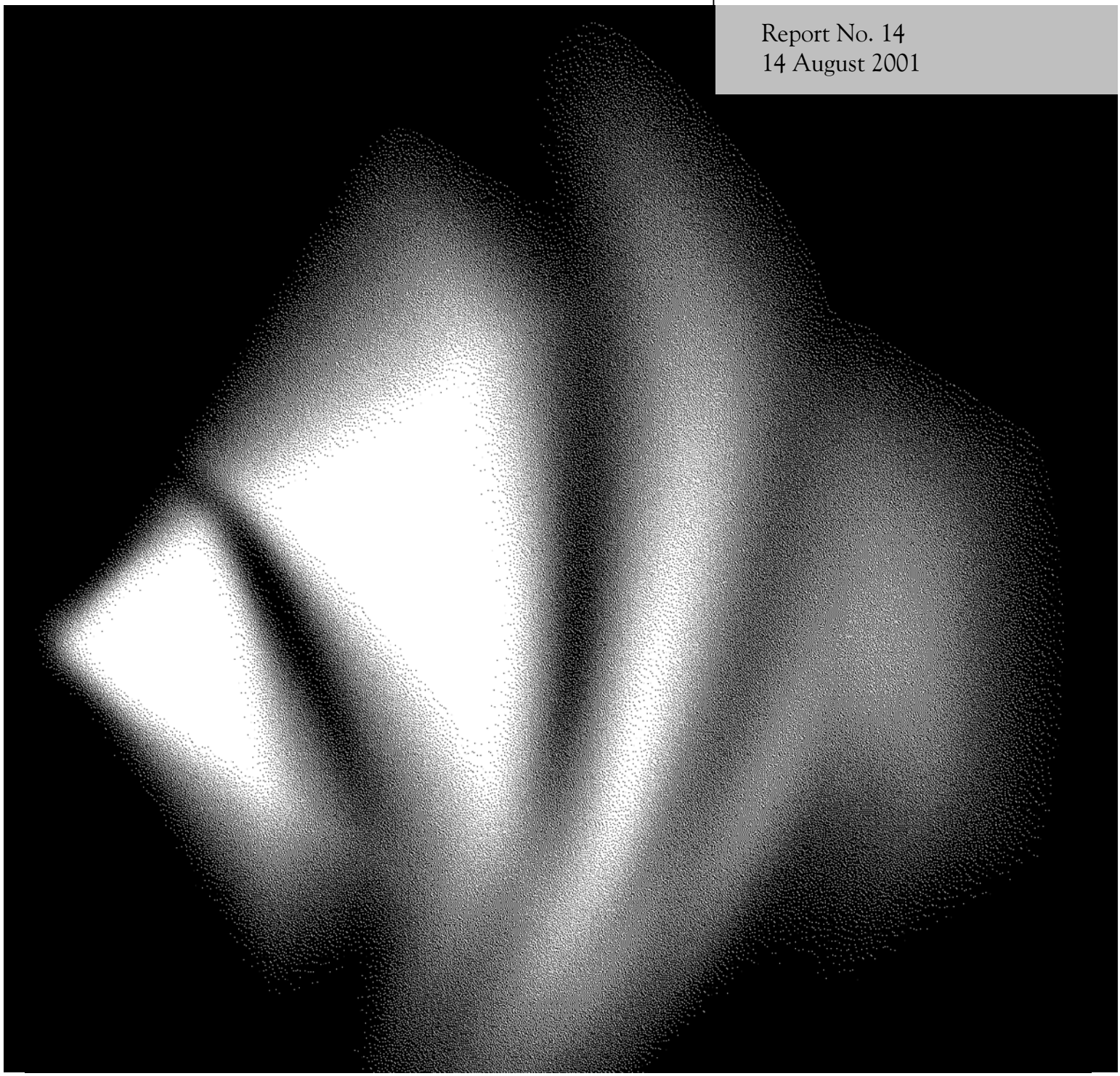
PRODUCTIVITY COMMISSION

Review of the *Prices Surveillance Act 1983*

Inquiry Report

Report No. 14
14 August 2001



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The Productivity Commission

The Productivity Commission, an independent Commonwealth agency, is the Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

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PRODUCTIVITY COMMISSION

14 August 2001

Senator the Hon. Rod Kemp
Assistant Treasurer
Parliament House
CANBERRA ACT

Dear Assistant Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report on the Review of the *Prices Surveillance Act 1983*.

Yours sincerely

Dr Neil Byron
Presiding Commissioner

Mr John MacLeod
Associate Commissioner

Terms of reference

I, ROD KEMP, Assistant Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer the *Prices Surveillance Act 1983* to the Commission for inquiry and report within nine months of receipt of this reference. The Commission is to focus on those parts of the legislation that restrict competition, or which impose costs or confer benefits on business. The Commission is to hold hearings for the purpose of the inquiry.

Background

2. The *Prices Surveillance Act 1983* (the PSA) provides for the surveillance of, and the holding of inquiries into prices charged, or proposed to be charged, for the supply of certain goods and services in Australia.

Scope of Inquiry

3. The Commission is to report on the appropriate arrangements, if any, for prices surveillance, taking into account the following:

   (a) legislation/regulation that restricts competition should be retained only if the benefits to the community as a whole outweigh the costs; and if the objectives of the legislation/regulation can be achieved only by restricting competition. Alternative approaches which may not restrict competition include quasi-regulation and self-regulation;

   (b) where relevant, effects on the environment, welfare and equity, occupational health and safety, economic and regional development, consumer interests, the competitiveness of business (including small business), and efficient resource allocation;

   (c) the need to ensure that regulation achieves its objectives, using the most appropriate means;

   (d) the need to promote consistency between regulatory regimes and efficient regulatory administration, through improved coordination to eliminate unnecessary duplication;

   (e) compliance costs and the paper work burden on business should be reduced where feasible, particularly for small business; and

   (f) the potential for increasing competition in those markets to which the provisions of the PSA have been applied.

4. In making assessments in relation to the matters in (3), the Commission is to have regard to the analytical requirements for regulation assessment by the Commonwealth, including those set out in the Competition Principles Agreement. The report of the Commission should:

   (a) identify the nature and magnitude of the problem(s) that the PSA seeks to address;
   (b) clarify the objectives of the PSA;

(c) identify whether, and to what extent, the PSA restricts competition;
(d) consider alternative means (including non-legislative approaches) of achieving the objectives of the PSA, including changes to the operation of existing price oversight arrangements and alternatives to prices oversight;
(e) analyse and, as far as reasonably practical, quantify the benefits, costs and overall effects of the PSA and alternatives identified in (d);
(f) identify the different groups likely to be affected by the PSA and alternatives;
(g) list the individuals and groups consulted during the review and outline their views;
(h) determine a preferred option for regulation, if any, in light of objectives set out in (3); and
(i) examine mechanisms for increasing the overall efficiency (including minimising the compliance costs and paper burden on small business) of the PSA and, where it differs, the preferred option.

5. In undertaking the review, the Commission is to advertise nationally, consult with key interest groups and affected parties, and produce a report.

6. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report.

ROD KEMP

14 February 2000

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BOXES

TABLES

Abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ACCC	Australian Competition and Consumer Commission
ACT	Australian Capital Territory
ACTU	Australian Council of Trade Unions
AGA	Australian Gas Association
AIRC	Australian Industrial Relations Commission
APAC	Australian Pacific Airports Corporation
AUSTEL	Australian Telecommunications Authority
BHP	Broken Hill Proprietary Ltd
CIF	Cement Industry Federation
CPA	Competition Principles Agreement
CPI	Consumer Price Index
FAC	Federal Airports Corporation
GBE	Government Business Enterprise
GPA	Gladstone Port Authority
HoR	House of Representatives
IAC	Industries Assistance Commission
IC	Industry Commission
IPARC	Independent Pricing and Regulatory Commission
IPART	Independent Pricing and Regulatory Tribunal
MMC	Monopolies Mergers Commission
NBPI	National Board for Prices and Incomes (United Kingdom)
NCC	National Competition Council
NCP	National Competition Policy
OECD	Organisation for Economic Cooperation and Development
ORG	Office of the Regulator General
OWR	Office of Water Regulation
PC	Productivity Commission
PJ Act	*Prices Justification Act 1973*
PJT	Prices Justification Tribunal
PML	Philip Morris Ltd

PPP Act	*Petroleum Products Pricing Act 1981*
PPPA	Petroleum Products Pricing Authority
PS Act	*Prices Surveillance Act 1983*
PSA	Prices Surveillance Authority
RIS	Regulatory Impact Statement
SPK	National Price and Competition Board (Sweden)
TP Act	*Trade Practices Act 1974*
URF	Utility Regulators' Forum

Key messages

- The economic environment has changed significantly since the Prices Surveillance Act (PS Act) was introduced in 1983. Prices oversight is seen now as part of competition policy, focusing on pricing by firms with substantial market power in important markets, rather than as part of a prices and incomes policy.
- In markets where competition is not strong, regulators attempt to emulate the efficient outcomes they believe would occur in more competitive markets. Yet this is a complex task requiring information that typically is not available. Hence, intervention may well result in prices that are more inefficient than would occur in the unregulated market, doing more harm than good to consumers and to the economy generally.
- Because of these risks, prices oversight is likely to be warranted only when there is substantial market power and when other pro-competitive options are not available.
- The PS Act has substantial deficiencies. It does not have clearly defined objectives. Under the Act, it is easy to implement price notification — an indirect form of price control — without sufficient investigation. Moreover, inquiries under the Act are not required to consider relevant policy options and there is insufficient guidance as to the role of price monitoring.
- Therefore, the Commission recommends that the existing PS Act be repealed.
- The Commission recommends that limited new inquiry and monitoring functions be written into a new part of the Trade Practices Act.
- If an inquiry considered further action was required, it could recommend pro-competitive reforms, monitoring or price control.
  - But the form of monitoring should ensure that it does not become de facto price control.
  - Implementation of any price control would need to be through industry-specific legislation.
- Given the increased exposure of Australian markets to competition, it is anticipated that the new provisions would be used infrequently and complement the other areas of competition policy and law that deal with the conduct of monopolies, in particular the national access regime for essential infrastructure.

Overview

The Prices Surveillance Act

The Commission has been asked to review the *Prices Surveillance Act 1983* (PS Act) and to report on the appropriate arrangements for prices surveillance in Australia.

Ministerial responsibility for the Act lies with the Minister for Financial Services and Regulation. The Australian Competition and Consumer Commission (ACCC) administers the Act. The Act provides for three forms of prices oversight.

- *Public inquiries* — whereby the Minister directs the ACCC to undertake a public inquiry into matters relating to the prices for the supply of goods and services and to report the results of the inquiry to the Minister. There is a penalty for increasing prices during the inquiry period without the approval of the ACCC.
- *Prices notification* — whereby the Minister declares that specified companies are to notify the ACCC of a proposed price increase for specified goods and services. The ACCC is required to make a determination about the notified price increase within 21 days unless the company agrees to an extension. The determination is not enforceable, but there is a penalty for increasing prices during the prescribed 21-day period without the approval of the ACCC.
- *Monitoring and reporting* — whereby the Minister directs the ACCC to monitor the prices, costs and profits of companies and government authorities in relation to specified goods and services and to report the results of the monitoring to the Minister.

Price notification and inquiries are a mixture of direct and indirect forms of price control. There is direct control while an inquiry is in progress or before a determination is made under price notification. Beyond this, price control is indirect in the sense that firms are encouraged to set prices considered appropriate by the regulator. The Act relies on firms deciding that it is prudent to abide by the ACCC's determination.

Why was the PS Act introduced?

The PS Act was introduced in 1983 as part of the Commonwealth Government's prices and incomes policy. The intention was to promote restraint in pricing to accompany wage restraint as part of the Government's strategy to control inflation and promote economic growth.

The Government recognised that competitive pressures act as an effective discipline on the prices charged by most businesses in Australia. Consequently, it was intended that the Act would be applied only where effective competition was lacking and where price increases could have pervasive effects throughout the economy.

The Act was designed to be flexible and wide-ranging in its application, allowing the Minister to target key companies and sectors selectively, without necessarily involving many companies in unnecessary regulation. However, there were few criteria to guide its application and, at its peak, price notification was applied to 24 product groups supplied by 75 companies.

What role is there for prices oversight today?

Since 1983, the economic and political environment has changed significantly. A program of microeconomic reform has increased competition in many industries and reduced the incidence of market power. Monetary policy has been targeted at keeping inflation low and there has been substantial decentralisation of wage fixing.

In this changed environment, the role of prices oversight has shifted to an explicit focus on controlling monopolistic pricing by firms that do not face effective competitive pressures and on industries in transition towards competition.

The area of the economy where monopolistic pricing is likely to be of greatest concern is in those infrastructure services dominated by a single firm and where there are no close substitutes. In such cases, prices may not be disciplined by competition.

Recognising this, in 1995 the Government introduced Part IIIA (national access regime) into the Trade Practices Act (TP Act). The aim was to prevent the misuse of market power by the owners of essential infrastructure facilities of national significance. This was achieved by making it possible for potential competitors in related markets to gain access to those services. Although Part IIIA and related industry-specific access regimes encourage negotiation by the parties concerned,

they also provide for regulation of the terms and conditions of access (including price) if negotiation breaks down.

As a consequence, the areas of possible monopolistic pricing that might otherwise be covered by the PS Act have been reduced substantially. The progressive dismantling of barriers to trade in goods and services has added to competitive pressures throughout the economy and further reduced the need for prices oversight.

Is there a need for prices oversight in areas not covered by the national access regime?

The national access regime does not apply to goods, intellectual property and production processes. It seems less likely that these areas will exhibit natural monopoly characteristics. Moreover, as pointed out above, the economy as a whole is exposed far more to competition than it was when the PS Act was introduced. Nevertheless, there may be a small number of markets that may not be subject to competitive pressures because they are dominated by, or can only support, a small number of firms, or are in transition to competition following deregulation. This raises the question of the type of prices oversight regime, if any, that might be required for situations not covered by the national access regime.

There are severe limitations to the role that price control can play in areas where competition is not strong. In such markets, regulators attempt to set prices at the levels they estimate would occur if there were more active competition. Yet this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment.

These limitations suggest that governments and regulators should be wary of setting prices (either explicitly or indirectly). This is particularly the case in markets other than where there is natural monopoly, even if competition is not strong.

The Commission's view is that price notification is an indirect form of price control and is no longer appropriate. A general discretionary mechanism such as this is no longer needed now that the majority of areas where price control may be warranted are covered by Part IIIA of the TP Act. The Commission has concluded, however,

that there may be a limited role for retaining modified inquiry and prices monitoring functions. There are two main reasons for this conclusion.

The first, although increasingly unlikely, is that pockets of substantial market power in markets of national significance in areas not covered by Part IIIA cannot be ruled out. Hence, there is a case for retaining the capacity to hold properly constituted public inquiries to address concerns about possible monopolistic pricing in markets of national significance.

The second reason draws on the potential costs, as noted above, that can emerge when prices are controlled inappropriately and the complexities involved in defining situations in which price control will create net benefits. The Commission's judgement is that, when there is a high degree of uncertainty about how to set the efficient price, there are likely to be smaller economic costs in the long term if prices are not controlled when perhaps they should be, compared with situations where they are controlled when there is no need. Including modified inquiries and monitoring functions, but removing the notification procedure, tilts the balance in favour of avoiding price control when it is unlikely to yield net benefits.

The monitoring function also could provide regulators with an alternative to declaration under the national access regime in situations where there is uncertainty about the benefits of declaration. The Commission has considered, in its inquiries into Telecommunication Specific Competition Regulation and the National Access Regime, whether price monitoring should be available in decisions about access declarations and revocations.

Given the increased exposure of Australian markets to competition in recent years, it is anticipated that the inquiry and monitoring functions would be used infrequently and complement the other areas of competition policy and law, particularly those under the umbrella of the national access regime.

Should the inquiry and monitoring functions be implemented through the PS Act?

The Commission has concluded that the PS Act in its current form should be repealed. It was written and enacted in quite different circumstances, for purposes very different from its current use. Further, it has many deficiencies from the perspective of good regulation:

- it does not have clearly defined objectives;
- it does not require that there be an assessment of the existence or significance of monopolistic pricing, prior to a decision to apply notification or monitoring;

- it does not require that there be explicit consideration of options for addressing monopolistic pricing; and
- the regulator is the primary adviser on the need for prices oversight.

Given these deficiencies, the Commission considers that new legislation enabling the proposed inquiry and price monitoring functions is needed. A new PS Act could be created, but since prices oversight is now part of competition policy, it is sensible to create a new part in the TP Act, appropriately written to avoid the deficiencies in the current PS Act and to complement the rest of the TP Act.

The new part in the TP Act would:

- have a clearly defined objects clause stating that the objective of pricing inquiries and prices monitoring is to enhance economic efficiency;
- provide guidance to the relevant Minister as to the circumstances in which an inquiry could be initiated;
- specify that inquiries must be undertaken by an entity that is independent of the price regulator;
- provide guidance as to how any inquiry should be undertaken;
- specify that the reasons for inquiry recommendations be made publicly available; and
- provide for prices monitoring to be undertaken, but impose limitations on the way it is undertaken to ensure that it does not become a de facto form of price control.

There would be no provision in the new legislation for the ACCC to be directed administratively by the Minister to approve price increases or control prices. If price control were recommended by an inquiry, industry-specific legislation would be required if the Government wished to implement the recommendation.

Implications for current applications of the PS Act

The implementation of the recommendation has implications for the current applications of the PS Act. The Productivity Commission is currently undertaking an inquiry into Price Regulation of Airport Services. That inquiry could be deemed to be equivalent to one that would otherwise have been held under the new part of the TP Act. If that inquiry recommends monitoring, it could be implemented under the new part of the TP Act. Otherwise monitoring of aero-related services would cease when the PS Act is repealed. In the case of stevedoring, monitoring would cease when the PS Act is repealed. The new part of the TP Act would, however,

provide scope for an inquiry to be held, which could consider the extension of monitoring as one of a range of options.

Currently four sectors are subject to price notification (some airport services, Australia Post, Airservices Australia and harbour towage). If the Government wished to continue with some form of price control after the repeal of the PS Act, it would need to introduce industry-specific legislation. In keeping with the spirit of the recommendation, any such decision would be preceded by an inquiry. In the case of airports, the current inquiry into Price Regulation of Airport Services could again be deemed to be such an inquiry, as a transitional measure.

Findings and recommendation

Findings

FINDING 2.1

Prices oversight under the PS Act is now part of Australia's competition policy, with its primary focus on pricing by firms with substantial market power in markets of national significance.

FINDING 2.2

Because of its limitations and potential costs, price control should be used as a 'remedy of last resort'.

FINDING 3.1

Generally, price control should be applied only to markets that display substantial market power and are of significance to the national economy. In other markets where competition is not strong, the long-run costs of regulatory failure are likely to outweigh the cost of the market failure which regulation attempts to correct.

FINDING 3.2

*There is no compelling case to provide **generic** price control powers in Australia's national competition policy and law framework beyond those already available in the Trade Practices Act.*

FINDING 3.3

Retaining some form of inquiries and monitoring functions in the national competition policy and law framework for prices oversight would provide an alternative, so that any specific price controls are enacted only when they are warranted and to encourage their removal when they are no longer warranted.

FINDING 3.4

Price notification provided under the PS Act is no longer appropriate.

FINDING 4.1

The PS Act fails to meet best practice principles for legislation and prices oversight. It does not:

- *have adequately defined objectives;*
- *require an assessment of the significance and causes of monopolistic prices for each case to which it is applied;*
- *provide guidance concerning the factors that should be considered as part of such an assessment;*
- *require a statement of costs and benefits of the options, including pro-competitive alternatives to prices oversight or options for prices oversight; and*
- *require that advice to the Minister about whether price oversight is needed should be provided by an entity that is independent of the regulator.*

FINDING 4.2

The PS Act also has the potential to inhibit and retard the development of pro-competitive options in industries that have historically been considered to have market power.

Recommendation

RECOMMENDATION 5.1

The Prices Surveillance Act 1983 should be repealed and a new part inserted in the Trade Practices Act to provide for inquiries and prices monitoring in nationally significant markets where there may be concerns about monopolistic pricing.

Specifically, the new part of the Trade Practices Act would:

1. *Include an objects clause stating the objectives for the inquiry and monitoring part of the Act.*
2. *Provide for public inquiries into monopolistic pricing.*
   - *(a) Require the relevant Minister to be satisfied that the pricing issue is of significance to the Australian economy, before initiating an inquiry.*
   - *(b) Require the relevant Minister to make public the reasons for the inquiry and specify the duration of the inquiry, which normally should not exceed six months.*
   - *(c) Require that the inquiry be conducted in a transparent manner with input from, but not by, the regulator.*
   - *(d) Specify that a public inquiry should:*
     - *(i) identify the nature and significance of the pricing issue referred to it by the Minister;*
     - *(ii) identify and assess alternatives to prices oversight, including pro-competitive reforms;*
     - *(iii) be required to publish a report, containing the reasons for its recommendations;*
     - *(iv) be able to recommend price monitoring;*
     - *(v) in the event that monitoring under this part is recommended, be required to nominate the indicators to be disclosed and the period for which monitoring will apply (which normally should not exceed three years and would be limited to a maximum of five years); and*
     - *(vi) be able to recommend structural reform, industry-specific measures, or appropriate forms of price control.*

3. Provide for monitoring.

(a) Monitoring could be initiated by the responsible Minister following:

(i) a recommendation from an inquiry under this part; or

(ii) a recommendation from an independent public inquiry initiated by the Commonwealth or a State Government that is deemed to be equivalent to an inquiry under this part (one that included 2(d) above in its terms of reference); or

(iii) a recommendation from the ACCC or NCC, as an alternative to third party access declaration, where provided for in the relevant access legislation.

(b) Designate the ACCC as the administrator for the monitoring provision.

(c) Require Chief Executive Officers to sign a declaration stating that the monitoring data are true.

(d) Provide for the ACCC to seek financial penalties through the courts if declared firms fail to provide the information.

(e) Require the ACCC to publish and report on the information being monitored under this part. The ACCC should not have the authority under this part to request information beyond that specified in the monitoring declaration issued by the Minister.

4. Not provide for price control to be administratively implemented. In the event that an inquiry recommended some form of price control, it would need to be implemented through industry-specific legislation.

1 Introduction

The *Prices Surveillance Act 1983* (PS Act) was enacted as part of the Commonwealth Government's prices and incomes policy. The policy had its origins in the Prices and Incomes Accord between the Australian Labor Party and the Australian Council of Trade Unions. The policy formed part of the Government's broader response to the economic problems prevailing in the early 1980s — high inflation and unemployment, and low investment and growth — as outlined in the second reading speech of the Prices Surveillance Bill:

> The Government's policies, based on an effective prices and incomes policy, are directed towards achieving these goals of sustained non-inflationary economic growth. … Establishment of the Prices Surveillance Authority will help to complete the implementation of this policy and will encourage price restraint as a counterpart to the wage restraint being exercised by wage and salary earners under the wage fixation principles established by the Australian Conciliation and Arbitration Commission (HoR 1983, p. 3072).

Economic conditions and the competitive environment have changed significantly since the PS Act was introduced. Inflation is lower and economic reforms have permeated most sectors of the economy. Tariff barriers have been lowered, public utilities and statutory marketing organisations have been reformed, and Commonwealth, State and Territory Governments are progressively implementing the National Competition Policy (NCP).

The Commonwealth Government has asked the Productivity Commission to review the PS Act and to report on appropriate arrangements, if any, for prices oversight. The terms of reference for this inquiry are set out in full on page v. The inquiry stems from the April 1995 agreements between Commonwealth, State and Territory Governments to implement the NCP. One of the agreements — the Competition Principles Agreement (CPA) — committed Australian Governments to review all legislation that restricts competition by the year 2000.[1]

The Commonwealth Government agreed to amend the reporting date for this inquiry from 14 November 2000 to 14 August 2001, following a request from the

[1] In November 2000, the Council of Australian Governments (COAG) extended the deadline for completing the NCP legislation review program from 31 December 2000 to 30 June 2002 (Communique, COAG, November 2000).

Commission. The extension was sought because the Commission is undertaking two inquiries into legislation (telecommunications specific competition regulation and the national access regime) which are related to matters arising in this inquiry.[2] The revised reporting date allows parties participating in these inquiries and the Commission to consider the three inquiries concurrently. Also, the Government will be able to consider the outcomes of the inquiries into the PS Act and the national access regime together.

1.1 Defining prices oversight

In this report, the term prices oversight refers to a range of instruments used by Governments to examine, monitor, influence or control pricing by businesses. The principal instruments for prices oversight (box 1.1) vary in their degree of intrusiveness on the operation of businesses.

A rationale for applying prices oversight to businesses is to achieve outcomes which are more economically efficient in markets where prices might otherwise be sustained at levels which significantly exceed costs (including an adequate return on capital). The terms monopolistic pricing and monopolistic prices are used throughout this report to describe the nature of pricing in these types of market.

In this report, inquiries and monitoring are distinguished from price control, which comprises instruments used to control economic variables (such as prices, revenues and rates of return), which are normally left to markets to determine. Price notification is considered to be an indirect form of price control. Compared with inquiries and monitoring, price control usually involves substantially larger information demands, higher administrative costs, and the determination of prices, revenues or rates of return at levels acceptable to the regulator.

2 Subsequent to this extension, the Commission received terms of reference to inquire into the price regulation of airports, which also covers issues that are closely related to this inquiry into the PS Act.

Box 1.1 **Instruments of prices oversight**

Price control requires nominated businesses to provide a range of financial information to the regulator, who then determines allowable prices and/or the rate of allowable price increase or decrease. Compliance with price controls is mandatory. Price controls can take various forms, including:

- command and control regulation, which encompasses cost plus, cost of service and rate of return regulation; and
- 'true' incentive regulation, which is price-based regulation such as CPI-X price caps and revenue caps.

Price notification is specific to the PS Act and refers to the requirement that nominated businesses notify the regulator of proposed price increases. The regulator examines these proposals and issues determinations stating whether the price increases are acceptable or not. The regulator also has the power to collect relevant data from nominated businesses and other parties. Compliance with the regulator's determinations is voluntary.

Price monitoring requires nominated businesses to provide price, cost and profit data to the regulator periodically. The regulator may report on the performance of firms, but does not have the authority to make price determinations.

Inquiries into pricing investigate market situations to determine the nature, significance and causes of alleged pricing problems. The inquiry body normally has powers to obtain information and summons witnesses. It makes recommendations to Government as to the appropriate response.

1.2 Key features of the *Prices Surveillance Act 1983*

The PS Act enables the responsible Commonwealth Minister[3] to direct the Australian Competition and Consumer Commission (ACCC) to examine the prices of selected goods and services in the Australian economy.

The Act was drafted deliberately to be flexible in its application, allowing the Minister to target, selectively, key companies and sectors without including large numbers of companies across an industry. Originally, this was to ensure that the operations of the Prices Surveillance Authority (PSA) — which was later combined with the Trade Practices Commission to form the ACCC — remained within the framework of the Government's prices and incomes policy.

The PS Act does not incorporate powers of price control. Moral suasion through publicity, and the threat of the Minister initiating an inquiry, are the principal

3 Currently the Minister for Financial Services and Regulation.

enforcement mechanisms available under the Act. The second reading speech stated that:

> While compliance will be voluntary, consistent with the consensus approach on which the prices and incomes policy is based, the force of public opinion and companies' recognition of their public responsibilities will be powerful factors ensuring compliance with the findings of the Authority (HoR 1983, p. 3072).

To date, there has been only one case of non-compliance with ACCC (or PSA) determinations on price notification. In 1998, Waratah Towage Pty Ltd increased charges for tug services in Port Jackson by 15 per cent, despite the ACCC's objection to the price increase (sub. 10, pp. 29-30).

The Act provides for three forms of prices oversight (section 17).

- *Monitoring* — whereby the Minister directs the ACCC to monitor and report on the prices, costs and profits of companies in relation to specified goods and services.
- *Price notification* — whereby the Minister declares that specified companies are to notify the ACCC of a proposed price increase for specified goods or services. The ACCC is required to make a determination about the notified price increase within 21 days unless the companies agree to an extension. The determination is not enforceable, but there is a penalty for increasing prices during the prescribed 21-day period without the approval of the ACCC.
- *Public inquiries* — whereby the Minister directs the ACCC to hold an inquiry into specified matters and report its findings to the Minister, who then makes decisions on the recommendations. Companies are liable to a penalty if they increase prices during the inquiry without approval from the ACCC.

Public inquiries initiated under the PS Act have been used for a number of purposes, including:

- to determine whether pricing outcomes reflect competitive market forces;
- to advise the Minister on what types of prices oversight, if any, should be applied to the company or companies under inquiry;
- to assess price notifications in greater depth and to encourage compliance with determinations about notified price increases; and
- to play an educative role by bringing information into the public domain, thereby facilitating public understanding of the pricing matters at issue.

