PSA to date. In these circumstances, the Committee favours reliance on less intrusive powers unless and until serious compliance difficulties are encountered. The Committee sees some consistency in this regard with its strong stand against price fixing by firms — to the maximum extent possible, pricing decisions should be made by individual firms rather than regulators or cartels.

The Committee considers that current information-gathering powers available to the PSA provide an acceptable basis for the proposed prices oversight arrangements.

3. Bases for Assessing Notified Prices

Where prices surveillance is ordered, it is necessary to determine what pricing behaviour will be considered appropriate, ie, does not constitute monopoly pricing behaviour. Prices can be assessed by reference to general policy principles and/or criteria referring to appropriate benchmarks.

Current Approach

The PS Act requires the PSA to take account of the need to:

- maintain investment and employment, including the influence of profitability on investment and employment;

16 As outlined in Chapter 14, this body is proposed to be the Australian Competition Commission, which would administer the general conduct rules and parts of the additional policy elements, including the prices oversight mechanism.

- discourage a person who is in a position substantially to influence a market for goods or services from taking advantage of that power in setting prices; and

- discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

In addition, the PSA must have regard to two general Ministerial directions:

- the Government's policy of generally not supporting price increases in excess of movements in unit costs; and

- the Government's policy that increases in executive remuneration in excess of those permitted under wage fixation principles and decisions by the Australian Conciliation and Arbitration Commission in national wage cases should generally not be accepted as a basis for price increases.

The PSA generally assesses prices by reference to movements in unit costs, although it has recently moved towards reference points based on movements in the general price level.[17]

The NSW GPT may fix the maximum price for a government monopoly service in any manner the Tribunal considers appropriate, but must have regard to the factors set out in Box 12.3 in the next Section. In its interim report on the water industry it favoured a CPI–X revenue cap.

Submissions

The PSA expressed support for access to wider and more flexible bases for examining the appropriateness of price behaviour, including price capping arrangements of the CPI-X variety.[18] Some submissions observed that the PSA was subject to broad and potentially conflicting objectives.[19]

---

17 See PSA, *A Review of the Prices Surveillance Authority's Role*, (1991) at 77.

18 PSA (Sub 97). DPIE (Sub 50) also suggested that there may be a need to allow alternatives to cost-based prices surveillance.

19 Eg, Carlton and United Breweries (Sub 34); and Pioneer (Sub 81).

Consideration and Conclusions

The Committee supports the inclusion in the relevant Act of guidelines to assist the NCC in framing recommendations on appropriate price behaviour. However, it considers that several of the existing principles are not appropriate for a national competition policy. Under a new policy regime, principles should focus on competition and efficiency concerns, rather than broader and potentially conflicting social and political goals. For example, a more appropriate principle for a national competition policy might be for the NCC to have regard to:

> the promotion of long term economic efficiency, taking into account the desirability of fostering investment, innovation and productivity improvement, and the desirability of discouraging a person who has a substantial degree of power in a market from using that power to set prices above efficient levels.

There are several potential bases, or benchmarks, which can be used to assess the appropriateness of a firm's proposed price increases, including movements in the firm's costs,[20] movements in the general price level, and so-called "yard-stick" competition, where the performance of comparable firms is used as a reference.[21] Box 12.1 sets out some of the possible pricing approaches.

The Committee considers a national policy should have the flexibility to draw on a range of bases. The determination of which is most appropriate for a particular market situation should be made by the inquiry preceding the application of prices surveillance, and be subject to a formal decision by the Minister as part of the declaration process. Declarations could also specify whether or not each proposed price increase should be notified to the administrator of the prices oversight mechanism, the proposed Australian Competition Commission (ACC).

---

20 See, for example, Beesley M & Littlechild, S, "The Regulation of Privatised Monopolies in the United Kingdom", *RAND Journal of Economics*, (1989) 20, at 454.

21 See Cave M, *Recent Developments in the Regulation of Former Nationalised Industries*, (1991).

Box 12.1: Examples of Possible Pricing Approaches

APPROACH	ELEMENTS	COMMENTS
Cost Based	Price changes linked to changes in firm's costs	• Flexible as to changes in costs • Limited incentive to improve efficiency
Price (or Revenue) Capping ("CPI - X")	Price (or revenue) changes linked to a set rate ("X") below (usually) increases in the Consumer Price Index	• Clear benefits to consumers • Incentive to improve efficiency (particularly if X is set for reasonably lengthy periods) • Allows firms to restructure prices
Yardstick	Price changes linked to average (or lowest) changes in costs of a group of peer firms	• Incentive to improve efficiency • Eliminates need to determine X • Most effective when firms are readily comparable

4. Summary of Proposed Prices Oversight Mechanism

The Committee supports the inclusion of a limited and focussed prices monitoring and surveillance process as part of a national competition policy. The main features of the proposed system are summarised in Box 12.2.

C. PRICES OVERSIGHT OF GOVERNMENT BUSINESSES

Firms with the greatest potential to engage in monopoly pricing are those protected by legislated monopolies. In Australia, the overwhelming majority of these are owned by Commonwealth, State and Territory Governments. This Section examines the potential application of the proposed national prices oversight mechanism to these government enterprises.

Government businesses raise a number of special considerations in this context. While their monopoly permits them to charge inefficiently high prices, traditional approaches to prices regulation have encouraged a "cost-plus" mentality, allowing these businesses to operate very inefficiently. Under government direction, these

Box 12.2 : Main Features of Proposed Prices Oversight Process	
WHEN APPLIED	• Concerns over possible monopoly pricing should be addressed primarily through reforms aimed at improving the contestability of the market • Prices oversight should be declared by the designated Commonwealth Minister only where satisfied that it is in the public interest and the firm: (a) agrees; or (b) has substantial market power in a substantial market in Australia and application of prices oversight has been recommended by an independent body (NCC) after a public inquiry.
INTENSITY OF OVERSIGHT	• Prices oversight powers should be limited to: – monitoring, which requires a firm to provide specified cost and price data to the pricing body at regular intervals; or – surveillance, which requires a firm to provide specified cost and price data and seek the pricing body's non-binding recommendation as to prices; current administrative arrangements should be reviewed to ensure they are cost-effective.
ASSESSMENT OF PRICES	• Pricing principles should be limited to efficiency and competition concerns • Price bases could be determined according to the characteristics of individual markets.

businesses often charge "monopoly" prices to some customers to cross-subsidise inefficiently low prices to other customers or to fund other community service obligations. Increasingly, it appears that governments have also been looking to their businesses as a source of revenue, although many government businesses still make large losses.

