Legislation Review of Clause 6 of the Competition Principles Agreement and Part IIIA of the Trade Practice Act 1974

Further Submission to the Productivity Commission

Prepared on behalf of

Freight Australia

by

LECG Asia Pacific

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FREIGHT AUSTRALIA

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1 Introduction

1.1 Profile of Freight Australia

Freight Victoria Limited, trading as Freight Australia, is wholly owned by the US-based RailAmerica. Freight Australia purchased the business of the Victorian government-owned V/Line Freight Corporation on 1 May 1999 and took out a long term lease of the non-urban rail infrastructure as well as a major portion of the Dynon Container Terminal. The infrastructure lease is for an initial term of 15 years with options to renew for two further terms of 15 years each.

Freight Australia is an integrated track operator and rail freight service provider. As a track operator, Freight Australia provides access to its non-urban rail network to other train operators such as V/Line Passenger, West Coast Railway, Hoy's Coach Lines and Great Northern Rail Services. As a rail freight service provider, Freight Australia has successfully negotiated access on commercial terms with the Australian Rail Track Corporation (ARTC) and the Rail Access Corporation (RAC) in NSW.

Freight Australia is the single largest freight transport company in Victoria, hauling on average some 7 million tonnes of freight per year. Most of this tonnage is carried on rail but the company also spends about $22 million per year on road freight contracts. Many of these are very successful "intermodal partnerships", in which road operators bring consignments to a railhead for line haul by rail to the ultimate destination. Freight Australia therefore has an interest in both road and rail infrastructure.

1.2 Submission to the National Access Regime inquiry

The Law and Economics Consulting Group (LECG Asia Pacific) was commissioned by Freight Australia to prepare a submission that was lodged with the Productivity Commission ('the Commission') in December 2000. In that submission, we contended that:

- Part IIIA of the *Trade Practices Act* should only apply to truly essential facilities;
- the objectives of Part IIIA should be clarified to promote economic efficiency;
- regulators should be accountable for their decisions and should place greater weight on the guidance value of clear and robust pricing principles;
- pricing principles should allow facility owners to recover all opportunity costs – including the cost of investments that will, when made, become sunk – to encourage pricing innovations.

In March 2001, the Commission released a *Position Paper* setting out its initial thinking on a range of access issues. Consistent with the views expressed in our December 2000 submission, we support the Commission's proposals to:

- insert an objects clause in Part IIIA with regards to the efficient use of, and investment in, essential infrastructure facilities (Tier 1);

- incorporate a set of pricing principles in Part IIIA to make access determinations more 'predictable' (Tier 1); and
- amend and focus the declaration criteria in Part IIIA on the objective of promoting overall economic efficiency (Tier 2).

This further submission prepared on behalf of Freight Australia – is a response to the Commission's call for further information and comment on the matters raised in its *Position Paper*. In particular, we have focused on two of the Tier 1 proposals for improving the operation of the National Access Regime, *viz.*

- the requirement placed on a service provider to give *sufficient information* to an access seeker to ensure that the parties can negotiate effectively (Proposal 6.3 of the *Position Paper*).
- the incorporation of a set of *pricing principles* in Part IIIA to provide greater certainty to all parties and to facilitate a speedier resolution of access disputes (Proposal 8.1 of the *Position Paper*).

2 Information Disclosure Rules

The Commission is of the view that "negotiation between access seekers and providers can be affected by the imbalance of information available to the parties" (p. 153) and that "mandatory disclosure rules … would be a reasonable means to help address information asymmetries and expedite access negotiation" (*Position Paper*, p. 154). The Commission proposes that

> *Part IIIA should require the provider of a declared service to give sufficient information to an access seeker to enable the access seeker to engage in effective negotiation.* (Proposal 6.3)

In principle, we agree that information asymmetries can and do affect the way parties negotiate and there is a role for legal rules to influence how the parties share information with one another. That said, we submit that any legal rules governing the disclosure of information should enhance allocative efficiency rather than redistribute bargaining power *per se*.

2.1 Information asymmetry, bargaining power and effective negotiation

Casual empiricism suggests that parties do enter into access contracts without necessarily being equally informed on all the matters that are the subject of contract negotiations. As an access seeker, Freight Australia itself has successfully negotiated access contracts with the ARTC and RAC in NSW. In both cases, there was an agreed exchange of information between the contracting parties.

