A REVIEW OF THE LAW COUNCIL OF AUSTRALIA'S SUBMISSION TO THE PRODUCTIVITY COMMISSION ON PART IIIA OF THE TPA

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1. Introduction

The Law Council of Australia (LCA), in its Submission (henceforth: LCA Submission) to the Productivity Commission on Part IIIA of the Trade Practices Act (TPA) starts off with some appropriate premises but its conclusions are fatally distorted by a flawed understanding of the economics underlying Part IIIA and even of the meaning of its provisions. These flaws can be attributed in part to a triumph of formalism over pragmatism in the LCA's interpretation of Part IIIA and in part to a simple misunderstanding of the architecture of Part IIIA and a failure to appreciate the context behind some of its key concepts.

The flaws in the LCA's analysis are evident from an examination of the conclusions it reaches regarding Part IIIA:

i) The LCA argues that Part IIIA is over-inclusive because it applies to entities that are not vertically integrated[1], yet economic theory and practical wisdom suggest that it is undesirable to confine the scope of the regime to vertically separate entities (see **Section 2**);

ii) The LCA argues that Part IIIA should be solely concerned with access provision[2] and also suggests that any provisions in Part IIIA which could be used to address the issue of monopoly rent-taking by entities under its purview are inappropriate[3]. In other words, the LCA argues that the issue of access provision can and should be dealt with separately from the issue of monopoly rents. However, in many cases, the problem of monopoly rents is inseparable and indistinguishable from the problem of access provision (see **Section 3**);

iii) The LCA argues that Part IIIA is inappropriately wide in its scope because it allegedly catches activities which fall short of being natural monopolies[4], and later goes on to criticise the 'uneconomical to duplicate' criteria[5]. The LCA fails to recognise that this criteria provides a pragmatic and non-technical test for 'bottleneck' problems that a 'natural monopoly' test would struggle to provide (see **Section 4**);

iv) Finally, the LCA argues that that the 'promotion of competition' test gives Part IIIA over-inclusive coverage and that the criterion should be amended to become a 'substantial promotion of competition test'[6]. In fact, the LCA fails to acknowledge that the competition test under Part IIIA already poses a significant hurdle, comparable in many respects to the substantial lessening of competition test under Part IV. To introduce a 'substantiality' element into the promotion of competition test, as suggested by the LCA, would thus introduce an inappropriately high threshold for allowable intervention on the Part IIIA access regime (see **Section 5**).

2. Vertical integration

In its Executive Summary, the LCA Submission argues that,

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1 LCA Submission, p. 6-7.
2 LCA Submission, p. 8.
3 LCA Submission, p. 8.
4 LCA Submission, p. 5.
5 LCA Submission, p. 14.
6 LCA Submission, p. 12.

> '... in accordance with generally accepted economic theory, the Hilmer Committee noted that vertically integrated natural monopolies have an incentive to deny access. Part IIIA goes beyond this. It ... applies even though the facility owner is not vertically integrated.' (p. 2)

The LCA goes on to cite the Hilmer Report's recognition that where the monopoly owner is not vertically integrated, it *may* have an incentive to allow access to maximise profits[7]. In a bold leap of logic, however, the LCA then asserts that if the controller of the bottleneck is providing a natural monopoly service, one may presume that denial of access would be desirable from the community's point of view unless the controller is vertically integrated[8]. The LCA bases this on the 'simple' argument that 'unless the facility controller is vertically integrated, any denial of access is likely to be for reasons of economic efficiency.'[9]. Somewhat confusingly, the LCA then contradicts its own argument, acknowledging that

> 'This is not to say that unintegrated natural monopolies are likely to behave perfectly efficiently. On the contrary, they are likely to charge monopoly prices that have well-known efficiency problems.'(p. 6)

There are two problems with the LCA's apparent desire to restrict access provision to vertically integrated entities. Firstly, as **Section 3** demonstrates, questions regarding the terms and conditions of access (which may be tailored by the entity to capture monopoly rents or frustrate access even where access is decreed) and questions about facilitating access provision cannot be so easily separated.

Secondly, and most fundamentally, the LCA's analysis of the efficiency of vertically integrated versus vertically separated entities is flawed. It is quite a leap from the Hilmer Report's recognition that non vertically integrated facility owners **may** have an incentive to allow access (as is also true of a vertically integrated firm) to the conclusion that **any** denial of access by a non vertically integrated facility owner will likely be economically efficient. As the Hilmer report acknowledged, in particular circumstances, denial of access by non-vertically integrated entities may lead to economically inefficient outcomes meriting regulation. Any such denial of access may well be privately profitable for the facility owner and it may even capture economies of scope – but the capturing of economies of scope alone is hardly conclusive of the overall economic efficiency of particular arrangements.

The LCA's conclusions about vertical integration stem from two fundamental errors.

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7 LCA Submission, p. 2.
8 LCA Submission, p. 6.
9 LCA Submission, p. 6.