Recently, there has been increased appreciation of the cost of inefficient government businesses to society, particularly where their inefficiencies are passed on as higher costs to firms which compete in

world markets. The pro-competitive reforms discussed in the previous three Chapters are an important part of the response to this problem. Where those reforms are not practicable or sufficient, however, the question arises of whether some prices oversight mechanism is required. In a Federal system like Australia's, the question also arises as to whether that prices oversight should be administered nationally or by individual governments.

Current Approach

All Australian Governments use pricing mechanisms to guard against monopoly pricing by their businesses which have substantial market power.

Commonwealth-owned monopolies are subject to prices surveillance by the PSA, an independent body. Particularly when examining government enterprises, the PSA does not limit its attention to price levels *per se*. It also looks at whether costs are minimised and at the structure of prices, including inefficiently low prices achieved through cross-subsidisation between different classes of consumers.[22] It also draws on new pricing approaches (such as CPI – X) to break the link with the "cost plus" mentality commonly associated with earlier forms of price regulation, thus improving incentives for achieving higher productivity. It can also take account of explicit community services obligations and appropriate levels of profitability. In each case, however, the overarching goal is to ensure that, within the constraints imposed by owning governments, monopolies operate efficiently and do not misuse their market power in setting prices.

State and Territory government businesses are specifically excluded from the reach of the PS Act.[23]

Since 1992, New South Wales government monopolies have been subject to price setting by an independent Government Pricing Tribunal. The Tribunal takes a similar approach to that of the PSA in terms of a broader focus on efficiency issues, and its enabling legislation allows it to have regard to a range of factors peculiar to government businesses. Some of the principal factors are set out in Box 12.3.

---

22 See, for example, PSA, *Inquiry into the Aeronautical & Non-Aeronautical Charges of the Federal Airports Corporation* (Draft Report, June 1993).

23 See s.4(2) of the *Prices Surveillance Act 1983*.

Box 12.3: Matters to be Considered by NSW Government Pricing Tribunal

Section 15 of the NSW *Government Pricing Tribunal Act 1992* requires the Tribunal to have regard to, inter alia:

- the cost of providing services;
- the protection of consumers from abuses of monopoly power in terms of prices, pricing policies and standard of services;
- the appropriate rate of return on public sector assets, including appropriate payment of dividends to the Government for the benefit of the people of New South Wales;
- the need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers and taxpayers; and
- the impact of pricing policies on borrowing, capital and dividend requirements of the government agency concerned.

Other States and Territories leave pricing decisions to Ministers or Cabinet without the benefit of independent and expert advice. Efficiency reforms appear to be pursued primarily on an enterprise by enterprise basis. However, Queensland has recently canvassed the possibility of establishing a body similar to the NSW Tribunal.[24]

Submissions

Several submissions expressed concern at alleged monopoly pricing and cross subsidies by State Government businesses[25] and another argued that the PSA should be responsible for overseeing pricing of interstate industries including electricity and gas.[26] The TPC also pointed to the benefits of adopting a national approach to monopoly pricing concerns.[27]

The NSW Government argued that the States should retain responsibility for pricing matters and other State and Territory

24 Qld Govt, *Corporatisation in Queensland: Policy Guidelines* (1992) at 99.

25 Eg, Australian Institute of Petroleum (Sub 22); Shell Australia (Sub 30); Victorian Gas Users Group (Sub 47); National Bulk Commodities Group (Sub 71); NFF (Sub 90); BCA (Sub 93); Burdekin Canegrowers (Sub 105).

26 DPIE (Sub 50).

27 TPC (Sub 69).

Governments raised more general concerns over revenue matters or community service obligations.[28]

The PSA proposed that the pricing body under a national competition policy should be jointly responsible to the Commonwealth and State Governments with respect to State government businesses, and that State Governments should agree to refer their enterprises to coverage by the national body.[29]

Consideration

The extension of competitive conduct rules and other competition policy elements to government-owned businesses raises the question of whether the proposed new prices oversight mechanism should also be extended to them, and if so in what circumstances.

Finding the most effective means of dealing with government businesses with monopoly pricing capability that have not been subject to pro-competitive reforms, or for which such reforms have been found impracticable or insufficient, is an important question for Australia, particularly as these businesses tend to supply key inputs to sectors that compete in global markets.

Commonwealth Government Businesses

Commonwealth businesses such as Australia Post and the Federal Airports Corporation are already subject to prices surveillance by the PSA. The proposed new prices oversight mechanism would appear to be appropriate for these businesses.

State & Territory Government Businesses

The application of a national prices oversight mechanism to State and Territory government businesses offers several possible advantages. Independent and expert analysis of monopoly pricing issues would be applied to government businesses currently immune from such scrutiny. This would be a beneficial development in sectors such as electricity, rail, and ports that provide key inputs to export and import competing businesses. A national body could examine pricing issues affecting industries around Australia in a consistent and nationally-

28 Eg. SA Govt (Sub 98); ACT Govt (Sub 109); NSW Govt (Sub 117).

29 PSA (Sub 97).

focussed way. And technical expertise could be consolidated, avoiding any unnecessary fragmentation or duplication of resources and effort.

The application of a single national prices oversight process would be particularly desirable where a government business has a clear inter-state dimension, such as where an inter-state pipeline or electricity grid is jointly owned by several governments. In these circumstances, individual State or Territory prices oversight could lead to regulatory overlap and potentially distort inter-state or national markets, particularly were different approaches adopted. Where the facility in question was subject to an access declaration under the regime proposed in Chapter 11, access prices would be determined nationally. Even in the absence of an access declaration, there are strong national interests in ensuring such key national infrastructure operates efficiently and does not misuse its market power in setting prices.

