Australian
Competition &
Consumer
Commission

Australian Competition and Consumer Commission

Submission to the Productivity Commission Review of National Competition Policy Arrangements

13 July 2004

CONTENTS

Abbreviations

ACA	Australian Communications Authority
ACCC	Australian Competition and Consumer Commission
AGL	Australian Gas Light
ACG	Allens Consulting Group
AMS	Australian Maritime Services
ARG	Australian Rail Group
ARTC	Australian Rail Track Corporation Limited
CAPM	Capital asset pricing model
CCA	Conduct Code Agreement
CoAG	Council of Australian Governments
Court	Federal Court
CPA	Competition Principles Agreement
CR4	Four firm concentration ratio
EMS	*Emerging market structures in the communications sector report prepared by the ACCC*
FA	Freight Australia
FRC	Full retail contestability
FTA	Free to air
FTTH	Fibre-to-the-home
Gas Code	*National Third Party Access Code for Natural Gas Pipeline Systems*
GDP	Gross Domestic Product
GTK	Gross tonne kilometre
HFC	Hybrid fibre coaxial
HSAC	Health Services Advisory Committee
MCE	Ministerial Council on Energy
MFP	Multifactor productivity
MWh	MegaWatt hour
NCC	National Competition Council
NCP	National Competition Policy
NEC	National Electricity Code
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NGMC	National Grid Management Company
NRTC	National Road Transport Commission
NTC	National Transport Commission
NWI	National Water Initiative
OECD	Organisation of Economic Cooperation and Development
Part IIIA	Part IIIA (Access to Services) of the *Trade Practices Act 1974*
PN	Pacific National
SCT	Specialised Container Transport
TFP	Total factor productivity
TPA	*Trade Practices Act 1974* (Cth)
TUOS	Transmission use of system charge
VoIP	Voice over Internet Protocol

Executive Summary

In 1995, all Australian governments committed to a comprehensive and ambitious microeconomic reform agenda to improve Australia's economic performance. While there have been transition costs, the benefits to the Australian economy are substantial.

National Competition Policy (NCP) and related reforms have coincided with a prolonged and sustained period of economic and productivity growth, combined with rising living standards. While a causal link is inherently difficult to establish, the ACCC believes that NCP and related reforms have contributed to this impressive performance.[1]

The heart of NCP was protecting and facilitating competition across the economy. This was pursued by making the *Trade Practices Act* (TPA) the economy wide competition law and creating the ACCC as the central body to administer that law. The TPA operates to constrain anti-competitive conduct and allow market forces to operate to improve efficiency and economic performance. It also provides a consistent and transparent mechanism for authorising anti-competitive conduct when it is in the public interest.

Competition law, however, is generally ineffective in establishing competitive markets. To address this issue, the NCP reforms included structural and legislative reforms to promote competition in markets were it was limited. In markets where competition was not feasible or desirable, access regulation was introduced. The ACCC also administers the general access law and access regimes in the gas, electricity and telecommunications industries.

After a decade of reform, the ACCC believes that it is now time to reinvigorate and refine the current competition framework. This submission outlines the ACCC's experience in relation to:

- some of the outcomes of NCP reform
- areas where reforms are incomplete or yet to be applied
- areas where a policy response may be required to achieve further benefits.

The following are the specific areas where the ACCC believes that further reforms could be adopted.

Trade Practices Issues

The ACCC believes that extending the operation of the TPA to all sectors of the economy and removing legislative barriers to its operation have created a transparent and consistent framework to prevent anti-competitive conduct or to authorise such conduct provided it is in the public interest. This has been achieved by removing shield

[1] See OECD, 2003, *Policy Brief: Economic Survey of Australia*, p. 5

of the Crown provisions and applying the TPA to unincorporated associations. This has promoted pro-competitive conduct across the economy.

The operation of the TPA could be further broadened by considering removal of the ability of governments to create exemptions from the TPA via the procedure contained in s.51(1) of the TPA.

A pending High Court decision on the scope of the shield of the Crown should be monitored and a legislative response provided if anti-competitive practices, engaged in by either Crown entities or private firms dealing with Crown entities, are protected under current law.

Communications

The telecommunications sector has been subject to gradual deregulation since the late 1980s, with full liberalisation established in 1997. Reform of the telecommunications industry has opened contestable elements of the industry to competition and subjected non-contestable elements to access regulation to facilitate competition in related sectors.

There has been substantial new investment in the sector with new competitors, technologies and modes of service delivery. There has also been a general downward trend in the prices of most call services.

However, the telecommunications sector remains substantially horizontally and vertically integrated. The ACCC believes that consideration should be given to the costs and benefits of structural reform to the telecommunications industry. Further, regulatory impediments currently restrict competition within the broadcasting sector. The TPA, however, is not an effective mechanism for addressing structural or legislative restrictions upon competition and a policy response may be warranted.

Energy

During the 1990s, similar reforms were introduced into both the gas and electricity industries. These reforms dismantled state based public monopolies, separated contestable and non-contestable elements of vertically integrated businesses and removed impediments to interstate trade. In the case of electricity, a National Energy Market was created.

These reforms introduced competition into the contestable elements of both industries and have resulted in significant economic benefits. However, their natural monopoly elements remain and continue to require access regulation to ensure that efficient outcomes are achieved. Within the electricity industry, structural reforms, particularly in generation, may assist in the further development of a competitive national electricity market. Recent moves in the industry towards re-aggregation have heightened structural concerns and it is believed require a policy response from governments in order to be effectively addressed.

Transport

A combination of NCP and other competition based reforms have improved the competitiveness of sectors of the transport industry.

Within the rail industry, access regimes and the formation of the National Rail Corporation have improved access and enhanced above rail competition. The establishment of the Australian Rail Track Corporation by the Commonwealth and jurisdictions has enabled the emergence of a common interstate track operator.

Reforms to the road sector, implemented by the National Road Transport Commission and its successor the National Transport Commission, have increased the consistency of regulations and standards between states. Within the aviation industry, regulatory impediments to competition have been removed.

Transport reforms have lacked an integrated and national focus.

The ACCC believes that increasing the consistency of access regimes and pricing principles within, and between, the road and rail sector could enhance the competitiveness and allocative efficiency of the transport sector as a whole. Further, bottlenecks should be monitored to ensure they do not impede competition within modes of transport or the switching of freight between modes of transport. In particular, the ACCC is concerned that increasing vertical integration within the transport sector may impede competition.

Chapter 1 Introduction

> In many respects the [competition policy] package is simply a statement of common sense. It is not a radical notion that businesses should not be permitted to engage in anti-competitive conduct. It is not a radical notion that consumers generally benefit from greater competition, and that where possible, greater competition should be encouraged. It is not a radical notion that in reviewing legislation or market structures, due consideration should be given to opportunities to enhance efficiency through competition. But the great step forward made by this package is that it sets out these statements of common sense for all to see; it creates new institutions better able to encourage businesses and governments to act in accordance with these statements of common sense; and the resulting principles will be applied to all Australian businesses regardless of ownership or legal form.[2]

1.1 National Competition Policy reforms

Despite microeconomic and macroeconomic reforms in the 1980s, concerns remained about Australia's poor economic performance compared with other developed countries. In response, Australian governments agreed to examine a national approach to microeconomic reform in order to increase the economy's performance. [3] As a result, the Independent Committee of Inquiry into National Competition Policy, chaired by Professor Fred Hilmer, was commissioned in 1992.

Following the release of its report in 1993 and consideration by the Council of Australian Governments (CoAG) in 1994[4] and 1995[5] it was agreed that a NCP would be introduced for Australia. In 1995, Australian governments agreed to the NCP reform package with the objective of increasing the competitiveness and growth prospects of the economy. [6]

The NCP reforms comprised three components:

- Competition Policy Reform Act to amend the TPA and state and territory competition legislation
- Conduct Code Agreement (CCA)
- Competition Principles Agreement (CPA)

The CCA and the amendments to the TPA and the CCA established an economy-wide competition law and also refined the processes to exempt anti-competitive conduct

---

2 Commonwealth of Australia, 1995, *Second Reading of the Competition Policy Reform Act 1995*

3 Council of Australian Governments', *Communique*, 8 - 9 June 1993

4 Council of Australian Governments', *Communique*, 25 February 1994; Council of Australian Governments', *Communique*, 19 August 1994

5 Council of Australian Governments', *Communique*, 11 April 1995

6 Council of Australian Governments', *Communique*, 11 April 1995

from the TPA provided it was in the public interest. The ACCC was established as a single agency responsible for administering the TPA by merging the Trade Practices Commission and the Prices Surveillance Authority.

The TPA is the economy-wide law designed to prevent conduct that would have the effect of lessening competition in competitive markets. However, it was and still is recognised that the TPA was not intended to be used for the purpose of creating or developing competitive markets, or enhancing competition where barriers to entry are substantial.

In recognition of this, instruments other than the TPA were used to remove legislative barriers and restrictions on competition. The authorisation provisions provide an economy-wide instrument for granting an exemption from the TPA provided there is a net public benefit in such an exemption.

The CPA sought to remove legislated restrictions to competition and reform publicly owned enterprises through a comprehensive program of reform to remove distortions that prevented the efficient operation of key sectors of the economy. As part of the CPA, Australian governments committed to:

- structural reform of public monopolies, separating contestable and non contestable segments of vertically integrated businesses
- implementing a national access regime to enable access to nationally significant and non-contestable infrastructure
- prices oversight of government enterprises
- reviewing and where appropriate reforming legislation that restricted competition
- introducing competitive neutrality so privately owned businesses could compete with those owned by government on an equal footing.

The CPA also led to the establishment the National Competition Council (NCC).

The CoAG *Agreement to Implement the National Competition Policy and Related Reforms*, which was part of NCP, required governments to implement industry specific reforms in the electricity, gas, water and road transport sectors. Reforms in these sectors were driven by CoAG agreements, not the TPA, which reflects the generally held views that the TPA is not the appropriate instrument for market creation, structural reform or increasing competition within an industry.

In addition to NCP reforms, other competition-based initiatives have been implemented in the communications, postal, sea and air transport sectors of the economy. These were introduced with the intent of increasing the contestability of markets, restraining market power, and delivering more competitive outcomes where appropriate. These reforms have complemented the NCP measures.

1.2 Reform outcomes

NCP and other competition-based reforms have contributed to the impressive performance of the Australian economy over the past decade.[7] Sustained rates of economic growth and strong productivity gains are part of the dividend from an ambitious and comprehensive reform program. These reforms have changed the fundamental structure and incentives that underpin the operation of the economy and the community, producing a more resilient and competitive society. These outcomes were achieved through economy-wide and sector specific reforms.

