INDUSTRY
COMMISSION

IMPLEMENTING THE NATIONAL COMPETITION POLICY

ACCESS AND PRICES REGULATION

INFORMATION PAPER

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CONTENTS

Acronyms and abbreviations **v**

Overview **vii**

Chapter 1 The National Competition Policy **1**

1.1 The Hilmer Report 1

1.2 Competition policy reform package 2

1.3 Competition principles 4

1.3.1 Putting public and private businesses on an equal footing 4

1.3.2 Restructuring GBEs 5

1.3.3 Ensuring access to the services of infrastructure facilities 7

1.3.4 Preventing monopoly pricing 8

1.4 Focus of this information paper 9

Chapter 2 Access to the services of significant infrastructure facilities **11**

2.1 Costs and benefits 12

2.2 Identifying essential facilities and establishing a right of access 14

2.2.1 Declaration by the NCC 15

2.2.2 Undertakings 28

2.3 Limiting the scope of the access package 31

Chapter 3 Terms and conditions of access **35**

3.1 Commercial negotiation 35

3.2 Regulated terms and conditions 38

3.2.1 Economic efficiency and the matters arbitrators must consider 39

3.2.2 Uniform pricing 40

3.2.3 Access pricing and investment 42

3.2.4 Public versus private: should access conditions differ? 43

3.3 Regulatory models 44

3.4 The NCC's processes 45

Chapter 4 Prices regulation 49

4.1 Introduction 49

4.2 Prices control or oversight? 51

4.3 Declaration for prices oversight 53

4.3.1 The criteria for declaration 53
4.3.2 Institutional inconsistencies 58
4.3.3 Monopoly and competitive activities of GBEs 60
4.3.4 National impact 62

4.4 Criteria for assessing prices 62

4.5 Method of price regulation 64

4.5.1 Types of price regulation 65
4.5.2 Design issues 68

4.6 Institutional arrangements 69

4.7 Conclusion: sustaining 'light–handed' regulation 72

Appendix A Access-related initiatives 75

References 83

Boxes

1.1 Elements of the national competition policy package 3

2.1 Costs of regulation 13

2.2 International approaches 14

2.3 Is the monopoly natural? 20

3.1 GBE prices oversight – a model? 46

4.1 Forms of price regulation 50

4.2 Commonwealth approaches to assessing market power 54

4.3 Guidelines for prices oversight by the ACCC 56

Acronyms and abbreviations

Agreement

The Agreement	Competition Principles Agreement

Legislation

The Act	*Competition Policy Reform Act 1995*
PS Act	*Prices Surveillance Act 1983*
TP Act	*Trade Practices Act 1974*

Organisations

ACT	Australian Competition Tribunal
ACCC	Australian Competition and Consumer Commission
COAG	Council of Australian Governments
NCC	National Competition Council
NGMC	National Grid Management Council
PSA	Prices Surveillance Authority
TPC	Trade Practices Commission
TPT	Trade Practices Tribunal

Other terms

CPI	Consumer price index
CSOs	Community service obligations
GBEs	Government business enterprises
GDP	Gross Domestic Product
RPI	Retail price index
TERs	Tax equivalent regimes

OVERVIEW

A major step in extending the reach of competition policy to previously sheltered sectors of the economy was the commissioning in late 1992 of the report of the Independent Committee of Inquiry into a National Competition Policy (Hilmer Report 1993). Governments were seeking a national competition policy framework which would be consistent with developing an open, integrated domestic market for goods and services by removing unnecessary barriers to trade and competition.

At the meeting of the Council of Australian Governments (COAG) in April 1995, Heads of Government signed agreements to implement the national competition policy reform package (see section 1.2). The package extends the competitive disciplines of the Trade Practices Act to State Government business enterprises (State GBEs), statutory marketing arrangements and unincorporated enterprises. It also sets out a process for the review and reform of regulations and other interventions which impede competition throughout the economy.

A new institutional framework has been created for advancing competition reforms. The Australian Competition and Consumer Commission (ACCC) absorbs the functions of the Trade Practices Commission and the Prices Surveillance Authority (PSA). The ACCC is also responsible for enforcing the provisions of the Conduct Code Agreement and for making declarations under the new access regime (see 'Access to essential facilities' below). The role of the National Competition Council (NCC) is to advise on access declarations and on prices oversight of State or Territory Government businesses as well as to undertake reviews under the Competition Principles Agreement.

For its part, the Commonwealth has enacted the Competition Policy Reform Act. This Act is ambitious in its coverage. Its implementation requires many complex issues to be resolved, such as how regimes for access to essential facilities and prices regulation will operate. The way these issues are resolved will be critical to ensuring that competition policy makes the most effective contribution to raising Australia's productivity.

This information paper seeks to contribute to the resolution of these issues.

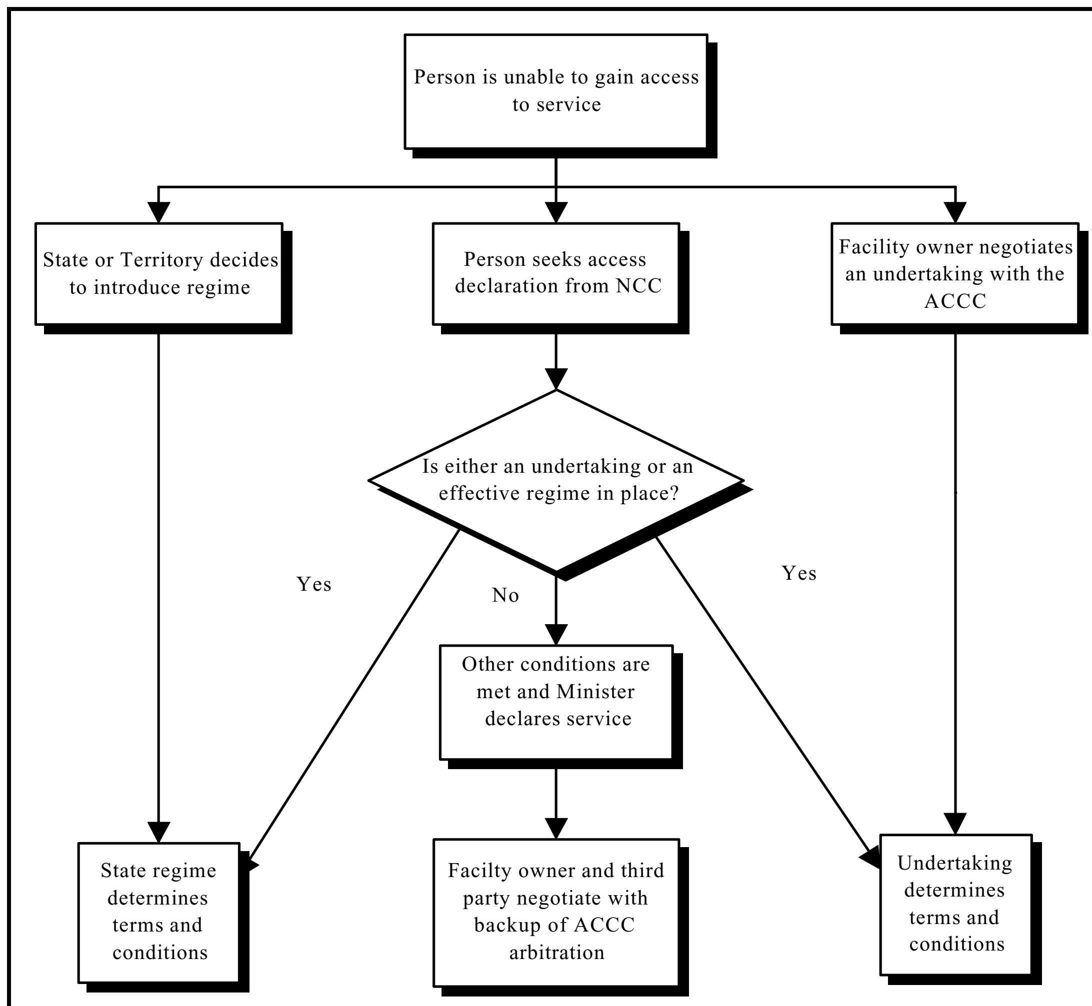
Access to essential facilities

Effective competition in some markets requires that competitors have access to the services of certain 'essential facilities' that cannot be duplicated economically. For example, the creation of a competitive electricity supply market requires that generators have access to the electricity transmission grid. Such access can improve economic efficiency by increasing competition in downstream and upstream markets.

Access regimes also impose potential costs, particularly where they involve uncertainty for future investment in areas that are eventually assessed as not warranting regulation as essential facilities (see box 2.1). Care needs to be exercised, therefore, in the regulation of access arrangements. Potentially, the medium- to long-term costs of an overly permissive allowance of access are likely to exceed the benefits (see section 2.1).

Access regimes can be established in three ways (see figure 1).

Figure 1: Three paths to access



First, the Competition Policy Reform Act requires the NCC to consider applications from any person for a *right of access to be declared* to the services of certain essential facilities of national significance. Second, the Act, in conjunction with the Competition Principles Agreement, also makes provision for the *endorsement of State and Territory access regimes*. Third, the ACCC can accept *'undertakings' from providers of access services* on the terms and conditions under which they will provide access to third parties (see section 2.2).

Declaration criteria

The Act sets out six criteria, all of which must be met before the NCC can recommend to the designated Minister that a right of access be declared (see section 2.2.1):

- access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;
- it would be uneconomical for anyone to develop another facility to provide the service;
- the facility is of national significance, having regard to the size of the facility, or its importance to constitutional trade or commerce, or to the national economy;
- access to the service can be provided without undue risk to human health or safety;
- access is not already the subject of an effective access regime;
- access (or increased access) to the service would not be contrary to the public interest.

The Commission considers it important that the criteria are interpreted in ways that ensure that rights of access are declared only where the efficiency benefits to the community exceed the costs. For example, the first criterion requires that access to a service 'promote' competition. If economic efficiency is to be improved, this criterion should be interpreted as requiring that an access declaration is essential to bring about a substantial (not trivial) improvement in the nature of competition in a downstream or upstream market (see pp. 17–9). Likewise, interpreting the 'public interest' criterion to mean the achievement of concrete efficiency gains would reduce unnecessary uncertainty for facility owners about situations in which access rights might be declared (see pp. 25–7).

When introducing the Commonwealth's legislation, the Minister indicated that the underlying notion was that access regimes would apply to facilities with natural monopoly characteristics. A natural monopoly technology is one where total costs are the lowest possible when there is only one service provider. The Competition Principles Agreement also refers to situations in which facilities cannot be 'duplicated' economically. The Act is couched more broadly, with the second criterion for declaration referring to situations where it would be uneconomical for anyone to develop another facility to provide the service.

In practice, deciding what constitutes a natural monopoly is a complex analytical task; the answer may change according to how broadly markets are defined and as new technologies develop. If the boundaries are blurred beyond natural monopoly to include situations in which there are two or more facilities serving a market, the size and difficulty of the regulatory task and its potential cost may increase substantially, without the prospect of further significant efficiency gains.

Declarations of access should be limited to facilities with natural monopoly characteristics which are of national significance and where third-party access is required for effective competition in related markets. This is not to say that mandatory access to the services of more than one facility will always be inappropriate on economic grounds. However, such action should occur only after careful investigation, and should be kept separate from the declaration process (see pp. 19–21).

Commercial negotiation

Once an access right has been declared by the NCC, the terms and conditions of access are to be negotiated commercially between the third party and the facility owner. Compulsory arbitration is to be used if agreement cannot be reached. The intention is that parties should reach agreement through negotiation rather than have terms and conditions set by regulation. Commercial negotiation respects property rights and gives the parties the potential flexibility to tailor terms and conditions to suit their needs (see section 3.1).

Negotiation between the parties, however, may not diminish market power where competition in the final goods market is weak. In these circumstances, there may be an incentive for the facility owner and parties seeking access to engage in collusive behaviour and share monopoly profits — denying final consumers benefits from access arrangements. Requiring agreed terms and conditions to be lodged on the public register with the ACCC may provide some constraint on such monopoly pricing (see pp: 37–8).

The alternative course of regulating access prices imposes its own costs — both on government and business — such as in compliance, in collecting and evaluating information, in resolving disputes and in uncertainty. It is not easy for regulators to determine efficient access prices and, where they fail to do so, regulation can distort production and investment decisions. For example, setting access prices too low would, by reducing profitability, weaken incentives for further investment in the facility by the owner (see section 3.2).

Given the inherent difficulties in the regulatory task, the process by which access decisions are made is particularly important. A process that is transparent and exposes the reasoning to public scrutiny prior to the final determination stands the best chance of achieving robust outcomes that will improve economic efficiency. In particular, the NCC's assessment of 'effectiveness' and the declaration processes should be open and transparent. Applications for declarations and recommendations of 'effectiveness' should be

advertised, and public submissions invited. The NCC's recommendations and, equally importantly, the reasons for them, should be published (see section 3.4).

Access undertakings

Access undertakings to the ACCC, if accepted, provide an avenue for facility operators to avoid the uncertainties associated with the NCC declaration process. In evaluating proposed undertakings, the ACCC has to have regard to its own set of criteria, including the legitimate business interests of the service provider, the public interest, the interests of all those who may want access to the service and any other matters the ACCC thinks relevant. The ACCC is required to publish proposed undertakings, invite submissions from the public and maintain a public register of all accepted access undertakings.

The ACCC may have to deal almost immediately with applications for undertakings for a wide range of facilities. As the ACCC's early judgements will be influential as precedents for future decisions, its reasoning should be exposed to as much public scrutiny as possible. The institutionalisation of arrangements by the ACCC only in areas where they are clearly warranted, and which would likely be declared as essential facilities by the NCC, would maximise the benefits from greater competition while minimising the economic costs of regulation. The ongoing costs of the undertaking process will be reduced if the ACCC is flexible about allowing firms to withdraw undertakings when it has become clear that declaration is unlikely (see section 2.2.2).

This raises the important issue of achieving consistency between the NCC and ACCC and the need for common guidelines and understanding. The requirement to achieve greater consistency will also extend to State regulatory bodies in regard to declaration processes and decision-making criteria for both access rights and prices oversight. While access regimes have the potential to increase competition and productivity, differing regulatory approaches by different jurisdictions could undermine these potential gains (see section 3.3).

Prices regulation

Legislated monopolies, firms operating in markets with natural monopoly characteristics and firms in poorly contested markets have significant potential to engage in monopolistic pricing. The exposure by governments of previously sheltered industries to increased competition will encourage greater efficiency in the supply of goods and services and minimise the need for price regulation. However, effective competition may not be achievable in all markets or may

take some time to occur. Prices regulation may continue to be appropriate in these circumstances.

Under the new competition policy agreements, prices surveillance processes will be streamlined, less obstructive prices monitoring will be formally introduced, and prices oversight (encompassing both surveillance and monitoring) will be extended to State and Territory GBEs. Responsibility for prices oversight of declared private enterprises and major Commonwealth enterprises will lie with the ACCC. Prices oversight by the ACCC of State- or Territory-owned enterprises will be possible where the owner government has agreed or where the NCC has recommended, on request of another government, declaration of an enterprise for such oversight. Some States have established independent bodies to oversee prices and other States and Territories have agreed to consider doing so (see section 1.3.4).

Price controls or oversight?

Price regulation in Australia consists of price control measures and prices oversight arrangements covering prices surveillance and monitoring. For the most part, price controls are used to regulate the prices of monopoly GBEs, whether by governments or independent regulatory bodies, while privately-owned firms that are assessed to have monopoly power are subject to prices oversight mechanisms.

There is a case for revising this dual approach to public and private monopolies by reducing the extent of price controls in favour of prices oversight (see section 4.2). Price control measures may involve greater costs than prices oversight in terms of reduced incentives for investment and productivity improvement. They may also encourage greater intervention in the management of firms and be used as an alternative to promoting competition. Differences in the regulation of prices of publicly and privately owned infrastructure facilities may unduly affect the competitiveness of firms using these services and their location decisions. Price control by government ministers also raises problems of conflict of interest between efficiency, budgetary and other objectives.

Declaration for prices oversight

A critical issue for governments to address is the development of declaration processes and criteria which confine prices oversight to statutory and natural monopolies and other circumstances where competition is very weak. It is unlikely that there would be net benefits from prices oversight where enterprises are not in a position to dominate the market. Recent Commission inquiries have found that unwarranted price surveillance is detrimental to

consumer choice, adds to business costs and adversely affects production and investment plans without a commensurate pay-off to the community.

The Commission argued in its submission to the PSA's general review of goods and services subject to surveillance that costs would be reduced if prices surveillance was used more sparingly and was refocussed (see section 4.3.1). The Commission considered that the balance between the costs and benefits of prices surveillance are such that it should be limited to circumstances 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 or to expansion by rivals.

Surveillance of prices can improve economic efficiency where pro-competitive reforms would be ineffective. While the Commission has supported prices surveillance in a number of inquiries involving public utilities and natural monopolies, it considered much of the PSA's surveillance activity to be difficult to justify. To date, the Government has removed some goods from surveillance and has decided on less onerous price monitoring for other goods.

While the criteria for declaration for price regulation at the Commonwealth level are likely to lead to unnecessary regulation of firms, criteria that tightly restrict the scope of prices oversight may lead to overcharging and inefficient levels of service being provided. Some State governments require a complete monopoly to exist for a service to be declared for price regulation; this may exclude firms with the potential to exercise monopoly power in pricing.

Prices monitoring

The introduction of a formal prices monitoring function for the ACCC is intended to reduce the use of the more costly process of prices surveillance and contribute to greater flexibility in prices oversight. However, the circumstances in which formal monitoring is envisaged are very broad and may cover firms subject to effective competition (see section 4.3.1). The Commission considers that the same threshold market share used in broader investigations for prices surveillance should be applied to prices monitoring. Prices monitoring would be adopted where there was doubt about the other criteria for prices surveillance. It could also be used as a transitional measure for firms previously subject to another form of price regulation.

The contribution that prices oversight can make to improving efficiency and controlling abuses of monopoly power would also be strengthened if price regulators were required to focus on competition and efficiency concerns. At present, independent price regulators are required by governments to have regard not only to competition and efficiency, but also to other considerations such as investment and employment, dividend payments to governments, protection of the environment, protection of consumers, social welfare and equity considerations and community service obligations. Many of these broader objectives of government can be pursued more effectively through the use of other instruments or dealt with by other regulatory bodies.

Objectives of price regulation

Governments have provided little guidance to existing tribunals on the priorities to be attached to the different objectives set for prices oversight. Consequently, various trade-offs have been constructed between conflicting objectives. For example, in setting prices for GBE-supplied goods and services, tribunals have been involved in making trade-offs between the interests of consumers in lower prices and those of the particular government as shareholder in securing adequate dividend payments (see section 4.4).

The Competition Principles Agreement specifies that State-based agencies are to take efficient resource allocation as their primary objective. However, no such specification is made for the national institutions established under the Agreement. The NCC and the ACCC should also be required to give priority to efficiency in resource allocation in their deliberations. This could be achieved by governments agreeing to common criteria to guide the work of these institutions. Efficiency of resource use should be the primary criterion.

Institutional arrangements

There is considerable scope for differences in approach to price regulation to arise between institutions and jurisdictions in the process used for declaration for price regulation and the guidelines to be followed by regulatory authorities. These bodies are able to choose also between a wide range of types of price regulation, and implementation will be affected by a number of regulatory design issues involving matters such as the method of asset valuation and depreciation, the appropriate cost of capital and the allocation of joint costs between monopoly and competitive activities of firms (see section 4.5).

Governments have undertaken to work cooperatively to examine issues associated with prices oversight of GBEs and may seek the assistance of the NCC in this regard. A priority for the work program of the NCC should be the

development of a consistent approach to prices oversight for consideration by governments. While some differences in approach to price regulation may provide useful experimentation, they may also induce artificial price differentials for similar goods and services provided by different suppliers which do not reflect the costs of supply. This would distort the competitiveness of users in different locations and distort future investment decisions. Problems of overlap between the Commonwealth, State and Territory pricing regulators will need to be resolved in relation to prices oversight of enterprises supplying services on interstate networks (see section 4.6).

CHAPTER 1
THE NATIONAL COMPETITION POLICY

In April 1995, Commonwealth, State and Territory governments agreed to establish a national competition policy and to work cooperatively on competition issues within their jurisdictions. The national competition policy has several elements, including legislation to amend the *Trade Practices Act 1974* (TP Act) and the *Prices Surveillance Act 1983* (PS Act), as well as intergovernmental agreements setting out aspects of the national competition policy that could not readily be legislated. This chapter provides a brief history of the process leading up to the April 1995 agreement and an outline of measures in the competition policy reform package.