Against this, there may be three potential concerns.

The first relates to possible ***revenue impacts*** on States. As indicated in Box 12.4, a number of government businesses have increased their profits significantly in recent years. However, the Committee was not presented with any material that would allow it to conclude whether those profits exceeded commercial or efficient levels and would thus be contrary to economic efficiency. The current national prices surveillance arrangement makes provision for commercial profits, as would the proposed new price oversight mechanism. To the extent prices exceeded commercial levels, a surveillance process would increase the transparency of the pricing arrangements but not control prices. Where prices surveillance served to improve the efficiency of the business, profitability would be able to be maintained at lower cost to consumers and the community generally. Furthermore, as set out in Chapter 15, transitional arrangements would apply in relation to prices oversight arrangements. The proposed NCC — which would be established jointly by the Commonwealth, State and Territory Governments — would have a specific mandate to advise on transitional arrangements associated with its recommendations.

The second concern related to the potential impact of a prices oversight process on ***community service obligations*** (CSOs), particularly those currently funded by cross-subsidies. The proposed prices oversight process would be able to take these into account in

considering pricing arrangements, as does the PSA currently in relation to businesses like Australia Post. However, an important object of prices surveillance is to improve the transparency of CSOs and identify means of improving the efficiency of the funding of CSOs (this will often involve funding via government budgets).[30]

A third potential concern relates to more general *sovereignty* issues. Contrary to some suggestions, there appears to be no constitutional impediment to the Commonwealth imposing a prices oversight process on State Government businesses.[31] However, the Committee has accepted the principle that, as a matter of comity between governments, the prerogatives of State and Territory Governments should generally not be over-ridden unless this is required in the national interest.

Viewed in this light, the Committee believes the primary means of progressing pro-competitive pricing reform relating to government businesses should be via cooperative approaches between the Australian Governments. Governments should work together to improve the pricing efficiency of government businesses, with emphasis on businesses in transition to a more competitive operating environment, or which are of national economic significance. Government revenue requirements and CSOs may be important matters for cooperative action.

30 For example, see Qld Govt, *ibid*, at 94: "the preferred option would be for a fee paid to an enterprise for the provision of CSOs to be funded directly from the Budget."

31 Legal and constitutional issues are discussed in Chapter 15.

Box 12.4: Government Businesses — Earnings before Interest & Tax ($m)[32]			
	1989-90	1990-91	1991-92
Commonwealth			
TELECOM / AOTC	2,332	2,565	2,419
QANTAS	10	225	307
Australian Airlines	14	205	18
Australia Post	26	141	213
OTC	348	408	n/a
Snowy Mountains Authority	77	83	-13
ANR	-36	-16	-184
AUSSAT	16	7	n/a
ANL	25	20	-17
Pipeline Authority	51	47	49
Commonwealth Serum Lab.	14	9	14
Total Commonwealth	2,877	3,695	2,807
Electricity & Gas			
EC NSW / Pacific Power	623	802	1,186
SECV	1,177	1,132	1,151
Gas & Fuel Corp of Victoria	171	153	169
Electricity Supply QLD	537	368	571
Electricity Trust SA	219	198	200
Energy Commission WA	527	539	583
HEC Tasmania	166	148	203
ACTEW	16	31	28
Power & Water NT	-46	-53	-19
Sydney Electricity	-6	163	120
Total Electricity & Gas	3,382	3,480	4,191
Rail			
QLD Railways	168	176	298
State Rail NSW	-345	-373	-440
Public Transport Corp.	-985	-1,031	-886
Westrail	15	39	54
Total Rail	-1,147	-1,188	-974
Water			
Rural Water Victoria	16	20	12
E&WS South Australia)	116	117	100
Water Authority WA	98	151	154
Sydney-Illawarra-Blue Mt WB	424	465	506
Dept Water Resources	-73	-80	-94
Hunter WB	43	16	27
Melbourne Water	395	449	559
Total Water	1,018	1,139	1,265

32 From Clare R & Johnstone K, *Financial Performance of Government Business Enterprises: An Update*, (1993). Note that no attempt was made to reconstruct the accounts of the various enterprises. Notes on the various data are presented in the above document.

An important element in this process would be for governments to consider establishing independent pricing bodies along the lines of the NSW model. These pricing bodies should be encouraged to work together and with the national body in establishing principles and approaches consistent with the aims and limitations of price regulation set out in this Report. Governments could also progress pricing reform by agreeing to subject a particular area of activity to the proposed national prices oversight process. This would be particularly appropriate where facilities involve a number of States or where there is a significant interstate or international dimension to the prices charged.

While these two approaches should be the primary means of dealing with State and Territory government monopoly pricing issues, there may be exceptions. In the unlikely event that a government failed to progress effective pricing reform in an area which had significant direct or indirect impacts on interstate or overseas trade, it may be appropriate to take steps to declare that business notwithstanding a lack of consent by the owning government. An application to the NCC seeking a finding on this issue should be able to be made by any government.

Commonwealth-State discussions on these issues, including their interface with other pro-competitive reforms, would be assisted by the analysis and advice of the independent and expert body, the NCC, the establishment of which is proposed in Chapter 14. It is proposed that all Australian Governments would be fully involved in establishing the NCC. As any unilateral Commonwealth declaration of a business would require such a recommendation being made by the NCC, the NCC has an important role in ensuring that the legitimate interests of owners of businesses, including State and Territory governments, are safeguarded.

The Committee considered whether further protection of State and Territory interests was appropriate under these processes. However, the Committee considers that where a government business has been found by the NCC — an independent and expert body — to have failed to progress effective pricing reform in an area that was judged to have a significant direct or indirect impact on interstate or overseas trade, and there has been due consultation, the Commonwealth should be prepared to act to protect the national interests involved. In these circumstances, it would not be appropriate to allow the States or

Territories in question to have a right of veto over Commonwealth action.

Conclusions

Governments should work together to address government monopoly pricing issues, particularly in the context of introducing competition in markets or improving the efficiency of sectors of national economic significance. State and Territory Governments should consider establishing expert and independent bodies along the lines of the NSW Government Pricing Tribunal. Governments may also agree to subject their government enterprises, on a case-by-case basis, to the national prices oversight arrangements. These cooperative efforts should be supported by the proposed National Competition Council.

