

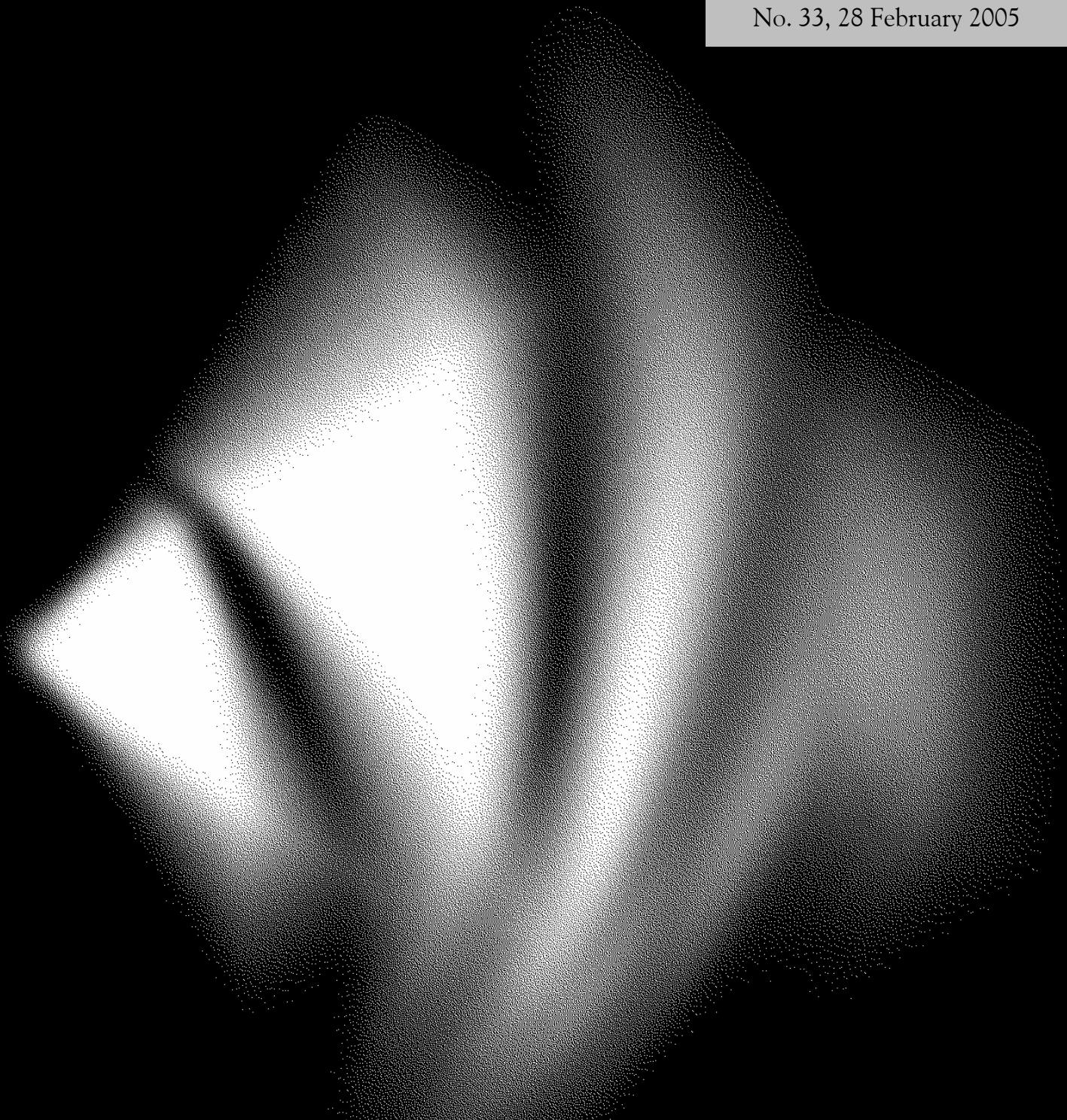


Australian Government
Productivity Commission

Review of National Competition Policy Reforms

Productivity
Commission
Inquiry Report

No. 33, 28 February 2005



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The Productivity Commission

The Productivity Commission, an independent agency, is the Australian Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

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28 February 2005



The Honourable Peter Costello MP
Treasurer
Parliament House
Canberra ACT 2600

Dear Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report on the *Review of National Competition Policy Reforms*.

Yours sincerely

Gary Banks
Chairman

Philip Weickhardt
Commissioner

Robert Fitzgerald
Commissioner

Terms of reference

I, PETER COSTELLO, Treasurer, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998*, hereby refer the following inquiry to the Commission for inquiry and report within nine months of receipt of this reference. The Commission is to hold hearings for the purpose of the inquiry.

Background

1. In 1995 the Australian, State and Territory Governments agreed to a program of competition policy reform. National Competition Policy (NCP) and related reforms provide a timely, coordinated and comprehensive approach to reform across all levels of government. There has been substantial progress in the implementation of NCP over the past eight years, including in the related reform areas of electricity, gas, road transport and water. This has delivered significant benefits to Australia. The States and Territories have shared in these gains, including through competition payments made by the Australian Government.
2. In November 2000, the Council of Australian Governments (CoAG) agreed to a further review of NCP arrangements by September 2005.
3. It is therefore timely to undertake an independent review of these arrangements to consider the extent of the benefits the reform program has delivered to date and to inform an assessment of the most worthwhile competition related reforms that could be achieved in the future, including competition related reforms which could apply beyond current NCP arrangements.

Scope of Inquiry

4. The Commission is to report on:
 - a) the impact of NCP and related reforms undertaken to date by Australian, State and Territory Governments on the Australian economy and the Australian community more broadly. To the extent possible, such assessment is to include:
 - i. impacts on significant economic indicators such as growth and productivity, and to include significant distributional impacts, including on rural and regional Australia; and
 - ii. its contribution to achieving other policy goals.
 - b) at the Australian, State and Territory level, areas offering opportunities for significant gains to the Australian economy from removing impediments to efficiency and enhancing competition, including through

a possible further legislation review and reform programme, together with the scope and expected impact of these competition related reforms.

Considerations

5. In conducting this review, and in recommending changes, the Commission should take into account the desire of the Government:
 - a) to focus new review and reform activity on areas where there is clear evidence of significant potential gains, in particular where clear gains are possible in Australia's international competitiveness, in the efficiency of domestic markets or for Australian consumers; to ensure possible reform activity considers appropriately the adjustment and distributional implications and its contribution to achieving other policy goals.
 - b) to take into account but not replicate significant current and recent review activity in areas such as the CoAG work on energy and water and the review of the competition provisions of the Trade Practices Act.
6. In undertaking the review, the Commission is to advertise nationally inviting submissions, hold public hearings, consult with relevant Australian Government, State and Territory agencies and other key interest groups and affected parties, and produce a report.
7. The Government will consider the Commission's recommendations, and the Government's response will be announced as soon as possible after the receipt of the Commission's report. The report will inform the CoAG review due to be completed by September 2005.

PETER COSTELLO

Received 23 April 2004

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OVERVIEW

Key points

- National Competition Policy (NCP) has delivered substantial benefits to the Australian community which, overall, have greatly outweighed the costs. It has:
 - contributed to the productivity surge that has underpinned 13 years of continuous economic growth, and associated strong growth in household incomes;
 - directly reduced the prices of goods and services such as electricity and milk;
 - stimulated business innovation, customer responsiveness and choice; and
 - helped meet some environmental goals, including the more efficient use of water.
- Benefits from NCP have flowed to both low and high income earners, and to country as well as city Australia — though some households have been adversely affected by higher prices for particular services and some smaller regional communities have experienced employment reductions.
- Though Australia's economic performance has improved, there is both the scope and the need to do better. Population ageing and other challenges will constrain our capacity to improve living standards in the future. Further reform on a broad front is needed to secure a more productive and sustainable Australia.
- In a number of key reform areas, national coordination will be critical to good outcomes. These areas — many of which have been encompassed by NCP — should be brought together in a new reform program with common governance and monitoring arrangements. Priorities for the program include:
 - strengthening the operation of the national electricity market;
 - building on the National Water Initiative to enhance water allocation and trading regimes and to better address negative environmental impacts;
 - developing coordinated strategies to deliver an efficient and integrated freight transport system;
 - addressing uncertainty and policy fragmentation in relation to greenhouse gas abatement policies;
 - improving the effectiveness and efficiency of consumer protection policies; and
 - introducing a more targeted legislation review mechanism, while strengthening arrangements to screen any new legislative restrictions on competition.
- An 'overarching' policy review of the entire health system should be the first step in developing a nationally coordinated reform program to address problems that are inflating costs, reducing service quality and limiting access to services.
- National action is also needed to re-energise reform in the vocational education and training area.
- Reform is important in other key policy areas, including industrial relations and taxation, but there would be little pay-off from new nationally coordinated initiatives.
- The Australian Government should seek agreement with the States and Territories on the role and design of financial incentives under new national reform programs.

Overview

The National Competition Policy (NCP) has been a landmark achievement in nationally coordinated economic reform. It has yielded benefits across the community, though there have been some costs and the implementation process has not been without defects.

Most of the reforms initially agreed to are now in place, and will provide ongoing gains. But population ageing and other challenges mean that if Australians are to enjoy higher living standards in the future, further reform is required.

The Commission was asked by the Australian Government to conduct this inquiry into the impacts of NCP to date, and report on future areas ‘offering opportunities for significant gains to the Australian economy from removing impediments to efficiency and enhancing competition’. The Commission’s report is intended to help inform the Council of Australian Government’s (CoAG) own review of NCP and possible future reforms, which is currently due to be completed by September 2005.

Why was the National Competition Policy introduced?

The strength of Australia’s recent economic performance represents a marked turnaround from a lengthy period of economic malaise. During the 1970s and 1980s, output growth slowed, inflation and unemployment rose, and productivity growth was consistently low by international standards. By the late 1980s, Australia’s ranking on the international ladder of per capita incomes had slipped from 12th to 16th.

While external developments contributed to this deteriorating performance, high trade barriers and various regulatory and institutional restrictions on competition in the domestic market led to significant inefficiencies across the economy. They also created a business culture that focussed on securing government preferment rather than on achieving a competitive edge through cost control, innovation and responsiveness to customer needs.

In recognition of the policy-related inhibitors on growth, from the early 1980s, Australian governments embarked on a program of extensive economic reform. The decade that followed saw the liberalisation of capital market controls, the abolition

of import quotas and phased reductions in tariff assistance. The heightened competitive pressure from these changes in turn prompted the introduction of greater flexibility to Australia's previously rigid and highly centralised labour market arrangements, and various institutional and regulatory reforms to promote more efficient delivery of infrastructure services.

As the reform program gathered pace, it became apparent that aspects of Australia's wider competition policy framework were impeding performance across the economy and constraining the scope to create national markets for infrastructure and other services. Hence, in April 1995, the Australian and State and Territory Governments committed to the implementation of a wide-ranging National Competition Policy — that drew heavily on a blueprint established by an earlier independent inquiry, the so called Hilmer Review. In effect, NCP represented the consolidation and natural extension of the reforms of the preceding decade.

What changes were introduced under NCP?

NCP is based on an explicit recognition that competitive markets will generally serve the interests of consumers and the wider community, by providing strong incentives for suppliers to operate efficiently and be price competitive and innovative. A key principle of NCP is that arrangements that detract from competition should be retained only if they can be shown to be in the public interest.

Specifically, NCP provided for: the extension of the Trade Practices Act (TPA) to previously excluded businesses; governance and structural reforms to government businesses to make them more commercially focussed and expose them to competitive pressure; regulatory arrangements to secure third-party access to 'essential' infrastructure services and, more generally, to guard against overcharging by monopoly service providers, especially in the infrastructure area; and a process for reviewing, and where appropriate amending or rescinding, a wide range of legislation which restricted competition. NCP also incorporated previously agreed reform programs for the electricity, gas, water and road transport sectors (see box 1).

This package was implemented through a number of intergovernmental agreements which, amongst other things, provided for the creation of the Australian Competition and Consumer Commission (ACCC) and the National Competition Council (NCC). An important feature of the institutional framework has been the financial incentives — so called competition payments — made by the Australian Government to the States and Territories to 'return' the fiscal dividend from their implementation of agreed reform commitments.

Box 1 An overview of the NCP reforms

General reforms

- Extension of the anti-competitive conduct provisions in the TPA to unincorporated enterprises and government businesses.
- Reforms to public monopolies and other government businesses:
 - structural reforms — including separating regulatory from commercial functions; and reviewing the merits of separating natural monopoly from potentially contestable service elements; and/or separating contestable elements into smaller independent businesses; and
 - competitive neutrality requirements involving the adoption of corporatised governance structures for significant government enterprises; the imposition of similar commercial and regulatory obligations to those faced by competing private businesses; and the establishment of independent mechanisms for handling complaints that these requirements have been breached.
- The creation of independent authorities to set, administer or oversee prices for monopoly service providers.
- The introduction of a national regime to provide third-party access on reasonable terms and conditions to essential infrastructure services with natural monopoly characteristics.
- The introduction of a Legislation Review Program to assess whether regulatory restrictions on competition are in the public interest and, if not, what changes are required. The legislation covered by the program spans a wide range of areas, including: the professions and occupations; statutory marketing of agricultural products; fishing and forestry; retail trading; transport; communications; insurance and superannuation; child care; gambling; and planning and development services.

Sector-specific reforms

- *Electricity*: Various structural, governance, regulatory and pricing reforms to introduce greater competition into electricity generation and retailing and to establish a National Electricity Market in the eastern states.
- *Gas*: A similar suite of reforms to facilitate more competitive supply arrangements and to promote greater competition at the retail level.
- *Road transport*: Implementation of heavy vehicle charges and a uniform approach to regulating heavy vehicles to improve the efficiency of the road freight sector, enhance road safety and reduce the transaction costs of regulation.
- *Water*: Various reforms to achieve a more efficient and sustainable water sector including institutional, pricing and investment measures, and the implementation of arrangements that allow for the permanent trading of water allocations.

Though clearly wide-ranging, NCP did not encompass industrial relations reform, or a range of competition-related reforms that were being implemented concurrently — for example, the introduction of competition to the delivery of various human services, through mechanisms such as ‘purchaser-provider’ models. Nor did it mandate asset sales and privatisation, compulsory tendering or contracting out of government service provision, removal of community service obligations (only that they be made transparent), or require any reductions in infrastructure services to rural and regional Australia.

NCP also recognised that competition is a means to an end and that it is neither practical nor desirable to promote competition in every activity and circumstance. Thus, the NCP’s procedural framework explicitly provided for consideration of social, environmental, equity, regional and adjustment objectives in assessments of particular reform options.

Most NCP reforms are now in place

In most areas, the agreed reforms under NCP have been, or are being, implemented. The main areas of unfinished business relate to water reform and to the Legislation Review Program (LRP).

- Progress in implementing aspects of the water reforms — for example, environmental allocations and water trading arrangements — has been variable, with differences emerging between jurisdictions on the best ways forward in some areas.
- Some significant pieces of anti-competitive legislation have yet to be reviewed, including Australia’s anti-dumping regime and cabotage arrangements. In addition, the efficacy of review processes and outcomes in several areas have been questionable. Indeed, most of the deductions to competition payments to the States and Territories have been for breaches related to compliance with LRP requirements.

What has NCP delivered?

It has contributed to our recent strong economic performance

Australia’s economic performance over the last decade or so stands out, not only by our own standards, but also among OECD countries:

- there have been 13 years of uninterrupted output growth — one of the longest expansion phases on record;

-
- the rate of increase in real per capita incomes in the second half of the 1990s was as high as at any time during the 20th century; and
 - the unemployment rate is currently at its lowest level in nearly three decades, with labour force participation at its highest level since WWI.

Underpinning this strong performance has been a surge in Australia's rate of productivity growth. For example, in the five year cycle to 1998-99, productivity growth rates were the highest for at least forty years, with the increase effectively boosting the 'average' Australian household's annual income by \$7000. While productivity growth slowed after 1999, this seems largely attributable to temporary phenomena such as the drought. Notably, productivity performance appears to have rebounded in the past year.

In contrast with the 1970s and 1980s, Australia's recent productivity growth has also been very strong by international standards. That rapid overall growth has been sustained despite a decade of economic stagnation in Australia's largest export market (Japan), and the financial crisis which struck that country and other key Asian trading partners in 1997.

While many factors can influence productivity growth, a number of analytical studies indicate that microeconomic reforms — including NCP — have been a major contributor to Australia's productivity surge in the 1990s, and to the economy's increased resilience in the face of economic disturbances. The reforms have achieved this by increasing the pressures on both private and government businesses to be more productive, through increased competition, while simultaneously enhancing their capacity to respond through more flexible work arrangements, the removal of unnecessary red tape and the like. Other suggested causes of the productivity surge, such as recovery from recession or unsustainable increases in work intensity, have not withstood analytical scrutiny.

That NCP and other microeconomic reforms have yielded a significant payoff in productivity and income growth should not surprise. Previous model-based projections by the Industry Commission suggested that the major elements of NCP could potentially generate a net benefit equivalent to 5.5 per cent of GDP. More selective analysis, undertaken for this inquiry, indicates that the observed productivity and price changes in key infrastructure sectors in the 1990s — to which NCP and related reforms have directly contributed — have increased Australia's GDP by 2.5 per cent, or \$20 billion (see box 2). And such modelling does not pick up the 'dynamic' efficiency gains from more competitive markets.

Box 2 The economy-wide gains from NCP

Prior to this inquiry, the Commission had twice used quantitative modelling to illustrate the prospective economy-wide impacts of NCP reforms.

- In 1995, it modelled many of the Hilmer recommendations and estimated that, at the ‘outer envelope’, Australia’s level of real GDP would be 5.5 per cent higher once the productivity gains, price rebalancing and other changes associated with the reforms had fully worked their way through the economy.
- In 1999, it undertook a similar ‘outer envelope’ exercise for a smaller sub-set of NCP reforms of particular relevance to rural and regional Australia, projecting a boost to GDP in the longer term of 2.5 per cent.

In this inquiry, the Commission was asked to report on the impacts of NCP to date. Such impacts are very difficult to separate from many other factors influencing economic outcomes. To provide a partial indication, the Commission sought to quantify the economy-wide gains from productivity improvements and price changes observed over the 1990s in the electricity, gas, urban water, telecommunications, urban transport, ports and rail freight sectors. In a number of these sectors, NCP and related reforms are widely acknowledged to have been key (though not the only) drivers of productivity improvements and ensuing price benefits for many service users.

The modelling indicates that observed productivity and price changes in the selected infrastructure services have boosted Australia’s GDP by 2.5 per cent. However, this modelling does not cover all areas encompassed by the NCP reforms. Nor does it pick up impacts from NCP reforms undertaken since 2000, or from earlier reforms that did not add to productivity until after that time; or make allowance for the ‘dynamic’ benefits of more competitive markets, such as the stronger incentives for service providers to continue to improve their productivity and quality and to innovate in order to achieve a competitive advantage. Even allowing for transitional costs which are similarly not encapsulated in the modelling, the implication is that the total boost to GDP from the reforms will ultimately be considerably larger than the figure emerging from this particular modelling exercise.

The increase in Australia’s GDP and national income has also substantially boosted taxation revenue — as the NCP agreement on competition payments anticipated. This has increased the capacity of all governments to fund a range of services of benefit to the community, such as health and education, and to provide social welfare support.

It has delivered direct price benefits, especially for businesses

One of the main ways in which NCP and related reforms have boosted total output is by reducing the costs and prices of many goods and services. Indeed, NCP has had a dual role in this regard. Not only has it provided a means to improve

productivity and thereby lower costs, but by promoting competitive markets, it has created pressure for most of those cost savings to be passed on to users.

Clearly, it is not possible to isolate with any precision the impacts of NCP from the myriad of other factors influencing prices in the market place. However, it is telling that in a number of areas targeted by NCP and related reforms there have been significant price reductions. For example:

- In the electricity sector, notwithstanding variation across and within jurisdictions, average real prices Australia-wide have fallen by 19 per cent since the early 1990s.
- There were substantial reductions in rail freight rates in the second half of the 1990s — ranging from 8 per cent for wheat, to as much as 42 per cent for some coal traffic.
- Real port charges fell by up to 50 per cent during the 1990s.
- Since the mid 1990s, average telecommunications charges have fallen by more than 20 per cent in real terms.
- The average retail price of drinking milk has fallen by 5 per cent in real terms since full deregulation in 2000, despite the imposition of an 11 cents a litre levy to fund an assistance package for dairy farmers.

Further, while technological advances have clearly been an important influence on price reductions in sectors such as telecommunications, there has often been significant complementarity with reform measures. For instance, the entry of new players in the telecommunications sector, made possible by the removal of previous barriers, undoubtedly accelerated the uptake of new technologies and helped to ensure that users shared in the cost savings.

At face value, businesses generally appear to have benefited more than households. Across Australia, real prices paid by households for services such as electricity, gas, water and urban transport have, on average, risen over the last decade or so, though there has been considerable variation across jurisdictions. Also, there is a limited amount of evidence suggesting that:

- in overall terms, price rises for households in regional areas may have been somewhat higher than for their counterparts in metropolitan areas; and
- increases in household prices for services such as electricity have generally been greater for households with low demand and often lower incomes.

While price outcomes have varied, and been adverse for some, this does not mean that the reforms have been unsuccessful in improving performance. Indeed, in some

cases, price increases for households or consumers in general were an intended consequence of the reform process.

- For services such as electricity and gas, there has been significant price rebalancing to address, in particular, previous arrangements whereby business users had borne a disproportionate share of the costs of service delivery. This inflated their costs and reduced their competitiveness (and indirectly penalised all consumers).
- There was a widely accepted need to increase cost recovery levels for services such as water. Apart from providing a poor return to taxpayers, artificially low prices encourage excessive consumption and distorted investment signals, with sometimes costly consequences for the community and the environment.

Significantly, even where prices have risen, so too has productivity. In urban water, for example, labour productivity increased by more than 60 per cent over the 1990s.

This is not to underplay the significance of the additional financial burden imposed on some households by NCP-induced price increases. However, specific compensation measures for low income households should have lessened the impacts for many of those least able to cope with these increases (though the adequacy and targeting of such measures needs to be kept under review).

Further, many households will have benefited from lower prices for *other* goods and services made possible by cheaper infrastructure inputs for businesses, as well as from the longer term stimulus to employment and wages provided by NCP. In this regard, the Commission's modelling of the *net* impacts of productivity and price changes in key infrastructure sectors during the 1990s suggests that while higher income households derived the largest benefits, those on lower incomes also gained.

Finally, it is important to recognise that NCP and related reforms cannot be expected to deliver continual reductions in the prices of services such as electricity. Some of the price benefits of the reforms will be of a 'one-off' nature. And while the dynamic efficiency gains resulting from more competitive markets will put ongoing downward pressure on prices, in some years, those pressures may be more than offset by other cost drivers. The need to fund major new investments to meet growing demand and sustain service quality over the longer term, and to better reflect the costs of externalities in prices, are but two examples.

It has provided a range of other benefits

Apart from putting downward pressure on the prices of many goods and services, the more competitive market environment created by NCP and related reforms has contributed to improvements in service quality and reliability in some sectors. The

reforms have also led to an expansion in the range of products and services available to consumers.

- Retail contestability in energy markets means that many users are now free to choose their supplier. This has increased the pressure on suppliers to provide a range of new and innovative product and service offerings to attract and retain customers.
- The advent of new players in the telecommunications market has similarly contributed to the availability of a much wider range of service packages and, as noted above, accelerated the introduction of new technologies.

As the consequent changes in shopping patterns illustrate, deregulation of retail trading hours in most jurisdictions has provided convenience benefits for many households.

Consumers are not the only ones to have benefited directly from NCP. For example:

- relaxation of controls on the marketing of some grains and lamb has boosted returns to many producers, with flow-on benefits for surrounding regional communities; and
- water reforms have encouraged more efficient use of this scarce resource and generally improved environmental outcomes.

The benefits have been widely spread

Though varying in size, the benefits of NCP and related reforms have been spread across the community. Contrary to some perceptions, this includes most of rural and regional Australia. For example, the Commission's modelling of productivity and price changes in key infrastructure sectors during the 1990s suggests:

- a consequent increase in regional output (and by implication regional income) in all but one of the 57 regions modelled across Australia; and
- a generally small impact on employment (up or down).

For some smaller regional communities facing considerable adjustment pressures, such a conclusion may seem to fly in the face of the facts. However, many of the negative influences on activity and employment in parts of country Australia, such as declining terms of trade and population drift from smaller rural communities (often to larger regional centres), are of a long term nature and unrelated to NCP. By putting downward pressure on the costs of some key inputs for rural industries, such as power and transport, NCP and related reforms may well have helped to ease the adjustment burden.

NCP has not been an unqualified success

Not all reforms have delivered

In some cases, even though agreed reforms were implemented, they have proven insufficient to achieve underlying objectives. For example, the electricity market reforms have as yet failed to deliver a fully effective national market. And, while considerable progress has been made in water reform, there is still much more to do to achieve efficient and sustainable water use across Australia.

Similarly, the legislation review program has had mixed results. Apart from the failure to proceed with certain reviews, the outcomes from a number of key reviews have been problematic. The failure to act on recommendations by a national independent review of pharmacy to relax ownership and other anti-competitive restrictions is a case in point. The continuing statutory monopoly over export wheat marketing is another example.

There have been transitional costs

Removing unwarranted restrictions on competition, while benefiting many, will inevitably impose costs on those who had gained from the restrictions. In this respect, NCP has been no different from any of the other generally beneficial economic reforms implemented in Australia over the last two decades. However, the broadly-based nature of the NCP reform program has often meant that those penalised by a particular reform have benefited from others.