In a sense, information asymmetry is a 'natural state' in a world of positive transaction costs. The condition of information asymmetry – and its association with a real or contrived imbalance in bargaining strength – is less of a problem for effective

negotiation than is opportunism, i.e. the calculated actions of one party to conceal or withhold information to frustrate negotiations.

A regulatory focus on imbalanced bargaining is a misplaced one and it has more to do with the redistribution of economic surpluses between the parties to the bargain than with effective negotiation or the efficiency of the bargain.[1] An access seeker who becomes better informed, by virtue of a mandatory information disclosure rule, will be undoubtedly more able to negotiate effectively to improve 'his or her side of the bargain.' But if this is achieved at the expense of the access provider, then the information disclosure rule has merely redistributed the gains from the trade without necessarily improving the efficiency of contracting.

In our view, the real issue of concern in an access regime is not whether one or the other negotiating party should be made more informed to improve his or her bargaining position, but whether both parties are able to negotiate in 'good faith' given the information they hold or otherwise acquired through legitimate means.

This distinction is an important one: a legal rule which mandates disclosure to strengthen the bargaining position of a less-informed party is tantamount to a 'nirvana fallacy'[2], whereas a legal rule which helps induce the giving or making of credible commitments is more likely to facilitate effective negotiation.

2.2 Voluntary disclosure

It should be noted that negotiation is a form of 'repeated game' in which parties can be reasonably expected to form beliefs or draw inferences from the offers or counter-offers made in previous rounds of the 'game'.[3] In such a repeated game, information is continuously discovered and transmitted even if the parties were to have commenced negotiations with unequal information. The source or accuracy of a party's beliefs is irrelevant, what matters is that these beliefs are held by that party.

For a vertically integrated facility operator – such as Freight Australia – the provision of access is another 'line of business.' A profit-maximising access provider is likely to disclose relevant information to secure an access contract, rather than be subject to the inferences that arise from a failure to disclose that information when s/he can do so. The incentive for voluntary disclosure is strengthened:

- by the presence of pricing principles which allow the access provider to at least recover the incremental costs of access; and

[1] As noted in our first submission, if one-sided bargains are a cause of concern, they can and should be dealt under the common law doctrine of unconscionability.

[2] H. Demsetz's (1969), "Information and Efficiency: Another Viewpoint" *Journal of Law and Economics*, 12 (April), pp. 1 – 22 introduced the term 'nirvana fallacy' into the economic literature. We use the term here to refer to misguided attempts to modify existing (and 'real') institutional arrangements to fit an idealised world that have no constraints on the cognitive competence of economic agents.

[3] It should also be noted that counter-offers made by seekers are likely to be based on information that is not available to the provider.

- if the access provider believes that a privately negotiated access price is likely to be higher than an arbitrated price.

In our view, a mandatory requirement to disclose information makes sense only if a regulator is able to determine – *after the fact* – what the access provider knew (but did not disclose) at the time of contracting. Once it is known that a regulator can do this, it is difficult to envisage why voluntary disclosure would not occur even without a mandatory information disclosure rule. We also note, with some irony, that voluntary disclosure may be incomplete or does not occur (and is thereby mistaken as an imbalanced bargaining problem) when an access seeker is unable to draw inferences due to plain ignorance.

2.3 Design principles for information disclosure rules

As stated earlier, we agree in principle with the Commission's view that there is a role for mandatory disclosure rules in encouraging and facilitating private negotiations. However, to the extent that disclosure rules are needed to redress bargaining imbalances, we would argue that such rules should only be mandated for efficiency purposes. To enhance efficiency, mandatory disclosure rules should be:

- limited to information that is verifiable ('design principle 1');
- confined to information that would be generated and kept by an access provider in the course of its business ('design principle 2');
- 'two-sided' rules – that is, they should induce the access provider to disclose relevant information *as much as* the access seeker to acquire relevant information. ('design principle 3').