Economy-wide reforms

Amongst the NCP reforms was the removal of legal impediments that prevented the application of Part IV (restrictive trade practices) of the TPA to economic activity conducted by unincorporated entities. These reforms have been combined with an extensive communications strategy which has been successful in changing the behaviour of firms (and consumers) through facilitating a culture of compliance with the TPA. Extending the scope of Part IV of the TPA has enabled a uniform and consistent application of the TPA across the economy.

Other changes extended competition laws to state and territory government business enterprises, by limiting shield of the Crown protection that previously exempted these entities from the TPA. The CCA reforms have meant that many entities previously outside the scope of the TPA were now subject to that law and can be held accountable for anti-competitive activities. This now ensures that a significant portion of economic activity is within the scope of the TPA and allows the law to be applied to public and private businesses.

Competitive neutrality was introduced to remove any net benefit that government ownership provided to its businesses. This measure removed distortions that gave public entities or departments an advantage against their privately owned competitors and has facilitated a fairer competitive environment for private firms. Changes to NCP arrangements reduced the burden of the original objective of competitive neutrality. It may be that further competitive benefits could be achieved by extending the scope of competitive neutrality principles and this could be an area for further consideration.

As part of the CPA, governments agreed to conduct legislation reviews to remove anti-competitive provisions of laws that could not be justified in the public interest and that could not be achieved other than by restricting competition. This measure has increased competitive pressures in a wide range of markets by removing barriers to entry through applying a cost benefit assessment to anti-competitive elements of legislation. Legislation-review should continue.

The TPA authorisation process is an effective means of balancing the protection of competition and achieving other goals compared with the process of legislative restrictions and s.51(1) exemptions. Compared with alternatives, the authorisation

---

[7] Organisation of Economic Cooperation and Development,,2003, *Policy Brief: Economic Survey of Australia 2003*, p.8

process is a more transparent and accountable instrument for granting exemptions where there is a net public benefit. Unlike other means of exempting anti-competitive conduct, it is available economy-wide and enables a uniform and consistent approach to exempting conduct from the TPA provided it is in the public interest.

Sector-specific reforms

In addition to economy-wide reforms, sector specific programs were introduced across a wide range of markets to assist them make the transition from monopolies to more competitive industries. The ACCC has assumed a key role in many of these newly created markets and based on its experience believes that these reforms have improved the structure, performance and efficiency of key sectors of the economy.

CoAG parties have been successful in meeting their reform targets and have restructured their public monopolies. Public monopolies were given a greater commercial focus through corporatisation and by removing the regulatory functions they once performed. These measures have been complemented by access to monopoly services and the introduction of competition to markets previously protected from competition.

1.3 Principles for further reform

The available evidence indicates that NCP and other competition based reforms, while not without transitional costs, have been a success. This review provides an important opportunity to reinvigorate and refine the competition policy program in response to changes that have taken place since the implementation of reforms a decade ago.

Extending the gains from reform is a new challenge requiring the support of the community for the preservation and application of competition principles to sectors of the economy where competitive pressures are weak and vested interests dominate. In considering options for further reform, the following principles are relevant.

Protecting competition

The NCP reforms recognised that the TPA was designed to protect the competitive process in functioning markets rather than be used as an instrument for structural reform. Developing and enhancing competition requires policy responses rather than application of the TPA.

Promoting competition

The TPA's roles is promoting competition where it is limited. In markets where competition is emerging, for technological or legislative reasons the competition will be of limited effectiveness. But where barriers remain regulation is needed. To that end, access legislation encourages more efficient use of scarce capital. Evidence available indicates that access frameworks have balanced the interests of infrastructure owners and third party users. It also acts as a signal to infrastructure developers to consider the interests of third parties which can assist developments in related markets.

Access to facilities that should not be duplicated economically is one mechanism that is used to promote competition in markets that are dependent upon access to natural monopoly services.

Regulatory certainty

Businesses should be confident that legislation will prevent moves to lessen competition and that legislative reform will also assist to develop competitive markets, where appropriate. In natural monopoly sectors of the economy, regulation that limits market power needs to provide service providers with revenues that cover efficient costs. In sectors where competition is weak, regulation has an important role in creating and developing markets.

Efficient pricing

Pricing principles and objectives should have the effect of promoting efficient resource allocation and outcomes within and between competing industries. Prices that closely reflect costs, promote efficiency and deserve greater consideration in the context of competition between different sectors of the economy, particularly in the transport industry.

Developing contestable markets

The development of national markets, by removing barriers to entry through coordinated and consistent regulatory frameworks, is an important element in facilitating the emergence of more competitive markets across the economy. This is crucial where the barriers to entry are legislative rather than industry-based.

The TPA provides an effective mechanism to balance competing interests and permits anti-competitive conduct where it is in the public interest. This is a transparent process that is better placed to allow exemptions from the conduct provisions of the TPA, compared with s.51(1) exemptions and legislative restrictions granted by governments.

Based upon the ACCC's experience, this submission examines progress made to date and explores options for further reform in greater detail.

Chapter 2 Trade practices issues

2.1 Introduction

The TPA is the economy-wide competition law administered by the ACCC which has applied to all firms in all sectors of the economy since 1996. Under legislation introduced as part of NCP, the application of Part IV of the TPA was extended to non-incorporated businesses. Additionally, the TPA has been extended to government businesses enterprises through partial removal of shield of the Crown. These reforms have enabled consistent and uniform application of the TPA across the economy and improved the scope of the TPA to prevent lessening of competition in key industries.

In addition to the application of the TPA being extended across the economy, the authorisation provisions of the TPA have continued to balance the protection of competition with other interests. The NCP reforms intended that the TPA would provide a single mechanism for granting restrictions on competition provided there was net public benefit from such a restriction. The authorisation provisions have worked effectively in achieving this balance, while further reforms could be made to the s.51(1) framework for exempting certain conduct from competition.

These reforms have produced a significant change in behaviour in key sectors of the economy that were previously immune from the TPA. However, there continues to be some resistance from the application of the TPA on an economy-wide basis. The benefits achieved to date indicate that the reform process should continue.

2.2 Outcomes

The introduction of the economy-wide application of the TPA has been accompanied by extensive education and compliance activities to inform all sectors about the rights and obligations under the TPA. This was necessary to raise awareness about the TPA and deter potentially anti-competitive conduct through education rather than other means. While this education campaign has continued since the NCP reforms, it has been complemented by enforcement action by the ACCC, where appropriate, to encourage a broad change in the behaviour and encourage a culture of compliance across the economy.

An important part of creating a culture of compliance with the TPA is ongoing dialogue with key stakeholders. This dialogue is important, but more so where there are new and emerging industries, competition is weak or the impact of change is not understood. In recognition of this, the ACCC has produced publications for the following sectors:

- the e-business industry
- rural and regional communities
- the small business sector

- service industries
- industry associations

In addition, the ACCC has set up special consultative arrangements with particular sectors. For example, the Health Services Advisory Committee (HSAC) was created to promote consultation and exchange of information between the ACCC and health professionals on matters relevant to the effective administration of the TPA. HSAC has met four times since its establishment in September 2003 and has been an effective forum for constructive and open communication between the ACCC and the medical profession.

This strategy has worked to improve conduct and behaviour across the economy. The ACCC will continue to implement initiatives which are consistent with the objective of the TPA which is to:

> Enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection. [8]

Competition concerns

While there has been a significant change in behaviour as a result of the extension of the TPA, there remain areas of concern about some conduct. For example conduct that has come to the attention of the ACCC includes:

- *collusive agreements that include price fixing or exclusionary provisions*: Agreements of this type are per se breaches of the TPA and the ACCC has been, and will remain, active in pursuing such conduct.
- *codes of ethics and rules of associations*: The ACCC has investigated a number of professional associations. For example, an investigation of the NSW Bar Association in relation to restrictions on work to be performed by barristers, recently resulted in the issue of a joint press release regarding clients' rights of direct access.
- *entry restrictions imposed by private parties*: The ACCC has investigated a number of complaints alleging that groups of specialists at hospitals have prevented specialists (who may be competitors) from being credentialed at hospitals and/or have put pressure on hospital administrators not to credential particular specialists by threatening to boycott the hospitals if credentialing rights were granted. Similar issues have arisen where bar rules provide a system that is not transparent for the appointment of barristers as senior counsel.
- *recommended fee scales:* The ACCC has consistently taken a strong stance against 'recommended fee scales' which can be a means of fixing prices for services. Fee scales are usually implemented by the circulation of a list of recommended fees under the auspices of a professional association.

---

[8] s.2 TPA

The ACCC will continue investigating and applying the TPA in all areas of the economy.

The scope of the TPA

In addition to applying the TPA to new sectors of the economy, the NCP reforms broadened the application of the TPA to businesses owned by governments. Previously, where competition concerns existed, the ability of the Trade Practices Commission to deter and seek a remedy for such behaviour under the TPA was limited due to the operation of 'shield of the crown'. NCP reforms have extended the application of the TPA and improved the conduct of government businesses when operating in commercial environments.

Since the introduction of NCP reforms, several cases have been decided regarding the operation of the shield of the crown. In the most recent case regarding NT Power Generation Pty Ltd, the High Court has reserved its decision on whether the carrying on of a business and the TPA are to be interpreted as applying to all activities of a government agency which is carrying on a business or only to the specific activities of that agency which involve the carrying on of a business.

Aside from the application of Crown immunity to Crown entities, regard should also be had to the potential impact upon competition should a party engaged in business dealings with crown entities itself derive an immunity from the TPA by reason of its business dealings with the Crown entity.

The ACCC has argued that other than contracts protected by transitional provisions of the *Competition Policy Reform Act 1995*, any immunity from the TPA conferred in relation to Crown entities should not extend beyond that provided to the Crown where it is not carrying on a business and, in particular, should not extend to parties engaging in business dealings with Crown entities.

Other restrictions

The use of statutory marketing schemes in the rural sector has shielded, and continues to shield, some industries from the competitive process and exempts conduct from the TPA. While there maybe public benefits from statutory marketing schemes, the validity of these exemptions is best assessed through the authorisation provisions of the TPA which seeks to ensure that restrictions on competition provide a public benefit.

Businesses which have a statutory monopoly can raise competition concerns when they seek to extend their operations vertically or horizontally. In these circumstances, the issues of market power or competitive neutrality objectives can be raised but are difficult to substantiate.

Authorisation

Protection under the TPA can be provided by authorising anti-competitive conduct that is in the public interest. The TPA, and NCP reforms, recognise that restrictions on competition can sometimes be in the public interest, provided that there is a net public benefit. This authorisation process is conducted in an open and transparent manner to enable a full consideration of the relevant issues. This mechanism has been used by

several professional associations for certain activities they undertake to ensure they do not contravene the TPA.

