



Australian Government
Productivity Commission

Submission to the
Competition Policy Review

Productivity Commission
Submission

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Key points

- Competition is not an end in itself but plays a crucial role in promoting economic efficiency and enhancing community welfare. Competition:
 - gives consumers choice
 - provides firms with greater incentives to innovate to reduce their costs, as well as to increase their revenues by better meeting the preferences of their customers
 - helps society to generate the greatest value from its scarce resources, and in so doing, to generate higher real household incomes and living standards.
- There is scope to undertake further policy reform that can increase competition in the economy and deliver net benefits to the Australian community.
 - Some sectors of the economy remain relatively untouched by competitive pressures, with firms in those sectors offered protection from competition by government regulation.
 - Applying further reforms to some government-owned businesses could produce efficiency gains.
 - Digital-based competition is an emerging presence in many markets. Competition policy should accommodate all new sources of competition, and be sufficiently flexible to accommodate alternative models of service and product delivery.
- Governments should undertake assessment processes to determine priority areas for competition policy reform, and to assess the costs and benefits of policy options.
 - Governments have many policy options available to them to increase the scope and benefits of competition, including the use of market-based instruments and the removal of regulatory impediments. The policy option chosen should be informed by thorough analysis.
 - Opening markets to more competition has proven in many cases to produce efficiency gains — but caution needs to be exercised in some markets. Potential market failures and non-efficiency objectives, such as the promotion of equity, mean that simply promoting competition may not always be desirable.
 - Additional measures can help mitigate market failures or address equity concerns associated with competition reform. However, additional measures have costs that will affect the overall net benefits of introducing more competition.
 - It remains appropriate to require advocates of restrictions to competition to demonstrate net community benefit from those restrictions, as was the case under the original National Competition Policy reform process.
- In the human services sector, the characteristics of the relevant markets, the complexity of arrangements for funding and delivering services, and the need to consider equity objectives, mean that policy options need to be properly structured to deliver the desired outcomes. The policy options may include: opening the sector to further competition; the use of market-based instruments that capture some of the benefits of competition; and administrative, regulatory, and workplace reforms.

Introduction

National Competition Policy (NCP) — agreed between the Australian, state and territory governments in 1995 — has delivered substantial and ongoing net benefits to the Australian community. NCP recognised that competition will generally serve the interests of consumers and the wider community by providing strong incentives for firms to operate efficiently, to innovate, and to be price competitive, and for resources to be allocated to their highest value use.

It has been two decades since the Hilmer Committee developed its blueprint for the NCP reforms. The Competition Policy Review is thus timely. It affords the opportunity to question the rationale for current policy settings, to test the need for new policy initiatives, and to ensure that the community captures the potential net benefits of increased competition.

In the Commission's view, however, the introduction or enhancement of competition will not be desirable or feasible in all sectors or in all circumstances. Rather than opening every market to full competition, it is important that the Competition Policy Review considers other policy options, such as the use of market-based instruments that may capture some of the economic efficiency gains that competition can offer, or incremental policy changes that may provide the foundation for increased competition in the future.

This submission draws on previous Commission work that addresses competition-related issues and policy processes for developing competition policy, and provides additional *in-principle* commentary.

- Section 1 describes the nature and benefits of competition and its importance in promoting economic efficiency.
- Section 2 presents the Commission's view on the principles that should guide competition policy development and the design of governance and institutional arrangements.
- Section 3 draws on the principles in section 2, and identifies opportunities for further competition policy reform that could enhance community welfare through improvements in economic efficiency.
- Section 4 gives consideration to whether governments should open markets in the human services sector (such as health and education) to increased competition, and whether other policy options would be preferable.

1 The benefits of competition and objectives of competition policy

The nature and benefits of competition

Competition is a dynamic process that can enhance community welfare by encouraging greater overall economic efficiency. When an economy is operating more efficiently, the community is receiving greater value from its scarce resources and is benefitting from higher real incomes and improved living standards.

In essence, economic efficiency is achieved when resources are allocated such that any reallocation would make the community worse off. This principle is universal and applies to decisions by firms about their inputs, outputs and investments as well as to decisions by consumers about what to buy.

Competition is not an end in itself, but plays a crucial role in promoting economic efficiency. In a competitive market, informed choices available to consumers, and the value signals contained in prices, are important forces. Thus, while producers seek to maximise their profits, competition or the threat of it limits their ability to increase profits simply by raising the prices paid by their consumers. Instead, to remain competitive, they must focus on driving down their cost of production (productive efficiency). Competitive pricing encourages more efficient levels of both production and consumption, that is, where the marginal benefits of consumption equal the marginal costs of production (allocative efficiency). Competition also encourages firms to invest and innovate to reduce their costs, as well as increase their revenues by better meeting consumer preferences through product development and improvement (dynamic efficiency).

In practice, the competitive process drives efficiency improvements by encouraging the entry of new, or expansion of existing, more efficient firms and forcing the decline or exit of less efficient ones ('creative destruction'). Thus, the survival of particular firms (or types, or a specific number, of firms) is not necessary for, and indeed can be inimical to, the competitive process and economic efficiency.

At times, some producers may have the ability to set prices (for example, because of product differentiation or the introduction of an innovative product) but the associated profits will act as a signal to rival firms. In those circumstances, effective competitive entry to the market by firms that imitate or improve on the products or processes can be expected to constrain, and over time erode, this market power. Economic efficiency may be improved without actual market entry by rivals — the threat of entry can be sufficient to remove or constrain market power.

Market power can be enduring where governments or firms have created barriers to market entry. Firms can use their market power to charge prices that yield monopoly rents. Where market power is enduring, governments may consider the need to intervene to improve economic efficiency.

Impediments to efficient market outcomes

Markets may not generate efficient outcomes where the scope of competition is limited, such as when there are market failures (for example, when there is a lack of effective competition or inadequate information) (box 1); and when governments intervene in markets through regulations and policy arrangements, or through the direct ownership of businesses and the funding of services.

Box 1 Sources of market failure

Externalities arise when the actions of an individual or firm create a benefit or a cost for others who are not a party to the transaction and these impacts are not reflected in the transaction prices.

Public goods arise where consumption of a good is non-rivalrous (consumption by one party does not affect the amount available to others) and non-excludable (individuals cannot be prevented from consuming the good). Producers and consumers cannot capture the full benefits of provision and payments for provision cannot be enforced. Consequently, public goods are likely to be under-provided by the private sector.

Lack of effective competition may arise in the presence of market characteristics such as natural monopoly or when the market has a small number of firms that are able to restrict output and maintain prices above efficient levels. The threat of new entrants may discourage the use of market power, as may any countervailing power held by customers. A small number of participants in the market alone is not evidence of the exercise of market power.

Inadequate information about a transaction can occur where there are barriers preventing parties obtaining relevant information about the characteristics of a transaction (most notably risks) and/or each other. In such cases, market participants may adopt simplified decision rules based on a reduced set of information.

Information asymmetry arises where one party knows more about key aspects of a transaction than the other party. One possible consequence is 'adverse selection' — a bias toward entering into a transaction that provides a lower quality or higher risk for the other party. Another potential problem is 'moral hazard', which is another form of risk transfer and occurs when a party exploits an information advantage and this affects the probability or magnitude of a payment from another party.

Source: PC (2012a).

Lack of effective competition

A lack of effective competition at any given point in time can provide an incumbent firm with an opportunity to engage in anticompetitive practices that prevent competition from emerging. For example, firms with temporary market power can entrench their market positions by making it difficult or prohibitively costly for their consumers to switch to other providers. This sort of practice can create barriers for other firms to enter the market. As another example, a firm might only supply its product to another party on the condition that the other party does not acquire products from a competitor of the firm. Most types of exclusive dealing are against the law only when they substantially lessen competition (although some types such as third line forcing are prohibited outright irrespective of the supplier's purpose or the effect of the practice on competition).

Inadequate information

Markets may not facilitate efficient outcomes where consumers are prevented from gathering sufficient information to determine the price, quality and other characteristics of products or services that best meet their preferences. For example, choosing a health care service provider to treat an acute medical condition is often made quickly in a stressful situation, and consumers may be unable to make choices that are in their best interests. Inadequate information can distort market signals and lessen the degree of competition between actual and potential suppliers.

Government intervention

Governments establish the broad institutional frameworks that underpin market activity, such as the legal framework that supports property rights and contracts. Governments also intervene more directly in the functioning of particular markets to improve safety, raise revenue, promote equity, redistribute income, assist particular industries or increase economic efficiency. Well-designed intervention can enhance the operation of markets, for example by reducing transaction costs or by providing information. At the same time, poorly designed government intervention can impede the efficient functioning of markets, including through restricting the scope and benefits of competition. Broadly, governments intervene in markets either through regulations, policy instruments such as taxes and subsidies, or through the ownership of businesses and the funding of service delivery.