1.1 The Hilmer Report

Until recently, Commonwealth, State and Territory governments were pursuing microeconomic reforms largely independently of those occurring in other jurisdictions.[1] The practical effect of this relatively uncoordinated approach to reform was that different arrangements were being put in place to deal with similar issues. For instance, while some jurisdictions had removed many of the barriers to competition in GBE-dominated markets, others retained protections such as exemption from certain government taxes and charges. Overall, progress with reforms was variable and intermittent.

In 1991 the Commonwealth, States and Territories agreed to examine a national approach to competition policy. It was believed that a more coordinated approach to reforms was required to maximise the benefits and limit the costs of change. Consequently, a committee was established in October 1992 and its report into national competition policy, known as the Hilmer Report (1993), was released in August 1993.

The Hilmer Report made a number of significant recommendations on the nature of competition policy as well as the processes and principles that should guide the implementation of such a policy. These findings were then considered by Commonwealth, State and Territory governments. The competition policy

[1] There were some exceptions. For instance, in 1994 the Commonwealth, States and Territories agreed to impose tax equivalent regimes (TERs) for sales and income taxes on their wholly owned GBEs by 1997. Cooperative reforms have also been undertaken in the electricity, gas and water industries (see IC 1995d, appendix H).

reform package emerged out of the consultation process. It was approved by all Council of Australian Government (COAG) members in April 1995.

1.2 Competition policy reform package

The competition policy reform package comprises legislative and non-legislative elements designed to extend the coverage and depth of existing competition policy (see box 1.1).

The coverage of the existing competition policy will be widened through a number of measures. Provisions in the *Competition Policy Reform Act 1995* (the Act) extend the reach of the anti-competitive conduct provision of the TP Act to all businesses in Australia, irrespective of their ownership or legal form. Previously exempt unincorporated entities, GBEs and professions will now have to comply with the TP Act conduct rules. The Act also extends the coverage of the PS Act to include GBEs in certain circumstances, and State and Territory governments have agreed to subject their respective GBEs to independent prices oversight.

The national competition policy 'tool kit' has been expanded through the introduction of provisions covering access to essential facilities. This is a new area of business regulation which extends to private enterprise as well as the public sector.

A number of aspects of the Hilmer Report recommendations could not readily be adopted through amendments to existing legislation. As a result, the Commonwealth, States and Territories developed several agreements that, among other things, establish the institutions, guiding principles and incentives to promote the development of a nationally consistent approach to competition policy. These intergovernmental agreements are an important element of the competition policy reform package. They embody the measures that underpin a cooperative approach to national competition policy.

The Competition Principles Agreement is a key part of the competition policy package. It sets out principles to guide the further development of competition policy.

Box 1.1: Elements of the national competition policy package

In April 1995, COAG agreed to implement a package of measures designed to extend pro-competitive policies to previously exempt sectors of the economy (unincorporated enterprises, GBEs and the professions).

The Commonwealth's *Competition Policy Reform Act 1995* is a key element of the competition policy package. The Act:

- amends the competitive conduct rules of part IV of the TP Act and the provisions that exempt specific forms of conduct from these rules;
- inserts provisions into the TP Act extending the coverage of the competitive conduct rules to the unincorporated sector and to State and Territory GBEs;
- creates 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;
- amends the PS Act to extend prices oversight to State- and Territory-owned business enterprises;
- creates two new institutions responsible for overseeing and providing advice on the implementation of the policy package. The Australian Competition and Consumer Commission (ACCC) has been formed from the merger of the Trade Practices Commission (TPC) and the Prices Surveillance Authority (PSA) and will primarily be responsible for administering the PS Act and the TP Act. The National Competition Council (NCC) will be formed to provide coordination of reform efforts, to ensure that the Commonwealth, States and Territories meet their commitments under the Agreement, and to assess whether jurisdictions have met the reform obligations set out in the Agreements.

The competition policy package also consists of three intergovernmental agreements.

- The *Competition Principles Agreement* establishes agreed principles on structural reform of public monopolies, competitive neutrality between the public and private sectors, prices oversight of government enterprises, a regime to provide access to essential facilities, a program of review of legislation restricting competition and consultative processes for appointments to the NCC.[2]
- The *Conduct Code Agreement* sets out the basis for extending the application of the TP Act and the consultative processes for making modifications to the competition law and appointments to the ACCC. It also commits each State and Territory to pass the required application legislation enabling the Commonwealth's new legislation to take effect.
- Under the *Agreement to Implement the National Competition Policy and Related Reforms*, the Commonwealth will provide payments in return for States and Territories meeting agreed obligations set out in the Agreement, the Conduct Code Agreement plus reform commitments in electricity, gas, water, and road transport.

Source: IC 1995d, appendix H.

[2] The Agreement is not intended to promote public or private ownership.

1.3 Competition principles

The Hilmer Report (1993) recognised that introducing free and open competition to certain sectors of the economy required more than just extending the coverage of the TP Act. It argued that addressing impediments to competition may also require:

- removing legislation that restricts competition in particular markets;
- putting public and private businesses on an equal footing by removing the special advantages and disadvantages given to some government business;
- altering the structure of some public monopolies;
- ensuring that potential competitors can get access to the services of certain facilities (such as power transmission grids and gas pipelines);
- preventing monopoly pricing, where effective competition cannot be introduced.

The Competition Principles Agreement (the Agreement) seeks to establish agreed principles and processes for addressing these concerns.[3]

1.3.1 Putting public and private businesses on an equal footing

The term 'competitive neutrality' describes the idea that firms should compete on their inherent strengths and weaknesses irrespective of ownership. A lack of competitive neutrality — for example in the form of special 'advantages' accruing to government businesses — can stifle competition and distort economic activity. For instance, Hilmer (1993 p. 305) stated that:

> Net competitive advantages...reduce economic efficiency and community welfare, have the potential to impede the development of efficient national markets and can also give rise to legitimate equity concerns.

The Agreement sets out a number of principles relating to competitive neutrality. It aims to eliminate the distortions in resource allocation that arise from public ownership of enterprises engaged in business activities. It requires governments to corporatise[4] GBEs 'where appropriate' and apply tax equivalent systems, debt guarantee fees and the same environmental, planning and

[3] See IC 1995e for a discussion of issues in removing regulations restricting competition.

[4] In its most basic form corporatisation involves subjecting GBEs to the corporations law. However, in practice it is usually accompanied by a range of initiatives such as providing clear commercial objectives, performance monitoring and competitive neutrality.

approval regulations to GBEs and core business activities of government agencies as apply to private enterprises.[5]

The Commonwealth Government has stated that, as well as GBEs, its business activities in education, health, welfare, community services and labour market programs will be subjected to the competitive neutrality agreement. In defining business activities, the Government excluded 'activities that do not involve competition to earn revenue and profits'. Two examples deemed not to be business activities were public schools and public hospitals treating public patients or providing in-house hospital services (Gear, G. in Australia, House of Representatives 1995, p. 2796–7).

Governments are not obliged to implement the competitive neutrality principles if costs are judged to outweigh benefits. While the Agreement does not set out the process that must be followed in considering costs and benefits, it does identify relevant factors. For instance, in addition to considering the efficient allocation of resources, parties must also take into account, among other things, ecologically sustainable development and social welfare and equity considerations.

The only mandatory part of the competitive neutrality element of the Agreement is the requirement that States and Territories publish a policy statement on competitive neutrality by June 1996. While this must include an implementation timetable and a complaints mechanism, no other guidance is given on the content and degree of detail that it should cover. States and Territories must also publish an annual report noting progress in implementing the Agreement and reporting allegations of non-compliance.

1.3.2 Restructuring GBEs

Introducing competition to markets traditionally supplied by government monopolies will require more than just removing regulatory barriers to entry and putting government businesses on the same footing as private firms. Where restrictions on competition have allowed government enterprises to develop into integrated monopolies, structural reforms will be needed to dismantle market power and to increase contestability (Hilmer Report 1993, p. 215).

The structural reform element of the Agreement is designed to encourage governments to examine the appropriate structure of public monopolies before

[5] The agreement does not, however, require the removal of regulations applying to GBEs where the party considers that those regulations are 'appropriate'.

they privatise or introduce competition.[6] Each party to the Agreement is free to set its own agenda for the reform of public monopolies and so is not formally required to remove regulatory barriers to competition.[7] However, before a government introduces competition to a market, it must remove from participants any responsibility for industry regulation.

In the past, some GBEs had responsibility for setting and enforcing technical regulations. For instance, Telecom (now Telstra) previously had responsibility for approving communications equipment produced by other firms for use in Australia. Yet it also manufactured a large range of telecommunications equipment, often in competition with private enterprise. In 1989, the Commonwealth Government allocated responsibility for technical regulation of telecommunications to the industry regulator AUSTEL (Hilmer 1993 p. 217). Indeed, prior to signing the Agreement many governments had already undertaken to relocate responsibility for industry regulation in a range of areas.

In undertaking reviews into the appropriate structure of public monopolies, governments must examine a number of issues, namely:

- the appropriate commercial objectives for the enterprise;
- the merits of separating natural monopoly elements from competitive elements of the public monopoly;[8]
- the merits of separating potentially competitive elements of the public monopoly;
- the best means for splitting regulatory and commercial functions;
- the merits and most appropriate means of funding and delivering mandated community service obligations (CSOs).[9]

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[6] The Agreement refers to ‘public monopolies’ undergoing structural reform. While these are usually thought of as GBEs, some business units within government departments also operate as monopoly service providers. An unresolved issue is whether to include business units within the scope of structural reform programs for public monopolies.

[7] However, as noted in box 1.1, governments are required by the legislative review provisions of the Agreement to review legislative restrictions on competition.

[8] An activity is deemed to be a natural monopoly if the lowest costs of supply are achieved when there is only one producer in the relevant market (see chapter 2).

[9] The Agreement also requires the parties to review the appropriate price and service regulations to be applied to the industry, the most effective means of implementing the competitive neutrality principles and the appropriate financial relationship between the government and its public monopoly (including rate of return targets, dividends and capital structure).

1.3.3 Ensuring access to the services of infrastructure facilities

Effective competition in some markets requires that competitors have access to the services of 'essential' facilities that cannot be economically duplicated (for example some rail lines, gas pipelines and electricity networks). The Act, in conjunction with the Agreement, establishes a national process and a set of principles for State regimes that seek to facilitate access to such essential facilities.

The Agreement requires the Commonwealth Government to put forward legislation to establish a regime for third-party access. It also sets some limiting principles. For instance, the regime should apply where, among other things:

- access to the service is necessary to permit effective competition in an upstream or downstream market;
- it would not be economically feasible to duplicate the facility;
- the facility is of 'national significance'.

The Act limits the national coverage of the Commonwealth's access regime and does not cover facilities subject to existing access regimes within a State or Territory, unless:

- the influence of the facility extends beyond the boundaries of the State or Territory; or
- the State or Territory regime is deemed to be 'ineffective'.

The Agreement and the Act set out the characteristics of 'effective' State and Territory access regimes. For instance, State and Territory regimes should incorporate the following principles:

- wherever possible access should be provided by means of commercial negotiation between the facility owner and the person seeking access;
- governments should establish a right to negotiate access, with an enforcement process;
- access need not be provided on exactly the same terms and conditions to all persons;
- in the event of parties failing to reach agreement on the terms and conditions of access, they should appoint an independent dispute resolution body to resolve the dispute and the decisions of this body should bind the parties;
- separate accounting arrangements should be required for the elements of a business that are covered by an access regime.

The Agreement also sets out the relevant factors that dispute resolution bodies should take into account in deciding on the terms and conditions of access. These criteria primarily emphasise the economic costs and benefits of access.

1.3.4 Preventing monopoly pricing

Where governments decide not to implement the competitive reforms described in this chapter, government enterprises may retain a certain amount of market power. Failure to limit the use of market power can lead to prices rising above the efficient level for a sustained period. Such ‘monopoly pricing’ can be detrimental to economic efficiency and to the interests of consumers. As a result, governments have examined the role for prices oversight in restraining the adverse efficiency consequences of market power.

The Agreement, in conjunction with the Act, recognises that oversight of prices charged by public and private enterprises may be required where competition is weak. The Agreement and the Act set out new arrangements for national prices surveillance and principles to guide State prices oversight arrangements.

Under the new arrangements, prices surveillance processes have been streamlined, formal prices monitoring has been introduced and prices oversight has been extended to State and Territory GBEs. Responsibility for prices oversight of declared privately owned monopolies and major Commonwealth-owned enterprises has been transferred to the ACCC as a result of the merger of the PSA and the TPC.

The ACCC has been provided with a new power to monitor enterprise pricing practices. Previously, the PSA had to declare an enterprise for surveillance or rely on a firm to provide data voluntarily to be able to exercise prices oversight. The new monitoring power is intended to add to the flexibility of the prices oversight process and enable the ACCC to react more quickly to emerging market problems. In addition, the scope of prices oversight is to be extended through informal monitoring to a wider selection of consumer goods and a greater focus is to be placed on services.

Under the Agreement, State and Territory governments have agreed to consider establishing bodies to undertake prices oversight of GBEs that are characterised by:

- being independent from the GBE whose prices are being assessed;
- having efficient resource allocation as the prime objective but having regard to any explicitly identified and defined community service obligations imposed on a business;

- applying to all significant monopoly or near monopoly GBEs;
- providing for submissions by all interested parties;
- publishing pricing recommendations, and the reasons for them.

The Agreement also specifies that prices oversight of State- or Territory-owned enterprises by the ACCC will be possible where the owner government has agreed or where the NCC has, on the request of another government, recommended declaration of an enterprise and the Commonwealth Minister has consulted the appropriate Minister of the State or Territory. The NCC cannot recommend declaration if the government business is already subject to effective prices oversight.

1.4 Focus of this information paper

The agreement by the Commonwealth, States and Territories to the competition policy package has the potential to deliver significant gains to the community.[10] For the potential of these reforms to be realised, governments need to resolve a number of outstanding issues and fully implement the agreement.

This paper seeks to contribute to this task by identifying and examining a number of key implementation issues. The paper focuses on the access and prices oversight components of the Agreement and the Act.

The legislative review provisions of the Agreement were referred to in the Commission’s recent report, *Regulation and Its Review: 1994–*95 (1995e). Some of the issues surrounding competitive neutrality and structural reform are currently being examined in the Commission’s inquiry into competitive tendering and contracting out by public sector agencies (IC 1995f). The Commission has examined structural reform issues in several recent inquiries.[11] A major conclusion of this work has been that the nature of the issues warrants a case-by-case analysis.

This paper seeks to draw together and build on the Commission’s work on access and price regulation issues. These issues assumed particular importance with the passing of the Act and the establishment, on 6 November 1995, of the

[10] The Commission (1994d) estimated that the implementation of national competition policy and related reforms has the potential, in the longer term, to produce a level of Gross Domestic Product (GDP) 5.5 per cent higher than would otherwise be the case. This would be equivalent to adding permanently to Australia's GDP around $23 billion in real terms.

[11] See, for example, IC 1991a; 1991b; 1995c.

ACCC and the NCC. Among other things, the Act alters the arrangements for prices surveillance and establishes a national regime for access. The NCC and ACCC will be responsible for implementing and overseeing these key elements of the Agreement.

Chapters 2 and 3 discuss some key issues in implementing the access provisions of the Agreement and the Act. These include the appropriate scope of a national approach to mandatory access; the establishment of an appropriate framework for firms to achieve efficient outcomes through commercially negotiated terms and conditions; and the difficulties facing regulators where it is necessary for them to determine the terms and conditions of access.

Chapter 4 then examines issues likely to arise in implementing the prices regulation elements of the Agreement and the Act. The focus is on identifying the costs and benefits of price regulation under the new arrangements. Since price regulation has the potential to be costly, a key concern for governments is to find ways of minimising potential costs. A number of factors — such as the objectives of regulators, the criteria for identifying firms with market power, institutional arrangements and the methods of price control — will play an important role in influencing the outcomes of price regulation.

CHAPTER 2
ACCESS TO THE SERVICES OF SIGNIFICANT INFRASTRUCTURE FACILITIES

In some markets, access to the services of a specific 'essential facility' operated by one enterprise is necessary for another enterprise to be able to produce or supply a particular good or service. Where facilities have natural monopoly characteristics (the lowest costs of supply are achieved when there is only one facility in the relevant market) it is more efficient for competitors to use the same facility than it would be for them to each construct and operate their own.

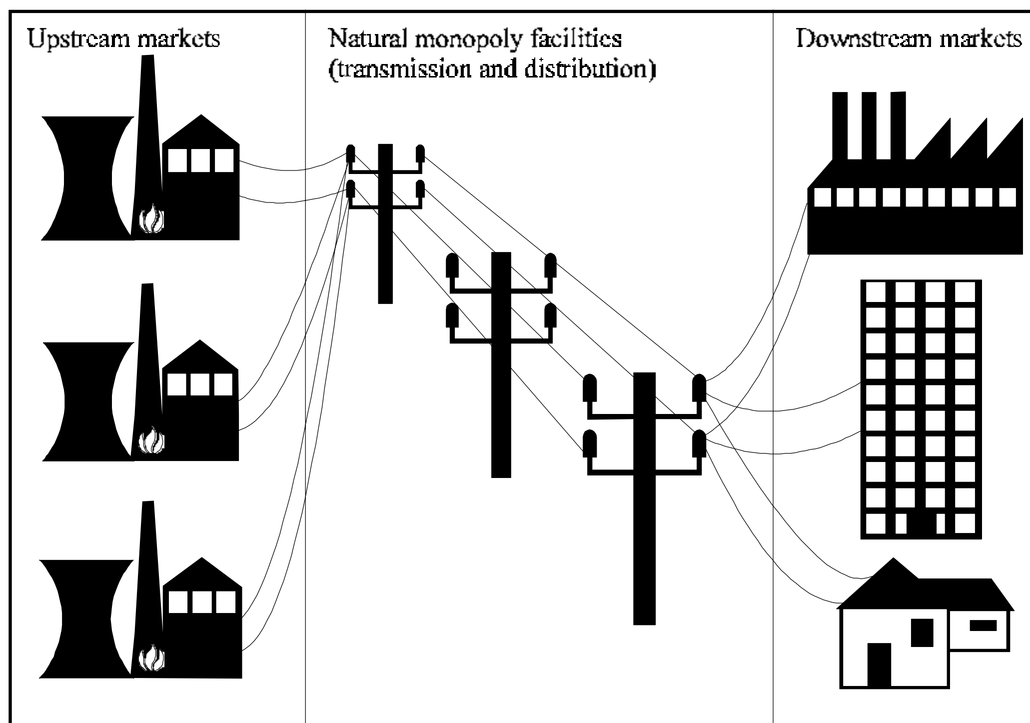
For example, it is probably efficient to have only one set of high-voltage transmission lines connecting electricity generators (an 'upstream market') with a major market, and within that market to have only one set of low-voltage distribution wires running down a local street. This means that an enterprise wishing to compete to supply electricity to consumers in a particular street (a 'downstream market') must have access to both the transmission lines and the local distribution system, each of which could be viewed as an essential facility (see figure 2.1).

Typically, the Government's new access package might also apply to ports, railways, and gas pipelines. The Act specifically excludes access to goods, intellectual property, and production processes.[12] This means, for example, that a competitor could not use the Act to gain access to another car-maker's assembly line.

The administration of an access regime involves two main stages: identifying essential facilities to which third parties should have access, and determining the terms and conditions of third-party access. This chapter discusses the first of these two stages and chapter 3 discusses the second. It also provides a more general discussion on the benefits and costs of an access regime. This will facilitate a full understanding of the issues raised in the discussion of the two stages of administering an access regime.

[12] The Act also specifies that the access provisions do not apply to the supply of a service by Australia Post or a telecommunications service by a carrier or under a class licence under the *Telecommunications Act* (*1991*).

Figure 2.1: Upstream and downstream markets



2.1 Costs and benefits

Access can promote the efficient use of essential facility assets in three ways:

- in the short term, the entry, or threat of entry, of new firms in the downstream market will encourage lower cost production of services, such as the supply of electricity to households (productive or technical efficiency);
- in the longer term, competitive pressures should encourage greater innovation to lower costs and develop new products (dynamic efficiency);
- provided the terms and conditions of access are appropriate, the efficient allocation of resources will be promoted such that all consumers who value the service more than its cost of supply will be serviced (allocative efficiency).

Competitive access is an important element of GBE reform. It will also affect private sector enterprises, both as users and providers of access services.[13]

[13] The Industry Commission has examined the role of access in a number of reports. These include 1991a, pp. 109–36; 1991b, pp. 322–37; 1992a, pp. 124–7; 1992b, pp. 192–205; 1994b, p. 171; 1995a, pp. 58–64, 142.