Authorisations are an effective instrument for achieving a change of behaviour. For example, after granting authorisation to the Royal Australasian College of Surgeons in 2003, the ACCC has been working with health departments to develop its approach to assessing the training programs and processes for assessing overseas trained specialists of the other remaining specialist medical colleges.

At a meeting of the Australian Health Ministers Conference in April 2004, health ministers announced that 'a more streamlined and efficient process will be introduced by applying the requirements of the ACCC's determination for the Royal Australasian College of Surgeons to other medical specialist colleges'.

The public interest

The use of this economy-wide authorisation process is a more effective mechanism for allowing restrictions on the public interest compared to legislative restrictions on competition. It is therefore important that legislation review continue to reform those restrictions on competition that have been enacted by legislation. If retention of that restriction is desirable the authorisation provisions of the TPA provide a means for granting an exemption from Part IV of the TPA.

Under the TPA, s.51(1) provides for governments to exempt anti-competitive conduct from the competition law. Reliance on s.51(1) provides an avenue other than through the authorisation process to exempt behaviour from the TPA. A s.51(1) exemption is not conducted in as public and transparent a manner as the authorisation process and is not subject to review by an independent authority, such as the Australian Competition Tribunal.[9]

Exemptions to the TPA which may be made for the purposes of s.51(1) would reduce the scope for applying the TPA to activities for which an exemption from the TPA is not in the public interest. Consideration ought to be given as to whether the use of s.51(1) exemptions are appropriate or if the authorisation provisions of Part VII are more appropriate for exempting certain conduct that would otherwise breach the TPA.

In this instance issues relating to the effect of s.51 exempts are not referring to such matters as labour market arrangements, patents and consumer boycotts.

2.3 Avenues for further activity

The ACCC will continue to seek compliance and enforce the TPA in relation to all sectors of the economy. The ACCC administers the authorisation provisions of the TPA

---

[9] Under s.51(1C)(f), the commonwealth has the power under the TPA to prescribe conduct which has been specifically exempted by state and territory laws for the purposes of s.51. Where it does so, the exemption in subsection 51(1) of the TPA will not be available.

to balance competition and other social objectives, in a transparent and accountable manner.

Consideration should be given to the appropriateness of the s.51(1) exemption mechanism, given its potential to impede the uniform and consistent application of the TPA across the economy. This would require the cooperation of Australian governments and could be implemented through CoAG when it considers NCP issues during 2005. It is not intended that such a review should look at other elements of s.51 dealing with matters such as labour, patents, consumer boycotts.

Once the judgment of the High Court is handed down in the NT Power Generation case, consideration should be given to whether it represents an appropriate response to the issues raised by shield of the Crown and whether legislative reform is required to narrow any exemption from the TPA in accordance with the principles originally contemplated by Hilmer.

Chapter 3 Transport

3.1 Introduction

Reforms to the transport sector have been a combination of NCP and other competition based reforms that have improved the competitiveness of the transport sector. However, reforms have been implemented on an industry by industry basis and have lacked an integrated and national focus.

3.2 The integrated transport chain

An approach to reform that treats the transport sector as an integrated chain rather than a set of functionally discrete elements could further improve competitiveness and allocative efficiency. Such an approach requires:

- consistent regulatory and pricing structures between modes of transport
- effective mechanisms for ensuring that bottlenecks do not constrain competition within modes of transport or the switching of freight between modes of transport

The efficiency of the integrated transport chain could be improved through greater consistency between the pricing and regulatory frameworks of the road, rail, sea and air freight industries. For example:

- state based rail access regimes vary between states and the Australian Rail Track Corporation (ARTC)
- access to road and rail infrastructure is priced differently
- elements of the air and sea sectors lack effective competition and are potentially subject to inefficiencies arising from the exercise of market power

Further, the transport sector as a whole is becoming increasingly vertically integrated. Vertically integrated businesses that own bottleneck facilities (such as rail terminals or stevedoring facilities) may be able to restrict access or charge prices that favour their operations to the detriment of competitors that rely on those facilities. The implications of increased vertical integration for competition within the transport sector as a whole should be monitored.

Reforms that create greater consistency, or remove bottlenecks, within and between transport sectors may further improve the competitiveness of Australia's transport and logistics industry.

The ACCC's comments on the need for reform in the transport sector, reflect the ACCC's experiences in particular sectors and therefore do not give a comprehensive view of the need for reform in the transport sector of the economy.

3.3 Rail

Substantial structural reform to the rail industry occurred during the 1990s through a number of inter-governmental agreements and the establishment of the National Rail Corporation Limited. These reforms did not arise directly out of the NCP process. However, they occurred in accordance with the principles laid out in the CPA.

Outcomes

Reforms included:

- establishment of the National Rail Corporation Limited to manage all interstate rail freight
- vertical separation of rail ownership from above rail businesses of some government entities
- corporatisation and privatisation of some government entities
- co-regulation of safety across states and mutual recognition of accreditation
- improving uniformity of technical standards and operating practices
- implementing access regimes and ring fencing to cover various track networks.

In 1997, ARTC was established by agreement between the Commonwealth and states to manage the interstate rail network. The ARTC has submitted an access undertaking under Part IIIA that has been approved by the ACCC. Access regimes for the various intrastate rail networks have also been established under Part IIIA. To date, only the access regimes for the New South Wales intrastate network (certification of this regime expired at the end of 2000), the Tarcoola to Alice Springs line and the Alice Springs to Darwin line have been certified.

Vertical separation and an access regimes have facilitated above rail competition on ARTC's network.

Over the past five years, above rail competition (as well as intermodal competition) appears to have driven technical efficiency improvements in the haulage of interstate freight. Examples of productivity improvements are expanded train lengths and heavier axle loads. In 2002-03, train lengths increased by approximately 5-6 per cent on the east-west corridor. [10] This appears consistent with reports that intermodal efficiency (gross mass per train) improved by 30 per cent over the past five years, while average real access freight revenue yields have fallen by 20 per cent over. [11]

---

[10] Australian Rail Track Corporation, 2003, *Annual Report 2002-03*. Real average freight access revenue yields have declined from $0.38 per gross tonne kilometre (GTK) in 1996-96 to $0.295 per GTK in 2002/03.

[11] Australian Rail Track Corporation, 2003, *Annual Report 2002-03*.

Rail volumes have improved. Despite falling grain volumes gross tonne kilometres have grown, on aggregate, by 14 per cent over the past three years. [12] Moreover, volumes on the east-west corridor increased by 6.7 per cent in the March 2004 quarter on the same period in 2003 and almost 16 per cent on the March 2002 quarter.

Avenues for further reform

A number of access regimes currently exist across the interstate and various intrastate networks. These regimes are administered by different bodies under different principles. It may be possible to extend the gains of establishing the ARTC through a more coordinated approach to access across the various intrastate rail networks. This could involve establishing a uniform and national rail access framework for promoting competition in the rail sector. The emergence of a common set of operating standards could also improve the operation and effectiveness of the provision of rail access services.

The tracks from Kalgoorlie to Kwinana (Perth) and from the NSW/Queensland border through Acacia Ridge to Fisherman Island (Brisbane's freight terminal and port facilities) currently are not covered by the national rail access regime. [13] A single co-ordinated approach to access and train services along the entire interstate track between Brisbane and Perth could further increase the efficiency of the interstate rail network. It would improve co-ordination of investment, consistency of approach in operating conditions and lower transaction costs to operators.

3.4 Road

In the 1990s, Australian governments agreed to a number of reforms to address the diverse regulation and standards for road use across the nation. These reforms were contained in the *Heavy Vehicles Agreement* and the *Light Vehicles Agreement* made in 1991 and 1992 respectively. Observance of the intergovernmental agreements on road transport reforms was included in NCP assessments under the CPA.

Outcomes

The National Road Transport Commission (NRTC) developed the initial national road transport reform package that was endorsed by transport ministers. It included:

- heavy vehicle charges
- the transport by road of dangerous goods
- vehicle operations

---

[12] Australian Rail Track Corporation, 2003, *Annual Report 2002-03*.

[13] Currently, the interstate track between Kwinana (Perth's major rail terminal) and Kalgoorlie is owned and operated by WestNet Rail, and the interstate track between the Queensland/NSW border and Brisbane's port (Fisherman Island), via Brisbane's main freight terminal (Acacia Ridge), is owned and operated by QR.

- heavy vehicle registration
- driver licensing
- compliance and enforcement

Of particular significance, the NRTC has introduced heavy vehicle charges that are designed to recover a portion of the cost of providing and maintaining roads. The third heavy vehicle road pricing determination set by the NRTC's successor, the National Transport Commission (NTC), is designed to recover heavy vehicles' share of the annualised capital expenditure upon roads.

In its most recent assessment of competition reforms, the NCC stated nearly all of the road reforms were implemented.[14]

Avenues for further reform

Currently, heavy vehicle and train operators are charged for access to infrastructure under different pricing principles. Train operators pay for access to rail infrastructure under the various intra and interstate access regimes where charges are generally set by negotiation within a wide floor-ceiling band. ARTC pricing structure comprises floor-ceiling tariffs in addition to reference tariffs which are set under its access undertaking. Due to competition from other transport modes, rail access charges do not always recover the cost of providing the rail access services including the initial capital investment, capital expenditure and variable operating expenses. In general it is considered that most infrastructure managers' current access charges do not generate sufficient cost recovery for long-term financial viability.[15]

Heavy vehicle road charges are currently designed to recover only new road construction and maintenance costs. These are determined by allocating expenditure on different types of roads works between different classes of road users, in proportion to their use of the road system. Once each road user's share of costs is determined, a two part pricing system is applied. This comprises a variable charge on fuel consumption, as part of the diesel excise and a fixed annual registration charge. The NTC is at present exploring two alternative pricing options for heavy vehicle charges.

Neither mode of transport is priced to take into account the external costs that the users impose on other transport users and on the general community, including the costs of congestion, noise and accidents.

To the extent that access to infrastructure for different modes of transport is priced differently, one mode of transport may be unduly favoured over the other. As well as leading to a potential misallocation of resources, this may create congestion problems on the lower cost transport mode. Increasing the consistency between the two pricing

---

[14] NCC, August 2003, *Assessment of governments' progress in implementing the National Competition Policy and related reforms: 2003 - Volume one: Overview of the National Competition Policy and related reforms*, pp. 10.1-10.5

[15] Bureau of Transport and Resource Economics, *Rail Infrastructure Pricing: Principles and Practice Report 109*, p.v and p.98

regimes should foster competitive neutrality between modes of transport and improve the efficiency of Australia's logistics network.