Even so, for some, the adjustment burden has been considerable. Apart from the pressures imposed on certain households by NCP-induced priced increases for several infrastructure services (see above), some regional communities have had to deal with losses of income and reduced employment opportunities. For example:

- Dairy deregulation has substantially reduced returns to those farmers heavily dependent on supplying the previously protected market for drinking milk (though across Australia, dairy farm income appears to have risen since deregulation, mainly as a result of higher revenues from milk used for manufactured products).
- Reforms to improve the efficiency of public utilities and other infrastructure services have seen reductions in employment in those industries, some of which have been regionally concentrated.

Though generally small from an economy-wide perspective, such costs have sometimes added to other pressures facing particular communities, with the

cumulative impact threatening the viability of some basic services in these communities.

Some NCP reforms have also been procedurally costly to implement relative to the potential benefits. This has been a particular issue at the local government level and for smaller State and Territory Governments in dealing with more minor items on the legislation review program.

Overall the benefits have outweighed the costs

Such transitional costs, and the fact that NCP has not delivered on every goal, do not detract greatly from the overall benefits it has produced for the community as a whole, and most groups within it.

Moreover, though many of the costs have now been incurred, NCP will deliver substantial ongoing benefits. By opening up large new areas of the economy to competition, the reforms have reinforced the role of tariff reductions and other policy changes in the development of a more cost conscious, responsive and innovative business culture in Australia. This will facilitate continuing productivity improvement and provide a platform for future wages growth and increases in living standards.

What reform lessons emerge?

NCP has been a highly innovative exercise in national economic reform. Several factors have underpinned its success:

- recognition by all governments of the need for reform;
- broad agreement on the priority problem areas;
- a solid conceptual framework and information base to guide policy prescriptions; and
- some highly effective procedural and institutional mechanisms to implement reform.

In this latter regard, the flexibility afforded jurisdictions in how to implement many of the reforms, and transparent and independent monitoring of progress and outcomes, have been especially important. The provision of financial incentives to the States and Territories, allowing them to share directly in the fiscal dividend from meeting their agreed reform commitments, has also played a critical role in keeping the reform process on track.

But some aspects of the procedural arrangements have been found wanting.

- Implementation of parts of the package, especially the LRP, has been hampered by the lack of prioritisation.
- Public interest test requirements have not always been rigorously applied. Also, while a key to the success of the NCP reforms overall, putting the onus of proof on those seeking to retain anti-competitive arrangements continues to be a source of contention when social and environmental impacts loom large.
- The independence of some legislation reviews has been questionable, and the conduct of reviews and basis for the outcomes have not always been transparent.
- Measures to lock-in the gains from reforms and guard against backsliding are underdeveloped.
- The reform framework provides no guidance on the circumstances in which mechanisms to facilitate adjustment, or to address adverse distributional consequences ensuing from the reform process, may be warranted. This heightens the risk of inappropriate intervention, or failure to provide adequate and well targeted support when desirable.

Some high level lessons from NCP which the Commission has carried into the forward looking part of its task are summarised in box 3.

Why further reform is essential

NCP can be seen as the culmination of a reform process that has extended over two decades. Not surprisingly, after such a prolonged period of policy-induced change to economic rules, institutions and ways of doing business, there is some evidence of ‘reform fatigue’. There are also perceptions in parts of government and the community that the reform task is largely complete; that it is now time to relax and enjoy the dividends.

The reality, however, is that there is a pressing need for further reform to enable higher living standards across Australia in the face of some major challenges that lie ahead:

- Integration of the world’s economies is increasing, with large developing countries like China and India becoming major global players. While this will provide important new opportunities for Australia, it will also heighten competitive pressures. Our future income growth will depend on how well we can respond.
- Compounding these ongoing globalisation challenges is the growing emphasis on preferential trading arrangements relative to multilateral trade reform.

Countries which are able to match the world's best are more likely to benefit from participation in preferential agreements and cope better with exclusion from them.

- There will be pressure both domestically and internationally to improve environmental outcomes and encourage more sustainable resource use. In some cases, substantial outlays will be needed to achieve these goals.

Box 3 Looking to the future: what to draw from NCP

- That such an ambitious program received support from all governments can be attributed to much pre-existing evidence of the potential gains from reform, to broad agreement on the means of achieving those gains and to effective political leadership.
- A broadly-based reform program improves the prospect that those who might lose from a specific reform still gain overall. This can make it easier to progress reforms that might be difficult to implement on a stand-alone basis.
- A reform framework which embodies agreed principles, while providing for some flexibility in implementation, is well-suited to a multi-jurisdictional reform agenda.
- Reform is likely to progress more effectively where commitments are specified in advance and there is prioritisation of the reform task.
- An effective public interest test is essential to secure beneficial reform and to enhance community acceptance of the reform process.
- Independent and transparent review and assessment processes are critical to secure good outcomes, especially on contentious issues; prevent backsliding; and promote public understanding of the justification for reform.
- In any reform program, the potential adjustment and distributional implications should be considered at the outset, with decisions about transitional assistance guided by appropriate principles.
- Where reforms involve the establishment of new regulatory arrangements, it is important that those regulations be well scrutinised in advance and periodically reviewed to ensure the benefits continue to exceed the costs.
- Providing financial incentives for jurisdictions to follow through with agreed reforms can be very useful in promoting effective outcomes, although the rationale and value of such payments clearly depend on the nature of the reforms.

But perhaps the biggest foreseeable challenge facing Australia in the next 50 years is the ageing of the population (see box 4). Though not unique to Australia and having some important benefits, it will reduce labour supply relative to the population and substantially increase demands on the health and aged care systems. This will constrain growth in household incomes and put considerable pressure on government budgets.

Continued growth in household incomes, while by no means the sole determinant of overall community wellbeing, is a pre-condition for promoting many of the other outcomes that contribute to higher standards of living. Policy initiatives to improve productive capacity and raise incomes will therefore enhance our ability to meet the costs of an ageing population.

Box 4 Challenges from Australia's ageing population

Over the next 40 years, the number of Australians over 65 will increase by more than 70 per cent. Conversely, the numbers of those aged under 15 is set to *fall* by about 6 per cent.

This change in the age structure will have profound economic impacts:

- It will significantly reduce the growth in labour supply. The additions to the labour force in the seven year period 2003-04 to 2011-12 will be more than the projected cumulative additions over the 21 year period to 2044-45. In per capita terms, hours worked are projected to decline by 10 per cent over the next 40 years.
- Slower labour supply growth will in turn constrain economic growth. Per capita GDP growth rates are likely to fall to as low as 1.3 per cent a year in the 2020s — a little over half the present rate. Without ageing, cumulative GDP from 2003-04 to 2044-45 could have been nearly \$4000 billion greater.
- At the same time, there will be greater demands on the health, aged care and social security systems. By itself, ageing of the population could add as much as \$1000 billion to the government-funded component of health care spending over the next 40 years.

While the challenges posed by ageing do not at this stage constitute a 'crisis', equally, their future significance should not be underplayed.

How will further reform help?

To meet these challenges, and to raise standards of living more generally, timely action is needed to increase Australia's productivity and improve sustainability. In essence, sustainability requires that policy settings are consistent with, and help to promote, the economic, social and environmental needs of future as well as current generations.

Further competition-related and other economic reform will be an important part of the policy armoury for achieving these goals. For example:

- Reform-induced improvements in productivity will allow for the production of more and better quality goods and services from a given bundle of resources.

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- Downward pressure on the costs of infrastructure services and other inputs will enhance the capacity of Australian firms to operate successfully in more competitive and complex global markets.
 - So too will the greater flexibility, innovativeness and responsiveness to customer needs engendered by ongoing microeconomic reform.

Competition-related and other reforms can also directly assist in offsetting the economic impacts of population ageing. For instance, reforms which reduce constraints on labour supply will ameliorate one of the important aged-related brakes on Australia's future growth potential. And, as a variety of recent policy initiatives across Australia illustrate, carefully considered market-based approaches can sometimes be employed within a managed framework to improve the cost-effectiveness (including the quality) of 'human services' and to deliver better environmental outcomes. Given the projected escalation in expenditure in areas such as health and aged care, taking advantage of *all* opportunities to improve the efficiency of service delivery will be especially important.

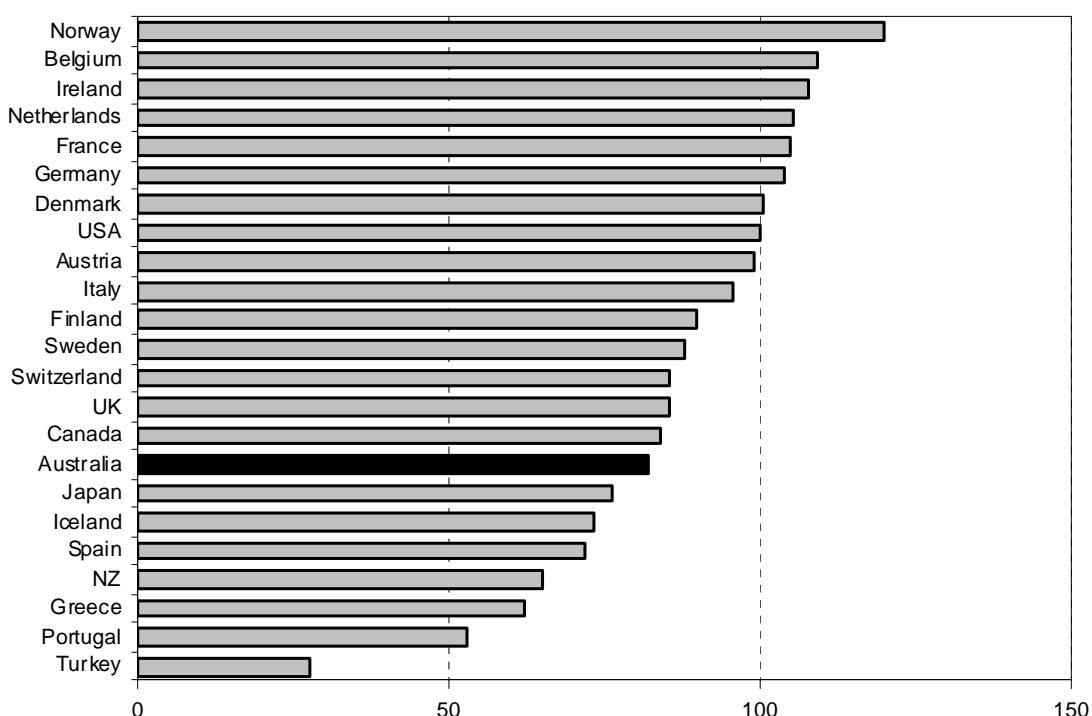
Concerns have been raised that a continuing emphasis on competition and market-based reforms will undermine social capital and add to existing access and equity problems in some key human service areas. But with careful implementation and tailoring to the circumstances at hand, such reforms can be compatible with, and contribute to, important and necessary social goals. For example, the dividend from reform-induced improvements in performance can be returned to the community in various ways, including through better levels of service or more widely accessible services.

The scope for further gains is large

Notwithstanding the improvement in Australia's economic performance in recent years, there are still inefficiencies and performance gaps which, if removed, could yield substantial benefits. For example, if Australian industry could achieve the same labour productivity levels as in the United States — still below the world's highest levels (see figure 1) — gross average household income would be 20 per cent, or some \$22 000 a year, higher.

Whether or not matching US levels of productivity is realistic, the benefits for Australia from realising our productivity *potential* would be substantial and accumulate over time. Indeed, if Australia could sustain even half the improvement in the rate of productivity growth achieved during the 1990s, real cumulative GDP from 2003-04 to 2044-45 would be some \$2000 billion higher than if average productivity growth rates slipped back to the levels of the preceding two decades.

Figure 1 GDP per hour worked in OECD countries, 2003^a



^a Index calculated in 'purchasing power parity' terms. Note that GDP per hour worked depends on the capital and other resources available to a country, as well as on how effectively they are employed.

What criteria for a nationally coordinated reform agenda?

As submissions to the inquiry have demonstrated, the opportunities for further economic reform are wide ranging. In many of these areas, the issues involved are complex and could be the subject of inquiries in their own right. And, in most, competition-related measures could play at least some part in delivering better outcomes. This has posed a considerable challenge for the Commission in reporting on areas 'offering opportunities for significant gains to the Australian economy from removing impediments to efficiency and enhancing competition'.

Reflecting the intent of its terms of reference, the Commission has sought to delineate an agenda that provides some continuity with, and draws on the experiences and lessons from, NCP. Specifically, it has endeavoured to identify areas of national significance where:

- reform is likely to bring substantial productivity and sustainability benefits for the Australian community;
- competition-related measures could usefully form part of the reform package required to deliver those benefits; *and*

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- there is likely to be a high return from using a nationally coordinated reform framework overseen by CoAG or another national leadership body.

Of course, such criteria do not remove the need for judgement about priorities, especially given the limits on the number of reform programs that a body such as CoAG could provide leadership to at any one time. For this reason, the Commission has sought to prioritise further those parts of its proposed agenda which would require the development of major new programs (see later).

Also, in most of the areas that feature on the proposed agenda, the Commission has not been prescriptive about specific reforms. This is because more fact-finding and analysis will be required before detailed reform programs can be developed with confidence. As noted, such detailed preparatory work was a key to securing broad commitment to reform under NCP. Moreover, this time a nationally coordinated reform agenda needs to include areas such as health care, for which the objectives and characteristics of service provision will require the development of principles and frameworks tailored to a quite different set of circumstances — though a number of the lessons from NCP will still be relevant.

Finally, the Commission stresses that exclusion of a policy area from its proposed agenda does not imply that reform in that area is unnecessary or unimportant. Indeed, it has pointed to a number of other areas where further reform is very important, and complementary, and which may require action at a national level. But it has judged that pursuing reforms in these other areas through new coordinated frameworks involving the Australian and State and Territory Governments, is unlikely to be particularly beneficial or effective at this time.

Key elements of a proposed agenda

Infrastructure reform must continue to be a high priority

Infrastructure services are a large part of the Australian economy. They are key inputs for Australian businesses — and their costs, reliability and quality have a major bearing on Australia's international competitiveness. Moreover, affordable and reliable infrastructure services are central to quality of life in the community.

Economic infrastructure is also capital intensive, requiring major investment expenditure on long-lived assets. Poor investment decisions or under-investment could constrain Australia's growth and living standards for many years. The lack of capacity at some of Australia's major ports that is impeding mineral exports — our biggest export earner — provides a contemporary example of what can happen when the supply of and demand for infrastructure are out of balance.

Notwithstanding the performance improvements secured through NCP and related reforms, significant impediments to greater productivity and sustainability remain evident in several infrastructure areas. Many of these would be most effectively addressed within a nationally coordinated reform framework. Indeed, CoAG has already sponsored the development of a suite of new reforms for two of the priority sectors — energy (the Ministerial Council on Energy reform package) and water (the National Water Initiative).

Implementation of the new *energy and water programs* has the potential to provide substantial benefits — though much of the detailed development work has still to be undertaken. The Commission considers that it is very important that governments follow through with these reforms. In addition, it has identified various other reform issues that need to be progressed in these areas.

- In the energy sector these include ensuring that the regulatory regime governing common ownership across transmission and generation activities is adequate to facilitate the efficient development of the national electricity market. A more effective process for addressing regulatory fragmentation in relation to greenhouse gas abatement and the removal of regulatory constraints on retail prices once effective competition has been established (see below), are further key requirements for future performance improvement in the sector.
- In the water sector these include: examining ways to reduce inappropriate water use, including through more effective management of externalities; and developing the property right regimes and trading arrangements necessary to provide scope for the transfer of water between irrigation and urban uses.
- In both energy and water there is also a need to ensure that future monitoring arrangements provide sufficient discipline on all governments to progress agreed reforms.

The Commission also considers that nationally coordinated reform frameworks should be developed for *freight and passenger transport*. Australia's size and distance from major overseas markets necessitates an efficient, reliable and modally integrated freight transport system. Similarly, efficient and effective passenger transport services can promote a variety of economic, social and environmental goals, including: providing access to employment and community services; facilitating social interaction; and assisting with greenhouse gas abatement.

While both of these areas were encompassed by the general provisions of NCP, for the most part, reforms have been developed and implemented in a piecemeal fashion within individual transport modes and jurisdictions. And even then, in areas such as rail transport and coastal shipping, progress in implementing some reform commitments has been very slow. Hence, Australia still has a long way to go to

achieve a transport system that encourages an efficient distribution of the overall freight task between road, rail, water and air; allows for the efficient and seamless movement of freight along the entire logistics chain; and meets the needs of commuters in a cost-effective and sustainable fashion.

Many of the current problems stem from the division of policy responsibility between the Australian and State and Territory Governments. As well as contributing to an array of inefficiencies in service delivery and in the interface between different services, this division of policy responsibility has retarded the development of the sort of institutional arrangements needed to support a more integrated approach to reform. Thus, without much more effective national coordination, it seems inevitable that future reform efforts will again fail to deliver the sort of transport system that Australia urgently needs.

Finally, though a matter for the Australian Government to progress, a key message emerging from the NCP legislation review process is that further reform to promote competition in the communications sector is very important. In an area that has a pervasive impact on the competitiveness of business and the quality of everyday life, Australia can ill-afford regulatory arrangements that hinder the diffusion of new products or that restrict or inhibit new players to the market.

- Removing the still significant number of unwarranted constraints on competition in broadcasting — including restrictions on the number of commercial free-to-air television stations, multi-channelling and datacasting — should be an early priority.
- Government should also undertake the scheduled review of the regulatory regime that would apply to a privatised Telstra as soon as possible, and, among other matters, make explicit provision for that review to consider:
 - whether further operational separation of Telstra's wholesale and retail arms would yield net benefits;
 - the merits of an access regime for telecommunications content; and
 - whether the current regulatory regime is adequate to address any future acquisitions or entry into new activities by Telstra, that could threaten the development of a more competitive telecommunications market.

A more focussed legislation review mechanism should continue

Though the current Legislation Review Program is nearing completion, the Commission considers that it is very important that a review mechanism is retained beyond the current NCP. However, it is proposing that the new mechanism be better targeted towards significant anti-competitive legislation, and involve greater

transparency and independence of review processes. In addition to initiating the scheduled review of anti-dumping legislation, and examining cabotage restrictions as part of the proposed freight transport review, priority should be given to undertaking:

- the previously recommended ‘second round’ review of the single desk marketing arrangements for export wheat as soon as possible; and
- a second round review of pharmacy regulation, covering all potential restrictions on competition in the sector, and conducted in time to inform the negotiation of the 2010 Australian Community Pharmacy Agreement.

In the event that continuing inefficiencies in the provision of workers’ compensation insurance cannot be addressed through new national frameworks foreshadowed by the Australian Government, a second round review of this area together with compulsory third party insurance would also be a high priority.

Moreover, processes for monitoring new and amended regulation should be strengthened to prevent unwarranted restrictions on competition from resurfacing. The Australian and Victorian Government’s regulatory ‘gate-keeping’ arrangements provide useful models for other jurisdictions to follow, though there is scope for improvement in these arrangements as well.

Other aspects of the competition and regulatory architecture can be improved

While many of the NCP’s ‘systemic’ reforms to promote efficient competition across the economy appear to be operating effectively, there are shortcomings in particular aspects. And, in seeking to build on those systemic reforms, some other legislative frameworks affecting competition across large parts of the economy require examination.

Apart from improvements to legislation review and gate-keeping arrangements, one important task is to improve prices oversight arrangements for regulated infrastructure services. Where explicit price controls remain necessary, they should include appropriate incentives for providers to properly maintain facilities and to enhance and augment networks. And in retail infrastructure markets, once effective competition has been established and adequate mechanisms are in place to protect disadvantaged groups, regulatory price constraints should be removed.

A national review of consumer protection policy and administration is also warranted. Such a review would be a natural follow-on to recent reviews of other aspects of trade practices regulation. Amongst other things, it would provide an opportunity to examine:

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- whether such policies are continuing to meet the needs of consumers in a more competitive environment;
 - ways to unify competition and consumer protection laws or to otherwise harness complementarities between them; and
 - options for addressing evident shortcomings in the mechanisms for coordinating the activities of the plethora of Australian Government and State and Territory bodies involved in policy development and application in this area.

Coordinated national reform should extend to areas beyond NCP

The provision of key human services such as health, education and aged care, and natural resource management (other than water), has been largely outside the purview of NCP. Non-economic objectives are very important in these areas, as is the role of cooperation between providers in enhancing service quality and promoting equitable access to services. Accordingly, the scope to employ competition as an effective reform tool is more limited than in infrastructure provision — though there have in fact been various competition initiatives within ‘managed market’ frameworks (see box 5).

Whatever the particular approaches employed, it is clear that these areas will need to feature prominently on future reform agendas aimed at enhancing productivity and sustainability.

- Equitable access to cost-effective human services and sustainable management of the nation’s natural resources are central to the wellbeing of current and future Australians.
- Major and growing resource commitments are involved in both areas. For example, over the next forty years, total expenditure on health care is projected to increase from just under 10 per cent of GDP to between 16 and 20 per cent, with the already substantial government funding commitment increasing commensurately (from 6 to 10 per cent of GDP — see figure 2). Reforms to address widely recognised performance gaps in some of the key human service areas have the potential to provide major savings which could be at least partly used to enhance service quality and accessibility and to cater better for the needs of an ageing population.

Given the complex nature of these areas and the important social objectives involved, a range of strategies will be required to deliver better outcomes. In many cases, competition-related reform will only be a small part of the overall policy package. Explicit recognition that reform is designed to boost productivity and sustainability rather than promote competition, and tailoring reform principles and

frameworks to the particular circumstances involved, will also be essential, both to achieve good outcomes and to secure support for change.

Box 5 Harnessing competition to improve human service delivery and natural resource management

Many areas of human service delivery have traditionally involved an element of competition, even where a share of funding has been provided by government. These include private medical practice, services provided by other health practitioners such as dentists and optometrists, private hospitals, private schools and child care.

But more recently, competition or ‘market-based instruments’ have been introduced into a broader range of human services largely funded and/or delivered by governments. Some focus on creating better incentives for providers to improve their efficiency and to deliver the levels and quality of service required by users, for example:

- ‘yard-stick’ competition involving performance benchmarking against other providers of the same service; and
- performance-based funding (eg. casemix funding for hospitals) and competitive tendering and contracting out, including devolution of responsibility for providing the entire service under ‘purchaser-provider’ arrangements (eg. Job Network, hospital services for Veterans).

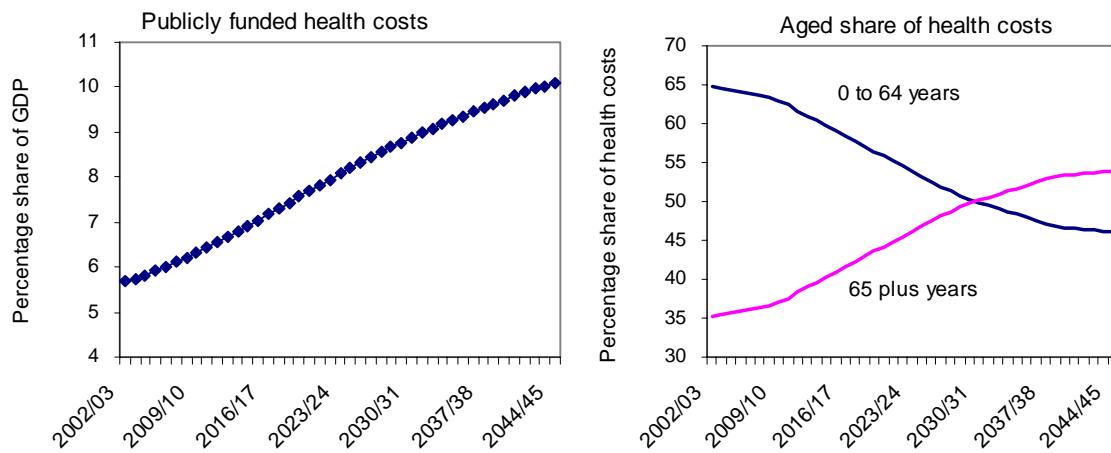
Others seek to improve performance by signalling to providers the value which users place on the services concerned and discouraging wasteful consumption, for example:

- giving users scope to choose their service provider (eg. ‘User Choice’ arrangements in Vocational Education and Training); and
- requiring users to meet at least part of the cost of the services they receive (eg. co-payments for subsidised pharmaceuticals and higher education charges).

Similarly, market-based instruments are increasingly being used to achieve better resource management outcomes. Apart from the creation of tradeable water rights — a key focus of recent water policy reform — examples include: levies on waste disposal and other polluting activities; the purchase of desired environmental outcomes through programs such as BushTender in Victoria; and the salinity and nutrient trading regime in the Hawkesbury Nepean river system in New South Wales.

In the Commission’s judgement, the human service area that currently offers the largest potential benefits from a nationally coordinated reform approach is health care. Australian governments also need to take collective action to energise vocational education and training (VET) reform. And greenhouse gas abatement is but one aspect of natural resource management where enhanced national coordination of the reform process would be highly beneficial.

Figure 2 Projected growth in government-funded health expenditure



Health care reform is at the crossroads

Though Australia's health care system still performs adequately against a number of overall outcome indicators, it is beset by widespread and growing problems. Inefficiencies in resource use, poor outcomes for some community groups and increasing difficulties with access are all indicative of scope for significant improvement. Overlapping roles and responsibilities between the Australian and State and Territory Governments either cause or contribute to some of these problems.

Moreover, underlying demand and costs have been increasing rapidly as a result of strong income growth and advances in medical technology. Over the next forty years, an ageing population will see demand grow even more quickly. It is far from clear that current service delivery and funding arrangements will be able to cope with this potent demand cocktail and its attendant implications for the cost of meeting future health care needs.

In the Commission's view, health care is therefore a prime candidate for a nationally coordinated reform approach under the auspices of CoAG or another national leadership body. While performance deficiencies and the challenges posed by population ageing and advances in medical technology are generally acknowledged, there is little agreement evident across jurisdictions about the best way forward. A circuit breaker is needed.

