Our Ref:
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Contact Officer: Jeremy Llewellyn
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24 November 2004

NCP Inquiry
Productivity Commission
PO Box 80
Belconnen ACT 2616

Dear Mr Banks

I am writing to you in response to the recent submission, number 134, from the Network Economics Consulting Group (NECG) in relation to the Productivity Commission's Review of National Competition Policy Arrangements.

Costs and benefits of integration

The Australian Competition and Consumer Commission (ACCC), in line with clause 4 of the Competition Principles Agreement (CPA) and also the recommendations of the OECD Council on 26 April 2001 concur that when faced with micro-economic issues, involving vertical structures in network industries, the benefits and costs of structural measures should be carefully balanced. [1,2] The ACCC's view is, whether the monopoly be public or private, that a cost-benefit analysis of structural separation would be a prudent starting point in considering such micro-economic issues. Further, the ACCC notes that the grounds for a *presumption in favour* of separation were explicitly noted in the conclusion reached in the OECD Secretarial Report, which accompanied the recommendations of the Council.[3]

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[1] OECD, *Recommendation of the Council concerning Structural Separation in Regulated Industries*, 26 April 2001 – C(2001)78
'When faced with a situation in which a regulated firm is or may in the future be operating simultaneously in a non-competitive activity and a potentially competitive activity, member countries should carefully balance the benefits and costs of structural measures against the benefits and costs of behavioural measures.'
These recommendations came out of the Report by the Secretariat, OECD, Structural Separation in Regulated Industries, Report by the Secretariat, DAFFE/CLP (2001) 10,11 April 2001
[2] *Competition Principles Agreement 11 April 1995 clause 4.3* 'Before a Party introduces competition to a market traditionally occupied by a public monopoly, and before a Party privatises a public monopoly, it will undertake a review into:…(c) the merits of separating the potentially competitive elements of the public monopoly.
[3] OECD Report of the Secretariat (2001) Op. Cit at p22 'Such a presumption minimises the risk of inefficiently restricting competition in the competitive activity and enhances the incentives on advocates of integration to produce evidence of the economic efficiency benefits of integration'.

We note the contribution of NECG in raising a number of issues for consideration in relation to (largely) the possible benefits of continued integration. In our view, however, the paper over emphasises the benefits of integration whilst under emphasising the potential for, and the likely costs of, the stifling of competition in the market. Discussion of the costs and benefits of vertical integration will form part of a further, more comprehensive, submission to the Commission shortly. These are important issues which need to be addressed. Briefly, however it is noted that:

- economic modelling shows those circumstances (such as where upstream margins are constrained by regulation) under which incentives to discriminate in favour of the vertically integrated firm's own operations and against non-integrated competitors will be greater (Mandy 2000, Bustos and Galetovic 2003)[4];
- restrictions on competition caused by discrimination generally will harm consumers (OECD 2001)[5];
- post fact empirical data shows evidence of discrimination by vertically integrated monopolists (Reiffen and Ward 2002, Mini 2001)[6];and
- divestment is welfare enhancing absent major losses in economies of scope (Crew, Kleindorfer 2004)[7].

Regulatory approach

NECG, under the heading 'circumstances have changed since the Hilmer inquiry' note that:

> structural separation may have made practical sense when the goal was to 'shake up' the bureaucratised structures…the excess capacity that existed in the major infrastructure industries in the early 1990s is not as prevalent today

and then suggest that

> set against this background, there are strong arguments for leaving it entirely to the market forces…to determine the vertical structure of firms.[8]

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[4]D Mandy, *Killing the Goose that may have Laid the Golden Egg : Only the data know whether Sabotage pays*, Journal of Regulatory Economics; 17:2 157 -172; Bustos and Galetovic, *Vertical Integration and Sabotage in Regulated Industries*, June 2003, Universidad de Chile Centre for Applied Economics Working Paper No.164 – in Bustos' paper these factors are listed as the intensity of scope economies and scope diseconomies, the size of the upstream margin granted by the regulated access charge, the cost of sabotage, the intensity of competition in the downstream market and the extent of downstream product differentiation.