However, mandatory access imposes costs, including compliance and administration costs (see box 2.1). It may also prove costly if it is administered poorly, or applied too broadly, and thus create disincentives to invest. The costs and benefits of access regulation will also partially depend on the objectives of the essential facility operator. A purely profit-orientated enterprise may be expected to respond to regulation differently from one that is more concerned with increasing output, sales or assets. While the commercial orientation of most GBEs has increased, many are still pursuing other objectives.

Box 2.1: Costs of regulation

Regulation of access to the services of essential facilities has costs as well as benefits. Regulation can be costly in a number of ways. First, regulation can impose significant administrative and compliance costs. For instance, the regulated firm must devote resources to supplying the regulator with information, and the regulator must in turn have means for independently verifying that information, perhaps by making comparisons with similar enterprises in other markets, or by developing models of the enterprise's cost structure. The resources devoted to lobbying the regulator constitute another cost.

Second, significant costs can arise through regulatory failure. Unlike administrative and compliance costs, however, the costs of regulatory failure are less transparent and more difficult to assess. If regulation is imperfectly constructed or administered it can have a significant effect on economic efficiency.

For instance, regulatory failure could lead to prices that are too high or too low. If prices are set too high some customers will not be served even though they are willing to pay a price that exceeds the short-run marginal cost of supplying them. Also, the organisation involved may earn profits that the community would consider excessive. If prices are set too low, facility owners may not adequately invest in new or replacement capital.

Third, the costs of regulation can include the effects of sovereign risk on investment decisions. That is, a change of policy may affect the value of existing assets and create uncertainty about the returns to be expected from future investments.

As the cost of imposing access regulation may be large, it is important that:

- regulatory authorities are given clear guidance about the objectives of regulation, with economic efficiency as the primary objective;
- facilities that are not 'essential' are not declared for access regulation;
- there is no unnecessary duplication and overlap of regulatory functions between bodies within jurisdictions and nationally;

- the regulatory framework provides timely results with a degree of certainty and predictability;
- processes for undertaking regulation are open to public scrutiny.

Different approaches to introducing and administering access have been used in different countries. These range from the court-based approach used in New Zealand, to industry-based approaches in the UK, and a mixed approach in the USA (see box 2.2).

Box 2.2: International approaches

Three broad approaches are used to establish and regulate access. First, courts can establish a right of access based on provisions of general competition legislation. Second, regulatory agencies — either industry-specific or general competition agencies — can establish rights of access and regulate the terms and conditions. Third, ministers can direct that access be provided.

New Zealand has relied on the courts to establish a right of access, most notably in telecommunications where the basis for establishing terms and conditions was finally settled on appeal at the Privy Council. Gas transmission in Germany is not currently subject to an access regime, instead relying on oversight by the general competition regulator, the Federal Cartel Office.

In many countries a number of industry-specific regulatory agencies have been established which regulate terms and conditions of access as well as other pricing matters for public utility industries. The UK has established separate agencies to cover water, gas, electricity, telecommunications and rail. Canada's National Transportation Agency administers access and pricing for rail, air and water infrastructure, pipelines and some road infrastructure (BTCE 1988).

Both regulatory agencies and the courts mandate access in the USA. Access to many public utility facilities is regulated by industry-specific agencies at the national (typically governing interstate trade), state, and local levels. For example, the regulation of electricity is the joint responsibility of fifty State-based bodies and the Federal Energy Regulatory Commission (TPC 1993). In other cases the US courts have required firms to provide other firms with access in industries as diverse as railroads and ski resorts (Areeda 1990).

In other countries, for example Japan and France, the responsible ministries regulate access where a right of access is established (BTCE 1995b, pp. 52–4). In Australia, some State and Territory legislation covering petroleum pipelines has, in the past, given the responsible Minister power to require that access be provided (IC 1995a).

2.2 Identifying essential facilities and establishing a right of access

Depending on the particular circumstances, there are three main routes by which third parties can gain access to the services of a facility:

- Where an access regime already exists, the third party can negotiate directly with facility owners. Existing regimes can be those introduced by States or Territories, or by the Commonwealth. (Appendix A outlines recent access initiatives by Australian Governments.)
- The facility owner may have given an undertaking to the ACCC setting out the terms and conditions on which they will provide access. Before it comes into operation such an undertaking must be approved by the ACCC.
- Underpinning these processes is the right for third parties to apply to have the service of a facility 'declared'[14] under a process administered by the NCC. (See attachment 1 for an outline of the process and the rights of appeal.) A facility cannot be declared if it is the subject of an undertaking or is covered by an 'effective' access regime. For a State or Territory regime to be considered effective, it must meet certain tests set out in the Agreement. Where a regime is established under other Commonwealth legislation the NCC is free to determine how it assesses effectiveness (Gear 1995, p. 26).

(See also figure 2.2.)

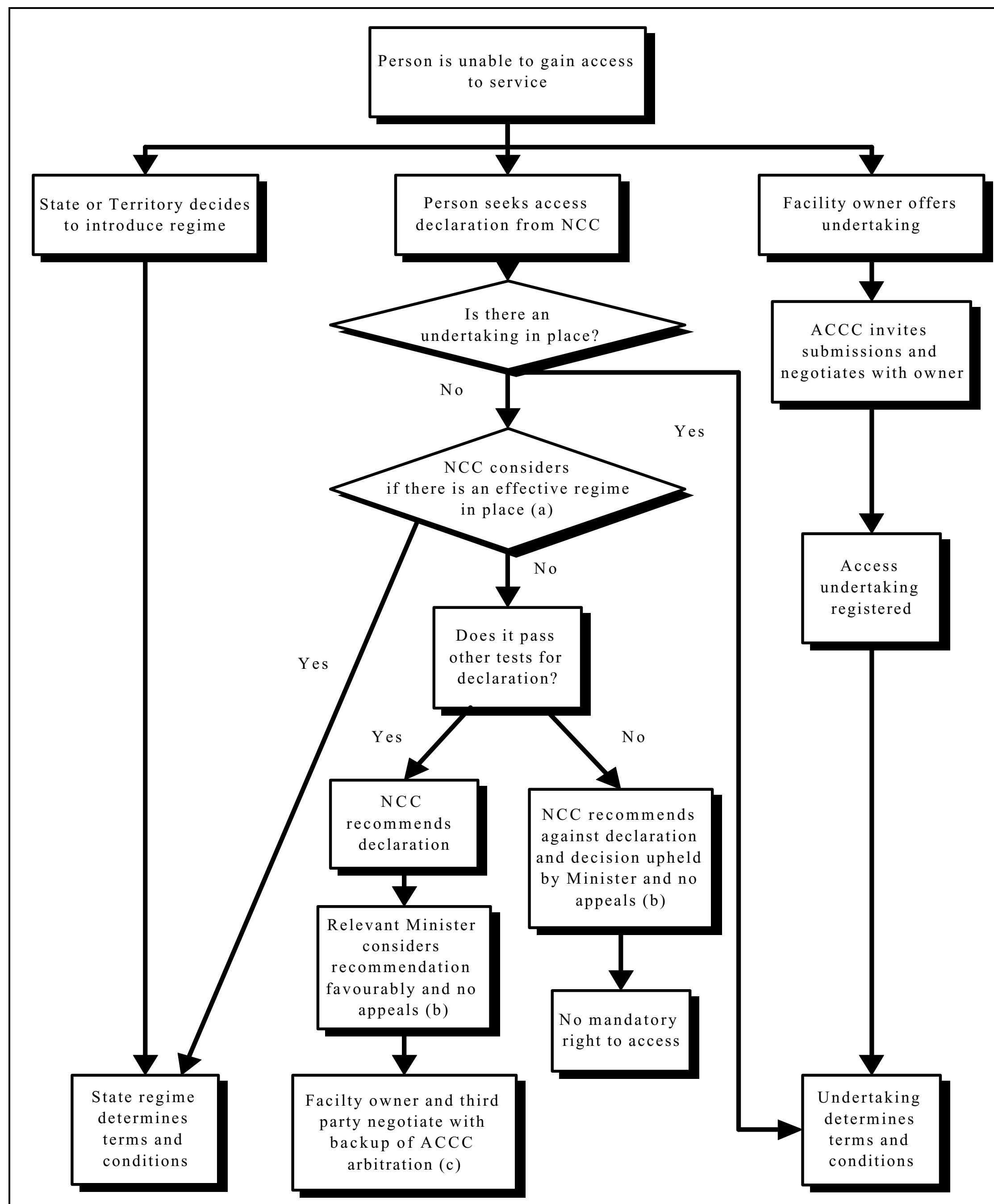
2.2.1 Declaration by the NCC

The declaration process lies at the heart of the Government's new access package. While State and Territory regimes and undertakings via the ACCC are likely to cover many essential facilities, the declaration process will play an important defining role. This will arise either through:

- individuals having the right to apply for declaration, and hence having the effectiveness of a pre-existing regime tested by the NCC; or
- facility owners negotiating an undertaking with the ACCC to avoid the prospect of being declared.

[14] If a facility is declared, the service provider must negotiate terms and conditions of access with the party that applied for the declaration.

Figure 2.2: Three paths to negotiating access



(a) Effective regimes may also include regimes established under other Commonwealth legislation such as the regime for the Moomba–Sydney gas pipeline.

(b) The provider or the applicant who sought the declaration can seek a review by the Australian Competition Tribunal (ACT) of the Minister's decision.

(c) There are subsequent rights of appeal to the ACT and the Federal Court (see attachment 1 at the end of chapter 2).

The NCC must be satisfied of *all* of the following matters before recommending the declaration of a service to the appropriate minister:

1. access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;
2. it would be uneconomical for anyone to develop another facility to provide the service;
3. the facility is of national significance, having regard to:
   i. the size of the facility; or
   ii. the importance of the facility to constitutional trade or commerce; or
   iii. the importance of the facility to the national economy;
4. access to the service can be provided without undue risk to human health or safety;
5. access to the service is not already the subject of an effective access regime;
6. access (or increased access) to the service would not be contrary to the public interest. *(Competition Policy Reform Act 1995*, *S. 44G.(2))*.

The 'designated Minister' must subsequently consider the same matters before actually declaring the service. In time, therefore, the NCC's interpretation of the declaration criteria set out in the Act, and the subsequent action of the Ministers concerned, will be important in defining the coverage of facilities by one form of access regime or another.[15] The problem, however, is that due to the ambiguity and apparent breadth of some criteria, there is considerable scope for quite different interpretations to arise.

Criterion 1: '...promote competition in at least one (other) market...'

This criterion raises three issues: first, the scope of the relevant market; second, how promotion of competition should be interpreted; third, the concept of encouraging competition in export markets.

Market definition is a perennial problem in the application of trade practices law, and will be crucial to the determination of what is, or is not, an essential facility. At its narrowest, a market could be defined to encompass competition

[15] If a State or Territory regime is judged not to be effective, a facility's services can be declared if it passes the other NCC criteria for declaration. In addition, services of facilities that would not meet the NCC's tests for declaration can still become subject to State or Territory imposed regimes.

between enterprises supplying a single product, whereas a broader and more realistic definition would encompass substitutes.[16]

The narrower the definition of markets, the more likely that facilities may be declared. The Commission noted in its report *Rail Transport* (IC 1991b) that railways face varying degrees of competition from other modes, depending on the good being carried. Consequently, the rail line between two points may be an essential input for an enterprise wishing to offer a bulk freight service, but not for one seeking to provide passenger services. Thus individual facilities may be essential for the promotion of competition in some downstream markets and not others.

The *Trade Practices Act 1974* (TP Act) defines markets to include goods and services that are substitutable for, or otherwise competitive with, the good or service in question. However, the problem is to formally identify the appropriate degree of substitution, a task that requires considerable analysis. In practice, fairly narrow definitions of markets have typically been adopted in the application of the TP Act (IC 1992a).

The second issue concerns the need for access to 'promote competition'. If economic efficiency is to be improved, this criterion should be interpreted as requiring that an access declaration is essential to bring about a substantial, not trivial, improvement in the nature of competition in a downstream or upstream market. Competition needs to produce efficiency gains to outweigh the costs of regulation.

In this context the promotion of competition needs to be regarded as a means to an end, and not an end in itself. While declaration will have the effect of increasing the number of participants in upstream or downstream markets, and is a necessary precondition for effective competition to occur, it may not always be sufficient. There is a risk that the benefits of competition will be equated with the number of competitors (concentration) rather than the vigour of competition. In arguing that the US courts have not sufficiently limited the application of the 'essential facilities' concept, Areeda (1990, p. 852) noted that:

> No one should be forced to deal unless doing so is likely substantially to improve competition in the marketplace by reducing price or by increasing output or innovation. Such an improvement is unlikely (a) when it would chill desirable activity; (b) the plaintiff [the party seeking access] is not an actual or potential competitor; (c) when the

[16] Market definition can encompass four components: the relevant temporal dimension; the relevant functional market; the relevant product market; and the relevant geographic market.

> plaintiff merely substitutes itself for the monopolist or shares the monopolist's gains; or (d) when the monopolist already has the usual privilege of charging the monopoly price for its resources.

This particular criterion also establishes as desirable the promotion of competition in markets 'whether or not in Australia'. While this wording was apparently conceived to accommodate access to the facilities of major export oriented resources projects, it is nevertheless difficult to envisage the circumstances under which access would need to be mandated.

Consider, for example, the likely development of an iron ore mine close to an existing mine, the infrastructure of which includes a dedicated port and rail link. For the second mine to be economically feasible, access to the port and rail line are required. But if spare capacity exists, it is unclear why the incumbent would deny access on commercial grounds unless the addition to the supply of iron ore is likely to depress world prices and impair the viability of their operation. Even then they would not necessarily deny access if they were able to negotiate an access fee which compensated them for revenue forgone. If the anticipated profits of the second mine were insufficient to compensate the incumbent, the incumbent would be expected to refuse access on commercial grounds. But since this action would coincide with the national interest, mandatory access would not improve national welfare, and may prove to be harmful.

Criterion 2: '...uneconomical for anyone to develop another facility...'

The second criterion would appear to allow the NCC to declare the services of a facility where more than one facility exists. Yet the intention of the Government seemed to be more tightly focussed when it was explained that:

> The notion underlying the regime is that access to certain facilities with natural monopoly characteristics, such as electricity grids or gas pipelines, is needed to encourage competition in related markets, such as in electricity generation or gas production. (Gear, G. in Australia, House of Representatives 1995, p. 2799.)

The criterion also seems to be at odds with the Commonwealth's commitment under the Agreement (sub-clause 6.(1)(a)) to establish a third-party access regime that would apply to the services of significant infrastructure facilities where 'it would not be economically feasible to duplicate the facility'. While too much could be read into the change in wording of this particular criterion, the broadening of the scope of access was further supported by the removal, after the draft legislative package was circulated, of an additional criterion that would have left no doubt of a focus on monopolies (see box 2.3). That criterion read: 'that no other facility exists that can economically provide the service' (Gear 1994a, p. 1.35).

There is, therefore, some ambiguity as to how restrictive this criterion might be. A broad interpretation would be that, provided the other tests are passed, the general access regime could be imposed in situations where there are competing facilities, such as the services of domestic airline terminals, or taxi booking systems in capital cities.

The benefits of extending access regulation to services that are provided by more than one facility are likely to be considerably less than where only one facility is present. This is because some degree of competition must already exist. And some new and perhaps unintended costs may arise through disincentives to invest.

The case for imposing access where competing facilities exist is based on two assumptions. First, it assumes that mandatory access will significantly increase competition beyond what already exists; second, it assumes that mandatory access is the most efficient policy to achieve this. But it is important to establish why there may be insufficient competition between the present incumbents in the first place.

Box 2.3: Is the monopoly natural?

A natural monopoly exists where one facility can in principle supply a market at a significantly lower cost than can two or more facilities. Whether a facility is a natural monopoly therefore depends on the technology (how costs vary with output), the definition of the relevant market (taking into account substitute products) and the size of that market.

The extent of the cost savings from having one facility will change with developments in technology (which can affect both the cost structure and range of potential substitutes) and will depend on the relevant market's size.

A facility can also have a monopoly position due to barriers to entry, even though two or more facilities could supply the same market (perhaps urban mail delivery). Equally, two or more facilities could be supplying part of a service even though that element of the total service could, in principle, be supplied at somewhat lower cost by one facility (for example, broad-band cable to deliver pay TV in suburban areas) (King & Maddock forthcoming).

One source of policy dilemma associated with natural monopolies is that while the technology may be such that, in principle, one facility could serve the market at lowest cost, the incentives to minimise cost may be weak without direct competition, so that in practice costs could be lower with two competing facilities in some cases.

Muted competition due to explicit collusion, for instance, may be dealt with more effectively through the application of part IV of the TP Act, which deals with restrictive trade practices.

In the absence of collusion, other policy measures less costly than introducing access may be more effective in addressing the impediments to adequate competition. For example, the deregulation of the airline industry has made that market more contestable and has provided consumers with the benefits of lower air fares (BTCE 1995a, p. 2). Where more than one facility exists, access should be considered in the context of all possible policy options. This would be broader in scope than the declaration process.

As noted above, it may be presumptuous simply to equate the number of suppliers present in a market with the degree of competition. The Commission noted in *What Future for Price Surveillance?* that, based on the experience of domestic beer, airline and telephone duopolies and recent US studies:

> ... while from time to time, there will be some shortcomings in the pricing performance of some duopolies — which, in comparison with monopolies, result in modest overcharging of consumers — many other duopolies are competitive ...(IC 1994c, p. 58).

Widening the scope of access beyond natural monopolies could actually reduce the potential for competition if it discouraged investment in an additional facility on grounds that it may subsequently be declared for access. Where natural monopoly characteristics are weak, and barriers to entry are not prohibitive, scope may develop for a firm to gain a competitive advantage by building a new facility rather than sharing the existing facility. For instance, an airline seeking to attract business travellers could decide to duplicate terminals so as to offer its customers better facilities, including quicker baggage handling, while another airline seeking to focus on more price-sensitive passengers may wish to operate out of more spartan but less costly facilities. However, if an access regime requires (or may in the future require) the airline which invested in the second facility to provide access to other airlines, it may be unable to differentiate itself and capture the benefits. This may reduce the viability of investing in the competing terminal.

Confining the NCC's recommendations for declaration (of mandatory provision of access) to the services of natural monopoly facilities is desirable. Where competition between existing facilities is inadequate, other policy measures are likely to be more appropriate than mandatory access. However, mandatory access to the services of a facility where more than one exists may be appropriate on economic grounds in some special

cases. This should proceed only after investigation of all possible policy options.

A further feature of the criterion that may cause interpretation problems concerns the qualification of whether or not it is economical for *anyone* to develop another facility. Potential entrants to an industry will bring with them various resources — financial, technical or otherwise — and so their ability to develop another facility will differ. For example, while the inability of Compass Airlines to develop its own terminals may have hindered its successful entry into the aviation market (TPC 1992a), it is not clear that another better capitalised firm would have had the same difficulties.[17] In a similar situation, Ansett established its own terminals at major New Zealand airports to enter that market.

Criterion 3: '...national significance...'

The national significance test serves two roles. First, it helps to delineate national and State and Territory areas of responsibility (an effective State or Territory regime uses the lesser test of 'significance' (see discussion on criterion 5: '...effective regime...'). Second, it discourages applications for declarations which might broaden the net of regulation to encompass relatively insignificant facilities where the costs of regulation may well exceed any benefits that accrue through access. Even so, State or Territory governments could still introduce mandatory access regimes for relatively small facilities (or indeed where more than one facility serves a market) outside the NCC framework.

There are situations, however, where a facility may not be deemed to be nationally significant in a stand-alone capacity. But as part of a larger network it may assume a much greater importance. For example, the services of isolated rural airports may be 'essential' to operate intrastate rural air services, but none alone may satisfy the tests for national significance. The NCC could declare that it was in the national interest that there be a network of rural airports around Australia, and hence that a particular airport is significant in the context of the national network. This would require that the NCC take a liberal view of the national significance test in certain circumstances.

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[17] The IC examined access to airport terminals in *Intrastate aviation* (IC 1992a, p. 127) and concluded that while 'misuse of market power' provisions of the TP Act could be used to require access, it is difficult to prove misuse of market power, and to determine the conditions of access subsequently.

Facilities that are not nationally significant may still be subject to national competition law through the section 46 (abuse of market power) provisions of the TP Act (Pengilley 1995, p. 251), although the courts may face problems devising easily enforced remedies. For example, access to local facilities, such as a taxi cooperative's radio network may still be subject to s. 46 (Pengilley 1995).[18]

Criterion 4: '...human health or safety...'