Regulations and policy instruments such as taxes and subsidies

Some government regulations and policy instruments restrict the scope for markets to generate economically efficient outcomes. Participants to the Commission's inquiry into electricity network regulatory frameworks highlighted that the design of regulatory incentives encouraged excessive investment in electricity transmission and distribution networks (PC 2013c). The costs of these investments are ultimately passed on to the users of electricity through higher prices.

Regulations and policy arrangements can also decrease economic efficiency by directly or indirectly impeding competition. Pharmacy ownership regulations directly impede competition by preventing supermarkets and retail chains from operating in-store pharmacies. Similarly, the licensing of some professional services diminishes competition in the supply of labour to those professions. More recently, direct impediments to competition have been introduced in coastal shipping and wholesale markets for broadband services.

Competition can be impeded indirectly in industries where prices are regulated — where prices are set too low, market entry is less attractive to other firms. Policy arrangements such as industry subsidies also distort market signals by shielding assisted firms from competitive pressures.

Regulations that have the sole purpose of protecting firms in a particular industry are unlikely to provide net benefits to the community. However, there are some specific and limited circumstances where governments can improve community welfare by impeding competition, including where competition is in conflict with the achievement of other objectives, such as the promotion of equity. The issuing of patents may improve efficiency and community welfare by increasing the incentives for firms to innovate, which can in turn lead to new, improved or less expensive products. At the same time, patents are a potential source of market power. Intellectual property issues are discussed further in section 3.

Government ownership of businesses or the funding of services

Government ownership of businesses can reduce economic efficiency. Among the reasons for this is that governments often impose conflicting objectives on businesses that they own (or services that they fund) and may fail to give weightings or rankings to profit maximisation and price minimisation, efficiency and equity imperatives, environmental outcomes, the delivery of community service obligations and other obligations (such as local procurement and employment benefits). Related to this, government-owned businesses may be subject to political intervention. Government-owned businesses are also unlikely to be subjected to the

same level of scrutiny as private businesses when obtaining funding, and as a result, they are unlikely to face the same financial incentives to manage risk efficiently (PC 2013c). Finally, government-owned businesses do not face market tests for survival. Consequently, they will often have weaker incentives to operate efficiently than their private sector peers (or deliver services that consumers prefer), with the costs ultimately passed on to consumers and the community more broadly.

Government ownership of businesses or funding of services can also reduce economic efficiency by distorting the competitive process. Governments might use their legislative or fiscal power to advantage their own businesses over those in private ownership. This may take the form of government businesses borrowing at below-market interest rates (with the benefit of explicit or implicit government guarantees), or enabling government businesses to operate while earning a sub-commercial rate of return. (The role of competitive neutrality policy in providing market discipline to government businesses is discussed below.)

Government funding arrangements and procurement processes for service delivery can also distort competition if they preclude more efficient providers from entering the market, or can reduce the frequency of entry (and exit) through the lack of regular market testing. In some instances, government failure to create efficient market structures for the delivery of publicly funded services can also distort competition.

Objectives of competition policy

The objective of competition policy should be to improve community welfare by increasing economic efficiency. Competition policy should focus on conduct or rules that harm the competitive process, as opposed to conduct or rules that harm specific firms or types of firms. Hence, the case for any further reforms to competition policy should rest on their capacity to enhance the efficiency outcomes from competition for the community as a whole, rather than on their specific benefits (or costs) to a particular sector, industry, firm or type of firm. This means it is important that decision makers are not unduly influenced by features of the market, such as the number of actual competitors, when considering the need to introduce policy measures to open markets to more competition, or in analysing when to apply competition policy or competition law.

Competition policy should focus on the process of competition and, to the fullest extent possible, should be neutral to the type of technology or business practice employed (box 2). At the same time, competition policy should recognise that competition is a means to an end, and that it is neither desirable nor feasible to open markets to more competition in every sector, activity or circumstance. Strong policy

development processes and institutional arrangements should therefore underpin competition policy (discussed in section 2).

Box 2 The emergence of new technologies and business models

The nature of competition is evolving. Globalisation and e-commerce are lowering the barriers to entering some markets, opening up new sources of competition and increasing consumer choice. Digital-based competition is an emerging presence in many markets. The Internet and e-commerce have also increased the amount of information available to consumers through, for example, price and product comparison websites, and by facilitating a reduction in search and transaction costs, including for imported purchases.

A current example of technology opening up a new source of competition is the emergence of Uber, which uses a smart phone application to connect consumers and providers of passenger vehicle services. Uber competes with the taxi industry, an industry that has successfully stalled competitive reforms and benefited from a restrictive regulatory framework that raises service costs for consumers. The regulatory response to Uber's receipt and dispatch service may differ across jurisdictions due to variation in state and territory commercial passenger vehicle service legislation. Under Victorian legislation Uber's service is regulated as a hire car service (not a taxi service). Some jurisdictions are still formulating their regulatory responses to Uber's receipt and dispatch service.

New digital-based sources of competition can deliver mixed outcomes for the community. On the one hand new sources of competition can promote community welfare by driving increases to economic efficiency. On the other hand new competitors or different business models may be able to skirt regulation that serves a legitimate purpose, such as protecting public safety or data security, leading to practices that might be detrimental to the community.

Competition policy should be able to accommodate all new sources of competition, and be sufficiently flexible to accommodate alternative models of service and product delivery. Governments should not impede new sources of competition to protect 'their patch' of the regulatory framework, incumbent firms or the users of a particular technology.

2 Principles underpinning sound regulatory processes and institutional arrangements

Good regulatory processes are important not only for achieving good competition policy outcomes, but also for building support for policy reforms through demonstrating the case for change. The Commission's views on the principles that should guide regulatory processes (and associated governance and institutional arrangements) are set out in box 3. Processes and institutions associated with each stage of developing a regulatory regime are considered in turn below, drawing on lessons from previous reforms.

The importance of good process in developing policy and communicating the case for reform

At the outset of the policy development process, an institutional capability should be applied to objectively evaluate the effectiveness of existing policy arrangements, to identify policy reform options, to consult widely and transparently, and to offer governments an unbiased assessment of the reforms necessary to improve the policy framework.

Reform efforts that have had a flawed process for policy development have undermined the achievement of sound policy outcomes — often evidenced by inadequate objective analysis, poor design or rushed implementation. Recent examples include state governments promoting projects that are yet to be fully evaluated, and the truncated timeframe for implementation of the National Disability Insurance Scheme.

The process under which competition policy is developed is critical not only to getting policy changes right, but also to building and communicating the case for reform. A properly constructed, transparent review process can generate stakeholder engagement and promote public awareness and acceptance of the need for reform, the issues and trade-offs associated with different policy approaches, and the resultant community wide benefits. International case studies illustrate the importance of transparency of the policy process in winning stakeholder and public support for reform (OECD 2009).

Appropriate consultation is a critical part of policy development. It is a two-way process: it allows stakeholders to put their views forward and also tests the thinking of policymakers and provides a forum for them to communicate the reasons for pursuing a particular solution.

Box 3 Principles of good regulatory process

Policy development

- Articulate the policy problem to be addressed:
 - determine the type of market failure (or regulatory barrier), and identify any equity or other distributional issues that need to be addressed
 - include why the problem is of sufficient magnitude to warrant priority assessment
 - identify why (and which level of) government needs to be involved.
- Specify the objectives that are to underpin the policy solution.
- Assess the costs and benefits of the most feasible policy options to determine the option that generates the greatest net benefits to the community:
 - ensure appropriate governance of the assessment process and the capability and objectivity of the body responsible for policy assessment — this body should have transparent and consultative procedures, as well as the timeframe and resources to develop well thought out, evidence-based recommendations
 - explore all fiscal, administrative and regulatory tools available to government
 - include the option of doing nothing
 - identify linkages to, and consistency with, other policy objectives and the most effective sequencing of reforms and their implementation
 - include the ‘flow-on’ costs to the broader economy, including distributional consequences and environmental costs.
- Ensure the policy is clear and simple.

Implementation and administration

- Develop governance arrangements for implementing and administering the policy:
 - regulatory institutions should be accountable, and decisions transparent
 - guidance should be provided to regulators and regulated entities to ensure the objectives of the policy are clear
 - there should be appropriate recourse to appeal regulatory decisions.

Policy monitoring and review

- Develop policy monitoring and periodic review arrangements, with consideration given to the institutional capacity to undertake monitoring and review:
 - unnecessary or ineffective regulation should be revised or removed
 - the policy should be subject to review to ensure its ongoing appropriateness.

Sources: Australian Government (2010); COAG (2007); OECD (2005).

Consultative processes and the raising of community awareness take time. For example, the Petroleum Resource Rent Tax took about two years to be developed and about two more to be refined through intensive consultations with industry

before it was implemented in 1989. By contrast, the Resources Super Profits Tax was announced (following the Henry Tax Review) with far less public consultation.

The design of the resource rent tax and the rushed process by which it was introduced was severely criticised. An alternative Minerals Resource Rent Tax was introduced but the willingness to embrace reform had been lost. The subsequent public debate around the design and introduction of a resources rent tax has consequently eliminated from dispassionate analysis any question of whether better tax arrangements would serve to benefit the community as a whole, and if so how they might be best designed and implemented.

