

**Submission to the Productivity Commission
Inquiry into the
Review of National Competition Policy (NCP) Reforms
By
Nor West Pearls Pty Ltd**

Our Requests

We ask the Commission:

1. to highlight the NCP process and policy failures by the Western Australian Government in dealing with anti-competitive hatchery shell quota restrictions under the Western Australian pearling legislation;
2. to highlight, in particular, the WA Government's failure to provide any substantive public justification for its decisions:
 - (a) on the 25 March 2002, to retain the existing hatchery shell quota restrictions; and
 - (b) on the 9 August 2004, to impose a 'moratorium' on the release of any additional hatchery quota, for the foreseeable future that is consistent with national competition policy obligations and principles;
3. to add the Commission's voice to the case for change in the absence of any independently validated net public benefits arising from these restrictions; and
4. to recommend that the Commonwealth use its Constitutional powers to deal with what is effectively an export control to bring about sound and sensible change in this matter.

Background

Hatchery shell options and quota have been in existence under the Western Australian Pearling legislation since the early 1990's. These shells are input into pearl hatchery operations, and, unlike shell captured from the wild, they are grown out in laboratory style conditions.

The capture of shell from the wild for use in pearl farms is also subject to quota controls. These controls are justified on resource sustainability grounds, and, unlike hatchery shell quota restrictions, are not in dispute under competition policy guidelines.

Rationale for Hatchery Shell Quota Restrictions

The control over hatchery shells as input into pearl hatchery operations under WA legislation is predicated on market power grounds. This has been an uncontested theory, held by the WA Government and among certain Australian pearl producers, that this indirect control over 'south sea' pearl production enables the WA export industry to exercise market power and extract monopoly returns that offer net benefits to industry and the State.

The Lack of Demonstrable Net Public Benefits

This theory has not been validated by independent analysis. The existence of material 'net public benefit' arising from the existing hatchery shell quota restrictions on competition has not been substantiated. This is the conclusion reached by the independent

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NCP review of the WA Pearling legislation carried out by the Canberra based Centre for International Economics four years ago¹.

The NCC, as the independent auditor of States' compliance with national competition policy obligations and principles, effectively supported the CIE finding. The NCC did so, after the Pearl Producers Association, the State Fisheries Department, and the WA Government had been given every opportunity (either directly or indirectly) through the bilateral consultation processes between the NCC and WA to clearly demonstrate, with a reasonable degree of probability, a 'net public benefit' arising from the hatchery quota restriction.

Indeed, the WA Government's stated reasons for rejecting the NCP review findings, at that time, were at one level vague and superficial, whilst at another (i.e. "the lack of clear benefits that might arise from deregulation") clearly inconsistent with competition policy principles (See enclosed 23 March 2002 Media Statement by the WA Fisheries Minister).

The NCC pointed out, at the time of the NCP review of the Pearling legislation, that, under agreed principles of competition policy, "it is not necessary to demonstrate that there would be a net public benefit from removing any identified restriction on competition. Rather those restrictions should be removed unless there are demonstrable net public benefits from retaining them."

The Federal Government concluded that the WA Government had not met its NCP obligations in relation to this restriction (and others) identified under WA fisheries legislation. As a consequence of this (and other) obligation breaches, the Commonwealth withheld competition payments to Western Australia.

The Overwhelming Case for Change

A Group of five small WA pearl hatchery operators advanced a well documented, and, in our view, cogently argued and soundly based case for easing the existing hatchery quota restrictions (see attached submission to non-industry members of the Pearling Industry Advisory Committee dated 31 May 2004).

As explained in our further correspondence to the National Competition Council in relation to this matter (see the attached 15 September 2004 letter), we embarked on this course of action, notwithstanding the lack of justification by the Pearl Producers Association, the Fisheries Department or the State Government of the 'net benefits' to the State of retaining the existing hatchery quota restrictions following the findings of the independent NCP Review of the WA Pearling legislation four years ago.

As you will see, our attached submission indicates that 'south sea' type pearl production is not dominant in world pearl supplies and that WA is no longer the dominant supplier

¹ Centre for International Economics, "Review of the Western Australian Pearling Act"(November 1999) and "Supplementary Papers" (30 June 2000) published by the Western Australian Fisheries Department.

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(around 30 per cent and declining rapidly) of 'south sea' type pearls to world markets. This is because of rapidly expanding and unrestricted pearl hatchery production in Indonesia and elsewhere.

There are those within the Australian industry who believe that the 30% to 60% fall in 'south sea' pearl prices across the product range, in recent times, is due largely to short term aberrations in world demand conditions and that they were not the result of these rapidly expanding overseas supplies. They also believe that the expanding overseas supplies of these 'south sea' type pearls are not substitutes for the WA produced pearls.

Against current WA policy settings that are predicated on the grounds that hatchery quota restrictions are designed to enable the industry to exercise market power and extract monopoly profits to benefit industry and the State, these perceptions defy economic logic and commonsense. Market intelligence from the international pearl trade and economics tells us that these overseas produced pearls are substitutes for WA produced pearls. They can either directly substitute for WA produced pearls or indirectly substitute if the price differential becomes too great.