The first step would be to convene an independent public inquiry into Australia's health care system, akin to the Hilmer inquiry that preceded NCP. This inquiry

should draw on other recent reviews and the work of the Health Reform Task Force established by the Prime Minister in October. It should cover all aspects and sectors of the health care system, but with a particular emphasis on the development of options to clarify roles and responsibilities and associated funding arrangements, and to ensure effective coordination across individual service areas and with aged care services. The findings and recommendations of this broad inquiry would in turn inform the development by Australian governments of an agreed reform framework and program, a timetable for implementation, and mechanisms for monitoring and reporting on progress.

National action is required to re-energise training reform

Australia needs a high quality education and training system, both to meet general community aspirations and to provide the workforce with the skills necessary to sustain our place in an increasingly competitive global environment. There is also a strong link between educational achievement and workforce participation. Hence, as well as enhancing workforce productivity and the capacity for innovation, a world class education system will help to offset the impacts of population ageing on labour supply.

Parts of the education system — for example, the university sector — have been subject to some major recent changes which should ideally be monitored and evaluated before further significant changes are contemplated. And, though there are aspects of school education where a more coordinated approach would be helpful in progressing reform, the challenges posed by joint Federal and State and Territory involvement in the funding and delivery of services do not appear to be of the same order of magnitude as in health care. Moreover, some new initiatives designed to improve outcomes at the national level have recently been announced. Accordingly, the Commission is not convinced that a new wide ranging national initiative in these parts of the education system is warranted at this stage.

In the case of VET, however, there is a considerable risk that efforts to move forward in a nationally coordinated fashion could unravel. Implementation by the States and Territories of agreed reforms in this area has been progressing very slowly. Indeed, increasing concerns about the capacity of the existing regime to address emerging skill shortages has led the Australian Government to announce funding for ‘parallel’ VET arrangements. Collective action by governments to re-energise the reform process is therefore essential.

Coordination of natural resource management needs to be improved and extended

To date, CoAG's role in this area has focussed predominantly on the water sector. And while there have been efforts to pursue some other aspects of reform to natural resource management through nationally coordinated frameworks, the results have generally been disappointing.

An immediate and high priority is better national coordination of greenhouse gas policy. Divergent approaches to greenhouse gas abatement across jurisdictions, as well as uncertainty about future policy directions, risk impeding necessary investment in key parts of the economy. Early action to provide greater policy uniformity and certainty in this area is therefore very important.

The Government has also signalled that CoAG is to play a role in the introduction of less costly ways of meeting environmental objectives in relation to native vegetation and biodiversity. Identification of other natural resource management areas where the pay-offs from national coordination, or more effective coordination, would be high, should be the subject of a future review.

Other key reform areas — but outside a nationally coordinated reform agenda

Two other human service areas where the gains from reform are potentially large are aged care and child care. Apart from promoting broad social objectives, reform in both areas could have a direct role to play in addressing the ageing challenge — the former through improving the cost-effectiveness, range and quality of services available to meet increasing demands on the aged care system, and the latter through helping parents to remain in the workforce while raising their families.

In the case of *aged care*, the recent Hogan review has already put a number of useful reform options on the table. The immediate priority will be to monitor the impacts of changes already made in response to that review and to seriously explore the longer term options proposed, including those calling for greater user contributions. This is a controversial issue which will need to be handled carefully. But without greater emphasis on charging those able to pay, especially for their ongoing accommodation needs, the provision of an appropriate level and quality care for other elderly Australians will be that much harder. While new coordinated reform initiatives do not appear to be needed at this time, it is imperative that reform momentum be maintained.

Continuing to build on past reforms to the delivery of *child care* is similarly important. However, with the private and not-for-profit sector delivering the majority of services (outside pre-schools) and the bulk of subsidies to parents

funded by the Australian Government, the sort of large scale coordination problems that have plagued health care do not appear to be evident in this sector. Hence, while monitoring and evaluating the outcomes of current policies with a view to identifying opportunities to better meet underlying objectives will be important, the pay-offs from developing a nationally coordinated reform approach and strategies do not seem high at this stage.

The Commission's proposed agenda for nationally coordinated reform also leaves out a range of other areas where further policy improvements could be of major benefit to the community, including labour market arrangements, taxation policy, urban planning and regional development.

In the Commission's judgement, most of the issues in the latter two areas are primarily ones for individual States and Territories to resolve (though some planning issues would need consideration within the proposed coordinated reform programs for freight and passenger transport). A key future reform issue in *taxation* policy — the interface between the taxation regime and social security support and its implications for labour supply — lies largely within the province of the Australian Government. And while there have been some concerns expressed about current Ministerial Council arrangements for progressing tax changes that require inter-jurisdictional cooperation, there was no strong push during the inquiry to have tax reform nominated as an area requiring policy attention from CoAG (or another national leadership body).

Labour market arrangements are characterised by significant restrictions on competition which can reduce productivity and constrain the scope for reforms in other markets. For these reasons alone, notwithstanding considerable reform over the past two decades, further policy changes to increase the flexibility and responsiveness of Australian labour markets remain a high priority. In addition, differences in State and Territory provisions, and their interface with Federal arrangements, can create significant complications for, and impose substantial costs on, multi-State employers.

Balancing the costs of divergent approaches against the potential benefits from competition between jurisdictions on the basis of distinctive features of their labour market arrangements is not easy. In any event, given evident differences of opinion at the political level, the development of effective national approaches and frameworks through a body such as CoAG would be unlikely at this time. Indeed, the Australian Government has just announced its intention to unilaterally develop a new national labour market framework. This would retain the current emphasis on negotiating wages and employment conditions at the enterprise level, with such negotiations being governed by a nationally uniform set of rules.

At issue in pursuing a national regime is whether it may still be possible to enhance the scope for beneficial jurisdictional competition. For example, consideration could be given to an optional approach like that recently introduced on a more limited scale for workers' compensation insurance. Under that arrangement, some multi-State employers are able to opt-in to an alternative national regime. The efficacy of a more broadly-based arrangement of this sort (for employees as well as employers) would, of course, depend on the detail.

Suffice to say that building on the labour market reforms of the past two decades is vital to support further improvements in productivity and sustainability, including through easing ageing-related constraints on future labour supply and complementing reforms in other areas. It is also critical that the much needed flexibility and capacity to adapt to changed circumstances provided by previous reforms are not compromised by any backsliding.

Some priorities within the proposed agenda

The proposed agenda developed by the Commission is a challenging and complex one.

That said, significant parts of it are largely continuations of, or extensions to, NCP. These could be accommodated within existing frameworks and draw on well-established reform principles. In several key areas, a considerable part of what is required to deliver better outcomes has already been established. Hence, implementing the additional (or modified) reforms proposed by the Commission for say energy and water should not involve a major new workload for CoAG (or other bodies with policy leadership responsibilities).

But a major new commitment would be entailed in relation to proposed 'new' national agenda areas such as health care. Ideally, CoAG would be responsible for coordinating reforms in all of these areas. However, given its already significant responsibilities, requiring it to action all of the proposed new agenda items immediately could be counterproductive. In particular, the quality of the review and reform process in individual areas could be compromised in the face of resource and time constraints.

Prioritising reforms within the new areas involves considerable judgement. All are economically, socially and/or environmentally significant. And in each, there is evident scope for substantial performance improvement through coordinated policy action. However, based on the complexity of the coordination task and the extent of coordination failure to date, the Commission considers that initiation of nationally coordinated review and reform programs is most pressing for:

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- *health care*: where the complexity and diversity of service provision and the current delineation of financing and delivery responsibilities between the Australian and State and Territory Governments put a premium on effective coordination, but where it is widely accepted that coordination efforts to date have been found wanting;
 - *freight transport*: where the development of an integrated system has been held back by a lack of consistency in policy approaches for individual transport modes, and where an efficient distribution of the freight task will not be achieved without considerably more coordination and cooperation at the national level;
 - *greenhouse gas abatement*: where ineffective coordination has led to divergent policy approaches in an area where national consistency is critical, putting at risk important new investments in key parts of the economy; and
 - *consumer protection policy*: where although the benefits and costs are much less tangible, it seems clear that ineffective national coordination mechanisms have led to regulatory inefficiencies and inconsistencies, to the detriment of both consumers and businesses.

In nominating these four areas, the Commission reiterates that progressing coordinated national reform in the other new areas on its proposed agenda is very important. One option would be for CoAG to commit to picking up these areas at a later date. Alternatively, another national leadership body could be charged with responsibility for initiating the review and reform programs for these areas, or at least be given initial responsibility as a precursor to later CoAG stewardship.

Robust institutional arrangements will be essential

Successful implementation of the Commission’s proposed agenda will require considerable effort by, and cooperation among, governments. In most areas, more detailed work will be needed to determine the most beneficial reform measures and to develop detailed policy prescriptions.

Robust institutional arrangements will also be crucial to the success of the recommended reforms. Indeed, whatever the specific frameworks employed to progress the proposed agenda, it is important that they:

- spell out objectives and principles to underpin reform programs (including effective public interest tests and provision for up-front assessment of adjustment and distributional issues);
- facilitate the analysis required to develop well-founded specific reform options and provide for public input to that process;

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- provide for independent monitoring of progress in implementing changes according to agreed timetables; and
 - embody mechanisms to lock-in the gains of past reforms and prevent backsliding.

Without such features, and strong leadership from CoAG and/or other national leadership bodies with stewardship responsibilities, any new reform program is likely to come up short.

A broadly-based approach would be appropriate for much of the proposed agenda

As to the specific institutional arrangements, a key choice is between:

- encompassing all or many components of the proposed agenda in a broadly-based successor to NCP, with all reform areas subject to broadly common coordination and governance arrangements; or
- implementing individual reform programs on a stand-alone basis, with separate coordination and governance arrangements for each.

To a large extent, the proposed reforms and policy reviews in the areas of infrastructure, legislation review and the economy-wide competition ‘architecture’ represent a continuation or extension of NCP. Hence, in the Commission’s view, there would be considerable merit in continuing to employ the broadly-based approach in these areas. Provision for independent monitoring of implementation progress and outcomes across a sweep of reforms would be particularly beneficial. Moreover:

- There are important synergies between greenhouse gas abatement policies and infrastructure reform, suggesting that the greenhouse area would also fit well within a broadly-based successor to NCP.
- Though having important social objectives, consumer protection policy has significant complementarities with competition policy. Hence, in this area too, there would be advantages in pursuing reform within a broadly-based program.

But not for human service areas

Conversely, in the Commission’s view, it would not be desirable to incorporate the proposed reform programs for health care and VET (or indeed other human services) within a direct successor to NCP. While such a broadly-based program would be concerned with boosting productivity and sustainability rather than simply focusing on competition-related reform, ‘packaging’ an area like health care with economic infrastructure and the like would most probably be counterproductive.

Apart from sending the wrong signal about the motivation for policy change in the human services area, the inclusion of these two areas in the broadly-based program could render it unwieldy and undermine effective monitoring of reform progress and outcomes for all of the constituent elements.

Accordingly, the Commission considers that the proposed nationally coordinated review and reform program for health care, and the energisation of VET reform, should be pursued and monitored on a separate, stand-alone basis. However, were nationally coordinated reform approaches to extend to other human services areas in the future, commonality of policy objectives and strategies required to secure desired outcomes, may offer scope for beneficial combination within a separate broadly-based human services program.

Financial incentives

As noted earlier, competition payments have played a very important role in keeping the NCP reforms on track. In a number of ways, financial incentives could similarly help in progressing a new nationally coordinated reform agenda:

- The vertical fiscal imbalance argument for ‘returning’ revenue dividends from State and Territory NCP reforms would also apply to some of the reforms on the proposed agenda.
- Reforms in areas such as health care where funding and delivery responsibilities are shared between the Australian and State and Territory Governments, will almost inevitably require concomitant adjustments in fiscal transfers.
- In some areas, financial incentives could help the States and Territories to address transitional costs, or any adverse distributional effects from reform, that are not adequately catered for by generally applicable income support and other mechanisms.
- They could help to leverage reforms which, in the face of opposition from vested interests, might otherwise be put in the ‘too hard basket’. The threat of even quite small reductions in payments for non-compliance with NCP commitments appears to have had a salutary effect in this regard.

In the Commission’s view, it follows that any explicit financial incentives should primarily be directed at prospective reforms. That said, to help lock-in the gains from past reforms, it would also be useful to have scope to impose financial penalties for backsliding.

The potential payoffs would be large

Given its concern with broad priorities for reform, the Commission has not sought to put a dollar value on the potential gains. In most of the proposed ‘new’ areas, these would be difficult to estimate with any precision and would depend on the specific reform measures adopted.

However, given the economic, social and/or environmental significance of most of the areas encompassed by the proposed agenda, and the evident scope for performance improvement, the potential pay-offs are likely to be large.

- With productivity levels in most of Australia’s key infrastructure sectors still below world’s best practice, there remain sizeable prospective gains that further competition-related and other reforms could help to unlock. Commission estimates indicate that the flow-on benefits to other parts of the economy from a 10 per cent improvement in productivity in the transport sector alone, could see GDP rise by 1.5 per cent or around \$12 billion annually.
- As noted, health care is a major and growing component of the economy. An efficiency improvement of 10 per cent in service delivery in this sector would provide cost savings equivalent to around 1 per cent of GDP at the present time, and as much as 2 per cent by 2050. Such cost savings could be drawn on to improve service quality and access to the health care system, and to help meet the costs of servicing an ageing population.
- Further improving the efficiency of water use and reducing policy fragmentation and uncertainty in relation to greenhouse gas abatement could increase productivity in a range of agricultural and infrastructure industries, as well as promoting a range of environmental objectives.

By building on the role of past reforms in developing a more resilient economy and a more responsive and innovative business culture, there would also be ongoing dynamic benefits.

A productive and sustainable Australia

In sum, the Commission considers that implementation of its proposed reform agenda could play a central role in helping to enhance living standards in the face of population ageing and other major challenges ahead. Though the proposed agenda envisages further competition-related reforms, its remit is much broader — namely, to harness national coordination and cooperation to promote economic, social and environmental goals and thereby help build a more productive and sustainable Australia. All jurisdictions need to work together to develop the institutional frameworks and supporting processes that would allow the nation as a whole to reap these dividends.

Recommendations for a national reform agenda

Infrastructure services (chapter 8)

Energy

RECOMMENDATION 8.1

Governments should complete all outstanding National Competition Policy electricity and gas reforms, including the introduction of full retail contestability.

RECOMMENDATION 8.2

The Ministerial Council on Energy should give high priority to resolving any outstanding issues concerning the commencement, operation and governance of the Australian Energy Regulator and the Australian Energy Market Commission.

RECOMMENDATION 8.3

Consistent with the findings of the Parer Review, the New South Wales and Western Australian Governments should further examine opportunities for the disaggregation of their publicly-owned generation assets. Once efficient market structures have been established, governments which currently own generation businesses should consider divesting them.

RECOMMENDATION 8.4

An independent national review should be initiated by the Australian Government, in consultation with State and Territory governments, into the competition implications of cross-ownership of transmission and generation assets in the electricity industry. This review should consider the adequacy of the current regulatory regime impacting on such integration, including the access, prices oversight and merger provisions of the Trade Practice Act 1974. It should also consider the need for new legislated cross-ownership restrictions proscribing some forms of integration that involve the transmission network.

RECOMMENDATION 8.5

The Australian Government, in consultation with State and Territory governments, should: re-establish a process, independent of the Ministerial Council on Energy, to monitor the implementation and outcomes of the energy market reform program; and undertake a stocktake of progress in 2010.

Water

RECOMMENDATION 8.6

All governments should complete outstanding NCP water requirements and give high priority to resolving the current uncertainty about the future of the National Water Initiative. Moreover, all parties should work towards the National Water Initiative being national in coverage through re-assessing the possibility of involvement by Western Australia and Tasmania.

RECOMMENDATION 8.7

The CoAG water reform process should also give close attention to:

- *better integrating the rural and urban water reform agendas, including through facilitating water trading between rural and urban areas;*
- *developing ways to better reflect the scarcity value of water and achieve more efficient and effective management of environmental externalities;*
- *developing a set of best practice principles to help ensure that urban waste water recycling proposals are cost effective and environmentally sustainable; and*
- *ensuring that monitoring arrangements post-NCP provide a discipline on all governments to progress agreed water reforms.*

Freight transport

RECOMMENDATION 8.8

The Australian Government, in consultation with State and Territory governments, should initiate an independent national review into the requirements for an efficient and sustainable national freight transport system (encompassing all freight transport modes). Taking account of reforms to date by the Australian Transport Council and individual jurisdictions, this review should map out what is required to:

- *achieve competitive neutrality across all transport modes;*
- *address barriers to competition and efficiency in individual modes; and*
- *enhance interfaces between modes.*

It should also examine what future institutional arrangements would give best effect to the next phase of freight transport reform.

Passenger transport

RECOMMENDATION 8.9

The Australian Government, in consultation with State and Territory governments, should commission an independent national review of the passenger transport sector, to assess the impacts of recent reforms and determine what is now required to deliver further performance improvements in both urban and regional areas.

Communications

RECOMMENDATION 8.10

Unless the reviews currently in progress provide a good case to the contrary, the Australian Government should simultaneously remove the restrictions on the number of commercial free-to-air TV stations, multichannelling and datacasting.

RECOMMENDATION 8.11

Any future liberalisation of cross-media ownership rules should have regard to these and other pre-conditions set out in the Productivity Commission's review of broadcasting regulation.

RECOMMENDATION 8.12

The Australian Government should bring forward the scheduled review of telecommunications regulation prior to the sale of Telstra. The terms of reference should provide for an assessment of:

- *whether further operational separation of Telstra's wholesale and retail arms would yield net benefits;*
- *the merits of an access regime for telecommunications content; and*
- *whether the current regulatory regime is adequate to address any future acquisitions or entry into new activities by Telstra, that could threaten the development of a more competitive telecommunications market.*

Legislation review and gate-keeping arrangements (chapter 9)

The legislation review mechanism

RECOMMENDATION 9.1

Governments should complete the existing legislation review program and agree on a more targeted program of legislation review to continue thereafter. The modified mechanism should:

- *be limited in its scope to areas where reform of anti-competitive legislation is likely to be of significant net benefit to the community;*
- *include provision to bring forward second-round reviews where circumstances have changed significantly, or where the external monitoring agency has assessed a previous review outcome to have been ‘problematic’;*
- *give greater emphasis to independent reviews; provide for adequate public consultation; and require governments to make review reports public;*
- *give explicit recognition in the public interest test to distributional, regional adjustment and other transitional issues;*
- *involve effectively constituted national reviews where legislation in individual jurisdictions has a significant impact on the scope to develop national markets;*
- *give more emphasis to monitoring whether review outcomes are within the range of those ‘that could reasonably have been reached’; and*
- *provide for the monitoring body to be involved in helping to set priorities and timeframes within the more targeted program.*

Gate-keeping arrangements for new or amended regulation

RECOMMENDATION 9.2

All Australian governments should ensure that they have in place effective and independent arrangements for monitoring new and amended legislation.

Governments should also consider widening the range of regulations encompassed by gate-keeping arrangements and strengthen national monitoring of the procedures in place in each jurisdiction and the outcomes delivered.

Priority legislation reviews

RECOMMENDATION 9.3

The Australian Government should, as soon as practicable, initiate the independent review of anti-dumping arrangements previously scheduled under the NCP.

RECOMMENDATION 9.4

The Australian Government, in consultation with the States and Territories, should initiate a broad review of all of the restrictions on competition in the pharmacy sector no later than 2008, in time to inform the re-negotiation of the Australian Community Pharmacy Agreement in 2010.

In re-negotiating the 2005-10 Pharmacy Agreement, the Australian Government should consider introducing a CPI-X indexing arrangement for PBS dispensing fees.

RECOMMENDATION 9.5

The Australian Government should initiate an independent, transparent review of the future of the ‘single desk’ export wheat marketing arrangements in accordance with NCP principles as soon as practicable.

RECOMMENDATION 9.6

The remit of the foreshadowed Advisory Council to develop nationally consistent frameworks for workers’ compensation insurance should be expanded to encompass the development of national frameworks for compulsory third party insurance. As part of that process, the Council should consider whether a further (national) review of restrictions on competition and efficiency in workers’ compensation and compulsory third party insurance is required to facilitate the development of these frameworks.

Other competition and regulatory architecture matters (chapter 10)

Application of the TPA to government businesses

RECOMMENDATION 10.1

The Australian Government, in consultation with the States and Territories, should give consideration to amending the TPA to ensure that all Federal, State and Territory government procurement activities are covered by relevant sections of the Act.

Consumer protection policy

RECOMMENDATION 10.2

The Australian Government, in consultation with the States and Territories, should establish a national review into consumer protection policy and administration in Australia. The review should draw on, rather than replicate, the findings of recently completed and current reviews into aspects of trade practices and product safety legislation. It should focus particularly on:

- *the effectiveness of existing measures in protecting consumers in the more competitive market environment;*
- *mechanisms for coordinating policy development and application across jurisdictions and for avoiding regulatory duplication;*
- *the scope for self-regulatory and co-regulatory approaches;*
- *ways to resolve any tensions between the administrative and advocacy roles of consumer affairs bodies, or introduced by the inclusion of measures to protect small business from unfair competition; and*
- *possible impediments in the current arrangements to greater economic integration between Australia and New Zealand.*

State bidding for investment

RECOMMENDATION 10.3

The recently signed State and Territory agreement aimed at preventing investment ‘bidding wars’ should have strengthened provisions to encourage compliance and be extended to cover all jurisdictions, including the Australian Government.

The competitive neutrality regime

RECOMMENDATION 10.4

The competitive neutrality regime should be retained beyond the life of the current NCP.

Oversight of regulated infrastructure providers

RECOMMENDATION 10.5

Governments and regulatory agencies should continue to explore opportunities to improve the efficacy of price setting and access arrangements for regulated

infrastructure providers. Having regard to approaches outlined in recent Productivity Commission reports into the National Access Regime and the Gas Access Code, particular emphasis should be given to improving incentives for providers to undertake investment to maintain existing facilities and expand networks — including through the implementation of clear and nationally consistent principles to guide regulators.

In retail infrastructure markets, once effective competition has been established, regulatory constraints on prices should be removed. Ensuring that disadvantaged groups continue to have adequate access to services at affordable prices should be pursued through adequate, well targeted and transparent community service obligations (or other appropriate mechanisms), that are monitored regularly for effectiveness.

'New' areas for nationally coordinated reform (chapter 11)

Health care

RECOMMENDATION 11.1

The Australian and State and Territory Governments should initiate an independent public review of Australia's health care system as the first step in the development of an integrated reform program. The review should include consideration of: the key future determinants of demand for and supply of health services; health financing issues (including Federal/State responsibilities and their implications); coordination of health care services (including with informal and formal aged care services); the interface between private and publicly provided services; information management; and the appropriate balance of resourcing between prevention and treatment.

Vocational education and training

RECOMMENDATION 11.2

In taking collective action to re-energise the process of VET reform, Australian Governments should examine whether recent changes to institutional arrangements are sufficient to provide for effective national coordination, or whether further changes to frameworks and processes are required.

Natural resource management

RECOMMENDATION 11.3

The Australian Government, in consultation with State and Territory Governments, should as a matter of urgency develop a more effective process for achieving a national approach to greenhouse gas abatement. Australian Governments should also initiate a review to identify other areas of natural resource management where the pay-offs from new or improved nationally coordinated reform could be high and what is required to reap those gains.

Some priorities within the agenda (chapter 12)

RECOMMENDATION 12.1

As well as continuing to provide policy leadership in areas targeted by NCP, CoAG should give particular priority to leading the development and implementation of new national reform programs for:

- *health care;*
- *freight transport;*
- *greenhouse gas abatement policy; and*
- *consumer protection policy.*

Institutional matters (chapter 12)

General frameworks

RECOMMENDATION 12.2

The institutional framework(s) used to progress future nationally coordinated reforms should be underpinned by:

- *sponsorship of, and effective leadership by, key coordinating and decision making bodies such as CoAG and Ministerial Councils;*
- *clearly enunciated objectives and reform principles;*
- *effective preparatory work detailing the benefits of reform in particular sectors and the specific changes required within jurisdictions to reap those benefits;*
- *some flexibility for jurisdictions to determine how to implement reforms, but with sufficient specification of desired outcomes and priorities to allow for effective monitoring of reform progress;*

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- transparent and independent assessment processes, incorporating a comprehensive public interest test and providing scope for consultation with, and input from, interested parties;
 - a timetable for the implementation of the review and reform program including, as appropriate, interim targets and provision to refine targets as new information emerges, or if circumstances change;
 - independent monitoring and public reporting on progress made in implementing the program; and
 - mechanisms to lock-in the gains of past reforms and prevent backsliding including, as appropriate, financial incentive arrangements (see recommendation 12.4).

RECOMMENDATION 12.3

Those areas of the Commission’s proposed agenda that represent a continuation or extension of NCP, should be brought together in a broadly-based successor with ‘whole of program’ governance arrangements. The proposed national initiatives for greenhouse gas abatement and consumer protection policy should also be included in this broadly-based program.

The proposed national initiatives for health care and vocational education and training should be progressed through stand-alone sectoral reform programs. However, monitoring of, and public reporting on, the reform process and its outcomes in these two areas should be undertaken by a body or bodies independent from those responsible for policy development and implementation.

Financial incentives

RECOMMENDATION 12.4

The Australian Government should seek agreement with the States and Territories on the role and design of financial incentives in a future nationally coordinated reform program, having regard to:

- the revenue impacts of vertical fiscal imbalance on the distribution of the reform dividend;
- the potential role of incentives in leveraging reform and in helping to address transitional and distributional costs attaching to the agreed reform program; and
- the need to orient incentives towards prospective rather than past reforms, while including, where appropriate, penalty provisions for backsliding.

Recognition of adjustment and distributional issues

RECOMMENDATION 12.5

The framework(s) used to progress future nationally coordinated reforms should make explicit reference to the need for up-front assessment of distributional and adjustment issues. It should also include criteria relating to circumstances in which support to ease adjustment difficulties or adverse distributional outcomes is likely to be warranted, and the characteristics such support should embody to facilitate rather than frustrate adjustment and avoid duplication with generally applicable income and other support measures.