Firstly, the LCA wrongly views the concept of vertical integration as a simple 'either-or' matter. According to this view, firms either are vertically integrated or they are not vertically integrated, and it is a matter of deciding which type a firm is and then proceeding to apply Part IIIA if it is vertically integrated. However, in reality, as the National Competition Council's Submission to the Productivity Commission on Part IIIA (henceforth known as 'NCC Submission') rightly observes, vertical integration is invariably a matter of degree[10]. Firms establish different degrees of vertical control, that is, different kinds of linkages between distinct steps in the functional chain through a mixture of ownership and contractual mechanisms[11]. Presumably what the LCA means by vertical integration is the classical form of vertical integration that the NCC Submission points out is just one unique type of vertical integration, wherein a single firm supplies two or more steps in a functional chain through facilities under integrated ownership. However, taking a more nuanced approach to the analysis, the classical form of vertical integration is recognised as not being exhaustive of the other possibilities available of of the more general phenomenon of vertical control.

In fact, classical vertical integration lies at one pole of the spectrum of vertical control possibilities. From an economic perspective it makes no sense to single out this form of vertical control lying at one end of the spectrum of possibilities if the aim of access regulation is to prevent inefficient access restrictions and if other types of vertical control can facilitate these restrictions.

Secondly, it is not at all obvious that only the firm that is vertically integrated in the classical sense set out above will have incentives to distort competition in dependent markets. As the NCC Submission rightly points out, the ability or incentives of a facility owner to foreclose downstream rivals to monopolise the downstream market do not depend on its employing the classical form of vertical integration[12]. Indeed, at the opposite end of the spectrum from classical full integration, an alternative way of capturing monopoly rents from the downstream market would be as follows: a vertically separate upstream monopoly could deal on an exclusive basis with the most efficient downstream firm, thus precluding all downstream competitors, and extracting the chosen downstream firm's rents by using a two-part tariff.

The final outcome is that the downstream firm earns zero economic profit while the facility owner secures all the rent in the downstream market[13]. In other words, the vertically separated firm can earn the same monopoly profit that a classical vertically integrated firm would earn. Furthermore, output in the retail market is identical to the case of the vertically integrated monopolist and hence identically inefficient. The resulting profits of the vertically separate monopolist, outputs sold and prices paid by consumers will be no different from the profits, output and prices of its vertically integrated counterpart[14]. This being the case, the question remains – why regulate the latter but not the former?

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[10] NCC Submission, p. 22.
[11] NCC Submission, p. 22-23.
[12] NCC Submission, p. 23.
[13] NCC Submission, p. 23
[14] NCC Submission, p. 23

What happens if two-part pricing is ruled out because it is not feasible for some reason or if it is prohibited? Problems still arise in the application of Part IIIA to one form of vertical control and not another. The NCC Submission produces as an example of this, the case of a vertically separate upstream monopolist which is able to charge an input price to the downstream firm that leads to inefficient output levels[15]. Indeed, due to problems of double marginalisation, the profit maximising but unintegrated firm is likely to set prices that increase downstream inefficiencies as compared with the unregulated vertically integrated firm. The presence or absence of vertical integration will, in other words, not reduce and may increase the social costs of monopoly power, including that component of those costs effected through the reduction in competition in dependent markets and this, ultimately, is what Part IIIA is aimed at addressing.

All of these points suggest that if one form of vertical control as a means of extracting monopoly rents downstream and as a consequence, reducing competition downstream, is foreclosed by regulation, then the facility owner merely has to restructure itself to take advantage of an alternative form of vertical control which it can then proceed to use to capture monopoly rents again. In other words, once the 'either-or' view of vertical integration is rejected, one must look carefully to the long run incentive effects of an access regime which only targets classical vertically integrated entities.

The exclusion the LCA proposes from the scope of the regime of entities that are not classical vertically integrated firms would have two effects.

Firstly, as suggested above, it would create incentives for avoidance and evasion of the regulations through the restructuring of production and coordination activities. Such restructuring would be socially costly precisely because it would not be induced by efficiency considerations but solely directed at avoiding access regulations. Aside from the allocative inefficiencies created by regulatory-induced restructuring, productive inefficiencies would also be created, not only by the once-off costs involved but also the consequent loss of economies of scope. Furthermore, as discussed, the vertical separation would result in double marginalisation, or replication of the problem of distortion that would have occurred due to the presence of a vertically integrated monopolist. In both cases continuing social costs would be incurred, though the former would exceed the latter.

The long run loss of economies of scope from an access regime that targeted classically vertically integrated firms alone as firms merely divested themselves and then reintroduced new forms of vertical controls through contractual mechanisms, etc would be particularly ironic given the concern of the LCA with the possible loss of economies of scope associated with an excessively interventionist access regime[16].

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[15] NCC Submission, p. 23

[16] For instance, on p.7 the LCA writes ' ...denial of access may be desirable from the community's point of view wherever there are significant economies of scope between the activity to which access is sought and the activity in which the access seeker would engage. To sacrifice those economies is a cost to society.'

Secondly and quite obviously, as the NCC Submission also observes, such a restriction on the scope of the access regime would lead to under-inclusiveness – it would allow socially costly behaviour (that is, the suppression of competition in dependent markets by the facility owner) to continue unchallenged and escape from the main remedy available[17].