Determining priority areas for policy reform

The pursuit of multiple reforms simultaneously can be challenging for the affected stakeholders and for governments, particularly for major reform programs. Attempting to do too much at once can dilute the resources available to undertake *ex ante* evaluation of policy proposals or to review current programs or regulatory arrangements, reduce the scope for effective stakeholder participation, and ultimately compromise the potential for beneficial reforms. Also, governments can become concerned that multiple reforms might dilute their political capital.

Accordingly, major reform programs have often prioritised the policies to be assessed, focusing on those with greater payoffs first. For example, the Australian Government applied a tiered screening process in the Legislative Review Program under NCP, with a Council representing different community groups appointed for the purpose of determining those regulations needing detailed review.

In prioritising reforms to competition policy, attention should be paid to the potential benefits as well as the costs of developing and undertaking reforms. Payoffs will generally be greater:

- the deeper the impacts of changes that are likely to come from reform
- the broader these impacts are across the community
- the lower the costs of planning and implementing the reform (PC 2011e).

The sequencing of reforms is also essential to their effective implementation, particularly where one reform provides the foundation for another. For example, NCP was preceded by reforms that opened international markets for currency, capital and goods, which created pressure for further reforms in key domestic markets. Also important is the demonstration effect of successful reforms in building support for further reform (especially those with immediate and apparent benefits) — another reason to prioritise reforms with greater payoffs first.

Policy objectives should clearly target the identified problem

All government policy should address an identified and material policy problem, have a clear set of objectives that are relevant to the identified problem, and have a rationale as to why government (and which level of government) needs to be involved in addressing the problem.

The Commission's report into the urban water sector highlighted that governments had assigned multiple and conflicting objectives to their agencies, utilities and regulators in the urban water sector, and had provided inadequate guidance on how to make trade-offs between those different objectives (PC 2011a). The Queensland Competition Authority, for example, was required under its legislation to have regard to more than a dozen matters when making a price determination. The Commission recommended that governments should articulate a common objective for the urban water sector associated with maximising net benefits to the community by providing water-related services in an economically efficient manner.

Identifying the policy problem: context matters

In identifying the policy problem that government policy should address, it is important to consider the broader context to determine whether an apparent problem justifies government intervention. The presence of a monopoly provider, for example, is not sufficient evidence to determine that market power is being exploited, or that government should intervene.

In its inquiry into wheat export marketing arrangements, the Commission found that although port terminal facilities used for bulk wheat exporting are perceived by many policymakers and industry participants as having 'natural monopoly' characteristics — a market characteristic that can lead to market failure (box 1) — industry-specific access arrangements were not required following a transition period to 2014. This reflected broader considerations such as constraints on the ability of port operators to take advantage of any market power they might have, incentives to maximise the level of throughput at port terminals (rather than deny or restrict access to extract higher prices as a monopolist may do) as well as the role of Part IIIA of the *Competition and Consumer Act 2010* (Cwlth) (CCA) as a general backstop for access issues (box 4).

Assessing the costs and benefits of policy options

An assessment of the costs and benefits of policy options to address the policy problem should be undertaken to determine which option is likely to generate the greatest net benefits to the community. The evaluation should assess the range of feasible options that would meet the policy objective, including the option of doing nothing.

Even where there is a market failure or regulatory impediment to increased competition, the costs of policy to address imperfect competition might still outweigh the benefits, and should be considered on a case-by-case basis. For example, the risk of regulatory error needs to be weighed against the costs of market failure, and any policy change needs to be subjected to analysis of the risk of perverse or unintended consequences.

Box 4 Wheat export facilities

The Productivity Commission found in its 2010 report on wheat export marketing arrangements that the transition to competition in exporting bulk wheat had progressed relatively smoothly, aided by the government's role in requiring accreditation arrangements for bulk exporters, and the sector-specific access regime for port terminal services. Under the *Wheat Export Marketing Act 2008* (Cwlth), port terminal operators that export wheat were required to pass an 'access test' as part of an access regime. The access test included a mandatory requirement (from 1 October 2009) to have an access undertaking that sets out the terms and conditions of access to port terminal services for other businesses (unless an effective access regime was in force) accepted by the Australian Competition and Consumer Commission (ACCC).

However, the Commission expressed concern that, over time, the access regime would provide incentives for wasteful strategic behaviour by both port terminal operators and traders, constrain the efficient delivery and pricing of port services, and reduce the incentives for investment in terminal facilities and dependent supply chains. The Commission also highlighted factors that limited the ability of bulk wheat terminal operators to take advantage of any market power they might have, including the highly competitive nature of the global wheat market and benefits to bulk wheat terminal operators from maximising throughput at port terminals.

Accordingly, the Commission recommended that, at the end of a period of transition, the accreditation scheme be abolished in September 2011, and the access regime be abolished in September 2014. This would remove the mandatory requirement for port terminal operators that export wheat to have an access undertaking accepted by the ACCC. The Commission noted that the generic Part IIIA regime would still be available to deal with access disputes and advocated the development of a voluntary access code to supplement the Part IIIA backstop.

Source: PC (2010c).

A comparison of costs and benefits of policy that affected competition was a systematic part of the legislative reviews under NCP. A key feature of those reviews was that arrangements that inhibit competition were to be retained only if they could be shown to be in the public interest — that is, it needed to be demonstrated that the benefits of restrictions to competition outweighed the costs.

The NCP approach represented a reversal of the traditional onus of proof (under which it is up to the proponents of change to demonstrate that the change would yield net benefits) on the grounds that theory and evidence strongly suggest that removing restrictions on competition will typically improve community welfare. Also, requiring those who benefit from legislative restrictions on competition — and thus those who typically have most incentive to see those restrictions retained — to address the wider community effects of those restrictions can act as a counterweight to political pressure from vested interests to ignore the less readily identifiable costs (PC 2005b).

Given the potential benefits from competition outlined in section 1, the Commission considers that it remains appropriate to require advocates of restrictions to competition to demonstrate net community benefits from those restrictions. Such a requirement should be built into the governance framework of future competition policy reviews.

Who wins and who loses? The distribution of costs and benefits of policy reform

In building a case for competition policy reform, it is important to consider not just the aggregate costs and benefits of policy change, but also who in the community will benefit from the change, and who will lose — both in the short term and over time. In many policy reforms there is potential for those who lose from a policy change to be concentrated, organised and vocal, whereas those who are likely to gain will often be dispersed more widely throughout the community. As gains to individual winners are often small, they are often poorly informed about the trade-offs and will devote few resources to achieving those gains.

Removing regulations that reduce competition in the provision of pharmacy services is one example of where the benefits of reform are likely to be much more widely dispersed than costs. A level of competition-based deregulation could provide opportunities for supermarkets and other retail chains to operate in-store pharmacies (with appropriate quality and safety safeguards in place). Retail chains may be able to take advantage of economies of scale and scope in the provision of pharmacy services and offer greater convenience for many consumers — the benefits would be received by a very large segment of the population. In comparison, the costs associated with reduced value of some pharmacy businesses

are likely to be concentrated among existing owners of pharmacies. Of course, whether the overall benefits exceed the costs remains a matter for proper analysis and should not be pre-judged.

Institutional arrangements for policy development

Institutions responsible for policy assessment and development need to be appropriately placed and adequately resourced (in terms of skills and funding) to undertake the consultative, transparent process described above. There can also be advantages from holding policy assessment processes that are independent from government. This can assist in developing public support through indicating that policy advice is not only ‘expert’ but also removed from politics in what are often complex and potentially sensitive areas. Governments can also benefit from observing the views of stakeholders, the analysis of experts and the reaction of the community to reform proposals, before having to make a final decision.

Implementation and administration

Where a regulatory solution is identified as the best vehicle for implementing reform, the second stage involves the detailed design and making of the regulation and administration of that regulation — including assignment of responsibilities and accountabilities. Object clauses and guidelines for regulators need to encourage cost-effective and risk-based approaches to administration and enforcement. Drafting should make the intent of policy clear and establish the desired scope for regulators to interpret the regulation. Where embedded legislative reviews are to be provided for, their scope, governance and data collection requirements need to be specified.

Institutional arrangements for regulators

The institutional design and capability of the regulatory, advisory and decision reviewing agencies are fundamental to the proper application of the legal and policy framework. The institutional arrangements need to clearly assign responsibilities, provide for appropriate incentives and ensure that the institutions have adequate capabilities and resourcing. A number of principles and leading practices have emerged from Commission inquiries and research that can provide guidance for good governance arrangements for regulators and other agencies (PC 2013c). These principles include that the regulator:

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- has been given clear and appropriate objectives, such as to maximise community wellbeing or economic efficiency, and guidance on which objectives to prioritise where they conflict
 - has a governance structure and statutory appointment process that ensures independence and expertise
 - has staff with appropriate expertise and skills, and adequate funding to efficiently fulfil its functions
 - is consultative, transparent and timely in making decisions
 - is accountable to others for its actions and decisions and can have its decisions reviewed by an appropriate body
 - is subject to periodic independent reviews of its capability and performance.

