RESPONSE TO THE ACCC'S RECENT COMMENTS ON THE REGULATION OF INDUSTRY STRUCTURES: A SUMMARY

1. INTRODUCTION

1. The ACCC seems to be on a quest to ensure that Australia's infrastructure industries do not involve vertically integrated firms. This is reflected in a number of recent comments made by the ACCC and its representatives. The sources of these comments are:

   - ACCC supplementary submission 1 to the NCP inquiry (DR145);
   - ACCC supplementary submission 2 to the NCP inquiry (DR165); and
   - the comments of ACCC representatives at the NCP public hearings.

2. The comments essentially cover:

   - the need for a review of the structure of Telstra;
   - the conclusions of academic and other literature discussing the impact of industry structure on competition, consumer welfare and regulatory costs; and
   - claims about the purpose of section 50 and its inapplicability to major infrastructure industries such as the electricity industry.

3. Each of these comments is considered below.

2. THE STRUCTURE OF AUSTRALIA'S TELECOMMUNICATIONS INDUSTRY

4. The ACCC support the need for a review of the structure of Telstra, recognising that there are both costs and benefits of structural separation.

5. However, they seem to have pre-judged the conclusion by noting that, in the event that Telstra is not broken up, then some form of operational separation between wholesale and retail should be enforced. They suggest that this is very much a second-best outcome.

3. THE EVIDENCE CITED BY THE ACCC

6. The ACCC cite a number of sources as supporting their views on structural separation. These include:

   - various OECD documents supporting vertical structural separation as the preferred configuration of major infrastructure industries;
   - the recent literature on vertical foreclosure and sabotage;
   - various papers suggesting that discriminatory pricing of inputs harms consumers; and
   - papers suggesting that divestment is welfare enhancing in the absence of major economies of scope.

7. We will address each of these in turn.

4. OECD EVIDENCE

8. The ACCC refers to two OECD publications to support its contention that vertical integration in major infrastructure industries, such as electricity and telecommunications, should be avoided. These are

   - an OECD report from 2001 concluding that there ought to be a presumption in favour of structural separation.[1]
   - an OECD working paper from 2000 by Faye Steiner that examines the impact of a number of factors on the efficiency and competitiveness of electricity industries in various countries. One of the factors considered is the extent of vertical integration.[2]

9. It is surprising, given the apparent credence placed in OECD publications by the ACCC, that the ACCC did not mention the more recent publication on telecommunications that concluded that structural separation could well have negative consequences and in general, was not a viable or useful policy option: see http://www.oecd.org/dataoecd/39/63/18518340.pdf. This report is very clear that there is no prima facie case for structural separation in telecommunications.[3]

---

1 OECD 2001, "Recommendations of the Council concerning structural separation in regulated industries", OECD, France.

2 Steiner, F. 2000, "Regulation, industry structure and performance in the electricity supply industry", OECD Economics Working Paper Number 238.

3 OECD 2003, "The benefits and costs of structural separation of the local loop", OECD, France.

10. Furthermore, a number of points need to be noted about the Steiner paper.

- The econometric model employed is a reduced form random effects panel data model.
- While it calculates indicator variables for both the unbundling of generation and transmission and other forms of vertical integration, it only reports coefficient estimates for the generation-transmission variable in the regression tables. As such, it is likely that other forms of structural separation were either not incorporated in Steiner's preferred models or were incorporated but turned out to be so insignificant (either economically or statistically) that they were not worth reporting.
- The estimated coefficient on the generation-transmission unbundling variable in the electricity price regression was statistically insignificant in any event. The reason suggested for this was multicolinearity between this variable and other electricity market liberalisation variables. However, the generation-transmission unbundling variable appears to have been statistically significant in the efficiency regressions.
- A number of caveats to the study are mentioned by Steiner.

11. Thus, if the OECD's publications are credible, it would appear that structural separation may not be warranted in telecommunications, while only vertical mergers involving generation and transmission should be of concern in the electricity industry. This is a very different picture to the one painted by the ACCC.

5. VERTICAL FORECLOSURE LITERATURE

12. The ACCC cite a number of papers (including the Mandy[4] paper that NECG cited in its submission) to suggest that, far from being ambiguous, in the circumstances likely to prevail in the relevant industries, sabotage is very likely to be a problem.

13. In fact, Mandy concludes overall that the outcome is ambiguous. He discusses the factors that are likely to affect the outcome. Using telecommunications industry data, he finds that sabotage is likely to occur. But he notes that there are a number of factors that weren't incorporated in that particular part of his paper that may offset this. He further notes that the factors that drive his telecommunications results are:

4 Mandy, D. 2003, "Killing the goose that may have laid the golden egg: only the data knows whether sabotage pays", *Journal of Regulatory Economics*, vol. 17, no. 2, pp. 157–172.

- a sufficiently low upstream margin;
- a sufficiently small downstream efficiency differential; and
- insufficiently intense downstream competition.

14. Some alternative assumptions about these three variables may overturn the sabotage result.

15. That the results in respect of incentives for foreclosure are ambiguous is consistent with a very long line of literature on vertical integration, stretching back to the work of Aaron Director and the Chicago School in the 1950s. The ACCC ignores the complexity of the results on which it rests and their sensitivity to the underlying assumptions.[5]

16. In a widely cited series of papers, Patrick deGraba has shown that one important source of downstream distortions (including incentives to 'sabotage') is access prices that are set too low.[6] Given the PC's previous concerns about the manner in which the ACCC has set access prices, this appears a highly relevant consideration.