In its Submission, the LCA acknowledges that some non vertically integrated natural monopolists may deny access even though it would be profit maximising to allow access[18]. This could occur due to the long entrenched culture of former State owned monopolies and a lack of incentives for firms to achieve commercial returns. The LCA then deals with this argument by suggesting that Part IIIA is an unwieldy instrument for changing the economic incentives of these former State owned monopolies[19]. All this, is of course, attacking a strawman.

The core concern which would be expressed by proponents of the view that non-vertically integrated entities continue to be under the purview of Part IIIA is not that access is being denied even though it would be profit maximising for particular facility owners otherwise lacking in incentives to achieve proper commercial returns. The LCA is correct to point out that other changes in the institutional environment may be needed to alter such satisficing behaviour, for instance, the injection of additional commercial incentives through privatisation and through reliance on the market for corporate control facilitated by privatisation. The real concern is with the possibility that denial of access which is motivated by the facility owner's incentives to capture monopoly rents is likely to be harmful to competition in markets dependent upon the facility owner.

In other words, what is being dealt with here is not behaviour that, from a strictly commercial perspective, is irrational: rather, it is the very type of profit-maximising behaviour that can also induce a classically integrated firm into refusing third party access.[20]

The LCA acknowledges that many of the effects of classical vertical integration can be achieved through contracting[21] and that as a consequence, an access regime which focused solely on vertically integrated entities would lead to dis-integration and thus the loss of economies of scope. The LCA's rejoinder to this suggestion is to argue that in cases where contracting is used to stifle downstream competition, such conduct is likely to be captured by the prohibitions of anticompetitive conduct in Part IV of the TPA[22]. There are two problems with this quite flippant answer.

What the LCA is really suggesting is that Part IV can be relied upon to deal with the problem of inefficient denials of access where entities are not vertically integrated in the classical sense, while Part IIIA can and should be relied upon to deal with such denials where classical vertical integration is present. This is problematic.

Firstly, for the very reason that Part IIIA was enacted (i.e. perceived inadequacies in the ability of s.46 and the courts to deal with access problems) it is not clear why the LCA thinks that Part IV is adequately equipped to deal with the monopoly rent-seeking activities of a non-vertically integrated entity that harms competition.

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17 NCC Submission, p. 24.
18 LCA Submission, p. 7.
19 LCA Submission, p. 8.
20 It is arguably this type of consideration, rather than any lack of commercial orientation, that seems to have led SACL (not a vertically integrated entity) to the denial of access that was ultimately prevented by declaration.
21 LCA Submission, p. 7.
22 LCA Submission, p. 7.

More importantly, the LCA response fails to address the additional complications created by having separate regimes, each with different thresholds for intervention, and each dealing with what is effectively the same kind of problem (see also **Section 5** for a similar argument in relation to the 'promotion of competition' test). Even if the other means of stifling downstream competition are captured by Part IV, the different thresholds mean that conduct aimed at similar outcomes is treated differently for no obvious reason other than a simplistic linguistic distinction between vertical integration and non vertical integration that is not even supported by economic analysis.

Even abstracting from the real limitations of the provisions of Part IV in dealing with access problems, the LCA's claim, when taken together with its general endorsement of the need for a regime like Part IIIA, leads to a rather strange conclusion. According to the LCA, Part IV is sufficient to cure rent-taking in cases involving firms that are not vertically integrated[23]. By implication from the LCA's endorsement of the need for a regime like Part IIIA, Part IV is not sufficient where the access provider is vertically integrated. The NCC Submission[24] deftly highlights the fallacious implications of the LCA's claims - if Part IV is sufficient to deal with rent taking by facility owners who employ other forms of vertical control besides classical vertical integration, why is it not capable of dealing with rent-taking by facility owners who rely upon classical vertical integration and why is a separate set of provisions from Part IV needed at all? Put straightforwardly, the LCA professes to support the need for provisions other than those of Part IV: but does it really?

Thus, the LCA's arguments, as well as being based on poor economics, seem quite inconsistent. If implemented, they would lead to a nightmare of legislative drafting, as an economically relevant definition of vertical integration would need to be constructed. The likely main effect would be to encourage avoidance, making the costs of monopoly all the higher as firms incurred wasteful expenditures so as to benefit from the escape hatches the LCA approach would provide.

3. Access provision and monopoly rents

The same formalist mentality which plagues the LCA's understanding of the economics of vertical integration is evident in its discussion of the need for regimes facilitative of access provision and what these regimes might require to effectively achieve their aims.