Legal rules that require disclosure of information must confine itself to verifiable information *and* limited to cases in which a regulator can determine whether the access provider possesses the relevant information. This is because the access provider cannot be sanctioned for breaching a rule to disclose information if a court has no way of determining whether the provider possesses the information in the first place.

'Design principle 2' – which confines the disclosure rule to information generated in the course of an access provider's business – will help to ensure that compliance costs are kept to a minimum. It may also help to avoid an unintended consequence – such as the one that has been observed with regards to disclosure of product safety information in the US. Given the costs involved, some US manufacturers chose not to collect or generate the relevant safety information since they were not obliged to reveal information that they don't have.

In these regards, we agree in part with BHP's submission (sub. 48, p. 3) that facility owners "should be obliged to maintain regulatory accounts (which) … should be standardised, audited and consistent". We would add that the information bases for such accounts should extend no further than the financial and accounting data kept and generated by the facility owner in the ordinary course of running the access 'line of business.'

‘Design principle 3’ recognises that the mere existence of mandatory disclosure rules can affect whether a party (such as an access seeker) decides to become informed or better informed in the first place. In our view, a one-sided disclosure rule not only relieves an access seeker of the cost of acquiring private information, it also relieves the seeker of any obligation to submit meaningful access requests. All other things being equal, a one-sided rule is at best Pareto-neutral and at worst Pareto-inefficient.

In a negotiate-arbitrate regime *without* mandatory disclosure rules, the information costs are primarily those relating to information acquisition incurred by the seeker (say, S_a) and information-keeping incurred by the provider (say, P_k).

In a regime *with mandatory but one-sided disclosure rule*, the information costs incurred by the seeker is at most S_a. This is because the seeker is unlikely to acquire any more information in a regime which places an obligation on the provider to disclose relevant information. On the other hand, the information costs incurred by the provider is likely to be an amount (strictly) greater than P_k because of the additional (and positive) costs of generating the information that is required to be disclosed under the legal rule. Furthermore, there are likely to be regulatory costs (say, C_r) associated with the costs incurred by the regulator in monitoring and verifying the information disclosed by the provider.

From a comparative institutional perspective, the one-sided rule is unambiguously inefficient if $(P_k + C_r) > S_a$. If $(P_k + C_r) < S_a$, the one-sided rule has a neutral effect on efficiency but it will have also shifted the information cost burden from the access seeker to the access provider and the regulator.[4]

Aside from the efficiency implications, we contend that a two-sided disclosure rule is also likely to ‘perform better’ in terms of encouraging and facilitating private negotiations. While we do not dispute that the “service provider will have a greater appreciation of … cost and price structures of the services …, their technical operation, the degree of spare capacity and the scope for capacity augmentation” (*Position Paper*, p. 153-4); we would argue that access seekers are likely to have an equally good appreciation of their technical operations and cost structures as well as the degree of capacity they require from the essential infrastructure to deliver services profitably to the markets they intend to serve.

Just as access seekers are frustrated by an access provider who withholds relevant information, an access provider may and can be equally frustrated by access seekers with ambiguous or ill-specified access requests. An access provider is not likely to be able to offer credible terms and conditions without knowing the commerciality or technical feasibility of the access request. On the other side of the market, access seekers are not likely to be able to assess their ‘business case’ in the absence of genuine offers from a provider.

[4] As a technical aside, these conclusions hold even under the ‘strong’ assumption that the private information acquired by an access seeker has no social value.

The 'best' response to pre-contractual opportunism (in the context of access negotiation) is to devise a set of rules that places mutual obligations on the parties to reveal information to support and reinforce the conduct of private negotiations.

2.4 Specific comments on the concept of 'sufficient information'

The disclosure rule proposed by the Commission turns on the concept of 'sufficient information'. We offer the following comments as a response to the Commission's specific request for information on this matter.

We submit that a legal rule which relies on a concept of 'sufficient information' is fraught with difficulties.

If that concept is meant to refer to the 'quantum of information', the question of whether or not the level of information provided is sufficient would depend on a range of factors specific to the access arrangements sought by the seeker. For example, the level of information disclosed by a provider may be 'sufficient' for a seeker requesting access to a 'plain vanilla' service, but that same level of information may be inadequate for another seeker with more complex access requirements.