Communication and consultation

RECOMMENDATION 12.6

Governments should take a lead role in explaining to the community why further reform is required and what benefits it will bring. They should also ensure that there is effective consultation and engagement with those parties directly affected by reforms.

Other key reform areas

Australia's future reform initiatives need to range more widely than the above program, which focuses on areas where there would be a high pay-off from nationally coordinated approaches.

Other important areas for policy attention include:

- building on recent and current initiatives to improve the quality and responsiveness of primary, secondary and tertiary education and interfaces with the training regime;
- following through on identified measures to enhance the performance of aged care services and monitoring their impacts;
- exploring opportunities to further improve the delivery of child care services;
- extending the scope for workplace flexibility within industrial relations frameworks and addressing constraints on labour supply;
- removing general inefficiencies and perverse work-incentive effects in the taxation system, including by improving its interface with social support programs;

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- finishing the job of removing Australia’s trade barriers;
 - promoting the efficient development of our cities and regions, allowing for their diverse circumstances; and
 - ensuring that there are cost-effective mechanisms in place to address market failures in technological innovation, including appropriate intellectual property protection.

Like the items included on the Commission’s proposed agenda for nationally coordinated reform, policy initiatives in these areas offer the prospect of significant gains for the community. Indeed, in many cases, they would be complementary. However, the Commission’s judgement is that new (or additional) nationally coordinated approaches in these areas are unlikely to be necessary or effective at this time, and hence they have not been included on the proposed agenda.

1 About the inquiry

1.1 Background to the National Competition Policy

Australia's economic performance during the 1970s and 1980s deteriorated markedly. Output growth slowed, inflation and unemployment rose, and living standards (in terms of per capita incomes) relative to those in many other developed countries declined. While external developments (such as the oil price shocks of the 1970s) contributed to this deterioration, recognition began to grow that domestic policy and institutional factors were constraining Australia's productivity potential and were responsible for much of its economic malaise. In particular, tariffs and quantitative import restrictions, inefficient infrastructure services, excessive regulation and inflexible labour and capital markets had collectively insulated much of the economy from competition, led to widespread and significant inefficiencies and constrained Australia's ability to adapt to changing international economic circumstances.

Landmark policy decisions in the early 1980s to float the currency and remove controls on foreign capital flows signalled the first steps in reversing Australia's declining economic fortunes and establishing a more flexible and outward looking economy. Trade reforms followed — initially with the abolition of import quotas and, from the late 1980s, phased reductions in tariff assistance. In the second half of the 1980s, a number of reports highlighted the significant inefficiencies in infrastructure service provision — the overwhelming majority of which were publicly provided. Such inefficiencies not only imposed costs on domestic users, but also reduced the international competitiveness of the traded goods sector. In response, governments at all levels began to focus on improving the performance of key infrastructure sectors such as energy, transport and communications services.

As the reform program gathered pace into the 1990s, it became apparent that the limited purview of existing competition policy arrangements (encompassed primarily within Part IV of the *Trade Practices Act 1974*) would constrain the scope for further reform and the development of a more internationally competitive economy. This view was reflected in the 1991 Prime Ministerial statement — *Building a Competitive Australia*:

The Trade Practices Act is our principal legislative weapon to ensure consumers get the best deal from competition. But there are many areas of the Australian economy today that are immune from that Act: some Commonwealth enterprises, State public sector businesses, and significant areas of the private sector, including the professions.

This patchwork coverage reflects historical and constitutional factors, not economic efficiencies; it is another important instance of the way we operate as six economies, rather than one. The benefits for the consumer of expanding the scope of the Trade Practices Act could be immense: potentially lower professional fees, cheaper road and rail fares, cheaper electricity. (Hawke 1991, p. 1761)

Accordingly, governments saw merit in adopting a coordinated and systematic approach to competition policy reform. This was manifest in the establishment in 1992 of an independent *Committee of Inquiry into a National Competition Policy for Australia* (Hilmer et al. 1993) — known as the Hilmer inquiry after its chairperson. The Committee's recommendations focused on extending the reach of competition to previously sheltered activities.

To help it assess the benefits of adopting the Committee's recommendations, the Council of Australian Governments (CoAG) asked the Industry Commission to quantify the potential economy-wide impacts of key competition policy reforms. In its report to CoAG, the Commission estimated that once the reforms had fully worked their way through the economy: Australia's real GDP would be 5.5 per cent or \$23 billion a year greater than otherwise; households would, on average, benefit by around \$1500 per year; aggregate employment could rise by 30 000; and there would be large revenue gains for the Australian, State and Territory Governments (IC 1995).

In light of the prospective gains, and in recognition of the benefits from a nationally coordinated approach, each jurisdiction committed, in April 1995, to a far reaching six year program of competition reform (subsequently extended to 2005) broadly in line with the Hilmer Committee recommendations. This program also incorporated previously agreed CoAG reforms in electricity, gas, water and road transport. Commenting on the benefits that the National Competition Policy (NCP) was expected to deliver, the Australian Government stated:

Implementing this policy is the most important single development in micro-economic reform in recent years. Ultimately, the ability of the economy to grow, to provide jobs and an improved standard of living, depends on how well the productive potential of the economy is employed and enhanced. ... The payoff ... for ordinary Australians is very real. It paves the way for cheaper prices, more growth and more jobs.

The new integrated and complete approach to national competition policy, which balances economic efficiency and broader elements of the public interest, will give Australia one of the most sophisticated competition policies in the world. ... The

reward will be an economy that provides more opportunities to satisfy the aspirations of all Australians. (Crowley 1995, pp. 2434–9)

1.2 Scope of the inquiry

The Commission was asked by the Australian Government to conduct an inquiry into the impact of current NCP arrangements and report on future competition-related reform priorities. This inquiry report will provide an independent input to CoAG deliberations on a possible future competition policy agenda which are due to be completed by September 2005.

The full terms of reference are reproduced at the front of the report. In essence, they require the Commission to:

- assess the impacts of NCP and related infrastructure reforms undertaken to date on the Australian economy and the community more broadly; and
- report on areas offering future opportunities for significant gains to the Australian economy from removing impediments to efficiency and enhancing competition.

1.3 The Commission's approach

It has used the terms of reference to set the boundaries for the inquiry

In looking at the impact of past reforms, the terms of reference centre specifically on NCP, rather than on microeconomic reform in general. To address this component of its task, the Commission has therefore endeavoured to disentangle the impacts of NCP initiatives from the many other policy and general economic factors that have influenced outcomes in areas targeted by NCP. While precise attribution has (not surprisingly) proved difficult, in many areas it is clear that NCP has been an important contributor to observed outcomes.

In reporting on future reform opportunities, and in keeping with the terms of reference, the Commission has focused on areas that are inherently national in character and which offer the prospect of a significant payoff for the Australian community as a whole. Accordingly, it has not addressed particular issues raised in submissions, which although important in a sectoral or regional context, were not judged to have significant ramifications for Australia as a whole.

Moreover, in seeking to build on, and provide continuity with the approach adopted in the NCP, the Commission has further narrowed its investigations to concentrate on areas where competition-related reform would be potentially beneficial (though not necessarily the primary vehicle for delivering better outcomes). And from this group, it has separated out those areas where nationally coordinated reform frameworks and programs could be particularly helpful in providing impetus to the reform process and/or facilitating effective reform.

The focus of the terms of reference is on reform impacts and opportunities rather than institutional or procedural arrangements. In practice, however, these elements are interrelated as the achievement of specific reform objectives will depend on a well designed and functioning institutional framework. Hence, the Commission has commented on the strengths and weaknesses of institutional settings in the NCP, including the role of the National Competition Council and financial transfers, and the pros and cons of some broad approaches for implementing any future nationally coordinated reform agenda.

It has taken a community-wide perspective

In assessing NCP impacts and reporting on opportunities for further reform, the Commission has been guided by the operating principles and general policy guidelines contained in the *Productivity Commission Act 1998*. Like the terms of reference, they require the Commission to consider impacts on overall community welfare, as well as on specific industry and community groups.

This community-wide framework implicitly recognises that policy change typically involves both winners and losers, benefits and costs. While the costs imposed on particular groups need to be taken into account, they do not provide a justification for forgoing reforms where those costs are substantially outweighed by benefits to the wider community. However, they do point to the need for effective implementation mechanisms to ease the burden of adjustment and any significant adverse distributional impacts associated with policy change. The importance of adjustment issues is recognised explicitly in both the terms of reference for this inquiry and the Commission's Act.

It has tailored its proposals to the nature of individual activities

The Commission's assessment of priority areas for future nationally coordinated reform covers not only activities in the market sector of the economy, but also publicly provided human services and aspects of natural resource management.

Some of these activities have been subject to considerable review (including by the Commission) and public debate in recent years. In several of the ‘traditional’ reform areas, a broad consensus has emerged on the most appropriate way forward. In these areas, the Commission has therefore been able to point to some specific policy initiatives which are likely to deliver effective outcomes.

However, in other areas, while the nature of the problems which need to be addressed is clear, the way forward is much less so. For example, in the human services area, differences in service and consumer characteristics, and potential trade-offs between economic and social objectives, mean that reform approaches must be heavily tailored to take account of specific circumstances. This is particularly so in areas such as health care where access to services by the community in general, and disadvantaged groups in particular, is a key objective. In such cases, the Commission has focused on identifying broad service areas where the pay-offs from addressing inefficiencies through nationally coordinated reform frameworks and programs are likely to be high, and where reform opportunities should therefore be subject to more detailed review.

Indeed, in an inquiry of this type — which seeks to identify an agenda for future reform across a broad range of areas — it is not feasible to undertake a detailed review of each specific area. Accordingly, the primary purpose of this report is to raise issues and canvass reform options and approaches which will provide an input to the development of a future reform agenda by CoAG.

It has provided opportunities for extensive public input

The Commission has sought to provide the opportunity for a range of interested parties to contribute to its deliberations.

- At the outset of the inquiry, the Commission released an Issues Paper (PC 2004g) and invited written submissions on the matters under review. Prior to releasing a Discussion Draft (see below), it received 135 submissions from a cross-section of industry, union, government, environmental, welfare, regional and community interests.
- Over the period April to July 2004, the Commission met with 49 organisations, groups and individuals covering a wide range of interests across all jurisdictions.
- Two formal roundtable discussions were held on specific aspects of the inquiry in July 2004. The first, in Wagga Wagga, focused on NCP impacts on rural and regional communities and was attended by representatives from a broad cross-section of agricultural interests, manufacturing firms, infrastructure service providers, welfare associations, local government, health care and education providers. A second roundtable, in Canberra, covered the future reform agenda

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- and related priorities and was attended by a group encompassing academic, consulting, social welfare and public policy interests.
- The inquiry also benefited from feedback at a roundtable discussion on competitive neutrality issues organised by the Australian Government Competitive Neutrality Complaints Office. This roundtable, held in Canberra on 15 June 2004, was attended by various State and Territory officials involved in the development and application of competitive neutrality policy, as well as by representatives from the National Competition Council.
 - In October 2004, the Commission released a Discussion Draft (PC 2004h) outlining its preliminary analysis and proposals for a future reform agenda. To elicit views on the Discussion Draft, the Commission held public hearings in Sydney, Melbourne, Canberra and Perth during November and December. Some 44 organisations and individuals participated in discussions at those hearings. (A further hearing scheduled for Toowoomba, Queensland, was cancelled due to a lack of participants wishing to make presentations). The Commission also received around 130 written submissions responding specifically to the analysis and preliminary proposals in the Discussion Draft.

More detail on inquiry processes is provided in appendix A, including lists of those with whom the Commission met, those who made submissions and those who participated in the roundtable discussions and the public hearings. The Commission thanks all of the organisations and individuals who contributed to the inquiry.

It has drawn on other relevant analysis

In preparing this report, the Commission has had regard to assessments in recent published studies examining progress in NCP implementation (in particular those by the National Competition Council) and the impacts of specific NCP reforms. It has not reproduced this work in detail. (The studies it has drawn upon are included in the reference list at the rear of the report). The Commission has also drawn on related review activity such as the CoAG work on energy and water and the Dawson Review of the competition provisions of the *Trade Practices Act 1974*. In accordance with its terms of reference, it has not replicated this work.

Further, in examining the impacts of NCP to date, the Commission has undertaken economic modelling to help inform its own assessment of the reform program. While modelling cannot replicate reality, and is only one of many inputs relevant to assessing NCP impacts, it can provide indicative orders of magnitude on the economy-wide effects of productivity and price changes induced by reform, as well as provide insights into adjustment and distributional impacts — including those on rural and regional communities.

However, in contrast to its previous modelling of NCP reforms, the Commission has not attempted to quantify the gains from the new reform areas identified in this report. This is mainly because it has viewed its task as primarily scoping in nature, rather than the development of detailed options in individual areas. Moreover, in areas such as human services and natural resource management, data limitations and conceptual issues (such as how to place a dollar value on access and equity effects) render modelling problematic.

The results of the Commission's preliminary modelling of the impacts of productivity and price changes in key infrastructure sectors subject to NCP reforms were made available for scrutiny and comment at a workshop held in Canberra on 26 July 2004. It also held a further workshop on the distributional components of that modelling in Canberra on 1 February 2005. Feedback from those workshops has been taken into account in the version of the modelling results presented in this report. The Commission also had access to the results of modelling undertaken by the Victorian Government, which focused on the prospective impacts of NCP on the Victorian economy. A supplement to this report, documenting the Commission's modelling results and summarising the workshop proceedings and referees' comments, is available on the inquiry website.

1.4 Guide to the report

The report comprises three parts.

- The remainder of the first part provides:
 - a snapshot of progress in NCP implementation (chapter 2).
- The second part looks at impacts of NCP to date. Specifically, it covers the:
 - contribution of NCP to Australia's recent economic performance (chapter 3);
 - price and service quality outcomes for businesses and households and impacts on the financial performance of government business enterprises (chapter 4);
 - social, employment, regional and environmental impacts (chapter 5); and
 - lessons learnt from NCP processes and outcomes that could help inform the development and implementation of a future nationally coordinated reform agenda (chapter 6).
- The final suite of chapters covers future reform opportunities. Specifically, they:
 - explain the importance of continuing with competition-related and other reform (chapter 7);

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- identify infrastructure areas where there are likely to be high pay-offs for the community from further reform and where competition-related reform is likely to be a key element in delivering those benefits (chapter 8);
 - consider the operation of legislation review and gate-keeping processes for new and amended legislation, and the scope to improve their effectiveness, as well as identifying some priorities for future legislation reviews (chapter 9);
 - explore ways to improve other institutional and regulatory structures in place to promote efficient competition across the economy (chapter 10);
 - look at the role of nationally coordinated reform frameworks and programs in improving the delivery of some key human services and in enhancing aspects of natural resource management, as well as briefly canvassing some other high priority reform areas (chapter 11); and
 - identify some priorities within the proposed reform agenda and outline institutional and procedural approaches that would assist in its implementation (chapter 12).

2 Progress in implementing the NCP

Key points

- National Competition Policy (NCP) aims to improve Australia's economic performance — and thereby raise living standards — by promoting competition in previously sheltered activities.
- Key reform commitments include extending the reach of the *Trade Practices Act 1974* to a range of new businesses (including government businesses), measures to improve performance in key infrastructure sectors and the review and reform of a wide range of legislation restricting competition.
- While NCP has a presumption in favour of competition, provision was made to allow restrictions on competition to be maintained where they could be shown to be in the public interest.
- Most NCP reforms have been, or are being, implemented. The main areas of unfinished business involve the completion of the legislation review program and reform in the water sector.
- While much has been achieved, the agreed NCP initiatives have not always been sufficient to realise their underlying objectives — a notable example is electricity, where the reforms have yet to deliver a fully competitive national market.
- Competition payments from the Australian Government to the States and Territories have been an important motivator of reform. Nevertheless, penalties imposed for non-compliance by some States and Territories in 2003-04 and 2004-05, were substantial.
- The Australian Government has also failed to meet some important NCP reform commitments, particularly in relation to the legislation review program.

2.1 Introduction

In broad terms, the National Competition Policy (NCP) was aimed at exposing previously sheltered activities to competition — an explicit recognition that, in most cases, competitive markets deliver better outcomes than administrative (or heavily regulated) systems of service delivery (see box 2.1).

Box 2.1 Competition versus administered market arrangements

The role of competitive markets in encouraging efficient resource use and promoting community well-being more generally has long been recognised. Competitive markets usually deliver good outcomes because they act to align the interests of consumers and suppliers. That is, in seeking to maximise profits, suppliers have strong financial incentives to produce at the lowest cost, to provide the mix and quality of goods and services required by consumers and to innovate in order to achieve a competitive edge.

Moreover, competitive markets often need relatively little regulation to function effectively — relying on prices to convey information about supply and demand, and thereby conditioning the behaviour of consumers and producers. Importantly, while well functioning competitive markets require defined and enforceable property rights, they do not depend on the existence of a large number of firms. Where there is only a small number of suppliers, the threat of being undercut by new entrants to the market if prices are too high or quality is poor will often ensure that the needs of consumers are met efficiently and expeditiously.

However, competitive markets are not feasible in some circumstances. Two examples are markets with natural monopoly characteristics (where the threat of entry is low) and those where significant externalities exist — such as in research and development. In such cases, well designed regulatory interventions that modify market place behaviour can improve outcomes for the community.

Further, while competitive markets will often deliver cost-effective outcomes, they do not guarantee access to goods and services. That depends on individual incomes. Access objectives are often pursued through income transfers to certain community groups. But governments have also tended to regulate supply in areas where access is seen as a key priority. Two prominent examples are the provision of health and education services where governments have traditionally determined what, and how much, to produce (through a specific budget allocation).

Unlike competitive markets, administered market arrangements often fail to provide strong incentives for efficiency, to respond to changes in consumer needs and facilitate innovation. For example, as outlined in chapter 11, administrative delivery of health services has contributed to a range of problems, including rising costs and inefficiencies in service delivery. Also, with governments often having a significant role to play in funding service provision, the adequacy of that funding is critical to the outcomes achieved.

In response to these sorts of problems, as well as the escalating cost of providing such services, governments in many countries (including Australia) have been exploring ways to introduce managed competition into administered markets. Market-based incentives to improve efficiency (within a framework which maintains service quality, equity, access and quality) have included performance benchmarking, performance-based funding, user charges, competitive tendering and contracting out. However, the scope to use competition depends on the characteristics of the particular service, meaning that a case-by-case assessment is required (see chapter 11).

This involved extending the reach of the anti-competitive conduct provisions of the *Trade Practices Act 1974* (TPA) to a range of new businesses, structural and other reforms to public monopolies (particularly those providing infrastructure services), the implementation of a national access regime for essential infrastructure and the review and, where appropriate, reform of legislation which has restricted competition across a broad range of areas. Some previously agreed reforms in the electricity, gas, water and road transport sectors were also brought within the NCP. A summary of NCP and its institutional framework is shown in figure 2.1. (Some examples of competition-related initiatives that are often attributed to NCP, but which are not required by it, are presented in box 2.2.)

Much has been accomplished since NCP was introduced in April 1995. A wide range of activities — including infrastructure services, agricultural marketing, professions, occupations, financial services, retail trade and water resource management — have undergone substantial change. In addition to the direct economic, social and environmental impacts, NCP has also contributed to a more responsive and innovative business culture in both the private and public sectors.

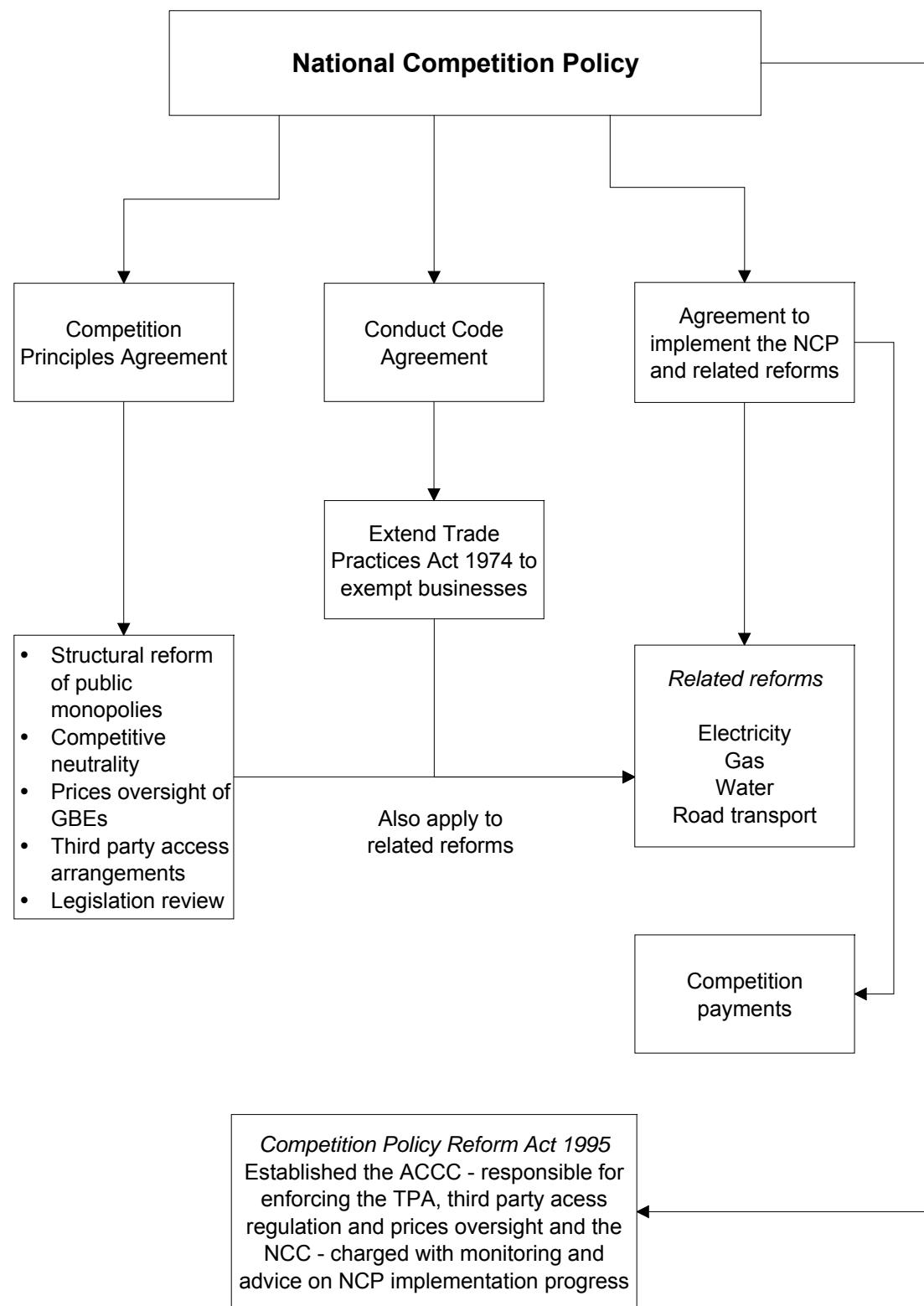
That said, the implementation of the package (as a whole) remains incomplete. This reflects the sheer size of the NCP agenda, differences in the required degree of reform and the approach adopted across jurisdictions, and extensions to the original timetable for some initiatives. This chapter provides an overview of progress in implementing the NCP reforms, with a more detailed description of the package provided in Appendix B. The outcomes of these reforms are assessed in subsequent chapters.

2.2 Progress in NCP implementation

Extending the anti-competitive conduct provisions of the TPA

The TPA has been the central legislative instrument governing competition law in Australia for the past three decades. Its primary aims are to promote competition and fair trading. At the heart of the TPA are provisions that prohibit various anti-competitive practices (unless authorised on public benefit grounds by the Australian Competition and Consumer Commission — ACCC). These prohibitions cover collusive agreements (for example, price fixing and market sharing), misuse of market power, exclusive dealing, resale price maintenance and mergers that are likely to substantially lessen competition (see appendix B, table B.1).

Figure 2.1 The National Competition Policy framework



Source: Derived from NCC (1998b).

Box 2.2 What is *not* part of the National Competition Policy

Coinciding with the implementation of NCP, a number of other competition-based reforms have been introduced. These include: the increased use of contracting out and competitive tendering by government agencies; the introduction of competition (through a variety of mechanisms) in the provision of some human services (such as health, education and training, and community services); and the use of market-based instruments to deliver better environmental outcomes.

These other competition-based reforms are not formally part of NCP (although they do share the same underlying rationale). Similarly, reforms in other areas of the economy — such as industrial relations and taxation — are not part of NCP.

Also, NCP does not require, as a matter of course, asset sales and privatisation, reductions in public sector employment, removal of community service obligations (just that they be made transparent) or reductions in infrastructure services to rural and regional Australia, even though these outcomes may have been associated with some NCP reforms.

Prior to the commencement of NCP, the TPA's coverage was limited by the scope of the Australian Government's constitutional power. Thus, State and Territory governments, government business enterprises (GBEs), unincorporated entities (such as sole traders and partnerships) and various other activities were generally exempt from the conduct provisions.

Extending coverage of the TPA to previously exempt government business activities and unincorporated enterprises was one of the earliest (and perhaps most straightforward) NCP reform initiatives. To give effect to this reform, the Australian Government amended the TPA in 1996 by inserting the Competition Code (Part XIA) into the Act to provide for the States and Territories to pass legislation to enact a modified version of Part IV, the Competition Code, in each of their jurisdictions. All States and Territories subsequently implemented the agreed legislation to take effect from July 1996.

Reforms to public monopolies

Reform programs for the electricity, gas and water sectors that were previously (and in some cases remain) dominated by public monopolies, and which had been the subject of earlier Council of Australian Governments (CoAG) agreements, were subsequently incorporated into NCP (see below). In addition to these specific commitments, governments agreed to adhere to certain principles, outlined in the Competition Principles Agreement (CPA), *should they choose* to expose their other

public monopolies — in areas such as railways, ports, airports, public transport, telecommunications and postal services — to competition or privatised them.