The scope for operators of publicly owned infrastructure facilities to use this criterion as a means of precluding competition has been constrained by the Competition Principles Agreement. The Agreement requires parties to review existing regulatory arrangements before introducing competition into a sector traditionally supplied by a public monopoly. This includes examining:

> ... the most effective means of separating regulatory functions from commercial functions of the public monopoly (p. 7).

Queensland has already removed from Queensland Rail the regulatory responsibility for licensing to ensure safe standards by rail operators, transferring it to the Department of Transport.[19] When AUSTEL (the Australian Telecommunications Authority) was established it took over Telecom's responsibilities for setting technical and safety standards in the telecommunications industry.[20]

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[18] Section 46 (misuse of market power) as well as s. 45 (contracts, arrangements or understandings restricting dealings or affecting competition) of the TP Act were used to gain access to a taxi booking network in the early 1980s. An owner of a new taxi licence plate in Canberra equipped his car with a radio and meter in October 1982, but was then told that he could not be admitted to Canberra's only taxi cooperative until July 1983. After discussions with the TPC and legal advice, the cooperative agreed that all new plate-holders would be admitted and given immediate access to its radio facilities (TPC 1983, pp. 76–7).

[19] The *Transport Infrastructure Amendment (Rail) Act 1995* introduced a rail safety accreditation system whereby the Director General of Queensland Transport accredits railway managers and operators, rather than Queensland Rail.

[20] In changes to telecommunications regulation that have been announced AUSTEL will retain technical and safety regulation while being merged with the Spectrum Management Agency. In July 1997 AUSTEL's commercial regulatory functions and the staff from this area will move to the ACCC (Department of Communications and the Arts 1995, pp. 14–16).

Criterion 5: '...effective regime...'

The NCC must consider whether or not a facility is already the subject of an effective access regime. This may occur through assessing an application for a declaration or from a request by a State or Territory Minister that the NCC recommend to the Commonwealth Minister that their regime be considered effective. Effective regimes may include regimes established by the States and Territories, and specific Commonwealth regimes.

The Agreement outlines several principles that a State or Territory regime *should* incorporate for it to be considered effective. Like the national regime, an effective State or Territory regime should, wherever possible, be based on commercial negotiation subject to compulsory arbitration where agreement cannot be reached.

The agreement specifies that the regime should:

> ... apply to services provided by means of significant infrastructure facilities where:
>
> (i) it would not be economically feasible to duplicate the facility;
>
> (ii) access to the service is necessary in order to permit effective competition in a downstream or upstream market; and
>
> (iii) the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist; ...(p. 9)

The NCC may decide that a State- or Territory-based access regime is not effective if facilities covered by the regime have an influence on trade in another State or Territory. Similarly, the national regime may apply where substantial difficulties arise from the facility being situated in more than one jurisdiction.

The tests for effectiveness raise three points:

- While the tests ensure that State and Territory regimes are broadly consistent, they nevertheless provide considerable scope for variation in the regimes adopted. This has implications for resource allocation between jurisdictions, and it may add to the compliance costs of enterprises operating facilities in more than one jurisdiction.
- The lesser test of significance may, in the short term, require State and Territory regulators to develop guidelines to contain the coverage to a workable level and eliminate trivial cases where regulatory costs may

exceed any consequent benefits.[21] Over time, the publication of the interpretations by State and federal regulators of the respective criteria contained in the Act and the Agreement will help tighten the application of access, and give some focus to this criterion (and others). However, there is currently no requirement for these interpretations to be published.

- Unlike the national regime, an effective State or Territory regime is required to focus more clearly on facilities that are natural monopolies and hence is more in line with the Commonwealth Government's stated intent for access.

The Government has indicated that an effective access regime could be a regime established under other Commonwealth legislation although this is not explicitly mentioned in the Act or the Agreement. An example is the access regime for the Moomba-Sydney gas pipeline (Gear 1995, p. 26). These regimes would not be subject to the same effectiveness tests as would apply to State or Territory regimes. The Minister may have regard to the principles set out in the Agreement, but could consider other matters.

Criterion 6: '...not contrary to the public interest...'

This criterion raises some fundamental issues about the extent to which public benefit or interest is synonymous with efficiency in the application of competition policy. If this criterion is interpreted to require that declaration should not impinge on specific equity goals, efficiency could be adversely affected.

Although the Act does not define public interest[22], the term *public benefit* is used in the TP Act merger test and in the evaluation of authorisations of anti-competitive agreements. While there is no legislative definition of public benefit either, the TPC in *Re ACI Operations Pty Ltd* (1991 ATPR 50-108) has listed a wide variety of potentially conflicting matters that could constitute public benefit. This has resulted in the term being interpreted broadly 'and including anything of value to the community generally' (Miller 1994, p. 467).

[21] More specific criteria such as the absolute revenue or value of the facility providing the service in question is one option. However, there may be no relationship between the size of the facility, and the benefits in terms of lower prices or improved quality of service. For instance, a small facility in an isolated rural market may give the operator considerable market power, robbing consumers of the downstream service of the benefits of competition.

[22] McEwin (1995, p. 5) found that public interest was mentioned 386 times in a search of 1167 Commonwealth Acts and 566 regulations without defining the term.

Public benefit has been interpreted differently by the TPC and the Trade Practices Tribunal. When applying tests of public benefit to assess authorisations of anti-competitive behaviour, the Tribunal has focused primarily on the benefits in terms of overall efficiency, whereas the TPC has also given consideration to the distribution of those benefits (Officer & Williams 1995, p. 165).

The Commission argued in *Pro-competitive Regulation* that economic efficiency should be the goal of trade practices regulation and competition policy (IC 1992c, p. 10). This does not mean that equity and other welfare considerations are unimportant. Indeed, a focus on efficiency lowers costs and prices and can indirectly serve other objectives, such as employment, investment, or consumer benefits. And there are other instruments to target equity objectives. The danger is that multiple and potentially conflicting objectives, such as seeking to address equity objectives through competition policy, can reduce efficiency and the welfare of the community. As Treasury has stated:

> Governments have means of promoting fairness of income distribution including transfer payments and taxation systems and via programs to provide subsidised goods and services. Competition policy, on the other hand, is a very blunt instrument for achieving fairness of outcomes; if equity considerations were allowed to override...efficiency goals...competition policy could make the community poorer in the aggregate sense. This would act to reduce the level of income available to redress income distribution via transfer payments and the taxation system (Department of Treasury 1991, p. 6).

Determining where mandatory access is likely to increase efficiency may be a difficult task in some instances. If economic efficiency is the prime objective, access could be judged to be in the public interest if the benefits outweigh the costs (Helm 1994. p. 18). But the measurement of costs and benefits will often be difficult, especially where technological change and product development are proceeding rapidly, as in the telecommunications industry.

The potential gains from access will accrue from improvements in allocative, technical and dynamic efficiency, both in the provision and consumption of the access service itself and in related markets. Competition in pursuit of market share encourages innovation in developing new and better products and services, and it drives down costs. For instance, in the Australian telecommunications industry there has been vigorous competition among the three mobile phone operators, with a rapid increase in the range of services offered. Telstra (1995b, p. 7) has claimed that the greatest fall in prices has

been in those parts of the market that are most contested.[23] Telstra (1995a, p. 27) also noted that in telecommunications:

> ... the primary force driving improvements in quality of service is, and will continue to be, competition.

Weighed against the benefits are a number of costs. In addition to the generic regulatory costs discussed in box 2.1, access regulation may impose additional costs through structural reforms that result in losses of economies of scale and scope.[24] For example, in some cases there may be considerable costs in establishing and maintaining procedures to coordinate trains that seek to share a congested rail line. These costs may exceed the benefits of greater competition in the provision of train services. One of the problems of regulation is that in such situations the incumbent has an incentive to overstate the extent of economies of scale and scope and the difficulties associated with more market-based approaches to sharing scarce capacity.

The level of transactions costs — such as negotiating and enforcing contracts — will influence the terms and conditions under which a vertically integrated enterprise will be prepared to provide access to a facility.[25] It will also influence the desirability of vertical separation — from full structural separation where the monopoly elements are operated by a separate enterprise, to separate accounting for the 'essential facility'. However, these costs may be difficult to measure as the existing level of transactions costs involved in coordinating activities within the enterprise is seldom readily visible in an integrated firm.

The design of access regulation will also influence how well it serves the public interest. For instance, an access regime which both constrains the monopoly power of the 'essential facility' operator and promotes vigorous competition in the downstream market reduces the need for regulation of final good prices. Shifting the burden of regulation from the final goods stage to the 'essential

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[23] While this could be attributed to technical change, that would not explain Australia's relatively rapid adoption of this technology, Blount cited Australia's movement from tenth to fourth in international comparisons of per capita mobile phone penetration between 1990 and 1994 as evidence that competition was the key.

[24] Economies of scope exist when the cost of producing two or more products by a single enterprise is less than the cost of their separate production by a number of more specialised firms (IAC 1989, vol. 3, p. 80)

[25] Where there are significant sunk investments in assets specific to a relationship between two firms the threat of opportunistic behaviour — that is, ex-post a party demanding a lower price that is not sufficient to allow a reasonable return on sunk investment — must be addressed. Long-term contracts and vertical integration are two responses to this problem (see IC 1995a, pp. 239–51 for a discussion of the role of transactions costs and long-term contracts in the gas industry).

facility' stage may ease the regulatory task by reducing the number of services that must be regulated, and hence may be in the public interest. The NCC may, as a result, need to assess how costly and effective the regulation of pricing is likely to be for the 'declared' facility.

2.2.2 Undertakings

In the preceding section, two paths to obtaining access were discussed: the NCC declaration process, and as an adjunct to that process, the creation by States and Territories of their own access regimes. The third path to establishing an access regime is via an undertaking to the ACCC (see figure 2.1). To avoid uncertainty and potential delays arising from the NCC's declaration process, operators (and potential operators) of facilities can submit an undertaking on terms and conditions of access to the ACCC. An undertaking can reduce uncertainty in three ways:

1. once accepted by the ACCC the services of that facility cannot subsequently be declared;
2. the owner has the opportunity to influence the terms and conditions of access, or the basis on which they will be negotiated and/or arbitrated;
3. subject to the ACCC's consent, the undertaking can be withdrawn.

The public process by which the ACCC is to accept an undertaking involves the publication of the undertaking, inviting submissions to the ACCC, and the maintenance of a public register of all access undertakings accepted, and any subsequent variations (see figure 2.3). Unlike the Minister's decisions on declarations, there is no right to appeal the ACCC's decision to the Australian Competition Tribunal.

The incentives to make an undertaking will depend on two considerations:

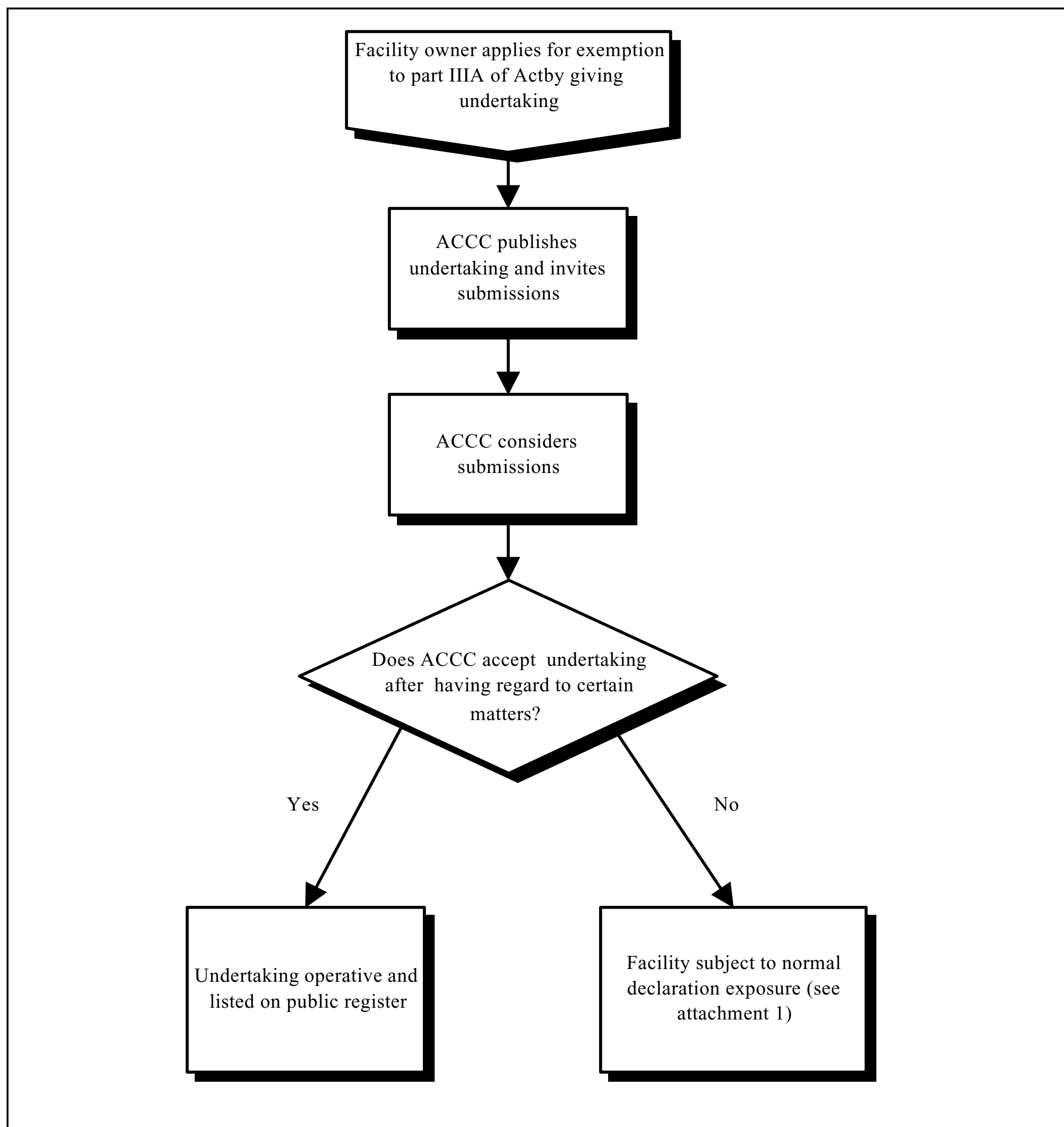
- first, how the NCC interprets the criteria for declaration;
- second, how the ACCC interprets the criteria for acceptance of undertakings.

If, for instance, owners of facilities come to believe that the NCC is using relatively narrow definitions of markets, they may regard the risk of declaration as intolerable and seek an undertaking. On the other hand, they may believe that the ACCC would extract from them various concessions in obtaining an undertaking that they would not have to agree to under a declaration by the NCC. The differences in criteria and their interpretation thus are at the core.

The Act states that the ACCC may accept an undertaking it if thinks it appropriate, having regard to:

1. the legitimate business interests of the providers;
2. the public interest, including the public interest in having competition in markets (whether or not in Australia);
3. the interests of persons who might want access to the service;
4. whether access to the service is already the subject of an access regime; and
5. any other matters the ACCC thinks are relevant. (s. 44ZZA. (3))

Figure 2.3: The undertaking process



In assessing undertakings, the ACCC faces a number of challenges.

First, guarding the public interest will be difficult, even if it is narrowly defined in economic terms. Undertakings may come in various forms, from non-negotiable published tariffs to sets of principles by which the facility owner will be prepared to negotiate access. During the submission phase, interested parties will have an opportunity to influence the subsequent content of the undertaking accepted by the ACCC, which will help to protect the public interest. But given that the possibilities for entry into the particular industry may be limited for one

reason or another, agreement between interested parties may not always be a sufficient condition for promoting economic efficiency. The ACCC must, therefore, evaluate whether the undertaking reflects, or is likely to produce, terms and conditions that promote efficiency, or whether it will tend to entrench monopoly outcomes.

Second, undertakings must specify an expiry date. The ACCC, in determining whether the term of the undertaking is reasonable, will need to balance the provider's desire to reduce uncertainty, particularly with long-lived sunk assets, against the need to accommodate changes in circumstances, including market size, technology, and new potential downstream providers. This exercise of judgement is all the more important given that there are no provisions in the Act for the ACCC to respond to a change of circumstances and withdraw approval of an undertaking.

Third, there are no formal links to the NCC's declaration recommendations. While this creates flexibility in the undertaking process, the challenge for the ACCC will be to evaluate undertakings on a consistent basis. By considering applications for declaration, and subsequently accepting some and rejecting others, the NCC (and the Minister in reacting to that advice) will help to define the sorts of services that will be 'declarable'. In the meantime, it is likely that the ACCC will have to deal with applications for undertakings for a wide range of facilities.

The process may also raise some interesting (although not entirely unfamiliar) challenges for the ACCC. One possibility is that expected providers of services may argue that high prices for access in the short term are essential to bring the facility into being. While in the long term relatively low access prices may be viable, it may only be possible to secure debt funding for a long-lived facility, with a high proportion of sunk costs, if the operator can repay most of any loan during the early stages. For instance, in North America, banks financing new gas pipelines have insisted on ten-year ship-or-pay contracts which can limit the extent of open access in the medium term (IEA/OECD 1994, p. 102).

The undertaking process will play an important role in encouraging self-regulation. It enables industry organisations to develop codes of practice which their members can use as a generic basis for undertakings they submit to the ACCC. This is the way in which the Australian Petroleum Exploration Association (APEA 1995) proposes that access to gas transmission pipelines be addressed. A variation on this theme is also being used in the telecommunications industry. However, under the specific policies applying to

that industry there is a compulsion on general carriers to develop an industry code of practice and submit undertakings to the ACCC.

Undertakings will involve some costs to the community. The process of gaining acceptance of an undertaking may be costly in itself. Where undertakings are sought for the services of facilities which would not otherwise be declared by the NCC, or subjected to a State or Territory regime, the new legislation may add to the costs of regulation without producing any offsetting benefits from greater competition. Costs may also result from allowing an undertaking to outlive its usefulness. For instance, if a firm remains subject to an undertaking after a competing facility has emerged, it may be at a disadvantage relative to its rival who may face little prospect of declaration.

The ongoing costs of the undertaking process will be reduced if the ACCC is flexible about allowing firms to withdraw undertakings when the facility owner feels that it has become clear that declaration is unlikely.

The undertaking process may also raise jurisdictional issues. Within the limits of the Commonwealth's constitutional powers, once the ACCC has accepted an undertaking it will prevail over any State regime that is inconsistent with the undertaking and seeks to cover the same service.[26] This provides scope for a private sector access provider to seek an undertaking if it does not consider the relevant State, Territory or Commonwealth regime to be suitable.

2.3 Limiting the scope of the access package

This chapter has attempted to illustrate that a number of the criteria used in the declaration process are open to interpretation, the net effect being that the coverage of facilities that must provide access could be unnecessarily wide, and could extend to cases where more than one facility is present. The costs of bringing the wrong firms into the regulatory net could be substantial.