3.5 Sea

The Productivity Commission has commenced a review of Part X of the TPA which governs international liner cargo shipping. This part of the TPA allows the international liner cargo shipping industry to have exemptions from engaging in restrictive trade practices outlawed in Part IV of the Act. Part X was last reviewed by the Productivity Commission in 1999. The current review will need to consider whether there is an economic rationale for giving a particular interest group special protection in the TPA from engaging in anti-competitive practices which no other industry has. The ACCC will make a submission to the review of Part X of the TPA.

3.6 Stevedoring

Competitive reforms to the stevedoring industry have occurred outside of NCP. The Commonwealth Government undertook a number of policy measures in 1996/97 directed at reform to the stevedoring industry. In January 1999, the ACCC was directed under the *Prices Surveillance Act* to monitor prices, costs and profits of container stevedoring operators located in the ports of Adelaide, Brisbane, Burnie, Fremantle, Melbourne and Sydney.

Outcomes

The industry has achieved productivity improvements. Productivity measures have demonstrated a consistent upward trend since 1998. By way of example, crane rates have increased from 18.7 uplifts per hour in 1998 to 27.5 in the June 2003 quarter. [16] Benefits to stevedores' customers have included faster turnaround times and falls in real prices.

The stevedores' unit revenues have declined by 18 per cent and unit costs by 22 per cent since 1995. [17] The ACCC's Stevedoring Monitoring Report No. 5 indicated that port volumes increased by 16 per cent during 2002-03. The stevedores' profits grew during 2002-03, predicated on larger unit margins (14 per cent larger) and revenue growth derived from 'non-core' activities. [18] On the basis of information provided by stevedores, average rates of return on assets increased from 19.3 per cent in 2001-02 to 25.6 per cent in the ACCC's latest monitoring report.

---

[16] Productivity or crane rates are available at the BTRE website at: http://www.btre.gov.au

[17] Australian Competition and Consumer Commission, 2003, *Container Stevedoring Monitoring Report No.5.*

[18] Non-core activities include charging shippers for storage costs, refrigeration costs and additional handling costs etc. The growth in non-core revenue has evolved as these services were tendered to shippers free of charge until recently.

The ACCC's 2003 monitoring report indicated that the stevedores' average per unit revenue is currently considerably above their unit costs. [19] Average unit costs have declined substantially since 1998. Further technical and dynamic efficiency benefits could further improve the stevedores' cost efficiency. For example, capital expenditure programs could improve cost efficiency through enhanced technology.

Avenues for further reform

The stevedoring industry is still in a state of transition as it continues to adjust to the effects of microeconomic reforms implemented in the mid 1990s. It may be too early to arrive at a conclusive judgement on whether further reform is required. For example, while margins in the industry have increased significantly, it is unclear whether they are excessive in relation to the costs associated with efficiency provision of stevedoring services. If barriers to entry are low, new firms are likely to start up stevedoring operations in response to the high profits and, ultimately, constrain prices.

However, the evidence on barriers to entry in stevedoring is mixed. Economies of scale may provide incumbents with competitive advantages relative to new entrants if the minimum efficient scale is large relative to the size of the market. Efficiencies may be available to a large operator in terms of management and coordination of workforce and equipment, which may not be available to small scale operators. Evidence on the costs of entry and exit tends to suggest that these do not represent a major entry deterrent.[20]

In Australia, entry may also be discouraged by no single port acting as a primary destination (as is often the case in other countries). Consequently, shipping trade is shared across several ports. A new entrant may have to offer stevedoring services in every port to compete with the incumbents' national services.

On balance, it is not clear whether economies of scope and scale act as a deterrent to entry into stevedoring. Further evidence is required on the strength of economies of scale and scope and the efficiency of current prices.

The ACCC has pointed, in previous monitoring reports, to the existence of other possible barriers to entry. In particular, the exclusive and long term nature of the lease arrangements between stevedores and port authorities can be a potential barrier to a new entrant. Moreover, decisions made by state Governments in fulfilling various regulatory and planning functions may influence the level and nature of barriers to entry.

Consideration the form and nature of these lease arrangements is required to determine whether further reform is required. Further investigations could assess whether the lease arrangements contain aspects that prevent economically efficient outcomes. For

---

[19] Australian Competition and Consumer Commission , 2003, *Container Stevedoring Monitoring Report No.5*.

[20] According to the Productivity Commission, the cost of a crane was about $10 million in 1997-98: Productivity Commission, 1998, *Work Arrangements in Container Stevedoring*, p. 140. It is understood that secondary markets exist for stevedoring cranes.

example, the typical term of a lease of twenty years may be too long. It is possible that leases with a shorter term could promote greater competition for the market. Additionally, the size of land under lease may discourage further entry, if current terminal configurations contain significant spare capacity.

An efficient market structure is more likely to be developed once regulatory barriers to entry are minimised.

3.7 Harbour towage

The major recent reform in the harbour towage industry has been the repeal of declaration of harbour towage services and the subsequent removal of the ACCC's prices surveillance powers, in September 2002. Consequently, harbour towage providers no longer have to notify the ACCC of proposed price increases.

Outcomes

The remoteness and relatively small throughput of Australian ports was previously considered to characterise harbour towage services as natural monopolies in the geographically distinct ports around Australia. [21] This has enabled one operator (Adsteam) to service most major container ports with little threat of entry. [22] Price notification was meant to restrain the market power of towage service providers and prevent pricing above efficient costs.

Following increases in charges announced by Adsteam in 2002, Australian Maritime Services entered the market. AMS provides services into the ports of Melbourne, Brisbane, Botany, and has indicated an intention to expand into other ports around Australia.[23]

Avenues for further reform

It may be too early to reach conclusion on the impact of the recent entry into the harbour towage industry in Australia. While this suggests that entry and exit costs are not excessive, it is too early to assess the long term implications. The industry has witnessed unsuccessful entry in the past and it remains to be seen whether the current entry is sustainable. A number of scenarios could conceivably unfold. Appropriate

---

[21] Australian Competition and Consumer Commission, 1995,, *Inquiry into the Harbour Towage Declaration*, p42. See also Stirling Harbour Services Pty Ltd v Bunbury Port Authority [2000] FCA 1381 (29 September 2000), para 14.

[22] The ACCC considered each geographically distinct port in Australia to be a distinct market and as such it was efficient to service the market with one operator. Source: ACCC, *Inquiry into the Harbour Towage Declaration*, December 1995, p42.

[23] This statement is made on the basis of *Hong Kong Salvage & Towage's* (the recent acquirer of 55 per cent of AMS equity) stated intention is to expand beyond Melbourne, Brisbane and Botany into other Australian ports within 12 months. Source: http://www.hktug.com/

policy responses should be considered in the light of evidence about the sustainability and efficiency of the new entry.

3.8 Airlines

Reforms in aviation have evolved outside the NCP reform process.

International reforms

In June 1999, the Commonwealth announced a range of measures aimed at liberalising air travel between Australia and the rest of the world. The Commonwealth has been actively encouraging the expansion of airline capacity within the framework of international bilateral aviation agreements with the objective of meeting demand for international air travel on routes to and from Australia.

International outcomes

Following a report by the Productivity Commission into international air services, [24] the Commonwealth implemented the following initiatives:

- negotiation of reciprocal "open skies" agreements with like minded countries where this was in the national interest[25]
- foreign international airlines would be offered unrestricted access to all of Australia's international airports except Sydney, Melbourne, Brisbane and Perth
- on aggregate, foreign persons (including foreign airlines who can individually acquire up to 25 per cent) would be allowed to acquire up to 49 per cent of the equity of an Australian international airline and up to 100 per cent of the equity in an Australian domestic airline, unless that was contrary to the national interest
- Australia would offer unrestricted access to all international airports for dedicated freighters.

These measures have sought to create and develop further contestability for and within the aviation industry through changes to legislation.

The expansion of foreign airlines into Australia appears to have been hastened by the bilateral Air Service Agreements the Commonwealth has negotiated with other countries. Flights on international routes to and from Australia have increased in frequency and capacity.

---

[24] Productivity Commission, 1998, *International Air Services: Inquiry Report*..

[25] New Zealand is the only country with which Australia has an unrestricted "open skies" policy.

Domestic reforms

Reforms to the domestic airlines industry occurred during the 1980s, prior to the NCP reforms. Following the *Independent Review of Economic Regulation of Domestic Aviation* (May Review) in 1985, the two airline policy that operated on trunk routes across Australia was removed in October 1990. Deregulation included removal of:

- controls over the importation of aircraft
- allocations of capacity between the two airlines
- the Independent Airfares Committee which set fares for scheduled passenger services
- constraints on the entry of new domestic operators onto trunk routes

Domestic outcomes

The Australian domestic market has undergone substantial change in the last few years. The entry of Virgin Blue and Impulse in 2000, with lower cost structure than the incumbents Qantas and Ansett, sparked a period of intense competition. Impulse ceased to operate in May 2001 and Ansett in March 2002. Although Qantas' share increased to almost 90 per cent following the failure of Ansett, vigorous growth from Virgin Blue has subsequently seen Qantas' market share fall to around 70 per cent. This intense activity appears to be a result of the reforms which have sought to further develop competition within the domestic aviation industry.

Airline prices have declined, especially for the price sensitive passengers. For instance, real best discount airfares (cheapest advertised) for domestic travel in April 2004 were 31 per cent lower than in September 1999.[26] The real domestic fare index dropped by 2 per cent from April 2003 to April 2004, whilst the real business index climbed by 2 per cent.

At least in the recent past, it has been the practice in some Australian States to grant exclusive access to individual airlines to operate on specific intrastate routes. The extent to which such routes are able to sustain more than one airline is understood to be a factor in granting exclusivity. It is also possible that airlines operating on such routes may receive payments from State Government as a form of community service obligation to ensure the sustainability of services. These exclusive access rights may need to be examined in the context of NCP.

Avenues for further reform

The degree of contestability since deregulation of the two airline policy has been variable. There have been a number of failures within the industry and Qantas has increased its market share to a substantial level. There is a need to monitor the underlying conditions for competition, including acquisitions of key assets and anti-competitive behaviour to ensure that the effective competition can be maintained to constrain the market power of Qantas.

---

[26] Bureau of Transport and Regional Economics, *Avline*, 4 May, 2004.

3.9 Airports

Prior to 30 June 2002, price regulation and special access arrangements accompanied the privatisation of various airports. In particular, the airports at Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth, Sydney and Townsville were subject to CPI-X pricing regimes.