The Minister determines which companies, goods or services are to be subjected to prices oversight under the PS Act and issues declarations and directions to that effect (sections 27A, 21(1) and 18(1)). The Act deliberately provides little guidance

to the Minister regarding whether a product or service may be declared for price notification or subjected to monitoring, or whether to hold a public inquiry. The ACCC applies the instruments of prices oversight in accordance with the declarations and/or directions issued by the Minister.

In performing its functions under the PS Act, the ACCC has to take into account three statutory criteria contained in section 17(3):

- the need to maintain investment and employment, including the influence of profitability on investment and employment;
- the need to discourage a firm, which is in a position substantially to influence a market for goods or services, from taking advantage of that power in setting prices; and
- the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The ACCC also must take into account ministerial directions issued under section 20 of the PS Act. The key directions, which were issued in the 1980s, relate to Government policies of generally:

- not supporting price increases in excess of movements in unit costs; and
- not accepting increases in executive remuneration in excess of those permitted under wage-fixing principles as a basis for price increases.

The ACCC has certain powers to obtain information under the PS Act. Section 32(1) enables the Chairperson of the ACCC to request that organisations or individuals provide information or documentation relevant to a price notification, an inquiry or monitoring.[4] The ACCC also can summons people to appear as witnesses at an inquiry (section 34(2)).

The PS Act can be applied to trading, financial and foreign corporations, and people or firms supplying goods or services across State boundaries. Price notification need not extend to all products sold by a declared company, nor need it extend to all firms selling declared products. For example, past declarations have covered the largest sellers of coffee, tea, and biscuits and one of the two sellers of liquefied petroleum gas in Western Australia.

4 There are penalties (up to $1000) for failing to comply with an information order or summons unless a reasonable excuse is provided (sections 32(2) and 35). Under sections 32(2A) and 36, a reasonable excuse for failing to comply with such an order can be made on the grounds that it may incriminate the individual.

The Act also can apply to State and Territory Government businesses, provided that the relevant State or Territory Government agrees or the National Competition Council (NCC) has recommended a declaration for price notification, following a request from an Australian Government. In making its recommendation, the NCC must apply the relevant principles set out in the CPA. To date, the PS Act has not been applied to a State or Territory Government enterprise.

Currently, four groups of services are declared for price notification:

- aeronautical services (including aircraft movement and passenger processing facilities) at 11 privatised airports[5] and Sydney airport;
- air navigation services (including terminal navigation services, fire-fighting and rescue services, and airway facilities) provided by Airservices Australia — a Commonwealth business enterprise;
- harbour towage services in the ports of Melbourne, Sydney, Newcastle, Fremantle, Brisbane and Adelaide; and
- letter services reserved to Australia Post, and the carriage within Australia of registered publications by Australia Post.

Two sectors are subject to monitoring under the PS Act, namely:

- aeronautical-related services (including aircraft refuelling, maintenance and storage sites, car parks and check-in services) at the 11 privatised airports and Sydney airport; and
- container stevedoring companies in the ports of Adelaide, Brisbane, Burnie, Fremantle, Melbourne and Sydney.

In the case of container stevedoring services, the Commonwealth Government directed the ACCC to apply monitoring to help ensure that the anticipated benefits of specific microeconomic reforms are achieved. Monitoring of the stevedoring industry was undertaken to:

> … ensure the constant and transparent monitoring of progress towards the Government's seven benchmark objectives and that the costs of the stevedoring levy are fully absorbed by the stevedores (Costello 1999, p. 1).

Monitoring was recently applied to the dairy industry as part of its deregulation and compensation package. The ACCC monitored retail milk prices to ascertain whether reductions in farm-gate prices for raw milk brought about by deregulation were being passed on to consumers. Milk prices were monitored from April 2000 to January 2001. The ACCC released a monitoring report in April 2001.

5 These airports are Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth and Townsville.

The ACCC also conducts informal monitoring in the areas of petrol prices, bank fees and charges, and sound recordings, which is undertaken independently of the PS Act (ACCC 2000a).

1.3 The Commission's approach

The PS Act was drafted in the context of the economic and political circumstances existing in the early 1980s. In evaluating the relevance and quality of the PS Act, the Commission has considered the Act in the context of today's economic environment and the foreseeable future. It has applied current best practice principles and processes for legislation to direct future actions, rather than applying the standards of a previous era.

The Commission's approach follows the terms of reference for this inquiry, the principles for legislation review and prices oversight set out in the CPA, the Commonwealth's guidelines for regulation, and the general policy guidelines in the *Productivity Commission Act 1998*. The approach used to determine the appropriate arrangements, if any, for prices oversight is outlined below.

First, the policy objectives motivating the use of prices oversight generally are reviewed (chapter 2). Since the PS Act was introduced in 1983, the economic environment in general, and competition policy and law in particular, have changed markedly. Thus, it is important to review under what conditions prices oversight generally, and those forms provided by the PS Act specifically, are still warranted (chapter 3).

Second, in the event that a rationale for some form of prices oversight remains, the strengths and weaknesses of the existing PS Act need to be assessed, to determine how effective the Act is likely to be in achieving the identified purpose of prices oversight (chapter 4). The framework for prices oversight contained in the PS Act is compared with a current best practice framework, based largely on the framework for legislation review set out in the CPA and the Commonwealth's guidelines for regulation (ORR 1998). The principles and processes forming the best practice framework are set out in appendix B.

The PS Act is a general prices oversight regime, not industry specific.[6] For this type of legislation, it is appropriate to examine whether the framework embodied in the

6 The PS Act is a general prices oversight regime in the sense that the companies, goods or services to which it may be applied are not specified in the legislation. The Act empowers the Minister to specify, from time to time, the companies, goods and services to be subject to prices oversight.

Act is sufficient to ensure that it will be applied only in situations where it is likely to achieve its policy objectives and generate net benefits to the community. This approach does not require the evaluation of the costs and benefits of each application of the Act in the past or whether alternative policies would have been superior in these cases.

Finally, the Commission sets out its recommendation regarding the future of prices oversight at the Commonwealth level in chapter 5.

1.4 Conduct of the inquiry

The Commission encourages maximum public participation in the inquiry process. Soon after the receipt of the terms of reference on 14 February 2000, advertisements were placed in the national press and a circular sent to a range of individuals and organisations thought to have an interest in the inquiry. An issues paper was released in March 2000 to assist participants in preparing their submissions.

Thirteen submissions were received in response to the issues paper (appendix A). All non-confidential submissions (or non-confidential parts of submissions) were made available on the Internet, from Commission and State libraries and from PhotoBition copy centres.

The Commission also held informal discussions with organisations, companies and individuals to seek information on the operation of the PS Act. In particular, the Commission sought information on the advantages and disadvantages of the current arrangements and possible alternatives. A list of those visited by the Commission is set out in appendix A. The Commission also held an informal round-table with invited academics to discuss the role of prices oversight in Australia.

Owing to the change in the reporting date for this inquiry, an interim report was released on 20 October 2000, setting out the Commission's initial views, but not containing any recommendations. Eight submissions were received in response to the interim report (appendix A).

Subsequently, the draft report was issued on 27 March 2001. To gain feedback on the draft report, the Commission invited submissions on the draft report and held a public hearing in Melbourne in June. Six submissions were received on the draft report and three interested parties attended the hearings (appendix A).

In preparing the final report, the Commission has drawn on evidence from a wide range of sources. These include input from those with an interest in, and knowledge of, the PS Act and prices oversight generally, submissions to this inquiry and the

Commission's inquiries into the National Access Regime, Telecommunications Specific Competition Regulation and Price Regulation of Airport Services.

The Commission thanks all those who participated in and contributed to this inquiry.

2 Prices oversight in Australia

The political and economic environments in Australia have changed significantly since the *Prices Surveillance Act 1983* (PS Act) was introduced. There also have been developments in competition policy and law. Reflecting this, the application of the Act has changed substantially.

In view of the developments since 1983, this chapter reviews and identifies the high-level policy objectives of prices oversight in contemporary Australia. It is an essential element in evaluating the appropriate arrangements, if any, for future prices oversight.

2.1 Prices oversight before the Prices Surveillance Act

Australia has a long and diverse history of prices oversight. From price controls during the Second World War to the current PS Act, Governments have attempted to regulate or influence prices through Commonwealth, State and Territory legislation. Examples of prices intervention include:

- general prices oversight under legislation such as the *Prices Justification Act 1973* (Cwlth), the *Prices Regulation Act 1949* (NT), the *NSW Prices Regulation Act 1948* and the *Prices Act 1948* (SA);
- industry-specific regulation such as the *Fuel Prices Regulation Act 1981* (Vic), the *Petroleum Products Pricing Act 1981* (Cwlth), the *Dairy Industry (Milk Price) Act 1986* (Vic) and the *Bread Industry Act 1979* (Qld);
- numerous statutory authorities that regulated the marketing of particular products (such as eggs, meat, milk, sugar, tobacco, wheat and wool) and which often played a role in fixing prices or setting minimum and maximum prices;
- requirements that Government business enterprises (GBEs) fund the provision of services to specific groups of consumers through cross-subsidies; and
- price regulation as part of the arrangements for third-party access to the services of essential facilities under the umbrella of access regimes covered by Parts IIIA and XIC of the *Trade Practices Act 1974* (TP Act).

The Commonwealth Government typically has relied upon forms of prices oversight that do not involve explicit price control. In the past, this may have

reflected doubts about the Commonwealth Government's power under the Constitution to directly control the prices of goods and services supplied by privately-owned businesses (apart from periods of war), a power which rests largely with the States. Referenda seeking this power were rejected in 1948 and 1973.

More recently, however, a view has emerged that the Commonwealth may be able to exercise control over the prices of foreign, local trading or financial corporations by virtue of the corporations power in the Constitution (section 51(xx)). Based on an assessment of High Court cases involving section 51(xx), Hanks (1996) found that recent decisions, particularly the *Tasmanian Dam* decision,[1] have reflected a broader interpretation of the scope of the corporations power:

> Despite the equivocation of Brennan J's judgments in the *Tasmanian Dam* case and the *Actors Equity* case and the division of opinion in *Re Dingjan; Ex parte Wagner*, the weight of contemporary judicial authority appears to support an expansive reading of s 51(xx) (Hanks 1996, p. 364).

According to the Australian Competition and Consumer Commission (ACCC), there is little doubt that the Commonwealth has extensive powers to regulate prices:

> … the ACCC would argue that the limitations of the Commonwealth's constitutional powers are insignificant. Because the overwhelming preponderance of economic activity in Australia is carried out by corporations, the Constitution supports the introduction by the Commonwealth of a legislative regime that allows valid and effective prices oversight in respect of all significant economic activities within Australia (sub. 19, p. 4).

State Governments do not have constitutional constraints with regard to price controls. State-based involvement in price control and fixing after the Second World War commenced when Price Commissioners were established in SA and NSW.[2] These State-based agencies were generally responsible for industry-specific arrangements and had greater statutory power than the Commonwealth agencies that followed, such as the Prices Justification Tribunal (PJT). A diverse range of goods have been subjected to some form of State-based prices oversight, as noted by the ACCC:

> Generally, basic foods like eggs, bread and milk were subject to some control and depending upon the individual State, so were a range of other goods and services like taxi charges, rents, building society interest rates, real estate fees and some utility charges (sub. 10, p. 7).

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1 *Commonwealth v Tasmania* (1983) 158 CLR 1.

2 Legislation establishing the SA Prices Commission in 1948, for example, granted the Minister the power to 'fix and declare the maximum price at which declared goods may be sold throughout the State'. Similar powers were granted under the *NSW Prices Regulation Act 1948*.

Prices Justification Act, 1973 to 1981

The PJ Act was introduced in 1973 to combat rising inflation, and to address trade union concerns that wages were regulated while prices were not. The introduction of the Act followed the public rejection in 1973 of a referendum to grant the Commonwealth power to control prices.

The PJT, which was set up to oversee the operation of the PJ Act, was primarily concerned with the justification of proposed price increases, rather than attempting to control prices. The function of the PJT was to inquire and report to the Minister on whether the price at which a company supplied (or proposed to supply) goods or services, was justified, and if the Tribunal believed the price was not justified, what lower price would be justified. Although the Tribunal's findings were not binding, the company was required to advise the Minister of the price at which it intended to supply the goods or services (Nieuwenhuysen and Norman 1976).

The focus of the PJ Act was broadened in 1974 to allow the prices charged by any company, irrespective of the size of its turnover, to be the subject of the Tribunal's attention (unless specifically exempted). The obligation to notify proposed price increases, however, still only applied to companies with turnover in excess of $20 million. The extension of the 'prices oversight net' resulted in 476 companies and 3114 subsidiaries and related companies being subject to the Tribunal's jurisdiction by June 1974.

In response to concerns that the Tribunal's decisions were reducing business profits, with adverse consequences for investment and employment (Sutherland 1987), the coverage of the PJ Act was narrowed. The PJ Act was amended to exempt automatically companies from notification procedures if they were not in a position substantially to control the market. This signalled the beginning of a more targeted approach to the use of the Act. Companies had to possess a specific characteristic, market power,[3] before they were obliged to notify the Tribunal of any proposed price increase. This approach was extended via amendments to the Act in 1979. Notification procedures still existed, but only for companies which had been the subject of a general price inquiry during the preceding twelve months (CEDA 1987).

This approach continued until 1981, when the PJ Act was repealed and the Government introduced industry-specific legislation — the *Petroleum Products*

3 The term market power, as used in this report, refers to the ability of a firm to earn abnormally large profits in the long run by setting prices above the cost of supply (including an adequate return on capital). The outcome is a higher price and lower level of output than would occur under competitive conditions.

Pricing Act 1981 (PPP Act) — to address what was perceived to be one of the most politically vexing pricing issues of the time.

Petroleum Products Pricing Act, 1981 to 1983

Under the PPP Act, the Petroleum Products Pricing Authority (PPPA) was required to conduct inquiries into the prices charged (or proposed to be charged) for the supply of petroleum products and related services in Australia. The inquiries conducted by the PPPA included:

- prices justification inquiries — focusing on whether the price at which a company supplied petroleum products was justified and, if the Authority was of the opinion that the price or any of the prices was not justified, what lower price was justified; or
- inquiries into a matter specified by the Minister.

The PPP Act was but one stage in a long history of legislation and regulation pertaining to the Australian petroleum industry. The key government interventions in petroleum product pricing over the last 60 years are outlined in box 2.1. The PPP Act was abolished in 1983, when the PS Act was introduced.

2.2 Operation of the Prices Surveillance Act, 1983 to the early 1990s

By the early 1980s, high inflation and unemployment and slow economic growth appeared to be entrenched. In 1983, the Australian Labor Party signed an Accord with the Australian Council of Trade Unions in an attempt to improve this situation. The Accord was implemented when the Labor Party came into government. At this time, prices and incomes policies were widely regarded as a means for dealing with high unemployment and inflation:

> The general argument for prices and incomes policies in developed capitalist countries is that, if successful, they can enable an economy to operate at a higher level of resource utilisation and employment than would otherwise be possible at a given rate of inflation (Fels 1983, p. 64).

In implementing the Accord, the Government drew on international experience with prices and incomes policies:

> The Labor Party, while in opposition, and the ACTU realised that achievement of a sustained reduction in unemployment required a policy to influence directly competing income claims, particularly during periods of economic recovery when such claims might otherwise tend to accelerate. We were encouraged in this view by the relatively

better economic performance of countries such as Austria, Norway and West Germany which had operated forms of prices and incomes policy based on a substantial degree of social consensus (Willis 1985, p. 16).

Box 2.1 **Prices oversight for the Australian petroleum industry**

The Commonwealth Government and/or State Governments have subjected petroleum products to price regulation since 1939. The number of products subject to price setting, and the level and extent of government intervention, has fluctuated over this period.

Key Government interventions in petroleum product pricing

Year	*Government intervention*
1939-48	Commonwealth Government controlled petrol prices.
1948-73	State Governments controlled petrol prices. The States gradually rescinded this role and in the mid 1950s the only remaining state authority, the South Australian Prices Commissioner, effectively set the Australian price of petrol.
1964	Commonwealth Government introduced the Crude Oil Allocation Scheme, requiring the use of set quotas for domestically produced crude oil.
1973	The Prices Justification Tribunal (PJT) began setting petroleum product prices.
1981	Petroleum Products Pricing Authority (PPPA) took over from the PJT. NSW, Victoria, SA and WA reintroduced forms of wholesale and retail price control.
1984	Prices Surveillance Authority (PSA) subsumed the PPPA. State Governments removed wholesale price control; WA retained retail controls; Victoria adopted trigger price system. Price surveillance was limited to petrol, diesel, aviation gasoline, aviation turbine fuel and refinery produced liquefied petroleum gas (LPG).
1988	Government abolished the Crude Oil Allocation Scheme and ceased setting import parity prices for crude, effectively deregulating the Australian crude oil market.
1990	Prices surveillance removed from aviation gasoline and aviation turbine fuel. The PSA set a daily common capital city maximum wholesale price for petrol and diesel based on an import parity pricing system. This was interrupted in mid 1990 by the Gulf crisis. In August 1990, the Government imposed a 21 day price freeze. From November 1990 to September 1991, the formula for adjustment gradually reverted back to product prices.
1991	Price surveillance removed from producer LPG prices.
1993	WA abandoned the setting of maximum retail prices of petrol.
1994	Industry Commission report into Petroleum Products.
1996	ACCC Inquiry into the Petroleum Products Declaration under the Prices Surveillance Act.
1998	Prices surveillance of petroleum products revoked in August.
1999	ACCC Inquiry into the Increase in the Average Retail Petrol Prices in Australia Compared with the Rise in International Prices.
2001	Commonwealth Government inquiry into Fuel Taxation.

In addition, at least 18 Government inquiries into the petroleum industry have been undertaken over the last decade alone.

Source: IC (1994a) and Australian Institute of Petroleum (unpublished).

The general objective of the PS Act during this period was to restrain price increases of selected goods and services as a counterpart to wage restraint as determined under wage fixation principles established by the Australian Conciliation and Arbitration Commission (PSA 1991b).

The Government sought to target companies with the greatest perceived ability to influence the rate of inflation. These were companies operating in markets where competitive pressures were lacking. As highlighted in the second reading speech of the Prices Surveillance Bill:

> … the selection of goods and services subjected to surveillance will focus on areas where effective competitive disciplines are not present and where price or wage decisions have pervasive effects throughout the economy (HoR 1983, p. 3072).

And, the PSA indicated that:

> The goods and services which are likely to be of greatest interest are those supplied on a wide, usually national, scale. Consumer goods which are strongly represented in average family budgets will be of interest where they are not supplied on a competitive basis (PSA 1984b, p. 7).

The idea underpinning this approach was that policies to moderate inflation are less effective when industries with market power are present. Implicit in this view was the presumption that companies with market power had little incentive to absorb cost increases arising from increased input costs (including wage rises). This view was not unique to Australia, with the World Bank and the OECD noting:

> … price stabilisation measures are less likely to succeed when monopolistic tendencies exist in an economy (World Bank and OECD 1999, p. 4).

In addition to its economic objectives, the Accord also sought to promote a range of social objectives, including income redistribution and the 'social wage'. To the extent that it constrained price increases, prices oversight may indirectly have influenced income distribution by helping to preserve real wages. In addition, prices oversight may have been used to promote regional development objectives. The Industry Commission noted that the application of prices oversight to the petroleum industry was intended, *inter alia*, to reduce the differential between rural and urban petrol prices (IC 1994a). There also is evidence that prices surveillance (or the threat of it) was used to maintain the Accord by encouraging companies not to concede wage increases in excess of those established under wage fixation principles (box 2.2).

It does not appear, however, that the PS Act was perceived as a key instrument in promoting social objectives. Rather, the main instruments, as outlined in the National Economic Summit (NES 1983a and 1983b), included:

- government expenditure on services such as health and community services, to create employment and enhance living standards; and
- real income increases to low income earners and disadvantaged groups.

Box 2.2 **Inquiry into the supply of fruit juices**

On 13 March 1985, the Prices Surveillance Authority (PSA) was directed by the Treasurer to hold an inquiry into the pricing of fruit juices by Sun Pack Fruit Juices Pty Ltd and Life Savers Ltd. As part of the inquiry, the Authority was to recommend whether prices surveillance should be extended to cover fruit juices.

The inquiry was prompted by two negotiated settlements in the industry involving wage increases and changes in employment conditions which had not been endorsed by any industrial tribunal. There were concerns that the settlements may have fallen outside of the wage-fixing principles existing at that time. It also appeared that the two companies may not have been fully aware of the implications of section 17(3) of the PS Act.

The inquiry found that neither company was able to exercise substantial market power in the fruit juice market. There was a high level of competition between companies supplying fruit juices as well as competition from substitute drinks. As such, the companies were unable to pass on the full amount of the additional labour costs to consumers.

In its report, the PSA noted that the changes in wages in one company could be used as a precedent in other companies. This was most likely to occur in companies where labour costs were only a small proportion of total costs, such as the fruit juice industry. However, evidence was presented which indicated that there were several new constraints on further wage claims in the fruit juice industry, including:

- the PSA's inquiry would fulfil an informational role such that companies would be aware of the obligations imposed upon them by the PS Act; and
- wage claims contrary to the union's undertaking to abide by wage-fixing principles were likely to result in a rapid hearing before the Australian Conciliation and Arbitration Commission.

In view of the evidence presented at the inquiry, the PSA recommended that fruit juices should not be declared for prices surveillance.

Source: PSA (1985b).

Although the Commonwealth Government originally emphasised that prices oversight would be applied only where price or wage decisions had pervasive effects on the economy, prices oversight was applied extensively in the early years of the Act's operation. For instance, price notification was applied to day-old

chicks, dressed table chickens, pre-mixed concrete, jams, marmalades, biscuits, chocolate, confectionery, cordials, soft drinks, mineral waters, pet foods, high alloy steel products, glass containers and petroleum products. A number of public inquiries also were undertaken into, among other things, the prices of sound recordings, book prices, postal services and petroleum products prices. At its peak in 1991, the PS Act applied to approximately 75 companies in 24 product groups (table 2.1).

2.3 Changing economic environment

The economic environment within which the PS Act operates has changed significantly since 1983. Inflation has fallen to low levels. There has been extensive microeconomic reform and changes in other Government policies which have increased competition generally throughout the economy and contributed to the changing economic landscape.

Microeconomic reforms

A wide-ranging program of microeconomic reforms since the early 1980s has improved the efficiency and competitiveness of the Australian economy. Reforms include the elimination or significant reduction in barriers to import competition (such as tariff reductions), reform of GBEs (through privatisation, corporatisation, restructuring and deregulation), new forms of prices oversight (Part IIIA of the TP Act and industry-specific regulation) and deregulation of financial markets.

These reforms have strengthened competition in many markets, improving the functioning of the price mechanism (box 2.3).

The impact of these reforms on the competitiveness of the Australian economy is one possible explanation for the decline in the number of companies declared for price notification (table 2.1).

As the PSA noted in 1995 in reference to a systematic review of businesses declared under the PS Act:

> The review process has led, so far, to the removal of another 20 companies from prices surveillance. The outcome reflects the heightened competition in many sectors of the Australian economy and the PSA's readiness to adopt a more light-handed form of regulation where it is considered likely to be effective (PSA 1995a, p. 25).

The decline in coverage of the PS Act also may have reflected a greater recognition of the potential costs associated with prices oversight, an issue discussed further in section 2.4.

Table 2.1 **Number of companies declared under the PS Act, by product group[a], 1984 to 2001**

	Year																	
Product group	*84*	*85*	*86*	*87*	*88*	*89*	*90*	*91*	*92*	*93*	*94*	*95*	*96*	*97*	*98*	*99*	*00*	*01*
Telecommunications	1	1	1	1	1													
Petroleum	12	11	11	8	8	8	7	7	7	7	7	7	7	7	7			
Australia Post	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Float glass		1	1	1	1	1	1	1	1	1	1							
Glass containers									1	1	1	1	1	1	1	1		
Beer		5	4	4	4	4	4	4	4	4	4	2	2					
Cigarettes		3	4	4	4	6	3	3	3	3	3	3	3					
Tea		2	2	2	2	1	1	1	1	1	1							
Instant coffee		4	4	3	3	3	3	3	3	1	1							
Concrete roof tiles		1	1	1	1	1	1	1	1	1	1	1						
Ready-mix concrete			3	3	3	5	5	5										
Portland cements			9	9	9	9	9	9	9	9	9							
Breakfast cereals			3	3	3	3	3	3	3	3	3							
Biscuits			3	3	3	3	3	3	1	1	1							
Toothpaste			3	3	3	3	3	3	1	1	1	1						
Tampons			3	1	1	1	1	1	1	1	1							
Toilet soap			3	3	3	3	3	3										
Steel mill products			4	3	3	3	3	3	3	3	3	3						
Steel pipes			1	1	1	1	1	1	1	1	1	1						
Alloy steel products			1	1	1	1	1	1										
Broiler chicks			4	4	4	4	4	4	4									
Table chickens			6	6	6	5	5	5	5									
Pet foods			1	1	1	1	1	1	1									
Jams and soft drinks[b]				2	2	2	2	2										
Liquefied petroleum gas						7	7		1	1	1							
FAC[c]/airports								1	1	1	1	1	1	1	12	12	12	12
Air services								1	1	1	1	1	1	1	1	1	1	1
Towage									9	9	9	9	8	8	8	8	8	8
Total product groups	**3**	**9**	**22**	**23**	**23**	**23**	**23**	**24**	**23**	**20**	**20**	**12**	**8**	**6**	**6**	**5**	**4**	**4**
Total companies[d]	**14**	**28**	**66**	**64**	**62**	**68**	**73**	**75**	**62**	**51**	**51**	**31**	**24**	**19**	**30**	**23**	**22**	**22**

a The numbers in each column denote the number of companies specified in a declaration. **b** The declaration covered the following product categories: jams, marmalades, chocolate and sugar confectionary, cordials, soft drinks and mineral waters. **c** Federal Airports Corporation. **d** The total number of companies declared may differ from the sum of the individual columns for two reasons. First, a company may have been declared for more than one product, which means that they would appear more than once in the count of companies declared for each individual product group, but appear only once in the total figure at the bottom of the table. Second, the total figure at the bottom of the table includes companies that were declared at any stage during the financial year (including those that were subject to a declaration for only part of that year), whereas the individual components are restricted to a count of those companies that were subject to a declaration at 30 June in that year.

Sources: PSA and ACCC Annual Reports (various).

Box 2.3 **Role of prices in a market-oriented economy**

Prices play an important role in a market-oriented economy by coordinating the interactions of a large number of people and firms, providing signals which facilitate the production of goods and services which people want. Market prices convey information about the ability and willingness of consumers to pay for goods and services and the ability and willingness of firms to produce them. In most cases, this promotes the efficient allocation of society's resources, increasing living standards. As the Australian Chamber of Commerce and Industry noted:

> Beyond the operation of individual firms, it is the price mechanism which provides the necessary signals to market participants over where resources ought to be deployed (sub. 13, p. 3).

Prices and competition are important in determining profits, influencing new investment (in Australia or elsewhere), and facilitating innovation, technological change and progress in the economy as a whole. Opportunities for profit, and the potential to replace rivals, drive firms to find new ways of meeting consumer preferences through innovation. As innovation takes place, prices provide signals as to future requirements for skills and physical capital.

If a company charges monopolistic prices, its customers will if possible switch to rival firms or new firms who enter the industry, buy from overseas suppliers, or seek out substitutes. Reliance on competitive markets, wherever possible, is important to maximising the living standards of Australians.

National Competition Policy

In 1993, a report by the Independent Committee of Inquiry into National Competition Policy, known as the Hilmer Report, proposed the establishment of a National Competition Policy (NCP). The policy would consist of laws, institutions, principles and processes aimed at improving Australia's international competitiveness and living standards (Hilmer Report 1993).

The Commonwealth, State and Territory Governments agreed to implement the NCP two years later. The NCP package (box 2.4) outlined a number of key elements for pro-competitive reform, including major amendments to the TP Act designed to extend the application of trade practices legislation to all sectors of the economy, including State and Territory GBEs. The reforms increased competition in markets previously dominated by one (or a few) firm(s) with the ability to charge monopolistic prices (section 2.4 discusses this practice in more detail). One important consequence was that the role of the PS Act in discouraging monopolistic pricing became far less important.

Box 2.4 **Elements of the National Competition Policy package**

The NCP contained three inter-Governmental agreements.

- The *Competition Principles Agreement* established agreed principles for the structural reform of public monopolies, competitive neutrality between the public and private sectors, prices oversight of Government enterprises, access to essential facilities and review of legislation restricting competition.
- The *Conduct Code Agreement* set out the basis for extending the coverage of the TP Act to unincorporated businesses and GBEs. It sets out the consultative processes for making modifications to competition law and appointments to the ACCC. It also committed States and Territories to enact legislation enabling the Commonwealth's new legislation to take effect.
- The *Agreement to Implement the National Competition Policy and Related Reforms* provided for payments by the Commonwealth to States and Territories. These are in return for them meeting agreed obligations set out in the Agreement, the Conduct Code Agreement plus reform commitments in electricity, gas, water and road transport.