Governance of ACCC informal merger decisions

The Competition Policy Review may wish to consider the transparency and accountability of Australian Competition and Consumer Commission (ACCC) decisions under the informal merger review process. Since the Dawson Review of the Trade Practices Act in 2002-03, the ACCC has taken steps to increase the transparency of its informal merger process, including issuing Public Competition Assessments (box 5). However, it has been suggested that these steps do not provide sufficient transparency in informal merger decisions because there is no access to third-party submissions, and detailed reasons for decisions may not be publicly available (Williams 2014).

One way to increase the transparency and standing of the ACCC's process and the expertise feeding into the informal merger review process may be for an independent, peer-based panel to provide further advice to the ACCC. Panel members with expertise in mergers and acquisitions (similar to the Takeovers Panel) could provide advice on the legislation and its intent, taking into account a range of commercial and market factors. The panel's advice could be made public, with the final informal review decision being left in the hands of the ACCC (as is currently the case).

Box 5 Merger reviews

Section 50 of the Competition and Consumer Act (CCA) stipulates that mergers are prohibited if it can be demonstrated that they will have the effect or likely effect of substantially lessening competition. Merger parties have three avenues available to have a merger considered and assessed on competition grounds.

1. *Informal merger review*: The informal merger review process provides the merger parties with the ACCC's informal view on whether a merger proposal is likely to breach s.50 of the CCA.
2. *Formal merger clearance*: Formal merger clearance from the ACCC confers legal protection to the person to whom clearance is granted from the application of s.50 of the CCA.
3. *Merger authorisations*: Merger parties may seek legal protection from court action under s.50 of the CCA by applying to the Australian Competition Tribunal for authorisation of the merger proposal.

Almost all applications to date have proceeded through the informal merger review process. The ACCC will explain the reasons for its decision on an informal merger in a summary on the mergers register. A more detailed Public Competition Assessment is published where: a merger is rejected; a merger is subject to enforceable undertakings; the merger parties seek such disclosure; or a merger is approved but raises important issues that the ACCC considers should be made public.

Review of regulatory decisions

There is general agreement that some recourse to appeal regulatory decisions is appropriate. Review bodies should be independent of policymakers and the regulatory bodies that they review. They should also possess sufficient resources and expertise to appropriately review decisions as required.

However, there is often debate over the appropriate form of review. An important distinction exists between merits review and judicial review. Judicial review is concerned with the legality of the decision-making process (and is provided for under the Australian Constitution) (ARC 2003).

Merits review generally involves reconsideration of the facts, as they apply to a particular decision, in order to determine the correct or preferable decision. The availability and type of merits review of regulatory decisions varies by sector and by jurisdiction (box 6).

Merits review processes can be time consuming and costly. For example, the time taken to resolve some third-party infrastructure access matters under Part IIIA of the

CCA has been lengthy — the Pilbara rail case is the standout example of an access matter that became mired in a complex legal dispute (PC 2013d).

The appropriate balance between the process and accountability benefits of merits review and the associated resource costs will vary on a case-by-case basis, but some form of limited merits review of decisions by regulatory bodies will typically be appropriate. For example, a review of the limited merits review regime for electricity and gas networks headed by Professor George Yarrow concluded that changes should be made to arrangements in energy markets, but that properly structured limited merits review was preferable to relying on judicial review only, or introducing full merits (*de novo*) review (Yarrow, Egan and Tamblyn 2012). Similarly, the Commission concluded that merits review of declaration decisions under Part IIIA of the CCA is likely to be more confined and more timely than in the past (following a High Court decision in 2012) and that maintaining a limited merits review process was appropriate (PC 2013d).

Box 6 The scope and type of merits review varies

In some cases, merits review processes are explicitly limited in scope.

- An access seeker or service provider can apply to have a decision on declaration under Part IIIA of the Competition and Consumer Act (CCA) (made by the Minister, who is informed by recommendation of the National Competition Council) reviewed on its merits by the Australian Competition Tribunal. Merits review is confined to consideration of information taken into account by the original decision maker, along with additional information that the Tribunal considers reasonable and appropriate (but not so as to constitute broad additional investigations).
- Affected or interested parties can apply for pricing determinations for gas and electricity network suppliers by the Australian Energy Regulator to be reviewed on their merits by the Australian Competition Tribunal. Merits review is limited to cases where there is a materially preferable outcome on the basis that the original decision maker made an error of fact, incorrectly exercised discretion or was unreasonable.

In others, merits review processes constitute a full re-hearing of the original decision. For example, an applicant or interested party can apply for ‘re-hearing’ by the Australian Competition Tribunal of decisions of authorisations (authorising conduct that may otherwise be prohibited) by the ACCC under Part VII of the CCA.

Sources: ACCC (2013); PC (2013d); Yarrow, Egan and Tamblyn (2012).

Policy monitoring and review

Ex post evaluation of the outcomes of competition policy reform is important not only to determine the extent to which desired outcomes were achieved, but also to help generate or maintain support for further necessary reforms. It is important to demonstrate to the community that reforms were worthwhile — that is, that the community is better off. Evaluation needs to be proportionate to the nature and significance of the regulations concerned, and be able to address the issues that are germane to their performance.

Evaluation can involve a mixture of quantitative and qualitative techniques to draw causal links between policy and outcomes. Cost–benefit analysis can be used for both prospective evaluations of options for government action (discussed above) and for retrospective evaluation of policy. Policy evaluation should seek to assess change against a counterfactual scenario, draw on evidence from multiple sources (particularly when relying on subjective evidence), and report on the confidence in the findings of the evaluation. Any unintended consequences from the policy should be considered.

Policy monitoring and periodic review is also important to ensure that unnecessary or ineffective regulation or other governmental intervention is revised or removed. ‘Sunsetting’, whereby a regulation will lapse if it is not re-made after a certain period (typically five to ten years), may provide a basis for evaluating the ongoing worth of the regulation.

Institutional arrangements for policy monitoring and review

Ex post monitoring and review of policy needs to be undertaken transparently, by an independent and expert body. Bodies responsible for monitoring and reviewing policy should be independent of those responsible for implementing and administering the policy.

The reviews necessary to identify and implement reforms to regulation require people who are at least as skilled as those responsible for developing the regulations in the first place. The Commission has strongly advocated that the Australian Government should commit to building skills in evaluating and reviewing regulation (PC 2011e).

Generating momentum for (and sustaining) the reform process

The potential for those who benefit from reform to be more widely dispersed throughout the community than those who lose can make advancing competition policy reforms politically difficult, even where the overall benefits to the community as a whole outweigh the costs to the few. The experience with previous reforms provides some lessons on how beneficial reforms can be advanced.

Should affected parties receive compensation?

There will often be calls by those that are negatively affected by policy reform for compensation to ameliorate the costs they face. The value of capital assets such as property, licences and quotas can be inflated by above-market prices (in large part due to the market distortions of those restrictive licences and quotas), and returns to those investments will decline in some cases even at the *prospect* of more competition. A reduction in the artificially inflated value of assets held by incumbents (and the excess returns they have enjoyed during those times) does not necessarily provide justification for compensation.

The tax and transfer system and other generally available measures can assist adjustment and moderate adverse distributional impacts that arise from policy-induced change. These measures should be relied on in most cases. However, they are not designed to handle all contingencies and there may be some limited circumstances where additional measures, such as direct compensation or specific adjustment assistance, are warranted.

As the Commission set out in its 2001 research paper on structural adjustment, the case for additional measures should be assessed on a case-by-case basis but is likely to be strongest where a proposed policy change:

- imposes a clear and sizeable burden on a specific group in the community (particularly if the affected group is relatively disadvantaged)
- imposes large and/or unexpected losses in income or wealth on a minority of individuals, even if they are not among the most needy or vulnerable in society
- involves a largely unanticipated and material change to a well-defined and defensible ‘property right’ (PC 2001b).

Assistance designed to ‘buy-off’ opposition or act as a ‘circuit breaker’ to progress a policy change is fraught with difficulties and carries considerable risks. Singling out particular groups for special treatment runs the risk of jeopardising fair process and — without a clear basis for deciding which groups should be paid off — is unlikely to yield consistent and equitable outcomes. A decision to compensate the

opponents of a specific policy proposal is likely to encourage others to lobby against other proposed policy changes in the hope that they too will receive compensation.

Should states and territories receive payments from the Commonwealth for progressing reforms?

Competition policy reforms often relate to matters that are the responsibility of the states and territories, so that reforms formulated collectively at a national level need to be implemented across multiple jurisdictions.

Payments under past reform programs

A feature of the NCP institutional framework was the use of financial incentives from the Australian Government to the states and territories. These competition payments were dependent on the jurisdictions making satisfactory progress in meeting their commitments. The main rationale for the payments was that reforms would generate income gains that would in turn yield tax revenue which accrued disproportionately to the Commonwealth — one of the characteristics of the vertical fiscal imbalance which exists between the Commonwealth and the states and territories.