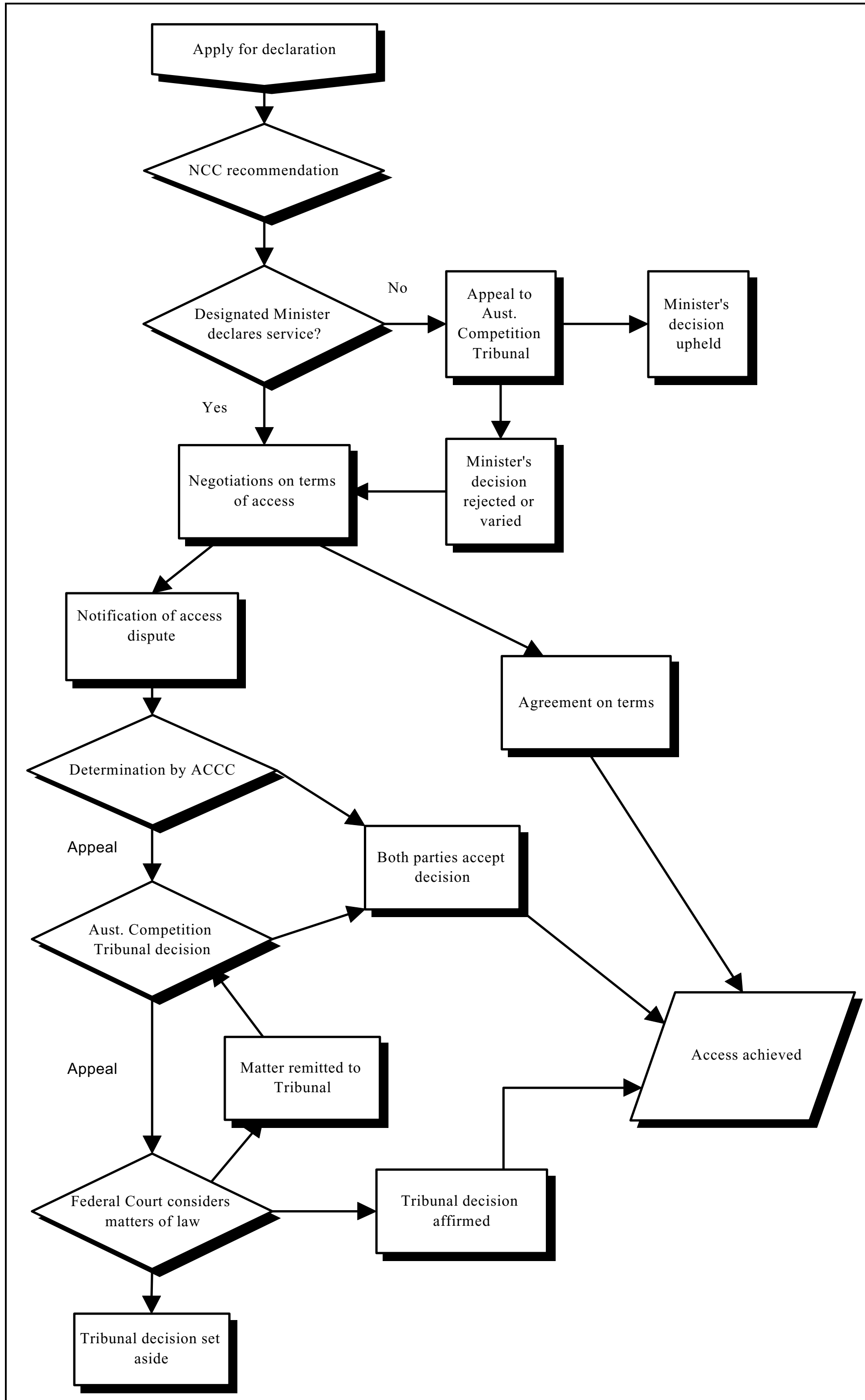
The interpretation of 'public interest' will play a crucial role. An interpretation that primarily emphasises economic efficiency is argued to be appropriate. This is important in generally focussing the declaration process on cases where net benefits are expected to be achieved. In this regard the Commission believes that the efficiency gains from extending

[26] Section 44ZZJ.(2) of the Act provides the constitutional link. This subsection limits the scope of Federal Court orders relating to undertakings to where the provider or third party is a corporation, or access to the service is used for interstate or international trade or commerce. An undertaking and a regime would be inconsistent if it was not possible to comply with both at the same time.

the coverage of access to cases involving more than one facility are dubious. In these circumstances, attaching an economic efficiency interpretation to the public interest criterion would lessen the likelihood that the NCC would declare facilities that are not natural monopolies.

While the requirement that all criteria be met before the services of a facility can be declared may prevent the net of 'essential facilities' becoming too broad, the individual tests should be as clear as possible. To assist this process and to reduce the uncertainty associated with declaration, guidelines should be developed as a matter of urgency (and possibly tested in the Australian Competition Tribunal). A better understanding of the declaration criteria and their interpretation will assist in defining the respective scope for State and Territory regimes, and it will assist facility owners in deciding when and whether to give undertakings.

Attachment 1: The declaration process



CHAPTER 3
TERMS AND CONDITIONS OF ACCESS

Once it has been established that third parties should have a right of access to the services of a facility — whether by way of a declaration by the designated Minister, the introduction of an access regime by a State or Territory government, or in some cases by way of an undertaking — the next step is to determine the terms and conditions of access. Important issues are the advantages and disadvantages of commercial negotiation compared with regulated pricing, and the implications of adopting different regulatory models. The challenge in third-party access pricing is to determine a price that provides an adequate return for the facility owner, yet promotes economic efficiency by preventing excessive exploitation of market power.

3.1 Commercial negotiation

Following Hilmer (1993), the Act requires that once the service of a facility is declared, the access provider and the third party (or parties) must enter into commercial negotiation. If agreement cannot be reached, either party may advise the ACCC that a dispute exists, which triggers a compulsory arbitration process.

In the case of a national regime there are subsequent rights of appeal to the Australian Competition Tribunal (ACT), and as a last avenue, the Federal Court (see attachment 1 to chapter 2). For an effective State or Territory regime, commercial negotiation is intended to be the basis for setting the terms and conditions of access 'wherever possible'. This must be backed by 'dispute resolution' and 'enforcement' processes, and 'rights of appeal under existing legislative provisions should be preserved'. Essentially, therefore, the two processes are the same: commercial negotiation backed by binding arbitration.

Given that access providers are in a position of considerable bargaining strength, the presence of an arbitration process is an important feature of the access regime. However, while the threat of arbitration may influence the behaviour of access providers to some extent — in particular by encouraging them to offer a lower access price than otherwise — the extent to which end–users benefit from access is uncertain (King 1995, p. iv).

In most circumstances, commercial negotiation is an appropriate method for price determination. It respects existing property rights (thus reducing sovereign risk concerns) and gives the two parties flexibility to tailor a price structure, and associated terms and conditions, to suit their respective needs. The alternative of regulation is costly and imperfect, and as the Industry Commission (1992c) noted:

> ... requiring firms to provide other firms access to their intermediate products at a 'reasonable' price may undermine the role higher prices can play in rewarding innovation and/or signalling the desirability of entry of new firms to a market (p. 6).

The problems with commercial negotiation of access can be illustrated by two cases involving a single access provider whose objective is to maximise profits. For the sake of simplicity the illustrations consider the entry of new firms in a downstream market, for instance in electricity retailing. The two cases are:

- one in which the barriers to entry to downstream markets are high, so that very few access customers emerge; and
- one in which the costs of entry are much lower and more vigorous competition is present.

In either case, the access provider could charge its customers at the monopoly rate, provided that there is no arbitration process. Profit to the facility owner would be maximised, and little or no benefits to consumers would arise.

In both cases the bargaining strength of third parties is improved where an arbitration process is present. This will be especially so where the arbitrator has a fairly unambiguous goal of improving economic efficiency, where arbitration provides a credible threat to the incumbent, and delays and costs are minimised. Thus the access provider would run the risk of triggering the arbitration process if it tried to overcharge, or otherwise frustrate entry, for instance by unduly prolonging negotiations. Faced with the prospect that the arbitrator may set the price at or below the efficient level, the incentive for the access provider is to share rent rather than lose it all together.

In the first case, where there are likely to be few entrants to the downstream market, the access provider may be able to offer users a price that is sufficiently attractive to entice them not to go to arbitration. The access provider will also seek to create a pricing structure that both discourages potential entrants, and ensures higher prices in the downstream market. With little or no fear of further entry occurring, the access purchasers benefit by not passing on to their customers the lower access fee. Rent is merely shared between the access provider and the entrants.

In the second case, where there is the potential for greater entry into the downstream market, it may be futile for the access provider to try to bribe entrants with a lower price, since any above-normal profits would attract additional entry. By the same token, there may not be strong incentives for an individual party seeking access to incur the costs of going to arbitration. Their ability to capture the benefits of a lower arbitrated access price (by not passing the cost saving on to consumers in the downstream market) may prove to be short-lived. To the extent that other firms can avail themselves of the new lower access price, the entry of any such firms downstream will erode profits. Thus the gains that an early entrant may achieve must be weighed against the costs of arbitration and associated delays.

In practice neither scenario may realistically describe the behaviour of industry participants. Nevertheless, such processes are likely to create sufficient tension to force prices below what the monopolist would charge in the absence of the access regime. What is not clear is just how much lower prices might be, and how they would compare with the costs of providing that access.

In summary, the problem with using commercial negotiation to determine access pricing is that a pricing solution that captures at least some of the benefits of monopoly power is the obvious negotiated outcome for firms to aim at, and there may be insufficient constraint on this (King & Maddock forthcoming).

Where the access provider is vertically integrated, the commercial negotiations also provide a venue for it and its potential competitors to discuss pricing and output, activities that would normally be deemed anti–competitive. Yet, because the pricing structures have been formally negotiated, and the details of the access agreement are not required to be divulged publicly, such an outcome could appear to be outwardly consistent with the principles of the Act, and/or the Agreement.

Disclosure of agreed pricing may have a limited role to play in discouraging blatantly anti-competitive provisions. In this respect both the Queensland and South Australian natural gas pipeline access regimes require commercially negotiated agreements to be lodged with the respective regulator. This does, however, place the regulator in the position of being able to identify undesirable pricing practices, a difficult and complex task that is virtually synonymous with regulating prices.

The potential for commercial negotiation of access to improve allocative efficiency is uncertain. Requiring agreed terms and conditions to be lodged on the public register with the ACCC in line with the Hilmer

recommendations (Hilmer 1993, p. 267) may provide some constraint on monopoly pricing.

In the two scenarios described above there was a presumption that the goals of the arbitrator are clearly focussed on economic efficiency. If this were not the case, and the respective bargaining positions of the two parties were not clear, disputes could be more likely to go to arbitration. As the New Zealand Government (1995, p. 2) noted in a discussion paper on access issues:

> ... two parties are unlikely to reach agreement as long as their underlying legal 'rights' [that is, the set of terms and conditions that the monopolist can legally demand] are ill-defined, particularly in a context such as this, where the monopoly firm has a strong incentive to test the upper limits of legal behaviour.

The costs of such uncertainty can be high, both in terms of the legal expenses and management time involved, and in the distortion of production and investment decisions during the negotiation period. In New Zealand, Clear Communications is reported to have already spent up to NZ $10 million in legal fees alone in its access dispute with New Zealand Telecom (Ahdar 1995, p. 106).

3.2 Regulated terms and conditions

Where commercial negotiation fails, compulsory arbitration commences — thus the terms and conditions of access enter the realm of regulation. Initially such regulation would cover the third party and the access provider only, with the rights of existing users preserved. However, where secondary markets in access services are permitted, it may be difficult over the longer term to set the terms and conditions for one user at a substantially different level from that for others. Contract renegotiation, and/or arbitrage in access services would help to ensure that relatively uniform prices prevail among competing users. Thus, in setting the terms and conditions for one user, the arbitrator will be setting a powerful benchmark for all other users, so regulation for one user essentially becomes regulation for all.

Access regulation involves many of the same issues as regulation of final goods prices in monopoly markets (see chapter 4). In both cases the information requirements are considerable and regulated firms have strong incentives to withhold or distort information. A regulator acting on poor information may set prices that are too high, in which case the benefits to end-users may be limited, or they may set prices that are too low, which may consequently affect the ability of the incumbent to maintain his or her investment. One difference is

that regulation of access focuses on a narrower range of services — the access service itself rather than the potentially more numerous services that use the service as an input.

3.2.1 Economic efficiency and the matters arbitrators must consider

A common objective in regulating monopolies is to promote the efficient allocation of resources. Earlier it was argued that economic efficiency should be the primary objective in determining the scope of mandatory access.[27] Similarly, economic efficiency should be the primary objective of access regulation. However, while both the Act (referring to the ACCC's arbitrations) and the Agreement (referring to the dispute resolution bodies of 'effective' regimes) specify a number of broadly similar matters that must be taken into account in setting the terms and conditions of access, economic efficiency is only indirectly addressed.

For instance, under section 44X.(1) of the Act the ACCC must take into account '*the public interest in having competition in markets*'. Similarly, according to clause 6.(4)(i) of the Agreement the 'dispute resolution body' under an effective State or Territory regime should take into account '*the benefit to the public from having competitive markets*'. Quite apart from the concerns raised in the previous chapter about the meaning of public interest or the benefit to the public, and the potential for these to be interpreted to include both efficiency and other objectives, these 'matters' tend to confuse means (competition) with ends (efficiency). Competition in related markets may be promoted by enforcing access, but depending on the terms and conditions this may or may not be in the public benefit or interest.

Efficiency is given some recognition in the expression, common to both the national and State or Territory regimes, that the 'arbitrator' must also take into account the *'economically efficient operation of the facility'.* However, this could be narrowly interpreted to mean producing a given amount at least cost (technical efficiency), and have no regard for third parties who have a willingness to pay that exceeds the cost of supply, but is less than the going price (allocative inefficiency). Hence, an arbitrated solution would not necessarily be inconsistent with monopoly pricing.

[27] The New Zealand Government (1995, p. 46) noted that the regulatory framework should meet three objectives, in that it should promote economic efficiency; be timely; and act with a high degree of certainty and predicability.

Another issue that arbitrators must take into account is the 'direct costs' of providing access.[28] Presuming that costs can be measured accurately — a substantial task in itself — this requirement helps to ensure that the arbitrator does not set a price so low that the access provider subsidises the entrant. While it therefore creates a lower limit, the arbitrator can set a higher price, and this would be consistent with consideration of the owner's legitimate business interests (and investment in the facility).

The lack of a clear emphasis on allocative efficiency is important as it will create uncertainty in the minds of the incumbent and third parties about the likely directions that arbitration may take if it is invoked, and hence render unlikely the possibility that commercially negotiated prices will bear much resemblance to efficient prices.

It will, therefore, be important for arbitrators to interpret the criteria in a way that promotes the efficient allocation of resources. The promotion of commercial negotiation will be enhanced if or when many of these issues are better defined and/or a body of case law develops. Prior announcement of the arbitrator's approach to setting access charges may increase the likelihood of successful commercial negotiation, enabling the negotiating parties to avoid the costs and delays of arbitration.

3.2.2 Uniform pricing

The goal of allocative efficiency and its achievement by regulation requires a clear choice to be made between uniform pricing and other methods such as price discrimination. Since the Agreement and the Act allow for different terms and conditions of access for different users, price discrimination is an option.

Allocative efficiency requires that no user who places a value on the service at least as great as the marginal cost be excluded. But in the case of natural monopolies where average costs are greater than marginal costs, charging all users a price equal to marginal cost will not be sustainable without recourse to subsidy payments from an external body. There are two options to uniform

[28] Costs are defined to exclude any losses providers may incur arising from increased competition in upstream or downstream markets. This appears to prevent the endorsement by the regulator of the Efficient Component Pricing rule, the use of which may be appropriate in some circumstances (see IC 1995b, pp. 20–4, for an explanation of this pricing rule). For example, if an investment in a private sector facility was predicated on the possibility of high returns based on a degree of market power, setting terms and conditions that fail to compensate providers for taking those risks may deter some socially beneficial forms of risk taking activity.

pricing that can help overcome this problem: multi-part pricing and price discrimination. In practice, multi-part pricing has usually been restricted to a two-part arrangement with a connection fee related to the fixed costs of providing the service, and a variable component that can be set to reflect marginal cost. One of the problems with this arrangement is that if the fixed component is the same for all consumers, it may discourage any purchases by very price-sensitive customers.

The advantage of price discrimination is that by being able to charge a different fee for different customers based on their willingness to pay, the monopolist supplier has an incentive to aim for the allocatively efficient output.[29] As the IC (1992e, p. 45) has commented previously:

> As long as price discrimination increases sales, as it usually does, society moves closer to competitive output levels, and efficiency losses associated with market power are reduced. Prima facie, the welfare effects are ambiguous as some consumers are paying more and some are paying less. But as a rule of thumb, welfare in aggregate is improved when total sales increase.

Where customers are numerous, the information needs for setting different prices for every customer are unrealistic. However, a variation that involves charging different classes of customers different prices has long been a characteristic of most Australian gas and electricity markets. Since the number of customers in most access markets is likely to be relatively small, a commensurately high degree of price discrimination may be possible. If a price discrimination approach is permitted, the task shifts from one of price regulation to one of preventing or constraining the resale of access services.

For example, the regulator could allow an operator of a rail line to charge all operators of coal trains access prices calculated on the same basis (say a fixed charge per train plus an amount per tonne kilometre) but perhaps offer a lower rate to operators of passenger trains who face greater competition from road transport. To sustain this approach the regulator may need to prevent the resale of access services between coal train operators and passenger train operators.

Price discrimination may have efficiency advantages over uniform pricing, but prices that vary between users can also be designed to reduce competition, which is very difficult for a regulator to identify. In addition, such pricing can raise equity concerns.

[29] This is sometimes referred to as Ramsey pricing.

3.2.3 Access pricing and investment

In setting a price for access, arbitrators need to consider the likely effects on the quantity of access that will be demanded at that price, and the ability of the facility to meet demand. Where demand exceeds the capacity of the existing facility, new regulatory problems emerge in coping with the need for further investment.

The arbitrator must take into account the costs of providing access, and hence may have regard to the long-run marginal cost of access services. As congestion sets in, the regulator faces a dilemma if the facility owner is permitted to use price to ration capacity. In a competitive market, a shortage of capacity and temporarily higher prices would encourage new entrants or further investment by existing firms. But the operator of a natural monopoly facility has different incentives to expand capacity, because this would lower access prices and profits. If the facility owner is permitted to price discriminate, and/or is able to implement a multi-part tariff system with usage charges that reflect marginal cost, they will be more interested in matching their capacity to meet growth in demand. However, if the facility operator is required to charge uniform prices, it will be difficult to devise a set of inducements to lure them to increase voluntarily the size of the facility at the right time.

The upshot is that in some situations the regulator may be required to direct the provider to undertake the extra investment when it is required. To this end the ACCC and dispute resolution bodies at State or Territory level can require the owner to 'extend' the facility, and the user to pay for the extensions. While there is some uncertainty how the word 'extend' may be interpreted (Is it consistent with expand?), this requirement will place a very considerable burden on regulatory bodies.

Some of the issues involved in ensuring timely investment in increased capacity are illustrated by the draft Code of Conduct for the national electricity market. The draft code contains a process for ensuring that there is adequate investment in new transmission capacity. The intention is that decisions about the need for building new network infrastructure will not be the exclusive preserve of incumbent transmission corporations or other existing network service providers. Instead, such decisions will be made following a process of consultation between network planners and other affected participants and network service providers. The latter group will have the benefit of formal review periods of thirty business days followed by dispute periods of forty business days for any proposal that will change their network service price by more than 2 per cent. Once determined, the decision to augment the network

will be binding on all parties and the relevant network service provider *must* ensure that the project is implemented. The implementation may permit construction and ownership by any participant (IC 1995c, p. 21).

3.2.4 Public versus private: should access conditions differ?

Neither the Act nor the Agreement differentiates between privately and publicly-owned facilities when establishing an obligation to negotiate access. Furthermore, while there are some differences in the factors that arbitrators must consider under the two approaches, ownership is not a matter for consideration or special treatment under either.

Two related questions arise regarding government ownership in the context of access:

- First, should governments impose a general obligation on their GBEs to provide access, even if the facility would not be subject to declaration?
- Second, should GBEs be obliged to provide access on more generous terms than those of comparable privately owned facilities?

In principle, there is no case on efficiency grounds for special access requirements for publicly owned facilities if they operate without special advantages (that is, there is competitive neutrality with the private sector) and managers have the same profit-maximising objectives as their private sector counterparts. In these circumstances, requiring a GBE either to grant access where it would not otherwise be granted, or to provide access on more favourable conditions than would be set for a privately owned facility, could result in inefficient entry into upstream or downstream markets, and underinvestment by the GBE.

There may be a case, however, for imposing different requirements if the GBE has competitive advantages or disadvantages (for example, tax advantages, loan guarantees, or the possibility of political intervention), and/or its managers have objectives different from those of private sector managers. Despite the widespread adoption by GBEs of corporatisation principles which emphasise commercial performance and competitive neutrality (among other things), some differences are almost certain to remain. In practice, the task of establishing whether these differences are present, and whether they are sufficiently large to justify introducing special access arrangements, can only be undertaken on a case-by-case basis. For instance, if the predominant interest of managers of a GBE was to retain market share, rather than maximise profit, liberal access regimes may improve efficiency. However, the encumbrance of a more liberal access regime could detract from the sale price of a GBE — if or when it was

privatised — and if access prices are set too low, there is the risk of inefficient entry.

The upshot is that a policy of requiring GBEs to provide more liberal access is likely to enhance economic efficiency in some cases, but reduce it in others. There is no way of ensuring that gains exceed losses. A more effective alternative approach may be to sharpen the focus on competitive neutrality and managerial objectives (see section 1.3.1).

3.3 Regulatory models

The provision for the States and Territories to develop 'effective' access regimes means that regulation of many facilities may occur at either a State (or Territory) or national level. The general issues surrounding choices between State or Territory and national approaches, and industry-specific versus general approaches, are common to both access pricing and the pricing of the final goods of utilities, and are discussed in more detail in chapter 4 and appendix B.