The *Competition Policy Reform Act 1995* was the Commonwealth's legislative element of the package, which:

- amended the competitive conduct rules of Part IV of the TP Act and the provisions that exempt specific forms of conduct from these rules;
- inserted provisions into the TP Act extending the coverage of the competitive conduct rules to the unincorporated sector and to State and Territory owned business enterprises;
- created a new section of the TP Act (Part IIIA) establishing a new national regime for access to services provided by means of 'nationally significant' infrastructure facilities; and
- amended the PS Act to extend prices oversight to State and Territory owned business enterprises.

Source: IC (1995).

The *Competition Policy Reform Act 1995*, along with amendments to existing legislation (the TP Act and the PS Act), was introduced to improve Australia's general competitiveness and change the way in which the Australian economy operates. As noted by the ACCC:

> … the economy has changed as a result of the application of competition policy over the last five years. There has been a growth in national markets, privatisation has occurred in certain utility markets and the application of access provisions has brought about major structural changes in the economy (sub. 10, p. 15).

Macroeconomic policy

A number of changes to the Australian macroeconomic policy environment have occurred over the past two decades. Changes include the trend in fiscal policy towards balanced budgets or surpluses, and most importantly from the perspective of the PS Act, the shift in focus of monetary policy towards controlling the rate of inflation.

Monetary policy has evolved in the last three decades to form the centrepiece of the Commonwealth Government's anti-inflation armoury. From 1945 to 1971, the Australian dollar was pegged against the US dollar, and this was effectively the focus of Australian monetary policy (Macfarlane 1999). Although this link with the US dollar was broken in 1971, Australia retained a pegged system of exchange rate adjustments in one form or another until December 1983, when the Australian dollar was floated. The floating of the dollar essentially 'freed up' monetary policy such that it could be used to target something other than a fixed exchange rate, as Macfarlane noted:

> The move to greater exchange rate flexibility … meant that monetary policy needed a new guiding principle … Instead of having an external guide (the fixed exchange rate), a satisfactory internal guide had to be found. This process, beginning in the mid-1970s, took Australian monetary policy from a system based on pure discretion, to monetary targeting, and ultimately to the present system of inflation targeting (Macfarlane 1999, p. 215).

One of the ramifications of the shift in policy focus to an inflation target was that the PS Act became even less relevant as part of anti-inflation policy.

Along with the changes to monetary policy, the past decade has witnessed significant budgetary consolidation in Australia. There has been a pronounced tightening in fiscal policy towards balancing Commonwealth and State budgets. As the Commonwealth Treasury noted:

> Fiscal and monetary policies are now more likely to operate in a complementary fashion to limit, and not exacerbate, demand fluctuations. For example, the medium-term framework for fiscal policy implies that a loosening can be used to support the economy in the event of a downturn, but that the budget will need to be returned to surplus in the expansion phase of the cycle. This should assist the operation of monetary policy, as it is less likely that fiscal policy will contribute to excess demand pressures during the cyclical upswing (Commonwealth of Australia 1999, p. 3-11).

Industrial relations policy

Since the mid-to-late 1980s, there has been a major transformation in the structures and processes that underpin Australian industrial relations arrangements (Wooden *et al.* 2000). One of the most significant changes has been the shift from a centralised wage-fixing system to a decentralised system where wage levels and other conditions of employment are largely determined in the workplace. There have been a number of industrial relations reforms encouraging this shift. These reforms were designed to give firms greater flexibility to adapt to changing market conditions, and to strengthen incentives to improve productivity at the enterprise level. Given the decline in centralised wage-fixing, the original role of the PS Act in encouraging adherence to this system, as part of a broader prices and incomes policy, has ceased.

2.4 Changing role of the Prices Surveillance Act

The importance of the PS Act as an anti-inflation instrument began to diminish soon after its introduction. By the late 1980s and early 1990s, the PSA had started to view the PS Act as an instrument to address the competitive structure of industries and to encourage the implementation of reform by:

- recommending the removal of barriers to competition on both the demand and supply side of the market following inquiries into the prices of books, records, computer software and credit cards; and
- monitoring the pricing effect of Government microeconomic reform in sectors of the economy such as the waterfront, shipping, airlines and textiles, clothing and footwear (Cousins 1993).

Prices oversight as part of competition policy

By 1993, the primary objective of the PS Act had become to discourage monopolistic pricing (box 2.5). The Government implied this objective when it directed the PSA to undertake a comprehensive review of declarations under the Act:

> Where firms operate in free and competitive markets, Government intrusion into pricing policies simply adds to company costs, which are then passed onto consumers. The review will identify those markets where sufficient competition exists to revoke or modify declarations. However, where effective competition is lacking, the Government remains firmly committed to ensuring that consumers are not exploited through excessive prices. The Government therefore expects price surveillance to remain an integral part of competition policy (PSA 1994a, p. 153).

Box 2.5 **Monopolistic pricing**

In competitive markets, the ability of customers to switch to alternative domestic or overseas suppliers or for new firms to enter the industry, means that firms are unable to charge monopolistic prices — that is, prices sustained at levels which significantly exceed costs (including an adequate return on capital).

However, monopolistic prices may be sustained if:

- the minimum efficient scale of production for firms is large relative to the level of market demand, so that there is room for only a few firms in the industry;
- there are no close substitutes for the good or service available either locally or from overseas; and
- there are barriers to entry, for example, arising from legislation or significant sunk costs which advantage the incumbent firms.

In these circumstances, firms may be able to earn abnormally large profits for a long period of time. The result can be a lower level of consumption and production than is desirable from the perspective of both consumers and society, reflecting a misallocation of society's resources. As the Independent Committee of Inquiry noted:

> Where a firm is not subject to effective competition pressure — including both actual and potential competition — it may be able to restrict output and charge higher prices than would be possible in a contestable market. This behaviour … can result in higher prices to consumers and a misallocation or resources (Hilmer Report 1993, p. 270).

More broadly, firms facing little, if any, competition and which are able to exercise market power also may have less incentive to minimise their production costs, improve product and service quality and be innovative in general. This can generate productive and dynamic inefficiencies, with production costs above those that could be achieved in a more competitive environment. These problems are likely to be more acute where firms are Government-owned and/or benefit from some form of legislative monopoly or protection. In addition to the efficiency costs, there may be concerns about the redistribution of income from consumers to the owners of companies and their employees.

Further, firms with the power to charge monopolistic prices also may engage in lobbying activity, which does not add value, in order to preserve that power. This is particularly so when the power derives from legislation.

It was probably the implementation of the NCP, however, that had the most significant impact upon the application of the PS Act (box 2.4). The objective of restraining monopolistic pricing was highlighted in the legislation implementing the NCP in 1995. The Competition Principles Agreement (CPA), in conjunction with the *Competition Policy Reform Act 1995*, identified prices surveillance as an appropriate mechanism in markets where competition is weak. As noted in the second reading speech of the Competition Policy Reform Bill:

> Surveillance will continue to be appropriate for firms with substantial market power in substantial markets, where there is strong reason to believe firms will use their market power to increase prices (HoR 1995, p. 2800).

Formal price monitoring provisions were introduced into the PS Act as a less intrusive form of prices oversight, as outlined in the second reading speech:

> It is expected that price monitoring will be less intrusive and involve less administrative burden than prices surveillance. … Price monitoring may be appropriate where there is concern about the effectiveness of competition, a history of price problems or community concern about price levels or movements, or where industries have been recently reformed or deregulated (HoR 1995, p. 2800).

Under the NCP package, administration of the PS Act was transferred to the ACCC following the merger between the PSA and the Trade Practices Commission. Further, prices oversight processes under the PS Act were streamlined and extended to State and Territory GBEs:

> In keeping with the aim of achieving a truly national competition policy, the *Prices Surveillance Act 1983* will be amended to permit, in certain circumstances, price oversight of State and Territory Government businesses (HoR 1995, p. 2800).

Prices oversight is not needed in properly functioning markets because competition prevents firms from charging monopolistic prices. This was acknowledged in 1983 during the passage of the PS Act through Parliament, when the Government stated that:

> The best form of price restraint comes from the effective operation of competitive market forces (HoR 1983, p. 3072).

In 1996, the Government stated that:

> … in future, prices surveillance will only be applied in those markets where competitive pressures are not sufficient to achieve efficient prices and protect consumers (Costello 1996, p. 1).

In practice, prices oversight (including the PS Act) is now clearly focused on addressing monopolistic pricing. This development is consistent with international trends. As inflation subsided and the number of prices and incomes policies diminished, prices oversight in most OECD countries became a part of competition policy (box 2.6).

Participants generally agreed that if the PS Act was to be retained, consideration of its application should be limited to addressing monopolistic pricing in markets where competition is weak. For example, the Cement Industry Federation (CIF) stated that the Act should:

> Focus on improving economic efficiency by discouraging the use of substantial market power (sub. 5, p. 5).

Box 2.6 International trends in prices oversight

The interrelated nature of prices oversight arrangements and competition policy is a common feature in many OECD countries, and has emerged from a number of major developments throughout the 1980s, including:

- shifts in focus from direct price regulation to pro-competitive reforms to achieve efficient pricing practices. Such reforms were generally based on tightening controls over trade practices;
- removal of broad price controls, scaling down of selective price control schemes in more traditional areas and extension of controls to new areas of private sector monopolies;
- greater integration between competition and prices policies and between the institutions which implement these policies;
- broader application of competition policy to include public utilities and professional groups; and
- transformation in the nature of prices policies with greater emphasis on promoting market transparency and less emphasis on cost-based, rather than price-based, controls.

These developments are discussed in greater detail in appendix C.

Sources: PSA (1991b); World Bank and OECD (1999).

Similarly, Philip Morris Limited (PML) argued that prices surveillance 'is appropriate where there is a lack of competition in a market in order to protect consumers from abuses of market power' (sub. 3, p. 2). PML considered that price surveillance is costly and unnecessary when competition exists, pointing to its experience with price notification:

> Throughout this period [when PML was declared], the prices PML charged were considerably lower than the approved prices set by the PSA. By 1996 the in-market price of a packet of cigarettes was approximately 10% less than the prices approved by the PSA (sub. 3, p. 2).

CSR Limited reported a similar experience with prices oversight of pre-mixed concrete:

> The main characteristic of prices surveillance in the concrete business was however that prices realised in the market were generally always lower than the average prices endorsed by the PSA (sub. 20, p. 2).

Prices oversight at present, as part of competition policy, focuses primarily on economic objectives, such as improving economic efficiency. If prices oversight were used to pursue social objectives (such as income redistribution), this may conflict with the efficiency objective. For instance, PC (2001) noted that, if on distributional grounds a regulator attempted to set access prices to assist particular groups of consumers, this could have adverse effects on efficiency.

Assigning multiple and varied objectives to prices oversight would increase the likelihood of major conflicts between objectives. Moreover, this could place the regulator in the position of making trade-offs between different objectives when it may be more appropriate for Governments to make such decisions. For these reasons and given that there are more direct mechanisms for delivering social obligations, prices oversight is not the preferred instrument for pursuing distributional objectives.

Through the use of properly structured community service obligations (CSOs), Governments can assist particular groups without distorting the signals given to either regulators or regulated businesses. CSOs should be explicitly identified and defined by Government in policy documents and directions or other legislation. This approach is consistent with the principles set out in the CPA.[4] The second reading speech of the Competition Policy Reform Bill stated that:

> The [CPA] will facilitate a more careful and systematic consideration of the delivery of community service obligations, CSOs … The Commonwealth already has in place a set of administrative arrangements for the delivery of CSOs by its business enterprises. … These arrangements provide for CSOs to be explicit and transparent, to be provided at minimum cost … (HoR 1995, p. 2795).

In summary, the roles and functions of the PS Act have changed significantly in recent years to reflect the new economic environment in Australia. The Act is now part of the NCP, with a focus on addressing the problem of monopolistic prices set by companies which possess substantial market power in substantial markets.

FINDING 2.1

Prices oversight under the PS Act is now part of Australia's competition policy, with its primary focus on pricing by firms with substantial market power in markets of national significance.

4 Subclause 2(4(b)) of the CPA states that the prime objective of an independent source of price oversight advice 'should be one of efficient resource allocation, but with regard to any explicitly identified and defined community service obligations imposed on a business enterprise by the Government or legislature of the jurisdiction that owns the enterprise'.

Participants generally supported this view. Australian Pacific Airports Corporation (APAC) stated:

> In particular, we agree with Finding 2.1 that price surveillance now has its primary focus on competition policy. As such, it is appropriate to have a statutory instrument that represents best practice for that purpose rather than one designed 18 years ago to deal with issues in prices and incomes policy (sub. DR23, p. 1).

The ACCC also concurred with this view:

> Initially, the Act was an instrument of the Government prices and incomes policy under the Accord with a focus on moderating inflation. Today, the role of prices oversight is as an instrument of competition policy (sub. DR25, p. 4).

Costs of price control

Price control does not in itself remedy the underlying causes of monopolistic prices, which are the usual reason that it is introduced. Rather, it is normally introduced when it is felt that regulation can improve upon market outcomes.

There are three reasons, however, why the outcomes of price control may differ from what was intended.

The first reason relates to information. Regulators are typically confronted with an industry where there is little competition and are instructed to set prices as if competition existed in that industry. To do this, regulators ideally need detailed information about the costs, revenues, capital expenditures and productivity improvements that would be generated in a competitive environment. Yet in the absence of competitive pressures, the regulator has to estimate what the values of these variables would be if competition existed, often relying on the regulated firm for the information it needs to make these estimates.

In a submission to the Productivity Commission's inquiry into the national access regime, the Australian Gas Association noted that price regulation is usually based on incomplete information:

> … determining efficient costs with any degree of certainty is very difficult, especially given the substantial uncertainties that characterise regulated industries as to asset valuations, operating costs and the nature of efficient new and replacement investment. … The problem is not one of inadequate regulatory behaviour, but rather one of limited information. A regulator cannot be expected to exhibit perfect foresight about all future investment needs (AGA 2000b, p. 13).

CSR Limited made a similar point with respect to the PS Act:

> … the implementation of the Act rarely appeared able to fully appreciate the characteristics of the market which it was trying to regulate. This was mainly a result of the complexity of the particular market (i.e. range of products, variable size of customers, State differences, cyclical nature) (sub. 20, p. 3).

The ACCC pointed to the adverse consequences that can follow if prices are set at an inappropriate level:

> There is an extensive literature pointing to the inappropriateness of regulation in many cases and the distortions that it can create. Specifically pricing regulation is difficult. Price setting that is either too low or too high can either stifle innovation or reduce a firm's incentive to increase efficiency (sub. 10, pp. 35-36).

Sydney Airport Corporation Limited (SACL) also noted the possible adverse impact of regulation on investment:

> The most significant cost to society of unnecessary airport regulation is the potential to blunt investment incentives and to result in sub-optimal investment decisions (sub. DR27 p. 29).

SACL further argued that the:

> Other costs of regulation come in the forms of under investment leading to congestion and over-crowding, poor quality outcomes and lack of innovation (sub. DR27 p. ii).

The risk that regulation may have adverse impacts on investment decisions may be greater when technology is changing rapidly. For example, during the public hearings of the Productivity Commission's inquiry into telecommunications regulation, Vodafone commented that:

> … with the increasing rate of technological and market change in an already fast-moving industry, there is a very real risk that regulation will adversely distort the development of the industry in a way that will discourage investment and innovation and produce sub-optimal benefits for consumers (trans., p. 44).[5]

Second, given that imperfect information is available to regulators, the various parties involved — the regulated firms, customers and Government agencies — may try to influence outcomes in their favour, possibly distorting consumption, investment and production as a result. Several possibilities discussed in the literature include:

- capture of the regulatory process by the regulated firms, when the regulator — perhaps because it builds up a close relationship with the firm as it relies on the firm for information — identifies too closely with those it is regulating;
- capture of the regulator by users or consumers, perhaps because they are an important source of public support for the regulator; and

5 Transcripts for the public hearings of the Commission's *Review of Telecommunications Specific Competition Regulation*, held during August 2000, are available from the Commission's website (http://www.pc.gov.au/inquiry/telecommunications/index.html).

- capture of the regulatory process by the regulator, which may expand its influence by, for example, expanding the regulatory basket or increasing the intensity of its regulation.

By its nature, economic regulation takes place in a bargaining environment. As Evans and Garber noted:

> The behaviour of public-utility regulators seems to depend importantly on an array of economic, political, and institutional factors (Evans and Garber 1988, p. 446).

This is unavoidable in an environment where the regulation is dealing with customers, the owners of firms and the courts.

Third, regulation can superimpose risks additional to the market risks confronting a potential investor. 'Regulatory risk' refers to the risks associated with the regulatory process. If regulation keeps changing, is applied inconsistently by the regulator, or the price determination process is unduly slow, this increases the risks and uncertainty for regulated businesses contemplating new investment.

In a submission to the access inquiry, the Australian Pipeline Industry Association (APIA) argued that efficient investment in future infrastructure required regulatory certainty:

> … the gas transmission industry has indicated that, before it will commit to new investment in the form of significant capital (eg ordering of high cost items such as steel pipe), it must know in advance the regulatory arrangements, particularly the tariff path, that will apply to the development (APIA 2000, p. 4).

SACL also noted the importance of the economic and regulatory environment:

> That environment must be capable of attracting investors and innovative managers, must encourage the development of, and investment in, new facilities and services, and must provide the right incentives for the maintenance and upgrade of existing facilities and services to deliver the quality standards demanded by increasingly discerning airline customers and passengers (sub. DR27 p. i).

Some participants pointed to a link between the application of the PS Act and diminished incentives to invest (chapter 4).

The imperfections and incentive effects of regulation are recognised generally in the literature. As noted by Joskow and Rose:

> Regulators are unlikely to be perfectly informed, and regulation is unlikely to be costlessly implemented and enforced. When we expand our normative framework to recognise inherent imperfections, the set of potential regulatory effects becomes quite rich. Analysis of practical, as opposed to ideal, regulation must include explicit consideration of the incentive properties of specific regulatory rules and procedures used to set prices, the dynamics of regulation, the control instruments and information

available to regulators, and the responses of regulated firms to all of these (Joskow and Rose 1989, p. 1454).

Intervention by Governments in pricing decisions made in the market involves costs. It is important, therefore, to set out the costs of intervention and the expected benefits. The operation of regulatory bodies involves administrative costs to Government (chapter 4). Businesses bear the costs of complying with the regulatory process. In addition, if there are delays in regulatory and policy decisions, this can create uncertainty and have an impact on business strategy, which in some cases may lead to a reluctance to commit adequate new resources to regulated businesses.

This is illustrated by an empirical study by Bittlingmayer on the impact of antitrust filings in the US on business investment. He concluded:

> It turns out that whatever the ability of antitrust to lower prices and increase output in theory or in isolated circumstances, one actual effect of antitrust in practice may have been to curtail investment. In fact, the estimates here support the view that an extra case filed had its greatest effect on economy-wide investment (Bittlingmayer 2001, p. 322).

The above limitations of price control create a significant risk of inappropriate investment patterns, reduced incentives to provide improved or new products and poor operational efficiency. This suggests that price control should only be implemented when there is strong evidence of sustained monopolistic pricing.

Price control as a remedy of last resort

The number of areas prone to monopolistic pricing has been diminishing for some time and is likely to continue to diminish with further economic reforms, changing technology and increased international competition. Alternative policy approaches may overcome concerns about monopolistic pricing in remaining markets with substantial market power. Technological change and innovation may allow new providers into what were previously considered natural monopolies. Price regulation is therefore likely to be required only in a small number of markets with natural monopoly characteristics and no close substitutes (such as parts of the utilities industries like telecommunications, electricity and water).

The existence of only one firm (or a few firms) in a market does not necessarily constitute a problem. Consideration should be given to the full range of conditions on both the demand-side (for example, countervailing power of buyers and the availability of substitutes) and the supply-side (for example, the extent of countervailing power, import competition and the availability of substitutes), which are important in assessing whether a market power problem exists. In turn, this information is necessary to judge whether price control is required, or whether there are alternative options that introduce competition for the market, such as contracting and franchising.

Given the potential problems with price control, the generally preferred option for dealing with monopolistic pricing is to increase competitive pressures within the market, as noted by the Independent Committee of Inquiry:

> Regulated solutions can never be as dynamic as market competition, and poorly designed or overly intrusive approaches can reduce incentives for investment and efforts to improve productivity. There are costs involved in administering and complying with pricing policies. Finally, from a Government's perspective, resort to price control might be seen as an easy and popular way of dealing with what is in reality a more fundamental problem of lack of competition in an area. Since price control never solves the underlying problem it should be seen as a 'last resort' (Hilmer Report 1993, p. 271).

and:

> Given the risks associated with regulatory responses, the 'first best' solution is to address the underlying cause of monopoly pricing by increasing the contestability of the market (Hilmer Report 1993, p. 272).

This also was emphasised by the CIF:

> The legislation [PS Act] is not regarded the sole solution for control of market power where competition is weak. The CIF believes it is imperative in such circumstances for the Government of the day to take direct action to open such markets up to competition and to ensure that the process continues in those areas in transition to a fully competitive environment (sub. 5, p. 5).

and the ACCC:

> It is broadly acknowledged that pricing powers are a 'last resort'. They do not deal with the underlying problems of market power and therefore are a last resort where other pro-competitive reforms cannot be implemented (sub. 10, p. 3).

The problems with price control have been acknowledged generally by Governments in Australia. This is reflected in the trend to pro-competitive reform and the increasingly diminishing role that Governments have given price control over the last two decades. Given the limitations and potential costs of price control, it should be considered a remedy of last resort, applied only in important markets after careful evaluation of the options.

FINDING 2.2

Because of its limitations and potential costs, price control should be used as a 'remedy of last resort'.

Participants agreed with this finding. The ACCC noted:

> The ACCC is highly aware of the potential pitfalls of prices oversight and supports the PC's view that it should be a remedy of last resort (sub. DR25, p. 2).

Shell in its draft report submission stated:

> Shell supports the Commission's recommendations that price controls should be a remedy of last resort and only apply in markets where competition is not strong (sub. DR26, p. 1).

The ACCI agreed, while APAC had even stronger views. It stated that:

> APAC emphatically believes that price controls must be a last resort after market mechanisms and monitoring have led to the view, based on actual evidence and experience, that a firm's pricing capacity must be restricted (sub. DR23, p. 3).

3 Prices oversight as part of competition policy and law

The Trade Practices Act (TP Act) already contains provisions that directly and indirectly provide for prices oversight. This chapter assesses whether there is a case for additional instruments of prices oversight.

3.1 Relevant provisions of the Trade Practices Act

The TP Act is a national regime providing for the implementation of competition policy. Its objectives are to enhance community welfare through the promotion of competition and fair trading and to provide for consumer protection (section 2 of the TP Act).

Although the TP Act does not make monopolistic pricing by firms illegal *per se*, it contains provisions that aim to prevent the creation and misuse of market power, and allows for prices oversight of significant services of essential infrastructure facilities. The relevant provisions are Part IV (restrictive trade practices) and Part IIIA (access to services). Following amendments to the TP Act in 1995, Parts IV and IIIA apply to all incorporated and unincorporated businesses and Commonwealth and State and Territory Government businesses.

Part IV — Restrictive trade practices

Part IV aims to procure and maintain effective competition by proscribing certain practices that can create market power, and by making illegal the use of market power to harm or eliminate competitors where market power already is established.

The following anti-competitive trade practices are prohibited under Part IV:

- anti-competitive agreements — collective action between firms for the purpose or effect of substantially lessening competition are prohibited under sections 45–45D, 47–48 and 96–100. Such agreements include those between rival businesses (for example, price-fixing agreements, market-sharing arrangements and supply restrictions) or between upstream and downstream parties such as buyers and sellers, producers and distributors, or distributors and retailers (for

example, secondary boycotts, exclusive dealing and resale price maintenance). Anti-competitive agreements seek to create market power by restricting competition between suppliers.

- misuse of market power — section 46 prohibits a business with a substantial degree of market power from taking advantage of that power for the purpose of:
  - eliminating or substantially damaging a competitor;
  - preventing the entry of a competitor into any market; or
  - deterring or preventing a business from engaging in competitive conduct in any market.
- creation of market power through mergers or acquisitions — sections 50 and 50A prohibit mergers or acquisitions that are likely to substantially lessen competition in a significant market. However, sections 50 and 50A cannot prevent the accumulation of market power through innovation, the exploitation of exclusive rights or the natural attrition of competitors.

Under the TP Act, the regulator can authorise certain practices prohibited under Part IV where they are expected to deliver net social benefits. For example, a merger may create synergies, improve efficiency and facilitate research and development, allowing the merged business to compete more effectively in international markets and with imports in the domestic market, even though the merger may lessen domestic competition or result in higher concentration in the market.

The merger provisions of the TP Act do not provide explicitly for prices oversight. However, it is possible that the merged entity could be subject to prices monitoring or disclosure as a condition of permitting a merger. For example, in 1991 ACI Glass Packaging Australia gave an undertaking to the Trade Practices Commission to relate changes in the prices of glass containers to productivity growth and audited changes in a basket of costs, in order to secure an authorisation to merge (PSA 1995c).

Although the provisions relating to anti-competitive agreements can address some pricing issues (such as price-fixing or predatory pricing), they do not directly address situations where market power results in monopolistic prices, as Ray Steinwall noted in relation to section 46:

> … it does not deprive an organisation of the freedom to set the price that it wishes, even prices that are well above competitive levels. There is no contravention of s46 unless the price setting decision of the organisation is for one of the prohibited purposes. Absent this, there is complete freedom on pricing (sub. 7, p. 2).

Rather, they may indirectly discourage monopolistic pricing by proscribing anti-competitive practices used to exercise market power.

Part IIIA — Access to services

As noted in chapter 1, Part IIIA of the TP Act and Clause 6 of the Competition Principles Agreement are currently the subject of a Productivity Commission inquiry. A summary of Part IIIA is provided here because the operation of Part IIIA and its overlap with the PS Act is fundamental to the assessment of the PS Act. For a more detailed discussion of Part IIIA, refer to the report of the inquiry into the National Access Regime (PC 2001a).

In 1993, the Hilmer Committee concluded that competition law at that time did not provide adequately for access to the services of essential facilities necessary to allow competition in upstream and downstream markets. That is, a prospective competitor in a market may have been unable to compete effectively because another competitor in that market had control of, and would not give access to, the services of an essential facility. The Committee considered that section 46 of the TP Act was inadequate to deal with access issues and that:

> In addition to the difficulties in demonstrating a proscribed purpose, there may be difficulties in courts determining the terms and conditions, particularly the price, at which such access should occur … because of the difficulties in calculating a reasonable price (Independent Committee of Inquiry 1993, pp. 243–244).

The Committee proposed the introduction of a national access regime, and in 1995, Part IIIA of the TP Act was legislated as part of the National Competition Policy (NCP) (see box 2.3 in chapter 2).

Part IIIA establishes a legislative regime to facilitate third-party access under acceptable terms and conditions (including prices) to the services (not goods) of essential facilities of significance, in prescribed circumstances. Part IIIA is intended to apply when commercial negotiations fail to secure access to the services provided by an essential facility or when parties cannot reach agreement concerning the terms and conditions (including prices) of access.

In providing for access to the services of an essential facility, Part IIIA allows regulation of the terms and conditions for use of the facility. This is necessary because an obligation to supply could be circumvented by the terms and conditions of supply, especially price.

Under the umbrella of Part IIIA, a third party can seek access to eligible services through one of three avenues:

- requesting that the National Competition Council (NCC) recommend that the responsible Minister declare access to those services (if the facility is declared, the service provider is required to enter into negotiation with access seekers, supported by legally binding arbitration if negotiation is unsuccessful);
- through a legally binding undertaking from the facility operator approved by and registered with the Australian Competition and Consumer Commission (ACCC); or
- through a State or Territory access regime certified as being effective following a recommendation by the NCC.

Coverage

Part IIIA applies to services provided by essential facilities, but not to the facilities themselves, as some facilities may provide a range of services, only some of which may be eligible to be declared.

It does not extend to the supply of goods, the use of intellectual property or the use of a production process, except to the extent that these are an integral, but subsidiary part of the service.

The access provisions apply to the services of Commonwealth, State and Territory and privately owned facilities. The undertaking arrangements are available to owners of significant infrastructure, and industry bodies can have an industry code accepted as an undertaking. The certification regime currently focuses on State and Territory access regimes. Some Commonwealth industry-specific regimes are exempted from the umbrella of Part IIIA.

Examples of the three avenues of access under Part IIIA are presented in table 3.1.