[5] OECD Recommendation (2001) Op.Cit.

[6] D. Reiffen and M. Ward, *Recent Empirical Evidence on Discrimination by Regulated Firms*, Review of Network Economics Vol. 1, Issue 1 – March 2002; F.Mini, *The Role of incentives for opening monopoly markets : Comparing GTE and BOC Corporation with local entrants*, Journal of Industrial Economics, 43: 379-424. Reiffen gives a summary of Mini's analysis and cites a further example of an empirical study showing evidence of discrimination.

[7]M. Crew, P. Kleinforfer, *Regulatory Economics: Recent Trends in Theory and Practice*, A presentation to the ACCC Conference "Evaluating the Effectiveness of Regulation, Gold Coast Australia July 29-30 2004 updating their 2002 paper at page 17, citing the paper, M.Crew, Paul, Kleindorfer, J Sumpter, *Bringing Competition to Telecommunications by Divesting the RBOCs*, in M. Crew and M.Speigel, *Obtaining the best from Regulation and Competition* Kluwer Acadamic Publishers, Boston 2004 (at page 22).

[8] NECG 2004, Submission Number 134 to the Productivity Commission inquiry into the National Competition Policy, *Response to issues paper by NECG,* October 2004 pp 8,9

Notably, however, in the Hilmer report, conclusions favouring structural separation were made upon consideration, amongst other things, of the ability of a vertically integrated provider to use its monopoly power to stifle or prevent competition in the potentially competitive sector.[9] Regardless of industry structures then and now, the concern as to the cost of interference in, or distortion of, competitive markets remains and the need for a cost benefit analysis of the benefits of structural separation is as relevant today as it was then. In fact, the consensus of international academics at the 2003 ACCC Conference, '*Regulation, industry structure and market power*' was that recent analysis pointed to the need for further consideration of structural separation in a number of different industries.[10]

Regulatory Cost

NECG notes the 'sometimes raised' presumption that structural separation is compatible with 'less costly and more effective regulation' and suggests that 'it is not clearly the case that the regulatory task with structural separation would be easier'.[11] The Hilmer report, however, recognised the link between vertical integration and tighter regulatory control when concluding that it 'strongly supports structural reforms over more intensive conduct regulation'.[12] In his decision on *AGL v ACCC*, French J also recognised that market distortions arising from vertical integration might necessitate the need for regulatory responses.[13] The OECD notes that the primary advantage of vertical separation is a reduced incentive to restrict competition and that this is an important advantage since it decreases the regulatory burden and enhances the quality of the regulation and the level of competition.[14] Further, in regards to the Telecommunication Industry, the Productivity Commission has previously acknowledged that vertical separation would lead to a more light handed regulation, when discussing the joint application of vertical separation combined with forms of access regulation.[15] Finally, the ACCC's view is that vertical integration with monopoly infrastructure inevitably means a more intrusive regulatory regime and that structural separation, where appropriate, would enable a more light handed form of regulation.

If you have any queries re the issues raised in this letter, please do not hesitate to contact me on (02) 6243 1142. Please find articles referenced enclosed.

Yours sincerely

Ed Willett
Commissioner

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[9] F.G. Hilmer. Report by the Independent Committee of Inquiry, *National Competition Policy*, August 1993, AGPC at p 219

[10] 2003 ACCC fourth conference on key regulatory issues, *Regulation, industry structure and market Power* see www.accc.gov.au/content/index.phtml/itemId/259750/fromItemId/3765, speakers at the Conference included from the United Kingdom, David Newberry and Professor Stephen Littlechild and Dr Daryl Biggar from Australia

[11] NECG 2004, Op. Cit, pp 24,25

[12] Report by the Independent Committee of Inquiry, *National Competition Policy*, August 1993 at p 221

[13] [2003] FCA 1525, paragraphs 395-397

[14] OECD Report of the Secretariat 2001 Op.Cit at page 16

[15] Productivity Commission Inquiry Report *Telecommunications Competition Regulation* 2001