If, on the other hand, the concept is taken to refer to 'types of information', the question of sufficiency would then turn on the ability of an access seeker to interpret and apply the disclosed information to decision-making. For example, disclosure of information of a particular type may be sufficient for a seeker who had – prior to making the access request – acquired some 'market intelligence'. Where the same type of information is disclosed to a less-prepared seeker, the information may be considered insufficient for decision-making purposes. An ill-prepared or poorly informed access seeker who does not expend resources to acquire private information prior to seeking access is likely to require more information relative to one that does.

In our view, the concept of 'sufficient information' is only meaningful in the context of decision-making. That is, the level and type information that is required to be disclosed by the access provider would be considered 'sufficient' if an access seeker (who is reasonably informed *a priori*) can – on the basis of this information – decide to accept or reject the access terms and conditions offered by the provider.

That said, it is not clear to us how this concept could be implemented with any degree of precision.[5] Even if 'sufficient information' can be defined precisely, it is not likely to have the intended effect of encouraging private negotiation so long as access seekers have incentives to "eschew negotiation and move quickly to arbitration" (*Position Paper,* p. 150) in expectation of a more favourable outcome. If 'sufficient information' is defined too broadly, it will lead to more protracted access negotiations

[5] The rail access regime in Victoria relies on the concept of "access seeker information", defined as "information … that, in the opinion of the Office [of the Regulator-General], is necessary to enable a person to make an informed decision about whether to seek access to the (declared) service" (*Rail Transport Act 1996*, s.38DA(a)(i)). It is arguable whether this definitional approach contributes to a more precise implementation of disclosure rules. For a regulator to be able to form an "opinion" on the information that is required by any particular access seeker to make an informed decision, the regulator needs to have the same prior knowledge and decision making framework as the access seeker.

with disputes occurring not only over access terms and conditions but also over the adequacy or otherwise of the information provided by the facility owner.

We believe that a better approach would be to design the disclosure rules with reference to the set of 'information principles' suggested in section 2.3 above.

3 Pricing Principles

3.1 Should pricing principles be enshrined in legislation?

We broadly agree with the Commission's proposal to include a set of pricing principles in Part IIIA of the *Trade Practices Act*. That said, we also consider that doing so entails some risks which need to be managed carefully.

Generally speaking, having a clear set of pricing principles tends to increase the predictability of private as well as regulatory actions. In the case of a negotiate-arbitrate access regime, a common set of pricing principles could narrow the differences in the parties' expectations about possible pricing outcomes. This would save some transaction costs incurred by the parties in trying to guess each other's bargaining positions, thereby facilitating private negotiations.

Secondly, a set of pricing principles could speed up the arbitration process, provide discipline on the regulator, and reduce uncertainty to the parties. In a negotiate-arbitrate model, if the parties fail to reach an agreement, the regulator would step in to resolve the dispute through arbitration. A clear set of pricing principles would provide guidance to the regulator in setting prices thereby speeding up the arbitration process. As the regulator is obliged to determine prices in accordance with the 'rules' laid down by legislation, a legislated set of principles serves to limit the discretion of the regulators, providing increased certainty to the parties. In a sense, the pricing principles can be interpreted as a commitment by the regulator to regulate and/or arbitrate on a 'no-surprise' basis. This commitment would increase regulatory transparency, and help the parties make more informed decisions about whether or not to resolve their differences through arbitration.

We note that there are also risks associated with including pricing principles in legislation. A main risk has to do with the role of Part IIIA. Given that Part IIIA is intended to "provide a framework and guiding principles for industry-specific access regimes" (Proposal 5.1 Tier 1), the pricing principles would need to be applicable to a wide range of industries and relatively stable over time. This implies that the cost of error could be high, and any error would take considerable time to rectify.

Another risk is that the inclusion of pricing principles in legislation might be perceived as a regulatory tightening, which could in turn reduce the parties' incentives to reach agreements through private negotiation. It has been argued that the "very existence of (a negotiate-arbitrate model) appears to reduce incentives for commercial negotiation"[6]. There is a possibility that legislated pricing principles could be seen as a signal of heavy-handed regulation. If this were to be the case, the parties'

[6] ACCC submission to the Commission (sub. 25).

expectations about the regulatory solution would change. In particular, the access seeker might perceive a more favourable outcome from the regulator, and accordingly would be more willing to resort to the regulatory process to resolve disputes.