The CPA principles sought to establish the conditions necessary for effective competition in these markets. They cover four elements:

- *structural reforms* — including the separation of regulatory and commercial functions, reviewing the merits of separating natural monopoly from potentially contestable service elements and of separating contestable elements into smaller independent businesses;
- *competitive neutrality* — involving the adoption of a corporatised governance model for significant businesses which remained publicly owned, imposing on them similar commercial and regulatory obligations (such as liability for taxes or tax equivalent payments, dividends and rate of return requirements) to those faced by private sector businesses, and establishing independent mechanisms for dealing with complaints that these requirements have been breached;
- *prices oversight* — establishing independent authorities in each jurisdiction to set, administer or oversee prices for enterprises which remained monopoly service providers; and
- *third party access arrangements* — providing legal avenues for firms to use nationally significant infrastructure services (such as rail networks) owned and operated by others (on ‘reasonable’ terms and conditions and at ‘fair’ prices) if commercial negotiations for access to those services are unsuccessful.

Structural reform commitments (many of which were well advanced before NCP commenced) have resulted in extensive changes to the operations of GBEs in most jurisdictions. These businesses have either been corporatised, privatised and/or had their statutory monopoly protection removed. Many vertically integrated providers have been separated into competing businesses, either on an activity or regional basis, and regulatory functions have in most cases been transferred to independent authorities. Examples of developments in governance arrangements in the freight and passenger transport sectors are presented in box 2.3.

In addition, all jurisdictions have published competitive neutrality policy guidelines and established complaints handling offices. Similarly, each government (where they had not already done so) established independent prices oversight bodies to monitor and regulate monopoly service providers. The ACCC was given responsibility for setting and overseeing prices for monopoly businesses not under State/Territory control (such as Telstra).

Box 2.3 Examples of changes to governance arrangements in freight and passenger transport

Reflecting the flexibility provided by the Competition Principles Agreement, the approach to reform of governance arrangements in freight and passenger transport activities has varied across jurisdictions.

Rail

Substantial structural reform in the rail sector occurred during the 1990s, especially in Victoria and New South Wales. Structural separation of the formerly vertically integrated public monopolies has occurred in both States, with Victoria opting to privatised freight services and franchise its passenger services. In contrast, New South Wales has adopted a corporatisation model for all its separated government business units. In Queensland, both freight and passenger rail services have also been corporatised, but they are still provided by a single vertically integrated entity. And Western Australia has privatised its rail transport businesses.

Ports

Port authorities in all States and the Northern Territory have been corporatised with most moving to a ‘landlord model’, where the authority is involved in the provision of core activities only and the more contestable elements such as harbour towage, dredging and stevedoring are provided by private contractors. Stevedoring activities are declared services and subject to prices surveillance by the ACCC. Declaration of harbour towage activities was repealed in 2002.

Airports

As part of the Australian Government’s reform commitments, all major airports have been privatised. Price regulation of aeronautical services, which initially took the form of price caps, now involves price monitoring (under the *Prices Surveillance Act 1973*) by the ACCC.

Also, a national third party access regime (administered by the ACCC) has been established, along with a host of industry specific access regimes which have been certified as ‘effective’ (meaning they satisfy certain agreed criteria) under the TPA. Many of these industry regimes are governed by State/Territory legislation and are administered by their respective prices oversight bodies. They include regimes providing access to electricity distribution networks, gas pipelines, rail networks, shipping channels and ports. Federal regimes apply to the national electricity market and to telecommunications, airports and postal facilities.

Unfinished business in reforms to public monopolies

While substantial progress has been made in implementing NCP commitments in this area, the NCC (2004b) indicated that NCP requirements had not been satisfied in the cases of:

- Western Power — the public monopoly in the Western Australian electricity sector — where the Electricity Corporations Bill which was introduced in October 2003 to vertically separate the generation, network, retail and regional components of the entity, was subsequently withdrawn by the Western Australian Government;
- Telstra, where the merits of structurally separating the local fixed network from its other business have not been reviewed; and
- The Australian Wheat Board, where legislation continues to provide the Board with a monopoly export position.

In addition, the NCC has pointed to some gaps in the application of competitive neutrality principles in certain key sectors of the economy — particularly health services and universities.

Review of anti-competitive legislation

Under the CPA, each jurisdiction agreed to list, review and, where appropriate, reform all legislation which restricts competition by 30 June 2000. This deadline was subsequently extended to 30 June 2003, with incomplete or non-compliant review and reform activity after that date potentially subject to adverse recommendations on competition payments (see section 2.3). The guiding principle was that legislation (either existing or proposed) should not restrict competition unless it can be demonstrated that the:

- benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of the legislation can only be achieved by restricting competition.

As such, NCP reverses the usual onus of proof for regulatory restrictions to be maintained. That is, those seeking to retain such restrictions are required to demonstrate that removal would *not* be in the interests of the broader community.

Nonetheless, a central feature of NCP is its recognition that restrictions on competition may sometimes be desirable. Accordingly, the CPA provides a non-exhaustive list of factors to be considered in assessing whether particular anti-competitive legislation is in the public interest and should be maintained (see box 2.4).

Box 2.4 The public interest test

The guiding principle under the NCP is that competition will generally enhance community welfare by encouraging greater efficiency. Governments are given the flexibility, however, to deal with circumstances where competition is considered to be inconsistent with social, environmental, equity and regional objectives. Where the CPA calls for: the benefits of a particular policy or action to be balanced against its costs; the merits of a particular policy or action to be determined; or for an assessment of the most effective means of achieving a policy objective — a non-exhaustive list of public interest factors shall (where relevant) be taken into account. These include:

- laws and policies relating to ecologically sustainable development;
- social welfare and equity considerations, including community service obligations;
- laws and policies relating to matters such as occupational health and safety, industrial relations, access and equity;
- economic and regional development, including employment and investment growth;
- the interests of consumers generally or a class of consumers;
- the competitiveness of Australian business; and
- the efficient allocation of resources.

In addition, a 2000 CoAG directive to enhance the public interest test requires governments to consider reform impacts on particular industry sectors and community groups. However, this directive has not been codified in the public interest test.

Apart from recourse to the public interest test, governments can also secure exemptions for anti-competitive arrangements through: authorisation of anti-competitive conduct by the ACCC on public benefit grounds; and statutory exemptions for certain conduct provided for under Section 51 of the TPA.

Sources: Anderson (2001); NCC (1996b); PC (1999b).

Legislation review schedules were published by each jurisdiction in 1996, with around 1800 individual pieces of legislation listed for scrutiny. The legislation was subsequently divided by the NCC into priority areas (those restrictions likely to have the greatest impact on competition) and non-priority areas (see box 2.5). According to the NCC's latest published tranche assessment (NCC 2004b), while considerable progress had been made, no government had fully implemented its review and reform obligations at that time (see table 2.1).

Box 2.5 Priority legislation review areas identified by the NCC

Primary industries

Barley/coarse grains; dairy; poultry meat; rice; sugar; wheat; fishing; forestry; mining; food regulation; agricultural and veterinary chemicals; quarantine; bulk handling.

Planning, construction and development

Planning and approvals; building regulations and approvals; related professions and occupations (such as architects).

Fair trading and consumer legislation

Fair trading legislation; consumer credit legislation; trade measurement legislation.

Finance, insurance and superannuation

Workers compensation insurance; compulsory third party motor vehicle insurance; professional indemnity insurance; public sector superannuation scheme choice.

Retail regulation

Shop trading hours; liquor licensing.

Communications

Australian Postal Corporation Act 1989: third-party access regime; *Broadcasting Services Act 1992* and related legislation; *Radiocommunications Act 1992*.

Professions and occupations

Chiropractors; dentists and dental para-professionals; *Health Insurance Act 1973 (Commonwealth)*; medical practitioners; Medicare provider numbers for medical practitioners; nurses; occupational therapists; optometrists, opticians, optical para-professionals; osteopaths; pathology collection centre licensing; pharmacists; physiotherapists; podiatrists; psychologists; radiographers; speech pathologists; practitioners of traditional Chinese medicine; legal services; conveyancers; real estate agents; security providers; motor vehicle dealers; travel agents; employment agents.

Social regulation

Education services; gambling; child care services.

Transport services

Road freight transport (tow trucks, dangerous goods); rail services; taxis and hire cars; ports and sea freight; international liner cargo shipping (Part X of the TPA); air transport.

Water

Legislation relating to water management, supply, irrigation, trading and water corporations.

Source: NCC (2003a).

At 30 June 2004 (the latest available information), close to three-quarters of the priority reviews had been completed — that is, the reviews had been finalised and legislation passed to implement reforms consistent with the guiding principles. The completion rate for non-priority areas was close to 90 per cent. Examples of outstanding priority legislation review matters (where the review and reform of legislation was not completed, or completed reviews and/or the reforms undertaken did not satisfy NCP principles) are shown at table 2.2.

Table 2.1 Overall outcomes from the review and reform of legislation^a

Government	Proportion of complying 'priority' legislation		Proportion of complying 'non-priority' legislation		Proportion of total legislation complying	
	2003	2004	2003	2004	2003	2004
Australian	33	60	66	77	51	70
New South Wales	69	83	79	84	73	83
Victorian	78	84	83	86	81	85
Queensland	61	83	92	92	71	86
Western Australian	31	46	54	73	44	62
South Australian	37	60	82	90	63	77
Tasmanian	77	82	90	95	84	89
ACT	59	81	97	98	85	93
Northern Territory	47	79	83	90	62	83
All governments	56	74	81	87	69	81

^a Includes the stock of legislation identified by each jurisdiction in their original legislation review schedules, jurisdictions' periodic additions and existing, amending and new legislation containing restrictions on competition identified by the NCC. Excludes most water, electricity, gas and road transport related legislation.

Source: NCC (2004b, p. 9.6).

Table 2.2 Examples of priority legislation review breaches, as at 30 June 2004^a

Government	Regulation/legislation
Australian	<ul style="list-style-type: none">• Export marketing arrangements for wheat• Broadcasting regulations• Postal services
New South Wales	<ul style="list-style-type: none">• Chicken meat industry negotiation framework (currently being reviewed)• Rice marketing (review announced)
Queensland	<ul style="list-style-type: none">• Liquor legislation restrictions
Western Australia	<ul style="list-style-type: none">• Retail trading hours• Liquor legislation restrictions (review announced)• Potato marketing
South Australia	<ul style="list-style-type: none">• Liquor legislation restrictions• Barley marketing arrangements
Northern Territory	<ul style="list-style-type: none">• Liquor legislation restrictions

^a Victoria, Tasmania and the ACT had no priority legislation review breaches as at 30 June 2004.

Source: NCC (2004b).

In elaborating on this unfinished business in its latest published assessment, the NCC (2004b) noted that a number of difficult reform areas remain where assessments of anti-competitive legislation have been difficult or inordinately slow; where there has been renegeing on commitments; or where there has been a tension between social policy and competition policy objectives. A number of reviews

continue to fail the NCC's assessment on the basis that adequate 'public interest' cases for maintaining restrictions on competition have not been provided. Certain agricultural marketing arrangements (for example, single desk wheat marketing and chicken meat), retail trading hours, liquor licensing, professions and occupations, gambling and the regulation of taxis and hire cars have been some of the most prominent areas singled out by the NCC (see table 2.2).

Concerns have also been raised regarding the adequacy of review processes for new and amended legislation restricting competition. Specifically, the NCC has contended that there has sometimes been a failure to demonstrate a net public benefit and/or alternative means of achieving legislative objectives. According to the Council, this partly reflects deviations from the 'best practice' model of subjecting all proposed legislation to regulation impact assessments and examination by an independent agency. This issue is discussed further in chapter 6, with some possible design improvements in any future legislation review program and gate-keeping arrangements canvassed in chapter 9.

Related infrastructure reforms

All governments commenced reforms in the key infrastructure sectors of electricity, gas, road transport and water in the late 1980s. This led to several inter-governmental agreements being drawn up in the early 1990s. They included:

- the 1992 agreement by Australian Transport Ministers on national road transport reform to improve efficiency and safety, and reduce the costs of regulation;
- the 1993 agreement between the Australian, New South Wales, Victorian, Queensland, South Australian and ACT Governments to form a competitive interstate electricity market;
- the 1994 CoAG agreement to provide for free and fair trade in gas between and within the States and Territories; and
- the 1994 CoAG agreement to implement a framework for the efficient and sustainable reform of the Australian water industry.

As mentioned earlier, these specific initiatives were subsequently incorporated within the NCP and referred to as the 'related reforms'. Where relevant, the generic NCP reforms also apply to these sectors and reform packages. The nature of the related reforms, their broad objectives and progress in their implementation are discussed briefly below. More detail is provided in appendix B.

Electricity

Until the late 1980s, electricity supply in Australia was characterised by publicly owned, vertically integrated monopoly suppliers operating in separate, extensively regulated, State markets. Excess generation capacity and electricity prices which bore little resemblance to the cost of supplying different classes of users characterised the industry.

The cornerstone of reforms in the sector was the concept of establishing a fully competitive National Electricity Market (NEM) in southern and eastern States. This was to be achieved primarily through:

- structural separation of generation, transmission and distribution activities;
- corporatisation of government owned electricity utilities;
- allowing customers to choose their supplier (whether generators, retailers or traders);
- establishing an interstate transmission network and non-discriminatory access to the interconnected transmission and distribution network;
- removing all discriminatory regulatory barriers to entry for new participants in generation or retail supply, and to interstate and/or intrastate trade;
- implementing cost reflective pricing for transmission services with greater scope for averaging for distribution network services, and transparency and inter-jurisdictional consistency of network pricing and access charges; and
- facilitating inter-jurisdictional dispatch and sourcing of generation capacity (where cost effective).

As shown in table 2.3, although there are still some important areas of unfinished business in particular jurisdictions, most governments have met their key obligations in this area.

The NEM became operational in December 1998 (although as it has transpired, interconnection of transmission networks to provide for the sharing of reserve capacity by most participating jurisdictions has not proved to be particularly effective). Third party access arrangements for network infrastructure have also been established in each participating jurisdiction.

Table 2.3 Progress in electricity reform, as at December 2004

Reform	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Structural separation	✓	✓	✓	✗	✓	✓	✓	✓
Introduction of relevant NEM arrangements	✓	✓	✓	na	✓	□	✓	na
Third party access	✓	✓	✓	✓	✓	✓	✓	✓
Independent access and pricing regulators	✓	✓	✓	✓	✓	✓	✓	✓
Full retail contestability	✓	✓	✗	□	✓	□	✓	□

✓ – Fully implemented; □ – Implementing; ✗ – Little or no progress; na – Not applicable.

Sources: Commission assessment based on information contained in NCC tranche assessments (2003b, 2004b) and NCC (personal communication).

Competition has been introduced into the generation and retail sectors by permitting eligible users to negotiate directly with suppliers of their choice. All large customers (those consuming in excess of 100 megawatt hours per year) are now able to choose their supplier. Retail contestability for smaller customers (including domestic consumers) is in place in all jurisdictions except Queensland (where a review is currently being undertaken to assess the merits of introducing contestability to this group).

Structural separation of previously vertically integrated electricity providers has been completed in all NEM jurisdictions, with most opting to maintain government ownership of the separated entities under a corporatised governance model. However, Victoria has fully privatised its electricity assets, while South Australia has chosen a private sector leasing arrangement. The outcomes for prices and service quality are discussed in chapter 4.

While there has been considerable progress in electricity reform, it has become clear that the original objective of a fully competitive national electricity market has not been achieved. For a range of reasons, including inadequate transmission links, the regional markets have yet to be effectively transformed into a national market.

The recent CoAG Energy Market Review noted that while the failure to realise a fully competitive national market was due partly to incomplete implementation of the NCP reforms, some unintended consequences of those reforms had also played a role (CoAG Energy Market Review 2002b, p. 8). Specifically, among the factors detracting from reform objectives, the review identified inefficient institutional arrangements (due to multiple regulators); a lack of grid interconnection (arising from poor incentives for transmission investment and inappropriate pricing structures); insufficient competition in generation; inflexible price signals for

residential customers; and regulatory and market features limiting the use of long term contracts.

In response, CoAG has agreed to the establishment of a national regulator — the Australian Energy Regulator — and an agency to manage the national market — the Australian Energy Market Commission. It also committed to work towards the achievement of a National Energy Policy. These initiatives are discussed in chapter 8.

Gas

Australia's natural gas industry also developed on a jurisdictional basis, with exploration, production and distribution undertaken by vertically integrated (often government owned) monopolies. Extensive regulation of gas suppliers and legislation restricting the flow of gas both within and beyond State boundaries were also features of the industry.

Gas market reform has centred around the development of a national gas market characterised by more competitive supply arrangements. Specific reform commitments have involved:

- removing all legislative and regulatory barriers to interstate trade in gas;
- corporatisation of government owned gas utilities;
- structural separation (or ring fencing) of transmission and distribution activities in each State and Territory;
- introduction of a national framework for third party access to gas transmission and distribution pipelines (the National Gas Access Code); and
- full retail contestability allowing consumers to choose gas suppliers.

The majority of these reforms have been implemented, with only a few outstanding issues for particular jurisdictions (see table 2.4). Structural separation of vertically integrated suppliers has been completed and all governments have introduced legislation to apply the Gas Code to their jurisdictions (although the Queensland regime has been assessed by the NCC as not being 'effective'). All government owned gas utilities have been corporatised and, in many cases, privatised. Constraints on interstate trade in gas have been removed, contributing to a near doubling of transmission pipeline investment between 1989 and 2001 (with much of the increase occurring after the 1994 CoAG agreement). In addition, legislation to provide for full retail contestability is in place in most jurisdictions (the main exception being Queensland which has chosen not to implement retail contestability for customers using less than 100 terajoules of gas per year).

Table 2.4 Progress in gas reform, as at December 2004

Reform	NSW	Vic	Qld	WA	SA	Tas ^a	ACT	NT
Third party access regime in place	✓	✓	✓	✓	✓	✓	✓	✓
Access regime certified as effective	✓	✓	✗ ^b	✓	✓	□	✓	✓
Removal of legislative/regulatory restrictions ^c	✓	✓	✓	✓	✓	✓	✓	✓
Institutional reform (eg structural separation and corporatisation)	✓	✓	✓	✓	✓	na	✓	✓
Independent access and pricing regulators	✓	✓	✓	✓	✓	✓	✓	✓
Full retail contestability	✓	✓	✗	✓	✓	□	✓	✓

✓ – Fully implemented; □ – Implementing; ✗ – Little or no progress; na – Not applicable.

^a A natural gas pipeline to Tasmania only became operational in 2002 and the gas industry in Tasmania is in its infancy. Legislation for an access regime is in place and Tasmania applied to have this legislation certified by the NCC in October 2004. ^b The NCC found that the Queensland gas access regime did not meet the requirements for ‘effectiveness’ under Part IIIA of the TPA. This finding and recommendation against certification is with the Federal Treasurer. ^c While most review and reform of legislation relating to natural gas has been completed, the NCC noted that the review and reform of legislation relating to the exploration and development of undersea petroleum resources (an upstream issue) had not been completed in any jurisdiction at the time of its latest assessment.

Sources: Commission assessment based on information contained in NCC tranche assessments (2003b, 2004b) and NCC (personal communication).

But while NCP reform commitments are largely complete, the CoAG Energy Market Review (Parer 2002) expressed concerns about the impact on new investment of regulatory arrangements in the Gas Access Regime and the level of competition in upstream gas supply. As noted above, the Committee’s recommendations in these areas was considered by CoAG in the development of a National Energy Policy (see chapter 8).

Similarly, in its recent report on the Gas Access Regime (PC 2004i), the Commission found that the access arrangements could potentially discourage or distort investment in gas infrastructure. To address this problem, it advocated, where appropriate, a move away from cost-based price regulation and reliance instead on price monitoring, as well as the introduction of arrangements providing scope to exempt new gas pipelines (on a case-by-case basis) from access provisions for a 15 year period. In releasing the report, the Australian Government (Costello 2004b) indicated that the Ministerial Council on Energy would be charged with developing a response to the Commission’s recommendations.

Road transport

Australia's road transport industry has historically operated within a diffuse and inefficient regulatory framework which has imposed considerable costs on road users. Reform initiatives have primarily involved improving regulations (including their inter-jurisdictional consistency) and the introduction of road pricing arrangements that seek to provide greater alignment between heavy vehicle charges and road usage costs.

In 1992, CoAG agreed on a national approach to road transport reform aimed at improving transport efficiency and road safety and reducing the administrative and compliance costs of regulation. These commitments pre-date NCP and, following their inclusion in the package, have been modified and extended (see appendix B). In broad terms, the reforms in this area have attempted to achieve greater uniformity in six areas:

- heavy vehicle charges;
- arrangements for the transport of dangerous goods;
- vehicle operation reforms, covering national vehicle standards, road worthiness, mass and loading rules, oversize and over-mass vehicles, driving hours, route restrictions and other road rules;
- a national heavy vehicle registration scheme;
- a national driver licensing scheme; and
- a consistent and equitable approach to compliance and enforcement of road transport rules.

Implementation of the NCP road transport reforms is almost complete. Outstanding issues mainly relate to specific licensing and registration scheme initiatives in three jurisdictions. According to the NCC's most recent assessment (NCC 2004b), these outstanding reforms are expected to be implemented during 2004-05.

Despite this progress, concerns have been raised by the road transport industry about reform inconsistencies and shortcomings in the reform package. In responding to these claims, the NCC (2003a) stated that the reform agenda to 2001 had not comprised all of the initiatives needed to develop a nationally consistent regulatory regime.

In this context, a number of reform proposals put forward by the National Road Transport Commission (now the National Transport Commission) in recent years have yet to be endorsed by CoAG. They cover, among other things, securing further improvements in road safety, regulatory compliance and enforcement procedures, and initiatives that would involve greater reliance on performance-based standards

and emissions guidelines. The proposals also seek to consolidate a number of earlier NCP reforms. (More detail on the specific proposals is provided in appendix B.) Other opportunities to extend transport reform are discussed in chapter 8.

Water

Reform initiatives in this area date back to the early 1980s and were motivated by: excessive and inappropriate urban and rural water use; the cost of constructing new water supplies (dams); and the environmental damage caused to river systems, land (such as salinity and waterlogging) and biodiversity by excessive water use (IC 1998a, NCC 2003b). In 1994, CoAG agreed to a reform framework to make the Australian water industry more efficient and sustainable. The framework was to be phased in by 2001. Key initiatives included:

- *Institutional reforms* — involving the commercialisation and corporatisation of government entities delivering water and sewerage services by 1998, with the aim of increasing commercial disciplines on these entities; the separation (as far as practicable) of the roles of water resource management, standards setting and regulatory enforcement and service provision; and the adoption of integrated natural resource management arrangements.
- *Pricing reforms* — involving consumption-based pricing and cost recovery (including, where practical, a return on the replacement cost of assets); the reduction or elimination of cross-subsidies; making any remaining subsidies transparent and, ideally, paid to the service deliverer as a community service obligation; and the setting aside of funds for future asset refurbishment and/or upgrading of government supplied water infrastructure — for urban water services by 1998 and for rural water supply by 2001.
- *Investment reforms* — ensuring investment in new rural water supply schemes, or in the extension of existing schemes, occurs only where an appraisal indicates that it is both economically viable and ecologically sustainable.
- *Allocation and trading reforms* — requiring the implementation of comprehensive systems of water allocations or entitlements, including: allocations for the environment with substantive progress towards a better balance in water use in stressed and over-allocated rivers by 1998; water property rights separated from land title and entitlements clearly defined in terms of ownership, volume, reliability, transferability and quality; and permanent trading in allocations or entitlements by 1998 (including interstate trading where feasible).

The precise requirements differ between the rural and urban water sectors, with some initiatives applying only in the rural sector. And, upon their inclusion in NCP

in 1995, water reform commitments were extended to include groundwater supplies (artesian and sub-artesian) and initiatives aimed at improving water quality.

All governments are making progress in implementing their water reform commitments (see table 2.5), although at different rates and using different approaches. The NCC (2003d) noted that this reflects the complexity of the reforms, the diversity of administrative and legislative environments across jurisdictions, differences in the health of river systems and the different interests of stakeholder groups. At the time of its 2004 tranche assessment, the NCC (2004b) commented that satisfactory progress in implementing NCP water commitments had been made by all governments except New South Wales (with respect to environmental allocations) and Western Australia (legislation review). CoAG has extended the original timetable for the allocation and trading reforms with completion of these components due later in 2005.

More specifically, the reform initiatives that were required of the urban sector are, for the most part, well advanced, with the widespread introduction of a consumption-based component in charges to help discourage overuse and implementation of financial cost recovery by service providers to ensure better signals for new investment. Various institutional reforms have also been implemented to increase the commercial disciplines on, and the accountability of, those entities delivering water and sewerage services, with most jurisdictions having corporatised their urban water authorities. In South Australia, the management of the water supply has been contracted out to private sector operators.

In particular areas in rural water, significant progress against NCP requirements has also been made. All jurisdictions have enacted legislation separating water entitlements from land title and introduced arrangements for economic and ecological appraisal of proposed new water schemes. Implementation of pricing and institutional reforms has also led governments to either create independent regulatory bodies or bring water within the purview of existing regulatory agencies. Various administrative reforms have been implemented to improve the efficiency of the authorities delivering bulk water to irrigators. And according to the NCC (personal communication), most rural water providers are moving towards cost recovery, although some smaller rural services will never achieve this target.