The focus of the proposal by Hilmer was on businesses that both own essential facilities and compete in upstream or downstream markets (vertically-integrated businesses). However, Part IIIA also has been applied to non-integrated businesses (table 3.1). This was noted by the Australian Competition Tribunal in a recent case involving the declaration of cargo handling services at Sydney airport. In its ruling, the Tribunal stated that it:

> … is prepared to accept that an access declaration may be particularly appropriate where a facility, by means of which a service is provided, is controlled by a vertically integrated monopolist. But the provisions in Pt IIIA of the Act are not limited in their application to a vertically integrated organisation … (Australian Competition Tribunal 2000, p. 10).

This broader application recognises that monopoly pricing of access can be deleterious to economic efficiency.

Table 3.1 **Applications of the three avenues for access under Part IIIA of the Trade Practices Act[a]**

Avenue of access	*Industry*	*Sector*	*Jurisdiction*	*Vertically integrated*	*Non-integrated*
Declarations	Airports[b c]		Cwlth		✓
Undertakings & codes	Electricity[d]	Transmission	NSW		✓
			Vic		✓
			Qld		✓
			SA		✓
			ACT		✓
		Distribution and retailing[e]	NSW	✓	
			Vic	✓	
			Qld	✓	
			SA		✓
			ACT	✓	
Certification	Gas[f]	Transmission	SA		✓
			WA		✓
			Vic		✓
			NSW		✓
		Distribution and retailing	SA[g]	✓	✓
			WA		
			Vic		✓
			NSW	✓	
			ACT		✓
	Railways[i]		NT/SA[h]	✓	
	Shipping channels		Vic		✓

a This table broadly categorises the vertical structure that predominates in certain industries in the relevant jurisdictions rather than documenting exhaustively the vertical arrangements by each business entity. Vertical structure was assessed on the basis of ownership or governance arrangements. It includes only those declarations, undertakings and certifications that have been accepted. **b** Particular airport services were declared at Melbourne international airport from August 1997 until 9 June 1998 and at Sydney international airport for a period of five years from 1 March 2000. **c** Major airports and Airservices Australia are considered to be non-integrated in that they do not own and operate aircraft for the purpose of transporting passengers and/or freight. **d** The ACCC accepted relevant parts of the National Electricity Code as an industry access code under section 44ZZAA(3) of the Trade Practices Act. Transmission is separated from the other elements of the business but distribution and retailing remain part of the same business unit. **e** Independent retailers are permitted to operate in these jurisdictions. **f** Certification of the NSW gas access regime has been delayed pending resolution of cross-vesting issues. Applications for certification of gas access regimes for Victoria, Qld and the ACT are being considered. Transmission is separated from the other elements of the business but distribution and retailing remain part of the same business unit. **g** Distribution and retailing are treated as non-integrated because Origin Energy retails natural gas and Envestra owns the distribution networks even though Origin Energy operates these networks on behalf of Envestra. **h** The AustralAsia Railway Access Regime covers the proposed rail line from Darwin to Tarcoola. **i** The NSW rail regime expired in December 2000.

Sources: ACCC (1999c, 2000b); AGA (2000a); Dickson and Warr (2000); NCC (1999c).

Pricing principles

Although Part IIIA aims to encourage negotiation between parties, it provides scope for price control. For example, in the case of the National Third-Party Access Code for Natural Gas Pipelines Systems, the regulator assesses the pipeline owner's proposed total revenue requirements and reference tariffs against the code's pricing principles.[1] This involves assessing submissions from the pipeline owner and the public on issues including asset values, capital costs, depreciation rates and operating and maintenance costs. Reference tariffs accepted by the regulator must include incentive regulation mechanisms (such as CPI-X price caps) to ensure pipeline operators continue to improve their service and that the benefits of efficiency gains are shared with customers (ACCC 2000b).

A similar approach is taken in other sectors. The National Electricity Code, for example, requires the regulator to set a revenue cap for transmission services using prescribed pricing principles. The code also requires regulators to use CPI-X price caps or other incentive-based methods to encourage productivity improvements. The pricing principles in the code require the regulator to value the network's assets and determine a return on the asset. The final revenue caps are derived after accounting for efficient depreciation rates and operating and maintenance costs (ACCC 2000b).

Under the declaration avenue for access in Part IIIA, there is scope for arbitration by the ACCC when the granting of access fails to lead to a negotiated agreement between the access seeker and provider. Although there has been no case of arbitration, it is likely that any future arbitrations would condition prospective negotiations. From this perspective, the arbitration provision increasingly would become a form of price control.

National access regime inquiry

The Commission's inquiry into the national access regime has proposed (PC 2001a) among other things, that Part IIIA should:

- be retained;
- apply to both the denial of access and monopoly pricing of access;
- principally focus on natural monopolies;

1 Pipeline service providers must specify one or more reference tariffs, which serve as benchmark prices for services likely to be sought by a significant part of the market. Reference tariffs are established by determining the charges needed to meet each pipeline operator's proposed total revenue requirement.

- remain confined to services provided by essential infrastructure facilities and retain the exclusions applying to the supply of goods, intellectual property and production processes;
- cover the activities of vertically-integrated and non-integrated essential facilities;
- provide for the Commonwealth to submit its industry-specific access regimes for certification; and
- explicitly incorporate pricing principles.

If the Commission's proposals were to be adopted then all significant markets for essential services from infrastructure facilities, where enduring and substantial market power is likely to exist, potentially would be subject to Part IIIA.

3.2 Is there a case for additional price control powers?

Although Part IIIA does not apply to goods, intellectual property and production processes, these markets are unlikely to have natural monopoly characteristics. Notwithstanding the application of Part IV of the TP Act, some of these markets may not be subject to competitive pressures because they can support only a small number of firms or they are in transition to a more competitive structure, following deregulation and structural reform. This gives rise to the question of whether there is a case for price control under the national competition policy framework, beyond that provided by the Part IIIA provisions for declarations, undertakings and certification.

Although price control may be the best policy option in some cases of natural monopoly, this is unlikely to extend to imperfectly competitive markets (such as oligopoly) and those that are potentially competitive, following deregulation and structural reform (box 3.1).

Generally, economics has difficulty providing clear guidance about how to regulate prices in imperfectly competitive markets.

Demsetz, in exploring the guidance that economics can offer antitrust policy, wrote:

> For antitrust problems … the primary issue is the assessment of the competitiveness of industrial behaviour, with a view toward increasing competition where it is found inadequate. It is a problem to which relatively little theoretical attention has been given. Determining the degree of competitiveness is a very different problem from the application of either the competitive or monopoly model to a particular situation (Demsetz 1989, p. 196).

Analysis of the structure of imperfectly competitive markets is much more complex than in the case of competitive or natural monopoly markets. In these markets, it can be particularly difficult to determine which are candidates for control, and how and at what level prices should be regulated, if at all. It is difficult to establish unequivocally, that price control can improve economic efficiency.

Box 3.1 **Reasons for changes in the structure of markets**

The structure of markets can change for a range of reasons, including changes in technology, consumer demand and preferences, availability of substitutes, resource discovery and depletion, import competition, the strategic behaviour of market participants, and government policies.

For example, the telecommunications industry in Australia has experienced rapid growth and technological change, with a range of different technologies now available to deliver the same or similar services. Telephone calls can be transmitted by fixed line and mobile networks and television services can be broadcast via cable, satellite and land based transmitters. Internet-based systems are also emerging for both telephony and web TV. This may have potential to increase competition in some market segments.

Changes in market structure also may stem from government policies such as structural reform and deregulation. For instance, structural reform of the electricity industry involved separating the generation and retail segments (which are contestable) from the distribution and transmission segments (which have natural monopoly features). Many sectors in the Australian economy have undergone deregulation, including the banking, telecommunications and dairy industries.

As Joskow and Rose noted:

> When competing firms operate in a regulated market, the nature of price regulation itself typically changes, and the variety of possible regulatory effects expands. Regulated prices in industries with multiple competing firms generally are based on some measure of industry average cost rather than the cost of each regulated firm. While many of the variables that can be affected by regulation are the same as those described for monopoly markets, the nature of the regulatory effects may differ considerably from those that emerge when a single legal monopoly firm serves a particular market (Joskow and Rose 1989, p. 1455).

The Industry Commission recognised the difficulties in regulating prices in imperfectly competitive markets:

> … the efficient regulation of the prices of duopolies and oligopolies is likely to require more information, and deftness in changing circumstances, than is available to any regulatory agency. … The limitations of prices surveillance are so marked that it is doubtful whether it can make a constructive contribution to consumer welfare in duopolistic and oligopolistic markets (IC 1994b, p. 79).

These practical difficulties and the limitations in applying price control outlined in chapter 2, compound the problem. As Network Economics Consulting Group (NECG) noted, in its submission to the national access regime inquiry:

> In reality, determining efficient costs with any degree of accuracy is very difficult, if not impossible. This is true of any area of economic activity; ... As a consequence, access price estimates are often the result of a series of subjective decisions. The problem is not one of inadequate or inappropriate regulatory behaviour, but rather of limited information. A regulator cannot be expected to know with sufficient precision the efficient cost of current operations or future investment requirements of the firm (NECG 2001, p. 16).

The application of price control is intended to improve efficiency by removing monopolistic pricing. But, any benefits can be quickly eroded if the prices are set too low, consequently discouraging investment, product development, innovation, and the entry of new firms into the market. A similar point was made by NECG in relation to access pricing:

> In using their discretion, regulators effectively face a choice between (i) erring on the side of lower access prices and seeking to ensure they remove any potential for monopoly rents and the consequent allocative inefficiencies from the system; or (ii) allowing higher access prices so as to ensure that sufficient incentives for efficient investment are retained, with the consequent productive and dynamic efficiencies such investment engenders (NECG 2001, p. 16).

The setting of a price that is too low is of more concern than setting it too high. A high price may inhibit investment in related markets, but it also creates market incentives for substitutes or additional supplies to develop. However, when a price is set too low, an excess demand is created instead of a high price, forcing the market to rely on less efficient, non-monetary ways to adjust, as noted by Bidwell:

> By preventing the market price from reaching a clearing level, the intervention limits the reward for finding new substitutes or increasing supply. In this way, intervention transforms a short period of a high price into a long period of shortage (Bidwell 1996, p. 117).

The ACCC had a different view. Although it acknowledged the potential pitfalls of prices oversight, it opined:

> Given this, [potential pitfall] however, it is vital that a prices oversight regime has the appropriate characteristics to ensure that its implementation is likely to be effective (sub. DR25, p. 2).

However, given the difficulties of applying price control to imperfectly competitive markets, attempting to fine tune them is a risky task, particularly where cost and demand conditions change over time (Viscusi *et al*. 1995). History has shown this to be the case (box 3.2).

Box 3.2 Impacts of price control in imperfectly competitive markets: some examples from the US

Gasoline

At the time of the 1973 oil shock, the US Government intervened in the gasoline and oil market, fearing a shortage of gasoline. To prevent shortages, the current gasoline supply was allocated to users on the basis of the previous year's demand, and laws were passed which proscribed the exchange of gasoline at a market clearing price. By preventing the market reaching a new clearing price, government intervention created the very shortages it had sought to prevent (Bidwell 1996). The net social welfare losses of price control over the period 1975 to 1980 have been estimated at US$15 billion (Kalt 1981, cited in Viscusi *et al*. 1995, p. 633).

Airlines

Prior to deregulation in the late 1970s and early 1980s, the Civil Aeronautics Board was responsible for setting maximum and minimum airfares. In the absence of price competition, airlines engaged in non-price competition, attempting to provide higher quality services than competitors, which resulted in high prices. While consumers valued the higher quality resulting from regulation, they were hurt by not having the option of choosing lower priced, lower quality services. Fares have fallen in some markets following deregulation (removal of price and exit/entry regulation) and while quality also may have declined, the volume of air travel has exploded, suggesting that on balance consumers are better off. Innovation was also stifled by regulation — the development of hub-and-spoke networks following deregulation has resulted in lower fares and improved flight frequency (Viscusi *et al*. 1995).

Surface freight transport

Prior to 1920, the regulation of rail transport aimed to stabilise previously volatile rates at profitable levels, with the Interstate Commerce Commission (ICC) controlling rate setting and market entry and exit. Rates were set above cost, allowing the emerging trucking industry to undercut the railroads and take demand that would have been more efficiently served by rail. Because of the difficulties inherent in this situation, trucking was brought under ICC regulatory control in 1935. Allocative efficiency losses occurred because rail and truck rates were set non-optimally with respect to each other. Therefore freight that would have been more efficiently carried by rail (such as produce) was carried by truck. Various studies estimated that between 1950 and 1980 more than a billion dollars a year was wasted on transporting freight by truck rather than rail in the US.

In 1980, legislation was introduced which largely deregulated surface freight transport, giving firms unprecedented freedom to compete. Since deregulation (removal of price and entry/exit regulation), rail traffic has remained stable while productivity of labour and physical assets has increased dramatically. In trucking, physical outputs are at an all time high, as is net income, and the number of carriers has more than doubled (Viscusi *et al*. 1995; Thompson 1993).

In a review of the effects of economic regulation (control of prices and entry into markets), Joskow and Rose concluded:

> In other multi-firm industries, price regulation has been introduced primarily to protect consumers from precipitous price increases. This is true of natural gas, petroleum, hospitals and to some extent electric utilities with expensive nuclear power plants. These regulatory initiatives appear to be self-limiting. At some point, efforts to keep prices below market-clearing levels cannot be sustained. With prices below the marginal cost of additional supplies, shortages develop and the quality of service deteriorates (Joskow and Rose 1989, pp. 1496-1497).

An Australian example is the airline industry. Although the *Independent Air Fares Committee Act 1981* strived for efficient pricing and provided approval for a wide range of discount fares, the PSA acknowledged that relying on competition produced better outcomes:

> Deregulation has also seen the increased availability and wider range of discount fares … changes in frequency/scheduling of services between destinations, increased capacity in the market place and more varied marketing strategies adopted by the airlines all of which have contributed to a substantial increase in the number of passengers carried (PSA 1994k, p. 19).

In imperfectly competitive markets, it is generally preferable to rely on market outcomes than to apply price control.

The ACCC disagreed with this view, stating:

> It is significant that despite the potential pitfalls of price regulation being widely discussed and understood, including participants in this inquiry, there has been very little evidence presented to show that the theoretical distortions have actually occurred in practice. Given this, there is not a strong case for abolishing the generic prices regulation function. Rather there are grounds for amending and strengthening the generic pricing regime (sub. DR25 p. 5).

The Commission is aware of the limitations of relying on theoretical evidence. During the course of this inquiry, the Commission actively sought evidence on the actual costs of price regulation from firms subject to the PS Act. This evidence is presented in chapter 4 in sections 4.7 (Compliance costs), 4.8 (Effects of the PS Act on investment) and 4.9 (Does the PS Act restrict competition?). The Commission also has drawn on the lessons from history, discussed above, which shows that in imperfectly competitive markets, performance improved when they were deregulated. Conversely, no empirical evidence was presented to the inquiry (by consumers or regulators) of the net benefits of price regulation in imperfectly competitive markets.

The three tiers of evidence (that provided to the inquiry by participants, the historical lessons about price regulation and deregulation in imperfectly competitive markets, and the academic literature) provide a case for limiting the provision of generic price control powers.

FINDING 3.1

Generally, price control should be applied only to markets that display substantial market power and are of significance to the national economy. In other markets where competition is not strong, the long-run costs of regulatory failure are likely to outweigh the cost of the market failure which regulation attempts to correct.

In the Commission's view, Part IV (restrictive trade practices) and Part IIIA (national access regime) provide sufficient means to promote competition and regulate prices in situations where monopoly prices are likely to warrant intervention.

FINDING 3.2

*There is no compelling case to provide **generic** price control powers in Australia's national competition policy and law framework beyond those already available in the Trade Practices Act.*

If the national competition policy and law framework were to reflect finding 3.2, Governments would still retain the option to implement price control in imperfectly competitive markets using industry-specific regulation, where they consider it is justified and are willing to accept the risk that price control entails. In the Commission's view this is the preferable approach.

3.3 Is there a case for inquiries and monitoring?

From the outset it has been difficult to gather evidence about the effectiveness and efficacy of public inquiries and monitoring. What have been the net benefits to the community and the economy from the at least 18 government inquiries into the petrol industry over the last decade? In relation to monitoring, SACL argued that:

> While the impact of prices monitoring is far less troublesome when compared to the price approval process, it nevertheless does entail compliance costs for both airport operators and the ACCC and experience to date suggests that such cost has generated no net public benefit (sub. DR27, p. 40).

However, one benefit of inquiries and monitoring may have been that they deterred the imposition of price control in circumstances where it would not have been beneficial.

In making a decision to control a price, two types of errors can be made — referred to by economists as Type I and Type II. A Type I error occurs when a decision is taken not to control a price when it would have been beneficial. A Type II error occurs when price control is applied when it is not beneficial.

Briggs and Scheelings have suggested that there are two factors that may bias the application of price control to circumstances in which it is not beneficial in the long-run. These are asymmetry in observing errors and risk aversion. They noted:

> If a regulator permits a practice … and prices rise, then such a detrimental effect is immediately observable and the regulator's error of judgement available for all to see. If, on the other hand, a banned practice would have been of lasting benefit to the community, this would not be observable … The regulator's error of judgement in this case is invisible (Briggs and Scheelings 1998, p. 33).

The problem arises because of asymmetry in information about the outcomes of price control. Typically, the short-term outcomes from controlling monopolistic prices are readily observable, such as lower prices to consumers or firms using the good or service. However, the long-term effects of price control on investment, innovation, product development, and competition are less tangible and cannot be forecast with any degree of certainty at the time of making the decision to control prices. Even after the event, it would be difficult to isolate, quantitatively, the impact of price control from the many other factors that impact on markets over time. A risk averse regulator may have an incentive to regulate, given the asymmetry of information.

Consequently, there may be a benefit, albeit modest, in making available public inquiries and monitoring, if this reduces the risk of the excessive application of price control by providing regulators and governments with an intermediate alternative between price control and no intervention. The best response to concerns about monopolistic pricing in imperfectly competitive markets, for the reasons outlined in this report, may be to investigate the matter and to monitor performance. An inquiry may suggest that there are pro-competitive options that are preferable to price control. If the community is aware that the performance of a market is being monitored, there may be less pressure for the adoption of price control. In this way, inquiries and monitoring may encourage the development of competition and the use of price control only in natural monopoly markets, when it has been demonstrated that there are no pro-competitive options and that it significantly improves efficiency.

Public inquiries

A public inquiry provides a systematic process for gathering, assessing and disseminating information about particular pricing issues or problems. The Hilmer Committee proposed that:

> … firms should be subject to prices oversight in only limited circumstances defined by statutory criteria and after an independent inquiry has investigated the market situation, alternative pro-competitive reforms and recommended that prices oversight is appropriate (Independent Committee of Inquiry 1993, p. 273).

A public inquiry process can help to minimise the risk of over-regulation and encourage the use of price control only where it is the best instrument by:

- informing the community and policy makers, and facilitating public debate, about the factors influencing prices in the market concerned and the significance of the pricing issue; and
- providing a transparent process for evaluating policy alternatives — including alternatives to prices oversight such as pro-competitive reforms — and identifying the most appropriate way to encourage competition in a given market.

An inquiry could facilitate good policy making in situations where there is concern about the effectiveness of competition, strong community concerns about price levels and movements, or where governments are considering reform and deregulation of industries.

One of the airport operators Australian Pacific Airports Corporation (APAC), currently declared for notification and monitoring under the PS Act, supported having an inquiry function:

> APAC supports the retention of an inquiry mechanism within the competition policy framework and its proposed reform, especially if it is part of a wider process designed to deliver good policy outcomes (sub. DR23, p. 4).

Monitoring

In imperfectly or potentially competitive markets, scrutiny of prices and market performance can be achieved through the publication of key information. This enables customers, the community, policy makers and regulators to monitor market outcomes and gain a better understanding of the workings of the market. Thus, monitoring can enhance market transparency and assist the competitive process. This role for monitoring is not intended as a way to effectively regulate prices (box 3.3).

Box 3.3 **What is monitoring?**

The term monitoring is used often in different contexts with different meaning. In this report, two types of monitoring are identified on the basis of their intent.

As an instrument of regulation and compliance by a regulator

The intent in this context is to put pressure on firms to achieve acceptable outcomes in terms of key factors, such as prices, profits and quality. The reporting process is used by the regulator to state publicly whether they are satisfied with the outcomes and whether further action, such as price control, is warranted. The regulator can use the threat of more intrusive forms of regulation (which may be strengthened by public and government support generated by the regulator's report) to persuade the firm to comply with the regulator's formal or informal targets. In this context, monitoring is used as a form of incentive regulation. A variation on this is where monitoring is used to assess compliance of a firm or industry with an agreement it may have with the Government regarding the implementation of a policy.

As a means of observing and understanding the performance of a firm, industry or market

In some situations there may be suspicion about market power. This can arise because of price volatility, a significant increase in price, or deregulation of the industry. Monitoring provides a means of observing and understanding the performance of the firms and the industry. It facilitates the systematic disclosure of information not readily available from other sources, such as reports produced by firms. For example, it may collect, publish and report on segregated company results and key indicators of performance such as prices for certain classes of customers or users, profitability and quality. The monitoring report provides information to the public and policy makers. However, it is not intended to be used to regulate behaviour. Notwithstanding this intent, it is likely to have some effect on the behaviour of firms being monitored. The intent of this type of monitoring is to provide an alternative in circumstances where price control is likely to be inferior to the operation of the market, even though there is some degree of market power that might be exercised.

Monitoring may have a role in easing public concerns about the exercise of market power in some industries, providing reassurance that markets are functioning appropriately. As the ACCC stated:

> … from time to time there are likely to be areas of the economy where there is considerable public concern about particular pricing outcomes. Government is likely to want to respond to these community concerns. In this situation a price oversight power is required that allows Government to respond. Price monitoring which requires the firm to provide specific cost, profit and price data at regular intervals can be used in the first instance or a public inquiry may be considered to be necessary (sub. 10, p. 38).

This is especially important where major changes have occurred, such as deregulation and privatisation, as noted by the Industry Commission:

> In industries previously subject to prices surveillance, a transitional period of prices monitoring may be a useful device for assuring consumers that unforeseen difficulties will be quickly identified. In some industries, there will be rapid public acceptance that prices oversight has seen its day. In others, particularly those with a high public profile, acceptance that there is no longer a role for the [PS Act] may take longer. … Transitional prices monitoring would allow Governments to avoid stepping away from an industry so quickly that necessary public support for reform is undermined (IC 1994b, p. 83).

Monitoring for a limited period of time, if implemented effectively, may help measure progress against the expected outcomes of reform without unduly interfering in the market. It is the threat of price control with other legislative instruments, such as the national access regime and industry-specific legislation, that acts as an incentive for firms not to abuse market power, rather than monitoring itself.

A framework for moving from price control to monitoring and information disclosure, as a market moves from natural monopoly to one with emerging competition, has been incorporated into the Utilities Act 2000 in the United Kingdom. Two key principles underpin the framework — enabling the right combination of competition and control to be achieved and ensuring the right balance between the interests of consumers and shareholders. The framework recognises that favouring the short-term benefits for consumers can blunt incentives for companies to become more efficient, innovative and to undertake investment, which can be bad for consumers in the long-term. Therefore, the statutory duties of regulators have been amended to require regulators to exercise their functions to protect the interests of consumers in the short and long-term, wherever possible by promoting competition (DTI 1998).

FINDING 3.3

Retaining some form of inquiries and monitoring functions in the national competition policy and law framework for prices oversight would provide an alternative, so that any specific price controls are enacted only when they are warranted and to encourage their removal when they are no longer warranted.

The way in which the inquiry and monitoring functions would operate is outlined in chapter 5.

3.4 Implications for the instruments of prices oversight in the PS Act

Price notification

The price notification function in the PS Act is an indirect form of price control, even though it does not explicitly control prices beyond the 21-day period. Firms are placed under pressure to comply with a publicly disclosed price determination by the national regulator (ACCC). In light of the potentially adverse consequences of price control and given that areas where price control may be warranted are likely to be covered by the national access regime, the Commission's view is that the price notification function of the PS Act is no longer justified.

FINDING 3.4

Price notification provided under the PS Act is no longer appropriate.

Inquiries and monitoring

For the reasons outlined in section 3.3 above, there may be a limited role for public inquiries and price monitoring functions as part of the national competition policy and law framework.

4 Evaluation of the Prices Surveillance Act

This chapter evaluates whether the existing *Prices Surveillance Act 1983* (PS Act) is best practice legislation for providing prices oversight into the future.

4.1 Approach to evaluating the Prices Surveillance Act

The PS Act is a general prices oversight regime in the sense that the types of firms, goods and services to which it could be applied are not defined in legislation in the way that they are under industry-specific regimes, such as those applying to telecommunications. Instead, the PS Act empowers the Minister to specify from time to time, the firms, goods and services that are to be subject to price notification or monitoring.

In view of this, it is appropriate to examine whether the framework embedded within the PS Act provides sufficient safeguard that the Act will be applied only in situations where it is likely to achieve its policy objectives and generate net public benefits. The Commission has taken a forward-looking approach, which involves comparing the framework within the Act to a current best practice framework for legislation, rather than the standards of a previous era.

This approach does not require the evaluation of the costs and benefits of each application of the PS Act, or whether alternative policies (such as pro-competitive reforms) would have been superior in these cases. That said, there are other grounds for not conducting cost-benefit analyses of past applications. Insufficient information is available on the reasons why the Act was used and why alternatives were rejected. Recent applications of the PS Act have formed part of packages of reform to some industries (including airports, Australia Post, the dairy industry and the waterfront). In such cases, it is impracticable to isolate the costs and benefits attributable to the Act from those of the other reform elements and the broader policy decisions.

The best practice framework that the Commission has used to assess the PS Act is based on current principles and processes for the assessment of new regulation. The

main elements of the framework are outlined below. (Appendix B sets out the framework in detail and the reasons underpinning the principles and processes.)

The framework is designed to ensure that policy is formulated and implemented after the relevant policy options have been considered and that decisions by governments and regulatory bodies are transparent, in order to increase their accountability.

A best practice process would involve three key parties — the Government, an independent review body, and an independent regulator. The initial role for government in the process is to establish clear and non-conflicting objectives.

According to this process, if the Government decides that there may be a situation of monopolistic pricing, it would refer this issue for review by an independent body (which would not have on-going responsibility for implementing any regulatory solutions). This body, which would be required to operate transparently through a public process, would be asked to assess whether there is a significant pricing problem that needs to be addressed. If it decides that there is a problem, it would go on to identify all the relevant policy instruments which could be used to achieve the policy objectives (covering all feasible options including pro-competitive reforms, prices oversight and no response). The review would evaluate the advantages and disadvantages of each option and whether any restricts competition, before recommending to Government a preferred instrument, if any, for implementation.

The Government would then decide on the appropriate course of action within a defined period of time, publishing reasons for its decisions. If this involved some form of prices oversight, this would be undertaken by an independent regulator responsible for achieving the objectives that the Government has set. There would be a requirement for a periodic re-assessment of the need for prices oversight, to ensure that it is implemented only for as long as it is needed and that it remains the most suitable policy instrument.

4.2 Objectives of the Prices Surveillance Act

In evaluating the PS Act, the first issue to consider is whether the objectives underpinning the Act are clearly defined and non-conflicting. This is important for ensuring accountability and minimising uncertainty for organisations that are, or could be, subject to prices oversight.

Sources of objectives

The PS Act was written deliberately to be flexible in its application, allowing the responsible Minister to target key companies and sectors selectively, without involving large numbers of companies across an industry. While this flexibility suited the policy imperatives of the day, it is now considered by governments that setting clearly defined and non-conflicting objectives is both appropriate, given the more limited focus required for prices oversight identified in the current environment (chapters 2 and 3), and consistent with best practice regulation.

The PS Act does not contain an explicit statement of objectives or a preamble setting out the context for its application. However, the objectives of the Act in the current economic environment can be deduced from several sources (outlined in box 4.1), including:

- the second reading speech for the Prices Surveillance Bill;
- the statutory criteria in section 17(3) of the PS Act;
- the prices oversight provisions of the Competition Principles Agreement (CPA) (clause 2); and
- the Government's 1996 statement on the PS Act.

These sources are not explicit statements of objectives *per se*. They were intended to provide some guidance to businesses, regulators and the broader community about the circumstances in which the Act would be applied. For example, the primary purpose of the 1996 statement is to identify the situations in which the PS Act could be used. In doing so, the statement could be interpreted as establishing that the objectives of the Act are to achieve efficient pricing and protect consumers.

Clarity of objectives

The existence of multiple sources of guidance creates the potential for confusion as to the current objectives of the PS Act. There is no consensus over what source of information has primacy in detailing the objectives of the Act. The 1996 statement on the PS Act could be interpreted as the principal statement of objectives because it is the most recent source.