In summary, we consider that a legislated set of pricing principles has the potential to produce significant benefits, so long as the associated risks are managed carefully. Obviously whether the inclusion of pricing principles in legislation would actually confer net benefits depends on the form of the principles as well as the other features of the access regime, especially the criteria used to assess whether a particular service should be subject to the access regime.

Our analysis in this section is based on the assumption that the other features of the regime are well designed, and in particular the access regime and pricing principles will only apply to access services provided by a natural monopoly whose market power is not effectively constrained by existing or potential competition in the market for the services, nor in downstream markets. Given this assumption, we are of the view that for the pricing principles to generate a net social gain, they:

- should promote the objectives of Part IIIA;
- are robust across industries and over time; and
- can be applied practically and easily.

These attributes are discussed further in the following section.

3.2 Attributes of the pricing principles

Promote the objectives of Part IIIA

If the pricing principles were to be included in Part IIIA, they would become an integral part of the National Access Regime that, among other things, grants third party access rights to services supplied by essential facilities and creates an avenue for disputes to be arbitrated when negotiations fail. A important role of the pricing principles would be to provide guidance to access seekers, access providers and regulators, so that access to essential facilities could be granted more expeditiously, either through private negotiation or arbitration. As a part of the Part IIIA mechanism, it is important that the pricing principles should promote the objectives of Part IIIA.

At present, Part IIIA does not have a statement of objectives, but the objectives can be reasonably inferred. Given that the ultimate objective of any economic regulation is to promote overall welfare, and given that Part IIIA is a mechanism designed to facilitate access to services supplied by essential facilities, it is reasonable to infer that the purpose of Part IIIA is to promote overall welfare with respect to essential facilities. Since welfare maximisation is associated with Pareto efficiency under general conditions, the purpose of Part IIIA can be interpreted as promoting efficiency with respect to the use of and investment in essential facilities.

To the extent that Part IIIA serves as an overarching framework for regulating essential facilities, it would be logical to expect that an important objective of Part IIIA is to provide a general framework for access regulations at the industry level.

Thus we agree in principle with the Commission's proposed objects clause for Part IIIA, namely,

> *'The objective of this Part (IIIA) is to:*
> *(a) enhance overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure services; and*
> *(b) provide a framework and guiding principles for industry-specific access regimes'. (p. 102)*

It follows that for the pricing principles to promote the objectives of Part IIIA, they need to be efficiency enhancing, and sufficiently robust in terms of their application in industry specific access regimes.

Robust pricing principles

Consistent with the objectives of Part IIIA proposed by the Commission, the pricing principles would serve as guiding principles for access pricing issues in industry-specific regimes. It is therefore necessary that the pricing principles are generally applicable across a wide range of industries. This attribute would promote the second objective of Part IIIA, and encourage a consistent approach to access pricing across all industries subject to Part IIIA.

It is also important that the pricing principles remain robust over time. A stable set of pricing principles would reduce uncertainty, and increase industry confidence in the access framework.

A decision to enshrine a set of pricing principles in legislation can be seen as a credible commitment by government that the pricing principles are intended to be stable over time. The credibility of the commitment lies in the fact that once the principles are enshrined in legislation, modifications would be costly and time-consuming. As this commitment reduces the scope to "fine-tune" the pricing principles, it is all the more important that the initial choice of principles can withstand the test of time.

Practical pricing principles

For the pricing principles to be effective, they need to be practical to implement. The three key elements of implementation are: monitoring, verification and enforcement.

Firstly, the compliance of negotiated, determined or arbitrated access prices with the pricing principles needs to be easy to monitor. That is, they should provide sufficient guidance to access seekers and access providers so that they can make a reasonable judgement, on the basis of the information they ordinarily have, as to whether a certain price is consistent with the pricing principles. In this regard, compliance with a cost-based principle – especially one that refers to 'efficient' costs – is likely to be difficult to monitor in the absence of detailed and reliable information. Typically access seekers and providers (as well as the regulator) would have different

information sets, with some overlaps. It is desirable therefore that applications of the principles have low information requirements, and ideally the required information would be those that are commonly shared by the access seeker, the access provider, and the regulator.