The LCA is of the view that the problem being addressed by Part IIIA is that of:

> '... access to infrastructure. The problem is not the earning of monopoly rents. The problem arises where a natural monopolist denies access to access seekers.' (p. 1)

While the fundamental premise is correct, the conclusions that the LCA draws from it are not supportable. It can be agreed that the distributional issues associated with monopoly rents per se are not a concern of Part IIIA. However, it is incorrect to draw the additional conclusion that

> 'The questions of denial of access, on one hand, and charging monopoly prices on the other, are two conceptually and practically separate issues. Where monopoly prices are the issue and cause inefficiencies that outweigh the inefficiency of price regulation, then they can be addressed by a separate pricing regime' (p. 8)

Quite what this means is far from clear. The most reasonable interpretation that can be put on these sentences, once again, is that denial of access to a facility where such access is likely to be economically efficient, is a legitimate concern of Part IIIA but the mere presence of monopoly pricing by the facility

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[23] LCA Submission, p. 7.
[24] NCC Submission, fn. 7, p. 24.

owner is not a legitimate concern of access regimes. This, however, does not make sense. Monopoly pricing by a facility owner in an access situation (i.e. where it is dealing with a downstream user of the facility) may, in many cases, amount to an inefficient denial of access. A monopolist's terms and conditions can effectively frustrate access by downstream firms.

The LCA's position that a separation can be drawn between dealing with one particular instance of pricing, namely monopoly pricing, and dealing with inefficient denials of access is particularly strange given its perceptive observation that:

> 'Part IIIA should focus on access provision. A **necessary component** of access provision is the price and other terms and conditions of access.' (emphasis added) (p. 8)

If, as the LCA rightly points out, a necessary component of access provision is the price and other terms and conditions of access, then it follows that *it is meaningless to talk of an access regime that simply defines an obligation to supply, without also providing the means for determining the terms and conditions of that supply*. Thus, once it is conceded that a necessary component of an effective access regime is that in most circumstances it will need to provide the means for determining the terms and conditions of supply, it is illogical to automatically exclude issues relating to monopoly pricing or monopoly rents. Indeed, as will be shown below, it is not even clear how this could be done.

Following on from its mistaken premises, the LCA further submits that

> 'The appropriate regulatory response to a concern about the charging of a monopoly price is price regulation pursuant to a separate pricing regime, if a policy decision is made that monopoly prices are a problem.' (p. 8)

This implication is also mistaken, and on three levels.

Firstly, as has already been argued, it is usually necessary to have the means to address the terms and conditions of access charged by a facility owner to a downstream user if efficient access is to be facilitated.

This is just another way of saying that combining the determination of supply obligations with a process for the setting of access charges is indispensable if the access rights (which flow from a determination that a particular refusal to supply is to be prohibited) are to have content. It is surprising that this point is lost on the LCA when even case law has long recognised that a **constructive** refusal to supply (as was the case in *Queensland Wire*) is nonetheless still a refusal to supply. Given that the LCA rightly accepts in its Submission that courts are not the best-equipped to handle the setting of prices and terms and conditions of access[25]. Part IIIA, which brings these matters into a regulatory arena, would seem to be the best means of giving appropriate content to access rights where access has been found to be efficient.

The conclusions of the LCA are wrong on a second level because monopoly pricing and the rents which come from monopoly pricing are likely to be something that it is especially important for an access regime to deal with and in some cases prevent. This is not because an access regime is concerned with the distribution of profits between access providers and access seekers *per se* but rather, because it is concerned about efficient access to bottleneck infrastructure and more fundamentally, because it is concerned with the promotion of economic efficiency in general.

It follows from the uncontroversial assumption that the promotion of economic efficiency is the main objective of Part IIIA that the regime should not allow suppliers of services provided by bottleneck

[25] LCA Submission, p. 9.

facilities to set access prices in a way that distorts economic efficiency. The relevance of monopoly pricing and the search for monopoly rents to all of this is that, as the NCC Submission argues, firms with market power may well, in seeking to raise monopoly rents, set inefficient prices, including prices which suppress the potential for competition in the downstream market[26]. Furthermore, as the NCC Submission also recognises, the monopoly rents that accrue to the bottleneck firm from the freedom to set whatever terms and conditions it wants, especially when protected, whether explicitly or implicitly, by regulation, encourages highly wasteful rent seeking activity[27]. As a result, it is important that the terms and conditions of access be aimed at reducing the prospect of monopoly rents.

Thirdly, the conclusions of the LCA regarding the need to provide for a separate regime for dealing with monopoly pricing are misguided from an institutional efficiency perspective. In effect, account must be taken of the additional, unnecessary administration and compliance costs such a proposal is likely to create and the inefficiencies it is likely to perpetuate. These costs suggest that it is in fact, far better to deal with monopoly pricing at its source, that is, at the access negotiation level.

[26] NCC Submission, p. 28.
[27] NCC Submission, p. 28.

To see this, note that the claim that the function of regulating monopoly pricing by access providers ought not to form part of the access regime must be associated with the proposal that it be exercised elsewhere. Realistically, given that the courts are an excessively unwieldy place to deal with this problem, the likeliest option in this respect would be to devolve that function to some form of price control such as that exercised under the Prices Surveillance Act. This is an option which is strongly suggested by the LCA itself when it submits that

> 'If the policy decision is made that the earning of monopoly rents is also a problem, then the appropriate answer to that problem is some kind of prices surveillance legislation.' (p. 8)

As the NCC Submission observes, once one takes this approach then only two possibilities suggest themselves[28], and as shall be demonstrated, each is completely inadequate to the task set.