The national prices oversight arrangements should generally only be applied to a State or Territory government business by consent of the owning government. However, consent should be able to be waived where a government has failed to progress effective pricing reform in an area that was judged to have a significant direct or indirect impact on interstate or overseas trade, and there has been due consultation.

D. RECOMMENDATIONS

The Committee recommends that:

12.1 Concerns over monopoly pricing be addressed primarily through appropriate regulatory and structural reform to enhance competition, with prices oversight being a residual and second-best option.

12.2 A national competition policy include a targeted prices oversight mechanism to deal with those situations where pro-competitive reforms are not adequate or practicable. That oversight would provide for prices monitoring or surveillance but not prices control.

12.3 Under a national competition policy, prices oversight of a firm (either generally or in relation to specified goods or services) only be declared by the Commonwealth Minister where the Minister is satisfied that declaration is in the public interest and the firm:

(i) has agreed to the declaration; or

(ii) has substantial market power in a substantial market in Australia and application of prices oversight has been recommended by the proposed National Competition Council after a public inquiry.

12.4 Prices oversight powers should be limited to:

(i) monitoring, which requires a firm to provide specified cost and price data in respect of declared goods or services to the Australian Competition Commission at prescribed intervals; and

(ii) surveillance, which requires that a firm provide specified cost and price data to the Australian Competition Commission and seek its recommendation as to whether its prices are consistent with the principles set out in the relevant declaration.

12.5 In recommending pricing principles to the Minister, the National Competition Council have regard to statutory principles emphasising the efficiency rationale of prices oversight and taking into account the need for a firm to receive a reasonable rate of return on its assets.

12.6 Declarations lapse automatically after a period of no more than three years, unless renewed following a further public inquiry.

12.7 Declarations under the current Prices Surveillance Authority arrangements lapse within two years, although relevant firms, goods or services might be subject to declaration under the new prices oversight arrangements.

12.8 A formal mechanism be provided to allow firms subject to declaration to petition for revocation or modification of a declaration based on a material change in market circumstances.

12.9 Opportunities to streamline the administration of the prices oversight arrangements be examined.

12.10 Pricing issues affecting government businesses be dealt with according to the following principles:

(a) Governments should work together to address monopoly pricing issues, particularly in the context of introducing competition to public monopoly markets or improving the efficiency of sectors which are of national economic significance. A national, independent, advisory body — the National Competition Council — should assist governments in this regard. State and Territory governments should consider establishing independent and expert prices bodies along the lines of the NSW Government Pricing Tribunal;

(b) Governments may agree to subject their enterprises, on a case-by-case basis, to the national prices oversight mechanism; and

(c) the national prices oversight mechanism should generally only be applied to a government business with the consent of the owner. Consent may only be waived where:
   (i) on the application of any government, the NCC has found that the owning government has failed to progress effective pricing reform in an area that was judged to have a significant direct or indirect impact on interstate or overseas trade;
   (ii) there has been due consultation; and
   (iii) the processes prescribed under Recommendation 12.3 have been complied with.

13. Competitive Neutrality

Competition policy does not require that all firms compete on an equal footing; indeed, differences in size, assets, skills, experience and culture underpin each firm's unique set of competitive advantages and disadvantages. Differences of these kinds are the hallmark of a competitive market economy.

In some cases, however, firms competing in the same market face different regulatory or other requirements, potentially distorting competition and raising efficiency and equity concerns. While some submissions to the Inquiry expressed concern at such differences operating between private firms, by far the most systematic distortions appear to arise when government businesses participate in competitive markets. In particular, government businesses were often seen as enjoying a unique set of competitive advantages by virtue of their ownership, including exemption from tax. Policies dealing with these kinds of distortions can be described as elements of "competitive neutrality". Issues in this area are likely to be of increasing importance in Australia as public management reforms increase the commercial orientation of government businesses and pro-competitive reforms increase the number of government businesses which compete with private firms or with government businesses from different jurisdictions.

This Chapter argues that a mechanism to deal with these concerns in a systematic, nationally-consistent manner be established as part of a national competition policy. It proposes that Australian Governments agree to a set of principles aimed at addressing the distortions that can arise when government businesses compete with other firms. The principles would build on governments' current competitive neutrality reforms and, while not having the force of law, would be supported by appropriate institutional arrangements.

Section A examines the concept of competitive neutrality as it may apply to competition involving government businesses[1] and to competition between private firms. It concludes that a national

1 "Government businesses" are taken to include government departments, statutory authorities, corporations and other bodies that provide commercial goods or services to the public, private firms or other Government agencies.

competition policy should include a special mechanism to deal with competitive neutrality issues where competition involves government businesses, but that the proposed arrangements for reviewing regulatory restrictions on competition should address any similar issues affecting competition between private firms.

Section B considers the content and implementation approach for national competition policy to deal with competitive neutrality issues arising where government businesses engage in competition. It concludes that all Australian governments should agree to abide by a set of principles which would be implemented cooperatively and supported by appropriate institutional arrangements.

Section C presents the Committee's recommendations.

A. COMPETITIVE NEUTRALITY & COMPETITION POLICY

Differences in regulatory and other requirements imposed on firms competing in the one market may distort competition and hence undermine market efficiency. Differences of these kinds may also be seen as inequitable, particularly where they are not clearly supported on public interest grounds.

Australian competition policy has not traditionally dealt with competitive neutrality as a distinct policy element. However, the Constitution imposes some limits on discriminatory laws[2] and there is international precedent for disciplines over measures that specially advantage one competitor over another.[3]

In considering appropriate policy responses in this area it is useful to distinguish distortions affecting competition between private firms from distortions arising from the participation of government businesses. Distortions of the former kind generally arise through deliberate and open policy action by governments, typically

2 For example, s.92 limits the capacity of regulations to discriminate against interstate trade, and s.99 prohibits the Commonwealth from preferring one State over another by any law or regulation of trade commerce or revenue.