Secondly, applications of the pricing principles need to be verifiable. If there is an access pricing dispute, the regulator should be able to determine whether the offer price satisfies the relevant pricing principle. Since the regulator tends to have less information than the parties, verification of the pricing principles should have low information requirements. In addition, the pricing principles should be designed in such a way that the burden of proof falls on the party who has the relevant information and an incentive to reveal the information to the regulator.

Finally, compliance with the pricing principles needs to be easy to enforce. Effective enforcement depends on a number factors such as the clarity of the decision to be enforced, the authority and the performance of the enforcement agency. The design of the pricing principles can assist enforcement by increasing the clarity of the principles, so as to minimise ambiguity in arbitration decisions.

3.3 Pricing rules

As discussed earlier, consistent with the objectives of Part IIIA, the pricing principles should be efficiency-enhancing and sufficiently robust across industry-specific access regimes. Since industries differ in many respects – for instance, pricing structure conventions, nature and characteristics of the access services, information availability – the pricing rules in an industry specific regime may need to reflect the prevailing production technology or supply conditions in that industry. Moreover, facility operators in the industry are in a better position to acquire the knowledge and experience to develop innovative pricing rules over time. Thus we are of the view that the pricing principles should be sufficiently generic to accommodate a range of pricing rules – so long as the rules are demonstrably efficiency enhancing and can be implemented in practice. The following is a (non-exhaustive) list of the generally accepted pricing rules:

- pricing between long-run average incremental cost and stand-alone cost.
- the Efficient Component Pricing Rule (ECPR).
- Ramsey pricing.
- two-part pricing.

We briefly discuss these rules in turn.

Pricing between long-run incremental cost and stand-alone cost

In theory prices should be set at short run marginal costs in order to maximise allocative efficiency, all other things being equal. However in practice, such a pricing rule often does not provide sufficient revenue to cover the total cost of production in industries with high fixed costs (which is characteristic of the industries subject to Part IIIA). To preserve the incentive to maintain and invest in essential facilities, it is

necessary that the facility owner to be allowed to recover sufficient revenue to cover its total costs.

The lowest (linear) price that allows the recovery of total cost is a price that equals to the average costs of the firm. However, if the firm produces multiple products, the average cost of the firm is not well defined. It has been shown that, under conditions of perfect contestability, the price of a product will lie somewhere between its incremental costs and its stand-alone cost, just where it falls in that range depends on the state of demand.[7] For this reason, it would be reasonable for the price of access (which is one of the bundle of services provided by an access provider) to be somewhere above long-run average incremental costs and below stand-alone cost.[8]

The ECPR

According to the efficient component pricing rule (ECPR):

> *Efficient component (input) price = the input's direct incremental cost + the opportunity cost to the supplying firm of the sale of the input.*

The opportunity cost refers to all potential earnings the supplying firm forgoes by selling the product to the market, and equals the market price for the output less the incremental cost of making the output.[9] The ECPR ensures that only firms (access seeker) that are more efficient in the downstream market than the incumbent (vertically integrated access provider) can profitably enter the market. This property promotes productive efficiency in the market. An ECPR price also coincides with the price that an access provider charges its own downstream operations under some conditions, and therefore is non-discriminatory and encourages competition in downstream markets.[10]

Ramsey pricing

Ramsey pricing is a linear pricing method that enables a multi-product firm or a firm selling in multiple markets to fully recover its fixed or common costs in a way that is least distortionary to consumer decisions. The Ramsey pricing rule is commonly expressed as an inverse-elasticity formula according to which the percentage difference between price and marginal costs of a product should be inversely proportional to the price elasticity of demand for the product. That is, a product with low demand elasticity should have a higher mark-up than a product with high demand elasticity.

In practice, the usefulness of the Ramsey pricing rule is somewhat limited because precise calculation of Ramsey prices requires demand information that is unlikely to be readily available.

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[7] W. Baumol, J. Panzar and R. Willig (1988) *Contestable markets and the theory of industry structure*, revised edition, New York: Harcourt Brace Jovanovich.

[8] For instance, both New South Wales and Western Australia adopt this price floor/ceiling approach in their state rail access regimes.