While the NCC and ACCC will act as a general regulatory structure at the national level, the States and Territories may choose an industry-specific or general regulator.

Different regulatory structures already exist, and a number of State-based access regimes have been introduced, or are in the process of being introduced. There have been some efforts to reduce overlap and address jurisdictional issues. In the electricity industry, a Working Group of Regulators, convened by the National Grid Management Council, is developing a common approach to a number of jurisdictional issues, with the participation of relevant Commonwealth, State and Territory regulators (Fels 1995, p. 10).

Notwithstanding the guiding principles set out in the Agreement, and the commitments under COAG agreements on gas and electricity reform, sufficient leeway exists for jurisdictions to develop different regimes. This has the potential to discourage investment and raise the compliance costs of firms operating facilities in more than one jurisdiction. However, where more than one State or Territory regime applies to a facility, the Agreement states that to be considered 'effective' the regimes should be consistent and that the parties involved should be able to deal with a single regulator, although it is unclear how this would be achieved.

Undertakings allow enterprises to adopt a national approach to regulation of their industry voluntarily, even where each facility may not be of 'national

significance'. However, questions remain whether an undertaking, once accepted by the ACCC, would be dominant where a State or Territory regime exists. While the Act requires the ACCC to consider 'whether access is already the subject of an access regime' (s. 44ZZA.(2)), it does not preclude acceptance of an undertaking where an existing State or Territory regime is in place.

The net result is that a plethora of different arrangements is set to emerge for regulating access: some industry-specific and some general; some with specific legislation and some by way of undertakings. This will pose particular challenges, both for the NCC, in assessing what is, or is not, an effective regime, and for the ACCC in assessing whether to accept an undertaking when a State or Territory regime is already in place. Problems with the development of regimes that are not considered to be in accordance with the Agreement are already emerging. For example, the TPC, in advising on the 'effectiveness' of the Victorian Government's access regime for the electricity industry, has raised a number of concerns and concluded that it would not be fully effective when viewed in the context of the national electricity industry (TPC 1995, p. 12).[30]

While industry-specific approaches to setting terms and conditions may be appropriate, this does not preclude a single regulator at the State level. Such a regulator — ideally the independent prices oversight body (see chapter 4) — would provide the critical mass of expertise to undertake arbitrations and deal with the complex issues, many of which are common to the setting of GBE prices.

3.4 The NCC's processes

As is the case with any regulatory issue, confidence in the administrative processes surrounding the declaration and effectiveness of access regimes is essential. An open and transparent administration will be important in decreasing uncertainty and lessening the potential impacts of access regulation on investment in infrastructure industries. The complexity of the issues makes this especially important. Such an approach will also facilitate the development of the most useful guidelines.

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[30] These concerns were largely related to regulatory overlap between Victoria's Office of the Regulator General (ORG) and the proposed National Electricity Code Administrator; the interrelationships between the State and national market managers; apparent overlap between the ORG's licensing requirements and those set out in the National Code of Conduct; and the relationship between the ORG and the ACCC.

A recent OECD publication examined the costs and benefits of public consultation in the design of regulation and noted that:

> Unbalanced consultation with affected interests increases the risks that regulations will be ineffective, or have adverse distribution of benefits and costs across society. At worst, imbalances take the form of 'capture', in which an interest-group establishes a dominant influence over a regulator, in return for supporting the regulator in the political system. (Jacobs & Korhonen 1995, p. 30)

While the NCC has a high degree of independence, there is no requirement that the various processes be open and transparent. The Act details the criteria the NCC should follow in deciding whether or not to recommend that the services of a facility be declared, and in assessing the 'effectiveness' of State regimes.

In contrast to the model for independent price oversight that was agreed by COAG (see box 3.1), the NCC and the designated Minister are not required to notify interested parties (other than the provider of the service) that declaration is being considered, to call for public submissions, or to publish reasons when announcing decisions. While the Minister must give reasons for the decision to the provider and to the enterprise seeking access, there is no requirement to provide this information to other parties.

Box 3.1: GBE prices oversight – a model?

The Agreement stated that an independent source of price oversight advice should, among other things, have the following characteristics:

i It should be independent from the Government business enterprise whose prices are being assessed.

ii It should permit submissions by interested parties.

iii Its pricing recommendations and the reasons for them should be published.

The need for transparency in NCC processes is made more important by limitations on the scope for review by the ACT of some decisions. For example, if the assessment of effectiveness is made in the course of examining a request for declaration, the assessment could be reviewed by the ACT. But if a Commonwealth Minister has previously agreed to a request by a State or Territory Minister that a regime be considered 'effective', a service covered by the regime cannot normally be declared, nor is there a right of appeal.

Where a State or Territory requests the NCC to consider the effectiveness of a regime, the NCC is not required to publicly acknowledge the receipt of the application or its subsequent recommendation. The Commonwealth Minister's subsequent decision on the 'effectiveness' of that regime must be published, but the reasons are only given to the relevant State or Territory Minister. He or she

is the only person who can apply for a review by the ACT of the Commonwealth Minister's decision. There is no process by which providers or potential and actual users of the service can contribute to the assessment, or appeal the Commonwealth Minister's decision.

In contrast, the process the ACCC must follow in considering an undertaking involves publishing the undertaking, inviting submissions to the ACCC, and maintaining a public register of all access undertakings accepted and any subsequent variations.

The NCC's assessment of 'effectiveness' and the declaration processes should be open and transparent. Applications for declarations and recommendations of 'effectiveness' should be advertised and public submissions invited. The NCC's recommendations and, equally importantly, the reasons for them, should be published.

CHAPTER 4
PRICES REGULATION

4.1 Introduction

Firms protected by legislated monopolies and those operating in markets with natural monopoly characteristics or in poorly contested markets have significant potential to engage in monopoly pricing. Increased competition in these markets may encourage greater efficiency in the supply of goods and services and minimise the need for price regulation. However, competition in or for such markets may not be effective and, in the case of natural monopoly, may lead to increased costs. The national competition policy recognises that prices oversight may be necessary in the absence of effective competition in order to prevent abuse of monopoly power.

The new arrangements for price regulation outlined in section 1.3.4 and those already established by different governments provide for different approaches to price regulation. They include price control and prices oversight arrangements. Prices oversight arrangements incorporate prices surveillance and prices monitoring (see box 4.1).[31]

While price regulation is an instrument to reduce the scope for monopoly behaviour and its costs to the community, regulation also brings its own costs which have to be assessed in determining the nature and extent of regulation. The Commission's inquiry program has revealed instances where prices surveillance has had detrimental long-term effects on consumer choice and industry investment, has restricted the ability of firms to maintain a viable rate of profit through flexible pricing, or has caused markets to adapt in ways that impose additional costs on consumers.[32] In other cases the Commission has found that restraint of monopoly pricing through prices surveillance is likely to be of net benefit to the community.[33]

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[31] A description of the different approaches and arrangements for price regulation adopted by Australian governments is contained in a forthcoming Commission staff paper.

[32] See for example, IAC 1989b, IC 1992d, 1994a, 1994c.

[33] See for example, IC 1992b, 1992c, 1993.

Box 4.1: Forms of price regulation

Price control

Under price control arrangements allowable prices and/or the rate of allowable price increases are determined for the firm by the regulator, whether this is the Government or an independent agency.

Prices oversight

Prices oversight involves surveillance and/or monitoring of prices charged by firms and there is no requirement for firms to adhere to the recommendations of the oversight body.

Prices surveillance

Firms declared for prices surveillance are required to give notification of proposed price increases to an oversight body which examines the proposals and issues findings as to whether the increases are acceptable or not.

Prices monitoring

Prices monitoring requires firms only to provide certain price and cost data at regular intervals to the oversight body.

The costs of price regulation were a significant factor underlying the new arrangements announced by the Commonwealth Government for private sector and Commonwealth GBEs. The Assistant Treasurer stated that the new arrangements were designed to reduce the costs associated with unnecessary surveillance:

> Our goal is to have a pricing regime which achieves the right balance. We need a system which achieves price restraint in markets where competition is weak or non-existent without restraining business innovation, investment and efficiency. Unwarranted surveillance adds to business costs, affects investment planning and may jeopardise employment growth. For this reason we are setting up a regime which has more powers and more flexibility to examine and respond to pricing problems (Gear 1994).

The costs of prices regulation may be unnecessarily high and outweigh the benefits where:

- price controls are adopted in preference to prices oversight mechanisms;
- firms that do not have effective market power are declared for regulation or oversight;
- the goal of improving competition and efficiency is negated by other objectives;
- the type and design of price regulation unduly distorts decision-making by firms;

- there is duplication and overlap of functions between regulatory bodies and a diversity of regulatory regimes leads to inconsistencies in price regulation and artificial price differentials for similar services in different locations.

These factors are discussed in the following sections. The design and implementation of prices regulation under the competition policy reform package should consider these potential costs. New and existing regimes must ensure that the benefits of reducing abuse of monopoly power outweigh the costs associated with the exercise of price restraining powers and that these costs are minimised. The resources of the new ACCC and State bodies should not be dissipated in prices oversight where there is little gain for the community.

4.2 Prices control or oversight?

There are significant differences in the approaches adopted to prices regulation by Australian governments. Price control measures are universally applied to GBEs, whether by governments themselves or independent regulatory authorities. For the most part, privately-owned firms assessed to have monopoly power are subject to prices oversight mechanisms. These differences in approach create the potential for unnecessary costs to be incurred in the regulation of public enterprises and for conflicts of interest to emerge.

The Commonwealth and Tasmanian governments exercise price control over their GBEs. The relevant ministers retain legislative power to determine prices for GBE-supplied services. In both jurisdictions the Government receives advice from independent prices oversight bodies. The role of the PSA has been to conduct price surveillance and monitoring and make recommendations to the relevant Minister about proposed price increases, the structure of prices and pricing policies. Similar arrangements will apply for Tasmanian GBEs with the establishment of the Tasmanian Government Prices Oversight Commission.

In NSW and Victoria, independent regulatory bodies responsible for prices oversight of GBEs have the power to determine maximum prices. In the case of NSW, the approval of the Treasurer is needed if the GBE wishes to charge a price below the maximum price. Other governments have yet to indicate the outcome of their consideration of whether to establish independent sources of prices oversight as required under the Agreement.

In contrast to these approaches to price regulation for GBEs, few private firms are subject to direct price controls.[34] Private firms declared for prices oversight under the PSA Act are subject to surveillance and monitoring and not price control. They are not required to follow the recommendations of the ACCC and their managers continue to set prices. In practice, however, firms have always followed the recommendations of the PSA regarding allowable price increases.

The case for this dual approach to price regulation of private and public firms seems difficult to sustain.

First, as the Hilmer Report (1993) and the Commission's own research (IC 1994c) has found, price control mechanisms can reduce incentives for investment and improved productivity and can involve substantial administrative and compliance costs. The Hilmer Report suggested that price control measures should be seen as a 'last resort' (p. 271). Price control regulation is more likely to impose substantial costs on firms and the community through reduced incentives for investment and productivity improvement than prices oversight. It is more likely to involve detailed intervention in the activities of firms than other forms of price regulation and be used as an alternative to the promotion of competition.

Second, the dual approach is likely to lead to anomalous and inconsistent approaches to price regulation of infrastructure services as government reform programs proceed. For example, a privatised GBE in one jurisdiction would find itself subject to prices surveillance and/or monitoring while its public counterpart in another jurisdiction would be subject to price controls with all their attendant costs. Even if these firms do not directly compete with each other, the differential approach may affect the relative costs faced by users of these services and affect their ability to compete. It may also unnecessarily influence the locational decisions of firms.

Third, the costs of price controls on GBEs may be compounded by conflicts of interest that may arise where the shareholder (the Minister) sets prices. As the shareholder, the Minister may be unduly influenced by government budgetary priorities in allowing prices that provide a higher rate of return and higher dividend payments to government. At other times, electoral considerations may be a primary factor in decisions to keep prices charged by GBEs lower than purely efficiency considerations may warrant.

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[34] An exception is the AGL Gas Company whose allowable price increases are determined by the NSW Gas Council.

Such potential conflicts of interest and their implications for efficient resource use establish a case for independent and public regulation of prices proposed by monopoly GBEs. But the costs of price control measures also establish the case for independent price regulation to take the form of surveillance and monitoring for both private and public firms.

As governments review legislation relating to GBEs, consideration should be given to removing the powers of Ministers to determine prices and leave price determination in the hands of GBE managers subject to the appropriate surveillance and monitoring decided by governments under the terms of the Agreement.

4.3 Declaration for prices oversight

The declaration process for prices oversight remains critical to a streamlined prices regulation regime. If the criteria used for declaration for prices regulation are too broad, firms that face effective or potential competition may find themselves burdened with additional costs of regulation which actually impair their ability to compete and invest. The case for price control, surveillance or monitoring needs to be clearly established to warrant the associated costs.

The declaration process may influence the costs of price regulation in several ways. First, the criteria for assessing market power may promote more extensive price regulation than is warranted or may exclude firms with monopoly power from regulation. Second, different institutions may have different approaches for assessing market power and these may lead to inconsistencies which add to the costs of regulation. Third, the coexistence of monopoly and competitive activities in GBEs may involve prices oversight of their competitive activities in order to minimise the potential for GBEs to engage in anti-competitive behaviour.

4.3.1 The criteria for declaration

PSA and ACCC criteria

The assessment of market power is not confined to prices oversight processes. Several sets of criteria have been in use at the Commonwealth level to assess market power for different purposes. The PSA, the TPC and AUSTEL have adopted broadly similar approaches, although they differ in their detail, for example in the use of threshold market shares to trigger investigations (see box 4.2).

Box 4.2: Commonwealth approaches to assessing market power

Prices Surveillance Authority

The PSA (1994) has been using the following guidelines for reviewing declarations:

- define the relevant market;
- consider whether that market is substantial;
- make an assessment of the effectiveness of the process and outcomes of competition in that market;
- consider whether there are remedies more appropriate than prices surveillance to reduce or eliminate substantial market power where it is found to exist; and
- assess the likely costs and benefits of alternative forms of surveillance where other options are not feasible.

AUSTEL

The Market Dominance Guidelines (AUSTEL 1993) are as follows:

- define the market;
- examine the degree of market concentration and the market share of firms;
- examine the capacity of a firm to determine prices for its services without being consistently inhibited in its determination by other carriers;
- examine the extent of barriers to entry;
- examine the nature of corporate relationships and the extent of corporate integration;
- examine the extent to which services are characterised by product differentiation and sales promotion.

Trade Practices Commission

The draft merger guidelines (TPC 1992b) set out a five-stage evaluation process as follows:

- define the market;
- calculate market shares and concentration ratios and if the proposed merger does not meet one of the two concentration thresholds the merger is of no further interest to the TPC;
- consider the impact of import competition and if it is found to be an effective discipline on domestic firms, the merger is of no further interest;
- evaluate the likelihood of effective entry within two years on a sufficient scale to restrain market power;
- consider other relevant factors if the threat of entry is insufficient.

The Assistant Treasurer has announced separate criteria for the application of prices surveillance and price monitoring under the new arrangements for prices oversight by the ACCC (box 4.3).

The Commission (1994c) has expressed its concern that the criteria used by the PSA are deficient in several respects and result in unnecessary surveillance and costs to firms. It suggested that markets have tended to be too narrowly defined. It considered that the PSA has placed too much weight on domestic concentration in assessing the effectiveness of competition. While domestic market shares disclose what a firm has recently sold, they do not indicate how much business it will lose to rivals or potential rivals if it charges excessive prices.

Because there was no minimum concentration ratio threshold in the criteria used by the PSA, moderately concentrated industries have not been exempt from scrutiny. In some industries, one major seller has been declared for surveillance; in others, up to five have been declared. The consequence of too low a threshold is that direct costs are imposed on firms without any offsetting gains to the community.

The new arrangements (see box 4.3) have not resolved these problems and could even exacerbate them. While the intent is to streamline prices surveillance, the criteria envisaged for the ACCC are no more precise than those being used by the PSA in its review of declarations. Indeed these criteria may lead to firms being exposed unnecessarily to prices surveillance. Of particular concern is the fact that there are no thresholds to determine the presence of ‘substantial market power in a substantial market’.

The supplementary criteria of ‘a pervasive effect on other prices’ and ‘a significant proportion of household or business expenditure’ are imprecise and leave considerable scope for interpretation in assessing the presence of substantial market power. They are more legitimate as indicators of a substantial market than of substantial market power. For example, prices surveillance of products simply because they are major components of household expenditure is inappropriate.

The weight of a product in household expenditure is not necessarily an indicator of market power. Many products which form a significant component of household purchases are supplied in markets with effective competition and low entry barriers (for example, motor vehicles and housing). Competition reduces the potential for monopoly pricing and encourages supply at minimum cost. Prices surveillance of products supplied in competitive markets imposes unnecessary costs on firms. Consideration of consumption patterns in prices

surveillance should only arise after the existence of substantial market power has been established and then only as one factor in assessing whether the impact of exercise of market power is such as to warrant prices surveillance or monitoring.

Box 4.3: Guidelines for prices oversight by the ACCC

The Assistant Treasurer (Gear 1994) has indicated that he expects that prices surveillance and formal prices monitoring will be applied in the following circumstances:

Prices surveillance

- where competition is limited or absent;
- where a firm has substantial market power in a substantial market. That is, where its pricing decisions have a pervasive effect on other prices or the competitiveness of other industries, or where the firm's product represents a significant proportion of household or business expenditure;
- where there is strong reason to believe the firm will use its market power to increase prices; and
- in general, after a period of formal monitoring which provides evidence that the above criteria are met.

Prices monitoring

- where there is concern about the effectiveness of competition;
- where there is a history of price problems;
- where there is community concern about price levels or movements; or
- where industries have been recently reformed or deregulated.

The Commission considers that the balance between the costs and benefits of prices surveillance are such that it should be explicitly limited in ACCC guidelines to circumstances 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 (and expansion by rivals).**

In particular, the market share threshold should be used before any further inquiries regarding the extent and significance of market power. Market share thresholds do not necessarily indicate the effectiveness of competition. Indeed, their use for this purpose has been subjected to sustained criticism (see Hay &

Werden 1993). However, they usefully serve as a means of filtering out firms that have little prospect of exerting monopoly power.

The introduction of a formal prices monitoring function for the ACCC is intended to reduce the need to resort to the more costly process of prices surveillance and to provide greater flexibility in the performance of prices oversight. Prices monitoring is a less costly and less intrusive form of prices oversight because firms are not subject to a formal review of price increase proposals and are not constrained from increasing prices to the same extent as under prices surveillance. Prices monitoring may be a more appropriate form of prices oversight in circumstances where there is less confidence about the extent and significance of market power. Inevitably, there will be industries where it is difficult to ascertain the adequacy of competition and it may be appropriate to implement monitoring for a period to see if surveillance is warranted.

However, the circumstances in which formal monitoring is envisaged are very broad (see box 4.3) and, potentially, could sweep up many firms subject to competition from other domestic and overseas suppliers. This would create unnecessary compliance costs for the firms involved and unnecessary administrative costs for the ACCC, thus diverting its resources from more effective uses.

The Commission considers that the guidelines for prices monitoring should be specified more clearly to ensure that firms facing effective competition are not subjected to prices oversight. The market share threshold for assessing prices surveillance could be applied to prices monitoring as well. This would mean that only those firms with significant potential for market power would be subject to the costs of surveillance and monitoring.

Prices monitoring would come into play where there was doubt about the subsequent criteria for prices surveillance. For example, prices monitoring could be adopted where there is uncertainty about the strength of import competition and the height of entry barriers in an industry. Prices monitoring could also be adopted as a transitional measure for industries previously subject to some form of price regulation. In these circumstances, prices monitoring would have a more constrained, but complementary role to prices surveillance.

State Government declaration criteria

While the criteria for declaration for price regulation at the Commonwealth level are likely to lead to unnecessary regulation of firms, the criteria adopted

by some State governments may serve to exclude firms with the potential to exercise monopoly power in pricing.

The legislation for the NSW Government Pricing Tribunal (GPT) and the Tasmanian Government Prices Oversight Commission provide for declaration of a service supplied by a GBE where there are no other suppliers to provide competition in the relevant market and where there is no contestable market by potential suppliers in the short term. These criteria require that a complete monopoly exists for services to be declared for price regulation.

Research evidence and the judgements of overseas anti-trust bodies indicate that market shares of above 60 to 70 per cent for a single firm are a strong indication of market dominance (IC 1994c). While other factors should be taken into account in assessing the extent of market power, such evidence does suggest that declaration criteria of 100 per cent market shares may result in firms with considerable power to set prices being excluded from price regulation.