Following the report in 2002 by the Productivity Commission on price regulation of airport services, the government has largely deregulated airports, replacing price caps with price monitoring. Likewise, the government accepted the Productivity Commission's recommendation to phase out the special access arrangements.

Aeronautical services for regional airline services at Sydney airport are the only airport services still subject to a price cap. The ACCC has a prices surveillance role for the provision of en route navigation, terminal navigation and terminal fire-fighting services provided by Airservices Australia.

Outcomes

The ACCC's Airports price monitoring and financial report 2002-03 shows that the prices airlines pay Australia's major airports for aeronautical services, such as use of runways and terminal facilities have increased sharply in the two years following the replacement of price caps with price monitoring.

Average charges for aeronautical services have increased at the major airports by between 40 per cent and 160 per cent over the past two years. Average airport costs also increased between 2000-01 and 2002-03. Greater security requirements at airports since September 11 have been a significant contributor to this rise in airport costs. However, the changes in unit costs and volumes were small in comparison to the price rises, resulting in significant increases in several measures of airport profitability. Aeronautical margins, as well as returns on assets, have risen.

Avenues for further reform

The outcomes of reforms to the regulation of airports are uncertain. The ACCC believes that the effectiveness of price monitoring is should be assessed in the scheduled review of airport regulatory arrangements.

Given the natural monopoly characteristics of the services provided by Airservices Australia, prices surveillance should be sustained in the medium term to prevent and deter uncompetitive pricing of these services.

Chapter 4 Communications

4.1 Introduction

Reform of the telecommunications industry has opened contestable elements of the industry to competition. However, some infrastructure elements continue to have natural monopoly characteristics and are subject to access regulation to facilitate competition in downstream markets. These reforms have substantially improved the competitiveness of Australia's telecommunication industry.

However, these measures have been unable to address competition concerns in the industry arising from its extensive vertical and horizontal integration. This cannot be addressed through instruments designed to prevent lessening of competition, such as the TPA. Consideration should be given to assessing the costs and benefits of further structural solutions to create a more competitive telecommunications sector.

Extensive legislative restrictions on competition, within and between different modes of communication, have suppressed competitive pressures within the industry. Further consideration of the costs and benefits of these restrictions is required.

4.2 Telecommunications outcomes

The telecommunications sector in Australia has been subject to gradual deregulation since the late-1980s. Significant changes were made in 1997 with the establishment of full competition and revisions to the regulatory framework. The ACCC's *Telecommunications Infrastructure in Australia 2002* report found that $3.4b was invested in telecommunications infrastructure in 2001-02.

There has been a general downward trend in the prices of most call services. The ACCC estimates that between 1997–98 and 2002–03 the price of an average basket of telecommunication services fell by 20.1 per cent in real terms.

The Emerging Markets Report

In 2003 the ACCC prepared a report *Emerging markets structures in the communications sector*[27] (the EMS report) which commented on competition in broadcasting and telecommunications industries. It was in response to a request by the Minister for Communications, Information Technology and the Arts, for advice on the extent to which emerging market structures are likely to affect competition across the communications sector.

---

[27] Australian Competition and Consumer Commission June 2003, *Emerging markets structures in the communications sector*, A report to Senator Alston the Minister for Communications, Information Technology and the Arts.

Competition in local access

The EMS report stated that, despite the gains achieved since the opening up of markets to full competition in 1997, several telecommunications markets are not yet effectively competitive. Rather, Telstra remains the dominant telecommunications supplier in almost every market. It is one of the most integrated communications companies in the world, continuing to be the major wholesale and retail supplier of telecommunications services in Australia.

While some infrastructure competition has emerged since deregulation, Telstra's local access network remains the dominant network in most metropolitan areas (excluding some of the CBDs of the major capital cities) and less densely populated geographic areas. Telstra's competitors have no alternative but to seek access to or interconnect with its local access network for supply of a range services. These services include basic access, local, national long-distance, international, fixed to mobile calls and ADSL services.

Optus, the second largest carrier, is in a better position than most of the smaller players in the market but it still relies heavily on access to Telstra's customer access network for national coverage. There are also supply relationships between Telstra and Optus for services such as data interconnection and local call resale. Even on Optus' own network, major inputs to a key service (premium subscription TV content for Optus' subscription TV service) are provided by Foxtel which Telstra owns 50 per cent .

Optus' roll-out of its hybrid fibre coaxial (HFC) network had the potential to offer a significant competitive threat to Telstra's dominance of the telephony market. However, Telstra's action in duplicating Optus' network was intended to, and was successful in, reducing the competitive impact of Optus' cable network. At June 2003, Optus' take-up rate for pay TV services was 10 per cent of households passed. Optus stated in its submission to the recent Senate inquiry into broadband competition that it does not anticipate expansion of its HFC broadband network.[28]

Local access technologies and product developments

A wide range of technologies can be used to provide local access to end-users, such as copper networks, HFC, fibre optic, fixed wireless and satellite. In particular, wireless services have the potential to be a mainstream alternative to fixed broadband services, and therefore represent a potential threat to the market power of Telstra. However, it appears unlikely that wireless or the alternative technologies will significantly diminish Telstra's near monopoly of copper local access in the foreseeable future. The timeframes for the mass deployment of these local access technologies, at this stage, appear uncertain and there are still associated commercial and technical issues that need to be resolved.

---

[28] Optus, October 2003, *Submission to Senate Environment Communications Information Technology and the Arts Committee Inquiry into Competition in Broadband Services*, p.16.

A key future likely development will be fibre-to-the-home (FTTH). However, its high capacity may actually accentuate the natural monopoly characteristics of the local access network.

Voice over Internet Protocol (VoIP) services are currently available to business customers and some carriers intend to make the service available to residential customers in the near future. VoIP can be provided at a lower cost than traditional telephony services. The market for data services is also more competitive than the market for telephony services and the increased use of this technology may lower market shares in downstream markets. However, the timeframe for mass take-up of VoIP is uncertain and this technology still requires reliance on Telstra's local access network for delivery.

Access regime

In conjunction with increased contestability in sectors of the telecommunications sector, access regulation has been used to address market power in integrated upstream facilities that are necessary for downstream competition. However, access frameworks alone have limitations in promoting effective competition in markets that use monopoly services if not supported by other measures.

The ACCC noted in the EMS report that access frameworks may not change the underlying incentives of a firm not to provide fair and non-discriminatory access to its inputs when the firm also competes in downstream markets that rely on those inputs. As a result, access regulation alone may not facilitate efficient outcomes.

Since 1997 various measures have been adopted to strengthen the access regime to improve its effectiveness and address the limitations identified above. Recently, this has included removing the possibility of merits review for ACCC arbitration determinations, publishing indicative prices for Telstra's copper access network services and the enhanced accounting separation of the wholesale and retail operations of Telstra.

These improvements to the access regime, however, do not alter the underlying incentives of a vertically integrated firm such as Telstra to delay access or discriminate in favour of its own downstream operations over access seekers in relation to price and non-price terms and conditions of access.

4.3 Avenues for further reform

A key issue with the current structure of the communications sector is the extent of Telstra's horizontal and vertical integration and the impact this has on competition within the communications sector. Competitive industry structures reduce the need for intrusive mechanisms and application of the TPA to induce competitive conduct within industries.

In addition to Telstra's horizontal and vertical integration, its full ownership of the main HFC pay TV distribution network and copper network, as well as its 50 per cent shareholding in Foxtel, raise competition concerns. Telstra's ownership of a HFC network:

- diminishes opportunities for competition by actual and potential network competitors

- means Telstra's copper and HFC networks do not compete with each other denying potential price and service benefits that competition could deliver to consumers

Telstra's partial ownership of Foxtel provides it with the incentive to:

- foreclose supply of pay TV channels by Foxtel to other networks competing with Telstra for the supply of telecommunications services

- prevent other pay TV businesses or channel providers from gaining access to Telstra's HFC network.

Telstra is in a unique position to significantly influence important inputs of supply for its potential and actual broadband network competitors and for pay TV operators competing against Foxtel on the Telstra HFC network. The corresponding market power provides Telstra with a means to dampen competition or foreclose entry by competing entities through discrimination in supply, vertical foreclosure of upstream inputs and gaming of access arrangements where these exist. A key issue is that Telstra's dominance in local access telecommunications markets and Foxtel's dominance in the pay TV market can act to reinforce each other.

In view of the current industry structure, further consideration should be given to the benefits and costs of Telstra being required to divest the HFC network in full and divest its 50 per cent shareholding in Foxtel. Divestiture of the HFC would introduce a new infrastructure competitor into the market, establishing conditions for increased rivalry and innovation in the supply of a full range of telecommunications services. If Telstra were divested of its Foxtel shareholding, both Telstra and Foxtel are likely to have improved incentives to supply their services to competitors and Telstra would have a diminished ability to use its market power to leverage into converged markets.

Reviewing industry structure

As part of the introduction of a more competitive telecommunications sector measures such as access regulation have been introduced to restrain those elements of market power within the industry. However, unlike reform measures in other industries vertical and horizontal structural separation of contestable and non-contestable elements of the telecommunications industry did not occur. As Hilmer commented:

> 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 support lesser reform to establish why this is in the longer term public interest. [29]

[29] Commonwealth of Australia 1993, *National Competition Policy: Report by the Independent Committee of Inquiry*, pp.221-222

Issues surrounding the possibility of structural reform in the telecommunications sector have not been subject to a comprehensive assessment. However, given the scope of vertical and horizontal integration within the telecommunications sector such an assessment is warranted. Any assessment would need to examine, among other things, the benefits of increased competition that would result from structural separation against the costs of lost economies of scope and implementation costs.

4.4 Broadcasting outcomes

The EMS report expressed concern about current broadcasting regulation, particularly regulations restricting further competition between the subscription and free to air (FTA) television sectors. It also commented more generally on the costs and benefits of current regulation.

As stated in the EMS report, the current broadcasting regulation appears unduly restrictive. These restrictions include: the current prohibition on multi-channelling by FTA broadcasters; restrictions on the use of broadcasting spectrum, particularly regulations relating to datacasting and the number of FTA licences; and the current anti-siphoning regime.

While acknowledging that restrictions on competition in the media sector have been implemented, in part, to achieve various social policy objectives, these may be inhibiting consumer choice, competition, growth and innovation in this sector. Additionally, in some cases, such as the datacasting licence restrictions, they have not achieved their social policy objective. [30]

4.5 Avenues for further reforms

The Government's current digital television reviews[31] provide an opportunity to assess issues in broadcasting, particularly the barriers to facilitating greater competition within the overall broadcasting sector. The barriers to creating and facilitating competition in the broadcasting industry require legislative reform to open the way for greater competition.