3 For example, Article 92(1) of the EC Treaty of Rome restricts State aids which distort competition by favouring certain enterprises, or the production of certain goods, in so far as they affect trade between the countries of the EC. Article XVI of the General Agreement on Tariffs and Trade imposes some disciplines on subsidy practices, which have been built on in a separate Subsidy Code.

manifested in legislation. However, those in the latter category may be less deliberate and transparent, and typically flow from a failure to reform laws, policies and practices to keep abreast of developments as bureaucratic and monopolistic enterprises move to more commercial and competitive operating environments.

1. Competitive Neutrality Issues Involving Government Businesses

As part of moves to improve the efficiency of the public sector, governments in Australia[4] and around the world[5] are requiring their agencies to operate more commercially. Increasingly, government businesses are being exposed to greater competition in their traditional markets and, in some cases, government businesses are moving into traditional private sector markets. Recent and proposed reforms cover services provided to the public (such as telecommunications, electricity and gas) as well as to other arms of government (such as government printing, legal services and car fleets).

Reforms of these kinds have the potential to offer significant public benefits, including improved service delivery and lower costs to users and taxpayers. In the case of the Commonwealth Department of Administrative Services, for example, commercialisation and the untying of government clients has led to productivity improvements of 5% pa and a reduction in real costs by $250 m pa.[6] The recent introduction of competition into telecommunications has already seen significant price falls, including 20% on the peak rate on Sydney-Melbourne calls.[7]

At the same time, developments of these kinds strike at the heart of traditional differences between public and private organisations, and raise new and challenging questions for policy-makers. For example, recent reports have questioned whether more commercially-oriented

---

4 For a discussion of the reform context and an overview of approaches in different jurisdictions see Halligan J & Power J, *Political Management in the 1990s* (1992).

5 For a discussion of developments in the US see Rehfuss J, "A Leaner, Tougher Public Management? Public Agency Competition With Private Contractors" *Policy Analysis Quarterly* (Summer 1991) 239-252; and Osborne D & Gaebler T, *Reinventing Government : How The Entrepreneurial Spirit Is Transforming The Public Sector* (1992).

6 Tanzer N, "Has Micro-Economic Reform in the Public Sector Run its Full Course?" (1993).

7 AUSTEL advice based on published Telecom and Optus rates over the period from June 1992 (when Optus entered the market) to May 1993.

government operations should continue to enjoy various Crown immunities,[8] or continue to be subject to administrative, judicial and ombudsman review and freedom of information requirements.[9] From a competition policy perspective, the challenge is one of ensuring that government and private firms operate in a competitively neutral environment, thus promoting effective competition, without creating unnecessary impediments to other worthwhile reforms.

The following discussion examines the potential competitive advantages that government businesses may enjoy in competing with other firms; the competition policy impacts of those advantages; options for addressing competitive neutrality concerns; and the rationale for adopting a national approach to this issue.

(a) Potential Competitive Advantages/Disadvantages of Government Businesses

Government businesses may enjoy several kinds of competitive advantage relative to other firms, as well as some competitive disadvantages.

As discussed in Part I of this Report, the continuing exemption of some government businesses from competitive conduct rules is particularly anomalous, and the Committee has argued that these exemptions be removed as a matter of priority. However, this step alone is not sufficient to address the potential competitive distortions which may arise when government businesses compete with private firms, or government businesses from different jurisdictions compete in the one market.

Some of the other special advantages often enjoyed by government businesses by virtue of their ownership include: immunity from various taxes and charges; immunity from various regulatory requirements; explicit or implicit government guarantees on debts; concessional interest rates on loans; not being required to account for depreciation expenses; not being required to achieve a commercial rate of return on assets; and effective immunity from bankruptcy. In

8 Senate Standing Committee on Legal & Constitutional Affairs, *The Doctrine of the Shield of the Crown* (1992).

9 Administrative Review Council, *Administrative Review of Government Business Enterprises: Discussion Paper* (1993).

some cases a government business will also operate in both monopoly and competitive markets, presenting opportunities for cross-subsidisation.

At the same time, government businesses may enjoy unique competitive disadvantages by virtue of their ownership, with examples including greater accountability obligations; requirements to provide various community services obligations; reduced managerial autonomy; requirements to comply with government wages, employment and industrial relations policies; and higher superannuation costs. In any particular case, it may be difficult to determine the extent of the net competitive advantage or disadvantage with precision.

(b) Competition Policy Impacts of Net Competitive Advantages

Where a government business enjoys net competitive advantages it may be able to price below more efficient or equally efficient rivals. This has the potential to reduce economic efficiency and community welfare by distorting the allocation of resources between advantaged government firms and other firms. If a less efficient government business is able to rely on a net competitive advantage to take business from a more efficient firm, society's resources are not being put to their best use. From an equity perspective, the disadvantaged firm may feel justifiably aggrieved in this situation, particularly if its owners consider they are, in effect, subsidising their rival through their tax contributions.

Special competitive advantages enjoyed by government agencies also have the potential to retard the development of effective competition in many areas of the economy. For example, a government-owned electricity generator that retained non-commercial advantages might be able to under-cut more efficient rivals, whether they be private firms or generators owned by other governments. Similarly, reforms intended to promote the contracting out of services traditionally supplied by an in-house monopoly provider may be thwarted or undermined if the in-house producer's advantages serve to limit the emergence of effective competition.

Competitive neutrality concerns arising from the participation of government enterprises in competitive markets were raised in many

submissions to the Inquiry.[10] In assessing the impact of this issue, a distinction can be drawn between competition in a government business's traditional markets and competition in markets where the government business has not formerly operated. Competitive neutrality concerns are more pressing in the second case.

- *Traditional Markets*

Many government businesses' traditional markets are effective monopolies, either through legislation (eg, Australia Post in letter carriage), or because the businesses were created to be the sole supplier to government. While the activity remains monopolised, competitive neutrality issues do not arise.

Where the monopoly market is opened up to competition, any market share gained by private competitors should result in improved efficiency and a net gain to those competitors. Allowing the incumbent to enjoy some special competitive advantage for a temporary period may delay the benefits of more even-handed competition, but may be seen as justified as part of the transition to a competitive market. Where those advantages are allowed to continue, the benefits of the intended reform are diminished and may even be lost altogether.