The application of such strict declaration criteria will exclude few GBEs with significant monopoly power while governments maintain statutory barriers to competition for these enterprises. The problems with the criteria are likely to become more significant under government GBE reform programs. As barriers to competition are reduced, incumbent firms may be able to retain significant monopoly power and escape prices oversight unless the criteria for declaration are relaxed.

4.3.2 Institutional inconsistencies

Under the new arrangements for prices oversight, there remains considerable potential for differences to emerge between institutions and jurisdictions in the criteria used to declare firms. The ACCC will be responsible for advising the Commonwealth Government on which private and Commonwealth-owned firms are to be declared for prices oversight. State and Territory governments will decide which of their businesses are to be declared for prices oversight. As outlined in chapter 1, the NCC may be requested to make recommendations about declarations for State and Territory government businesses.

Jurisdictional differences in the declaration criteria for oversight may result in differential treatment of enterprises in similar market situations. The effect on enterprise pricing may be a factor influencing the investment decisions of firms using the services of these GBEs.

Cooperation between governments and tribunals is advisable to reduce both the overall costs of unnecessary regulation and the differential impact on firms

subject to different regimes. Under the terms of the Competition Principles Agreement (the Agreement), governments have undertaken to work cooperatively to examine issues associated with prices oversight of GBEs and may seek the assistance of the NCC in this regard.

An early priority for the work program of the NCC could be to assess the desirability of adopting a consistent approach to declaration for prices oversight. If this is found to be desirable, a further priority for the NCC is to suggest an appropriate approach. Such an assessment could consider issues such as defining the relevant market, determining the appropriate thresholds for triggering investigation for price regulation, and assessing barriers to entry to markets.

At the Commonwealth level, the formation of the ACCC — in combining the TPC and the PSA — raises the question of whether the same approach to the assessment of market power should apply for both prices surveillance and merger approval processes. This involves consideration of whether both processes should use a market threshold to trigger investigations and whether the trigger should be the same for both processes.

Prices surveillance and mergers approval processes are different instruments for achieving the same objective — to restrain the use of monopoly power. Both instruments, depending on their application, can involve substantial costs to firms and to the economy in general. Disallowance of mergers may result in loss of economies of scale and scope and increased transactions costs. Prices surveillance may depress prices unnecessarily and inhibit investment and innovation.

The PSA and the TPC adopted different criteria for the assessment of market power. The TPC utilised threshold market shares to trigger investigations as to whether proposed mergers involved the risk of substantially lessening competition. The PSA did not use a market share threshold as a way of screening out firms which did not have market power.

As discussed in section 4.3.1, the Commission considers that investigations for prices surveillance should only be undertaken where a single firm has greater than a two-thirds market share (with no major competitor). It sees this as a way of limiting surveillance to those cases where the benefits clearly outweigh the costs. The draft merger guidelines of the TPC set out specific market thresholds for single firms and coordinated action by several firms as triggers for investigations of mergers. The threshold used to consider unilateral market power is a situation where the merged firm would supply more than 40 per cent of the market. The Office of Regulation Review (1993) has suggested that this

threshold may be too low and may frustrate the formation of industrial units of an efficient size.

The case for applying a lower threshold to the merger approval process than to prices surveillance relates to the different functions and effectiveness of these instruments in dealing with monopoly power. Merger approval is a preventative device to forestall the potential development of an anti-competitive market structure and behaviour. Its concerns are prospective rather than current. In contrast, prices surveillance is an instrument for dealing with monopoly behaviour in an existing market structure. A lower threshold for merger approval investigations may be justified as a means of avoiding anti-competitive market structures developing and the subsequent need to resort to costly methods of dealing with monopoly behaviour.

4.3.3 Monopoly and competitive activities of GBEs

Where enterprises continue to undertake activities which overlap competitive and monopoly markets, the potential for cross-subsidisation from the monopoly to the competitive services creates special problems and issues for price regulation. According to Helm and Yarrow (1988):

> The combination of monopoly and non-monopoly elements accounts for much of the complexity of the regulatory problems for these industries...(p. i).
>
> The relationship between these is rarely simple. Indeed, it is at the heart of the regulatory problem...[which] does not disappear when those parts are separated... (p. vii).
>
> ... most of the interesting questions about regulation arise at the borders between natural monopoly and competition (p. xxviii).

Ideally, the competitive activities of firms should not be declared for prices oversight. Price regulation or oversight should be restricted to those areas where customers are not protected from the abuse of monopoly power by the existence of competing firms to which they can turn.

However, manipulation of the cost structures of enterprises engaged in monopolistic and competitive activities can lead to customers in the regulated markets paying more for services than they would otherwise. These higher prices may be used to cross-subsidise the firm’s operations in the unregulated markets and reduce the threat of competition. For example, an enterprise may have incentives to underprice in the unregulated market so as to gain competitive advantage if it can transfer some of the costs of supplying this market to the products subject to price regulation. Forgone revenue in the

competitive markets can be recouped via higher allowable (regulated) prices elsewhere because regulators are faced with severe practical problems in assessing joint cost allocations between the different activities.

Quite complex questions can emerge when there are different degrees of market power in the different markets in which an enterprise operates. For example, in the provision of aeronautical and non-aeronautical services by the Federal Airports Corporation (FAC), different degrees of market power permit manipulation of prices and the distribution of monopoly rents in different directions (IC 1992a, PSA 1993).

At the Commonwealth level, contrasting approaches have been adopted towards prices oversight of the competitive activities of enterprises that have market power in their core business activities. Part of the responsibilities of the Civil Aviation Authority (CAA) have been to provide rescue and fire-fighting services and to recover their costs from the aviation industry. The prices set by the CAA for these and other services were subject to scrutiny by the PSA. The CAA was also permitted to utilise spare capacity on incidental revenue-generating activities, such as servicing of fire equipment and provision of fire-fighting training, in competition with the private sector (CAA 1993). Charges for these services were not excluded from scrutiny by the PSA.

This approach continues under the new arrangements for Airservices Australia. In contrast, charges for non–aeronautical services such as property management, supplied by the FAC in competition with other suppliers, have not been subject to surveillance by the PSA. However, the Government has since indicated that services closely related to aeronautical services, such as check–in counters and baggage handling, at the four major airports will be monitored in future (Waller 1995). Furthermore, only the monopoly services supplied by Australia Post have been subject to PSA prices surveillance and notification to the Minister.

The potential for cost manipulation between monopolistic and competitive activities of enterprises needs to be addressed in the reviews and inquiries that assess which firms are to be subject to price regulation and oversight. Where a GBE that provides monopoly services also has a significant presence in other, competitive, markets, and where joint costs between the firm's activities are prevalent, there is a strong case to subject the competitive activities of the GBE to prices oversight. However, the need for GBEs to be subject to any form of price regulation may be precluded through structural reform and transfer of ownership of the competitive activities.

4.3.4 National impact

The NCC may be requested by an Australian government to declare a State or Territory enterprise for prices oversight. In making its decision the NCC must, under the terms of the Agreement, decide whether the enterprise has a significant direct or indirect impact on constitutional trade or commerce and whether it is already subject to an independent source of advice on prices oversight.

The direct impact may derive from participation in a national market. For example, this criterion may apply to networks such as the proposed national electricity grid which are connected across State borders and which will facilitate interstate trade. This, of course, raises issues about the jurisdiction of national and State prices oversight agencies over different parts of the network. This issue is discussed further in section 4.6.

The indirect impact may be assessed according to the role of the service as an input into firms and industries competing in national and overseas markets.

4.4 Criteria for assessing prices

The costs of prices oversight can be increased when the focus on improving competition and efficiency is weakened by the existence of requirements to pursue other government objectives, some of which may be better achieved by other policy instruments.

At present, governments require that independent regulatory bodies have regard not only to competition and efficiency considerations, but also to considerations such as investment and employment, dividend payments to governments, protection of the environment, protection of consumers, social welfare and equity considerations and community service obligations. For example, the GPT is required to consider a range of matters, including:

- the cost and efficiency of the provision of the services;
- the protection of consumers from abuse of monopoly power;
- the appropriate rate of return on assets, including an appropriate dividend to the government;
- the impacts on borrowing, capital and dividend requirements;
- the protection of the environment;
- effects on general price inflation.

There is not necessarily a conflict between these objectives. However, an emphasis on particular objectives in practice may induce unwanted effects on consumers and other industries. For example, if priority is given to the return on assets and dividend requirements in assessing pricing proposals where demand is falling, inappropriately high prices may result. Alternatively, if undue emphasis is placed on protecting consumers from monopoly power, prices that are insufficient to promote new investment may result. The GPT has drawn attention to difficulties it has experienced in assessing the competing interests of various stakeholders in the regulation of GBE prices:

> On the one hand, the owner of the GBE seeks ‘appropriate returns’ on business which typically employ large amounts of capital in producing their outputs. On the other hand, customers of these utilities seek prices that are ‘fair’ and which do not take advantage of the monopoly position that these GBE utilities inevitably possess. At the same time, interest groups representing the welfare lobby expect price regulation to take account of the needs of the economically disadvantaged. Environmental groups expect prices that reflect the ‘true’ costs of production, including the impact on the environment (GPT 1994, p.5).

Better guidance from governments on the priority to be attached to different objectives would give direction to the assessment of the trade-offs that may be involved in price regulation. This may be accomplished most simply by establishing an overriding objective for price regulation.

The Hilmer Report (1993) stated that several of the existing principles used in assessing prices are not appropriate for a national competition policy. It recommended that under the new policy regime, principles should focus on competition and efficiency concerns rather than broader and potentially conflicting social and political goals. It suggested that a more appropriate principle for a national competition policy may be for the NCC to have regard to:

> ... the promotion of long term economic efficiency, taking into account the desirability of fostering investment, innovation and productivity improvement, and the desirability of discouraging a person who has a substantial degree of power in a market from using that power to set prices above efficient levels (p. 279).

The Competition Principles Agreement specifies that the State-based agencies are to take efficient resource allocation as the primary objective. However, no such specification is made for the national institutions established under the Agreement. The PSA (1994 p. 19) has expressed its view that implementation of the recommendations of the Hilmer Report seems likely to necessitate change to both the statutory criteria and the ministerial directions affecting the PSA’s operation.

Consistency in approach suggests that the NCC and the ACCC should be required to give priority to efficiency in resource allocation in their deliberations. This could be implemented by governments agreeing to statutory criteria or ministerial guidelines to govern the work of these institutions and which incorporate efficient resource use as the primary criterion.

Emphasising the objective of improving efficiency in resource allocation does mean pursuing narrow economic objectives to the exclusion of other economic and social objectives. On the contrary, it is based on a recognition of the intrinsic relationship between efficiency in resource use and the general welfare of the community. Improving efficiency increases the supply of goods and services available to the community. By making better use of the nation's resources, more resources can be released to pursue social objectives and other private and community objectives. The objective of improving economic efficiency is fundamental to the achievement of many other objectives expressed in the matters to be taken into account under the Agreement.

4.5 Method of price regulation

The institutions that conduct prices oversight of GBEs are confronted by several key issues. They face choices about the type of price regulation to be adopted, the design of the regulation and the degree of intervention in enterprise decision-making to achieve efficient price outcomes. Choice about the system of price regulation is based on judgements about the incentives they provide to regulated enterprises to achieve economic efficiency — allocative, productive, in static terms and over time. The choice also depends on the information requirements of different methods and the cost of administration. The more intrusive and detailed the regulation, the more costly it is likely to be in terms of administration and its effects on incentives to invest and make productivity improvements.

When choosing between methods of price regulation, the likely regulatory outcomes are an important consideration. Public control over price can quite easily lead to perverse incentive effects with respect to other variables such as reducing the quality of the service. This outcome may cause regulators to seek control over other aspects of the firm's behaviour in order to counter the unintended effects of the initial control:

> ... costs and demands are typically functions of a wide range of choice variables (managerial effort, advertising expenditures, quality dimensions of the product/service, research and development expenditures, etc.) and not just output. Control of one, or a

> small subset, of these variables can quite easily lead to perverse incentive effects in respect of the others...Regulators often find that having fixed one variable (eg price) they are then driven towards control of other aspects of the firm's behaviour (eg quality) to deal with the unwanted effects of the first control. There is, therefore, a tendency towards more extensive and detailed control, and solutions based on the philosophy of 'regulation with a light hand' may be unstable and difficult to sustain (Helm & Yarrow 1988, p. v).

As a result of this in-built tendency in regulatory processes towards more extensive and detailed intervention in enterprise behaviour, there are trade-offs to be considered. These trade-offs are between the costliness of the regulatory system, particularly in relation to its detailed involvement in enterprise decision-making and its informational demands, and the acuteness of the efficiency problems created by the broader and less demanding forms of price regulation (the so-called 'light-handed' approach).

4.5.1 Types of price regulation

A variety of theoretical approaches are available to guide the setting of efficient prices for the products supplied by public enterprises. However, they are rarely applied strictly in practice because of the difficulty in obtaining sufficient information.

The imposition of ideal theoretical solutions requires the existence of an omniscient regulator who is fully informed of demand patterns, the costs of firms and the potential for cost reductions. Such detailed information is rarely available independently to regulators; their main source of information is typically the regulated firm. Thus the enterprise has an element of control or even monopoly over the information provided to the regulatory agency and has an incentive to present information selectively. This situation is likely to give rise to problems of adverse selection (where the regulator is influenced by selected information provision) and moral hazard (where the regulator cannot observe particular variables). It sets up a strategic regulatory game between the agency and the regulated firms, usually referred to as a principal–agent problem.

Moreover, there are difficulties in gaining long-term commitments from politicians and regulators about the stability of such detailed regulatory regimes. This commitment is required by firms in order to recover large sunk investments.

As a result of these information and commitment problems, practical approaches dominate the practice of regulation of public enterprise pricing. For

the most part they focus on allowable increases in prices rather than the structure of prices, although the structure of prices is influenced by applying different allowable increases to different baskets of goods and services.

Cost-of-service (or rate-of-return) regulation and elementary price-cap (CPI-X) regulation have been the dominant methods used in Australia. Increasing use is being made of price-cap regulation. For example, the Commonwealth Government uses price-cap regulation in the telecommunications sector and has announced that the ACCC will use price based methods for assessing the appropriate price movements for firms under surveillance (Gear 1994b). In NSW, price-cap arrangements have been used in the regulation of gas prices and in Victoria a combination of revenue and price-caps have been introduced for electricity transmission and distribution and for final prices to franchise customers.

An extensive literature has developed on the relative merits and effects of cost-of-service and price-cap regulation (see, for example, Rees & Vickers 1995). Initially, price-cap regulation seemed to provide a simple, different and superior method of regulation to the cost-of-service approach. It provided incentives for cost efficiency, minimal regulatory burden and low risk of regulatory capture.

It has become apparent, however, that price-cap regulation is more complex and its outcomes more problematic than originally believed (see IC 1994c for further discussion). Difficulties arise from the fact that a number of key parameters have to be set and reset periodically. They include the coverage of the price-cap, construction of the price index, whether and how much cost pass-through to allow, the level of X, the extent to which individual prices are made subject to regulation, the frequency of price reviews, and controls on quality.

Strong distinctions are no longer apparent between cost-of-service regulation and price-cap regulation. They have much in common and the contrast between the two is mostly one of emphasis. As Rees and Vickers (1995 p. 383) state:

> RPI–X, compared to rate-of-return regulation, may help in so far as it involves commitment to non-intervention for a period, but it does so imperfectly and may carry less of a promise that there will be an adequate return to investors. However, the decisive influence probably has more to do with the structure and behaviour of institutions, both regulatory and political, than with the form of regulation *per se*.

Nevertheless, as Laffont and Tirole (1993, pp. 18–19) note, there are differences that are relevant in making choices on the method to be adopted.

First, prices are fixed under cost-of-service while under price-cap regulation firms can price up to the cap. The downward flexibility under price-cap regimes

is relevant more for the structure of relative prices within the basket than for the price level itself. Price-cap regulation also implies that individual prices reflect variable costs and demand elasticities more precisely than cost-of-service regulation. Consequently, price-cap regulation may provide better incentives to economic and productive efficiency and to innovation. However, these may be reduced at the periodic review of the price-cap and over the long term. Under cost-of-service regulation cost savings are penalised because a price decrease follows.

A second difference is that the regulatory lag is supposed to be exogenous under price-cap regulation, although not always so in practice. Under cost-of-service regulation it may be determined by the regulator and on request from regulated firms.

A third potential difference is that, in principle, price-caps are not determined by previous costs or rates of return. However, in practice, the firm's past performance is a consideration in price-cap reviews.

A general conclusion from the comparison of these forms of price regulation seems to be that price-capping is more effective in conditions of public enterprise reform where a transition is being made from monopoly to greater competition. It can lead to a sharing of cost savings with consumers, give firms a reasonable chance of good profits, spur innovation and introduce an additional discipline on costs (IC 1994c, p. 70).

Whatever the method chosen to regulate prices, there are a range of further choices to be made regarding the details of the method to be implemented. Policy decisions in respect of each of these will have material effects upon the incentives facing the regulated enterprises and have implications for allocative and cost efficiency. For example, under a CPI–X regime the level of X may be chosen in different ways. One option is to use past trends in real unit costs of the firm. Another is to use average productivity trends in firms in similar industries or to look at international comparisons of firms in the same industry. A variety of factors may be taken into consideration, including the cost of capital, the asset base, the future investment program, demand growth and the effect of the value of X on potential competitors.

A slightly different approach to price-caps is to impose a cap on the permissible increase in the total revenue of an enterprise. This is similar to imposing a price-cap on the overall basket of services provided by the authority. Indeed, in some circumstances the two methods may be identical.

In its inquiry into water and related services, the GPT recommended that CPI±X revenue caps apply to water, sewerage and drainage services (GPT 1993). As noted above, revenue caps are being used in the Victorian electricity industry.

Revenue caps may be particularly appropriate in phasing in cost recovery on existing assets. The key issue in these circumstances is to integrate the necessary price increases with the need to encourage enterprises to look to cost savings to improve their commercial performance. For example, the Industry Commission examined the use of revenue caps in phasing in cost recovery in the water industry (IC 1992c, pp. 80–1).

Like price-caps applied at the individual customer level, revenue caps encourage authorities to pursue cost reductions as well as increase prices. They also give enterprises greater flexibility to restructure charges and thereby improve the efficiency of their pricing regimes.

But, as the Commission (1992e) has noted, revenue caps are not without problems. Like price-caps, they make it more difficult to use higher prices to ration scarce capacity as the next capital augmentation is approached. There is also the danger that the imposition of stringent revenue caps will result in too slow a move to full cost recovery as the potential cost savings associated with asset replacement will not be realised for many years. Conversely, generous revenue caps will reduce the discipline on enterprises to reduce costs. The adoption of revenue caps also involves anticipating demand.

4.5.2 Design issues

Whatever the type of price regulation chosen — this may vary according to industry circumstances — the regulatory body has further choices to make in applying its chosen method of regulation.

The regulation of prices of GBEs raises a number of complex technical issues relating to matters such as asset valuation, depreciation, the cost of capital and required rates of return, the allocation of joint costs, the identification and estimation of cross-subsidies, the valuation of community service obligations (CSOs), and measuring quality of service. In each case, the regulator is faced with a variety of choices. Practical considerations such as the availability of data will influence the choices of approach in the different jurisdictions.

Choices on these matters will add to the likelihood of inconsistencies in price regulation and differential outcomes across jurisdictions and even within jurisdictions. For example, it is far from obvious what gains derive from

employing different methodologies for valuing existing assets, estimating the cost of capital and valuing CSOs. They simply lead to inconsistency in price outcomes and returns.

Unnecessary and potentially costly inconsistencies in price regulation can be avoided if regulators develop consistent approaches on these matters. Some progress has already occurred in this regard. For example, the Steering Committee on National Performance Monitoring of Government Trading Enterprises has produced papers designed to facilitate more consistent approaches by jurisdictions to the costing of CSOs and the valuation of the assets of GBEs (SCNPMGTE 1994a, 1994b). **Further work on such technical issues could proceed by the establishment of a joint research program between regulatory organisations or as part of the work program of the NCC.**

4.6 Institutional arrangements

The enhancements to national regulatory arrangements for GBEs raise issues about the scope of activities of regulatory institutions, the relationship between new and existing institutions at the national level, between national and State regulatory institutions and between different State regimes. The nature and scope of the institutions to be established and their inter-relationships will influence the cost of regulation.