The National Competition Council (NCC) had the role of independent monitor and assessor of different jurisdictions' progress in implementing NCP reforms. The NCC identified where commitments had not been met or where the actions of the jurisdictions fell short, bringing a level of transparency to the reform process. Whether particular jurisdictions received their competition payments in full depended largely on the NCC assessments of their progress. The Australian Government Treasurer was responsible for the final decision on the level of any penalty (which was deducted from actual payments made).

The Australian, state and territory governments committed to further policy reform under the 2009 National Partnership Agreement to Deliver a Seamless National Economy (referred to hereafter as the National Partnership Agreement). The Australian Government agreed to provide payments, including reward payments to those jurisdictions that deliver on nationally significant reforms based on the achievement of performance benchmarks outlined in the Agreement. The COAG Reform Council has, to date, had responsibility for assessing whether the benchmarks have been achieved and reporting publicly on governments' performance.

Lessons from past reform programs

Evidence received by the Commission in the course of its review of NCP indicated that it would have been much more difficult to make progress without competition payments (PC 2005b). It should be noted, however, that competition payments did not *ensure* compliance with the reform program, and that at times substantial penalties were incurred by some states and territories.

The Commission also found that providing for ongoing independent assessment of governments' progress in implementing reform commitments by the NCC was a major strength (PC 2005b). The institutional arrangements that defined the role and independence of the agency responsible for determining the rationale for a payment, the magnitude of the payment and whether the jurisdiction had made satisfactory progress against its reform commitments were seen as important.

A shortcoming of the approach under the more recent National Partnership Agreement was that payments were based on achievement of process milestones rather than outcomes. The COAG Reform Council observed in its monitoring that the achievement of reform milestones does not necessarily reflect effectiveness in achieving reform outcomes (COAG Reform Council 2011).

The linking of payments to process milestones rather than to outcomes led to a timing mismatch, whereby reward payments were 'front-ended' well in advance of any fiscal (or other) benefits. For example, reward payments of \$200 million were provided to jurisdictions as part of the National Partnership Agreement in 2011-12 (Australian Government 2013). When combined with facilitation payments of \$100 million in 2008-09, this meant that more than half of total payments committed under the National Partnership Agreement (\$550 million) had already been paid by 2011-12 (COAG Reform Council 2013). By contrast, the Commission estimated that less than 5 per cent of the prospective benefits of 17 COAG business regulation reforms under the National Partnership Agreement had been realised by 2012 (PC 2012c). There is the real risk that the Commonwealth delivered more in reward payments than has been delivered in reform outcomes.

Is there a role for payments to jurisdictions as an incentive to progress reform?

Participants to the Competition Policy Review may point to the role of competition payments in generating reform outcomes under NCP as evidence that incentive payments should feature in future reform agendas, as a form of leverage to achieve reform outcomes. However, where policy development has been guided by sound principles — and the benefits of the proposed reforms have been clearly demonstrated to outweigh the costs to the community and articulated to the

community as such — then the reforms should be undertaken in order to capture those net benefits. Again, this highlights the importance of clearly building and communicating the case for reform through a robust, transparent and consultative policy development process.

As for affected parties elsewhere in the community, payments to states and territories that are designed to ‘buy-off’ opposition are fraught with difficulties and carry considerable risks. Jurisdictions that are ahead in implementing reforms would consider that they are not duly rewarded for having progressed reforms that other jurisdictions are paid to implement later. Indeed, an excessive focus on fiscal compensation — rather than wider economic and social benefits from reforms — could induce jurisdictions to hold off on implementing beneficial reforms in the expectation that they might receive incentive payments to do so later.

Is there a role for payments to compensate for fiscal imbalances?

Participants to the current Review might also advocate payments to states and territories on the basis that those jurisdictions are likely to incur the costs of reform, whereas the fiscal benefits flow primarily to the Commonwealth. This is a consequence of the constitutional allocation of limited but significant functions to the Commonwealth, and the associated vertical fiscal imbalance, where the states’ and territories’ revenue raising powers are insufficient to fund their expenditure responsibilities, while the Commonwealth raises more revenue than it requires for its expenditure responsibilities.

On balance, the Commission does not at this time support further payments to states and territories for progressing reforms. Further payments would risk creating unintended incentives through elevating fiscal considerations ahead of wider economic and social benefits. Vertical fiscal imbalances would be better addressed directly — the Commission is mindful that the Government has initiated a Federation White Paper and a Taxation White Paper, and thereby an opportunity to directly address some of the issues relating to vertical fiscal imbalance.

Broad-based reform

A broadly-based reform program can make it easier for governments to progress a set of individual reforms that might be difficult to implement on a stand-alone basis. A broadly-based and integrated reform agenda — as was the case for NCP — improves the prospect that those who might lose from one specific reform can benefit from others and gain overall. As such, a broadly-based program can moderate adverse distributional effects. For this reason, where the effects of policy

changes are broader, compensation of affected parties is less likely to be justified on equity grounds.

The need for political commitment to drive policy reform

Political commitment at the state and Commonwealth level, rather than monetary transfers, drives policy reform. Absent political commitment, the whole exercise is continuously in danger of becoming a search to forgive inadequate performance, or to weaken policy goals. The OECD has found that ‘political commitment to regulatory reform has been unanimously highlighted by country reviews as one of the main factors supporting regulatory quality’ (OECD 2010, p. 244). Agreement on the main problem areas and policy approaches that were required was an important part of progressing reform under NCP. By contrast, reversal of political support was identified as an issue in the context of the most recent COAG reform agenda, in the light of leadership changes and the emergence of competing issues (PC 2012c).

3 Opportunities for further competition reform

Improving competition law

Australia's core competition law provisions are contained in the CCA. The object of the CCA is to 'enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection'. The ACCC is responsible for ensuring compliance with and enforcement of the CCA. Industry-specific legislation and mechanisms such as enforceable undertakings are used on a case-specific basis (such as NBN Co and Australia Post) to apply competition law principles in a particular manner.

Competition law can increase economic efficiency by discouraging firms from interfering with the competitive process. It can provide for some degree of certainty and transparency about whether certain types of practices are acceptable. The CCA prohibits outright some practices (such as price fixing), while others (such as the merger provisions) require an assessment of whether the conduct would have, or would be likely to have, the effect of substantially lessening competition.

It is important that regulatory and policy arrangements are periodically reviewed to ensure that they are promoting community welfare by protecting the competitive process, as distinct from protecting particular firms or types of firms. Aspects of competition law may require review to ensure that they strike the right balance between prohibiting anticompetitive conduct on the one hand, and allowing efficiency-enhancing conduct on the other. Examples are discussed below.

Section 46 and the purpose test

There has been debate over whether the market power provisions of the CCA (outlined in s.46 of Part IV of the Act) should only apply when a firm engages in anticompetitive conduct for a particular *purpose*, or whether there should also be a focus on the *effect* of the conduct. While some have argued the evidentiary burden for the current purpose test is too high (which risks allowing anticompetitive conduct), the Commission considers that a high evidentiary burden is not sufficient, in itself, to justify changing the legislation. Changing the legislation to include an effects test would itself bring regulatory risks, particularly if the threshold to make the test were too low. A thorough analysis of the costs and benefits should be undertaken to determine whether the market power provisions in the CCA should be reformed, including whether statutory guidance should be given as to the burden of proof required to meet the purpose test if it is to continue.

Part VIIA

Part VIIA of the CCA provides for three types of price oversight: public inquiries; price notifications; and monitoring and reporting. Formerly contained in the *Prices Surveillance Act 1983* (Cwlth), these prices surveillance provisions have been applied to sectors of the economy, such as aviation infrastructure and harbour towage services, that were considered to be not subject to competitive pressures.

The Part VIIA framework was comprehensively examined in the 2001 Commission review of the Prices Surveillance Act (PC 2001a). The Commission expressed strong reservations about regulatory intervention:

- In markets where competition is not strong, regulators attempt to emulate the efficient outcomes they believe would occur in more competitive markets. Yet this is a complex task requiring information that typically is not available. Hence, intervention may well result in prices that are more inefficient than would occur in the unregulated market, doing more harm than good to consumers and to the economy generally.
- Because of these risks, prices oversight is likely to be warranted only when there is substantial market power and when other pro-competitive options are not available. (p. XIII)

In its review of the price regulation of airport services, the Commission highlighted the lack of clarity on the circumstances in which a public inquiry under Part VIIA might be initiated, and how that inquiry process is to be progressed (PC 2007). The Commission also raised concerns that this uncertainty led to the view that there was a lack of a credible threat of regulatory intervention underpinning light-handed regulation. The Commission concluded that:

This gap in the current arrangements is contributing to perceptions in some quarters that the threat of re-regulation, if there is misuse of market power by airports, is not a credible one. (p. XVIII)

As discussed above, regulatory frameworks should be periodically reviewed to ensure they are warranted and effective. The Competition Policy Review provides an appropriate opportunity to review Part VIIA given the changing economic and market circumstances that have taken place since the prices surveillance provisions were introduced.