The various regulations applying to the pay TV and FTA sectors should not be considered in isolation but should be considered in the context of a comprehensive review. The Productivity Commission noted in its broadcasting review:

---

[30] Content restrictions imposed on datacasters have not achieved the policy outcome of encouraging the provision of innovative services that are different from traditional broadcasting services.

The ACCC notes that the auction for the spectrum that had been allocated for datacasting was cancelled in May 2001 as a result of lack of interest.

[31] The Government announced on 10 May 2004 that it was initiating reviews of digital television in Australia. These reviews are required under schedule 4 of the *Broadcasting Services Act 1992*.

> Participants have emphasised how broadcasting policy is a structure built by quid pro quos: barriers to entry are balanced against programming obligations; free to air networks are prohibited from multi-channelling to help subscription services which in turn are disadvantaged by restrictions on advertising and anti-siphoning rules; free to air networks are required to broadcast in high definition because they have been lent the spectrum to do so; and so on and on.[32]

For example, one key relationship between the various regulations is the relationship between datacasting licence restrictions and the moratorium on additional commercial FTA licences. The removal of restrictions on datacasting would allow datacasting licences to closely replicate the services provided by existing FTA broadcasters. Therefore, datacasting licence restrictions could not be fully considered without also addressing the issue of the moratorium on additional commercial FTA licences.

Removing regulation affecting FTA broadcasting and datacasting may also diminish the need for other regulation such as restrictions on cross-media ownership. Lower barriers to entry and fewer licence conditions offer greater opportunities for new entrants including foreign entrants. This is likely to result in greater diversity of services offered, which is the aim of many of the current regulations applying to the FTA industry.

Introducing competition between and within the pay TV and FTA sectors is important because these markets are relatively immune to competitive pressure from the threat of new entry, given the high barriers to entry to both sectors. This is particularly so in the FTA broadcasting sector where regulation rules out new entry. If competition between the pay TV and FTA sectors were allowed to develop, the competitive discipline on operators would be likely to increase. Creating more competition can be achieved through legislative reform.

Digital television

An important issue is the efficiency of spectrum use. The conversion from digital to analogue transmission will have the impact of freeing up substantial portions of the broadcasting spectrum. This has the potential to benefit consumers through newly freed up spectrum being used for the broadcasting of additional channels, interactive content, and higher definition audio and video. Furthermore, the conversion to digital may lead to the freeing up of spectrum which can be used for the provision of telecommunications services such as mobile and wireless services.[33]

If the only incentive for the conversion to digital is the threat of analogue switch-off, this threat needs to be credible. If the switch-off of analogue is not considered credible, other options need to be considered in providing incentives for both broadcasters and consumers to move to digital. The current restrictions applying to FTA and Pay TV broadcasting may function to reduce these incentives. Increasing the potential for competition in FTA broadcasting, as well as between the FTA and Pay TV sectors,

---

[32] Productivity Commission, *Broadcasting*, p. 254.

[33] The ACCC notes that this may require significant changes to the current allocation and use of spectrum.

through the removal of regulatory impediments will likely drive customer choice and innovation, and therefore likely promote the take-up of digital services.

4.6 Postal services

In the postal industry, recent reforms have sought to provide incentives for pro-competitive conduct by Australia Post as a vertically and horizontally integrated firm. These measures have sought to govern Australia Post's conduct through independently administered accounting separation arrangements and record keeping rules rather than structural separation of contestable and non-contestable business elements.

Australia Post maintains, with some exceptions, a statutory monopoly in the carriage of letters and the production of postage stamps. Its activities in this market are subject to price monitoring. There is scope for competition in other parts of the postal industry.

Postal outcomes

Australia Post has achieved significant productivity growth over the 1990s and to a lesser extent since 2000. This is demonstrated by a Meyrick & Associates report commissioned by the ACCC during its 2002 assessment of Australia Post's price notification. This report shows productivity increased by 3.5 per cent per annum during the 1990s[34] but flattened out during the period from 2000 to 2002. The overall productivity growth rates compare favourably with productivity outcomes measured in the US and UK postal industries over similar time periods.[35]

The price of the standard letter has increased in nominal terms by approximately 11 per cent or five cents (from $0.45 to $0.50) since 1992. In real terms, there appears to have been a substantial reduction in the price of Australia Post's reserved services, reflecting its ability to make efficiency improvements across much of its mail business. It is possible that the benefits of efficiency gains would have been greater, or would have been shared with consumers in the form of lower nominal prices, had Australia Post been subject to greater competitive pressure.

Avenues for further reform

Australia Post has recently expanded its operations into new competitive businesses, such as integrated logistics services while legislation has maintained its reserved (monopoly) domestic mail business. The new record keeping rule regime should facilitate the assessment of potential cross-subsidisation between monopoly and competitive parts of Australia Post's business, and deter potentially anti-competitive behaviour.

---

[34] Meyrick & Associates, August 2002, *Australia Post – Past & Forecast Productivity Growth,* prepared for the ACCC as part of its assessment of Australia Post's price notification.

[35] Meyrick & Associates, August 2002, *Australia Post – Past & Forecast Productivity Growth,* prepared for the ACCC as part of its assessment of Australia Post's price notification,

The new accounting rules provide a means to deter potentially anti-competitive conduct in the industry. As these reforms to the postal industry have only recently been introduced, it is appropriate to consider whether these have been effective only after sufficient time has past to make such a determination.

Chapter 5 Energy

5.1 Introduction

Structural and legislative reforms to both the gas and electricity industries have substantially improved their competitiveness. However, both industries retain natural monopoly elements and access regimes were required to complement the structural reforms.

In the electricity industry, a national market has been created and the access regime has facilitated competition in the retail and generation markets. However, further structural reforms may improve their competitiveness. In the gas industry, access regulation has substantially improved the industry's competitiveness. Competition within the industry and related markets is only emerging and an effective access regime is still needed to promote competition in gas markets.

Historically, the gas and electricity industries were state-based and publicly owned. In the electricity industry each state was self-sufficient in terms of generation and there was little interconnection between states. In the gas industry, supply to demand centres was typically met by a single basin through state owned pipeline infrastructure. In both cases the infrastructure for transporting and retailing electricity and gas was vertically integrated.

During the 1990s, CoAG agreed to reforms for both industries aimed at improving their competitiveness and developing their respective national markets. Although reforms proceeded on a sectoral basis, CoAG agreed to similar reforms in both industries, including:

- placing utilities on a commercial footing through corporatisation
- vertically separating generation, transmission, distribution and retail businesses, and 'ring-fencing' these businesses from other activities
- allowing for customer choice of supplier through full retail contestability (FRC)
- implementing a system of third party access to transmission and distribution infrastructure on fair and reasonable terms
- removing restrictions upon interstate trade and, in the case of electricity, establishing the National Energy Market (NEM)

5.2 Electricity outcomes

The basis of the electricity reforms was a commitment to establish a fully competitive NEM. Specific reform commitments were set out in CoAG communiqués and included:

- implementing necessary structural changes to allow for the operation of a competitive NEM

- allowing customers to choose the supplier (including generators, retailers and traders) with which they will trade

- establishing an interstate transmission network and non-discriminatory access to the interconnected transmission and distribution network

- ensuring that there are no discriminatory legislative or regulatory barriers to entry for new participants in the generation or retail supply, and to interstate and/or intrastate trade

- implementing cost-reflective pricing for transmission services with greater scope for averaging for distribution network services, and transparency and interjurisdictional consistency of network pricing and access charges

- facilitating interjurisdictional merit-order dispatch of generation and the interstate sourcing of generation where it is cost-effective[36]

Reforms to the electricity sector have, to date, included the dismantling of state owned monopolies, the implementation of a system of third party access to natural monopoly network infrastructure and the establishment of a wholesale electricity trading market. FRC has largely been introduced in all NEM jurisdictions, except for Queensland.

Reforms during the 1990s have increased the productivity and performance of the electricity industry, resulting in substantial benefits for households, businesses, the industry and the economy.

Electricity prices have declined in real terms since the creation of the NEM. Both NSW and Victoria have experienced price reductions of around 50 per cent at the wholesale level, while Queensland has benefited from smaller reductions. Recently, wholesale prices have increased, reflecting the gradual take-up of excess generation capacity, and, in some instances, more commercially orientated bidding strategies by generators. Prices remain well below the levels seen before the reforms.

Investment in electricity transmission has been high over the past few years and substantial developments are either underway or planned. Over this decade transmission companies will spend around $3.7b on new regulated assets, adding some 40 per cent to the transmission asset base that existed prior to the reforms. Additionally around $1b in unregulated interconnectors are being developed or are completed. [37]

There has been substantial investment in base load and peaking generators. This is in part due to the pricing signals flowing from the NEM and the increase in the wholesale price cap from $5,000/MWh to $10,000/MWh. About 5200 MW of generating capacity has been added since the start of the NEM, which is around 15 per cent increase in

---

[36] National Competition Council, *'Assessment of government's progress in implementing the Competition Policy and related reforms: 2003- Volume one of the National Competition Policy and related reforms'* (August 2003), Chapter 7, page 7.2.

[37] It should be noted that Murraylink has been converted to regulated status and Directlink has applied to the ACCC for conversion.

installed capacity. Most of this has been in Queensland, with SA also experiencing a significant increase since the start of the NEM.

The ACCC engaged ACIL Tasman to model the impacts of access regulation on the Australian electricity and gas industries. It found that the net present value of increases to GDP from access regulation of the electricity and gas industries (net of avoidable costs) were between $2.2b and $11b between 1998-99 to 2012-13. ACIL Tasman expected around 90 per cent of the aggregate benefits to be attributable to electricity access regulation, due to the relative sizes of the industries. [38] The findings indicate that access regulation has resulted in significant benefits relative to the case where access regulation did not exist.

5.3 Avenues for further reform

Structural reforms have improved the competitiveness of the electricity industry and have encouraged the emergence of a national market. Complementary access arrangements have also been effective in constraining market power. However, the ACCC agrees with the Parer Review[39] findings that there are deficiencies with the current market and that a number of reforms could be pursued within the existing framework that could significantly improve the operation of the NEM.

Market Structure

The Parer Review found that insufficient generator competition has resulted in excessive generator market power and pool price volatility. It recommended further disaggregation of the NSW generators. It also considered that a range of other measures such as bidding rule changes could not address the lack of competition between generators. Exercise of market power by generators is recognised as a significant issue in other deregulated power systems around the world. [40]

The ACCC agrees with Parer's findings that there is a limited number of competing generators and therefore the potential for some generators to exercise market power remains high in some states at particular times. The most effective means of delivering a competitive and efficient energy market is through reform of the market's underlying structure. This could be achieved through increasing the number of competing generators, either through further disaggregation of generation assets or measures to encourage new entry. Structural reform would result in significant improvements in competition resulting in lower energy prices for consumers.