However, the statutory criteria in section 17(3) of the PS Act also have been interpreted as setting out objectives of the Act. For instance, Ray Steinwall indicated that in the absence of specific objectives, the statutory criteria could be viewed as *de facto* objectives (sub. 7).

Box 4.1 **Sources of objectives for the PS Act**

One source is the second reading speech for the Prices Surveillance Bill in which the Treasurer expected that surveillance would focus on areas where effective competition was not present and where price or wage decisions have pervasive effects (HoR 1983).

The statutory criteria also indicate possible objectives for the PS Act. Section 17(3) of the Act requires that the ACCC have regard to several matters in its deliberations under the Act:

- the need to maintain investment and employment, including the influence of profitability on investment and employment;
- the need to discourage a firm which is in a position substantially to influence a market for goods or services from taking advantage of that power in setting prices; and
- the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

Clause 2(4)(b) of the CPA states that the bodies established to provide prices oversight advice should have a number of characteristics, including that 'its prime objective should be one of efficient resource allocation but with regard to any explicitly identified and defined community service obligations'.

A fourth source of objectives is contained in a statement released by the Commonwealth Treasurer on the application of the PS Act. In announcing a series of changes to the operation of the Act, the Treasurer expected that prices surveillance would only be applied in markets where competitive pressures are not sufficient to achieve efficient prices and protect consumers (Costello 1996).

Sources: Costello (1996); CPA; HoR (1983); PS Act.

Commenting on the criteria in section 17(3) and directions issued by the Minister, the Australian Competition and Consumer Commission (ACCC) noted that:

> … the precise relationship between the criteria set out in these instruments is somewhat unclear. For example, different views have been expressed as to whether priority should be given to the directions over the section 17(3) criteria, or vice versa (trans., p. 8).[1]

Qantas argued that the statutory criteria require reconsideration and that:

> Although probably relevant to the original policy objectives of the PS Act, the criteria in section 17(3) are insufficient to guide the regulation of prices in an industry which exhibits natural monopoly characteristics (sub. 6, p. 6).

1 Transcript of the Public Discussion Forum of the Sydney Airport Pricing Proposal, held at the Melbourne Town Hall in December 2000.

Unclear and conflicting objectives

Although multiple sources of guidance about objectives provide flexibility in how the PS Act is applied, they also increase uncertainty. For example, section 2.4 noted that the PS Act was viewed initially by the Prices Surveillance Authority (PSA) as one of several tools for reducing inflation but that, as economic conditions in Australia changed, the inflation objective gave way to other objectives such as limiting price increases by firms with substantial market power. This shift in emphasis occurred without any legislative change.

The multiple sources of objectives also create the possibility of divergence between the intent of the regulation and the interpretation of operational criteria by the regulator and in legal proceedings. For example, the 1996 statement indicated that the PS Act is to be used in an effort to achieve efficient prices and protect consumers. However, depending upon how the statutory criteria are interpreted, the potential also exists for the statutory criteria to be applied in a manner that is inconsistent with an objective of efficient pricing.

Consider the statutory criterion about maintaining investment and employment. The criterion could be interpreted in an economy-wide context or alternatively, as applying to a particular region or, more narrowly, to one firm which is declared under the PS Act. If an economy-wide or market view is adopted in assessing prices, the regulator could arrive at a different conclusion than if the criterion is interpreted as applying only to a particular declared firm and a specified good. As outlined by Ray Steinwall:

> … the defacto objectives of the Act are clearly driven by considerations other than efficiency or efficiency alone (sub. 7, p. 2).

The PS Act has inadequately defined objectives regarding the role and use of prices oversight as part of Australia's national competition policy and law framework.

In contrast to the PS Act, the *Trade Practices Act 1974* (TP Act) provides explicit guidance to the ACCC on objectives. It is possible that these objectives have influenced the way in which the ACCC has interpreted and applied the PS Act.

The powers and functions of the ACCC are set out in the TP Act (Part II) and, as such, it is guided by the objectives of the TP Act. Section 2 states that the object of the TP Act is 'to enhance the welfare of all Australians through the promotion of competition and fair trading and provision for consumer protection'. Taking into account the TP Act and the PS Act, the ACCC sees its roles as:

> … to improve competition and efficiency in markets, foster adherence to fair trading practices in well informed markets, promote competitive pricing wherever possible and

restrain price rises in markets where competition is less than effective (ACCC 1999c, p. ix).

The focus of the ACCC in administering the notification and monitoring provisions of the PS Act, has been on the issues of competition and economic efficiency. For instance, in ten recent final price notification decisions publicly released by the ACCC, the discussion focused on the efficiency aspects of prices or proposed price increases in all cases.[2] Equity issues (relating to the rate of progress towards achieving full cost recovery at regional airports) were considered by the ACCC in only two cases.[3]

4.3 Identifying the significance of monopolistic pricing

The best practice framework highlights the importance of evaluating all alternatives for achieving the objectives of prices oversight legislation in a transparent manner, prior to any government action. A crucial part of this evaluation involves identifying the nature and significance of any problems to be addressed (appendix B). Such an evaluation is particularly useful because it may reveal that perceived high prices or relatively large price increases are due to factors beyond the control of firms, such as changes in exchange rates or raw material prices, rather than monopolistic pricing.

The issue examined in this section is whether any guidance is available, under the PS Act or elsewhere, concerning the factors that should be examined by an inquiry when assessing potential cases of monopolistic pricing.

Current arrangements

The Government can reduce business uncertainty concerning the likelihood of government intervention by identifying the factors that will be considered in assessing the significance of potential pricing problems.

The public inquiry function under the PS Act could be used to undertake an investigation. However, the legislation does not provide any guidance about the

2 The decisions related to notifications submitted by Airservices Australia (decisions dated 18 March, 10 June, and 24 June 1998), Waratah Towage (decisions dated 16 July and 16 October 1997), Howard Smith (decision dated 17 February 1999), Australia Post (decisions dated 9 October 1997 and 6 May 1999) and Sydney Airports Corporation Limited (decision dated 13 January 1999).

3 See the ACCC decisions on notifications by Airservices Australia (10 June and 24 June 1998).

factors to be considered in an investigation of whether significant monopolistic pricing is occurring. The Government could provide the review body with guidance via a general ministerial direction under the Act or via the terms of reference for a specific inquiry.

As a result, the onus is on the review body to determine how competition in an industry will be assessed. This does not provide sufficient assurance that appropriate factors will be identified by the review body and that consistent criteria will be used for assessing potential problems in different industries, which could lead to inconsistency and increased uncertainty about assessments.

The PSA, Industry Commission (IC) and ACCC have developed separate sources of guidance indicating the factors that may have been used in the past to assess the level of competition and the need for prices oversight (box 4.2). These sources were developed for somewhat different purposes and as such may not address adequately the full range of factors that should be considered. For example, none of the sources identify countervailing power as a factor that should be taken into account in assessing the level of competition and prices charged by airports. Australia Pacific Airports Corporation (APAC) stated that the countervailing power of airlines acts as a significant constraint on the ability of airports to charge monopolistic prices (sub. 1, pp. 12-13).

4.4 Evaluation of options

In the current economic environment, the primary objective of prices oversight is to promote economic efficiency by discouraging, in the limited number of cases likely to arise, the use of market power to price monopolistically (chapter 2).

However, this does not mean that prices oversight using the PS Act will be the best or only response if a pricing problem is suspected or found to exist, as there is a broader set of alternatives (including pro-competitive reforms and existing regulatory alternatives). The task for the Government (or its policy agencies) is to select the most appropriate instrument to address the problem identified. Under a best practice policy framework, this involves identifying and considering alternative responses as part of a transparent review process (appendix B).

Alternatives to prices oversight

In order to choose the best policy response to a potential pricing problem, the full range of relevant alternatives should be identified and evaluated with reference to their benefits and costs. A failure to identify and/or carefully assess pro-competitive

alternatives to prices oversight could result in the choice of an inferior option or the application of prices oversight where it is not strictly warranted.

Box 4.2 **Assessing the need for prices oversight**

In response to the recommendations of the Hilmer Report (1993), the Commonwealth Government directed the PSA to undertake a two-year review of all existing declarations (except those relating to Australia Post, airports and air services). The terms of reference for these reviews required that the PSA assess, *inter alia*, the competitive conditions facing declared firms. In turn, the PSA identified the following tasks as relevant to assessing the level of competition:

- define the relevant market;
- consider whether the market is substantial;
- assess the state of competition in the relevant market to determine if any firm has substantial market power in that market;
- consider appropriate remedies to reduce or eliminate substantial market power where it is found to exist; and
- assess the likely costs and benefits of alternative forms of price notification where other options are not feasible.

In a submission to the PSA's review process, the IC (1994b) argued that the balance between the costs and benefits of price notification are such that it should be limited to settings where a single firm:

- has a greater than two-thirds market share; and
- has no major rival; and
- faces sporadic or trivial imports (import penetration persistently below 10 per cent of the market); and
- is sheltered by substantial barriers to entry (expansion by rivals).

In its submission to this inquiry, the ACCC stated that there is likely to be insufficient competition in a market for a good or service if:

- the minimum efficient scale of operation in the industry is large relative to demand;
- there are barriers to entry and exit in the form of significant sunk costs or legislative restrictions; and
- there are no reasonable alternative sources of supply (sub. 10, p. 36).

Sources: ACCC (sub. 10); Hilmer Report (1993); IC (1994b).

The existing PS Act provides three means for prices oversight (notification, monitoring and public inquiries). However, the Act does not explicitly require the

Government or its policy agencies to consider whether there are other ways to address potential cases of monopolistic pricing prior to applying these instruments — although such deliberations may have taken place in the relevant Minister's office or department. This is largely a consequence of the original intent that the Act be used flexibly, as part of the prices and incomes policy at that time.

Consideration of the full range of alternatives, including pro-competitive reforms, can still occur under the PS Act — primarily through the public inquiry function. Public inquiries have preceded declaration in several instances. Moreover, some of these inquiries were required to consider alternatives to prices oversight by their terms of reference. For example, the inquiry into petrol prices in Tasmania required the PSA to consider measures that could improve the competitive environment in which petrol was sold in that jurisdiction (PSA 1990). In a later inquiry into real estate agents' fees, the PSA was required to have regard to further reforms to the market that could benefit home buyers and sellers (PSA 1992b).

However, terms of reference for most of the public inquiries initiated under the PS Act did not expressly direct the PSA (or the ACCC) to canvass alternatives to prices oversight. An examination of inquiries undertaken between 1984 and 1996 reveals that the terms of reference contained a requirement to review alternatives to prices oversight in only 4 out of 60 cases. The terms of reference for the public inquiries into sectors that are currently declared or subject to formal or informal monitoring by the ACCC (airport charges, bank fees and charges, harbour towage, petroleum products and postal services) did not explicitly require the PSA or ACCC to examine options including pro-competitive reforms.

Although the terms of reference for many reviews did not require that alternatives be examined, in practice the PSA or ACCC have done so, using their discretion in relation to the scope of the inquiry. For example, the generic terms of reference for the reviews of declarations announced by the Government in 1993 did not require that alternatives be examined. However, guidelines published by the PSA setting out its proposed approach to conducting the reviews stated that it would:

> … consider whether there are remedies more appropriate than prices [notification] to reduce or eliminate substantial market power where it is found to exist ... (PSA 1994b, p. 3).

A number of inquiry reports have covered areas that are currently subject to price notification, or formal and informal monitoring. Most of these inquiries examined alternatives to prices oversight and usually discussed pro-competitive policy responses even though they were not directed to do so (table 4.1). In its report on harbour towage, the ACCC discussed the potential role of pro-competitive reforms — involving the use of exclusive or non-exclusive licence arrangements — in

facilitating competition (ACCC 1995a). The ACCC concluded that pro-competitive reforms were unlikely to be a panacea for weak competition in this market.[4]

Table 4.1 **Consideration of pro-competitive reforms in public inquiries under the PS Act, selected industries**

Inquiry	*Final report*	*Directions in terms of reference?*[a]	*Pro-competitive reforms discussed?*[b]	*Pro-competitive reforms recommended?*
Postal services	1991	No	No	No
Airport charges	1993	No	Yes[c]	No
Bank fees and charges	1995	No	Yes	Yes
Harbour towage	1995	No	Yes	No
Petroleum products	1996	No	Yes	Yes

[a] This column notes whether the terms of reference included specific directions to examine pro-competitive alternatives. [b] Pro-competitive reforms are defined as including measures such as deregulation, structural reform, competitive tendering and access regimes which aim to improve efficiency by enhancing competition. [c] Structural reform to promote competition was mentioned briefly in the PSA's report (less than one page of discussion).

Sources: ACCC (1996a), ACCC (1995a), PSA (1995b), PSA (1993b), and PSA (1991c).

In some of the inquiries listed in table 4.1, the regulator recommended pro-competitive reforms such as deregulation. For example, in the inquiry into bank fees and charges, the PSA recommended that State and Territory Governments remove legislative barriers to credit unions and building societies gaining access to a range of deposit and investment funds (PSA 1995b).

Options for prices oversight

In some instances, pro-competitive reforms may be considered by a public inquiry process but rejected as the most efficient response to a potential pricing problem. Alternatively, the Government may rule out implementing pro-competitive reforms for social, political or other reasons. In situations where prices oversight is considered appropriate, a choice has to be made between a range of prices oversight instruments. The instruments differ in the degree of government scrutiny and intervention in firms' pricing (and hence investment and management) decisions. The main options include:

- public inquiries;

4 Howard Smith considered that the market for towage services is competitive (sub. 12) and that pro-competitive reforms (such as exclusive licence agreements) are not required. Others considered that exclusive licensing could be a viable alternative to the declaration of towage services for price notification (sub. 2, p. 1 and sub. 9, p. ii).

- price monitoring (official and private);
- price notification; and
- price control.

There is no requirement under the PS Act for a transparent review to occur prior to a decision by the Minister to apply price notification or monitoring. In practice, reviews of alternative instruments may have occurred within a department or the Minister's office. However, where an instrument was chosen in the absence of a public process such as an inquiry, it is not transparent how the instrument was selected and what factors were considered in the assessment of alternatives.

The public inquiry function under the PS Act provides a transparent mechanism for exploring the efficacy of different prices oversight instruments. Indeed, the terms of reference for inquiries under the Act have included a specific direction to examine alternative prices oversight instruments in 25 of the 60 cases examined by the Commission. All of the inquiries into areas currently declared, or subject to formal or informal monitoring considered alternative instruments of prices oversight (table 4.2), even though the terms of reference for several of them did not include a specific direction to do so.

Monitoring was recommended in most of the inquiries listed in table 4.2. In the inquiry into bank fees and charges, the PSA did not consider that price notification was necessary to deal with the pricing problems that were identified. However, it saw a role for monitoring to promote a more informed market and to assess responses of the market to the inquiry's recommendations. In the petroleum products inquiry, the ACCC stated that there should be limited monitoring of retail prices during the transition to a more competitive market.

Inquiries into airport charges and postal services by the PSA determined that price notification was appropriate for these industries. The PSA found that the Federal Airports Corporation (FAC) possessed monopoly power in respect to aeronautical services and therefore recommended that a broad range of aeronautical services be subject to price notification.[5] The PSA also considered that the FAC may have possessed market power in some non-aeronautical services and, rather than suggesting that price notification be applied, recommended that certain non-aeronautical services be monitored. The PSA inquiry into postal services

5 The Commonwealth Government applied price caps to aeronautical services at 11 airports when they were privatised.

recommended, *inter alia*, that the declaration of postal services be extended to include some services that were not reserved to Australia Post.[6]

Table 4.2 **Consideration of prices oversight instruments in public inquiries under the PS Act, selected industries**

Inquiry	*Final report*	*Directions in terms of reference?*[a]	*Instruments discussed*	*Instruments recommended*
Postal services	1991	No	Notification Price capping[b]	Notification (using a price cap)
Airport charges	1993	No	Notification Monitoring Price capping[b]	Notification Monitoring
Bank fees and charges	1995	No	Notification Monitoring	Monitoring
Harbour towage	1995	Yes	Notification Monitoring	Monitoring
Petroleum products	1996	Yes	Notification Price capping[b] Monitoring	Non-government monitoring[c]

[a] This column notes whether the terms of reference included specific directions to examine alternative instruments of prices oversight. [b] Under price capping a firm's allowable price increases are usually linked to some index of prices changes (such as consumer or producer price indexes) rather than changes in the actual costs of production. [c] The ACCC recommended that the minister write to appropriate non-government motoring bodies urging them to develop monitoring programs.

Sources: ACCC (1996a), ACCC (1995a), PSA (1995b), PSA (1993b), and PSA (1991c).

The best practice framework suggests that transparent reviews of the need for prices oversight should examine the appropriate method for assessing prices. There is a spectrum of methodologies, including cost of service and various forms of price and revenue caps. The ACCC considers that it is required to adopt a cost of service approach to assessing prices, unless it has been directed by the Government to use a different approach, or it reaches agreement with a declared company to follow an alternative methodology (ACCC 1998a).

The PS Act does not require an examination of the appropriate methodology for assessing prices. The absence of such a requirement increases the risk that an inappropriate methodology will be selected, especially if the Act does indeed require that a cost-based method be applied by the ACCC (unless directed otherwise).

6 In its response to the PSA's recommendation, the Government stated that it was not appropriate to extend notification to activities which were open to some degree of competition (PSA 1992a).

4.5 Separating policy and regulatory roles

In assessing the costs and benefits of the PS Act, it is important to consider the process that was followed by the Minister in determining which products, services or organisations would be subject to monitoring. Implementing best practice regulation involves, *inter alia*, separating the tasks of assessing the likely impact on the community of monopolistic pricing and identifying the appropriate policy response (policy formulation), from the task of administering prices oversight arrangements (policy implementation) (appendix B). This separation is needed to ensure the independence of the inquiry process.

As noted in section 4.4, decisions by the Minister to apply or discontinue price notification or monitoring have occurred after public reviews on a number of occasions. In all cases, the PSA or the ACCC undertook the public reviews.

In the early phase of implementing the PS Act, a number of products, services and organisations were declared for price notification on the PSA's recommendation, after a period of informal monitoring. During 1985-86, 13 product groups were added to the list of declared products. According to the PSA:

> In most cases, declarations followed recommendations of the Authority [to the Minister] based on its price and profit monitoring activities … (PSA 1986, p. 48).[7]

In the 1990s, it was more common for transparent public inquiries (rather than monitoring) to precede decisions to apply or remove price notification. For instance, in 1993 the Government initiated a review of many of the declarations that were in force at that time. The PSA, rather than an organisation without regulatory responsibilities under the PS Act, was asked to undertake the reviews of the 17 declared product groups specified by the Minister.[8]

The option is open to the Minister to seek advice on price notification or monitoring from an independent review body. Although some independent public inquiries into broader issues have made recommendations to undertake price notification or

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7 The PSA's recommendations were formed with the assistance of a public inquiry in only one of the 13 cases (table chickens) (PSA 1986, p. 48).

8 The PSA recommended that declarations covering six product groups be revoked (welded steel pipes, steel mill products, float glass, tea, coffee, and concrete roof tiles) and declarations covering three product groups be retained (glass containers, cigarettes and beer). The PSA recommended that declarations covering a further eight product groups be revoked but that monitoring be undertaken (biscuits, petrol, harbour towage, tampons, breakfast cereals, Portland cements, liquefied petroleum gas in Western Australia, and toothpaste). In a submission to the review, the IC (1994b) recommended that the Government revoke all of the declarations covered by the PSA's review except that for harbour towage.

monitoring,[9] the PS Act requires that the ACCC (and previously the PSA) conduct inquiries to assess the need for prices oversight following a direction from the Minister.

There are significant risks associated with combining the policy and implementation functions under the PS Act within one institution.

This issue was raised by several participants to this inquiry. Australian Pacific Airports Corporation (APAC) (which currently is subject to the PS Act) stated:

> APAC is generally concerned about the ability of regulators to create demand for their own services. For this reason, it has been a strong advocate of the review of Price Regulation of Airport Services being conducted by a body other than the ACCC.
>
> Such an approach ensures not only that there is no apprehension of bias in the result of the inquiry but brings to what are serious public policy, as well as regulatory, issues a fresh perspective not jaundiced by the experience of the day to day issues faced by an industry and its regulator. Further, the skills required of an efficient, competent regulator are not necessarily those required to conduct and facilitate wider ranging public policy discussions (sub. DR23, p. 4).

Requiring that reviews of the need for prices oversight be undertaken in a transparent manner (and the available evidence suggests that they have been in recent times) can help reduce the risk of a regulator developing pre-conceived recommendations in favour of one side of the market (consumers and users) or the other (suppliers). Also, the ability of the Minister to reject advice provided by the regulator provides a further check on any potential bias. However, combining the policy formulation and implementation functions contains an inherent conflict of interest when the institution evaluating the policy options has responsibility for implementing some of the options it is considering, but not others. The evaluation requires the assessment of the benefits and cost of regulation, which includes assessment of the regulator's likely performance in this regard. For this reason, combining the policy formulation and implementation functions is best avoided.

4.6 Best practice principles for administering prices oversight

So far this chapter has considered how the PS Act conforms with the best practice principles for prices oversight set out in appendix B. However, for a given legislative framework, outcomes obtained also can be influenced by how a regulator

9 The NCC (1998b) recently completed a review of postal services legislation. One of the NCC's recommendations was that services reserved to Australia Post continue to be declared under the PS Act (NCC 1998b, pp. 294-296).

interprets and applies the framework. The focus in this section is therefore on how the ACCC has sought to implement the PS Act. Rather than assessing the appropriateness of individual decisions, this section examines the ACCC's procedures and processes for implementing the Act in terms of transparency, accountability and timeliness.

Transparency

The ACCC has undertaken price notification, monitoring and inquiries in an open and transparent manner, in accordance with the requirements of the PS Act.

The PS Act has provisions designed to promote transparency. For example, the ACCC is required to maintain a public register of documents relating to declared companies, such as price notifications submitted by the companies and the ACCC's decisions on the notification.

Aside from these formal requirements, the ACCC also seeks to administer the Act in a transparent manner. For instance, the ACCC's notification guidelines state that it will normally consult with customers of the declared organisation as part of the process of assessing a notified price increase. Prior to consultations occurring, the ACCC will notify the declared company of its intention to consult with customers and the nature of the information that it intends to disclose to users (ACCC 1998a).

Generally a declared organisation must not implement proposed new terms and conditions of supply notified to the ACCC until the statutory period of 21 days has expired. A potential concern, given the complexity of some pricing decisions, is that the 21-day period may not allow a sufficiently detailed and transparent review of some price notifications. The ACCC considered that:

> Many notifications submitted to the ACCC under section 22 of the PS Act involve complex issues. In many cases resolution of these issues requires a process of public consultations. In such cases the requirement in section 21 [of the PS Act] to assess such notifications within 21 days is very difficult to achieve.
>
> It is important to note that in general the nature of notifications has changed radically since the inception of the PS Act in 1983. Price notifications for infrastructure-based utilities are now likely to involve complex economic issues, to which there are likely to be differences in views as to the right answer. The outcome of the Commission's decisions in such cases can have significant economic and financial consequences for the firms involved. The Commission is often required to obtain expert economic advice from independent consultants before reaching a decision; this is very difficult to achieve within a 21-day time frame (sub. 10, p. 32).

Similarly, Ansett submitted that:

> The major concern Ansett has with the 21 day timeframe is that we are often responding to [pricing] proposals we have not yet had an opportunity to consider in detail – and these are often complex and detailed proposals involving significant financial impact on Ansett's business. [And that] Short of refusing to approve a notification, the ACCC must comply with the 21 day timeframe. It is Ansett's view that [the lack of discretion on the part of the ACCC to extend the timeframe] can lead to a potential abuse of process by some airports (sub. 8, pp. 5-6).

These concerns raise several related matters, including the desire on the part of business, consumers and the Government to minimise bureaucratic delay. Another relevant consideration is that the Minister can ask the ACCC to undertake a public inquiry into a notification.

Previously, the PSA attempted to overcome the difficulties posed by particularly complex notifications by seeking the consent of the Minister to hold a public inquiry into the notification. The Minister granted such requests in a number of instances including, for example, in relation to Australia Post's prices and airport charges.[10] The inquiry function has not, however, been used in this manner by the Government since the early 1990s.

The ACCC has developed and implemented a new procedure designed to enable due consideration of more complex price notifications and facilitate greater input from users of declared services without requiring a public inquiry under the PS Act (see ACCC 1998a). This procedure allows for pre-submission of price notifications, which avoids triggering the 21-day period until the parties are ready to do so. Since February 1998, the ACCC has requested that declared companies pre-submit price notifications. The draft guidelines acknowledge the right of declared companies to lodge a notification without prior consultation and state that the ACCC will give due consideration to such a notification, 'although it would prefer a consultative process' (ACCC 1998a, p. 8).

The ACCC noted that the pre-notification procedure was introduced to address a lack of transparency and openness of the arrangements under the PS Act:

> … while the notice (of price increases but not the submissions supporting the notification) does have to be placed on the public register this does not occur until after the ACCC's decision has been made and the prescribed period (either 7 or 14 days) has elapsed. In contrast, the new procedures require a much more public process, which enhances transparency … (sub. 19, p. 5).

10 Three inquiries into postal pricing issues were initiated under the PS Act in September 1984, March 1986 and April 1989. According to the PSA, these inquiries were initiated following requests from the PSA and related to notifications submitted by Australia Post (PSA 1985a, p. 46, 1986, p. 56 and 1989, p. 43).

The pre-notification procedure may confer a number of benefits compared to the situation of limiting the ACCC's consideration of a notification to 21 days (without the declared company granting an extension or the Government initiating an inquiry). Pre-notification may enable a more detailed and thorough consideration of complex notifications than would occur otherwise. The extended process may reduce the likelihood of the ACCC reaching an incorrect decision due to inadequate time to consider the issues.

However, recent experience also demonstrates the potential for price notification to become quite onerous. For example, the pre-notification process for Sydney Airports Corporation Limited (SACL) has proven to be both resource and information-intensive for the key parties concerned. It also has been a lengthy process.

The benefits of pre-notification need to be balanced against the risks associated with the ACCC's procedure. The PS Act requires that the ACCC maintains a public register of the official notification and its decision, but not of submissions supporting the notification. Further, there is no requirement that documentation relating to the draft notification, draft decision and submissions from interested parties based on the draft notification be placed on the public register. In practice, the ACCC has made this documentation publicly available, as in the case of the SACL pricing proposal.

In the absence of a requirement to place documents in the public domain, the pre-notification procedure leaves room for discretion. There remains the possibility that documents might not be made publicly available or may be disclosed on a selective basis. This was raised by APAC in relation to pricing notification for Melbourne airport:

> Whilst the specification of instruments has certainly been an issue in airport regulation, the ACCC's approach has been an equal contributing factor. Below are just two examples:
>
> - The ACCC has generally been prepared to accept material from airlines on a commercial-in-confidence basis, thus denying airports the opportunity to comment on what has been said about their investment proposals and conduct. Whilst accepting that airlines may not want some information to be available to competitors, it is difficult [to] argue that transparent processes arise from a situation where entire submissions are made in confidence or that such basic information as a new entrant's expected traffic volumes is denied to regulated firms.
> - Melbourne Airport has asked the ACCC on a number of occasions to provide full details of its analysis of airport asset betas that are a core issue in regulatory decision making. The ACCC has yet to do so, despite both airlines and airports having made their analyses generally available. Most recently, the ACCC has advised the information is not in a form that could be provided. If this is the case,

> one must question whether it is in a form to enable robust decision making (sub. DR23, p. 6).

As it stands, the pre-notification procedure creates the risk that decisions may appear to be made in a less transparent manner, which could affect perceptions about the impartiality and accountability of the ACCC's processes.

Accountability

Ensuring accountability in economic regulation involves, *inter alia*, governments setting clear and non-conflicting objectives, ensuring that decision-making processes are transparent, and providing for regular independent reviews of the administration of regulation. Issues relating to objectives and transparency in decision-making have already been discussed. This section focuses on the issue of independent reviews of the administration of the Act.

Best practice prices oversight involves undertaking periodic public reviews of the way in which prices oversight has been administered and the need for it to continue. Moreover, someone other than the regulator should undertake the reviews (appendix B).

There is no requirement in the PS Act for a regular independent review of the administration of the Act. Although the current practice is that declarations have a sunset clause, there also is no requirement in the Act for an independent review prior to a decision to renew a declaration. This does not preclude it from happening. For instance, the current airport declarations expire in 2002 and 2003 and the Government has initiated a review by the Productivity Commission (PC).