[9] Sidak and Spulber (1998), *Deregulatory Takings and the Regulatory Contract,* Cambridge: Cambridge University Press.

[10] Laffont, J.J. and Tirole, J. 2000, *Competition in Telecommunications*, Munich Lectures in Economics, MIT Press, Cambridge, Massachusetts.

Two-part pricing

Two-part pricing is the simplest form of non-linear pricing that allows the firm to raise sufficient revenue to cover total costs of production. A two-part price consists a fixed entry fee and a marginal price. If the fixed entry fee does not exclude any customers from the market, two-part pricing can generate a higher social welfare than the Ramsey pricing rule.

Choice of pricing rules

In order to provide guidance for the choice of specific pricing rules, it would be useful for the pricing principles to clearly specify the purpose and the functions of the pricing rules to be chosen. A clear statement of purpose and functions would promote consistency and flexibility in the choice of pricing rules. Different pricing rules may be chosen to cater for different industry circumstances, but all pricing rules chosen would be expected to be consistent with the purpose of the pricing principles and perform similar functions intended by the legislation.

As discussed earlier, the purpose of the pricing principles should be the same as the purpose of Part IIIA, namely, to promote efficient use of, and investment in essential facilities; and to provide the necessary guidelines for dealing with access pricing issues in industry-specific access regimes.

Consistent with the objectives of the pricing principles, the functions of the chosen pricing rules should:

- allow the access provider to fully recover the long run cost of providing access services, including a normal risk-adjusted return on assets used in providing the services;
- prevent anti-competitive behaviour (eg., charging high prices to disadvantage rivals in downstream markets);
- encourage innovations in pricing structures that are efficiency enhancing (eg., multi-part pricing).

3.4 Comments on the pricing principles proposed by the Commission

The Commission proposes the following pricing principles:

> *Proposal 8.1 (Tier 1): The pricing principles in Part IIIA should specify that access prices should:*
>
> - *generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved* ('pricing principle 1');
> - *not be so far above costs as to detract significantly from efficient use of services and investment in related markets* ('pricing principle 2');
> - *encourage multi-part tariffs and allow price discrimination when it aids efficiency* ('pricing principle 3); *and*

- *not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher* (pricing principle 4).

Judging by the desired attributes (viz., efficiency-enhancing, generality, robustness and practicality), the proposed pricing principles appear to be broadly consistent with the efficiency enhancing objective of Part IIIA in that they preserve investment incentives by allowing access prices to fully recover the long run cost of providing the services (‘pricing principle 1’). The proposed principles also appear to meet with the criteria of robustness and generality, although ‘pricing principle 3’ may be overly specific as to limit the use of other forms of innovative pricing rules in the future. In terms of practicality, we submit that the vagueness of ‘pricing principle 2’ makes it difficult to monitor, verify and enforce. Judging by the form, ‘pricing principles 1 and 2’ set out the intended functions of the pricing rules and they both appear to be at the right level of generality.

Specifically, the ‘pricing principle 1’ allows the access provider to fully recover the long run cost of providing access services; ‘pricing principle 3’ gives examples of pricing innovations that are to be encouraged, and ‘pricing principle 4’ prohibits a form of anti-competitive behavior. However, the set of pricing principles do not have a statement of purpose, and we are of the view that ‘pricing principles 3 and 4’ may be worded in more general terms.

In summary, we broadly agree with the set of pricing principles proposed by the Commission, but we believe it could be improved further. In particular, we suggest:

- the insertion of a clear statement of purpose;
- deletion of ‘pricing principle 2’;
- a re-wording of ‘pricing principle 3’ to encourage other forms of efficiency enhancing pricing rules; and
- a re-drafting of ‘pricing principle 4’ in more general terms to prevent other forms of anti-competitive pricing.

Our reasoning for deleting ‘pricing principle 2’ is set out below.

It may appear that with the deletion of ‘pricing principle 2’, there would be no constraint on an access provider’s ability to charge high access prices. In our view, the market power of the access provider will be constrained – to some extent – by ‘pricing principle 4’ which prohibits a form of anti-competitive pricing. In any case, we do not see any benefit in retaining ‘pricing principle 2’ as it is too imprecise to provide an effective constraint in practice.