Table 2.5 NCC assessment of progress in NCP water reform, as at December 2004

Reform	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	MDBC
Pricing – urban water									
Full cost recovery	√s	✓	√s	√s	√s	√s	✓	✓	na
Two-part tariff	√s	✓	√s	✓	✓	✓	✓	✓	na
Cross subsidies removed, others made transparent	✓	✓	✓	✓	✓	□	✓	✓	na
Pricing – rural water^a									
Full cost recovery	□	□	√s	□	na	✓	na	na	✓
Two-part tariff	✓	✓	✓	√s	na	✓	na	na	✓
Cross subsidies removed, others made transparent	√s	✓	✓	□	□	✓	na	na	✓
Investment appraisal	✓	✓	✓	✓	✓	✓	✓	✓	na
Institutional reform^b									
Separation of service provision and regulatory roles	✓	✓	✓	✓	✓	✓	✓	✓	✓
Integrated catchment management approach	√s	√s	□	√s	√s	√s	√s	√s	✓
Commercial business focus	✓	✓	✓	✓	✓	✓	✓	✓	✓
Irrigation scheme management devolution	✓	✓	✓	√s	√s	√s	na	na	na
Entitlements & trading^b									
Legislation separating water entitlements from land title	✓	✓	✓	✓	✓	✓	✓	✓	na
Licences converted/ allocations defined	√s	√s	√s	✓	√s	√s	✓	✓	na
Trading in water rights	□	□	□	□	□	√s	□	□	na
Environment^b									
Environmental allocations									
Stressed and over-allocated river systems ^c	√s	√s	na	na	na	na	na	na	□
Other systems surface/groundwater ^c	√s	√s	□	□	✓	□	✓	□	na
Water quality management	√s	√s	□	□	√s	√s	□	√s	na
Landcare practices (high value rivers)	✓	✓	✓	✓	✓	✓	✓	✓	na
Ecological appraisal (new rural schemes)	✓	✓	✓	✓	✓	✓	✓	✓	na

^a These rural water pricing reforms apply to government owned water businesses. The ACT and the Northern Territory do not have government owned rural water businesses. South Australia has privatised many of its former government owned irrigation businesses and intends to privatise the remainder. ^b NCP reform requirements in these areas differ between the urban and rural sector. ^c These systems were self-identified by each jurisdiction in their 1999 implementation programs.

✓ – Fully implemented; √s – Substantially implemented; □ – Implementing; na – Not applicable. MDBC – Murray Darling Basin Commission.

Sources: NCC (sub. 71, personal communication).

However, progress in implementing some other NCP rural water reforms — including pricing that incorporates a component for the environmental impacts of water storage and distribution, appropriate environmental water allocations, the establishment of secure water entitlements and the trading of these entitlements — has tended to be generally slow and variable. In these areas, significant differences have emerged between jurisdictions in the interpretation of, and approach to implementing, some reforms.

In response to the complexities involved with the water reform program, CoAG has since developed the National Water Initiative (NWI) to progress and extend current NCP obligations. The Inter-Governmental Agreement on the NWI was signed by most jurisdictions in June 2004 and is discussed further in chapter 8, though there is currently some uncertainty about whether the NWI will proceed.

More recently, the Prime Minister (Howard 2004a) announced the establishment of the Australian Water Fund — a \$2 billion initiative primarily aimed at accelerating the dissemination and adoption of the latest water use technologies and practices across Australia over a five year period (see appendix B).

2.3 Competition payments

An important feature of the NCP institutional framework is the competition payments made by the Australian Government to the States and Territories for satisfactory progress in implementing their reform commitments. The payments are a recognition by CoAG (1994a) that all governments should share in the benefits of economic growth and the associated higher taxation revenue resulting from the reform program and that, with the high degree of vertical fiscal imbalance, much of the increase in tax revenue would initially accrue to the Commonwealth.¹

Funds totalling about \$5.7 billion were allocated for competition payments over the period 1997-98 to 2005-06 (table 2.6).² This funding level was developed with reference to the Industry Commission's (IC 1995) estimates of the benefits of implementing the reform program. According to CoAG (1994a):

1 While local governments are not formally parties to the NCP, each State and Territory government accepted reform obligations on their behalf. Some jurisdictions (Queensland, Victoria and Western Australia) have shared, at various times, part of their competition payment pool with local governments as an incentive for them to implement relevant NCP reform commitments.

2 The Australian Government had included an allowance in the Contingency Reserve of the budget for competition payments to continue in 2006-07 and 2007-08. However, it recently announced its intention to redirect these funds to the Australian Water Fund (Howard 2004a).

Table 2.6 Competition payments, 1997-98 to 2005-06^a
 \$ million

	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
NSW	127	139	210	156	243	252	257	262	269
Vic	93	102	152	115	180	182	190	194	199
Qld	74	82	119	73	148	139	146	151	156
WA	38	42	62	46	71	72	75	77	79
SA	34	38	54	36	56	57	59	59	61
Tas	13	14	19	11	17	18	18	18	19
ACT	6	7	11	8	12	12	13	13	13
NT	11	13	14	5	8	8	8	8	8
Total	396	437	640	448	733	740	765	782	802

^a Figures for 1997-98 to 2003-04 are final budget outcomes. Figures for 2004-05 and 2005-06 are estimates.

Source: NCC (2003b).

[These estimates] would be used to assist the Council in determining ... the increase in the Australian Government's revenue which might be expected from [NCP] reforms and the appropriate percentage share which should accrue to the States, Territories and local government.

Assessments of reform progress are undertaken by the NCC. To date, the Council has completed six assessments — in June 1997, 1999, 2001, 2002, 2003 and 2004. It has also undertaken supplementary assessments to reconsider certain outstanding issues. On the basis of these assessments, the Council makes recommendations to the Federal Treasurer on whether the States and Territories have met their commitments to implement the NCP reforms and, consequently, whether they should receive NCP payments in full. The Treasurer is responsible for the final decision on the actual level of any penalty. The Australian Government is not eligible for competition payments (nor subject to penalties for non-compliance).

The NCC commented in its initial submission that competition payments (and by extension penalties for non-compliance) have been an important contributor to the success of the NCP:

Using competition payments to leverage reform outcomes in areas of State and Territory responsibility has proven highly effective. ... Reform would have been far slower and less comprehensive without competition payments. These payments (now at around \$800 million per year) may not be large relative to State and Territory budgets, but nonetheless represent a significant source of incremental funds. (sub. 71, p. 35)

In assessing the nature and quantum of any penalties that it recommends, the Council takes into account the significance of the compliance breach, the extent of the State or Territory government's overall commitment to NCP implementation and the effect of that jurisdiction's reform efforts on other jurisdictions (NCC 2003a). Penalties fall into three categories:

-
- permanent deductions, for specific compliance failures;
 - specific suspensions, which apply until predetermined conditions are met; and
 - pool suspensions (which can also be recouped), which apply to groups of compliance failures in non-priority areas of the legislation review program, but which do not warrant an individual penalty.

Penalties imposed by the Treasurer for 2003-04 and 2004-05 are shown in table 2.7. In 2003-04 (the first year that significant competition payments were withheld), penalties totalled around \$180 million, equivalent to just under 24 per cent of the competition payments allocated for that year. The bulk of these penalties were in the form of (recoverable) specific or pool suspensions. Queensland accounted for around a third of total penalties, and Western Australia and New South Wales for around a quarter each. In its latest assessment (NCC 2004b), the Council recommended the release of nearly all specific and pool suspension payments for 2003-04, in light of action by State and Territory governments to comply with the NCP commitments concerned. The Treasurer accepted this recommendation.

Penalties for 2004-05 were around \$140 million (about 18 per cent of competition payments allocated for that year) with the majority of these also in the form of suspensions rather than permanent deductions. New South Wales, Queensland and Western Australia accounted for more than 90 per cent of the total penalties.

The Australian Government has also been notable for the extent and significance of its compliance breaches (see tables 2.1 and 2.2).

Table 2.7 Competition payment penalties for 2003-04 and 2004-05^a

	<i>Penalties imposed for 2003-04</i>	<i>Action on 2003-04 suspensions</i>	<i>Penalties imposed for 2004-05</i>	
New South Wales				
Water reform obligations	—	—	10% suspension (\$26.0m)	
Rice marketing legislation	—	—	5% suspension (\$13.0m)	
Chicken meat industry legislation	5% permanent deduction (\$12.7m)	—	5% suspension (\$13.0m)	
Regulation of liquor sales	5% permanent deduction (\$12.7m)	—	—	
Outstanding legislation review items	10% pool suspension (\$25.4m)	Release full amount	—	
	Sub-total	\$50.8m	Sub-total	\$52.0m
Victoria				
Outstanding legislation review items	5% pool suspension (\$ 9.4m)	Release full amount	—	
	Sub-total	\$ 9.4m	Sub-total	\$ 0.0m
Queensland				
Full retail contestability in gas	—	—	5% suspension (\$ 7.6m)	
Regulation of liquor sales	5% permanent deduction (\$ 7.3m)	—	5% permanent deduction (\$ 7.6m)	
Tranche 4A electricity reforms	10% suspension (\$14.6m)	Release full amount	—	
Full retail contestability in electricity	15% suspension (\$21.9m)	Permanently deduct funds	15% suspension (\$22.7m)	
Outstanding legislation review items	10% pool suspension (\$14.6m)	Release full amount	—	
	Sub-total	\$58.4m	Sub-total	\$37.9m
Western Australia				
Structural electricity reforms	—	—	15% suspension (\$11.5m)	
Retail trading hours regulation	10% permanent deduction (\$ 7.5m)	—	10% permanent deduction (\$ 7.7m)	
Regulation of liquor sales	5% permanent deduction (\$ 3.7m)	—	5% permanent deduction (\$ 3.8m)	
Regulation of potato marketing	5% permanent deduction (\$ 3.7m)	—	5% permanent deduction (\$ 3.8m)	
Lack of transparency in water pricing	10% suspension (\$ 7.5m)	Release full amount	—	
Regulation of egg marketing	5% suspension (\$ 3.7m)	Release full amount	—	
Outstanding legislation review items	20% pool suspension (\$14.9m)	Release 5 percentage points (\$ 3.7m) and permanently deduct 15 percentage points (\$11.2m)	15% pool suspension (\$11.5m)	
	Sub-total	\$41.0m	Sub-total	\$38.3m

Table 2.7 **continued**

	<i>Penalties imposed for 2003-04</i>	<i>Action on 2003-04 suspensions</i>	<i>Penalties imposed for 2004-05</i>	
South Australia				
Chicken meat industry legislation	5% permanent deduction (\$ 2.9m)	—	—	
Regulation of liquor sales	5% permanent deduction (\$ 2.9m)	—	5% permanent deduction (\$ 3.0m)	
Barley marketing arrangements	5% suspension (\$ 2.9m)	Permanently deduct funds	5% suspension (\$ 3.0m)	
Outstanding legislation review items	15% pool suspension (\$ 8.7m)	Release 5 percentage points (\$ 2.9m) and permanently deduct 10 percentage points (\$ 5.8m)	10% pool suspension (\$ 5.9m)	
	Sub-total	\$17.4m	Sub-total	\$11.9m
Tasmania				
Outstanding legislation review items	5% pool suspension (\$ 0.9m)	Release full amount	—	
	Sub-total	\$ 0.9m	Sub-total	\$ 0.0m
ACT				
Outstanding legislation review items	10% pool suspension (\$ 1.2m)	Release full amount	—	
	Sub-total	\$ 1.2m	Sub-total	\$ 0.0m
Northern Territory				
Regulation of liquor sales	5% permanent deduction (\$ 0.4m)	—	5% permanent deduction (\$ 0.4m)	
Outstanding legislation review items	15% pool suspension (\$ 1.1m)	Release full amount	—	
	Sub-total	\$ 1.5m	Sub-total	\$ 0.4m
Total		\$180.6m		\$140.5m

^a In response to the Council's recommendations in its 2003 NCP assessment, the Australian Government applied a range of penalties to governments' 2003-04 competition payments. The penalties included permanent (irrevocable) deductions and suspensions of payments. In response to the Council's recommendations in its 2004 NCP assessment, the Australian Government released most of the suspended 2003-04 payments, in addition to applying a range of new penalties to governments' 2004-05 competition payments.

Source: NCC (2004b).

3 Australia's recent economic performance and the role of NCP

Key points

- It was anticipated that NCP would enhance Australia's economic performance and community living standards by increasing the incentives for enterprises to be efficient, innovative and responsive to the needs of consumers.
- Previous quantitative modelling by the Commission (in 1995 and 1999) of the 'outer envelope' of potential improvements from implementing NCP reforms yielded estimates of GDP gains in the long term of up to 5.5 per cent.
- Australia's economic performance has improved markedly since the early 1990s on a number of measures and has exceeded that of many other developed countries.
- A key feature of this improved performance has been a surge in productivity growth. During the latest productivity cycle, multifactor productivity — a measure of the efficiency with which both labour and capital are used — grew at more than double the rate in the previous cycle. The productivity boost yielded the equivalent of an additional \$7000 to the 'average' Australian household.
- Notwithstanding difficulties in establishing causality, a range of indicators strongly suggest that microeconomic reform in general, and NCP in particular, have been principal contributors to the improvement in Australia's productivity performance and have delivered significant benefits to the community.
- Quantitative modelling by the Commission for this inquiry indicates that recent productivity improvements and price changes in six key infrastructure sectors have generated a permanent increase of 2.5 per cent in Australia's GDP (around \$20 billion). NCP reforms have been an important contributor to these observed productivity improvements and price changes.
- The more flexible, responsive and innovative business culture engendered by NCP and other microeconomic reforms should provide additional 'dynamic efficiency' gains to the community over time.

3.1 Introduction

Australia's economic performance since the early 1990s has shown a marked improvement compared to earlier periods and the experience of many other developed countries. Stronger growth in per capita incomes, lower inflation and (more recently) lower unemployment and sharply higher export growth, have been hallmarks of this improved performance. Importantly, these outcomes have been achieved against a backdrop of major domestic and international constraints on Australia's growth potential. Underpinned by a surge in productivity growth, that performance suggests a more responsive and flexible economy.

Such performance improvement and the ensuing enhancement of living standards was the key objective of the microeconomic reform program (of which the National Competition Policy (NCP) was a part) which began in the early 1980s. Obviously, it is not possible to draw an explicit link between specific reforms and the recent improvement in Australia's economic performance. Time lags between reform implementation and impact, the complementary nature of many reform initiatives, the concentration of adjustment costs in the near term and the influence of various other economic policies and developments (such as population growth and movements in the terms of trade) mean that care and judgement are required in reaching conclusions on causality.

Nonetheless, the timing of specific policy changes over the last two decades is strongly suggestive of a link between economic reform and the improvement in Australia's productivity performance that has underpinned the strong recent growth in per capita incomes. (A summary of key economic reforms over the last two decades is presented in box 3.1.) Indeed, it is now widely accepted that microeconomic reform — of which NCP is a part — has played a principal role in fostering this period of improved prosperity (see, for example: Forsyth 2000; OECD 2003c; Henry 2004c). The linkages between NCP and the recent improvement in Australia's economic performance are the subject of the remainder of this chapter.

Concerns have nevertheless been raised that the aggregate economic gains over the last decade or so have not been distributed evenly across the community and that inequality of incomes and wealth more generally is contributing to social problems. The distributional impacts of NCP are discussed in chapter 5.

Box 3.1 Two decades of economic reform

In addition to NCP and related infrastructure reforms in electricity, gas, water and road transport, Australia's program of economic reform over the last two decades has included extensive policy changes in the following areas:

Capital markets — the Australian dollar was floated in March 1983, foreign exchange controls and capital rationing (through interest rate controls) were removed progressively from the early 1980s and foreign-owned banks were allowed to compete — initially for corporate customers and then, in the 1990s, to act as deposit taking institutions.

Trade reforms — reductions in tariff assistance (that began in 1973) and the abolition of quantitative import controls — mainly in the automotive, whitegoods and textile, clothing and footwear industries — gathered pace from the mid 1980s. The effective rate of assistance to manufacturing fell from around 35 per cent in the early 1970s to 5 per cent by 2000.

Infrastructure services (pre NCP) — partial deregulation and restructuring of airlines, coastal shipping, telecommunications and the waterfront occurred from the late 1980s. Across-the-board commercialisation, corporatisation and privatisation initiatives for government business enterprises were progressively implemented from around the same time.

Government services — competitive tendering and contracting out, performance-based funding and user charges were introduced in the late 1980s and extended in scope during the 1990s; administrative reforms (for example, financial management and program budgeting) were introduced to human service provision in health, education and community services in the early 1990s.

Labour market policies — the Prices and Incomes Accord operated from 1983 to 1996. Award restructuring and simplification, and the shift from centralised wage fixing to enterprise bargaining, began in the late 1980s. Reform accelerated in the mid 1990s with the introduction of the *Workplace Relations Act 1996*, further award simplification (through limiting prescribed employment conditions in enterprise bargaining agreements) and the introduction of individual employment contracts (Australian Workplace Agreements).

Macroeconomic policy — inflation targeting was introduced in 1993. From the mid 1980s fiscal policy targeted higher national saving (and a lower current account deficit) and, from the mid 1990s, concentrated on reducing government debt, primarily financed through asset sales (privatisation).

Taxation reform — capital gains tax and the dividend imputation system were introduced in 1985 and 1987, respectively. The company tax rate has been lowered progressively from the late 1980s. A broad-based consumption tax (GST) was implemented in 2000, replacing the narrow wholesale sales tax system and a range of state-based duties. And income tax rates were lowered at the same time.

Sources: PC (1996); IC (1998c); Forsyth (2000); Gruen and Stevens (2000).

3.2 Australia's recent economic performance

Improved outcomes across a range of indicators

Measured against a range of indicators, the Australian economy could be said to have experienced a renaissance since the early 1990s.

- There have been thirteen years of uninterrupted output growth averaging around 3.5 per cent a year in real (inflation adjusted) terms — one of the longest expansion phases on record.

During the 1990s, real per capita incomes (a better measure of improvements in living standards, although just one element of wellbeing — see chapter 7) grew at the quickest pace since the 1960s — and without the benefit of an unprecedented boom in global demand for Australian resources which fuelled growth in the 1960s. Indeed, per capita income growth in the second half of the 1990s was equal to the highest rates achieved during the 20th century.

- In an international context, only one other OECD economy, Ireland, grew faster than Australia in the decade to 2001. And just three OECD countries recorded higher per capita income growth over the same period.

Inflation was also greatly reduced (although this was a global phenomenon). Underlying growth in consumer prices over the 1990s averaged just 2 per cent — the lowest since the 1930s and significantly below the very high rates recorded in the previous two decades. This was a striking outcome given the strength of economic activity, especially during the second half of the 1990s. Historically, the emergence of inflationary pressures has often served (through the need for remedial policy action) to limit the duration and strength of expansionary phases in the Australian economy.

Employment growth during the 1990s was somewhat slower than earlier periods and was characterised by much stronger growth in part time employment. The slower growth in aggregate employment is partly explained by demographic influences (which reduced labour force growth) and the boost to jobs in the preceding period provided by the Prices and Incomes Accord. More recently, the unemployment rate (an alternative and arguably better measure of labour market health) fell to a twenty eight year low of 5.1 per cent. This is at a time when the participation rate (the proportion of the working age population which is either in, or looking for, work) is at its highest level since just before WWI.

The trend toward part time employment (which accounted for two thirds of total job increases during the 1990s) largely reflects strong service sector growth and relatively high demand for part time and casual employment in that sector. While

the growth in part time employment has raised concerns that the labour force is under employed (see, for example: Australian Council of Social Service, sub. 106, p. 5; St. Vincent de Paul Society, sub. 120, p. 3), such growth has helped to deliver greater workplace flexibility and, arguably contributed to, rather than detracted from, Australia's recent productivity growth. It has also met the needs of those who prefer part time work (particularly students, and some parents and older Australians).

Encouragingly, there has also been a substantial decline in long term unemployment from a peak of around 172 000 in late 1993 to just over 60 000 in January 2005, about the lowest level in more than fourteen years. But, the number of jobless households remains relatively high, with some 15 per cent of children living in households where no person is employed (ABS 2004a).

Another feature of Australia's recent economic performance has been the rapid growth in exports. During the 1990s, export volumes grew, on average, by around 7 per cent per year — the highest growth rate of any post war decade. This was underpinned by a broadening of Australia's export base, with manufactures and services export growth (of 11 and 9 per cent a year, respectively) outpacing that of the more traditional resource and rural product groups (which both increased at around 6 per cent a year). More recently, export growth has stalled. However, this has been attributed to the (temporary) effects of drought, as well as the appreciation of the \$A, and capacity constraints in some parts of the resources sector and in key areas of transport infrastructure, such as ports and rail (Stevens 2004). Looking forward, strong economic conditions in most of Australia's major trading partners and significant growth in investment in the resources sector in recent years, provide a good basis for a resumption in export growth.

In the face of major domestic and international constraints

The strength of these outcomes needs to be viewed in light of prevailing business conditions. Importantly, Australia's economy has seemingly become more able to adapt to changing circumstances and 'external' shocks. Economic activity in Australia during the current growth phase has been much less volatile than in any of the preceding four decades. This is so despite:

- two periods of significant declines in Australia's terms of trade (historically one of the most important influences on Australian economic stability);
- a decade of economic stagnation in Japan — Australia's largest export market —and the financial crisis which struck key Asian trading partners in 1997;
- the impact of SARS on travel and tourism exports in 2003;

-
- recent severe drought conditions across much of the country which has reduced GDP growth by around 1 percentage point (Australian Treasury 2003); and
 - global economic weakness in 2001-02 caused by a subdued US economy.

Exchange rate adjustments, made possible by earlier deregulation of capital markets, played an important cushioning role in the face of these constraints and shocks. For example, the \$A fell by around 20 per cent on a trade weighted basis in the three years following the Asian financial crisis. The resulting improvement in Australia's competitiveness (reinforced by faster productivity growth — see below) provided opportunities for existing exporters to find alternative markets and for emerging exporters to develop new markets.

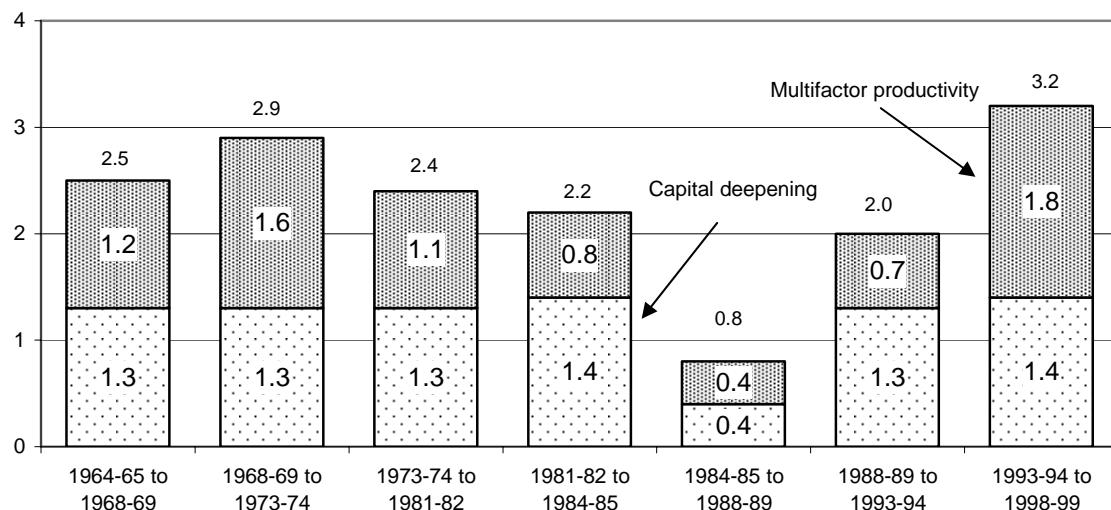
Notably, however, this depreciation did not lead to an outbreak of inflationary pressures. This has been due, in part, to markedly increased competition in the economy from structural reforms such as NCP.

Faster productivity growth underpinned these outcomes

As noted, the improvement in economic performance during the 1990s was underpinned by a surge in Australia's rate of productivity growth (especially during the second half of that decade). In particular, during the latest productivity cycle (completed in 1998-99), growth in multifactor productivity (MFP) — a measure of the efficiency with which both labour and capital inputs are used in production — was more than double the rate in the previous cycle (see figure 3.1). While MFP growth over the current cycle (which is yet to reach a peak) has slowed, this is largely explained by the effects of drought as well as global economic weakness, rather than reflecting an erosion of 'underlying' productivity performance (Parham 2004). In fact, productivity growth appears to have rebounded during 2003-04.

More specifically, during the five year period to 1998-99, both labour productivity and MFP growth rates were the highest for at least thirty years (the earliest reliable date available for MFP estimates is 1964-65). The improvement in the average productivity growth rate over this five year period (of around 1 percentage point) provided the equivalent of an additional \$7000 to the 'average' Australian household (PC 2003a). As discussed below, structural reforms (of which NCP has been a part) are likely to have been principal contributors to this productivity surge.