This inquiry into the PS Act is the first independent review of the Act. However, two reviews of elements of the PS Act were undertaken by the PSA in the early 1990s, but without widespread public input. In 1990 the PSA undertook an internal review of the effectiveness of the notification function. All existing declarations were reviewed by the PSA to determine whether they needed to be maintained or modified. According to the PSA (1991b), the review resulted in a number of recommendations to revoke or alter declarations. The PSA also undertook a broader review of its operations in 1991 at the request of the Commonwealth Treasurer.[11] Neither review was required to seek public submissions or consult widely with industries affected by the PS Act. Hence, these reviews may not have effectively

[11] The Treasurer wrote to the PSA on 21 March 1991 requesting that it undertake a review of the PSA's record and role in reviewing industry or firm price changes, and the PSA's possible role in relation to the price performance of industries in which productivity-based enterprise agreements had been implemented (PSA 1991b, p. v).

identified or addressed community concerns about the operation and effects of the Act.

The reviews of declarations, which commenced in 1993, were conducted in a more transparent manner than the earlier reviews. These reviews sought public input, and resulted in some changes to the operation of the Act (including some revocations). The reviews also identified a number of problems with the over-arching framework of the PS Act. The inquiries into the declarations were undertaken by the PSA and its successor, the ACCC.

The absence of a requirement for periodic independent reviews of the administration of the PS Act could lessen accountability if reviews are not undertaken or they are undertaken by the regulator itself.

Timeliness

The best practice framework for prices oversight suggests that the decision-making process should be implemented expeditiously without compromising the quality of decisions.

The time lags involved in making decisions under the PS Act are likely to impose costs on declared firms. The costs to declared firms may include uncertainty about outcomes and delays in changing prices that may stem from notification or inquiries. On the other hand, a longer time delay may provide a declared firm time to prepare a response to a draft decision or to customer criticism of a proposed price increase.

Delays can arise from the notification process. In recent years, this process has greatly exceeded the statutory period of 21 days specified in the PS Act. A number of participants were concerned about the time taken to obtain price approvals. For example, APAC claimed that:

> Given that the ACCC takes about 4 months to deal with applications, new infrastructure and services will take significantly longer to deliver to a rapidly changing industry. Indeed, in some cases, pricing approval will be the most time consuming part of the project process. The inability to respond on a timely basis will not only delay projects but is likely to lead to some simply not proceeding (sub. 15, pp. 2-3).

Similarly, Capital Airport Group (CAG) argued that it is commercially untenable for an organisation to experience an approvals process that has yet to be completed within six months (sub. 18).

SACL argued that:

> The PSA processes are lengthy, inefficient and expensive for both those regulated under it and the regulator itself (and thereby the Australian taxpayer) (sub. DR27, p. 45).

The approval process for considering recent proposals for aeronautical charges has ranged from three months to more than a year to reach completion (table 4.3). The longer approval times may reflect the complexity of some notifications. As noted earlier, the ACCC has sought to implement a pre-notification process to allow more time to handle such notifications. In the case of SACL's pricing proposal, 13 months have transpired between SACL submitting its draft proposal (December 1999) and the ACCC issuing its draft decision (February 2001), and a further three months to the final decision (May 2001).

Table 4.3 **Time taken to process recent price proposals, airports**
(proposals to increase or introduce aeronautical charges)

Airport(s)	*Proposal submitted*[a]	*Final decision issued*[a]	*Time taken (months)*
Adelaide	October 1998	October 1999	12
Alice Springs and Darwin	May 2000	September 2000	4
Brisbane	December 1999	April 2000	4
Canberra	May 2000	July 2001	11
Melbourne	May 2000	August 2000	3
Melbourne	June 2000	October 2000	4
Perth	December 1999	April 2000	4
Sydney	December 1999	May 2001	16

a Dates as published in ACCC documents.

Source: ACCC website.

Another potential source of delays relates to the inquiry function. Companies named in the terms of reference for an inquiry under the PS Act may be prevented from raising their prices until the inquiry is completed. Although firms can seek an interim authorisation before the inquiry is completed, the PS Act may impose costs on firms by limiting their ability to adjust their prices. Delays also may increase uncertainty for firms about future prices oversight arrangements for the duration of an inquiry, which may deter investment. The duration of any uncertainty may be affected by the speed with which governments respond to the recommendations of inquiries. For instance, Qantas noted that the Treasurer had not responded to a recommendation that aircraft refuelling services be included in the price cap, 18 months after the ACCC issued its report (sub. 6, p. 5).

However, any assessment of the effect on firms of delays due to inquiries under the PS Act also needs to consider the desirability of ensuring that potentially costly prices oversight, as a policy of 'last resort', is considered thoroughly.

As there have been no inquiries under the PS Act since 1996, it is difficult to assess the potential effect on firms of delays due to inquiries. However, the duration of the 60 inquiries held between 1984 and 1996 ranged from three months up to 11 months, with an average duration of five months. In comparison, when the PS Act was initiated it was expected by the Government that the duration of inquiries would be restricted to an average of three months.

A further source of delays may stem from the strategic behaviour of customers of the declared company. It may be to the financial advantage of users to draw out the notification or inquiry process for as long as possible. Delays may arise from key users deliberately making late submissions or requesting additional time to prepare their submissions. The resulting delays could benefit customers by forestalling the introduction of higher prices or additional capacity which may increase competition in related markets. For instance, CAG claimed that:

> … delays are forced on the Airport by the airlines and are a result of the regulatory requirement for explicit user support from all airlines for almost every minute detail of a project proposal. Therefore the delays in approvals are not a result of the ACCC's turnaround time but rather the fault of the process that enables the major airlines to force these unnecessary delays (sub. 18, p. 21).

The evidence suggests that inquiries and the approval processes for recent price notifications have taken considerably longer to complete than was originally envisaged by the Government.

4.7 Compliance costs

In 1997, the Prime Minister expanded the Commonwealth's legislation review program to include the assessment of legislation that imposes costs or confers benefits on business with the aim of reducing compliance costs and the paperwork burden for business. The terms of reference for this review therefore require the Commission to examine ways to reduce compliance costs and the paper work burden on business where feasible.

As noted in chapter 1, the PS Act gives the ACCC three principal functions (inquiries, monitoring and price notification), and only a small number of businesses are currently affected by the Act directly. The potential direct compliance costs associated with these functions fall into three categories:

- the costs incurred by business in preparing notifications, responding to information requests from the regulator and preparing submissions to inquiries, which include staff and consultant costs;
- the costs incurred by other parties, which include the ACCC's costs (including consultant fees) associated with administering the PS Act and the costs to the customers of declared organisations and other interested parties of providing input to the price notification process and public inquiries; and
- the cost of time delays, which include the cost to declared companies of delays in implementing price rises due to regulatory lags.

Other possible indirect costs of prices oversight, such as business uncertainty and distortions to production, consumption and investment decisions are discussed in following sections.

Costs to declared organisations

Compliance costs are likely to vary from industry to industry. Factors influencing compliance costs may include the:

- frequency and duration of inquiries, including delays in the Government responding to the inquiry recommendations;
- frequency of price changes and therefore the number of notifications a company submits;
- complexity of notifications and resulting delays in the ACCC assessing and reaching decisions on notifications;
- method adopted by the ACCC for assessing proposed increases;
- the level of detail and scope of information sought by the ACCC; and
- the extent of modifications to accounting systems required in order to meet information requests for the purposes of monitoring, notification or inquiries.

Anecdotal evidence suggests that direct compliance costs are not likely to be the major cost to business, at least for several of the organisations currently subject to the PS Act. For instance, Australia Post has not submitted a notification for increased prices for standard postal articles since 1991.[12] Airservices Australia usually submits only one notification per year covering charges for its declared services. Airservices Australia indicated that it did not consider complying with the

12 Australia Post submitted notifications covering bulk mail and presort delivery discounts in 1997 and 1999.

notification requirements of the PS Act to be burdensome (*pers. comm.*, 15 March 2000).

However, submissions from several companies that were declared up until recently argued that the costs of complying with the provisions of the PS Act were substantial. CSR Limited, which had concrete tiles and pre-mixed concrete subject to prices surveillance, stated that 'direct compliance costs were considered onerous, estimated at five weeks per submission for an individual State' (sub. 18, p. 3).

The Cement Industry Federation (CIF) (representing several cement companies that were declared between 1986 and 1995) stated that:

> From [the cement industry's] point of view, the direct administrative costs [of the PS Act] were very substantial. At the time of the 1994 PSA Inquiry [into the Portland Cements declaration], industry members estimated costs in excess of $40 000 per company submission (sub. 5, p. 6).[13]

Philip Morris Limited (PML), which was declared between 1984 and 1996, stated that:

> During the period PML was declared, PML incurred $1.4 million in compliance costs, its competitors no doubt incurred similar costs, and the Prices Surveillance Authority and the Australian Competition and Consumer Commission must also have incurred costs surveying tobacco prices without [delivering any] benefits to tobacco consumers (sub. 3, p. 2).[14]

The concern of cigarette manufacturers about the magnitude of direct compliance costs may stem in part from the frequency with which they submitted price notifications for new and existing products. For instance, in 1994-95 the three declared cigarette manufacturers submitted 31 price notifications. Four of these related to new products and 22 related to price increases due to the imposition by governments of higher tobacco taxes.

CAG, the operator of Canberra airport, also argued that its compliance costs are significant. It noted that costs are incurred as a result of annual reporting on compliance with the airport price cap, making submissions for charging increases

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13 Six declared cement companies made submissions to the 1994 PSA Inquiry giving an estimated total cost of $240 000. The estimated annual turnover of the Portland cement industry in 1992-93 was $878 million.

14 If the total compliance costs were $1.4 million for each of the major declared companies (Philip Morris, Rothmans, W.D. and H.O. Wills), total compliance costs for the industry were $4.2 million over 12 years (or around $350 000 per annum). Between 1984 and 1996, cigarette manufacturers submitted around 370 price notifications (which works out to an average cost of around $11 350 per notification) (PSA 1994a, p. 9 and 1995a, p. 39).

related to new investment, and public inquiries. CAG has estimated its costs of regulatory compliance at:

> $100,000 per annum since May 1998 for advocacy in relation to the regulatory system;
>
> $60,000 - $70,000 in additional accounting requirements;
>
> $25,000 - $100,000 each on new investment proposals (total of 9 proposals at an estimated cost of more than $370,000);
>
> These costs include consultant's reports, management time, travel etc but exclude costs to the Airport of construction delays resulting from an inability to proceed with projects until necessary approvals have been received (sub. 18, p. 28).

CAG estimated its expenditure on regulatory compliance at over $300 000 for the 1999-2000 financial year (sub. 18, p. 29). It argued that the costs of current regulatory arrangements outweighed the benefits, citing as an example its proposal to recover an investment in a new cross runway approach lighting system:

> After six months of negotiations with the airlines and the ACCC, the regulator passed a decision entitling Canberra Airport to an increase in the general landing charge of $0.02. This exercise cost CAG in excess of $25,000 — not including the costs to the airlines and the ACCC of this unreasonably long process — a cost burden that is ultimately borne by passengers and the taxpayer (sub. 18, p. 6).

APAC, which operates airports in Launceston and Melbourne, stated:

> Of the conservative estimate of $500 000 per annum that APAC spends on regulatory compliance (including quality of service monitoring) we would estimate that at least half of that would be associated with reporting (sub. DR23, p. 4).

Costs to other parties

The ACCC incurs costs in administering the PS Act. Some participants (including the Australian Airports Association (AAA) and CAG) argued that these costs are substantial. The AAA claimed that:

> The PSA processes are lengthy, inefficient and expensive for both those regulated under it and the regulator itself (and thereby the Australian taxpayer) (sub. 21, p. 7).

The ACCC performs a range of functions and allocates a share of its resources towards the implementation of the PS Act. Based on the information provided in the ACCC's annual reports, it is not possible to estimate accurately the administrative cost of applying the PS Act in recent years. However, the PSA (whose prime function was to administer the Act) spent around $4.2 million in its last year of operation (1994-95).

The direct compliance costs to third parties who are involved in consultations with the ACCC under the PS Act (such as the customers of declared organisations) are likely to be a small part of the overall compliance costs.

Third parties are not required to respond to information or consultation requests from the ACCC. Any compliance costs incurred by third parties are likely to reflect a judgement that there are greater offsetting benefits from involvement in processes under the PS Act. Ansett, which is a third party to airport and air services notifications, supported retaining the PS Act, it stated that it:

> … does not consider that, to date, the cost of compliance has been a concern. From time to time we have engaged consultants or legal advisers to assist us in preparation of submissions [to ACCC assessments] but do not find we have incurred undue costs — certainly no more than we would otherwise in negotiation of transactions of similar magnitude with Airports or Airservices (sub. 8, p. 10).

4.8 Effects of the PS Act on investment

A major issue for this inquiry is whether arrangements under the PS Act have had the unintended effect of deterring worthwhile investment in new production techniques and improved products and services in the industries to which the Act has applied. The Act specifically requires the ACCC to take investment effects into account (section 17(3)), and there is no reason to believe this is not a consideration in the ACCC's deliberations.

CSR Limited argued that prices surveillance had delayed investment in the concrete tile business during the period 1985 to 1995 when Monier was declared under the PS Act:

> Monier delayed the development of a public and trade selection centre in Victoria due to poor returns from a low regulated price. About a $3 million investment was required for the facility. … At the time the two other main competitors in the Victoria market had six such centres and Monier was suffering loss of market share because of the lack of such centres and package deals offered at such centres. The prices surveillance regime in this case effectively delayed an investment decision which in the normal course of events would have occurred earlier …
>
> In a similar example, improving profits were necessary before Monier could justify expending $50 million to build a facility to manufacture clay bricks and pavers in Victoria. Profits from sales in Victoria as regulated by the PSA were such that this investment could not be seriously considered and ultimately was not pursued (sub. 20, p. 2).

Some participants from the aviation sector were concerned about the operation of the arrangements for regulating airports and the implications for investment.[15] For instance, APAC claimed that:

> The [airport industry] arrangements have led to some perverse outcomes and the industry has been involved in a process of almost continuous regulatory discovery, both of which generate uncertainty that has and will continue to affect investment and other business decisions (sub. 1, p. 5).

APAC went on to argue that the ACCC's decisions under the PS Act can affect the incentive to invest. Commenting on the common user terminal at Melbourne airport, APAC stated that:

> If the price contained in the ACCC's draft decision had of been known at the time of commitment to construction, MA [Melbourne Airport] would not have started works. Going forward, MA will now wait until it has a final pricing decision from the ACCC and if it finds pricing unacceptable, it won't invest (sub. 15, p. 2).

Similarly, CAG claimed that the price cap arrangements applying to airport operators may have the effect of delaying or deterring new investment:

> Long and uncertain approvals processes have a detrimental impact on an airport's decision on whether to invest in necessary aeronautical infrastructure. With returns being insufficient to compensate for the regulatory risk involved in airport infrastructure development, the result being that it will become increasingly difficult to attract investment dollars for future necessary aeronautical infrastructure projects (sub. 18, pp. 11-12).

SACL was also concerned about the impact of the PS Act on investment incentives:

> An inherent problem with PSA regulation, … is that it not only delays the introduction of revised charges necessary to ensure that airport operators are assured of a reasonable return on their pre-existing investments but also, more importantly, it deters and delays new investment (sub. DR27, p. 45).

4.9 Does the PS Act restrict competition?

This inquiry stems from the Competition Principles Agreement (CPA) which committed Australian Governments to review all legislation which may restrict competition by the year 2000.[16] The terms of reference for the review therefore require the Commission to consider whether the PS Act restricts competition, and if so, to what extent.

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15 See the submissions by APAC (sub. 1), Qantas (sub. 6), BARA (sub. 7) and Ansett (sub. 8).

16 In November 2000, the Council of Australian Governments (COAG) extended the deadline for completing the NCP legislation review program from 31 December 2000 to 30 June 2002 (Communique, COAG, November 2000).

Unlike most legislation that is to be reviewed under the Commonwealth's legislation review program, the PS Act does not seek to restrict competition directly. In principle, the Act seeks to achieve efficient pricing in monopolistic markets. Some, however, may contend that any government intervention affecting management's freedom to adjust prices may have an adverse effect on production decisions, market outcomes and competition.

The application of the PS Act in its current form has the potential to restrict competition in a number of ways. In principle, it could:

- fail to identify and properly examine the relevant set of pro-competitive alternatives (due to the absence of a requirement to undertake a public inquiry into potential pricing problems or due to the failure to include such a requirement in the inquiry's terms of reference);
- facilitate tacit collusion between enterprises (where the regulator publishes the prices of regulated firms);
- deter new entry to an industry by suppressing prices (as a result of price notification and/or monitoring); and
- inhibit competition in related markets by constraining new investment in infrastructure.

In principle, a failure to fully identify and analyse policy options increases the risk that implementing price notification or monitoring may have smaller net benefits than omitted or poorly evaluated options such as pro-competitive reforms. For instance, an overlooked option could have promoted competition and increased efficiency to a greater extent than the option that was finally chosen for implementation.

In instances where prices oversight is applied to organisations facing competitive market disciplines, there is no overall economic benefit to the community and the costs of regulation could have been avoided. As argued by PML, price notification is costly and unnecessary when competition exists (sub. 3, p. 2). In the case of markets where competition is weak, the application of price regulation (such as price notification) is likely to result in efficiency costs which outweigh the costs of allowing these markets to set prices (chapter 3).

The use of price notification also may unintentionally encourage collusion between firms. Publishing information on prices or output may assist tacit price coordination that is difficult for the regulator to detect. For example, the IC found that, in a worst case scenario, setting a maximum wholesale price for petrol, as part of the oversight of petroleum products, could facilitate tacit collusion by providing a benchmark price to return to after a period of discounting (IC 1994a).

Price suppression also can deter potential competitors from entering a regulated industry. Where an incumbent enterprise is subject to prices oversight, the effect may be to restrain price increases, possibly dampening the market signals to potential entrants indicating that above normal profits can be made by entering the industry. As discussed in box 2.3, persistently high prices are likely to attract new entrants — provided that the barriers to entry are surmountable.

The processes under the PS Act could be used by third parties, such as customers, to maintain or gain a strategic advantage in other markets. Several participants argued that the PS Act has impeded the development of competition in the air transport market. They argued that the regulatory process has been used to obstruct investment in new capacity at airports. The AAA stated that:

> An inherent problem with PSA regulation, in requiring regulatory rather than negotiated approval for any aeronautical price increase, is that it not only delays the introduction of revised charges necessary to ensure that airport operators are assured of a reasonable return on their pre-existing investment but also, more importantly, it deters and delays new investment.
>
> This not only inhibits increased competition between airports and fails to promote the efficient operation of airports; it also adversely affects competition between airlines. PSA regulation thereby positively favours incumbent airlines and operates to the detriment of new entrant airlines and, ultimately, the travelling public (sub. 21, p. 7).

4.10 Findings

This chapter has assessed how the structure of the PS Act compares with a best practice framework for prices oversight. From this, conclusions can be drawn about the likely costs and benefits of applications of such legislation.

Assessed against today's general principles of good policy-making, the PS Act fails on a number of counts. The objectives of the PS Act are unclear and potentially conflicting. There is no requirement under the Act for the Minister to initiate a public review prior to the application of the Act. This has meant that in a number of instances the reasons for applying the provisions of the PS Act are unclear. In today's more competitive economic environment, the absence of a requirement to conduct an independent investigation of potential pricing problems and to evaluate all alternative policy responses, could lead to the prices oversight functions of the PS Act being applied inappropriately.

The deficiencies in the PS Act give rise to uncertainty about how the Act may be applied in the future. The absence of a requirement for a public assessment of the problems that supposedly led to the use of the PS Act also has the potential to reduce transparency and accountability in government decision-making.

FINDING 4.1

The PS Act fails to meet best practice principles for legislation and prices oversight.

It does not:

- *have adequately defined objectives;*
- *require an assessment of the significance and causes of monopolistic prices for each case to which it is applied;*
- *provide guidance concerning the factors that should be considered as part of such an assessment;*
- *require a statement of costs and benefits of the options, including pro-competitive alternatives to prices oversight or options for prices oversight; and*
- *require that advice to the minister about whether price oversight is needed should be provided by an entity that is independent of the regulator.*

The PS Act has the potential to restrict competition by, for example, unintentionally facilitating tacit collusion between firms, deterring new entry as a result of price suppression, or by favouring regulatory options ahead of pro-competitive options.

FINDING 4.2

The PS Act also has the potential to inhibit and retard the development of pro-competitive options in industries that have historically been considered to have market power.

5 Implementing prices oversight

The conclusion reached in this report is that although there is no longer a need for the prices notification powers under the Prices Surveillance Act (PS Act), there is a limited role for public inquiries and prices monitoring (chapter 3). However, the analysis in chapter 4 showed that the PS Act is unsatisfactory for this purpose.

Although prices oversight may be implemented by both the Commonwealth and the State and Territory Governments, this inquiry's terms of reference focus on Commonwealth prices oversight as part of the national competition policy. Two options available to the Commonwealth Government are to repeal the PS Act and either rely on existing non-PS Act arrangements or introduce a new inquiries and monitoring part into the Trade Practices Act (TP Act). These two options are considered in detail below.

5.1 Repeal the Prices Surveillance Act and rely on other arrangements

Table 5.1 shows that public inquiry and monitoring instruments currently can be implemented by governments through several legislative and non-legislative mechanisms, as outlined in the following sections. Therefore, it would be possible for the Government to repeal the PS Act and rely on these mechanisms for implementing future public inquiries and monitoring, on a case-by-case basis.

Table 5.1 **Current alternatives to the PS Act available to implement inquiries and monitoring**

	Public inquiries	*Monitoring and disclosure*[a]
Commonwealth Government		
Trade Practices Act		
• Powers and functions of ACCC and NCC, such as section 28 (functions of the ACCC in relation to dissemination of information, law reform and research), section 29 (ACCC to comply with directions of minister and requirements of Parliament), section 29B (Functions and Powers of the NCC), and Part IVB (industry codes)	Yes[c]	Yes[c]
• Industry or purpose specific provisions	Yes[c]	Yes[c]
Industry-specific legislation	Yes	Yes
Parliamentary committees	Yes	Yes
Other statutory authorities (eg the PC)	Yes	Yes[c]
Non-legislative arrangements[b]		
• Administrative mechanisms	No	Yes[c]
• Self-regulation	No	Yes[c]
State and Territory Governments		
General prices oversight regimes	Yes	Yes
Industry-specific legislation	Yes	Yes
Parliamentary committees	Yes	Yes
Non-legislative arrangements[b]		
• Administrative mechanisms	No	Yes[c]
• Self-regulation	No	Yes[c]

[a] Monitoring can be conducted on a formal or informal basis. [b] These arrangements may include informal monitoring conducted by government departments and agencies or by industry, consumer and community organisations. [c] In these cases, there are no formal (legislated) information gathering powers.

Existing provisions of the Trade Practices Act

In principle, public inquiries and/or monitoring can be undertaken under existing provisions in the TP Act:

- section 28 provides for the functions of the Australian Competition and Consumer Commission (ACCC) in relation to dissemination of information, law reform and research;
- section 29 requires the ACCC to comply with directions of the Minister and requirements of Parliament;
- Part IVB provides for voluntary and mandatory codes being declared by the ACCC; and
- section 29B details the functions and powers of the National Competition Council (NCC).

These provisions of the TP Act permit the Minister to direct the ACCC or NCC to undertake general research and analysis. Although the provisions do not explicitly provide for inquiries or monitoring, the Minister could direct either organisation to undertake public inquiries and/or monitoring in areas where there are pricing concerns. However, any monitoring or inquiries undertaken under these provisions of the TP Act would not necessarily follow the best practice framework outlined by the Commission in chapter 4 and appendix B.

Industry-specific provisions also may be included in the TP Act. For example, the Commonwealth has tabled in Parliament the Postal Services Amendment Bill 2000 that would, among other things, amend the TP Act (inserting Part XID) to implement a regime that allows competitors to gain access to services supplied by Australia Post (Draft Explanatory Memorandum 2000). The legislation also sets the minimum price that private businesses can charge for the provision of those standard letter services otherwise reserved to Australia Post.[1] If enacted, Part XID of the amended TP Act, rather than the PS Act, would regulate future prices for postal services.

Industry-specific legislation

Where pricing concerns exist, the Commonwealth is able to pass industry-specific legislation in relation to a particular industry. Such legislation can regulate prices or provide for monitoring and disclosure of data, and has been used extensively in the past to do so.

For example, in the case of telecommunications, access prices and price capping regulation, although monitored by the ACCC, were outlined in industry-specific legislation. Under the *Telecommunications Act 1997*, a price cap applies to Telstra's charges for a revenue-weighted basket of retail services. In addition, price caps were applied to some of Telstra's individual stand-alone charges for residential services (PC 1999c). Airports provide another example, where Parts 7 and 8 of the *Airports Act 1996* require airports to provide the ACCC with accounts and reports of airport operating companies and quality of service monitoring reports.

1 This is used as a device to prevent private companies competing with Australia Post for the carriage of standard letters. Currently, private companies cannot charge less than four times the Australia Post rate for the carriage of standard letters. The new legislation lowers this to one times the Australia Post rate.

Parliamentary committees and other statutory authorities

Commonwealth parliamentary committees undertake inquiries into pricing issues and could recommend monitoring of prices. For example, the Joint Parliamentary Statutory Committee on Corporations and Securities inquiry into fees on electronic and telephone banking recommended that fees charged by banks when customers use the automatic teller machines of competing banks be abolished and replaced with a new fee schedule. The inquiry also recommended that banks disclose fees for electronic services at the time they are imposed (Senate 2001).

Other agencies such as the Productivity Commission (PC) may undertake public inquiries following the receipt of terms of reference from the relevant Minister. For example, the Commission is currently undertaking an inquiry into appropriate arrangements for prices regulation of airport services (PC 2001b). The Commonwealth may also establish specific review panels. For example, the Commonwealth has recently established an independent panel to inquire into taxation arrangements in the petroleum industry (Costello and Minchin 2001) and a review of the energy industry has been foreshadowed (COAG 2001).

Non-legislative mechanisms

Self-regulation and administrative mechanisms are the primary non-legislative mechanisms available for implementing monitoring. They are unsuitable for conducting public inquiries because they lack the degree of independence and accountability enjoyed by inquiries initiated with specific legislative backing.

Under a self-regulatory approach, an industry or groups of firms develop their own disclosure arrangements without direct government involvement. For example, the Prices Surveillance Authority, in its review of the Portland cement declaration under the PS Act, recommended the declaration be revoked but that informal monitoring be conducted. The monitoring was based on information contained in the Cement Industry Survey that was already being prepared periodically for the Cement Industry Federation (PSA 1994j).

Administrative approaches also can direct monitoring to be undertaken by the relevant Commonwealth department. For example, the Ministerial Directions, which established the Bass Strait Passenger Vehicle Equalisation Scheme, provide for annual monitoring of the scheme by the Bureau of Transport Economics.[2]

2 Clause 16 of the Ministerial Directions for the operation of the Bass Strait Passenger Vehicle Equalisation state that: A service operator shall comply with all reasonable requests by the

Non-government bodies, such as industry associations (for example, motoring organisations) or consumer organisations, also may monitor prices and publish the results. This monitoring takes place on the basis of publicly available data or data supplied voluntarily. For example, the Royal Automobile Club of Victoria collects and publishes information on retail petrol prices in Victoria.

An assessment of existing Commonwealth alternatives to the Prices Surveillance Act

Like the PS Act, the alternative mechanisms available to the Commonwealth Government lack a clear framework for defining the objectives of inquiries and monitoring and ensuring their appropriate application. The absence of a clear framework for applying these alternatives for prices oversight purposes may give rise to uncertainty about how inquiries and monitoring may be applied.

The Commission does not consider it appropriate to recommend amending existing arrangements to make them consistent with best practice principles for legislation. These arrangements were not intended to be used to conduct inquiries and monitoring programs as part of Australia's competition policy framework. They have other purposes. In addition, even if they were amended, existing arrangements would remain outside the competition policy framework (which encompasses Parts IV and IIIA) established in the TP Act.

State and Territory prices oversight arrangements

State and Territory Governments can enact prices oversight legislation and implement prices oversight programs. They have generally used industry-specific legislation to implement prices oversight regimes and reform their utilities. Industry-specific legislation may be used to regulate governance arrangements, service and safety standards, as well as prices. The legislation may specify that prices oversight be undertaken by an industry-specific regulator, a general regulator or by a government department.

States also may enact general prices oversight regimes. For example, in Tasmania, the Government Prices Oversight Commission (GPOC) was established to apply prices oversight to government monopolies. Its function is to investigate prices charged by government bodies for monopoly services and to recommend maximum prices to apply for the ensuing three-year period (GPOC 1999). In Victoria, there is a proposal to create an Essential Services Commission by expanding the role of the

Bureau [of Transport Economics] for information or access to documentation, in relation to the Bureau's monitoring function.

existing Office of the Regulator-General (Department of Treasury and Finance 2001). One of the purposes of the proposed Essential Services Commission is to protect the interests of consumers by ensuring high quality, reliable, equitable and safe provision of electricity, gas and water services.