---

[38] A copy of ACIL Tasman's report titled '*Impacts of Access Regulation Gas and Electricity'* is attached to the ACCC's submission to the Productivity Commission's Draft Report: Review of the Gas Access Regime, 17 March 2004. (www.accc.gov.au).

[39] Council of Australian Governments Energy Market Review, 20 December 2002, Final Report: *Towards a truly national and efficient energy market*– also known as the Parer Review.

[40] See for example: *Horizontal Market Power in Restructured Electricity Markets*, March 2000, Office of Economic, Electricity and National Gas Analysis, US Department of Energy.

Moves towards re-integration

Moves within the electricity industry towards re-integration have heightened concerns about market structure issues and the development of a competitive national market. Recently the ACCC has received a number of applications for informal clearance of proposed acquisitions that would aggregate substantial generation, distribution and retail assets. Such integration would be a reversal of the reforms agreed to by CoAG which saw the disaggregation of utilities as the best means of promoting competition. Competition issues can be identified with three categories of mergers in the electricity industry.

Horizontal mergers – generation

The framework for considering electricity generation mergers is the same as that used for assessing other mergers under s.50 of the TPA. However, there are a number of unique characteristics associated with the electricity industry that must be taken into consideration when assessing electricity mergers:

- electricity cannot be economically stored, therefore supply must continuously equal demand for system stability
- demand is highly inelastic, especially in the short-term
- wholesale electricity is traded in the NEM pool, as well as in the forward contract 'market'. Outcomes in these two trading arenas are closely aligned
- electricity itself is homogenous, but is differentiated in the market place by the time of day/week/year and also the location that it is produced and consumed
- contract and pool prices, and the types of contracts traded, reflect this differentiation.

Accordingly, the capacity, location and type of generating plant held by the merging parties are critical to merger assessment.

In assessing mergers, the ACCC has historically used concentration measures, such as the Four Firm Concentration Ratio (CR4), to provide some guidance on the extent of market power. However, it has been argued that the usual safe haven thresholds for market concentration may be too high for electricity generation because of the nature of the product.[41] For example, the electricity industry expert, Steven Stoft, claims that demand inelasticity makes 'market power at least ten times worse in power markets than in most other markets'.[42] The UK electricity regulator, Office of Gas and Electricity Markets, has also noted that some generators with not more than 5 per cent of installed capacity may have market power.

---

[41] See for example Borenstein, S.; Bushnell, J.; and C. Knittel (1999) "Market Power in Electricity Markets: Beyond Concentration Measures," POWER Working Paper PWP-059, University of California Energy Institute.

[42] Stoft, S.,2002, *Power System Economics*, p.356.

While CR4 incorporates the likelihood of coordinated behaviour, it fails to take into consideration the:

- extreme inelasticity of demand in the electricity industry
- style of competition in the market
- extent of forward contracting and its impact on market power
- complication of interconnector constraints on market definition.

As a result, competition thresholds and rules derived from other industries may be misleading, as even small electricity generators can have substantial market power.

Aspects of the Federal Court's (the Court) decision in *Australian Gas Light Company v Australian Competition & Consumer Commission* (AGL v ACCC)[43] raise important competition and policy issues about the development and operation of the NEM. A significant result of the case is the defining of the market for electricity generation as being the whole of the NEM. This is broader than the state-based geographic market definition traditionally adopted by the ACCC. The Court did not find that markets for generation were state-based and thus appears to have given greater scope for generators to merge 'without gaining' market power.

Much of the reasoning behind the Court's decision was based on the premise that the interconnectors between regions rarely constrain and therefore power is able to flow between regions to defeat substantial price spikes. While the number of hours that interconnectors are constrained each year is relatively small, even the rare exercise of market power by generators can have a significant financial impact on the market. For example, an additional 5 hours of wholesale prices at their cap (or VoLL) in a year can be enough to raise the average wholesale price in a year by almost 19 percent.

Dialogue Box 1: Impact of generator market power on wholesale prices

No. of hours in a year = 8760
Assume average wholesale price is $30/MWh (this price is considered to be a conservative industry benchmark for electricity in the NEM)
Value of lost load (VoLL) = $10,000/MWh

Assuming an additional 5 hours of wholesale prices at VoLL for a year then the timeweighted cost of electricity is $312,650, (that is $30 * (8760-5) + $10,000 * 5).
Average wholesale prices for the year become $35.70/MWh ($312,650 / 8760 = $35.70) rather than $30/MWh. Therefore, an additional 5 hours of prices at VoLL results in a 19% increase in average yearly wholesale prices.

Note: Example is indicative only as it ignores contract prices and is not demand weighted.

[43] *Australian Gas Light Company v Australian Competition and Consumer Commission* (No 3) [2003] FCA 1525

The impact of interconnection needs to be taken into account but should not be examined in isolation and its ability to defeat price spikes should not be overstated. In Victoria roughly a quarter of total demand (around 2000MW) can be met by interconnection. The remainder must be met by generation capacity in Victoria and provides opportunities for exercise of market power in some instances. In addition, if there are coincident peaks in adjoining jurisdictions the amount of energy that is available for import into Victoria can be significantly reduced. The belief that interconnection, on its own, can prevent price spikes resulting from generator market power therefore appears misplaced.

Vertical integration – generation, retail and transmission

Generation-transmission and retail-transmission mergers can give rise to significant competition concerns.[44] When the owner of essential infrastructure also participates in a contestable market it typically has the ability and the economic incentive to restrict the level of competition in the contestable market in ways that are difficult to police and prevent. It has the ability to harm competition by restricting access to the essential facility by raising the price, lowering the quality and quantity of service provided or reducing the timeliness of the services it provides, relative to the services the integrated firm provides to its own affiliate. These problems are widely acknowledged.

For example, transmission is both a substitute and a complement for generation. An integrated transmission-generation company has the ability to restrict competition through its investment and maintenance decisions, its line rating decisions and through its negotiation and processing of connection agreements. Through its investment and maintenance decisions the integrated entity can influence the capacity/reliability of those parts of its network that allow other generators to compete with its own affiliated generators. At the same time it also has the capacity to influence the capacity/reliability of those parts of the network which allow its own generators to compete.

An integrated entity has the incentive to restrict the level of competition when the natural monopoly is tightly regulated but the competitive activity is not. In this instance, the owner of the natural monopoly has strong incentive to provide the competitive activity itself, restrict competition in this activity, thereby capturing some of the monopoly rents that it would otherwise lose to regulation. The US Federal Trade Commission has noted:[45]

> A monopolist whose rate of return is regulated has an incentive to evade the regulatory constraint in order to earn a higher profit. Its participation in an unregulated market may give it the means to do so, either by discriminating against its competitors in the unregulated market or by shifting costs between the regulated and unregulated markets.

---

[44] Organisation of Economic Cooperation and development, February 2002, *Policy brief: restructuring public utilities for competition.*

[45] Federal Trade Commission (1995), Comments of the Staff of the Bureau of Economics of the Federal Trade Commission, In the Matter of Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities; Proposed Rulemaking and Supplemental Notice of Proposed Rulemaking, Docket Nos. RM95-8-000 & RM94-7-001

> The discrimination strategy involves complementary products. The monopolist controls others' access to its regulated product in ways that permit it to earn supra competitive returns in its own operations involving the unregulated complement. Discrimination could appear as a subtle reduction in quality of service, whose effects would be more difficult to identify and measure than outright denial of access. An integrated trans mission monopolist might afford other generation sources access to its transmission services only on terms that raise others' costs and permit the monopolist to make supra competitive profits in the generation market.

Regulators can attempt to prevent an integrated entity from acting in such ways the firm has a number of tools at its disposal (including legal, technical and economic tools) that enable it to prevent, delay, lower the quantity and quality of service, or raise the price of access to its transmission customers. For these reasons the ACCC continues to be concerned about the potential anti-competitive effects of generation-transmission mergers and, in some cases, retail-transmission mergers where there is an existing generation interest.

Vertical reintegration – generation and retail

Re-integration can be used by retailers to mitigate the risks associated with generator market power by providing the retailer with a natural hedge against spot market volatility. However, ownership of a generator by a retailer may increase barriers to entry/expansion for stand-alone electricity retailers, through reduced scope for them to secure competitively priced hedging contracts. In the event that load closely matches output for the vertically integrated market participants, there is little surplus to be traded in contract markets. The evidence from New Zealand suggests that stand alone retailers could not obtain contracts from integrated players, as these firms kept contract cover to protect their own retail positions. Re-integration may also create pressures for other generators and retailers to merge.

In the UK, a market structure has developed over the past three years where there are now six major vertically integrated generator-retailers. Since this market structure has developed electricity prices have come down substantially from prices evident in the initial stages of the operation of the UK market. However, it should be noted that the UK reforms have combined vertical integration with horizontal disaggregation of generation and changed trading arrangements. As such, it is difficult to separate the impacts of vertical integration. The UK experience suggests that vertical integration may not have an adverse impact on electricity prices if the appropriate horizontal market structure is in place.

The ACCC considers that it is not clear that generation-retail mergers are necessarily undesirable and that they need to be considered on a case by case basis. It also believes that the best way to ensure that these types of mergers are not anti-competitive is to ensure that the generation and retail markets are competitive. If the generation sector were to be further disaggregated then vertical integration would not seem to raise the same concerns as the situation where generation was not effectively disaggregated.

Need for policy response

Reforms over the past decade have encouraged substantial new investment in generation and network businesses, and brought about significant price decreases for most users. The ACCC is of the view that the decision in AGL v ACCC will increase pressure on other market participants to enter similar re-aggregations to the substantial

detriment of competition in the NEM. The recent evidence, notably the proposed SPI PowerNet/TXU merger, would indicate that these concerns are not unfounded.

It is not clear following the Federal Court's decision how some of the Parer Report's key findings can be addressed. Parer expressed concern that the current market structure in the generation sector enables some generators to exercise market power, leading to price outcomes that are higher than would otherwise be the case. Parer noted that sustainably robust market structures were unlikely to emerge while ownership of generation remains concentrated, and recommended further disaggregation to provide more competition. Parer also suggested measures to prevent further re-integration in the industry. Specifically, Parer recommended that the ACCC's Merger Guidelines explicitly recognise the ability of generators to exercise market power.