Figure 3.1 Labour productivity growth in Australia's market sector^{a, b, c}
Per cent per year



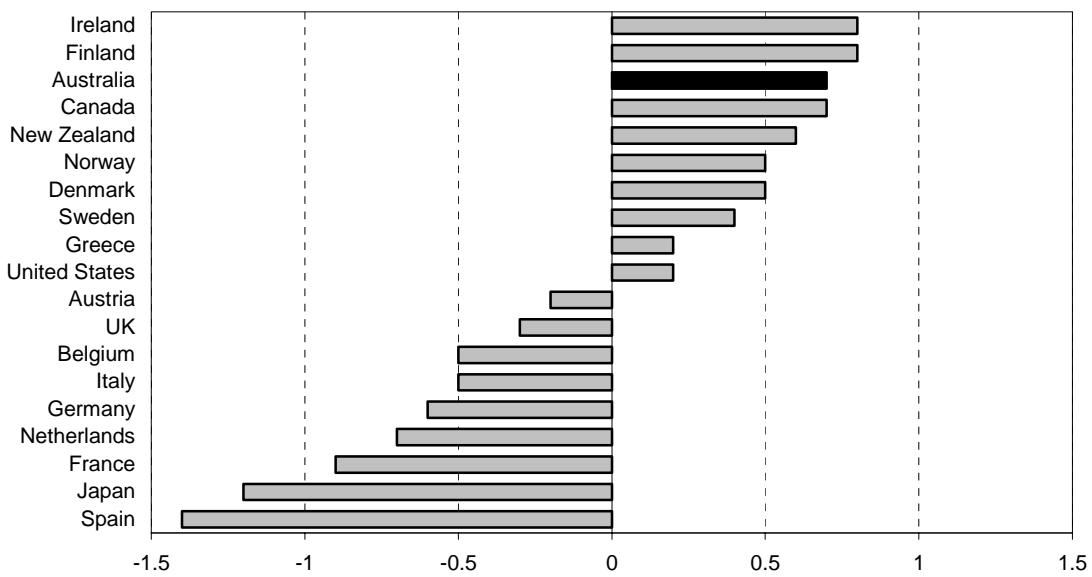
a Average growth between the productivity peaks in successive productivity cycles for the market sector.
b Labour productivity growth is influenced by capital deepening (increases in the amount of capital available per worker) and MFP growth. It is measured as output per hour worked and, at an aggregate level, is therefore highly correlated to growth in GDP per capita (a common proxy for living standards). **c** Labour productivity has yet to peak in the current cycle.

Data source: Parham (2004).

Australia's productivity performance was also strong by international standards, with only two OECD countries recording higher rates of *improvement* in MFP growth during the 1990s (figure 3.2). This followed a long period in which Australia's productivity record had been consistently poor compared with other high income countries and where Australia had made much less progress than other developed countries in catching up to leading international productivity levels.

Its rate of catch-up was slow even during the 'Golden Age' of rapid post war development and also during the global productivity slowdown post-1973. As a result, Australia's international productivity ranking (measured in terms of GDP per capita) slipped from 4th in 1950 to 12th in 1973 and to 16th by 1990. The resurgence witnessed during the 1990s saw Australia's per capita GDP ranking recover to 8th.

Figure 3.2 Changes in multifactor productivity growth in OECD countries
 Average annual percentage point change from 1980–90 to 1990–2000



Data source: Nicoletti and Scarpetta (2003).

Boosting international competitiveness

Higher productivity growth has enhanced the ability of Australian firms to compete internationally. Real unit labour costs (real wage costs adjusted for productivity changes) in Australia fell by close to 15 per cent between 1983 and 2003 (Henry 2004a). But just as importantly, the sustained strong productivity performance is reflective of a more flexible, innovative and dynamic economy. For higher income countries such as Australia, such attributes will be crucial to future competitiveness.

3.3 Determinants of Australia's productivity revival

In broad terms, productivity growth stems from factors such as technological advance (through, for example, new knowledge gained from R&D), better organisation of production (for example, specialisation and elimination of waste), investment in plant and equipment and human capital development (including skill formation through education and training).

Domestic competition, openness to trade and foreign investment and organisational flexibility are important conduits for these sources of growth, as they respectively provide:

-
- incentives to innovate and lower costs;
 - access to overseas capital, as well as the latest knowledge and ‘best practice’ production techniques; and
 - the ability to adapt to changing circumstances and take advantage of emerging opportunities (such as new technologies).

The rapid diffusion of technological advances has been a feature of past periods of faster global productivity (and economic) growth. In the 1950s and 1960s, for example, unprecedented levels of technology transfer from the United States to aid in the post war reconstruction of Europe and Japan underpinned the ‘Golden Age’ of global economic prosperity. During the 1990s, however, there was no evidence of a widespread international productivity acceleration (PC 1999e). In the absence of a technological advance specific to Australia, this suggests that the change in Australia’s relative position from productivity laggard to front-runner was due to the easing of domestic constraints on productivity growth.

Reflecting the importance of productivity growth to the enhancement of living standards, the analysis of trends and determinants of Australia’s productivity performance has been a key area of Commission research in recent years. This research effort has focused on examining the linkages between the microeconomic reform program — of which NCP has been a part — and productivity growth (see, in particular, PC 1999e).

On the basis of this work, it has emerged that economic policy reforms (including NCP) have been principal underlying drivers of the surge in productivity over the 1990s. Reforms have enhanced productivity in both direct and indirect ways:

- Policy initiatives such as the reduction in import protection, taxation reform and the removal of regulatory barriers have redirected resources into more productive activities.
- Exposing firms to greater competition and increased openness (through trade, foreign investment and domestic competition policy reforms) has sharpened incentives to reduce costs and innovate (including through R&D and the adoption of new technologies) in all areas of firms’ activities. Such incentives have flowed through to higher productivity.
- Industrial relations reforms have enabled greater enterprise and workplace flexibility — opportunities for which were heavily circumscribed when employment conditions and work practices were determined solely by centrally prescribed awards. This has helped firms become more adaptive and responsive to changing market needs and opportunities.

Reflecting the structural and behavioural changes in the economy resulting from the reform program:

- Australia's trade intensity (the ratio of exports plus imports to GDP) rose from 27 per cent in the mid 1980s to 44 per cent in 2003;
- inward foreign direct investment (FDI) increased from 17 per cent of GDP in the early 1980s to 30 per cent in 2003, while outward FDI rose from 4 per cent of GDP to 20 per cent over the same period;
- business expenditure on R&D as a proportion of GDP has doubled since the mid 1980s; and
- investment in information and communication technologies during the 1990s grew at 15 per cent a year — higher than most other OECD economies.

Significantly, alternative explanations that the 1990s productivity improvement was the result of either a cyclical recovery from recession, an unsustainable increase in work intensity, or a more rapid accumulation of labour force skills are not borne out by the facts (see box 3.2).

Moreover, the finding that reform has played a key role in Australia's productivity revival is supported by several international studies, including a recent OECD analysis of differences in growth performance across member countries during the 1990s (OECD 2003f). That study found that policy and institutional settings affecting competition, trade exposure and flexibility in product and labour markets went a considerable way toward explaining the diverging economic performances of OECD countries (described in section 3.1) over this period. Commenting on the drivers behind Australia's recent productivity performance in its latest country assessment, the OECD noted:

...enhancing product market competition has been central to microeconomic reform in Australia and has been a crucial element in improving general economic performance. Following the trade liberalisation of the 1970s and 1980s, competition in product markets has intensified since 1995, as a result of the National Competition Policy (NCP), the most extensive economic reform programme in Australia's history. (OECD 2004a, p.120)

The International Monetary Fund (IMF) concluded:

Far-reaching structural reforms over roughly the past decade and a half have significantly improved Australia's resilience to shocks and have contributed to the economy's solid growth and productivity performance. (IMF 2003, p.14)

Similarly, Salgado (2000) also attributed Australia's strong productivity performance during the 1990s to structural policy initiatives such as trade liberalisation, labour market reform and increased competition.

Box 3.2 Alternative explanations of Australia's productivity revival

Australia's productivity surge in the 1990s represented a significant break from past trends. The timing, strength and internationally atypical nature of the improvement helps to eliminate some of the 'usual suspects' as credible principal causes of the turnaround.

Firstly, the surge in productivity cannot be explained away as the normal result of recovery from the early 1990s recession. Business cycle effects are explicitly taken into account in the Commission's studies on productivity movements over time. In addition, Australia's improved performance was both longer and stronger than during previous recoveries.

Similarly, the productivity improvement cannot be attributed to more rapid development of workforce skills — an important contributor to the capability to absorb and develop new technology and other innovations and thereby to long run productivity and output growth. Available evidence suggests that skills grew faster and made a greater contribution to multifactor productivity growth in the 1980s than in the 1990s (Barnes and Kennard 2002).

Further, contrary to the contention of some commentators (see, for example, Quiggin 2001), greater work intensity — manifest in longer working hours and an increased pace of work — does not provide a credible explanation for the sustained improvement in Australia's productivity performance. The impacts of changes in hours worked are explicitly accounted for in measures of productivity growth. And claims that the productivity improvement would be temporary because of an unsustainable pace of work are inconsistent with the extended period of strong productivity growth that has been observed in Australia.

Source: PC (2003a).

But, notwithstanding the significant benefits brought by structural reform to date, there is considerable scope for Australia to do better. Opportunities for further gains are discussed in the final suite of chapters of the report.

Sectoral productivity estimates provide insights into the contribution of NCP

Sectoral productivity trends provide more scope to examine direct linkages between productivity improvements and individual reforms. Of course, productivity outcomes will also depend on a range of other factors. Moreover, attributing outcomes to specific reforms is further complicated by the fact that reforms have a range of indirect impacts. This means that observed improvements in one sector may, in part, be due to reforms in other areas:

- One example is provided by telecommunications reform where the entry of new service providers has led to much lower communications costs, promoted the

wider uptake of information and communication technologies (such as wireless telephony and the internet), and contributed to productivity improvements in user industries.

- Also, the productivity experience in wholesale trade — the best performing sector of the late 1990s, and one not directly subject to major reform initiatives — was greatly enhanced by reforms in related product and labour markets. For example, automotive assistance policy reform in the 1980s pressured suppliers (including wholesalers) to improve their cost, quality and timeliness performance. At the same time, industrial relations reform promoted enterprise flexibility and thereby enabled faster adoption of new technologies (Johnston et al. 2000).

Nonetheless, in many instances, it appears that strong sectoral productivity performance has been directly related to the introduction of industry specific reforms. In this context, several specific reviews of performance trends in key infrastructure sectors confirm the general improvement in productivity growth since NCP (and other) reforms were implemented (although the shift to contracting out, or outsourcing, means that some of these estimates may overstate the actual improvement). For example, in:

- telecommunications — where entry restrictions have been removed and an industry specific access regime and anti-competitive conduct code introduced — MFP increased by around 7 per cent per year between 1996-97 and 1999-2000 (ACCC 2001);
- rail freight and passenger services — where structural separation of public monopolies and third party access arrangements have been introduced — total factor productivity rose by an average of 8 per cent per year between 1989-90 and 1997-98 (PC 1999g);
- postal services — where contestability has been introduced to non standard letter delivery — MFP increased by an average of 3.5 per cent a year between 1992 and 2002 (ACCC 2002a);
- stevedoring — which has been subject to changes in work arrangements following industrial relations reform and a relaxation of entry restrictions — labour productivity increased by more than 70 per cent between 1995 and 2003 (BTRE 2004a).

In key infrastructure sectors which were explicitly the subject of NCP initiatives (see chapter 2), labour productivity has increased sharply. For example, in electricity generation, labour productivity more than doubled on average across Australia between 1993 and 2002 (ESAA 2003) and more than trebled between 1991 and 1999 in Victoria — where reforms were introduced earliest (Short et al.

2001). In gas distribution, labour productivity rose more than six fold between 1991 and 2000 (AGA 2003).

Several participants to the inquiry argued that a sizeable part of these productivity gains and ensuing broader economic benefits can be directly attributed to NCP reforms (see box 3.3).

Moreover, Salgado (2000) demonstrates that lags between reform implementation and observed improvements in productivity can be quite long. This suggests the eventual productivity and growth dividend to Australia from NCP (and other) reforms may be considerably higher than observed to date. Indeed, the Tasmanian Government contended that many of the dynamic benefits of reform cannot be directly observed:

It is not even possible to measure the full benefits of competition once it has been introduced. This is because the dynamic benefits arising from competition, particularly in terms of greater process and product innovation, are longer term benefits and may not be readily apparent. (sub. 109, p. 7)

3.4 Quantifying the economy-wide impacts of NCP

Modelling indicates the importance of reform induced productivity growth

As noted in chapter 1, quantitative modelling can be a useful tool in illustrating the broad impacts of reform and providing insights into adjustment and distributional issues. However, its results will depend on the underlying modelling assumptions (both with respect to the economic relationships which underpin the model and the policy changes or ‘shocks’ which are applied to it). Hence, the results must be interpreted carefully in the light of those assumptions.

In recent years, various studies have estimated the economy-wide benefits of NCP (and associated) reforms. Some of these studies have been concerned with the impacts of NCP reforms in specific sectors. For example:

- Short et al. (2001) projected that electricity sector reform could increase Australia’s real GDP by as much as \$21 billion in real terms by 2010;
- ACIL-Tasman (2002) estimated that extending NCP reform commitments in the electricity and gas sectors in line with the recommendations of the CoAG Energy Market Review (2002b) — see chapter 8 — would cumulatively increase Australia’s real GDP by around \$8 billion between 2005 and 2010; and
- Allen Consulting (2003) estimated that telecommunications reforms would have increased Australia’s real GDP by \$12 billion.

Box 3.3 Participants' views on the economic contribution of NCP

Commenting on the impact of NCP in the energy sector, Origin Energy said:

... the dramatic effect of competition on energy market outcomes since NCP was introduced, in terms of improved labour and capital productivity in generation, lower wholesale prices and substantial new investment in transmission and generation, is irrefutable. (sub. 89, p. 3)

In rail freight transport, the New South Wales Minerals Council commented:

There is also no doubt that NCP has resulted in significant efficiency improvements in above-rail operations of Hunter export coal rail freight through the threat of competition. This in turn has led to an improvement in the ability of the industry to compete on world markets. (sub. 59, p. 2)

In a more general context, the New South Wales Government said:

The success of the [NCP] structural reform policies can be seen in significant improvements in the labour productivity of NSW Government businesses since 1994-95 in the areas of electricity generation, electricity distribution, freight rail and metropolitan water services. (sub. 99, p. 2)

The Tasmanian Government noted:

... NCP has assisted the State in meeting its objectives of attracting investment, generating employment and achieving higher levels of economic growth. (sub. 109, p. 2)

The Victorian Government, in modelling the benefits from improvements in productivity as a result of NCP reforms, estimated that compared to a 'no reform' base case:

Victorian Gross State Product (GSP) is ... 2.0 per cent or \$3.8 billion higher, in real terms, in the long run. Victorian consumption increases by 2.3 per cent, investment increases by 1.6 per cent, and GSP per capita increases by 1.7 per cent. (sub. 51, p. 5)

And from a regulator's perspective, the ACCC said:

NCP and other competition-based reforms have contributed to the impressive performance of the Australian economy over the past decade. Sustained rates of economic growth and strong productivity gains are part of the dividend from an ambitious and comprehensive reform program. These reforms have changed the fundamental structure and incentives that underpin the operation of the economy and the community, producing a more resilient and competitive society. These outcomes were achieved through economy-wide and sector specific reforms. (sub. 111, p. 3)

Others have modelled the potential impacts of NCP in the broad, or significant components of it. The modelling undertaken by the Victorian Government as input to this inquiry provides a recent example (see box 3.3).

The Commission has also previously used general equilibrium modelling on two occasions to illustrate the *prospective* economy-wide impacts of NCP reforms.

- The first exercise (IC 1995), modelled many of the Hilmer recommendations and estimated that Australia's real GDP would be 5.5 per cent higher once the productivity gains, service price rebalancing and other changes associated with the reforms had fully worked their way through the economy.

-
- The second exercise (PC 1999b) adopted a similar approach, but was narrower in scope, concentrating on those NCP reforms most relevant to rural and regional Australia. In that case, the increase in GDP from full implementation of the modelled reforms was projected to be around 2.5 per cent.

Both of these studies were of an ‘outer envelope’ nature. That is, they modelled the benefits that would arise if, for example, reform enabled *world best practice* productivity levels at the time to be achieved.

- They did not account for any inherent constraints on the achievement of such productivity outcomes (such as the comparatively small size of Australia’s economy and the dispersed nature of its population), or the adjustment costs associated with the reforms.
- At the same time, however, the nature of the model used meant that the dynamic benefits of reform, such as the ongoing incentives (from heightened competition and a more entrepreneurial and innovative business culture) to improve productivity in line with developments in world’s best practice, were not taken into account.

In this inquiry, the terms of reference specifically ask the Commission to report on the impacts of past reforms. Hence, it has taken a different approach and used a version of the Monash Model (see box 3.4) to estimate the economy-wide outcomes from *observed*, rather than *prospective*, productivity improvements and service price changes in key infrastructure sectors subject to NCP reforms. The sectors modelled were electricity, gas, urban water, telecommunications, urban transport, ports and rail freight, with the results relating to the changes observed over the period from 1989-90 to 1999-00. Accordingly, the modelling encompasses productivity and service price changes during a period when many of the NCP and related infrastructure reforms were undertaken, though it does not pick up impacts of NCP reforms undertaken after 1999-00, or impacts from reforms that did not flow through until after that date.

As noted above, the observed productivity and service price changes in these sectors have of course been influenced by reforms other than NCP (such as in industrial relations), as well as by other factors (such as technological change). However, the Commission is not aware of any rigorous empirical basis for isolating the impacts of NCP reforms. Accordingly, the modelling does not purport to quantify the economy-wide impacts of NCP reforms in the sectors concerned. That said, the effects of reform and other factors have often been complementary. For example, as mentioned earlier, the removal of entry barriers in sectors such as telecommunications is likely to have facilitated the uptake of new technologies in a range of user industries — including some of the other sectors incorporated in the Commission’s modelling.

Box 3.4 The Monash Model

The Monash Model is a general equilibrium model of the Australian economy designed for policy analysis and forecasting. It was developed by the Centre of Policy Studies at Monash University in 1993. In this inquiry, the Commission has used a regional version of the model with some additional modifications (by the Commission) based on features of the NCP package of reforms (the Monash Multi-Regional Forecasting Competition Policy Reform model — MMRF-CR). This version distinguishes eight State and Territory regional economies (and governments), with 54 industries in each jurisdiction. NCP related infrastructure activities are covered by 8 of these industries.

The model is underpinned by an input-output database which captures the linkages between factors of production (labour, capital and land), industries, final demand categories (consumption, investment and exports) and government finances. Policy changes or ‘shocks’ are applied to the model (typically in the form of cost or price changes), with first-round effects dependent on the supply and demand characteristics of the targeted activity. Second-round effects are determined by the input-output linkages described above, assumptions about the economic behaviour of firms and households, and resource constraints. In the context of the specific modelling exercise undertaken for this inquiry, important structural elements of MMRF-CR include that:

- productivity improvements reduce resource costs;
- producers alter their use of labour, capital and land in response to changes in the relative cost of these factors;
- producers respond to changes in the competitiveness of Australian industry;
- households vary consumption patterns in response to changes in household income and the relative prices of goods and services consumed; and
- demand for Australian exports depends on the price of those exports.

Outputs from the model include projected changes in: national spending, as measured by gross national expenditure; national output, as measured by gross domestic product; sectoral output, value-added and employment by state; exports and imports by commodity, nationally and by state; and government revenues and expenditures by state and for Australia.

Importantly, the model, with its state disaggregation, is especially suited to analysing the jurisdictionally different infrastructure industry changes modelled in this inquiry. In addition, the state results can be disaggregated further into 55 sub-state regions (see chapter 5) using the industry-mix characteristics of each region. This provides for the modelling of changes in output and employment at the regional level and for comparisons to be made between metropolitan and regional outcomes. And, income and expenditure characteristics of households have been used to further analyse the distributional impacts of the modelled reforms (see chapter 5).

But such caveats aside, it is clear from the modelling that observed productivity growth and service price rebalancing in these sectors — resulting to varying extents

from NCP reforms — have contributed significantly to Australia's overall economic performance. Moreover, the modelling also provides some insights into the outcomes of that productivity growth and service price rebalancing across the States and Territories, between income groups and between metropolitan and rural/regional areas (see chapter 5). This, in turn, can help to inform assessments of the distribution of NCP reform benefits across the community — keeping in mind that a range of other factors will also have impacted on observed outcomes.

Projected impacts on GDP from the modelling are presented in figure 3.3. (A supplement to this report providing detailed results, a summary of the proceedings of two workshops convened to discuss preliminary results and referees' comments, is available on the inquiry website.)

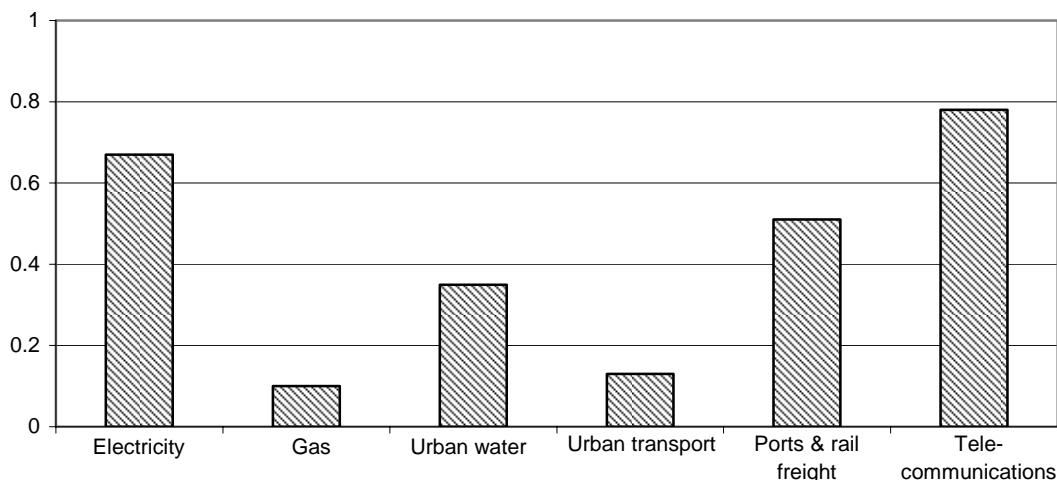
Specifically, once observed productivity improvements and service price rebalancing in the modelled infrastructure sectors have fully worked their way through the economy, Australia's real GDP is projected to be around 2.5 per cent (or \$20 billion) higher compared to a 'no change' base case.

- The largest contributions to the total projected increase in GDP come from productivity improvements and ensuing price changes in the telecommunications and electricity sectors, and reflect the significance of these services to both business and households.
- Productivity improvements and price changes in ports and rail freight services are also projected to deliver sizeable economic benefits, highlighting their importance to the traded goods sector of the economy.

The Commission reiterates that these results are not directly comparable to those from the earlier modelling. However, it is notable that the total GDP gains projected in this exercise, which include the impacts of non-NCP factors, were equivalent to earlier (PC 1999b) projected 'outer envelope' GDP gains from NCP reforms alone for this same set of sectors. This is consistent with the proposition that the reform effort during the 1990s was not sufficient to close all of the previously identified performance gaps reflected in the earlier modelling work. Moreover, 'world's best practice' productivity levels could be expected to have advanced considerably since then. Thus, the productivity data used in the current modelling exercise lend support to the notion that the reform task is far from complete. Opportunities for further reform in these and other sectors are the subject of the latter part of this report.

Figure 3.3 Estimated impacts on GDP of productivity and price changes in key infrastructure industries, 1989-90 to 1999-00

Percentage change



Data source: MMRF model.

3.5 Conclusion

Notwithstanding the difficulties in establishing causality, a range of indicators suggest that microeconomic reform in general, and NCP in particular, have improved Australia's productivity performance and delivered significant benefits to the community. At an aggregate level, it is difficult to attribute the productivity surge witnessed over the 1990s to other factors. In addition, a range of productivity improvements have been observed in sectors specifically targeted by the reform program, with many inquiry participants attributing those improvements largely to NCP reforms. The Commission's modelling indicates how important such productivity improvements and ensuing price changes have been to Australia's overall economic performance.

Moreover, the full gains from reform are yet to be realised. In particular, the more responsive and innovative business culture engendered by NCP and other reforms should be a source of dynamic efficiency gains for the community over time.

That said, aggregate indicators of the benefits of reform-induced productivity growth (such as higher average household incomes) on which this chapter has focused, do not provide a complete picture of what reform has meant for overall community wellbeing. How such reform dividends have been distributed among businesses, households and taxpayers, as well as among different income groups and between city and country areas, is also important. These matters are the subject of the next two chapters.

4 Prices, service quality and GBE performance

Key points

- The prices of several key economic infrastructure services have fallen in real terms since the early 1990s — though there has been considerable variation across sectors and jurisdictions.
 - NCP and related reforms have been significant (and sometimes major) contributors to those price reductions.
- Businesses have generally benefited more than households, with many enjoying substantial price reductions. This partly reflects intentional ‘rebalancing’ of prices between businesses and households to more closely reflect the costs of providing services to each.
 - As a result, for services such as electricity and gas, while real prices to businesses have fallen markedly, prices paid by households have increased.
- Average real prices for residential water and urban transport have similarly risen, because of the need to link charges more closely to the underlying costs of service provision.
- However, the impacts on households of these price increases have been partially offset by price reductions for other goods and services made possible by the input cost savings for businesses arising from NCP reforms.
- In general, price reductions do not appear to have come at the cost of reduced service quality. Indeed, service quality has improved in some areas and consumers have benefited from access to a wider range of services.
 - But there are concerns that prices of some infrastructure services may not be sufficient to ensure investments needed to sustain service quality in the long term.
- There has been a pronounced improvement in the financial performance of GBEs since the early 1980s, attributable to NCP and related governance reforms.
 - Nevertheless, around half of Australia’s GBEs continue to record rates of return below the risk-free government bond rate.
- The removal of restrictions on competition under the NCP has also provided price and service quality benefits in many other areas of the economy. Examples can be found in retail trading, professional and occupational services, and in the marketing of agricultural commodities.

The analysis in the previous chapter points to significant improvements in productivity and strong economic growth over the last decade. These outcomes reflect the *net* effects, for the economy as a whole, of changes stemming from NCP and a range of other factors. Hence, to understand the implications of NCP and related reforms for households, businesses, governments, regions and other groups in the community, it is necessary to delve deeper and look at some of the more specific impacts of NCP that impinge on living standards. To this end:

- this chapter examines trends in the price and quality of infrastructure services and the financial performance of government businesses delivering those services, as well as impacts for certain goods and services that have been subject to reform under the legislation review program; and
- chapter 5 explores NCP's social and distributional effects (including the impacts on regional Australia), as well as its environmental implications.

4.1 Price impacts of NCP

Prices perform an important role as signalling devices in a market economy. If they are ‘too high’, they can stifle demand, reduce the competitiveness of user industries and penalise consumers. If they are ‘too low’, they can unduly stimulate demand and encourage the wasteful use of resources.

