

Mr GR Banks
Chairman
Productivity Commission
PO Box 80
Belconnen ACT 2616

11 July 2001

Dear Mr Banks,

Thank you for inviting Bill Sashegyi and I to present the views of the Chamber of Commerce and Industry of Western Australia (CCIWA) at the recent Perth hearing of your Inquiry into the National Access Regime. During that hearing we offered to provide additional information on two issues of concern to the Inquiry – the adoption of pricing principles, and the use of declaration holidays or other means to reflect the need to appropriately regulate prices without discouraging additional investment. Our response is outlined below.

Pricing Principles

CCIWA accepts the validity of the main criticisms of current pricing principles outlined in the Position Paper *Review of the National Access Regime* – that the existing guidelines are vague, potentially contradictory, inconsistent between industries and jurisdictions, and give no indication of the weight which should be given to different factors where they are incompatible or where some are clearly more relevant than others.

CCIWA also agrees that the vague and inconsistent nature of the guidelines contributes to investor uncertainty and undermines incentives to negotiate access and pricing arrangements. The frustrations which the current arrangements generate are highlighted in many of submissions reported in the Position Paper.

Yet there are dangers in an overly detailed, prescriptive approach to price regulation. The Position Paper's discussion of different price-setting approaches highlights the fact that multi-part pricing might either improve or reduce economic welfare, depending on market conditions. Even where efficiency could in theory be maximised if higher access fees are demanded of clients which most value access, this begs the question of who is to determine which clients should be charged relatively high fees, and how price differentiation in the name of efficiency is to be distinguished from differentiation which is no more than abuse of market power to extract monopoly rent, or to undermine the potential competitor of a vertically integrated infrastructure owner.

On a wider note, it has been hard enough to persuade the general public that it is sometimes appropriate to charge different prices to different types and locations of customers for similar services when the cost of supplying that service varies. Arguing that it is appropriate to charge different customers different prices when the cost of supplying them is similar may be harder still.

If price discrimination is perceived to be efficient but unfair, it may be hard to get the principle accepted in the political arena. This is probably why non-discrimination is specified as a pricing principle in some pricing regulations and advocated in some of the submissions received by the Commission. Further, in some cases, social and equity considerations might legitimately outweigh efficiency alone in the pricing of services¹.

Finally, price discrimination between customers whose cost of service is identical is only likely to be sustainable in a monopolistic and segregated market – otherwise, opportunities for arbitrage would attract competitors or lead to on-selling between customers. As CCIWA pointed out in its first submission to this Inquiry, if the opportunity and incentive for the denial of access exist then there are probably more fundamental problems with the market structure which are best addressed by means other than price or access regulation. The same is true of price discrimination.

So while CCIWA is sympathetic to the criticisms of the existing, somewhat vague and contradictory, specifications of the objectives of price regulation, we would not endorse the adoption of overly prescriptive rules determining price setting. The vagueness and apparent inconsistencies in the existing rules on price setting largely reflect the fact that no single, simple rule of thumb on pricing will be adequate to maximise welfare in all market situations.

However, CCIWA would support the consolidation of existing pricing guidelines into consistent rules and objectives applying in all contexts where similar access pricing issues arise, notably under part IIIa of the Trade Practices Act and in the gas, electricity and rail access regulations.

CCIWA also supports the inclusion of market efficiency as a key objective of pricing principles. This will require that price discrimination should be allowed on those occasions where it enhances efficiency, although on occasion efficiency might take second place to other objectives of the price regime. But multi-pricing should be seen as a means to an end applicable only in such situations, and not an objective in itself.

On a similar note, CCIWA shares the reservations expressed in the Discussion Paper concerning cost-based pricing. Marginal cost pricing is the efficient, welfare maximising and expected outcome in normal competitive markets. It is the appropriate objective of regulators in markets which are monopolistic for reasons other than the fact that the market is a ‘natural monopoly’ because a single supplier faces increasing returns.

But investors in industries facing decreasing average returns would face many years of losses before making a return on their investments under marginal cost pricing, and even then profits may only be possible because capacity constraints force up prices in a manner which the wider community might deem unacceptable². In such markets, marginal cost pricing would deter investment and should not be sought by regulators.

¹ Ramsey pricing, in particular, can be perceived as exploitative because it requires that the people who most want and need a service are charged most for it. So a Ramsey pricing telephone company might charge more for calls to emergency services than between households.

² Indeed, under current regulatory regimes, the sharp increase in prices as usage approaches capacity, which is necessary for costs to eventually be covered under such a scenario, would almost certainly be prohibited.

Risk Return, and New vs Established Assets

This in turn leads to the second issue on which CCIWA offered to provide additional information to the Commission – that of balancing the need to ensure that market players do not earn excessive monopoly profits while at the same time ensuring that returns are high enough to attract new entrants into the market and new investments from existing operators.

This issue was touched on in our original submission, which emphasised the very different risk profiles of investors in new infrastructure investment projects compared to purchasers of existing and proven infrastructure assets, and the higher risk of stranding in the purchase of infrastructure compared to other forms of assets.

In terms of key objectives, CCIWA agrees with the principles advocated in the Law Council’s submission, that access pricing:

- *must not create incentives to delay or accelerate investment in infrastructure;*
- *must reflect the level of risk associated with investment in infrastructure;*
- *should not create incentives for inefficient by-pass of natural monopolies; and*
- *should encourage efficient rate of use of facilities.*

It is vital that some mechanism (or mechanisms) be adopted which reflects the different risk associated with different forms of investment; and which permits, when appropriate, *ex post* rates of return which might appear quite high, in recognition of the *ex ante* uncertainty about whether the investment would be profitable at all. In particular, one member commented that the current spread of values for WACC is “woefully inadequate”.

Whether the mechanism adopted takes the form of the declaration “holiday” canvassed in the discussion paper, or another means such as relatively high declared prices, is less important than the principle that some mechanism be adopted.

CCIWA is not convinced that one model will necessarily be superior to others in all situations - different solutions might best suit different markets or types of infrastructure.

For this reason CCIWA would strongly support the adoption of broad objectives statements along the lines advocated by the Law Council, but does not support the adoption of a single mechanism as the only means of achieving those objectives. It would prefer that the mechanism be left open to be determined according to the circumstances of the infrastructure and market concerned.

I hope this addresses the concerns raised during the hearing.

Yours sincerely,

Nicky Cusworth
Chief Economist and Deputy Director of Policy