6. DISCRIMINATORY PRICING OF INPUTS

17. The ACCC cites the OECD as claiming that restrictions on competition caused by discrimination will generally harm consumers. They then cite some papers that apparently establish that vertically integrated monopolists discriminate (presumably against their rivals).

18. The key results with respect to price discrimination are far more ambiguous than the ACCC claims. There can be no presumption that upstream price discrimination will reduce economic welfare, even when that price discrimination is conducted by a monopolist.

5 For an overview of the foreclosure literature, see Ergas, H and E Ralph 1998, "New models of foreclosure: Should antitrust authorities be concerned?", mimeo University of Auckland, New Zealand.

6 See in particular Biglaiser, G and P deGraba 2001, "Downstream integration by a bottleneck input supplier whose regulated wholesale prices are above cost", RAND Journal of Economics, vol. 32, no. 2, pp. 302–315 and deGraba, P. 2003, "A bottleneck input supplier's opportunity cost of competing downstream", Journal of Regulatory Economics, vol. 23, no. 3, pp. 287–297.

7. DIVESTMENT IN THE ABSENCE OF ECONOMIES OF SCOPE

19. The ACCC cite Crew and Kleindorfer as having claimed in a conference presentation that divestment will be welfare enhancing in the absence of major economies of scope. This is simply not true. Economies of scope are only one of many potential benefits from integration. Our original submission (number 134) outlined a number of such benefits that did not involve economies of scope.

20. In any event, the ACCC have not presented evidence that economies of scope do not exist between the relevant components of the firms they wish to separate or keep separate.

8. THE ROLE OF SECTION 50 AND ITS APPLICATION TO INFRASTRUCTURE INDUSTRIES

21. In their appearance at the NCP public hearing, representatives of the ACCC expressed concern about the ability of s50 to prevent reaggregation in the electricity industry. They cited three recent examples. These were AGL-Loy Yang, SPI-TXU and IPN-Eddison Emission Energy. They suggested that there would be considerable uncertainty about the effectiveness of s50 in dealing with electricity reaggregation until they get some final determinations from the full bench of the Federal Court or the High Court about what market definitions will apply to the electricity sector.[7]

22. In response to a question from Gary Banks, Ed Willett seemed to indicate that the ACCC has three main concerns about the use of s50 in the electricity industry. He also said that what they were saying at the public hearings had little to do with the AGL case.

23. First, Mr Willet said the ACCC is most concerned about a breakdown in the separation of natural monopoly elements from contestable areas. (in particular, the separation of transmission and generation):

- "Section 50 wasn't designed to promote competition by separating out natural monopoly components from contestable areas of the economy."

- "Section 50 can't deal with problematic small interests between contestable and non-contestable areas of energy supply in the way that, for example, the Airports Act limits the interest that an airline can take in a major airport to 5 percent."

24. There are three problems with the ACCC's first set of arguments.

---

7 These comments are all made in the initial presentation by Graeme Samuels.

- First, s50 is only relevant to merger cases, not to the breakup of existing firms (except in rare cases to undo a merger that was illegal). The role of seeking to introduce competition falls to Part IIIA and related instruments, rather than to Part IV of the TPA. The ACCC has regularly sought, and been refused, a wider divestment power — see the Dawson Review for the most recent such rejection.

- The second problem is that the ACCC doesn't indicate why s50 can't deal with the anticompetitive impacts of a merger between a natural monopoly and a competitive firm. The ACCC has used s50 to examine a very wide range of cases involving infrastructure; it is only since the AGL case that it has expressed any criticism of that section. Indeed, both in its submission to Hilmer and to Dawson it indicated that there were no problems with the current formulation.

- The ACCC's main concern here appears to be one of vertical foreclosure following the merger. To some extent, that can be dealt with via Part IIIA if it becomes an issue.

25. The ACCC's second concern was that s50 was not designed to promote competition in markets that weren't already competitive. Rather, it is designed to protect competition in markets that are already effectively competitive.

26. The ACCC seems to be concerned that there is insufficient competition amongst generators. Specifically, Mr Willet said that "One of the more frustrating things about section 50, given that it looks at the world with and without the acquisition — that sort of test — one of the very frustrating things you find about mergers regulation is when you're confronted by the argument that there can't be said to be a substantial lessening in competition associated with this proposed acquisition because there's no effective competition in the first place."

27. However:

- If the industry is so monopolised that a merger would not substantially lessen competition, then there is no anticompetitive detriment. If there is no obvious gain in terms of higher prices from the exercise of additional market power, then there must be some other reason for the merger, presumably in the form of cost savings. It is rather disturbing that the ACCC would feel frustrated by their inability to block a merger that has no anticompetitive detriments and is likely to reduce costs.

- In any event, the task of introducing competition does not fall to Part IV of the TPA. Rather, it rests plainly with Part IIIA and associated instruments.

28. The third issue the ACCC has with the use of section 50 in the electricity industry relates to the question of whether or not the courts are capable of dealing with the complexities of the electricity industry.

29. It is frankly pretty surprising that the ACCC would believe that the Courts, that are tasked with some of the most complex commercial disputes (for example in terms of tax and corporations law matters), at times with very substantial penalties (including criminal), could not deal with s50 matters.