If ‘pricing principle 2’ were to be made more precise, it would likely leave us with a specific cost-based pricing rule with intensive information requirements for implementation. Given the information limitations faced by a regulator, there is a high risk of regulatory error. The (potential) cost of these regulatory errors, together with

the cost of reduced incentives to lower costs, are likely to outweigh any efficiency gains from enforcing a strictly cost-based pricing rule.

While there may be some allocative efficiency losses – due to the potential abuse of market power by a less than fully price constrained access provider – our 'comparative institutional' analysis suggests that these losses are less than those that would likely be incurred if we adopt an incentive-incompatible cost-based pricing rule with a high margin for regulatory errors. On balance, we suggest the deletion of 'pricing principle 2'.

A modified set of pricing principles which incorporates our suggestions would read as follows:

> *The purpose of the pricing principles in Part IIIA is to promote efficient use of, and investment in essential facilities, and to provide guidance for access pricing issues in industry-specific access regimes.*
>
> *The pricing principles are that access prices should*
> - *generate sufficient revenue to cover the efficient long-run costs of providing access to these services, including a risk-adjusted return on assets used in providing the services;*
> - *prevent anti-competitive pricing such as discriminatory pricing by vertically integrated access provider in favor of its own downstream operations, unless the cost of providing access to other operators is higher.*
> - *encourage pricing innovations (such as multi-part tariffs and Ramsey pricing) that are efficiency enhancing.*

4 Summary and Concluding Remarks

The Commission has put forward a number of proposals for improving the operation of Part IIIA. Our submission focuses on two of the Tier 1 proposals – namely, *information disclosure rules* and *pricing principles* – to assist the Commission in its further consideration of the relevant issues.

Information asymmetry – which we contend is a 'natural' condition in a world of positive transaction costs – can and do affect the way parties negotiate access to essential facilities. Disclosure rules can facilitate and encourage private negotiation by influencing how information gets revealed, transmitted and shared between the parties. We submit that such rules should be for the purpose of enhancing allocative efficiency and not redistributing the balance of bargaining power *per se*.

Parties can form beliefs or draw inferences from the offers and counter-offers made in the course of negotiation. This process of self-discovery and voluntary transmittal has an incentive effect. A profit-maximising access provider will want to disclose relevant information to secure an access contract, rather than be the subject of unwarranted inferences that could arise from not disclosing that information. The incentive for voluntary disclosure is strengthened:

- by the presence of pricing principles which allow the access provider to at least recover the incremental costs of access; and
- if the access provider believes that a privately negotiated access price is likely to be higher than an arbitrated price.

We are of the view that a mandatory disclosure rule which relies on the concept of 'sufficient information' – such as the one proposed by the Commission – is fraught with difficulties. A better approach would be to construct the disclosure rules with reference to a set of 'information principles'. We submit that mandatory disclosure rules should be:

- limited to information that is verifiable;
- confined to information that would be generated and kept by an access provider in the course of its business;
- 'two-sided' rules – that is, they should induce the access provider to disclose relevant information *as much as* the access seeker to acquire relevant information.

Consistent with the views in our first submission lodged in December 2000, we support the Commission's proposal to incorporate a set of pricing principles into Part IIIA. A legislated set of pricing principles will make regulatory decisions more predictable, lower the transaction costs of private negotiations and improve the discipline on regulatory action. These potential gains in efficiency are likely to be realised so long as the associated risks of legislative errors and misperceptions of heavy-handed regulation are managed carefully.

The pricing principles that are to be incorporated into Part IIIA should promote the objectives of Part IIIA *inter alia* the efficient use of, and investment in essential facilities. These principles should be robust across industries and over time, and are practical for ease of implementation. The principles should be specified in a form that is sufficiently generic to allow different pricing rules, and at the same time able to provide guidance on the purpose and function of the particular pricing rules used in industry-specific regimes.

We believe that the pricing principles proposed by the Commission could be improved further by adding a clear statement of purpose to the Commission's list of principles, and by re-wording the relevant principles in that list to encourage other forms of efficiency enhancing pricing rules as well as to prevent other forms of anti-competitive pricing.