Over the next five to seven years, the competitive supplies of overseas produced 'south sea' pearls are set to expand even further as expansions in hatchery operations that are known to be already in the pipeline reach production maturity. For instance, one Indonesian mass producer alone, recently doubled seeding to two million shell annually; this is more than twice the combined number of wild capture and hatchery produced shell seeded in WA. Another, that now has a reputation for turning out quality 'south sea' pearls, Atlas Pacific, is also known to have recently doubled the number seeded to 350,000 shell.

Hatchery production experience tells us that, even without improvements in production practices, the law of averages alone will dictate an increased number of quality pearls will result from these overseas production expansions. But we know these overseas operations have improved, and are looking to continue to improve, pearl yields, including the average quality of the pearls produced. If nothing is done now to expand WA's hatchery based pearl production, WA's market share will decline even further (to less than 20 per cent) in the foreseeable future.

We also know that, as these competitive overseas supplies of 'south sea' type pearls expand across the product range, the world demand for the WA produced 'south sea' pearl will become more elastic. In these market circumstances, economics tells us that the scope to exercise market power is eroded and the optimizing strategy for WA is to expand not to restrict supply.

Based on market intelligence from the international pearl trade, we have acknowledged to the Minister (see our attached letter dated 29 June) that there is limited range of larger sized, round pearls that remains the domain of WA produced pearls and where higher

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prices are obtained. These pearls are few in number, produced mostly from wild capture (not hatchery produced) shell and satisfy particular niche markets.

The existence of these higher prices is cited and relied upon as indisputable evidence of the benefits from controlling pearl supplies by restricting an input (hatchery shell) into pearl hatchery production. We have stressed to the Minister that the existence of such higher prices for particular grades of WA produced 'south sea' pearls is not sufficient evidence of the existence of market power or that such power (if it exists) is being exercised. As in any other markets, for example diamonds, they can reflect different quality characteristics (i.e. size, shape, colour, lustre, etc) valued by the market. And, even if this were taken as at least prima facie evidence of the possible existence of some degree of market power, then these benefits (as measured by the extent to which higher prices were to exist for these pearls as a direct result of hatchery quota restrictions in WA) would need to outweigh the costs in terms of the net benefits forgone (increased producer surpluses) to the State by not increasing hatchery quota allocations.

Our data indicates that the benefits of the existing supply restrictions are at best \$4 million to \$5million (and diminishing). This is based on the most optimistic assumptions as to the number of these highly valued quality pearls and as to the extent of the 'monopoly margin' in the higher prices these pearl grades attract. On the other hand, the costs in terms of the net benefits forgone by not adopting our increased hatchery quota proposal are around \$48 million at full utilization (see our attached June 29 letter).

In our view, the developments that have occurred in international pearl markets over the past four years have established beyond reasonable doubt that material net benefits to the State from the continuation of the existing hatchery quota restrictions do not exist, if indeed, they even existed at the time of the NCP review given the expressed reservations and findings of the independent reviewer. The case for change is now, in our view, overwhelming

Our Case for Change Uncontested

In a perverse process that reversed the 'burden of proof' under national competition policy guidelines, we were invited to make our case for change to the existing anti-competitive hatchery quota restrictions before the non-industry members of the Pearling Industry Advisory Committee (PIAC) and subsequently before a full PIAC meeting in the presence of the Minister. Rather than PIAC, the Fisheries Department or the Minister providing substantive justification of the net public benefits from retaining the existing anti-competitive hatchery quota restrictions.

At no stage during these meetings and subsequently were the data that we submitted challenged or other information made available in our presence or later that disputed our findings by either PIAC members, PIAC, Fisheries Department or the Minister.

The Case for Rejection Unsubstantiated

The Minister rejected our case (see attached letter from the Minister dated 9 August 2004). As you will see the rejection is again superficial, providing no substantive response to the uncontested data and argument contained in our submissions and presentations.

Of particular concern is the Minister's new decision (as mentioned in his 9 August letter) to accept PIAC advice and impose a 'moratorium' on any additional hatchery quota issue in the foreseeable future. This new decision means a continuation of an existing restriction on competition but without offering any substantiation of the net benefits to the State in accordance with national competition policy obligations and the State's own competition policy guidelines.

In rejecting this analysis and our proposal, without providing any substantial justification, Minister Chance announced a new decision to impose a "moratorium"(sic) on any additional hatchery quota issue, for the foreseeable future. (This is referred to in the attached 9 August letter from Minister Chance to NorWest Pearls.) This decision was not the subject of any formal competition policy review process, nor, supported by any substantial justification of a material 'net public benefit' to the State

Failure of the WA Government to meet Competition Policy Obligations

The outcomes, in relation to this matter, are classic examples of both process and policy failure in relation to national competition obligations. They represent a net loss to the State and Australia. It also highlights a lack of adequate transparency and public accountability in the WA Government's decision-making processes, in this matter.

The hatchery quota restriction has not attracted as much public exposure and debate as certain other proposed national competition reforms relating to legislative restrictions in WA that are of a more direct interest to domestic consumers such as retail trading hours, energy, water, potato marketing, taxi, etc.

The efficiency gains from legislative reforms to pearling may be relatively small, in comparison to the gains from other reforms and have slipped off the radar in the West, with attention recently focused on the 'big ticket' reforms to retail trading hours, the break up of Western Power and the like. Nonetheless, hatchery quota reforms in WA are consistent with NCP objectives, and, in their own small way, will make a contribution to realizing the benefits expected from NCP reforms.

Kel Brown
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16th September 2004