If the PS Act were repealed, and no alternative generic monitoring and inquiries provisions were available, the States could play a more active role in providing prices oversight. A participant in the inquiry, Shell Australia, expressed concern that:

> … if the ACCC were no longer involved in monitoring the industry, Shell is not confident that some state governments would not simply step into the void and continue to re-regulate the industry. Intervention by state governments is likely to be far more interventionist than the activities of the ACCC (sub. DR26, p. 4).

The Commission has not evaluated State and Territory regimes against the principles of best practice outlined in appendix B because such a review is outside the terms of reference for this inquiry.

5.2 The Commission's preferred approach: repeal the Prices Surveillance Act and incorporate a new part in the Trade Practices Act

Following the repeal of the PS Act, a new part could be incorporated into the TP Act providing powers to undertake public inquiries and to implement monitoring programs. The States retain strong prices oversight powers.

The new part of the TP Act would establish the framework and principles for considering possible pricing problems while coexisting with existing alternatives. The Commission anticipates that the proposed new provisions would be used infrequently. The main benefits are likely to be from providing an alternative to price control and ensuring that price regulation or oversight is implemented only when necessary.

The repeal of the PS Act and insertion of a new part into the TP Act would consolidate the various legislative elements of Australia's competition policy into one legislative package. It would complement Part IIIA and Part IV of the TP Act as an element of Australia's competition policy.

The new part of the TP Act would:

- contain an objects clause that specifies the objectives of this part of the Act;
- provide a process for initiating public inquiries and provide guidance on the conduct of the inquiry; and
- provide for monitoring, which could only be implemented following a recommendation either from an inquiry under this part or an equivalent inquiry,

or following a declaration or revocation decision made under an industry-specific access regime or the national access regime.

Objects clause

In the Commission's view, the purpose of the inquiry and monitoring function is to:

- evaluate the existence and significance of perceived pricing problems;
- consider policy options if there is found to be a problem;
- recommend appropriate action to the Minister; and
- ensure that prices control is a method of last resort.

An objects clause at the beginning of the new part could reinforce the purpose and intent of the inquiry and monitoring part of the TP Act. The objectives would relate specifically to the inquiries and monitoring functions and would be consistent with the overall objectives of the TP Act.

The objects clause could indicate that there are two key objectives of this part of the TP Act. First, to enhance economic efficiency by investigating situations where there are pricing issues, and identifying suitable policy responses, if any, that are appropriate. Second, to facilitate removal of price control when it is no longer appropriate.

The ACCI supported the inclusion of such a clause, arguing that:

> In principle the inclusion of an objects clause within a new section of the TPA will help to clarify the outcomes the Commission is seeking to deliver. Such a clause would also make explicit the intent of the legislation, and facilitate more consistent application of prices surveillance (sub. DR24, p. 8).

Provision for public inquiries

Initiating the inquiry

The new part would provide guidance to the relevant Minister regarding the circumstances in which an inquiry could be initiated. The part would provide for a national significance test whose purpose is to limit inquiries to situations where they are likely to yield significant net benefits. Prior to initiating a public inquiry, the Minister should be satisfied that:

- the market is of significance to the national economy; and
- there are concerns that monopolistic pricing is present.

A national significance test

This criterion discourages further investigation of a firm or industry that is not significant in the national economy. A similar test applies in the case of declarations under Part IIIA of the TP Act. The NCC cannot recommend that a service be declared unless the facility is of national significance.

In the case of monopolistic pricing concerns, similar criteria could be adopted in deciding whether to proceed to a public inquiry. The application of a national significance test prevents resources being devoted to inquiries into insignificant cases where the benefits to the national economy are limited and the costs outweigh the benefits.

The Commission expects that this criterion will limit the possibility of inquiries to a few nationally significant areas of the economy. These are likely to include:

- industries in transition from public to private ownership;
- industries undergoing microeconomic reform when government wishes to ensure the benefits to consumers and users are realised; and
- some specific nationally significant industries.

Concerns regarding monopolistic pricing

When initiating an inquiry, the Minister should specify the concerns relating to monopolistic pricing which have led to the inquiry. These concerns could relate to persistent excessive profits (given the level of risk inherent in operating in the relevant market), a lack of entry by new firms over time even though industry profits appear high, and strong community concerns about price trends or movements. Other factors which may lead to an inquiry include general concerns regarding the effectiveness of competition, a history of pricing problems in the industry, or when an industry is being reformed or deregulated.

The Minister would announce the reasons for the inquiry at the time that he or she chooses to initiate it. As long as the pricing issue is one of national significance, the only other requirement would be that the Minister explain what concerns have led to the decision to initiate an inquiry.

Duration of the inquiry

The Commission is conscious of the need to minimise the costs and uncertainty faced by businesses and inquiry participants resulting from a long drawn out inquiry process. For this reason, the process should be completed as expeditiously as

possible. An inquiry would generally be expected to take no longer than six months and would be limited to a maximum of 12 months. In specifying a 12 month maximum inquiry period, the Commission notes the ACCC's concern that if inquiries were always limited to six months:

> … it would generally take at least that long to assess the competitiveness of the industry, let alone to consider the appropriate indicators to be monitored if prices oversight is warranted (sub. DR25, p. 8).

The length of each inquiry would be decided by the Minister having regard to the complexity of the pricing issue under consideration, the amount of information already available and whether the Minister deems it necessary to publish a draft report. Shorter inquiry periods are preferable to ensure that decisions are made quickly and to limit the ability of participants to draw out the process. For those inquiries where no prices oversight is recommended, it is important that the inquiry be the end of the process.

Conduct of the inquiry

If a decision were made to proceed to a public inquiry, the inquiry would analyse the alleged monopolistic pricing, consider all policy options to deal with any problem and recommend appropriate action (if any) to the Minister. Unlike inquiries conducted under the PS Act, the prices charged by firms subject to an inquiry would not be held fixed. The function of the inquiry is to determine what policy action, if any, is required. The purpose of the inquiry is not to regulate prices, but to assess the issue and provide guidance and make recommendations to government.

Participants supported the continued availability of such an inquiry process as part of the Commonwealth's generic prices oversight arrangements. For example, Australian Pacific Airports Corporation (APAC) stated that it:

> … supports the retention of an inquiry mechanism within the competition policy framework and its proposed reform, especially if it is part of a wider process designed to deliver good policy outcomes (sub. DR23, p. 4).

Evaluating the significance of monopolistic pricing

The first issue for the inquiry is to define the nature of the market and the significance of any monopolistic pricing problem. Evidence of excessive profits and monopolistic prices does not justify government intervention if barriers to entry into the market by new firms are low or expansion of existing rival firms is likely, or buyers possess strong countervailing market power. If such conditions prevail, any monopolistic pricing is likely to be transitory in nature and to be rectified by the

market. For example, if entry to the industry is unconstrained, new firms will enter in response to high prices and profits — without the need for government intervention.

Among the criteria that may be useful in providing guidance on how to perform this evaluation are the following:

- the actual and potential level of import competition;
- the significance and nature of barriers to entry in the market;
- the degree of countervailing power in the market;
- the likelihood that any monopolistic prices can be sustained in the long run;
- the extent to which substitutes or alternative sources of supply are likely to become available;
- the dynamic characteristics of the market, including growth, innovation and product development; and
- the efficiency costs of sustained monopolistic prices.

Evaluation of options

If the inquiry finds that there is a monopolistic pricing problem, it would identify all the relevant policy instruments that may be used to address it. This ensures that any pro-competitive reforms that may be appropriate are identified and explicitly considered as a possible remedy to monopolistic pricing. If the inquiry determines that an enterprise or industry has the market power to set monopolistic prices:

- pro-competitive reforms should be considered; and
- other prices oversight instruments, including monitoring, should be explored.

When assessing the possible policy options, the inquiry would evaluate the advantages and disadvantages of each option. Pro-competitive reforms should be considered in the first instance. However, where pro-competitive options are not deemed sufficient or feasible, the inquiry would then explore whether some form of prices oversight would yield net benefits. The analysis of each option, including the assessment of costs and benefits, should be included in the published inquiry report.

Inquiry recommendations

To conclude the process, the inquiry would make a recommendation to the relevant Minister. Publication of the final report ensures the transparency of the process and

also plays a role explaining to the community how markets work. The inquiry could recommend that:

- no further action be taken; or
- certain pro-competitive reforms be undertaken; or

- the industry be subject to monitoring for a prescribed period of time; or
- price control is required.

If monitoring were recommended, the inquiry would determine the period that monitoring would apply. This would normally be limited to three years or less, but the inquiry could recommend a period of up to five years in exceptional circumstances.

The inquiry also would nominate the set of indicators to be disclosed under the monitoring program. These would be restricted to aggregate indicators sufficient to allow an assessment of performance and comparisons of performance with other firms (both in Australia or internationally). The data is likely to consist of a small number of key variables, such as segregated results and indicators of quality. The data would be more extensive than is published in annual reports by firms, but less than that regulators typically use when controlling prices (based on, for example, cost of service or building-block models).

If an inquiry were to recommend price control, this could only be implemented through industry-specific legislation. Price control could not be implemented through the proposed new part of the TP Act.

In developing its recommendations, the inquiry would consider information provided to it as part of the public inquiry process. The inquiry could therefore draw on the experience of regulators, academics, the industry and consumers before finalising its recommendations. For example, the ACCC noted that it:

> …has extensive experience with establishing prices oversight regimes, often in highly complex industries. The ongoing use of this experience will minimise the administrative costs of establishing the regime. It will also ensure that the appropriate indicators are monitored and reported on and assist with the regulatory approach (sub. DR25, p. 8).

Participants also support the involvement of a range of organisations in the inquiry process, including the regulator. For example, APAC argued that:

> … it is important that the views of regulators are made clear in such debates [over appropriate prices oversight arrangements] and are given due weight along side those of (potentially) regulated firms, consumers of the services in question and other interested parties (sub. DR23, p. 4).

The Commission expects that the inquiry would consult interested parties in the course of the inquiry and all parties would have the opportunity to make submissions to the inquiry. If the regulator thought monitoring was important, it could comment in its submission on the nature of the monitoring process and the specific data to be monitored.

The decision on the final response is the responsibility of the relevant minister. Given that the inquiry may have taken up to 12 months to form its recommendations, it is important that the Minister announce a decision as soon as possible. The legislation could require the Minister to announce a decision within 30 days of receiving the inquiry report.

Independence of the body conducting the inquiry

The body undertaking the inquiry should not be responsible for implementing any policy recommendations. The principal reason is that the inquiry is about determining policy. Such an evaluation requires an assessment of whether prices oversight in the specific case has the greatest net benefits of the relevant options. This assessment needs to take into account how well prices oversight may work in practice, including an assessment of the costs of any monitoring or regulation. These costs can be affected by the inherent problems a regulator has in trying to regulate prices efficiently and the performance of the regulator in administering the regulation.

There may be technical and perceived conflicts of interest if the same agency is:

- responsible for assessing the costs and benefits of price regulation and other policy instruments that may be applicable;
- responsible for the implementation of any price regulation; but
- not responsible for implementing the alternatives.

APAC concur that there may be problems with the agency undertaking monitoring or regulating conducting the public inquiry. They stated that:

> I think if your purpose for this is a general public policy purpose and you're trying to understand and provide information about how an industry works, then that's more the province of statisticians and economists that it is of regulators. … If they're performing a regulatory function they are part of the process, and perhaps the reporting, monitoring, whatever process should be observed from the outside rather than from the inside looking out (trans., p. 12).

The NCC expressed a similar view in its submission to the inquiry into the national access regime:

> The Council also agrees that the two functions (imposing prices monitoring and conducting prices monitoring) should be the responsibility of separate agencies. The consideration of whether prices monitoring is appropriate involves different questions, information and skills compared to the application of prices monitoring. Separation of these policy and regulatory functions avoids problems associated with a regulator determining its own jurisdiction and imposes few, if any, costs of inconsistency or overlap between the two responsible organisation (sub. DR99, p. 40).

In contrast, the ACCC maintains that the separation of policy formulation and implementation may not result in the best regulatory outcome. The ACCC argued that:

> … the requirement for an independent body to nominate the indicators to be monitored may result in inappropriate indicators being selected if that body does not have expertise and experience in the implementation of prices oversight. Consequently, the effectiveness of the monitoring regime could be undermined (sub. DR25, p. 8).

The ACCC's concern over the separation of policy formulation and implementation functions is based on the need to ensure that the regulator's expertise is used during the inquiry. However, this concern is directly addressed in the Commission's framework embodied in the proposed new part of the TP Act. As discussed above, the Commission expects that the ACCC (or any other interested party) will be able to participate fully in the public inquiry process through submissions to the inquiry. The ACCC's submissions to the inquiry could include its views on the appropriate indicators to be monitored.

Monitoring provisions

A new part in the TP Act also would need to set out the institutional framework through which monitoring would take place. The monitoring provisions envisaged by the Commission would be as non-intrusive as possible in their application. They are designed to provide information to the public and not to interfere with, or regulate, business operations and management decisions. There are many forms of 'monitoring' and the Commission's conception of monitoring may differ from what others may regard to be monitoring. The purpose of monitoring as proposed by the Commission is:

- to facilitate the deregulation of industries;
- to provide an alternative to controlling prices; and
- to report on the performance of unregulated markets where there is concern about monopolistic pricing but price control is unlikely to generate net benefits.

In order to ensure that this intent is reflected in the changes to the TP Act, the monitoring part of the TP Act would specify:

- the paths through which monitoring could be initiated;
- the role and functions of the regulator; and
- the other conditions under which monitoring would operate.

Initiation of monitoring

The Minister would be responsible for initiating monitoring. The Minister would only implement monitoring following a recommendation from one of three possible processes:

- an inquiry initiated under the proposed part of the TP Act (as outlined in the previous section); or
- an inquiry process which the Minister is satisfied is equivalent to an inquiry outlined in the new part of the TP Act; or
- a decision by the ACCC and NCC not to recommend declaration or to revoke declaration under an industry-specific access regime, or the national access regime, respectively.

The second and third routes to monitoring acknowledge that the firm or industry may already have been subject to substantial investigation and analysis. Where such an investigation has been conducted, the ACCC noted that:

> … a public inquiry may not add anything new to knowledge deregulation. During the decision and implementation phases of deregulation it is likely that considerable information would have been gathered about the industry, including an assessment of whether participants in that industry need to be subject to prices oversight. If this is the case, then the need to undergo a further public inquiry would simply add another layer of administrative cost to the deregulation phase (sub. DR25, p. 6).

The Commission is conscious of the need to minimise the cost of inquiries to both the public and industry. Where a public inquiry process has addressed the issues which would have been examined in an inquiry under the new part of the TP Act, additional investigation or inquiry would be unnecessary. This would require the inquiry process to:

- identify the nature and significance of the pricing issue;
- identify and assess alternatives to prices oversight, including pro-competitive reforms;
- be conducted in a transparent manner with input from, but not by, the regulator;
- publish a report, containing the reasons for its recommendations; and
- in the event that monitoring is recommended, nominate the indicators to be disclosed and the period for which monitoring will apply.

In such cases, the Minister would have the power to deem that an inquiry has been completed which is equivalent to one conducted under the new part of the TP Act. Such an inquiry process may have taken place, for example, as part of a decision to deregulate an industry.

The assessment of a request to declare an essential service under the access provisions of Part IIIA of the TP Act (or to revoke a declaration) by the NCC or a similar assessment by the ACCC in the case of an industry-specific access regime (for example, telecommunications access under Part XIC of the TP Act) also involves detailed analysis of an industry. Such inquiries could also recommend to the Minister that a period of monitoring under this part of the TP Act is an appropriate policy response. The Commission has considered, in its inquiries into Telecommunications Specific Competition Regulation, the National Access Regime and Price Regulation of Airport Services, whether price monitoring would be beneficial in decisions about access declarations and revocations and airport pricing arrangements.

The NCC stated in its submission to the National Access Regime inquiry that:

> The Council supports the provision of prices monitoring as an alternative to declaration. Market power problems associated with natural monopoly can vary by degree. The availability of prices monitoring as an alternative to declaration would mean that declaration would not be imposed in some marginal cases where the criteria for declaration are met but where competition may emerge in a dependant market despite the market power of a natural monopoly service provider. Prices monitoring of the service provider would facilitate the appropriate oversight.
>
> For these reasons, the Council would consider it appropriate for prices monitoring to be considered in response to an application to declare an infrastructure service (sub. DR99, pp. 38-39).

In its submission, the ACCC expressed unease that the need to hold an inquiry prior to initiating monitoring reduces flexibility:

> … where the Government requires a quick response to perceived excess prices or price rises. … The requirement for a public inquiry significantly increases the time required to implement prices oversight and reduces the potential deterrent effect of the threat of swift price regulation action (sub. DR25, pp. 4-5).

However, the Commission is concerned that the ability to initiate monitoring without an inquiry could lead to monitoring in response to transitory price rises. It is the Commission's intent that prices oversight should only be applied in cases where the pricing problem is persistent and not a short term phenomenon. In the event of unexpected price movements, markets should be given sufficient time to adjust to changes in underlying economic conditions before imposing monitoring or other forms of prices oversight. Failure to allow sufficient time for markets to respond to price changes may distort the adjustment process and lead to inefficient outcomes (box 3.2 in chapter 3 provides examples of the problems caused by responding to price changes with regulation).

The choice of monitoring agency

Several participants expressed a view about which agency should administer a monitoring program. The Australian Chamber of Commerce and Industry (ACCI) argued against this role being given to the ACCC, contending that:

> Instead of handing this role of price surveillance to the ACCC, there should be no single agency monitoring prices where monopolistic pricing is seen to be a feature of the market structure. The role should be conducted by specialist agencies with deep knowledge of the industries. Price regulation should be undertaken by specialist agencies whose understanding of the issues is detailed and comprehensive. The specific knowledge required to monitor prices requires a knowledge not only of the price formation process as a general proposition, but of the industry itself (sub. DR24, p. 8).

In contrast, Shell Australia argued in favour of the ACCC continuing its role monitoring prices in the petroleum industry:

> Clearly the ACCC is well placed to monitor prices and, perhaps most importantly, its role in monitoring prices is crucial to the public perception of the petroleum industry (sub. DR26, p. 4).

Under the process envisaged by the Commission, the public inquiry would specify the variables to be monitored following a detailed examination of the relevant industry. The inquiry would develop an understanding of industry pricing issues. The agency administering the monitoring program would collect the data specified by the inquiry. This task could be undertaken by a range of agencies. For example, the monitoring of milk prices could have been conducted by the Australian Bureau of Agricultural and Resource Economics.

However, the Commission has concluded that the ACCC be designated the agency administering the monitoring program for the purpose of ensuring compliance with the provisions of the new part.

The role and functions of the monitoring agency

The ACCC would be responsible for collating information provided as part of the monitoring program as specified by the relevant public inquiry. The regulator also would be responsible for ensuring that firms subject to monitoring provide a declaration from the CEO that the information supplied is true and correct.

The ACCC also would be responsible for the public reporting of the information. As part of the monitoring report the ACCC could provide some commentary on the data. However, it is important to note that under the monitoring arrangements envisaged by the Commission, the ACCC would not make any determinations on

the appropriateness of prices or make recommendations to the Government using this monitoring provision. The ACCI noted that:

> … one of the important parts of the whole monitoring process should be that those that do the monitoring say nothing. It should not be their role to take on and to publicly chastise businesses, which are just simply trying to set prices in a very difficult market situation (trans., pp. 25-26).

Comments by the monitoring agency should be limited to those of a factual or descriptive nature. For example, the agency may wish to comment on the trend in data over the monitoring period or provide a factual comparison with data from the previous monitoring report. This is because, as discussed in chapter 3, the intent of monitoring is to facilitate information provision, it is not intended to be a form of price control or to entail unwarranted intrusion into the operation of businesses.

Data collected under the program should be made publicly available as soon as possible after its collection. APAC noted that with regard to information collected under the Airports Act:

> … we are required by statute to provide this information by the end of September for the preceding June ending financial year and we see that the ACCC doesn't publish it until the following May … It's important information for everyone who wants to participate in these public policy debates and for it to take so long to be released, it does question the purpose to which it's put (trans., p. 8).

The ACCC would be responsible for ensuring the timely publication of monitoring reports. The monitoring reports should be published no later than 90 days following the receipt of data.

Other conditions under which monitoring would operate

Such an amended TP Act should specify that a monitoring declaration would generally be for three years or less, (although in exceptional cases the maximum period could be five years). Monitoring is most likely to be appropriate for firms or industries that are in transition to a more competitive environment or where there are concerns about the strength of competitive pressures.

At the end of the monitoring period, the declaration would be revoked automatically. Like any other firm or industry, if monopolistic pricing concerns arose subsequently, the Minister could initiate the inquiry process again. However, the Commission expects that such cases would be very rare.

There should be legislative powers to require those subject to monitoring to provide data, with financial penalties for non-provision. As the ACCC noted:

> … the effectiveness of a prices oversight regime is likely to be reduced if it is not backed by strong information gathering powers and a requirement for industries subject to monitoring to comply with information requests. … If the need for price monitoring has been established then by implication the benefits of regulation exceed the costs. If industries are able to circumvent the regime by refusing to cooperate, then a monitoring exercise would simply impose administrative costs on the regulator with no offsetting benefits to the economy (sub. DR25, p. 7).

Such legislative powers should, however, be subject to checks and balances to ensure that they do not lead to expanding information requests. Under the Commission's proposal, the indicators to be monitored would be specified by the Minister following the public inquiry. Firms would be protected from information requests by the agency being permitted only to collect the information that is specified in the monitoring declaration by the Minister.

Recommendation

In light of the analysis in this report, the Commission makes the following recommendation.

RECOMMENDATION 5.1

The Prices Surveillance Act 1983 should be repealed and a new part inserted in the Trade Practices Act to provide for inquiries and prices monitoring in nationally significant markets where there may be concerns about monopolistic pricing.

Specifically, the new part of the Trade Practices Act would:

1. *Include an objects clause stating the objectives for the inquiry and monitoring part of the Act.*
2. *Provide for public inquiries into monopolistic pricing.*
   - *(a) Require the relevant Minister to be satisfied that the pricing issue is of significance to the Australian economy, before initiating an inquiry.*
   - *(b) Require the relevant Minister to make public the reasons for the inquiry and specify the duration of the inquiry, which normally should not exceed six months.*
   - *(c) Require that the inquiry be conducted in a transparent manner with input from, but not by, the regulator.*
   - *(d) Specify that a public inquiry should:*

(i) identify the nature and significance of the pricing issue referred to it by the Minister;

(ii) identify and assess alternatives to prices oversight, including pro-competitive reforms;

(iii) be required to publish a report, containing the reasons for its recommendations;

(iv) be able to recommend price monitoring;

(v) in the event that monitoring under this part is recommended, be required to nominate the indicators to be disclosed and the period for which monitoring will apply (which normally should not exceed three years and would be limited to a maximum of five years); and

(vi) be able to recommend structural reform, industry-specific measures, or appropriate forms of price control.

3. Provide for monitoring.

(a) Monitoring could be initiated by the responsible Minister following:

(i) a recommendation from an inquiry under this part; or

(ii) a recommendation from an independent public inquiry initiated by the Commonwealth or a State Government that is deemed to be equivalent to an inquiry under this part (one that included 2(d) above in its terms of reference); or

(iii) a recommendation from the ACCC or NCC, as an alternative to third party access declaration, where provided for in the relevant access legislation.

(b) Designate the ACCC as the administrator for the monitoring provision.

(c) Require Chief Executive Officers to sign a declaration stating that the monitoring data are true.

(d) Provide for the ACCC to seek financial penalties through the courts if declared firms fail to provide the information.

(e) Require the ACCC to publish and report on the information being monitored under this part. The ACCC should not have the authority under this part to request information beyond that specified in the monitoring declaration issued by the Minister.

4. Not provide for price control to be administratively implemented. In the event that an inquiry recommended some form of price control, it would need to be implemented through industry-specific legislation.

Timing and implications for existing arrangements

The implementation of recommendation 5.1 has implications for the current applications of the PS Act.

The declaration of the Phase II privatised airports under the PS Act is scheduled to continue until 1 July 2003. This is therefore the earliest practicable date to repeal the PS Act. However, this need not delay the amendment of the TP Act to include the new inquiries and monitoring part. The new part could be inserted into the TP Act as soon as possible. Any new monopolistic pricing concerns would be dealt with under the new provisions of the TP Act.

All current declarations would necessarily expire when the PS Act is repealed in July 2003. However, with the exception of the airports, the Commonwealth Government may decide to revoke the other declarations at an earlier date. In the case of harbour towage and Airservices Australia an inquiry could be held if there are sufficient monopolistic pricing concerns to warrant continuing prices oversight. In the case of airports, the current inquiry into Price Regulation of Airport Services would constitute such an inquiry. The Commission notes that in the Government's proposed legislation regarding Australia Post (Draft Explanatory Memorandum 2000), which was not passed by the Parliament, it was intended to move prices oversight of Australia Post into an industry-specific part of the TP Act.

Two industries are currently subject to monitoring (airports and stevedoring). The Productivity Commission is currently undertaking an inquiry into Price Regulation of Airport Services. This inquiry could be deemed to be equivalent to one that would otherwise have been held under the new part of the TP Act. If that inquiry recommends monitoring, it could be implemented under the new part of the TP Act. Otherwise monitoring of aero-related services would cease when the PS Act is repealed. In the case of stevedoring, monitoring would cease when the PS Act is repealed. The new part of the TP Act would, however, provide scope for an inquiry to be held, which could consider the extension of monitoring as one of a range of options.

APPENDICES

A Conduct of the inquiry

A.1 Introduction

This appendix outlines the inquiry process and the organisations and individuals that have participated in the inquiry.

On 14 February 2000, the Commission received the terms of reference for the inquiry. The reference directed the Commission to inquire into the *Prices Surveillance Act 1983* in Australia, and to report within nine months. The full terms of reference are on page v. The reporting date for the inquiry was subsequently extended to 14 August 2001.

Following receipt of the terms of reference, the Commission placed notices in the national press inviting public participation in the inquiry and released an issues paper to assist participants in preparing their submissions. The Commission received 13 submissions prior to the interim report, and a further 8 submissions were received after the interim was released and an additional six submissions following the draft report. A list of those who made submissions is in section A.2.

The Commission also held informal discussions with organisations, companies and individuals to gain background information and to assist in setting an agenda for the inquiry. Organisations visited by the Commission are listed in section A.3.

The Commission held an informal workshop with invited academics. The workshop discussed the role of prices surveillance in the Australian economy and provided the opportunity to discuss a range of issues relating to the terms of reference.

A.2 Submissions received

Participant	*Submission No.*
ACCI	13
ACCI	DR24
Ansett Australia	8
Australia Pacific Airports Corporation	1
Australia Pacific Airports Corporation	15
Australia Pacific Airports Corporation	DR23
Australian Airports Association	21
Australian Competition & Consumer Commission	10
Australian Competition & Consumer Commission	19
Australian Competition & Consumer Commission	DR25
Board of Airline Representatives of Australia	4
Capital Airport Group	11
Capital Airport Group	16
Capital Airport Group	18
Cement Industry Federation	5
CSR	20
Dale Cole & Associates Pty Ltd	9
Dale Cole & Associates Pty Ltd	DR22
Fremantle Port Authority	2
Howard Smith Towage	12
Howard Smith Towage	14
NSW Cabinet Office	17
Philip Morris Limited	3
Qantas	6
Ray Steinwall, Mr	7
Shell Australia	DR26
Sydney Airports Corporation Limited	DR27

A.3 Visits

Australian Capital Territory

ACT & Region Chamber of Commerce & Industry

Airservices Australia

Australian Institute of Petroleum

Capital Airport Group

Department of Communications, Information Technology and the Arts
Department of Transport & Regional Services
Office of Asset Sales & IT Outsourcing
The Treasury

New South Wales

Adsteam Marine Limited
Association of Australian Ports and Marine Authorities
Independent Pricing and Regulatory Tribunal
P & O Ports
Reserve Bank of Australia
Sydney Airport Corporation Limited
Trade Practices Committee of Law Society

Victoria

ACI Glass Packaging Australia
Australia Pacific Airports Corporation
Australian Bankers Association
Australian Competition & Consumer Commission
National Competition Council
Office of the Regulator General
The Shell Company of Australia Limited
Water Services Association of Australia

B Best practice principles for prices oversight

The terms of reference for this review require the Commission to report on appropriate arrangements, if any, for prices surveillance. In undertaking this task it is useful to consider what a best practice regulatory framework would look like. Such a framework would assist in evaluating the Prices Surveillance Act (PS Act) and identifying more efficient ways of achieving regulatory goals.

B.1 Best practice principles for prices oversight

Others have attempted to develop a set of best practice principles for prices oversight. A set of principles was devised by the Office of Water Resources (OWR) in Western Australia for the Utility Regulators' Forum — an informal group consisting of Commonwealth, State and Territory regulators (see box B.1).