The first possibility is for price control to be exercised over the access service itself[29]. From an institutional efficiency perspective, this proposal is a questionable use of resources. It implies that two legislative instruments – access regulation and price control – would be used, where one would otherwise suffice. It is hardly an efficient use of resources to establish a new set of institutional infrastructure and expertise unnecessarily. This proposal also goes against the recognition in public policy and in the Hilmer Report, that price control bodies and mechanisms should only be seen as a last resort.

A second possibility is for the price control to be exercised upon some final good or service. The access charge would then most likely be determined by reference to that final price.

As the NCC Submission is correct to note, this second possibility has even more problems associated with it than the first[30]. An important part of the rationale for access regulation is to *eliminate*, to the greatest extent possible, the need for downstream price control. This recognises the fact that the dependent activity is potentially competitive, and that controlling prices in that activity risks distorting price levels, price structures and price/quality combinations. A move to impose price controls in these circumstances would, even more so than the first possibility, be not only lacking in economic justification but, as the NCC Submission reminds us[31], would also be *prima facie* inconsistent with the clear tenor of the Hilmer Report and the Competition Principles Agreement, under which Governments committed themselves to controlling prices for activities which could not be supplied competitively – rather than for those where competition can do the job.

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[28] NCC Submission, p. 25.
[29] NCC Submission, p. 25.
[30] NCC Submission, p. 25-26.
[31] NCC Submission, p. 26.

This reflects a well-justified presumption against price controls. Experience shows that competitive markets are distinguished not only by competition over price levels, but also by innovation in price structures and in price/quality combinations. Price controls have the potential to distort and suppress these dimensions of the competitive process. Regulation of final prices, when setting access prices would be enough, is highly likely to impose economic costs.

Even assuming that a final price can be efficiently set (which is, given the reasons above, a very strong assumption to make), the second approach also underestimates the difficulties inherent in going from this final price to the determination of appropriate charges for the supply of intermediate inputs (such as access).

Arguably, as observed by the NCC Submission[32], the best approach which economists have developed for dealing with this problem (of going from given final prices to intermediate or access prices) is the Efficient Component Pricing Rule *("ECPR")*. However, it is an indication of the difficulty of the task that at a practical level, application of the ECPR, even in its most mechanical form, involves dealing with many complications with which are associated high implementation and compliance costs for all parties concerned.

The NCC Submission points out many of the complications involved in applying even this state of the art methodology[33].

Firstly, when efficient final prices are non-linear (as they should be for most utility industries), the definition of the base price for use in the ECPR will be essentially arbitrary.

Secondly, the definition of *"avoided costs"* is also far from being a straightforward or easy task. It will depend on the extent of the output change envisaged and the degree to which obligations to supply may cause a continued requirement to provide capacity, even if no services are being supplied.

Thus, the setting of final prices can never fully determine the access charges that will be relevant in any fact situation. Rather, this requires a particularised assessment of that fact situation. Some process must be determined for that assessment to be carried out.

Note that these are the practical difficulties associated with implementing the ECPR rule at its most mechanical. The complications involved are likely to be greater when flexibility is required. Yet, here another trade-off arises. The efficiency properties of the ECPR simply do not hold if it is applied as a mechanical principle: that is, if access charges are determined by merely subtracting avoidable costs from the pre-determined final price. This is because the services provided by the access supplier and the access seeker may not be perfectly substitutable. The lower the degree of substitutability, the greater the efficiency cost that mechanical application of the rule will entail. Thus, while the ECPR may in some instances provide a starting point, it cannot replace the particularised determination of access charges. The LCA itself does not even attempt to say how this would be done.

Given the complications that have been discussed, from an institutional efficiency perspective, it seems desirable to bring together, within a single legislative framework, the determination of the obligation to supply ***and*** of the terms and conditions of that obligation. In essence, this is what Part IIIA as it currently stands, accomplishes, though not without some blemishes, none of which, however, are addressed by the suggestions of the LCA discussed here.

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[32] NCC Submission, p. 26.
[33] NCC Submission, p. 26-27.

4. Natural monopoly and uneconomical duplication

The LCA argues that Part IIIA catches activities that fall short of being natural monopolies and goes on to say that there is no reason for Part IIIA to apply to facilities other than natural monopolies[34]. It thus submits that the current 'uneconomical to develop another facility' criterion for declaration under Part IIIA should be replaced by a criterion that is more unambiguously targeted at natural monopolies[35]. In short, the LCA argues that the real intention behind the 'uneconomical to develop' test is to provide a natural monopoly test in layperson terms, but that the legislation should be amended to reflect this intention more precisely.