The Court's decision suggests that Parer's recommendations are unlikely to be effective. The decision potentially allows for significant re-integration and highlights that regardless of any changes to the ACCC's Merger Guidelines it is still the court's decision which is determinative. For this reason, the ACCC is of the view that these highly complex issues could be more effectively addressed through a policy response by State Governments or the Ministerial Council on Energy. Various Governments are in the process of reviewing cross-ownership restrictions governing the electricity industry within their respective jurisdictions. Indeed, specific State legislation to guard against inappropriate re-integration of electricity supply assets appears to be one possible avenue to address these concerns in a constructive manner. Failure to do so could see the benefits that the reforms have achieved eroded over time.

Demand side participation

Without effective demand side participation large and potentially unnecessary investments in generation and network capacity will be required to meet peak demand. Currently most consumers are charged the same price whether they consume during peak or off-peak periods. Hence they have little or no incentive to reduce their demand at times when spot prices are high.

Once implemented, FRC should generate effective competition in retail markets and allow the removal of regulatory control over retail prices and enable significant gains to consumers in the long run by introducing both price and non-price competition. The impact of FRC can be enhanced by encouraging price signalling through such mechanisms as interval meters. Improved demand side responsiveness should in turn result in reduced need for supply side solutions. The implementation of FRC in line with planned timetables along with mechanisms to improve price signalling should occur.

Transmission pricing

Under the National Electricity Code (NEC), prices are determined by transmission companies by apportioning the revenue cap (set by the ACCC) to cover the costs of assets used to provide entry services, exit services, transmission use of system services (TUOS) and common services. Exit and entry costs are charged as a fixed annual amount related to the exit/entry cost at a particular connection point. Common service costs are allocated on a postage stamp basis across all connection points. In the case of

TUOS, 50 per cent of customer TUOS costs attributable to a particular connection point are recovered on a cost reflective basis (referred to as the TUOS usage charge) and 50 per cent on a postage stamp basis across all connection points (referred to as the TUOS general charge).

The current transmission pricing methodology has two main deficiencies. First, price signals are muted as only half the price is cost reflective with the remainder being averaged across all users. This results in poor locational signals for users of the network. To improve the locational signals to users, current pricing regime could be made more cost reflective. Second, under the current pricing regime generators do not pay TUOS charges and therefore do not receive any locational signals (generators only pay for their shallow connection costs). As such the current approach tends to favour distant coal fired plants over gas fired plants.

Network pricing has a key role to play in signalling efficient use of the network. In this context the two issues identified would significantly improve the efficiency with which the network is used by providing clearer locational signals.

5.4 Gas outcomes

The structural reforms to the gas industry are contained in in the 1994 and 1996 COAG agreements to encourage 'free and fair trade in gas', and the 1997 *Natural Gas Pipelines Access Agreement* (the 1997 Agreement). Together, these agreements are referred to as the national framework for free and fair trade in gas.

In its most recent assessment,[46] the NCC stated that CoAG's objectives for national free and fair trade in gas are now largely complete.

The successful implementation of the majority of the CoAG's objectives has substantially altered the structure of the gas industry. Gas transmission and distribution businesses have been corporatised and separated from each other, with the monopoly elements of private gas utility companies 'ring fenced' from their contestable elements.

The NCC discussed two areas were reforms were outstanding: certification of access regimes and FRC. Regarding certification, Queensland has not yet had its regime certified by the Commonwealth Minister. The NCC forwarded its recommendation to the Minister on 21 November 2002. However, the Minister is yet to make a determination.

Regarding FRC, the NCC noted that Queensland was yet to introduce contestability for users of less than 100 terajoules of gas per year. The NCC noted that Queensland had not yet received agreement from all jurisdictions to defer FRC.

---

[46] NCC, August 2003, *Assessment of governments' progress in implementing the National Competition Policy and related reforms: 2003 - Volume one: Overview of the National Competition Policy and related reforms,* pp. 8.1 – 8.32

Access regulation

The 1997 agreement discussed above included legislation to enact a uniform national access regime, the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Gas Code). This agreement was aimed at addressing the natural monopoly characteristics of the market that can not be addressed through structural reforms. Recently, the Productivity Commission Review of the Gas Access Regime was completed. In its submissions to the inquiry, the ACCC noted the substantial progress made in achieving the objectives set out in the Gas Code.[47]

5.5 Avenues for further reform

The reforms initiated by the national framework for free and fair trade in gas have delivered substantial economic benefits to Australia and are predicted to generate substantial benefits into the future.

The industry nonetheless remains immature and any scaling back of regulatory arrangements would put at risk the economic benefits of reform. The Gas Code, however, can be strengthened through refinement.

The ACCC in its submission to the Productivity Commission review of the Gas Code, proposed: [48]

- streamlining the process for the approval of access arrangements by limiting the ability of service providers to make amendments and removing the further final decision
- providing for an enforceable right to negotiate switching services provided by production facilities (which are more akin to a transportation service than a production service)
- clarifying the ability of a regulator to require an access arrangement to specify that expansions of pipeline capacity be covered
- improving the competitive tender process by allowing minor changes to submissions, explicitly allowing for the submission and ranking of conditional bids, and allowing a single process for tender of combined transmission and distribution pipelines
- providing for the approval of regulated interconnecters which are funded by users.

---

47 See Australian Competition and Consumer Commission, 15 September 2003, *Submission to Productivity Commission Review of the Gas Access Regime*, pp. 1-12 and ACCC, 17 March 2004, *Submission to the Productivity Commission Draft Report: Review of the Gas Access Regime*

48 See Australian Competition and Consumer Commission, 15 September 2003, *Submission to Productivity Commission Review of the Gas Access Regime*, p. 82-105 and ACCC, 17 March 2004, *Submission to the Productivity Commission Draft Report: Review of the Gas Access Regime*, p. 61

Chapter 6 Water Industry

Introduction

In 1994, CoAG agreed to a water resource policy and strategic framework for water reform in Australia, with the objective of developing an economically viable and ecologically sustainable water industry. The reform program was brought under NCP reforms as part of the CoAG *Agreement to Implement the National Competition Policy and Related Reforms* in 1995 with progress to be reviewed by the NCC.

Over the past decade, CoAG has developed and agreed to implement, by 2005, a range of reforms aimed at achieving a more efficient, flexible and sustainable water industry.[49] These measures include:

- changing the basis for pricing water services from property valuation systems to systems directly related to the volume of water used, to better manage the demand for water
- ensuring the prices charged for water and wastewater services cover the cost of providing those services; while also protecting against monopoly pricing by service providers
- converting water allocation arrangements that were imprecise, attached to land ownership and often over-allocated, to ensure systems of water entitlements are separate from land title
- facilitating water trading to allow water to be used where it is most valued
- requiring proposals for new investment in rural water infrastructure to undergo rigorous appraisal, to show that each project is economically viable and ecologically sustainable
- clearly defining the roles of water industry institutions so that the role of service provision and the roles of standards-setting and regulation do not overlap, to remove the potential for conflicts of interest
- ensuring that water and wastewater service providers have a commercial focus; that services are delivered as efficiently as possible; and that service providers seek to achieve international best practice
- undertaking public education and consultation on the need for and benefits of water reform, particularly where change and/or new initiatives are contemplated.[50]

---

[49] National Competition Council,2003, August, *Assessment of governments' progress in implementing the National Competition Policy and related reforms: 2003 - Volume three: Water Reform*, p.ix

The water reform program has sought to create markets through policy and legislative programs to establish competitive and efficient markets for water and water related services. This process has involved several initiatives such as creating appropriate prices, structural reform and introducing contestability in certain parts of the industry. These reforms mirror measures undertaken in other markets that were necessary to assist in the establishment of those markets.

Outcomes

Significant progress has been made and is being made towards the 1994 reform framework, with some of the benefits already being realised. For example, the experience of New South Wales with the introduction of two-part tariffs for regional urban water customers has been a reduction of about 20 per cent in total demand.[51] However, it is clear from the NCC's 2003 assessment that the current pace and breadth of reforms vary considerably across jurisdictions, and are not complete. Markets for the trading of water rights remain in a formative stage.

To date the ACCC has received relatively few complaints regarding conduct of participants operating in these emerging markets. The ACCC believes that the TPA can compliment policy and legislative initiatives for the development of water markets by restraining conduct that may impede the development of those markets. For example, the ACCC is currently investigating water trading arrangements in New South Wales. The ACCC has received a number of complaints about the restrictions imposed in relation to the trading of water out of certain irrigation districts. Such restrictions may constitute exclusive dealing in terms of section 47 of the TPA.

Avenues for further reform

In August 2003, CoAG reaffirmed its commitment to implementing the 1994 water reform program and agreed to develop a National Water Initiative (NWI) to build upon the existing initiatives. At its meeting on 25 June 2004, COAG agreed to and announced the details of the NWI. The NWI reaffirmed commitments under the 1994 COAG reform package, but extended the scope and detail of reforms. In particular, the initiative provide for:

- state and territory preparation of water plans, that include provision for environmental and other public benefit outcomes
- broadening the coverage of the existing arrangements to deal with over-allocated or stressed water systems

---

[50] Council of Australian Governments, *Communique – Attachment A Water Resource Policy*, 25 February 1994

[51] OECD Working Party No.2 on Competition and Regulation *Roundtable on Competition and Regulation in the Water Sector – Australia* February 2004

- allocation of tradable water entitlements, separate from land, as perpetual or open ended rights in accordance with water plans
- an allocation of costs to be borne for reductions in water access entitlements between users and governments
- measures to deal with interception of water flows reducing entitlements
- the introduction of public registers of water entitlements and trades and development of standards for water resource accounting
- provisions to facilitate and further reduce barriers to interstate trade
- more detailed pricing principles for water storage and delivery
- actions to improve demand management of water use in urban areas

The NCC will oversee the 2004 review of the implementation of the 1994 water policy reform package. However, a new National Water Commission is to be formed that will oversee the 2005 review and biennial assessment of progress of the NWI agreement beginning in 2006-07, with a comprehensive review planned for 2010-11.[52]

Elements of the NWI appear to be aimed at addressing market development issues particular to water. For example, water supply at one source may be dependent upon consumption at other sources (e.g. farm dams or capture of water flows may reduce water to users downstream). Further, water available to meet entitlements can vary with environmental or seasonal changes. Addressing these issues and providing mechanisms to facilitate trade (such as public registers of entitlements and clear definition of entitlements) should assist the further development of markets for the trade of water.

These are market development issues that are best dealt with by governments through policy and legislative initiatives. The TPA can complement these initiatives by ensuring that misuse of market power or unconscionable conduct does not impede market development. However, as the markets further emerge structural issues may emerge that cannot be adequately dealt with through the TPA and additional policy initiatives may be required.

---

[52] *Intergovernmental Agreement on a National Water Initiative*, Schedule C, 25 June 2004.