Participants and others have raised several issues that the Review Panel could explore, and the Commission notes the following — while not forming a view on any of them. The Panel could explore the merits or otherwise of:

- addressing the consequences of any imbalance of bargaining power between firms (particularly where small businesses are concerned)

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- addressing the exercise of substantial market power through pricing with offence provisions under Part VIIA (where this behaviour does not constitute an offence under another part of the CCA) — European law is sometimes referred to in this context
 - including a general pricing offence in Part IV and repealing Part VIIA
 - Part VIIA taking account of product or service quality (as well as price) to provide a basis for a more complete assessment of whether a firm had abused its market power.

The Commission considers, in the light of the evidence about efficacy and compliance costs from its own previous investigations and findings, that Panel recommendations to reform Part VIIA should be preceded by a thorough assessment of potential costs and benefits of reform options, based on a clear view of the policy problem that needs to be addressed.

Intellectual property

The legislative framework governing intellectual property is another area that may require further scrutiny by the Competition Policy Review. In its report into the compulsory licensing of patents, the Commission highlighted the overlap between patent law and competition law as an area for reform (2013b). The Commission recommended removing a provision from the *Patents Act 1990* (Cwlth) so that a compulsory licence based on the anticompetitive conduct of a patent holder is only available under the CCA. The Commission also recommended amending the CCA to explicitly recognise compulsory licences as a potential remedy under the Act. In addition, the Commission saw no reason why the CCA should include an exemption for certain conduct involving intellectual property from some provisions of the Act.

Australia, as a net importer of intellectual property, has likely incurred net costs from the inclusion of some intellectual property provisions in trade agreements. For example, analysis indicates that extensions in the duration of copyright protection required by the Australia–United States Free Trade Agreement imposed net costs on Australia through increased royalty payments (PC 2010b). The Australian Government should therefore be cautious about entering future trade agreements where the United States or other countries prescribe intellectual property arrangements that could be costly to Australia. The proposed Trans-Pacific Partnership Agreement between Australia and various other countries including the United States, as well as other proposed international agreements such as the Transatlantic Trade and Investment Partnership, are specifically considering intellectual property issues.

While the issuing of patents can improve efficiency and community welfare by increasing the incentives for firms to innovate (section 1), there is evidence that incentives for innovation from the patent system appear to apply only in a few sectors (Harris 2014; PC 2013e). Where not warranted to incentivise innovation, the patent system can impose costs on the community by impeding competition. For example:

- The accrual of ‘patent portfolios’ can potentially impede market entry by preventing access to technologies. In some cases, firms that accrue patents conduct no business other than asserting their patents against other firms — effectively ‘taxing’ other firms’ innovations via court cases. These strategies decrease the ability of other firms to innovate and compete.
- In areas of ‘cumulative innovation’, where innovation requires access to multiple patents, there are higher costs to innovate because of the need to purchase those patents. There can also be prohibitive transaction costs when negotiating access with multiple holders. The need to access multiple patents can lead to ‘hold out’, whereby the owner of a patent holds out for a better deal from a potential innovator, which can also serve to discourage innovation.

Reforms beyond the competition law

Removing unwarranted regulations that impede competition

There is a significant body of evidence showing that the removal of regulations that directly impede competition can improve economic efficiency by increasing consumer choice, lowering prices, and opening up new business, employment and occupational opportunities (PC 2005b). There is also scope to increase the benefits of competition by removing measures that impede competition indirectly. These measures include regulations that restrict firms’ abilities to set prices, or subsidies that favour particular firms (or types of firms, such as small businesses).

Despite the progress made under NCP in reducing regulatory impediments to competition, there are many more areas of potential reform. These include (but are not limited to):

- pharmacy ownership restrictions
- limits on retail trading hours and on how close to each other similar businesses can set up (planning and zoning rules)

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- coastal shipping protection (cabotage arrangements)¹
 - aspects of international aviation (ownership rules)²
 - some rail freight services
 - some foreign investment rules (restrictions on foreign ownership)
 - some restrictions on professions, such as limits on entry
 - restrictions on water trading from rural to urban areas
 - taxi licensing quotas
 - regulations and policies affecting the financial services sector³
 - trade restrictions and antidumping arrangements
 - restrictions on parallel imports of books.

The Commission has examined many of these competition issues in past studies and inquiries (table 1).

There is a case for conducting a further round of reviews that target the more significant restrictions on competition that avoided, or were not adequately subjected to, rigorous and independent scrutiny in the NCP reviews, or where the economic environment has significantly changed.

¹ On 8 April 2014, the Deputy Prime Minister and Minister for Infrastructure and Regional Development announced the release of an options paper on approaches to regulating coastal shipping in Australia for stakeholder comment.

² The Commission notes that Australia has obligations relating to international aviation that may be outside of the scope of competition policy reform in Australia.

³ On 20 December 2013, the Commonwealth Treasurer announced the final terms of reference for the Financial System Inquiry, headed by David Murray, which will examine options that promote a competitive and stable financial system that contributes to Australia's productivity.

Table 1 Past Commission studies addressing competition issues

<i>Area</i>	<i>Previous recommendations and findings^a</i>
Pharmacies	There has been a failure to act on recommendations by a national independent review of pharmacy to relax ownership and other anticompetitive restrictions. Priority should be given to conducting a second round review of pharmacy regulation, covering all potential restrictions on competition in the sector (PC 2005b).
Retail trading	Retail trading hours should be fully deregulated in all states. Governments should (where responsible) broaden business zoning and significantly reduce prescriptive planning requirements to allow the location of all retail formats in existing business zones to ensure that competition is not needlessly restricted (PC 2011d). ^b
Coastal shipping	The Government should conduct a broad review of impediments to efficiency and competition in coastal shipping (including cabotage arrangements) (PC 2005b). ^c The Australian Government should proceed with the foreshadowed review of coastal shipping regulation (including cabotage) as a matter of priority. The objective of the review should be to achieve the most efficient coastal shipping services feasible for Australia (PC 2014c).
Water trade	Policy bans on urban water supply augmentation from certain sources, such as rural–urban trade, should be removed (PC 2011a).
Parallel imports of books	Parallel import restrictions for books should be repealed and three years notice should be given to facilitate industry adjustment. The Government should review the current subsidies aimed at encouraging Australian writing and publishing, with a view to better targeting cultural externalities (PC 2009).
Anti-dumping	The imposition and continuation of antidumping and countervailing measures should be subject to a ‘bounded’ public interest test, to take account of wider impacts and prevent the imposition of measures that would be disproportionately costly (PC 2010a).

^a The list of recommendations is not exhaustive. ^b In June 2014, the Commission (2014a) identified that, while there had been some relaxation of restrictions, four jurisdictions were yet to fully deregulate their trading hours. There were some signs of partial progress on planning and zoning in some jurisdictions with Victoria leading the way. ^c Coastal shipping protections were strengthened in 2012 with additional restrictions put on foreign vessels operating between Australian ports.

Further reforms of government businesses

The NCP process supported reform of the governance and structure of government businesses to make them more commercially focused and to open them to competitive pressures. Structural separation has enabled competition to emerge in contestable segments of utility supply chains (for example, retail electricity markets). As identified below, the Commission’s recent work examining the performance of government-owned utility businesses suggests there is scope to undertake further reforms to improve service quality and reduce service costs.

The scope for particular competition reforms will vary across sectors and regions, and competition policy at the national level needs to be sufficiently flexible to accommodate these differences. In the urban water sector, for example, the largest

efficiency gains are likely to come initially from reforms relating to governance, regulation, competitive procurement of supply, and pricing reforms (PC 2011a). In the electricity sector, where there is greater private sector involvement and market reform is more advanced, further privatisation of government-owned businesses (such as state-owned network businesses) could result in efficiency gains (PC 2013c) (box 7).

The Commission has previously noted that if state and territory governments elect not to privatise electricity network businesses, they should refine the governance arrangements of those businesses to create, as much as is possible, the same incentives that exist for private businesses. Examples of measures that would promote more efficient outcomes include removing objectives currently given to network businesses that are non-commercial (or more appropriately allocated to other agencies) and making it clear that the board is expected to deliver a dividend payout and rate of return on the equity invested in the network business that would be considered acceptable by a commercial investor (PC 2013c).

Competitive neutrality

Where businesses remain under government ownership, competitive neutrality policy aims to promote efficient competition between public and private businesses. The Commission operates the Australian Government Competitive Neutrality Complaints Office (as provided for under its enabling Act), and through its experience in that role has identified several areas in which competitive neutrality policy could be improved, including:

- a revision and clarification of a number of policy elements, such as clearer guidelines on the application of competitive neutrality during the start-up stages of new government business enterprises
- a review by governments of their competitive neutrality policy statements
- a commitment by the Heads of Treasuries to produce their annual competitive neutrality matrix report within six months of the end of each financial year (box 8).