However, the LCA's evaluation is once again blinkered by its excessive faith in the power of formalistic definitions to resolve such matters. Contrary to its belief, any clarity associated with replacing the current 'uneconomical duplication' test with a 'natural monopoly' test would be illusory. What is likely to flow from such a change is that the burden of delineation would be transferred from a gradual, trial and error evolution of precedent in the NCC, the courts and tribunals, which are likely to be more flexible and open to new developments in the economy and economic knowledge in general, to a 'once-off' resolution of the issue (presumably by a committee of experts appointed to come up with a definitive test of how to determine whether a 'natural monopoly' exists). To imagine that such a one-off determination would end further dispute is naïve in the extreme, as the economic tests necessary to demonstrate natural monopoly are in most cases unlikely to provide sharp conclusions.

While the faith of the LCA in economists is touching, it is also misplaced in the particular circumstances. The measurement of 'natural monopoly' is still a highly contentious area. To go back to basics, the definition of a natural monopoly market is a market where at the existing level of demand, the cost function is sub-additive. This means that at the level of output corresponding to demand, the least cost means of providing the service is through a single unified production process.[36]

While the concept is simple to state, it is not easy to translate into an exact yet operationally relevant definition. Moreover, and perhaps most importantly, it is exceptionally difficult to demonstrate empirically that a particular industry is a natural monopoly. This is because most of the necessary estimations required must be built on speculation. To test that no combination of production by separate firms is cheaper than production by a single firm requires estimation of the efficient cost of many output levels not actually produced.[37] Thus, as the NCC Submission points out[38], explicitly rephrasing the criterion in terms of natural monopoly would simply invite the presentation of ever more complex and costly economic evidence, with little gain in terms of the quality of the ultimate decision and some loss in terms of its predictability.

The above concerns can hardly be illustrated better than by examining the confusion rampant in the LCA's own discussions of natural monopoly. For instance, close to the very beginning of its Submission, the LCA asserts that

> '... in a natural monopoly situation, it is generally economically efficient and socially desirable to allow one firm only to produce all the goods or services required.' (p. 5)

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34 LCA Submission, p. 5.

35 LCA Submission, p. 14.

36 As the definition suggests, under conditions of natural monopoly, technical or productive efficiency can only be obtained with one producer in the industry. However, while it may be technically or productively efficient to have one provider of natural monopoly infrastructure services, the resultant lack of competition can lower overall efficiency, and in particular, consumer welfare.

37 Sharkey, W.W. 1992, *The theory of natural monopoly* provides a careful discussion of the concept and its implications.

38 NCC Submission, p. 39.

This is a basic error. In the case of a natural monopoly, technical or productive efficiency requires only a single firm operate in the market. However, **overall** efficiency (both in-period allocative and dynamic efficiency) may be increased by allowing or even imposing competition in such a circumstance. This will be the case whenever the gains in allocative and potentially dynamic efficiency from rivalry in supply are sufficient to outweigh the loss in static productive efficiency.[39]

This basic misunderstanding finds its way into one of the LCA's proposed definitions for a natural monopoly:

> 'A service or the smallest group of services that can be most efficiently supplied by a single entity.'(p. 17)

The flawed and essentially empty nature of this proposed definition can be seen by observing that under it, a single taxi ride from point A to point B would seem to be classed as a natural monopoly.[40] But even putting that aside, the definition is full of ambiguity as it depends on whether technical or economic efficiency is to be preferred. If the former, then the definition is consistent with the economic definition of a natural monopoly, but the term "efficiency" is not. If the latter, then a new definition of natural monopoly inconsistent with nearly three decades of writing is being proposed.

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[39] This trade-off is by no means purely academic. Rather, it plays a fundamental role in many areas of policy. For example, Australian defence procurement has long had to wrestle with the fact that the small scale of the Australian market makes the supply of much materiel a natural monopoly, in terms of minimising in-period costs, but that any gains from this minimisation may be more than outweighed by the costs of diminished rivalry. One can of course change the definition of natural monopoly so as to try to exclude this kind of situation, but that is merely game-playing and in any case inconsistent with the LCA's stated goal of developing a test that can be implemented.

[40] The flaw arises for the obvious reason that the definition does not define a scale of output test. To do so, it would have had to at least implicitly define a market – i.e. the set of demand and supply conditions that are relevant to the test. The definition is, in other words, technically flawed. See below.

Additional ambiguities and confusions associated with the natural monopoly concept are hinted at by the LCA's following distinction between a natural monopoly and a natural monopoly **technology**:

> 'Natural monopoly' should not be defined to mean 'natural monopoly technology' – for example, rail technology may be natural monopoly technology even though the owner of the technology may have no market power because roads and planes are effective substitutes for rail. The owner of natural monopoly technology in this sense has no incentive to deny access, even if vertically integrated, because it has no market power to protect.'
> (p. 5-6)

It is not apparent what this distinction means from an economic point of view. What if anything is gained by defining the fish and chips shop at the corner (which can meet all of local demand at least cost) as a "natural monopoly technology"? All the LCA is trying to say is that **competitive conditions must be assessed relative to a market** – in the example above, rail transport is not a distinct market because of substitution from other transport modes; in the case of the fish and chips shop, there is not likely to be a distinct market for fish and chips (and if there is, it is not likely to be confined to a single location). This is hardly news: all economists know that the test of whether supply is sub-additive must be carried out with a definition of the supply and demand curves (that is, the market) in mind. So, the test the LCA is groping for must be whether a **market** (a term the LCA apparently does not like – see below) is or is not a natural monopoly. The distinction between a natural monopoly technology and a natural monopoly seems like a somewhat overblown way of making this very simple point.