The OWR principles provide a useful starting point in setting out desirable characteristics of a prices oversight regime. The primary focus of the OWR principles is on how the regulator should undertake its task once a decision has been made to impose prices oversight on a firm or industry. In considering the desirable characteristics of a prices oversight regime, however, it also is important to consider the role of Governments as they have responsibility for developing the regulatory framework, setting regulatory objectives and for deciding on the companies or industries to which it will be applied.

Box B.1 **Suggested principles of best practice regulation**

A recent discussion paper prepared by the Office of Water Resources for the Utility Regulator's Forum sets out nine principles of best practice regulation:

1. *Communication* (regulators should establish processes that provide relevant and comprehensive information that is accessible, timely and inclusive of all stakeholders).
2. *Consultation* (early consultations between regulators, regulated firms and consumers assist the regulator in understanding issues and in assessing how decisions may affect different groups).
3. *Consistency* (provision of consistent and fair rules that do not adversely affect the business performance of a specific participant).
4. *Predictable* (reducing unnecessary uncertainty about the application of regulation by establishing well defined decision-making criteria and timetables for the review of standards and regulations).
5. *Flexibility* (ability to use a mix of regulatory tools and to evolve and amend the regulatory approach over time as the external environment changes).
6. *Independence* (that although Governments may establish the regulatory framework, the regulator should have the freedom to make decisions that accord with the framework without interference by Government).
7. *Effectiveness* and efficiency (regulation should: include an assessment of the cost effectiveness of proposed regulations and alternative regulatory measures; balance the need for disclosure of information required for regulation against the need for confidentiality; eliminate unnecessary delays; and minimise waste and duplication).
8. *Accountability* (the performance of the regulator should be reviewed regularly by an independent body and there should be an appeal mechanism in relation to regulatory decisions).
9. *Transparency* (regulators should be open with stakeholders about their objectives, processes, data and decisions).

According to the discussion paper, these principles need to be considered as a 'package', involving balancing some of the principles against others. For instance, the principle of flexibility could be seen as contrary to the principles of consistency and predictability. Similarly, the principle of independence is a necessary element in providing stakeholders with confidence in the regulatory system, and is linked to achieving the principles of consistency and predictability. Independence also has implications for accountability and facilitates transparency in processes.

Source: OWR (1999).

In principle, a prices oversight regime should possess a number of broad characteristics, namely:

- clear and non-conflicting objectives;
- transparency;
- accountability;
- independence of policy advice and regulation; and
- oversight should only be applied after relevant options have been considered.

Clear and non-conflicting objectives make it easier for regulators to implement regulation, and to achieve consistency in the administration of prices oversight arrangements. Clear objectives assist in reducing uncertainty for businesses about the application of prices oversight and enhance the accountability of the regulator and the overall framework. Ideally, objectives for prices oversight should be defined in a way that avoids the need for the regulator to make judgements about the weights applied to conflicting objectives. Such judgements are properly the domain of Parliament.

Transparency involves both Governments and regulators seeking widespread public input into deliberations. This ensures that different sources of information and advice can be brought to bear, and that arguments and various points of view are open to public scrutiny and comment. Transparency also involves Governments seeking independent advice on the development of policy and explaining the reasons for adopting a particular approach, and the regulator publishing the reasons for its decisions. The need for transparency should be balanced by the need to protect commercially sensitive information.

Accountability is important in ensuring that Governments and regulators are responsible for their actions, and that deficiencies in the prices oversight framework are identified and remedied expeditiously. Also, accountability ensures that regulators act impartially, with due regard for proper process and within the limits of their authority. Accountability is enhanced where the regulator is required to achieve clearly defined objectives and to follow a transparent process.

The credibility and effectiveness of prices oversight can be enhanced if the entity that advises Government about whether regulation is needed is separate from the entity that implements the regulation. This will help avoid a conflict of interest that might exist if the regulator undertakes both functions — namely that it may tend to favour regulatory functions that expand its role. This conflict arises because the regulator has direct responsibility for implementing price regulation, but not for some of the options, such as pro-competitive reform. In addition, in weighing up the costs and benefits of options, the regulator has to assess the benefits and cost of

price regulation. This requires it to effectively undertake all assessment of how well it is likely to do its job. Further, its assessment may be clouded by its day to day experiences and dealings with firms during regulatory processes which are inherently adversarial in nature.

However, having separate entities undertaking these two roles could lead to a more cumbersome and lengthy process but result in better policy outcomes. Having these two functions undertaken by entities with some independence from the Government also can add to the credibility of prices oversight, by reducing pressures for decisions based on short-term political considerations.

The design and application of a prices oversight regime also should take into account the principle that prices oversight should only be adopted after other relevant options have been considered. This is necessary because of the limitations and potential costs of prices oversight and the risks of interfering with market prices (see chapters 2 and 3). A prices oversight regime can do this by requiring a detailed evaluation of the significance of the potential pricing problems and an assessment of alternative remedies, including pro-competitive reforms, prices oversight and the do nothing option (see below).

B.2 Best practice process for prices oversight

The best practice framework for prices oversight outlined below lays out a process which is intended to incorporate the broad principles described above. The elements of this process are derived from a number of sources[1] designed to improve policy formulation and implementation. Based on these broad principles and sources, a best practice prices oversight process would seek to:

- specify clearly the policy objectives;
- identify and define whether there is a monopolistic pricing issue that needs to be addressed;
- identify the relevant instruments which may be used to achieve the policy objectives (including the do nothing option);
- evaluate the advantages and disadvantages of each policy instrument and recommend the best policy instrument; and

[1] These include: the terms of reference for this inquiry; the principles set out in the Competition Principles Agreement (CPA) for legislation review (clause 5) and prices oversight of government business enterprises (clause 2); *A Guide to Regulation* developed by the ORR (1998); *Best Practice Utility Regulation* by OWR (1999); and a *Framework for the Design and Implementation of Competition Law and Policy* by the World Bank and OECD (1999).

- implement and monitor the recommended instrument for a finite period of time.

The individual steps in this best practice process are discussed in detail below.

Clearly specify the policy objectives

The first step in assessing the need for prices oversight is for the Government to set out a clear specification of the objective that prices oversight is intended to achieve.

Clearly defined objectives provide greater certainty for the regulator and businesses (particularly those to which prices oversight arrangements may apply). Clear objectives also assist in ensuring that the regulator is accountable to Government for its actions and that Government is accountable to the community in respect of prices oversight policy.

All Australian Governments have agreed to the Competition Principles Agreement (CPA), which provides a clear statement of objectives for prices oversight bodies. Clause 2(4)(b) of the CPA says that the prime objective of bodies established to provide prices oversight advice should be 'one of efficient resource allocation but with regard to any explicitly identified and defined community service obligations'. This is clear because it instructs the advisory body to seek to promote the efficient allocation of resources but within the constraints imposed by explicit Government directions with respect to community service obligations. By way of contrast, a requirement that regulators seek to 'promote fair and reasonable pricing' is less clear as an objective because such a statement lends itself to a range of possible interpretations about when prices are 'fair and reasonable'.

A best practice prices oversight process also should avoid setting conflicting objectives. Conflicting objectives can lead to uncertainty for businesses and regulators and may reduce accountability.

Conflicting objectives pose a problem because advisory bodies and regulators must not only interpret the meaning of the various objectives but also implicitly or explicitly attach weights to them. As noted above, making judgements about the weights to be attached to different objectives is properly the domain of Parliament.

The World Bank and OECD highlight the problems that may arise if regulators are given multiple objectives in the context of competition policy:

> For instance, protecting small businesses and maintaining employment could conflict with attaining economic efficiency. With the small business objective, competitors rather than competition may be protected. In addition, such concerns as community breakdown, fairness, equity, and pluralism cannot be quantified easily or even defined acceptably. Attempts to incorporate them could result in inconsistent application and interpretation of competition policy. Clear standards would be unlikely to emerge,

thereby leading to uncertainty and distortions in the marketplace and the undermining of the competitive process (World Bank and OECD 1999, p. 4).

With conflicting objectives, interest groups also have a strong incentive to seek to influence the regulator to attach a greater weight to the particular objective that concerns them. With transparent processes, such lobbying can be resisted with greater ease. However, conflicting objectives make it more difficult to hold the regulator accountable for decisions because it can be difficult to determine what weight was attached to particular objectives and whether or not the regulator was swayed by the concerns of particular interest groups.

Identify and define the significance of monopolistic pricing

A best practice process would require that monopolistic pricing concerns be investigated in a transparent manner by an independent body before prices oversight is applied. The purpose of this step is to determine the nature and significance of the problem so that the appropriate response can be implemented.

Reflecting the broad principle of separating policy and regulatory functions, the task of assessing the significance of monopolistic pricing and recommending solutions should normally be undertaken by a body with advisory powers only, not one with responsibility for implementing any policy outcome.

Combining the functions of assessing pricing problems and implementing solutions into a single agency may lead to a perception of a conflict of interest and may create incentives that favour the application of prices oversight. Combining policy-making and implementation also may reduce the accountability of the regulator if its responsibilities are blurred and may lead companies to accuse the regulator of bias in making recommendations.

Initiating an independent review of the nature and significance of monopolistic pricing may deliver a number of benefits. For instance, an examination may reveal that high prices (or price rises) may be attributed to factors outside the control of firms (such as rises in prices for key inputs to production), thereby avoiding some potentially costly interventions in prices. Transparency, involving seeking public input and publishing information and reasons for recommendations, assists in educating the community about the nature and significance of potential pricing problems. The investigation also may reveal that the costs of any feasible remedy to prices which appear to be high would far exceed the benefits. This could occur if high prices and profits were found to arise from innovation by a firm. In this case, action to strip away the firm's profits could deter further beneficial innovation.

In instances of suspected monopolistic pricing, an investigation of the nature and significance of the problem requires a detailed analysis of the competitive conditions in the relevant market. Undertaking a rigorous evaluation of the extent of competition in a market requires assessing a range of factors. Failing to consider important factors influencing the competitive conditions in a market increases the risk that an inappropriate decision will be reached. In extreme cases this may result in an unwarranted Government intervention in markets, imposing net costs on the community.

There are two broad approaches to assessing competition in a market. The structural approach applies competition tests and seeks to preserve markets with a number of competing suppliers. Such an approach also may consider barriers to entry and the potential for new competition to emerge if an incumbent supplier charges high prices. The second approach resembles more of a cost-benefit framework that takes into account conditions on both the demand-side (looking at, for example, countervailing power of buyers) and the supply-side, as well as the potential costs of regulation.

To reduce business uncertainty concerning the likelihood of Government intervention, it may be useful for Governments or review bodies to develop a list of the factors that are to be considered in an evaluation of potential cases of monopolistic pricing, and to provide information on these factors.[2] The benefits from a less uncertain environment are difficult to quantify but have been recognised in implementing other elements of Australia's competition law. For example, the ACCC has published guidelines for assessing mergers and acquisitions under section 50 of the TP Act (ACCC 1999a). These guidelines can help reduce uncertainty and compliance costs for businesses with regards to the assessment of mergers (IC 1995).[3]

[2] A government could enact legislation setting out the factors to be considered. For example, the statutory criteria contained in Part IIIA of the TP Act seek to limit the potential scope of the national access regime by setting out the conditions that must be satisfied before the relevant Minister can declare the services of an infrastructure facility. Alternatively, the government could issue guidelines or regulations describing the factors to be examined. A third approach is for the review body to publish a guide to the factors that it will consider each time an investigation of pricing problems occurs.

[3] The ACCC has released guidelines covering how it will assess notified price increases by declared enterprises. Understandably, these guidelines do not provide guidance on when the Government may invoke the PS Act.

Identify the relevant policy instruments

In order to maximise the net benefits of any Government intervention, it is important that an independent body be assigned the task of identifying the full range of relevant instruments available to solve the underlying monopolistic pricing problem. Possible options to be examined include pro-competitive reforms such as deregulation, structural reform and competitive tendering. Regulatory options might encompass self-regulation, quasi-regulation, prices monitoring and price control. The option of not taking action needs to be considered as well.

Each option is likely to have different costs and benefits that vary with the specific circumstances of the suspected pricing problem that is under scrutiny. The policy process should select the option that is most appropriate for the specific market circumstances. Some monopolistic pricing problems may be amenable to reforms that promote competition rather than price control or monitoring. Other market situations may warrant some form of prices oversight. In these cases, the choice between monitoring instruments and prices control depends largely on the monopoly characteristics of the market and the significance of monopoly pricing.

Failure to identify the relevant options could lead to the selection of an inappropriate instrument that fails to address monopolistic pricing, imposes excessive costs or inhibits the development of competition.

Evaluate the advantages and disadvantages of each policy instrument

Having identified the policy options, the independent review should undertake a rigorous analysis of the costs and benefits of each option.

A special principle for the review body to consider is whether any of the policy instruments that have been identified restrict competition. The legislation review provisions of the CPA (clause 5) establish the guiding principle that legislation should not restrict competition unless it can be demonstrated that the benefits of the legislation to the community as a whole outweigh the costs, and that the objectives of the legislation can only be achieved by restricting competition.[4]

The requirements of the CPA suggest that Governments, in responding to a pricing problem, should implement the pro-competitive option in preference to prices oversight, unless doing so would impose a clear net cost on society. In some cases, the best option may be to take no action.

[4] Prices oversight may restrict competition in a variety of ways. As noted in section 4.9, setting prices could deter entry by new firms or facilitate price collusion through establishing a target price for firms. These effects are hard to predict.

Implement and monitor the recommended instrument for a finite period of time

The last step is putting Government policy into effect. If monitoring or price control is required it should be administered by a regulator who is independent of Government (such as a statutory authority). The regulator should, for the same reasons as were identified above, be given clearly defined objectives and adopt processes that are transparent.

Over time, circumstances can change for many reasons. The initial pricing problem that triggered the Government response may solve itself. For example, new technologies and the emergence of substitutes may mean that a firm no longer has monopoly power and cannot sustain monopoly prices. In such circumstances, continued Government intervention is no longer the best option. To facilitate the removal of unwarranted and costly prices oversight any arrangements should be applied for a finite period of time and should specify a process to determine whether they should continue. Any review should be conducted in an expeditious manner.

C International perspective on the changing role of prices oversight

To put the Australian experience with prices oversight into an international context, this appendix outlines the origins and history of different prices oversight arrangements employed since the Second World War in three overseas markets — the US, the UK and Sweden. It also discusses the changing role of prices oversight in international markets, and how this compares with Australia.

C.1 The role of prices oversight in restraining inflation and wages

Despite differing degrees of price intervention across countries and over time, it is evident that prices oversight in the OECD member countries was originally introduced as part of a prices and incomes policy to control inflation. A range of prices oversight arrangements have been employed overseas since the Second World War, with many linked to some form of prices and incomes policy as a means for influencing the level of real wages.

United Kingdom

In the UK, inflation threatened to become a problem immediately following the Second World War during a period of relaxed price controls. This created the impetus for the Macmillan 'price and wage plateau' in 1956 which secured voluntary undertakings from the boards of all nationalised industries and from certain private employers and employers' federations not to increase prices (Fallick and Elliott 1981). By the mid-1960s, an administrative body, the National Board for Prices and Incomes (NBPI) was established to examine whether the implied movement of prices was in the national interest. Cases were referred to it by the Government, and the Board consulted with the relevant management and unions in forming its recommendations. The NBPI considered that its intervention in price determination was most relevant in situations where there was a lack of effective competition (PSA 1991b). Its decisions and price guidelines were very similar to those found in the US price guideposts formed in 1962.

In late 1965, the UK Government released the white paper *Prices and Incomes: an Early Warning System* in which it proposed to tighten its control over prices and incomes through the establishment of an 'early warning system' for proposed increases in prices. Strict price controls were imposed in the following year. In fact, from July 1966 until June 1967, there was a statutory freeze on prices in response to a currency crisis. Following the lifting of the prices freeze, the Government was to be notified at least one month in advance of any prospective increase in prices, which could then be referred to the NBPI for recommendation (Ulman and Flanagan 1971). Controls were relaxed in 1967-68 as price increases in excess of the norm (being zero at the time) were allowed as exceptions, although the Government had the authority to delay proposed increases in prices by up to seven months if they were referred to the NBPI. This was extended to twelve months towards the end of 1969.

By 1971, price controls in the UK were abandoned in favour of voluntary undertakings by business to restrain price increases to 5 per cent per year. However, in the following year, the high rate of inflation forced the Government to look at adopting a statutory policy. *A Programme for Controlling Inflation: the First Stage* was introduced in late 1971 and placed a statutory freeze on prices, initially for a period of 90-days, but with provision for a 60-day extension. Under this policy, the Government established the Prices Commission with the role of monitoring price increases throughout the economy. By mid-1975, the Government again targeted inflation with its incomes policy by introducing a price code, under which employers could not pass along above-norm wage increases in higher prices. In the following year, price controls were again relaxed as a means for encouraging new investment.

United States

As with many economies at the time, the US economy was experiencing problems with growing inflation following the Second World War. Consequently, the US Government established the Office of Price Stability in 1950 to freeze prices at the highest level at which deliveries of goods had been made, with some 65 per cent of commodities under the consumer price index covered. Throughout the rest of that decade, these controls were relaxed. In 1962, the Government introduced 'Guideposts for Non-inflationary Wage and Price Behaviour' which sought to ensure that prices could rise only to cover unavoidable cost increases. The Council of Economic Advisers monitored compliance with the guideposts, and could only use public pressure and other suasive measures as an incentive to comply.

Towards the end of the 1960s, the price guideposts were abandoned, and in response to an accelerating rate of inflation, the Government introduced a 90-day

freeze on all prices beginning on 15 August 1971 under its new Economic Stabilization Act 1970. The 90-day freeze came to be regarded as Phase I of a longer-term program of price controls — Phase II was introduced three months later, and established a Price Commission with responsibility for prices and rents (Fallick and Elliott 1981). The criteria governing price movements in Phase II were similar to those adopted under the previous guideposts policy: price changes were permitted only to the extent that they were linked with unavoidable cost increases. Phase III came into effect in early 1973, as price controls were gradually relaxed. However, a 60-day price freeze was introduced following a sharp jump in inflation in the first half of 1973. The introduction of Phase IV in August 1973 signalled the commencement of the selective phasing out of price controls. When the Economic Stabilization Act 1970 expired in 1974, so did the authority to control prices.

Sweden

Sweden's experiences with price controls are quite distinct for two main reasons. First, there has been a greater emphasis on direct intervention in the pricing decisions of individual firms and sectors, and second, price controls have not been accompanied by corresponding wage controls (Jonung 1990).

Like most economies at the time, Sweden was experiencing difficulties with high inflation in the immediate post-Second World War period. Consequently, in an attempt to curb rising inflation, Swedish economic policy was dominated by direct price controls between 1947 and 1949. This was followed by a period of rapid inflation in 1950–52 despite the continuation of price controls during this time. By the early 1950s, price controls were gradually abolished. Even at this stage, the role of prices oversight in regulating monopoly pricing was implied by the replacement of price controls with anti-monopoly legislation (Lindbeck 1974).

The introduction of the Price Control Act 1956 allowed for some limited use of price controls once again. This legislation, which was of a standby nature, was not implemented during the 1960s (Jonung 1990). It was not until the acceleration of inflation in Sweden in the early 1970s that price control policy was given new life. Almost complete price controls were enacted from the end of 1970 until the end of 1971 as a means for reducing inflationary expectations and influencing subsequent wage negotiations. The Price Control Act 1956 subsequently came into operation in December 1972.

Changes to the legislation in 1973 introduced new forms of price controls. These changes were conceptually similar to the development of the PS Act, which was occurring at the same time in Australia. The PS Act was to target 'specific cases in sectors of the economy where wages and prices have pervasive effects throughout

the economy'. That is, it was designed to target price increases by firms in the economy with the greatest perceived ability to influence the rate of inflation. In Sweden, a similar objective seemed to be implied with the 1973 amendments to the Price Control Act 1956:

> Previously 'an appreciable risk for a serious rise in the general price level in the country' had to prevail in order to bring price controls into operation. This stipulation was now altered to 'a risk for serious price increases in important sectors of goods and service production' (Jonung 1990, p. 7).

As a result of these changes, more selective price controls came into effect as the government body for price surveillance, the National Price and Competition Board (SPK), became more active (Krause and Salant 1977). Following this period, the Government imposed a temporary price freeze as a means for softening the inflationary effect of two 1977 currency devaluations. A partial price freeze followed in 1978, along with a system of general compulsory advance notifications of price increases (Flanagan *et al*. 1983). In 1980, a new stabilisation program was introduced which linked revaluation of the currency with a freeze on prices. However, by 1981, the Government replaced the price freeze with a milder monitoring scheme which favoured profits (Flanagan *et al*. 1983). Between 1982 and 1987, various price freezes were introduced in an attempt to curb rising inflation. In 1988, the legally binding price freeze was gradually replaced by mandatory prior notification of increases in prices one month in advance (Jonung 1990).

In addition to the various measures introduced by the Price Control Act 1956, Sweden monitored prices via the Price and Cartel Office. Initially passive in nature, the Office took a more active role in price monitoring after the 1970s by notifying the government of 'price movements that might warrant special measures' (Jonung 1990, p. 12).

C.2 The role of prices oversight in competition policy

Despite the original anti-inflation impetus for prices oversight in Australia and overseas, the emphasis of such measures gradually shifted throughout the 1980s towards restraining monopolistic pricing. Consequently, prices oversight began to be viewed as part of competition policy rather than an anti-inflation instrument, as demonstrated by evidence from the UK, the US and Sweden.

United Kingdom

The role and function of the Prices Commission — which was originally established to monitor price increases throughout the economy — were changed significantly in 1977 to reflect a shift in focus to uncompetitive markets. A more selective approach was adopted, with price controls considered relevant where pricing anomalies occurred in uncompetitive market situations. Consequently, the Prices Commission provided an additional avenue of Government policy for dealing with the problems of inefficiency and monopolistic pricing.

In 1980, the Prices Commission was abolished as the new Conservative Government introduced legislation to control anti-competitive conduct. The new Competition Act 1980 allowed for the Director General of Fair Trading to investigate certain pricing practices that were judged to be of major public concern. Following a reference by the Director General of Fair Trading, the Monopolies and Mergers Commission (MMC) could investigate the pricing practices of firms with significant market power (PSA 1991b).

In 1998, the UK Government introduced the Competition Act 1998, which replaced the majority of the Competition Act 1980 as well as other legislation pertaining to restrictive trade practices and resale price setting. The Competition Act 1998 established the Competition Commission, which replaced the MMC. The Act introduced two basic prohibitions with respect to anti-competitive behaviour, one of which related to abuse of a dominant position. Abuse in this context includes the setting of excessive prices by a dominant undertaking, where an 'excessive' price is one which is higher than it would normally be in a competitive market (Office of Fair Trading, undated).

United States

Between 1974 and 1981, the Council on Wage and Price Stability monitored wage and price movements. The Council introduced a new pricing program in 1978 that again involved limitations on price increases. A company's ability to increase prices in 1978 was restricted to the actual rate of price increase on the company's product over the 1976-77 period less one-half percentage point (Fallick and Elliott 1981).

It was at this stage that US price control policy began to focus more on uncompetitive markets, as the 1978 pricing program exempted from its limitations those companies designated to be operating largely in 'competitive markets'. Once again, penalties for non-compliance were non-existent. The Reagan Administration abolished the Council on Wage and Price Stability, and there were no further attempts to introduce national prices policies during the 1980s. However, selective

price controls continued to be applied by state and Federal regulatory authorities over industries ranging from taxis to electricity, natural gas and communications (PSA 1991b). In particular, state and local governments were slow to follow the deregulation policies implemented by the Federal Government. The insurance industry, for example, is regulated at the state level, with price floors and price ceilings used in different lines of insurance. Many federal regulations remained as well, such as price supports for major areas of the agricultural sector (White 1993).

Federal regulations continue to apply to various areas of the US economy, such as the utilities sector. Although the sector has become increasingly deregulated in recent years, ongoing government intervention continues the extensive history of utility regulation in the US. The gas industry, for example, has been subject to government price regulation for many years. From the late 1950s to the early 1970s, the Federal Power Commission regulated the field price of natural gas. By the mid-1970s, legislation was passed that effectively deregulated the prices of new gas, and permitted prices to rise on previously discovered gas. Consequently, as more 'old' gas was consumed and new gas found, the production and pricing of gas became less and less regulated (Majone 1992). However, regulation still applies to this and other utility service markets, largely because of the lack of competitive outcomes in some markets, as noted by the National Regulatory Research Institute:

> Many electricity, natural gas, and telephone services are no longer purely monopoly services. Many are becoming more competitive, and some are even becoming workably competitive. Nevertheless, competition is not workable in all utility service markets. Even where utility service markets have the potential of being workably competitive, such markets will require ongoing oversight to make certain that anticompetitive behavior, either conduct that would be exclusionary under antitrust laws or unfair trade practices, does not occur (Burns *et al*. 1999, p. 3).

Sweden

In the early 1990s, the Swedish Government introduced measures designed to increase competition in markets. This was reflected by two key events: the introduction of the Swedish Competition Act 1993, and the establishment of the Swedish Competition Authority in 1992. The Authority replaced the SPK and the Competition Ombudsman with the main task of implementing and administering the new Competition Act (OECD 1995).

Article 19 of the Swedish Competition Act prohibits the abuse of a dominant position by one or more undertakings in the market. A market share of between 40 and 50 per cent is regarded as being a clear indication of a dominant position — if the market share exceeds 65 per cent, the presumption of a dominant position is virtually conclusive. Abuse in this context can include 'directly or indirectly

imposing unfair purchase or selling prices or other unfair trading conditions (Swedish Competition Authority, undated). An example of unfair purchase or selling prices is when prices exceed costs significantly.

Thus, with the replacement of the SPK — the body formally responsible for price surveillance — the Swedish Government shifted the focus of prices oversight to firms with market power that set monopolistic prices. These developments are relatively similar to those that occurred in Australia in the mid-1990s when the ACCC replaced the PSA and the Trade Practices Commission, and prices oversight became concerned primarily with monopolistic pricing.

C.3 Trends in prices oversight in other countries

It is evident that approaches to prices oversight in the three countries examined above have changed over the last two decades, with most prices oversight now viewed as part of competition policy rather than an anti-inflation mechanism. This is a common trend in many OECD member countries, most of which underwent a number of major developments throughout the 1980s, as discussed below.

Greater emphasis on competition policy

There has been a shift in focus from direct price regulation to achieving efficient pricing practices via the promotion of competition through pro-competitive reforms and anti-competitive restrictions under trade practices legislation. Essentially such legislation regulates the structure and conduct of enterprises in the economy for the purpose of safeguarding competitive market structures and company behaviour.

Throughout the 1980s, most OECD countries introduced new laws and policies designed to promote competition, and removed inefficient price control regulations (World Bank and OECD 1999). There is scope in some countries for competition authorities to amend or abolish regulatory measures that may limit competition, as is the case in Sweden:

> In Sweden the Competition Ombudsman may propose changes to existing regulations that would enhance the competitive environment (World Bank and OECD 1999, p. 3).

The introduction of competition laws and policies was primarily reflective of the need to promote efficiency and structural change in order to achieve sustained high economic growth. Among other things, direct price controls were regarded as restrictions on such changes.

Removal of comprehensive price controls

As outlined earlier in this appendix, price controls have been a common form of prices oversight both domestically and internationally since the Second World War. Such controls have since been removed, and selective price control schemes scaled down in traditional areas of the economy, as inflation has declined and the adverse effects of direct price controls have been identified. At the same time, however, there have been moves by some countries (including Australia) to establish price controls in new areas of private sector natural monopolies, such as newly-privatised public utilities (PSA 1991b).

Greater integration between competition and prices policies

Prices policies have become increasingly integrated with competition policy as their focus shifts towards addressing monopolistic pricing. This increased integration of policies is also reflected in a number of countries (including Denmark, Finland, France, New Zealand, Norway, Portugal and Sweden) that use the same organisation to administer both price controls and competition policies. New Zealand has integrated competition and prices policies even further by using the one piece of legislation to monitor both restrictive trade practices and monopoly pricing.

Many OECD countries (Germany, New Zealand, Netherlands, UK and the US) have broadened the scope of competition policy, which in many cases has been done to coincide with increased deregulation (for example, of public utilities).

Along with the narrowing focus of prices policy to uncompetitive market situations, there has been an increasing emphasis, especially in the Nordic countries, on the educative role of prices oversight (PSA 1991b). There has been a general transformation in the nature of prices policies with greater emphasis on promoting market transparency and less emphasis on cost-based, rather than price-based, controls (PSA 1991b). Making comparative pricing information publicly available not only has an important educative role by assisting public understanding of the functioning and structure of markets, but also adds to the suasive pressure on firms to act in an appropriate, efficient manner with respect to pricing.

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