Submissions received by this Inquiry claimed that measures to address competitive neutrality issues in traditional monopoly areas had not been taken in areas such as road and other construction services[11] and project design services.[12]

Government enterprises whose traditional markets are not monopolies, eg, Commonwealth and State banks, often already operate in a competitively neutral environment. Where they do not, they should be subject to competitive neutrality reforms. In these cases, and as with enterprises which traditionally enjoyed a monopoly, some transitional arrangements may be acceptable

10 See, ACP (Sub 12); AFG (Sub 15); AGL Ltd (Sub 24); Unilever (Sub 28); AFCC (Sub 31); Spark & Cannon (Sub 36); AIIA (Sub 40); AERCF (Sub 49); Aust Legal Reporting Group (Sub 66); ACM (Sub 73); AMP (Sub 82); BCA (Sub 93); SBC (Sub 100); Aerial Taxis (Sub 102); National Registries (Sub 121); SPAA (Sub 123); ACEE (Sub 127); and AOQ (Sub 135).

11 AFCC (Sub 31); AERCF (Sub 49).

12 ACEA (Sub 127).

provided the enterprises do not expand their operations into new fields.

- *New Markets*

As part of their increasingly commercial operating culture, some government businesses are venturing into markets not traditionally supplied by them. If steps are not taken to neutralise any net competitive advantages they enjoy, government businesses may corrupt these markets and take business away from more efficient private businesses. While some period of temporary advantage may be acceptable in the traditional market, as private suppliers can only benefit, the same is not true in this situation. Even if moves into new markets coincide with the opening up of a former monopoly market, there can be no assurance that this fact alone will produce net public benefits if the government business remains, in effect, subsidised by virtue of various competitive advantages. The Committee was presented with no persuasive argument for allowing government businesses to enjoy net competitive advantages outside their traditional markets, even on a temporary basis.

Several submissions claimed that government agencies created to supply a traditional monopoly market have been permitted to compete for business in new markets without addressing competitive neutrality issues. Although the Committee was not in a position to assess individual claims, allegations were made in submissions relating to activities as diverse as court reporting,[13] printing,[14] audio-visual production,[15] and debt registry services.[16]

(c) Options for Dealing with Competitive Neutrality Concerns

The need to address competitive neutrality issues arising from the participation of government businesses in competitive markets is attracting increasing attention around Australia and overseas.[17]

---

13 Spark & Cannon (Sub 36); and Australian Legal Reporting Group (Sub 66). Auscript has responded to these submissions (Sub 125).

14 ACM (Sub 73).

15 SPAA (Sub 123).

16 National Registries (Sub 121). The RBA has responded to this submission (Sub 132).

17 For example, UK Treasury Guidelines state that "Normally, in-house bids should be based on full cost, whether or not all of such costs are charged to that budget... it will be important to ensure that tax differences should not be allowed to distort decisions" (HM Treasury, Public Competition and Purchasing Unit, *Market Testing and Buying In* (Guidance No.

Within Australia, however, there are no nationally-consistent norms governing this issue.

In principle, concerns over competitive neutrality involving government businesses could be addressed through four main ways: privatisation; corporatisation; reform of particular sources of advantage and disadvantage; or pricing directions. All Australian governments have adopted at least some of these measures.

- *Privatisation*

Privatisation involves transferring the ownership of the government business to the private sector. This approach fully removes any competitive advantages or disadvantages associated with government ownership, and may be the most appropriate response in many circumstances.

- *Corporatisation*

Full "corporatisation" is a means of converting a public enterprise into a firm which is as similar in terms of its objectives, incentives and sanctions to a private firm as is feasible while retaining the enterprise in government ownership.[18] This will involve eliminating, as far as possible, any special advantages and disadvantages which may flow from government ownership.

Although the concept of corporatisation as it applies to government businesses is subject to different interpretations between the Australian jurisdictions, it has been described as entailing comprehensive reform incorporating five basic principles: clarity and consistency of objectives; management authority; performance monitoring; effective rewards and sanctions; and competitive neutrality.[19] Competitive neutrality is achieved by ensuring that,

---

34). However, it has been observed that "Surprisingly few governments attack state-enterprise problems by putting public and private competitors on equal terms ... [H]elping state-owned firms become responsive to competition ... governments may also need to reform laws and regulations that discriminate in favour of state firms" : Shirley M & Nellis J, *Public Enterprise Reform: The Lessons of Experience*, (1991) at 9.

18 Forsyth P, *Public Enterprises : A Success Story of Microeconomic Reform?* (1992) at 20.

19 Allan P, *A Guide to the Theory and Practice of Commercialisation & Corporatisation in NSW* (1992) 2. Also see Task Force on Other Issues in the Reform of Government Trading Enterprises, *Characteristics of a Fully Corporatised Government Trading Enterprise* (1991).

inter alia, industrial relations, financing and taxation arrangements are the same as apply in the private sector.[20]

Governments around Australia are increasingly using the corporatisation model to reform their government agencies. The Commonwealth has corporatised entities through agency-specific legislation[21] while most States and Territories have recently introduced generic corporatisation legislation.[22]

While there is a clear trend towards corporatisation of government businesses, there are many exceptions, including in sectors likely to be open to increasing competition in coming years.[23] Significantly, no Australian government appears to have adopted the policy stance that its businesses must be corporatised before they may compete with other firms.

- *Reform of Specific Advantages and Disadvantages*

Another approach to competitive neutrality issues is to address the specific source of particular advantages or disadvantages directly. Removal of exemptions from the competitive conduct rules would be an example of reform of this kind, as would reforms relating to the availability of crown immunity[24] and application of administrative law requirements.[25]

A recent example of this kind of reform was the in-principle agreement of Premiers and Chief Ministers to apply the full range of Government taxes and charges to all commercial government

---

20 Note, however, that State government agencies may pay tax to the owning government in lieu of the Commonwealth Government.

21 Eg, see *Australian and Overseas Telecommunications Corporation Act 1991.*

22 Eg, *State Owned Corporations Act 1989* (NSW); *Public Corporations Act 1993* (SA); *Territory Owned Corporations Act 1990* (ACT); *State Owned Enterprises Act 1992* (Vic); *State Authorities Financial Management Act 1990* (Tas); and *Government Owned Corporations Act 1993* (Qld).