Box 7 **Privatisation of government-owned utilities**

Where the objective of reform is to achieve the most efficient management of assets, privatisation of utilities will often be the preferred policy option.

- For electricity network businesses, state-owned businesses, on average, have lower productivity than their private peers (PC 2013c). State-owned enterprises are also sometimes required to meet certain obligations — such as local content provisions or appeasement of sectional interests — that are antithetical to the interests of the consumers that they serve (PC 2013c, p. 270ff).
- There is evidence that in some sectors, such as airports, privatisation has been consistent with the objective of achieving more efficient investment (PC 2012b).
- All major utilities are already subject to sophisticated regulatory regimes designed to limit the misuse of market power. It is these regulations, not ownership that helps to protect end users from exploitation of market power.
- Privatised entities will generally have a greater incentive for good project selection and efficient delivery of infrastructure than government-owned businesses as they are subject to capital market disciplines (that is, they are exposed to the threat of takeover or market assessment of funds manager performance) and generally do not have a government guarantee (PC 2014b).

However, privatisation may need to be accompanied by complementary policies to ensure that outcomes are efficient and that certain community goals are met. These include:

- Structural separation of potentially contestable elements from natural monopoly network infrastructure (where justified by a comparison of costs and benefits). Where structural separation is not pursued prior to privatisation, there is a risk that a private provider will have an incentive to restrict access to network assets in order to protect other parts of their business. It has been argued that structural separation of Telstra would have led to a more competitive telecommunications industry (Sims 2013).
- The creation of a sound regulatory environment prior to privatisation, including third party access arrangements. Any major *ex post* changes in regulation may pass rents to the new owners (where economic regulation is subsequently weakened) or impose economic losses on buyers. Moreover, the absence of credible commitments by governments about key features of the future regulatory regime raises uncertainty for buyers, affecting sale prices. In its inquiry into electricity networks, the Commission argued that reforms to reliability standards and network planning should be implemented quickly to avoid these problems.
- Clearly-specified hardship policies and community service obligations, with the latter most desirably met through direct budgetary measures.
- A well-planned process for privatisation. There are many different pathways and timetables for privatisation.

Box 8 What should be done to improve competitive neutrality policy?

Competitive neutrality policy aims to promote efficient competition between public and private businesses. It seeks to ensure that government businesses do not enjoy competitive advantages over their competitors (actual or potential) simply by virtue of their public sector ownership.

The purpose of the policy, which stemmed from the 1995 Competition Principles Agreement, is to improve resource allocation. Policy requirements are set out in the Competitive Neutrality Policy Statement of 1996. Since that time, the policy has not been reviewed or updated.

The Productivity Commission, through the Australian Government Competitive Neutrality Complaints Office, is responsible for handling complaints that businesses owned by the Australian Government are not complying with competitive neutrality policy. Through this role, the Commission has identified several areas in which competitive neutrality policy could be improved to ensure better policy outcomes and more transparent compliance.

- A revision and clarification of a number of policy elements, including:
 - Clearer guidelines on the application of competitive neutrality during the start-up stages of new government business enterprises that are or will be engaged in significant business activities. This includes the extent to which competitive neutrality provisions should be included in business models and in initial planning.
 - A definition of the 'longer term' to which the policy applies. Of critical importance to the application of the policy is that government businesses should earn a commercial rate of return to justify the retention of assets in the business over the longer term. However, this term is not defined, nor is there guidance on its application to a start-up business.
 - The obligation of government to respond to the findings of policy breaches and recommendations. Currently there are no formal requirements and recent investigation reports (NBN Co and PETNET) have not had official responses.
 - Self-reporting requirements of government businesses or agencies conducting business activities. The policy should require self-reporting in annual reports of the steps taken to ensure compliance. This would both aid in the assessment of compliance and also provide some transparency to private sector competitors that the business is operating in line with government policy.
- A review by governments of their competitive neutrality policy statements to assess whether they are relevant and reflective of contemporary practice, and whether processes for handling competitive neutrality complaints are identifiable, independent and accessible.
- A commitment by the Heads of Treasuries to produce their annual competitive neutrality matrix report within six months of the end of each financial year.

4 Expansion of competition policy in human services

There is considerable interest in Australia and in other countries about the degree to which policies to increase competition should be employed in the human services sector. The Competition Policy Review Issues Paper highlights the need to examine the sector and the extent to which competition can promote the innovative, cost efficient and responsive delivery of human services to the community.

The heightened interest is driven in part by the large and growing amount of government expenditure in the sector, which suggests that even a small improvement in efficiency would make a large difference in government outlays and in the quantity and quality of services delivered for any given level of expenditure.

The existence of market failures in many aspects of markets for human services means that full competition will often not deliver efficient outcomes. For example, the public good nature of a healthy population means that, if based solely on their own preferences, individuals will tend to undervalue aspects of health care that generate benefits to the community as a whole. And, as discussed in section 1, inadequate information can mean that individuals will not always be able to make rational decisions about what health care services, or which providers, best serve their interests.

Further, while competition may deliver cost-effective outcomes, it does not guarantee the achievement of non-efficiency objectives such as equity of access to basic health services.

Governments have often pursued equity objectives in the human services sector through income transfers to certain community groups as well as through more direct involvement (PC 2005b). For example, key human services such as health and education have been traditionally provided under ‘administered market arrangements’ in which governments have a central role in determining what is provided, how much is provided (through a specific budget allocation) and who provides the service (public, private, and/or not for profit agencies).

A drawback of administered market arrangements is that they often fail to provide strong incentives for service providers to improve their efficiency and to deliver the levels and quality of service required by users. To provide stronger incentives for efficient delivery of human services, governments have, at times, empowered consumers through consumer directed care, opened areas of the sector to competition by multiple suppliers and introduced ‘market-based instruments’ within an administered framework.

Use of market-based instruments in the human services sector

Many areas of the human services sector involve an element of competition. These include private medical practice, services provided by allied and other health practitioners (such as physiotherapists, dentists and optometrists), private hospitals, private schools, non-TAFE registered training organisations and childcare.

More recently, market-based instruments have been introduced into a broader range of human services that have been largely funded and/or delivered by governments. These instruments help establish the basic conditions for competition to be effective, such as consumer choice and control, adequate information to support rational consumer choice, reduced barriers to entry by competing suppliers (while maintaining quality and safety) and more transparent and value-based pricing.

Some market-based instruments focus on creating better incentives for providers to improve their efficiency and to deliver the levels and quality of service required by users. These instruments include:

- ‘yard-stick’ competition, which involves benchmarking performance against other providers of the same service
- performance-based funding (such as casemix or activity based funding for hospitals, which aims to provide a financial incentive for service providers to reduce their costs for specific procedures) (box 9)
- competitive tendering and contracting out, including devolution of responsibility for providing the entire service under ‘purchaser-provider’ arrangements (for example, non-government agencies can compete for contracts to provide employment services to the unemployed).

Other market-based instruments seek to improve efficiency by sending signals to providers about the value that users place on the services concerned, or by sending signals to users about the costs of providing the service and enabling them to weigh up the costs (whether publicly funded or partly co-funded by users) against the value they receive from those services. Examples of these instruments include:

- giving users scope to choose the provider that offers services that best match the users’ requirements (for example, allowing recipients of disability or aged care services to choose their own provider) (box 10)
- requiring users to meet at least part of the cost of the services they receive (for example, co-payments for some health services, and fees for higher education courses and childcare).

Box 9 Activity based funding of public hospitals

Activity based funding (particularly for hospital services) benchmarks services according to their complexity, and assigns an 'efficient' price for each service. Hospitals benefit if they can deliver services for less than these prices, thus providing an incentive to improve efficiency. Activity based funding for public hospitals has been applied to acute admitted public patient services, non-admitted services and emergency department services under the National Health Reform Agreement.

Some estimates suggest significant benefits from these reforms. For activity based funding of public hospitals, the National Health and Hospitals Reform Commission estimated that annual savings could be in the order of \$400-\$900 million for acute public inpatient services and \$170-\$430 million for non-admitted public patient services.

However, there are difficulties in setting *ex ante* efficient prices, including the challenge each jurisdiction faces translating national prices into their own prices. This adds complexity to the model and inhibits cross-jurisdiction comparisons (Howes and Engele 2013). Howes and Engele consider that the gains from activity based funding are uncertain, and are likely to be much less than the National Health and Hospitals Reform Commission estimates suggest. With pure activity based funding, there is also a risk of 'cherry picking', where hospitals attempt to select the lower cost patients, leaving more complex and costly cases to other providers.

Source: PC (2013a).

Experience with market-based instruments in human services (and other sectors) in Australia suggests that such mechanisms often require refinement over time to promote improved outcomes. For example, initial attempts to apply market mechanisms to the provision of subsidised employment services in the late 1990s (through the Job Network purchaser-provider model) encountered several issues, including that many disadvantaged job seekers received little assistance. This limited assistance may have been in part due to deficiencies in the payment system for providers, which gave them an incentive to 'park' difficult-to-place job seekers (PC 2002). Since the introduction of Job Network, the Australian Government has introduced a number of changes to improve the cost effectiveness of its purchaser-provider model for employment services (now known as Job Services Australia), including amendments to fee structures.