A key issue to be addressed in establishing or reviewing institutional arrangements for price regulation is the scope of responsibilities to be accorded to the independent authorities. There are three dimensions to be considered: whether they are to be national- or State-based; industry-specific or general in scope; and whether they are to focus on price regulation only or conduct other forms of economic regulation. For example, under the Agreement, a State or Territory government may decide to subject its GBEs to the national prices oversight mechanism administered by the ACCC or to that operated by another State or Territory government. The commitments made in relation to other matters included in the Agreement, such as the establishment of access regimes and dispute resolution processes for access, raise further considerations as to whether the scope of regulatory agencies established by governments should include prices oversight and other economic regulation of GBEs and essential facilities.

The approaches taken by different governments on these matters will affect the extent of administrative and compliance costs of regulation and the impact of

inconsistencies between regimes. Where possible, the rationalisation of regulatory arrangements and institutions could serve to reduce these costs. However, in deciding on the appropriate institutional arrangements from a national point of view, governments must take into account the issues of jurisdictional sovereignty and the advantages of developing specialist regulatory knowledge.

Some progress has been made in the rationalisation of regulatory functions at the Commonwealth level. The Government has announced its intention to consolidate the administration of telecommunications competition policy, including interconnection and access, with the ACCC and to merge AUSTEL with the Spectrum Management Agency to provide a communications carriage regulator (Lee 1995). However, AUSTEL will continue to administer the price-cap arrangements for Telstra. As a result, there remains some potential for differences to emerge in the administration of price controls for telecommunications and those for some substitute services, such as postal services, which will be administered through the ACCC.

Problems of overlap between the Australian and State or Territory bodies are likely to occur in relation to prices oversight of enterprises supplying services on interstate networks. In particular, there will be issues to resolve concerning how far the national prices oversight regime should extend into networks. These problems are most likely to arise in the process of structural reform of GBEs and the transition to national and interstate markets for infrastructure services such as electricity, gas and water.

The establishment of the national grid for electricity transmission provides an example of the issues of coverage by different regulators that need to be resolved. Both the GPT and the Office of the Regulator-General (ORG) in Victoria will continue to be involved in prices oversight in electricity; and the precise long-term relationship between these bodies, the administration of the Code of Conduct for the national grid and the ACCC is yet to be established. The key areas concerning the appropriate jurisdictional boundaries of State and federal regulatory arrangements are in relation to price regulation for the high-voltage transmission grid and for electricity distributors which retain their wires monopolies despite the transition to a more competitive retail market.

Under the regime announced by the Victorian Government for electricity, the ORG would maintain a role as administrator of price-caps for both the transmission grid and distribution networks. Under the national regime agreed for the national grid, the ACCC is to assume a pricing function for the sectors

that require pricing oversight on a national basis; this may cover Victoria's high-voltage grid services as well as those in other States and Territories.

According to the TPC (1995), this situation raises the prospect of inconsistent prices oversight measures being applied both within Victoria and between it and other jurisdictions, particularly given the different powers available to the ORG and the ACCC. Such differences could translate into significant price differentials (not justified by different cost structures) which may distort electricity trading in the national market as well as investment and locational decisions by participants in the competitive national energy market. As with other cases of regulatory duplication and conflict, there is also the prospect that transactions costs in the national market would increase as a result, reducing the efficiency of that market.

In order to avoid the prospect of such duplication and its adverse economic consequences, governments will need to indicate a willingness to accept national pricing oversight arrangements for the national market in agreed areas and to cooperate in developing an agreed allocation of price regulation functions between State and national levels.

Despite the enhancement of national regulatory arrangements, substantial differences are likely to continue between national and State jurisdictions and between the various State jurisdictions. Differences between regulatory agencies will occur in relation to their range of functions and the scope of their powers. Differences in approach to price regulation may be apparent on matters such as guidelines for determining the presence of market power, the criteria for assessing price proposals, the method of price regulation, the determination of asset valuation, the rate of return and other factors influencing the determination of price levels and structure.

These differences in approach may induce artificial price differentials for similar products supplied by different GBEs which will affect the competitiveness of users in different locations. For example, differences in the approach to price control for water between NSW and Victoria may result in higher prices for users in one State, which may reduce their ability to compete with producers in the other State and with overseas suppliers.

Similarly, where privatisation takes place, differences in approach by regulators in different jurisdictions may influence investment decision-making in ways that reduce efficiency. For example, Helm (1994) has suggested that discretion by regulators over the main determinants of prices may lead to uncertainty and speculation in the pricing of utility shares in equity markets which impacts on the cost of capital. According to Helm (p. 28):

> A process of regulatory capital market substitution takes place, as investors switch between utilities, betting on the conduct of the regulators.

The impact on resource use and competitiveness of users of differences in approach to price regulation between jurisdictions will be difficult to determine. The effects will be clouded by differences in market conditions, the operating environment of firms (including technology and scale), and geographical factors such as climate and terrain. Nevertheless, the potential for inconsistencies between approaches to price regulation establishes a case for consultation and coordination between regulators in areas that impact heavily on prices in particular industries.

The NCC could assist in reducing the impact of such price differentials for similar services by developing approaches which tribunals might adopt in the implementation of prices oversight.

4.7 Conclusion: sustaining 'light–handed' regulation

The new national competition policy is designed to establish processes and institutions to encourage competition throughout the economy. It aims, in part, to bring a sharper competitive focus to those activities currently sheltered from international and domestic competition.

However, in some areas the conditions for workable competition may be absent, either in the long-term or while the structural and regulatory reforms necessary to promote competition are put in place. In these circumstances, there remains a residual role for price-based regulation within the national competition policy framework.

The essential requirement for the future of price regulation is that it remain cost effective, that is, the gains from regulation continue to outweigh its costs. Its costs need to be closely considered and assessed. The ultimate problem is one of balancing the costs of market failure and of regulatory failure.

Unnecessary price regulation, poorly designed and over intrusive price regulation and conflicting criteria for assessing prices will add directly to the costs of enterprises and may inhibit additional investment and reduce incentives for improved productivity. Duplication and overlap between regulatory regimes and institutions and inconsistencies in the application of price regulation by various authorities may add to these costs, particularly for firms operating in different locations.

Adherence to the principle of 'light-handed' regulation provides the best approach to minimising the costs of price regulation. This implies adoption of restricted prices surveillance and monitoring rather than price control mechanisms. It requires methods of price regulation that maintain incentives to economic and productive efficiency and to innovation. It also requires mechanisms that are not information intensive.

A key issue to be addressed concerns the inconsistencies in approach to price regulation between jurisdictions and the impact on user industries and resource allocation. The effects of such inconsistencies have long been with us but their source and extent were often not discernible because of the nature of the institutional arrangements across jurisdictions.

Focusing on national and interstate markets raises difficult issues of jurisdictional sovereignty and federal–State relations. The momentum of cooperation between Australian governments in setting up and operating price regulation needs to be sustained in the implementation of these arrangements. The goal is to minimise the prospect of unnecessary regulation, minimise inconsistencies where relevant and minimise duplication and overlap between regulatory institutions.

The NCC has a major research and advisory role to play in setting priorities to be addressed to rationalise regulation and develop the basis on which cooperation between governments may proceed.

APPENDIX A
ACCESS-RELATED INITIATIVES

Introduction

A variety of industry-specific and State- and Territory-based access regimes already exist, while Australian governments are also taking action to introduce new regimes in accordance with the Agreement across a broad range of industries. This appendix outlines some of these initiatives, building on material collected during the Commission's annual review of the progress of microeconomic reform which is published in the *Annual Report*. In the course of collating data on reform initiatives the Commission only conducts 'light-handed' checks for consistency and balance in description. As a result the review is based almost entirely on edited material submitted by jurisdictions to the Commission. No attempt is made to verify the nature and extent of the benefits claimed. This appendix also draws on other sources, such as annual reports, ministerial press releases, and draft legislation.

A1 Initiatives by Australian governments relating to access to significant infrastructure facilities

Sector	*Jurisdiction*	*Date*	*Nature of initiative*	*Significance*
Telecomm-unications	C'wealth	October 1993	A third mobile telecommunications carrier, Vodafone, commenced operations in October 1993 competing with Optus and Telstra in the provision of a digital mobile network.	Encourages the development of greater competition and provide further reductions in price and increases in service quality and efficiency.
Telecomm-unications	C'wealth	November 1994	Regulatory provisions for access to broad-band cable announced. Implemented by a carrier associates direction tabled in Parliament on 22 August 1995.	Applies open access provisions of the *Telecommunications Act* for broad-band cable to telephony and other services but exempts pay-TV until 1997, with possible extension to 1999, when subject to ministerial review.
Telecomm-unications	C'wealth	August 1995	Post 1997 regulatory framework announced, with retention of industry-specific regulation (but with a lighter hand based on industry codes of practice), and with entry barriers removed. AUSTEL's commercial regulatory functions subsumed into the ACCC.	Fully opens up telecommunications to competition, and retains a power for the competition regulator (ACCC) to act quickly to address anti-competitive behaviour. Retains price caps on the dominant carrier, enabling equity and cross-subsidisation concerns to be addressed.
Australia Post	C'wealth	February 1995	Bulk letters permitted to bypass Australia Post's line-haul arrangements, with discounts based on transport costs avoided by Australia Post, subject to scrutiny by PSA, and disputes arbitrated by TPC.	Allows bulk mailers to make cost and time savings by generating mail at different locations or transporting it themselves and then interconnecting with Australia Post's network at fourth-four mail centres.
Airports	C'wealth	May 1994	The Government announced the sale of federal airports. Legislation addressing the long term leasing of the airports and their regulation is expected to be introduced into Parliament in late 1995. The airports are to be leased individually except for Sydney and Sydney West, which are to be leased jointly.	Ensures that airport services are delivered efficiently. The regulatory regime will ensure that the purchasers of the airports are not able to abuse market power arising from the monopoly characteristics of airports. Individual leasing of the airports will mean a move from network pricing to location-specific pricing of airport infrastructure.

Sector	***Jurisdiction***	***Date***	***Nature of initiative***	***Significance***
Airports	C'wealth	January 1993	Introduction of a uniform access charge for aeronautical services supplied by the FAC to apply across all FAC owned and operated passenger terminal facilities.	Charge based of a maximum take-off weight (MTOW) for aircraft using the facilities.
Airports	C'wealth	May 1994	The Government announced the sale of Federal airports, subject to the outcome of a scoping study and the ALP conference in September. An ownership neutral regulatory regime for airports will be developed.	Ensures that airport services are delivered efficiently. The regulatory regime will ensure that the purchasers of the airports are not able to abuse any market power arising from the monopoly characteristics of airports.
General	Queensland	May 1995	Establishment of a National Competition Policy Implementation Unit. This will include establishing Trade Practices Act compliance programs for all government agencies and establishing prices oversight and access regimes.	Economic efficiency will be enhanced by the extension of competition in line with the National Competition Policy principles.
Regulatory Reform	Victoria	June 1994	Office of the Regulator-General established with the objectives, *inter alia,* of facilitating entry into the relevant markets, promoting competitive market conduct and preventing misuse of market power.	Independent regulator which aims to ensure open and fair competition in competitive markets and simulate competitive market outcomes.
Pricing	Tasmania	June 1995	Establishment of the Government Prices Oversight Commission with the power to review the prices charged by certain monopoly providers in the State public sector form 1 January 1996.	Aims to ensure that monopoly providers charge prices that are 'fair and reasonable'.
Grain loading	Victoria	1995	The Government has signed an agreement to sell the Grain Elevators Board to Vicgrain Operations Ltd. Ship-loading facilities will be subject to oversight by the Regulator-General on pricing and access issues.	Privatisation opens up the business to private sector initiatives for diversification and expansion.

Sector	***Jurisdiction***	***Date***	***Nature of initiative***	***Significance***

Sector	*Jurisdiction*	*Date*	*Nature of initiative*	*Significance*
Ports	Victoria	January 1995	Proposal for Office of Regulator General to have responsibility for supervision of an access regime and other economic regulation for ports. Aim is to facilitate transfer of ports to the private sector while guarding against abuses of monopoly power.	Owners will be required to deal with like customers on a non-discriminatory basis, while still permitting different commercial outcomes between customer classes.
Energy	WA	Jan 1995	Separation of State Energy Commission into two corporatised businesses: Western Power (electricity) and Alinta Gas (gas).	Maximises scope for efficiency improvements in the electricity and gas industries. Increases potential for competition from private sector providers.
Energy	WA	1994–95	Establishment of the Office of Energy	Separates regulatory functions from energy provision and facilitates the development of energy industry competition.
Gas	C'wealth	June 1994	The Moomba-Sydney Pipeline was sold to East-Australia Pipeline Limited (majority-owned by AGL; a distributor of gas in NSW). The sale legislation incorporates a series of provisions to encourage competition in gas transmission. The operations of AGL and the new pipeline company are to be separated through a 'ring fencing' provision.	The sale facilitates free and fair trade in gas. Provisions ensure open access to the pipeline, with the TPC to arbitrate disputes over third-party access. The sale legislation also requires PSA monitoring of the haulage fees charged by the Moomba operator.
Gas	C'wealth	April 1995	COAG's agreement to implement free and fair trade in natural gas by 1 July 1996, linked to the competition payments under the national competition policy.	Seeks to encourage a national approach to legislative and regulatory reform, third party access to natural gas transmission and distribution networks and facilities and pipeline interconnection. The estimated economic return from new pipeline interconnections is between $1 billion $1.5 billion over thirty-five years.
Gas	Queensland	April 1995	Provision for third party access to pipelines, for public and private providers of gas and oil. Designated facilities may also be subject to an access regime in some circumstances.	Aimed at removing impediments to free and fair trade in gas. Potential advantages in increasing the role of natural gas in the State's energy mix.

Sector	Jurisdiction	Date	Nature of initiative	Significance
Gas	Western Australia	March 1994	The Goldfields Gas Pipeline Agreement Bill introduced into Parliament ensures that gas transmission capacity in the pipeline is made available to third parties on a non-discriminatory basis at a fair and reasonable tariff.	The State as a whole will benefit from the additional energy infrastructure, which will enhance development activities in the inland Pilbara and Goldfields regions through lower gas and electricity prices.
Gas	Western Australia	January 1995	Deregulation ended the control SECWA and the North West Shelf Project had on gas prices in WA.	Lower gas prices (approximately 50 per cent reduction in Pilbara region) has led to lower electricity costs, resulting in improved viability of otherwise marginal projects. Resource projects worth $8 billion are now planned over the next decade.
Gas	South Australia	November 1993	Sale of the State Government majority share holding in SAGASCO completed. Regulation of the utility subsidiary maintained through the *Gas Act 1988*.	Represents a major ownership reform as control of the enterprise has now been wholly transferred to the private sector.
Gas	South Australia	April 1995	Establishment of a legislative framework for third-party access to natural gas transmission pipelines in SA, consistent with nationally agreed principles.	Provides a basis for improved competition within the gas industry through open and fair access to pipelines, promoting free trade in natural gas.
Gas	South Australia	May 1995	Assets of the Pipelines Authority of South Australia sold to Tenneco Gas Australia.	The private sector now controls production, transmission and distribution/retailing of gas in SA, providing for an increasingly competitive market.
Electricity	C'wealth	1993–94	In advance of creating an interstate electricity market on 1 July 1995 (initially including SA, NSW, Victoria and the ACT, and if the linkage is feasible, Tasmania and Queensland), an electricity 'market trial' providing all potential participants with market trading experience, was concluded on 30 June 1994.	The trial developed skills and provided participants with a feel for how the national market will work.

Sector	Jurisdiction	Date	Nature of initiative	Significance
Electricity	National	1994–95	Progressing national market arrangements under the NGMC. Commonwealth and States reaffirmed commitment to further reform at the 11 April 1995 COAG meeting.	These reforms will move Australia closer to a competitive electricity industry, leading to better, more cost-reflective electricity pricing and more efficient resource allocation.
Electricity	NSW	May 1994	*Electricity Commission (Amendment) Act 1994* established the network subsidiary within Pacific Power as a separate legal entity.	First step towards the separation of transmission from generation in NSW which is necessary for developing a national electricity grid and a competitive market
Electricity	NSW	November 1994	Passage of legislation (to be proclaimed) to provide non-discriminatory access to the distribution network.	Preparation for introduction of the competitive market.
Electricity	NSW	February 1995	Establishment of TransGrid to manage high-voltage transmission in NSW. This function was formerly undertaken by Pacific Power.	The reform separates transmission from generation in NSW and provides for non-discriminatory access to the grid. This is a necessary precondition for a competitive electricity market.
Electricity	NSW	1994–95	Approval of power purchase agreements for three private generation plants.	Opening of generation sector to private sector participation.
Electricity	NSW	May 1995	Government endorsement of a new code to effect the accounting separation of the network and retail businesses of electricity distributors.	Important precondition for a competitive electricity market.
Electricity	NSW	June 1995	Development of an interim NSW wholesale market to facilitate amalgamations of electricity distributors, restructuring of generation and provision of subsidiary ‘wires’ and retail supply businesses for each distributor.	Prepares the existing industry bodies for reform and provides the Minister for Energy with the requisite powers to implement reform.
Electricity	Victoria	1993–94	The State Electricity Corporation of Victoria was separated into three businesses responsible for generation, transmission and distribution functions.	Reforms will improve performance and accountability in preparation for corporatisation. Further division of generation and distribution businesses will create competition and prepare Victoria for open access under a national grid.

Sector	Jurisdiction	Date	Nature of initiative	Significance
Electricity	Queensland	March 1994	Sale of the Gladstone power station to a consortium led by Comalco Pty Ltd introduced a major private generator into Queensland's electricity grid.	Will ensure that a reliable, competitively priced source of supply is available to meet the State's electricity requirements and the requirements of the upgraded Boyne Smelter.
Electricity	Queensland	January 1995	Queensland Electricity Commission restructured into separate generation and transmission/supply companies. These will operate with a commercially based capital structure, explicit funding of CSOs and a performance monitoring regime. Open access to transmission facilities provided for in legislation.	Restructuring is aimed at facilitating competition in generation and separating regulatory from commercial functions. Market trading arrangements are being developed to be consistent with those proposed by the National Grid Management Council, facilitating open access to the grid.
Electricity	South Australia	June 1995	Creation of generation, transmission distribution and new business subsidiaries within Electricity Trust of South Australia Corporation.	Ring fencing of each business unit provides accounting separation and will prepare South Australia for open access under a national grid.
Electricity	Tasmania	June 1995	Passage of a package of legislation to reform the electricity supply industry. Reforms include, *inter alia,* setting up a framework for the participation of new entrants in the electricity industry; non-discriminatory access by other participants to the HEC's grid; the establishment of an independent regulator for the industry; formalisation of the role of the Office of Energy Planning and Conservation as an energy policy and planning body; and the specification of transitional arrangements to apply in the movement to a more competitive electricity market.	The legislative package has been developed to ensure that Tasmania can meet its commitments under the National Competition Policy. Changes expected to lead to increased competition, greater customer choice and reduced costs to certain customer classes.
Electricity	Northern Territory	1994–95	Private power supply at Macarthur River and Pine Creek and tenders for construction of a private power station to serve Alice Springs using Power and Water Authority network.	Private producers supplying power in competition with the PAWA.

Rail	C'wealth	June 1995	Commonwealth announces proposal for a national authority, Track Australia, to manage the standard gauge rail line from Brisbane to Perth.	Would ensure public and private operators pay the same access price for the same task and same train size, while setting investment priorities on the basis of priorities established by users.
Rail	C'wealth	1995	Establishment of an interim access pricing regime for the Australian National (AN) interstate rail network	Interim arrangements enabling third-party operators to access the AN rail network during 1995–96, pending the possible development of a formal arrangement under Track Australia.
Rail	NSW	1994–95	Accounting separation of ownership of State Rail Authority network assets from train operations. A Network Access Unit has been established to facilitate reform.	Open access is expected to drive efficiencies in network asset management and promote competition among current and potential operators.
Rail	Queensland	July 1995	Corporatisation of Queensland Rail, technical and safety regulation moved to Department of Transport, and access regime foreshadowed, by way of regulation.	Replicates a commercial trading environment and achieves competitive neutrality with the private sector. Track access to be given to private operators.
Rail	Western Australia	1994–95	Removal of Westrail monopoly on passenger, ore and grain freight services.	Introduced competition to previously closed marketplace.
Rail	Western Australia	August 1994	Westrail and National Rail Corporation finalised arrangements for track access rights in WA.	Commercial agreement over specified track and infrastructure related to interstate rail movements.
Rail	C'wealth, Victoria, & Western Australia	July 1995	AN, Westrail and V/Line negotiate access to track and provision of locomotives on a fee-for-service basis for the first private interstate train operator, while AN also provides vans.	Enables the first private firm to directly compete with the National Rail Corporation on the Melbourne to Perth route.

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