23 For example, most enterprises in the electricity sector are not corporatised, although Vic, Qld and WA have announced the corporatisation of elements of their systems.

24 See Senate Standing Committee on Legal & Constitutional Affairs, *The Doctrine of the Shield of the Crown* (1992).

25 See Administrative Review Council, *Administrative Review of Government Business Enterprises : Discussion Paper* (1993).

enterprises through the creation of tax equivalent payments encompassing both State and Commonwealth taxes.[26]

While these approaches address the underlying concerns, and hence serve to reduce the magnitude of net advantages, reforms typically proceed on an issue-by-issue basis and more comprehensive reform may take some time to achieve.

- *Pricing Directions*

In the absence of privatisation or corporatisation, efforts to comprehensively address net competitive advantages typically involve directions aimed at ensuring that the full economic costs of the resources deployed by the government business are reflected in its prices.[27] Under this approach, government businesses would be required to account for costs incurred by the business itself (such as wages), other associated costs (such as accommodation) and implicit costs (such as a commercial rate of return and income tax equivalents). This approach would lead to net competitive advantages held by a government business being offset, thus preventing them from pricing below equally efficient private firms.

Approaches of this kind are essentially accounting measures and are likely to be less effective in addressing competitive neutrality concerns than corporatisation, where competitive advantages and disadvantages are removed. However, they may be acceptable if corporatisation is not practicable, the relevant directions give due weight to competitive neutrality concerns, and those directions are strictly enforced. In this regard it is significant that many entities which submitters alleged to have taken advantage of special competitive advantages in determining pricing strategies appear to have been subject to pricing directions or guidelines of some form.

---

26 Premiers and Chief Ministers Meeting, *Communique*, 21-22 November 1992 at 8. Also, the Commonwealth and the States have agreed to explore the process for subjecting State Trading Enterprises to Commonwealth income and wholesale sales tax, in return for compensation payments from the Commonwealth. See Treasurer, *Premiers' Conference/Loan Council Outcome for 1993-94*, (July 1993) at 4.

27 For example, Commonwealth Finance Directions generally require Commonwealth Departments to adopt "full cost pricing" when supplying other Commonwealth agencies. However, there is provision to rely on market prices for a reasonable period if the public sector producer is not as efficient as a competitor and full cost pricing would render the public sector supplier unattractive. See Department of Finance, *Guidelines for Costing of Government Activities* (1991).

- *Conclusion*

Privatisation and corporatisation are likely to be the most effective means of addressing competitive neutrality concerns, although they may not be appropriate in all circumstances where government businesses compete with other businesses. There is clearly a role for ongoing review of the existing bases for special treatment of government businesses, particularly as they relate to such antiquated doctrines as Crown immunity. Pricing directions also have a part to play in some circumstances.

(d) A National Approach

The Committee considers competitive neutrality issues should be addressed in a nationally consistent and coordinated manner.

Failure to neutralise effectively the advantages of a government business which competes in a national or interstate market has the potential to distort the development of effective competition in such markets. For example, a State-owned electricity generator that retained non-commercial advantages might be in a position to undercut more efficient competitors, whether they be private firms or generators owned by other governments.

Differences in competitive neutrality arrangements between governments may also lead to particular distortions when government businesses from different jurisdictions compete in the one market, which may soon be a feature of competition in inter-State electricity generation, for example.

A national approach to competitive neutrality would also complement the proposal to ensure the competitive conduct rules of a national competition policy had consistent national application, including in relation to government businesses.

Overall, the Committee saw persuasive grounds for ensuring that responses to these issues form part of a national competition policy.

2. Competitive Neutrality between Private Businesses

Government interventions in markets supplied by private firms are generally intended to be neutral in their impact, or where

discrimination is involved, this is generally based on considered policy grounds. For example, a special tax provision favouring activities with a high research and development component may be "discriminatory" but may reflect government policy that encouragement of such activities is desirable. A number of such examples were raised in submissions to the Review.[28] In other cases, however, differences in the regulatory environment faced by competing firms may arise from developments leading to traditionally distinctive classes of suppliers competing in the same market,[29] or through anomalies arising from the pursuit of unrelated policy objectives.[30] In each of these cases, there will usually be pressure to review the rationale for the discrimination.

Where government regulations have a discriminatory impact, particularly in relation to market entry or permissible market conduct, they may be examined through the regulation review process proposed in Chapter Nine of this Report.[31] The discriminatory impacts of regulation as between competitors did not itself appear to warrant separate treatment under a national competition policy.

B. COMPETITIVE NEUTRALITY UNDER A NATIONAL POLICY

This Section proposes a set of principles to address competitive neutrality concerns where government businesses compete with other firms. It proposes a cooperative model whereby governments agree to the proposed principles but are individually responsible for their implementation. It proposes that an independent and expert body be

---

28 For example, the Inquiry received submissions claiming the Medicare system distorted competition between non-medical practitioners and medical practitioners who provided similar services: see Hospital Scientists Branch of the NSW Public Service Assn (Sub 19); Assn of Hospital Pharmacists of Vic, Medical Scientists Assn of Vic and Vic Psychologists Assn (Sub 26). Other submissions claimed that legislation discriminated against chiropractors (Chiropractors' Assn of Australia : Sub 137); non-uniform taxation arrangements applying to onshore and offshore gas fields distorted competition in the gas market: (BHP : Sub 133); and government policy discriminated between quality management training organisations: (Australian Organisation for Quality : Sub 135).

29 For example, the Inst of Chartered Accountants/ Aust Socy of CPAs (Sub 99) argued that their members are disadvantaged in the provision of tax advisory services relative to lawyers as only lawyers can offer clients the benefits of legal professional privilege.

30 For example, it has been claimed that the Government's policy on rebates for diesel excise but not other fuels distorts competition between crop dusters whose aircraft use different fuels: see Superair (Sub 124).