Overall, the LCA's discussion of what a natural monopoly is and is not does not augur well for the approach it proposes. The concept of a natural monopoly is a useful and important one in economic analysis; but it is not a simple one, nor is it readily implemented as a practical matter. The LCA does not articulate an economically coherent concept of natural monopoly nor show how it would guide policy. The LCA would do well to show how its approach could be implemented before so strongly advocating it.

In contrast to all this, how does the current 'uneconomical duplication' test fare in delineating appropriate subjects for access regulation? While there may have been some uncertainty before surrounding this term, the NCC Submission highlights the fact that this uncertainty has recently been resolved by the Sydney International Airport case[41]. In that case, it was decided that the test hinges on a consideration of the efficiency of developing another facility which is to be evaluated on the basis of whether the existing facility exhibits 'bottleneck' characteristics.

[41] NCC Submission, p. 38.

The NCC Submission notes the following passage from the Australian Competition Tribunal's judgement, which in considering the likelihood of the development of another airport to provide competing services, set forth an appropriate framing of the crucial issues in question[42]::

> '...SIA as a whole exhibits very strong bottleneck characteristics. From an economic perspective therefore the option to develop another facility is foreclosed because the relatively small size of the Australian freight market would not support the development of another separately-owned airport. The realities are reflected in the Government's decision that SACL will be responsible for the development of Sydney West as a supplement to, rather than a replacement for, SIA.'

It should be noted that according to the prevailing interpretation of this test, the *"other"* facility need not be a new facility – that is, an additional one relative to those that already exist - *"develop"* does not mean *"build"*. The test only requires that there be a viable alternative which could be used to provide the service at issue. In many, if not all, instances, the inquiry aimed at determining whether or not this is the case will thus amount to a consideration of whether the facility is a 'bottleneck' which confers market power on the facility owner which the facility owner could then use to seek monopoly rents also in a dependent market, and in the process, suppress competition.

Thus, as the NCC Submission points out:

> The test of uneconomic to develop another facility is, therefore, not a test of whether more than one facility exists, or is likely to exist. It is a test of whether, absent access regulation, it is likely that any problem of bottleneck market power would be resolved by the development of competing infrastructure. (p. 39)

In other words, the test is designed to identify infrastructure where competition would be undesirable from a social perspective or simply unlikely, based on the justifiable assumption that in general, infrastructure-based competition is a better regulator of bottleneck market power than the application of access regulation. As the NCC submits, making this a condition that must be met acts to ensure that access regulation is not applied inappropriately such that it would tend to deter the economically viable development of competitive infrastructure[43].

To put matters slightly differently, the current test, when considered as a whole, is really one for whether a facility is a bottleneck, rather than whether it is a natural monopoly in the technical sense in which this term is used in economics. It consequently can exclude from the regime instances in which a facility is a natural monopoly but not a bottleneck, while providing a policy response to situations in which a facility is a bottleneck even though it cannot be shown to satisfy the rather strict tests that must be used to identify natural monopoly.

The test as it currently stands is therefore likely to be a better guide to the economically efficient conditions for regulation than a natural monopoly test, even leaving aside the considerable uncertainty, loss of flexibility, drafting costs and error costs that might arise from attempting to replace it with a 'natural monopoly' test.

5. The promotion of competition

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[42] NCC Submission, p. 38-39.
[43] NCC Submission, p. 39.

In its Submission, the LCA refers to the Hilmer report's recommendation that an access regime should only promote effective competition[44]. The LCA contends that the declaration criterion that requires 'promotion of competition in related markets' is, as it presently stands, inconsistent with this recommendation and that it is over-inclusive because access is permitted where it would merely promote some competition in **another market**, however trivial or insignificant[45]. Ideally, according the LCA, the competition that should be promoted should be **effective** competition in an **upstream** or **downstream** market[46]. Thus, it recommends that the criterion be amended so that what is required is promotion of a **substantial** increase in competition to bring it closer to the 'effective competition' principle recommended by Hilmer[47].

The LCA also complains of the complexity of the current test's requirement that another market in which competition would be promoted must be defined[48]. However, the LCA does not suggest any specific amendments to deal with this market definition issue. Its complaints about the alleged complexity of the market definition segment of the current promotion of competition test are somewhat ironic in light of its recommendation, discussed in **Section 4**, of a 'natural monopoly' test (since such a test cannot be implemented without defining a market), as well as its lament that the concepts in Part IIIA differ from those in the rest of the TPA.

The concept of a market has been long established and refined in Australian competition law and there is ample discussion and elaboration of the concept by both academic writers and practitioners in the context of both Part IIIA and the rest of the TPA. It seems bizarre that competition lawyers should find it troubling or even more so, unfamiliar.