It is also important to consider the capabilities of government departments responsible for stewardship of public service markets. For example, some government agencies may need time to develop their capabilities to design and steward systems that rely on independent service providers.

Box 10 Enhancing consumer choice: disability and aged care services

Institutional and administrative settings in human services that limit consumer choice and restrict supply can dampen approved service providers' incentives for efficiency and lead to poor outcomes for people using those services. In Australia, this problem has been particularly evident in areas such as disability support and the provision of aged care services.

The Commission's review of Australia's disability support services (2011c) proposed a range of measures to improve service delivery. A key reform proposal was a consumer choice approach aimed at empowering consumers by providing them with access to relevant information on services and flexibility in determining what services they received. Under the Commission's proposed National Disability Insurance Scheme, support packages would be tailored to an individual's needs. People could:

- choose their own provider(s)
- ask an intermediary to assemble the best package on their behalf
- cash out their funding allocation and direct the funding to areas of need (with appropriate probity controls and support)
- choose a combination of these options.

The rationales for a consumer choice approach were that people are able to determine their own needs better than others can, it can increase pressures on suppliers to perform, and people value choice in its own right and have an incentive to get the best value for money.

The Commission's *Caring for Older Australians* report (2011b) included several measures to empower consumers of aged care services, including allowing older Australians to:

- access a simplified 'gateway' for easily understood information on service availability, quality, price and entitlements to service subsidies
- choose whether to receive care at home and choose their approved provider
- choose whether to purchase additional services and higher quality accommodation.

The report also proposed removing restrictions on entry (other than to meet quality and safety standards) by providers, to improve competition, efficiency and the delivery of services sought by consumers. An additional pro-competitive reform proposal was to require transparency of pricing for accommodation, personal services and care.

Other measures for increasing economic efficiency in the human services sector

Given the complex nature of the human services sector and the important social objectives involved, a range of strategies is often required to deliver better outcomes for the community. In many cases competition-related reforms (such as the use of market-based instruments) will only be a small part of the overall policy package.

Other reform measures that can play a role in achieving better community outcomes include:

- governance and administrative reforms (improving internal management processes by clarifying responsibilities and desired outcomes)
- workplace and other regulatory reforms (promoting more flexible workplace arrangements to increase system responsiveness to client needs and to deliver services by those most cost-effectively trained to do so — safely and at the required quality standard)
- better coordination (in sectors as large, diverse and multi-jurisdictional as health and education, effective coordination between the different components of the overall service is essential) (PC 2005b) (box 11).

A word of caution

Introducing further competition reforms in the human services sector warrants particular caution for several reasons.

First, the adverse consequences of ‘getting it wrong’ in some human services can be significant. It is therefore vital that reforms do not aim to simply lower costs without due regard to any effect that they may have on other objectives, such as ensuring equity of access, quality and safety (box 12).

In some cases, governments may choose to mitigate market failures or address equity concerns associated with competition reform by introducing additional measures (such as improving arrangements for monitoring service quality and prices). However, it is important to recognise that these additional measures will have costs as well as benefits, and that there is a need to ensure administrative and compliance costs do not outweigh the anticipated efficiency, quality and other benefits of introducing more competition.

Second, arrangements for funding and delivering human services such as health and education are often highly complex, meaning that changes in one part of a system will often have effects elsewhere. These knock-on effects can be difficult to predict in advance. For example, government intervention at both federal and state/territory level in health systems is pervasive, there can be multiple and sometimes conflicting objectives, price signals are often muted, and consumers of health services face difficulties in making well-founded choices. Professional norms and regulation often play a role in treatment choices and the allocation of health care resources (PC 2013a).

Box 11 Examples of other reforms aimed at improving the efficiency of the human services sector

Re-examining workforce demarcations

As noted in the Productivity Commission's Health Workforce report (2005a), a re-examination of the scopes of practice of particular professions and the appropriate skills mix required for particular tasks, could yield productivity gains. For example, ensuring that workers that are appropriately (but not overly) skilled to perform medical tasks could free up valuable resources for use elsewhere in the health system.

There has been some reform of workforce demarcations, including under the auspices of Health Workforce Australia, and there appears scope for more. As previously noted by the Commission, the scope of practice change is an ongoing process that requires continued analysis of appropriate roles in line with changes in models of care, training and technology (PC 2013a).

Reducing regulatory impediments to labour mobility

Historically, multiple laws and regulatory regimes for health professions acted as an impediment to the mobility of workers and imposed administrative costs.

Following a recommendation by the Commission, the national system of registration and accreditation (which includes 14 health professions), replaced eight separate regulatory systems, 65 pieces of legislation, 85 health practitioner registration boards and 38 regulatory organisations with one nationally consistent law and one national registration agency.

In 2012, the Commission estimated that, by improving the mobility of workers, this reform should improve the productivity of the health sector and result in long-run savings of around \$160 million per year (PC 2012c).

Giving public providers greater autonomy

The Commission's study into the vocational education and training (VET) workforce (2011f) found that there had been a rising trend to harness market forces in the allocation of VET services, with principles such as user pays and user choice increasingly underpinning VET policy. The Commission suggested that, as the VET sector becomes increasingly competitive, a move towards greater managerial independence for public providers would give them the autonomy and flexibility they need to respond.

The Commission (2011f) also noted that opening up of the VET sector had not been a complete success, with some stakeholders raising concerns about quality assurance, monitoring and enforcement (especially in the international student sector).

Box 12 Competitive bidding for the supply of medical equipment in the United States

In the United States there has been ongoing debate about whether a transition to competitive bidding for durable medical equipment, prosthetics, orthotics, and supplies (which includes hospital beds, wheelchairs, and oxygen equipment) could result in reductions in service choice, access and quality. Some critics of the competitive bidding program have argued that the program's emphasis on price competition may result in unsustainable price reductions, eroding supplier competition based on quality service and equipment. Reduced competition in the quality of service and equipment, it is argued, could result in vulnerable people experiencing medical complications, increasing their use of hospital, emergency room, and physician care, and losing their ability to live independently (Dobson et al. 2010). It has also been suggested that the laws underpinning the competitive bidding program lack a clear methodology for evaluating and monitoring the quality and safety of clinical care and services bundled in with medical equipment (Goldstein 2014).

The agency responsible for administering the competitive bidding program has argued that there was no evidence of negative health care consequences to beneficiaries as a result of competitive bidding after the first year of implementation (CMS 2012).

There can also be incentives for cost-shifting between different parts of the broader health and social welfare systems (in part due to different governments having responsibility for different services). Accordingly, changing a policy to fix one problem in the health system will often risk creating problems elsewhere (Carrera and Laudicella 2014; PC 2013a).⁴

Third, there is still debate about the empirical evidence supporting competition in specific areas of human services. For example, Jensen (2013) suggests that at least 40 to 60 per cent of schools in Australia face no or very limited competition of the sort that will improve performance. Reasons given for this include that not enough schools:

- have competitors that are as high-performing
- have room for new students
- are affordable for enough families
- are physically close enough to provide the kind of competition that increases performance across systems.

⁴ For example, competition that delivers cost containment in one area might reduce the rent available to providers to cross-subsidise more expensive patients and, in doing so, undermine equity goals in providing care (Carrera and Laudicella 2014).

Despite the inevitable uncertainty about the precise effects of reform, or the transactions costs that accompany any reform program, these concerns should not be used as reasons to preclude competition-related initiatives without first undertaking proper analysis (PC 2005b).

Given the need to address the multitude of policy problems in the human services sector — such as rising costs or inefficiencies in service delivery — careful analysis, extensive consultation, and possibly controlled policy experimentation, should all be pursued (consistent with the principles of good regulatory process outlined in box 3).

A further important consideration is the choice of indicators for measuring the benefits of reform. If productivity is mismeasured, say because partial or potentially misleading indicators of productivity are used, there is a risk that policies based on such measures will not generate genuine gains for the community. In particular, worse outcomes could result from failing to consider quality and simply pursuing increases in quantity (using the same resources).

For example, if a general practitioner's productivity were judged solely on the number of patients seen per day, the practitioner could improve 'productivity' by reducing the average consulting time per patient. Such 'drive-through' servicing could reduce health outcomes by risking a less than appropriate examination of patients' individual needs. An apparent productivity improvement may have led to cost reductions (at least in the short term), but could worsen health outcomes and overall productivity (PC 2013a)

Given the above discussion, policy options for reducing the costs and/or improving the quality of human services need to be properly structured to deliver the desired outcomes. While opening markets to more competition has proven to produce efficiency gains, experience suggests caution needs to be exercised. Importantly, there are several other reform measures that can play a role in achieving better community outcomes including administrative, regulatory and workplace reforms.

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