31 Such an examination could assess each distortion in context to determine whether the alleged discrimination was justified on considered policy grounds.

tasked with assisting governments on the implementation and further elaboration of the principles, and that a mechanism be established to facilitate prompt examination of allegations of non-compliance with these principles.

1. Policy Principles

The Committee's review of competitive neutrality issues supports the establishment of a set of principles to guide policy in this area. The Committee recognises that the issues in this area can be complex and that the proposed principles may need to be refined and developed in the light of practical experience. However, the principles should provide at least a starting point for progressing more concerted reform efforts.

I *Government businesses should not enjoy any net competitive advantage by virtue of their ownership when competing with other businesses.*

This principle reflects the competition policy concern that firms should compete on the basis of their relative intrinsic efficiencies, without any net competitive advantages arising through government ownership. Net competitive advantages of these kinds reduce economic efficiency and community welfare, have the potential to impede the development of efficient national markets and can also give rise to legitimate equity concerns. This and other principles should apply when government businesses are competing with private firms and/or with government businesses from other jurisdictions.

II *Government businesses competing against other firms within their traditional markets should be subject to measures that effectively neutralise any net competitive advantage flowing from their ownership. Unless exceptional circumstances exist, those advantages should be neutralised within one year of the introduction of competition:*

(a) where the government business has traditionally provided services directly to the public, there should be a presumption that this be achieved through corporatisation; and

(b) where the government business has traditionally provided services only to other government entities, this may be achieved through corporatisation or the application of effective pricing directions.

The effective implementation of pro-competitive reforms, such as opening former monopoly markets up to competition, requires competitive neutrality considerations to be addressed. However, where a government agency is subject to competition in its former market, and does not expand its operations into other markets, there may be some tolerance for a transition towards full competitive neutrality. Any transition period should be limited to ensure that the full efficiency and other benefits of a competitive market are realised.

Corporatisation is the most effective means of resolving competitive neutrality issues and is the preferred solution. When the government business has traditionally provided commercial services direct to the public — as is the case with public utilities — there should be a strong preference for corporatisation.[32] Where the government business primarily serves other entities within government, corporatisation may not always be practicable or appropriate, and there should be greater tolerance for the application of effective pricing directions.

III *Government businesses should not compete against other businesses outside their traditional markets without being subject to measures that effectively neutralise any net competitive advantage flowing from their ownership. No transition period should be permitted in this setting:*

(a) where the government business has traditionally provided services directly to the public, there should be a presumption that this be achieved through corporatisation; and

32 The IC has recommended corporatisation of, inter alia, electricity, gas and rail authorities; see IC, *Energy Generation & Distribution* (1991) and *Rail Transport* (1991). The Victorian Government has recently announced the corporatisation of its electricity supply sector: Office of the Treasurer of Vic, "Major Restructuring of Electricity Industry Commences" (News Release, 10 August 1993).

(b) where the government business has traditionally provided services only to other government agencies, this may be achieved through corporatisation or the application of effective pricing directions.

This principle is similar to Principle II, except that it applies to government businesses which compete outside their traditional markets and proposes that no transitional period be permitted before measures are applied to neutralise any net competitive advantage. Put simply, such businesses should not be permitted to wander outside their traditional domain without ensuring that they do not undermine or distort competition in those markets.

2. Implementing a National Policy

The Committee considered two issues relating to the implementation of the above principles: the role of legal rules versus more cooperative approaches; and the possible roles for institutional support.

(a) Legal Rules versus Cooperative Approaches

The Committee considered a range of possibilities in this area, including the development of a national law that prohibited government agencies from competing against private firms unless they met requirements based on the above principles. The Committee ultimately favoured a more cooperative approach, however, reflecting considerations of comity in a federal system as well as concerns that the threat of legal sanctions might deter desirable pro-competitive reforms.

The Committee proposes that governments consider the adoption of a set of principles on competitive neutrality along the lines of those set out above. More detailed requirements may need to be developed over time, particularly where competitive neutrality concerns have a significant and particularly interstate or national impact.

(b) Proposed Institutional Support

The Committee considers that, to be effective, a cooperative approach of this kind needs to be supported by appropriate institutional arrangements.

The Committee considers that an independent and expert advisory body — the proposed National Competition Council (NCC) — should be tasked with assisting governments in the implementation, elaboration and refinement of the principles. In particular, it could be tasked with assisting governments to develop an agreed definition of core concepts such as "fully corporatised" as well as appropriate pricing directions.

The Committee also considers that implementation of the agreed principles would be strengthened by establishing a mechanism for receiving and evaluating allegations of non-compliance with the agreed principles. The national competition authority — the Australian Competition Commission — should be tasked with reporting to the NCC and the owning government on any allegations of non-compliance with the agreed principles. The role would be more one of reacting to complaints than pro-active enforcement.

C. RECOMMENDATIONS

The Committee recommends that:

13.1 A mechanism to deal with competitive neutrality as between government businesses and other businesses form part of a national competition policy.

13.2 All Australian Governments agree to abide by the following principles:

I *Government businesses should not enjoy any net competitive advantage by virtue of their ownership when competing with other businesses.*

II *Government businesses competing against other firms within their traditional markets should be subject to measures that effectively neutralise any net competitive advantage flowing from their ownership. Unless exceptional circumstances exist, those advantages should be neutralised within one year of the introduction of competition:*

(a) *where the government business has traditionally provided services directly to the public, there should be a presumption that this be achieved through corporatisation; and*

(b) *where the government business has traditionally provided services only to other government entities, this may be achieved through corporatisation or the application of effective pricing directions.*

III *Government businesses should not compete against other businesses outside their traditional markets without being subject to measures that effectively neutralise any net competitive advantage flowing from their ownership. No transition period should be permitted in this setting:*

(a) *where the government business has traditionally provided services directly to the public, there should be a presumption that this be achieved through corporatisation; and*

(b) *where the government business has traditionally provided services only to other government agencies, this may be achieved through corporatisation or the application of effective pricing directions.*

13.3 An independent, nationally-focussed body — the proposed National Competition Council — be charged with assisting Governments develop and further refine these principles.

13.4 The national competition authority — the Australian Competition Commission — be required to report allegations of non-compliance with the agreed principles to the owning government and the National Competition Council.