In any case, the criticism of Part IIIA's requirement for the identification of a market seems deeply confused. Competition (like the identification of natural monopoly) has to occur in a market. Thus, to make out the case that competition will be promoted, it must be possible to identify a market in which this effect will occur. Thus, any reasonable test for the promotion of competition necessarily involves some process of market definition. As for the requirement that the competition being promoted be in some **other** market, this is in order to ensure that the resources put into the working of the access regime are not squandered on facilitating the mere resupply of a natural monopoly service, remembering that the purpose of Pt IIIA it is to prevent bottleneck power from being used in ways injurious to the community. That purpose requires identifying the market in which that power is or could be so used.

The LCA's recommendation that the promotion of competition test be amended to a promotion of substantial increase in competition test is, on its face, more appealing, but it is in fact misguided because it ignores the different regulatory thresholds that already exist between Parts IIIA and IV of the TPA.

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[44] LCA Submission, p. 4, p. 12.
[45] LCA Submission, p. 12.
[46] LCA Submission, p. 12-13.
[47] LCA Submission, p. 12-13.
[48] LCA Submission, p. 12-13.

More specifically, as the NCC Submission rightly notes, the test in Part IIIA requires that declaration **will** promote competition[49] – it is not a test of likelihood but rather one that requires a degree of certainty. In contrast, most Part IV provisions require proof of a 'purpose, effect or likely effect' of substantially lessening competition. Thus the competition test under Part IV can usually be satisfied even if it is only the 'likely' effect of the conduct that it will lessen competition. The regulatory threshold that has been set for application of Part IIIA in that respect is already higher than the threshold set for Part IV.

Importing a test of substantiality into Part IIIA would actually raise the threshold to an inappropriately high level, leading to an under-inclusive application of Part IIIA. This is because it would be very difficult, in many instances, to be **certain** that declaration would **substantially** promote competition[50]. Such a burden would be even greater in the typical Part IIIA case than in respect of most instances falling within the province of Part IV because Part IIIA cases often relate to industries subject to some restructuring, but in which patterns of competition have not yet fully evolved. Thus, judgements of competitive effects are more complex and controversial. In these circumstances, to require **both** that the effect be certain and that it be substantial could alter the balance of the Act by creating obstacles to its application where it may be most needed.

As for the claim that the test as it presently stands leads to access being allowed even though the increase in competition is trivial, this can only be described a disingenuous misreading of the Tribunal's decision in the Sydney Airports case, which in no way endorsed the view that even trivial increases in competition were sufficient. Rather, in that instance, there were grounds the Tribunal found compelling for believing that the tender process that SACL had used had systematically excluded a particular type of competitor; and that the type of competitor thus excluded was important in terms of the functioning of the competitive process. There were consequently tangible gains, in terms of removing obstacles to competition that could flow from declaration. The SACL decision, looked at in its substance, involves a hurdle of competitive effect that cannot fairly be described as low.

The LCA claim also overlooks a long established context in Australian competition law. As a practical matter, *"competition"* in Australian law and regulation has long been understood to mean workable competition rather than perfect competition. It is only when declaration will allow a market that is not workably competitive to come closer to being workably competitive that the test can be met. It is invariably easier for any real world situation to approach the workably competitive ideal than the perfectly competitive ideal. Thus, as the NCC Submission argues, once a market is **already** workably competitive, it becomes ever difficult to justify any additional intervention to make it 'even more' workably competitive, whatever that might mean[51]. In other words, the comparison between "the world with declaration" and "the world without" would not indicate any substantial difference to warrant policy intervention such that the dangers of there being excessive and inappropriate intervention are extremely slight. Again, the SACL decision, with its careful analysis of the obstacles to competition that the SACL tender process imposed (and that declaration could remove), should make the matter clear.

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[49] NCC Submission, p. 37.
[50] NCC Submission, p. 37.
[51] NCC Submission, p. 37.

6. Conclusions

It is not very difficult to point out areas where the Part IIIA access regime can be improved. Unfortunately the LCA's Submission fails to address most of these areas. The bulk of the Submission is preoccupied with criticisms of Part IIIA which stem from either a preoccupation with formal definitions at the expense of pragmatic public policy analysis or a simple failure to understand the architecture and content of Part IIIA.

The LCA's criticisms of Part IIIA relating to its application to non vertically integrated entities and Part IIIA's provisions providing for the determination of appropriate terms and conditions of access reveal the pitfalls inherent in taking an excessively formalistic approach to the legislation and the complex economic concepts it attempts to reflect. Contrary to the LCA's arguments, an access regime that restricted its purview to facilities which are vertically integrated in the classical sense would merely introduce distortions into the coordination of economic activity. Equally, an access regime which restricted itself to negating refusals to supply would be enforcing access rights without much content.

The LCA's suggestions for the replacement of the current duplication test with a 'natural monopoly' test underestimates the enormity and complexity of the task involved in constructing such a test and the costs likely to be imposed in its application.

Finally, the LCA's suggested amendment to the 'promotion of competition' test stems from a failure to recognise the high regulatory threshold already implicit in Part IIIA of the TPA compared to Part IV and the role of the 'workable competition' benchmark in preventing an over-inclusive application of the current test.