It is difficult to state simply what exactly constitutes an ‘efficient’ price structure. However, prices will generally promote economic efficiency if, over the medium to longer term, they reflect least cost production and are sufficient to cover all costs, including a commercial (risk-adjusted) return on the assets employed.

In competitive markets, rivalry among suppliers generally provides incentives for least cost production and for prices to mirror costs. However, until the late 1980s, many of Australia’s economic infrastructure services — such as electricity, rail, telecommunications, post and port services — were provided by government-owned monopolies that faced little or no effective competition. Consequently, prices were determined administratively, often with scant regard to commercial realities or to the cost of service provision.

A number of studies in the 1980s identified widespread inefficiencies in the pricing practices of infrastructure service providers. These included the maintenance of uniform pricing policies in the face of significant differences in the cost of supplying different user classes and regular requirements for governments to fund on-going financial losses — see, for example: IAC (1989); NSW Commission of Audit (1988).

A major aim of the NCP and related reforms — in particular, initiatives to corporatise government utilities involved in the provision of infrastructure services and to expose them to greater competitive pressure — was to overcome inefficiencies in both the structure and level of prices. More specifically, the reforms sought to more closely align prices with the costs of supply and to improve cost recovery by GBEs to enable them to earn a commercial return on their assets.

The overall impact of NCP on prices was not expected to be uniform.

- There was an expectation that the reform initiatives would initially lead to lower overall prices for many infrastructure services, as efficiency improvements moved service providers closer to ‘best practice’ productivity levels.
- However, it was recognised that prices for such services could not be expected to fall indefinitely (despite the ongoing dynamic benefits from reform), with the likelihood that input cost pressures, and requirements to refurbish existing assets, provide additional capacity and, in some cases, account for externalities, would likely lead to real price increases in particular years or over time.
- The need to ‘rebalance’ prices between different classes of users (such as businesses and households) to better reflect costs implied that, in many cases, price outcomes would vary between user groups.
- Moreover, the requirement for GBEs to earn a commercial return on their assets over the longer term was anticipated to result in higher overall prices for some infrastructure services.

The actual changes in infrastructure prices, and the influence of NCP on those changes, are discussed below.

Price changes across infrastructure services

Analysis of the price effects of NCP and related reforms for economic infrastructure services is constrained by data limitations.

- Comprehensive and consistent price data are only available for certain services.
- The data do not account for any quality changes that may have occurred.
- Price data for households (but not businesses) include increases related to the Goods and Services Tax (GST).
- The data relate only to ‘first round’ or direct effects. Thus, for example, they do not reveal gains realised by consumers if they buy goods more cheaply because infrastructure input costs (for example, energy) have fallen.

However, for the purposes of this inquiry, the major limitation is that the data show the net effect of all factors that influence infrastructure prices, not just NCP reforms.

Notwithstanding these limitations, the available data provide some useful insights into price changes in infrastructure services over the last decade or so, from which some inferences on the likely impacts of NCP can be drawn.

A summary of trends in real (inflation-adjusted) prices of a range of economic infrastructure services is presented in figure 4.1. Where possible, the reported changes cover the period 1990-91 to 2003-04. In most instances, the changes are for Australia as a whole, and thus do not pick up the sometimes significant jurisdictional variations in price outcomes for particular services (see below).

As shown in figure 4.1, in overall terms, real prices for several key infrastructure services fell. This is most evident for port services, rail freight, telecommunications and electricity:

- port service prices fell by up to 52 per cent between 1990-91 and 2000-01;
- rail freight charges decreased by up to 42 per cent between 1995-96 and 1999-2000;
- telecommunications prices fell by up to 29 per cent between 1996-97 and 2002-03; and
- electricity prices declined by 19 per cent, on average, between 1990-91 and 2003-04.

In contrast, prices rose substantially for urban transport services (up by 31 per cent between 1990-91 and 2003-04) and country passenger rail services (up 19 per cent between 1990-91 and 1996-97).

These aggregate trends mask some significant variations between household and business users, and across jurisdictions. For instance:

- electricity charges for households increased by 4 per cent between 1990-91 and 2003-04, while business users experienced price reductions of 27 per cent over the same period;
- although electricity prices for households increased on average across Australia, jurisdictional outcomes varied from a real price reduction of 13 per cent in Perth to an increase of 35 per cent in Adelaide;
- between 1990-91 and 2003-04, average real gas prices for households rose by 13 per cent, while prices paid by business users fell by a similar amount;

Figure 4.1 Real price changes in infrastructure services^a

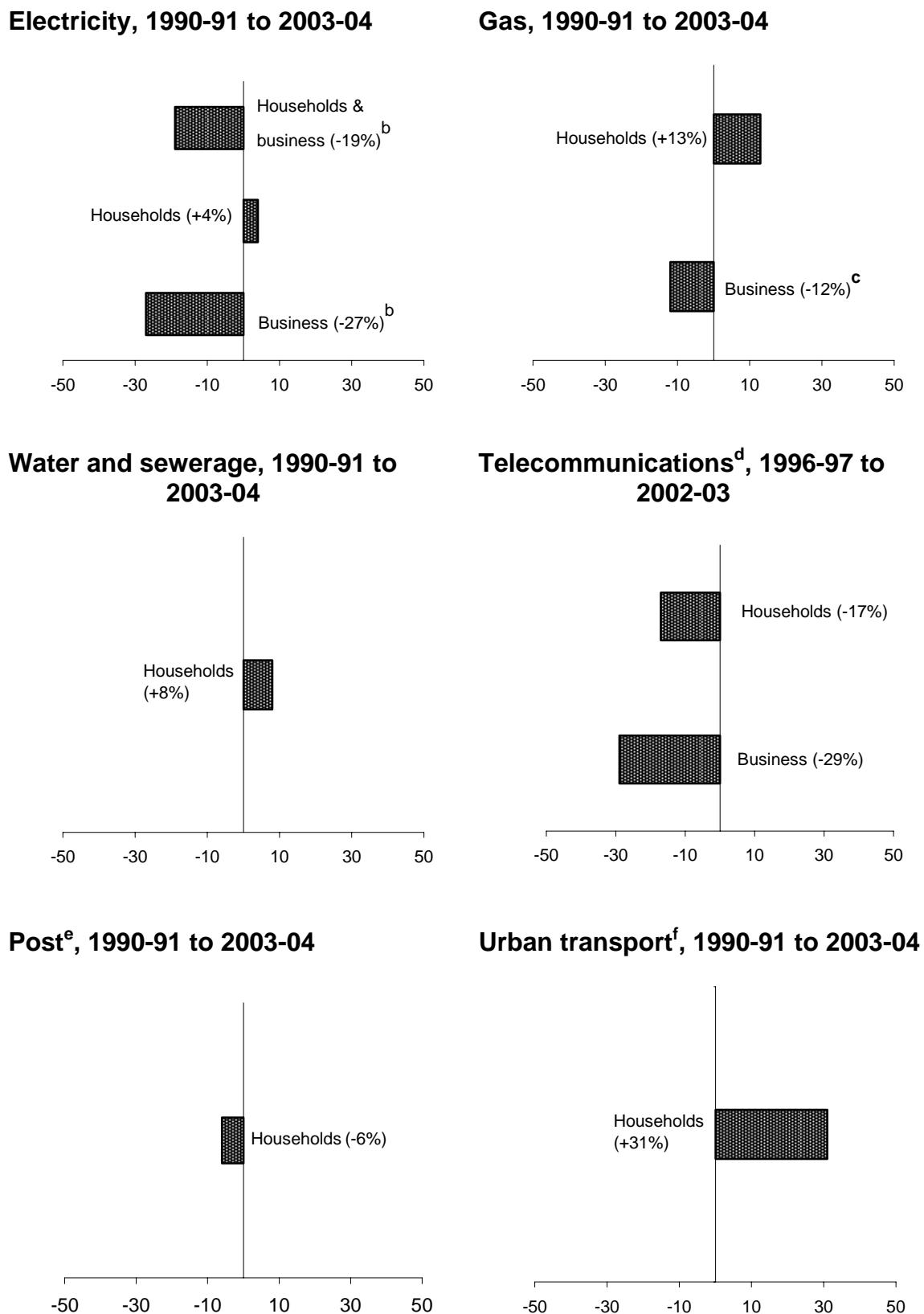
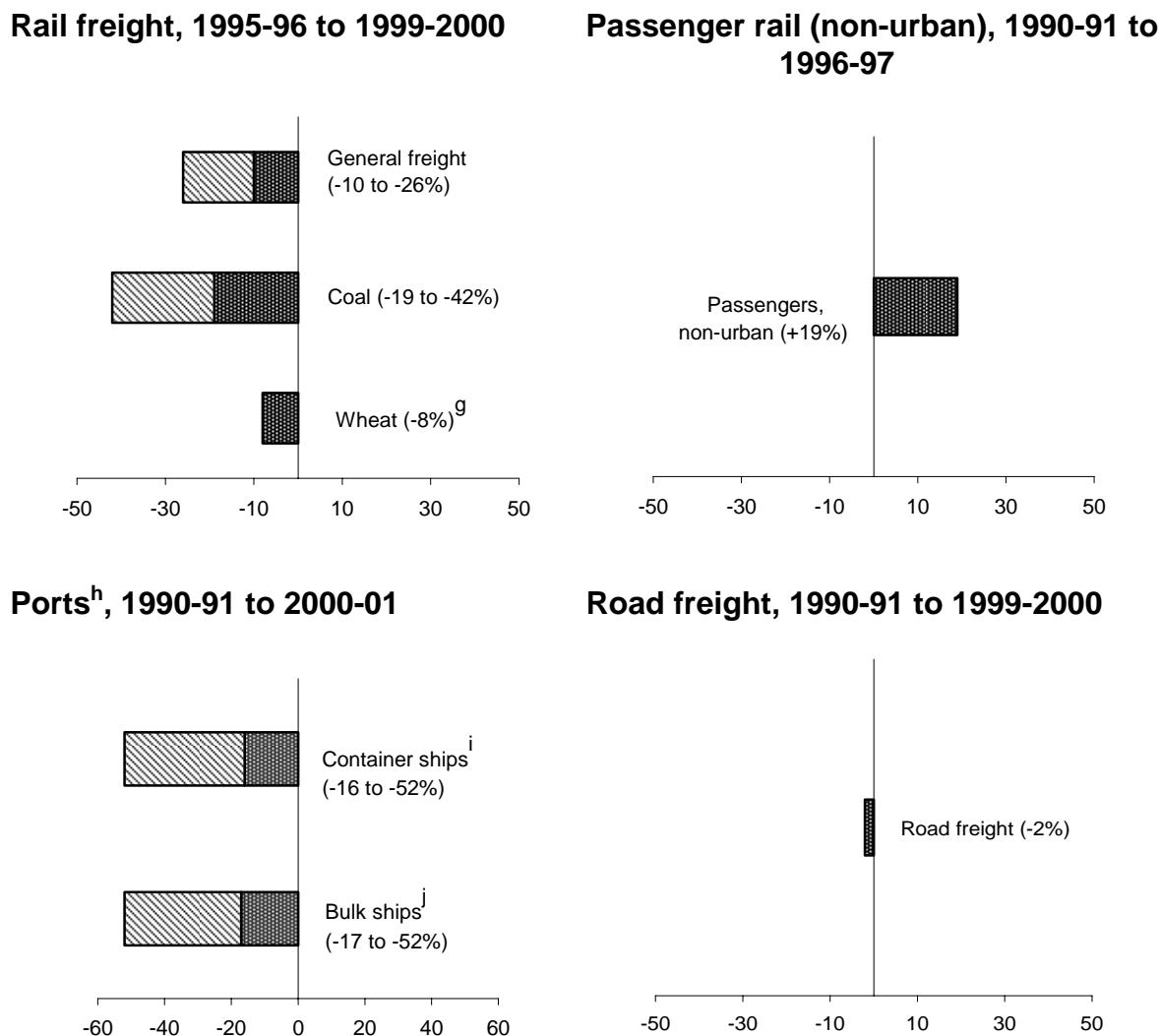


Figure 4.1 continued



^a Household prices are for capital cities only. Household prices are GST-inclusive (except for water and sewerage, which are exempt from the GST). Business prices are GST-exclusive. However, GST is included in the CPI (all groups) index used to deflate nominal prices to real prices. ^b 2000-01 to 2003-04 business prices are estimates. ^c Gas business price data based on gas prices paid by manufacturers. ^d Fixed line and fixed to mobile. ^e Envelopes, stamps and postage. ^f Bus, tram, ferry, train and taxi fares. ^g Data covers 1996-97 to 1999-2000 only. ^h Port prices cover charges that are directly levied on ship and cargo owners for containerised and bulk freight (eg wharfage, tonnage and berth hire; and navigation and environmental levies). Stevedoring services and indirect charges (eg pilotage, towage and mooring) are excluded. The range of prices for individual ports is reported, rather than a single average change in price. ⁱ Highest and lowest prices for the ports of Sydney, Melbourne, Brisbane, Fremantle and Burnie. ^j Highest and lowest prices for bulk ship cargo (wheat, coal, ore, cement, sand, petroleum and oils) at the ports of Sydney, Melbourne, Fremantle and Burnie.

Data sources: Household prices: Electricity, gas, post and urban transport - ABS (*Consumer Price Index*, Cat. no. 6401.0); Water and sewerage – PC estimates based on ABS (*Consumer Price Index*, Cat no. 6401.0) and PC 2002h; Telecommunications – ACCC 2004b and prior years; ‘Household and business’ and ‘business’ prices: Electricity – ESAA 2004 and prior years; Gas – ABS (*Producer Price Index*, Cat. no. 6427.0); Telecommunications - ACCC 2004b and prior years; Rail freight – PC 2002h; Passenger rail - PC 1999a; Ports - PC 2002h; Road freight – BTRE 2001.

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- on a jurisdictional basis, gas prices for small and medium-sized manufacturing businesses have fallen by 2 per cent in New South Wales, 9 per cent in South Australia and around 30 per cent in Victoria since the mid 1990s. In contrast, general gas prices for businesses in Western Australia have risen by about 10 per cent (IPART 2003, 2001 and prior years; SA Government 2003 and prior years; WA Government 2002 and prior years; PC 2002; ESC 2003).
 - water charges for households increased by 8 per cent between 1990-91 and 2003-04, while regulated water tariffs for business users fell substantially in some jurisdictions (by 30 per cent in Sydney) and rose in others (with both Perth and Brisbane recording increases of around 3 per cent) (IPART 1996, 2000; ERA 2004); and
 - urban transport fare increases over the period 1990-91 to 2003-04 ranged from 26 per cent in Tasmania to 38 per cent in Western Australia.

More information on price changes in individual jurisdictions is available in the Commission's report on trends in Australian infrastructure prices (PC 2002h).

In considering these outcomes, it is important to recognise that the introduction of the GST in July 2000 would have magnified the differences in the observed price changes between households and businesses. More specifically, while the GST is now included in the prices paid by households for all infrastructure services referred to in figure 4.1 other than water, the input tax rebate system effectively exempts businesses from the GST. Box 4.1 provides more detail on the impact of the GST on household prices.

Further, as the data relate only to *direct* price changes, the 'true' price effects on both households and businesses may have been more favourable than those shown in figure 4.1. For example, the small increase recorded for household electricity prices takes no account of lower prices paid by households for those goods and services which became cheaper because producers benefited from reduced electricity prices. Community service obligations (such as concessions to reduce energy prices) would also have reduced actual prices paid by some lower income or otherwise disadvantaged groups (see chapter 5).

To shed more light on this issue, as part of its modelling of productivity and price changes in key infrastructure sectors, the Commission estimated how the resulting overall increase in national income was distributed across the various income groups. As reported in chapter 5, while higher income groups benefited the most, households across the income spectrum were projected to gain from the modelled changes in productivity and prices.

Box 4.1 Impact of the GST on household prices

The introduction of the GST on 1 July 2000 increased prices paid by households for most infrastructure services relative to those paid by businesses.

- For households, GST is equivalent to 10 per cent of the pre-tax selling price.
- However, as the GST is a tax on final consumption, businesses can claim tax credits for the GST paid on inputs to production.

The impact of the GST on real household prices for infrastructure services depends on the interaction of a number of factors, including the extent to which some of the tax is borne by suppliers and the rate of increase in the nominal rate of inflation (as measured by the CPI). For some infrastructure services, the increase was significant (see table).

Average annual change in real household infrastructure prices (per cent)

	Electricity	Gas	Water & sewerage	Postal	Telephone	Urban transport
Pre-GST (1990-91 to 1999-00)	-0.5	0.0	1.0	-0.7	-2.3	2.6
GST implemented (1999-00 to 2000-01)	5.0	3.9	-4.1	-2.0	1.2	4.4
Post-GST (2000-01 to 2003-04)	1.1	2.7	1.2	0.7	-1.2	0.6

Data source: PC estimates based on ABS (*Consumer Price Index*, Cat. no. 6401.0).

- Real prices increased substantially for electricity, gas and urban transport in the year that the GST was introduced. In the case of telecommunications, 2000-01 was the only year since 1990-91 that real prices increased.
- Water charges are exempt from the GST, moderating price increases relative to other goods and services and contributing to a significant fall in *real* prices immediately following the introduction of the GST.
- Postal charges are subject to the GST. However, nominal prices were held fixed under price regulation and the cost of the GST was absorbed fully by Australia Post. As a result, real postal charges fell.

That said, it is apparent that changes in infrastructure prices over the last decade or so have been of greater direct benefit to businesses than to households. To the extent that NCP reforms have influenced prices, this is not surprising. As noted above, NCP has involved ‘rebalancing’ of prices to achieve a more efficient sharing of the costs of infrastructure provision between different classes of users.

It is also important to recognise that rebalancing has occurred across and within household and business groups. For example, the restructuring of urban water tariffs to more closely link charges to consumption levels has led to lower charges for low

use households. Equally, in areas such as electricity, there is limited evidence that increases in household prices have generally been greater for low demand and often lower income households.

Finally, in regard to relative price outcomes for metropolitan and regional areas, the evidence is mixed. In some cases, metropolitan consumers have fared better than their regional counterparts:

- real household electricity prices in regional NSW have increased by over 10 per cent since 2000 (after falling in the early to mid 1990s), while prices in Sydney have fallen marginally over the same period (IPART 2002, 2004; ABS 2004b);
- real household water prices in Caboolture and the Gold Coast have risen by more than those in Brisbane since the late 1990s (though water prices have fallen in Mackay and Toowoomba); and
- changes in real gas prices in Victoria and Western Australia since the mid 1990s have benefited consumers in capital cities more than in regional areas (ESC 2003; PC 2002h).

But in other cases, regional price outcomes have been comparable with those in capital cities:

- since the late 1990s, average real electricity prices in regional Victoria have fallen by the same amount as in Melbourne (ESC 2003);
- in New South Wales and South Australia, since the late 1990s the fall in regional business gas prices has been much the same as in the respective state capitals (IPART 2003; SA Government 2003 and prior years); and
- in the Hunter Valley, water price declines since the mid 1990s have largely matched those experienced in Sydney (IPART 2003).

Drivers of price changes

Many of the price changes for infrastructure services are broadly in accord with available information about productivity improvements (see chapter 3). For example:

- there is evidence of large productivity improvements in rail freight, telecommunications and port services, where prices have fallen significantly; and
- productivity gains in postal services — around 3.5 per cent annually between 1992 and 2002 — were somewhat smaller, as was the fall in prices (ACCC 2002a).

However, the changes in productivity and in prices reflect the *net* effect of NCP reforms and a range of other influences — such as technological advances, changes in patterns of demand and other reforms. Hence, as the Western Australian Chamber of Commerce and Industry (and others) observed, it is difficult to determine the impact on prices of NCP alone:

... measuring the effects of NCP is difficult because they must be separated out from a range of other demographic, government and market factors that affect economic and social conditions. (sub. 66, p. 22)

Nonetheless, in some sectors, NCP reforms have driven improvements in efficiency and contributed to significant observed price reductions. For example, there has been extensive reform of the electricity industry in most jurisdictions — encompassing structural separation, corporatisation, some privatisation and the development of the national electricity market in southern and eastern states (see chapter 2). Amongst other things, this has resulted in large falls in manning levels and the introduction of competition to the non-network aspects of electricity supply.

Although the effect of such NCP-related reforms on electricity prices is difficult to quantify, it is broadly accepted that their impact has been significant and that the reforms have stimulated other changes which have also had beneficial effects. In this context, Origin Energy stated that:

... the dramatic effect of competition on energy market outcomes since NCP was introduced, in terms of improved labour and capital productivity in generation, lower wholesale prices and substantial new investment in transmission and generation, is irrefutable. Other factors, such as technological change and general improvement in education and training across the economy, undoubtedly played a role in these outcomes, but to a far lesser extent. (sub. 89, p. 3)

It seems likely that NCP reforms have also been a major influence on those infrastructure service prices that increased — water, urban transport and country passenger rail services. As noted earlier, an important objective of NCP was to lift cost recovery to commercial levels and reduce the extent to which users were subsidised by taxpayers. In each of these areas, cost recovery levels were very low in the early 1990s.

The impact of reforms on prices in some other sectors is less certain. For example, path-breaking technological advances through the 1990s provided scope for price reductions in a range of telecommunication services. However, it is a moot point as to whether, in the absence of reforms to introduce competition to many of Telstra's markets, the new technologies would have been introduced as quickly as they were. Furthermore, without the competitive pressures associated with the reforms, the incentives for service providers to share the cost savings from new communication

technologies with users would have been considerably less. The significant role played by competition-enhancing reforms in delivering price reductions in telecommunication services has been recognised in previous studies and by participants to this inquiry. For example, an OECD study noted:

Even controlling for the influence of technological development, increasing product market competition ... generally brings about productivity and quality improvements and reduces the price of all the telecommunications services considered in this analysis. (Boylaud and Nicoletti 2000, p. 7)

And a paper by Albon noted:

... there is a marked acceleration of productivity growth from when reform began in the late 1980s, cost levels are moving closer to international best practice, prices have come down in general, prices are now more efficiently structured, and new technologies and services have become available more rapidly. (Albon 1998, p. 328)

Reinforcing these observations, a number of participants similarly contended that NCP reforms have been a major contributing factor to the price changes witnessed for many infrastructure services (see box 4.2). In this regard, many emphasised that, as well as underpinning reductions in infrastructure service costs, increased competition has helped to ensure that the benefits from lower costs have been shared with consumers. For example, the Australian Rail Track Corporation said:

There is little doubt that the more productive use of the rail infrastructure, improved above-rail productivity, improved service levels and greater product differentiation has been driven by above-rail competition on the Melbourne-Adelaide-Perth corridors. This has, in turn, seen cost benefits passed on to rail users through freight rate reductions in the order of 30-40 per cent ... (sub. 49, p. 7)

More generally, research undertaken by the Commission has found that a greater share of the benefits of productivity gains during the 1990s were passed on to consumers in the form of lower prices than in the past. According to Parham et al

This is consistent with producers facing stronger competitive pressure in the 1990s. Competitive pressures thus appear to be important not only in contributing to the generation of productivity gains ... but also in influencing the distribution of the gains. Competitive processes are likely to have put some brake on nominal wage increases and profit growth, and to have encouraged productivity gains to be passed on through lower prices. (2000, p. xxvii)

Box 4.2 Participants' views on how NCP has influenced prices

While it is difficult to demonstrate empirically, a number of participants (to this and previous Commission inquiries) contended that NCP reforms have been a major contributing factor to changes in infrastructure prices. The views of some participants are set out below.

Queensland Aluminium Limited (QAL)

In response to the National Competition Policy reforms ... QAL's gas transportation tariff immediately reduced by around 25 per cent and the tariff pricing principles provide for further incentive pricing as pipeline throughput increases. (IC 1998b, p. 77)

The New South Wales Minerals Council

There is also no doubt that NCP has resulted in significant efficiency improvements in above-rail operations of Hunter export coal rail freight through the threat of competition. ... the reduction in rail freight rates for export coal in the period since 1997 has enabled the industry to better survive the low price phase of the coal cycle. (sub. 59, p. 2)

Energy Users Association of Australia

The implementation of the Gas Access Regime since the mid-1990s has brought benefits to major gas users. Transmission and distribution network prices have been reduced, reflecting regulated determinations, which have reduced monopoly rents, and increases in the economic efficiency of network businesses. ... we are aware that recent contract negotiations for several large gas contracts have produced more favourable outcomes in terms of prices than were generally expected. These benefits are thought to be due to the emergence of a more diverse and competitive gas market. (sub. 123, p. 9)

Pastoralists and Graziers Association of WA

Rail reform in Western Australia has proved a huge windfall for the WA economy and especially for grain growers, who still rely heavily on the rail system to get their grain to port. Rail freight rates have fallen by 42 per cent in real terms since deregulation in 1991-92. (sub. 74, p. 19)

Queensland Government

The success of the Queensland [rail access] regime is demonstrated by its effect on coal rail freight rates, which have fallen by 20 per cent in real terms between 1998-99 and 2003-04, and the entry of Pacific National as a major new operator in the general rail freight market between Brisbane and Cairns. (sub. DR189, p. 9)

How will infrastructure prices move in the future?

Progress in implementing the NCP package varies, with some jurisdictions yet to implement some significant components of the agreed infrastructure reforms (see chapter 2). To the extent that outstanding commitments are met, there is likely to be further downward pressure on costs and prices in some areas.

That said, some jurisdictions have also yet to fully align costs with prices. As the Queensland Government commented:

... price changes, particularly for small gas customers, have often been masked through price cap and other regulatory and policy mechanisms used by governments to protect customers from substantial price rises associated with moves towards more competition (sub. DR189, p. 5).

More generally, as discussed earlier, in the face of offsetting cost pressures, NCP and related reforms cannot be expected to deliver year-on-year reductions in prices — even allowing for the ongoing incentives they have provided for performance improvement.

Indeed, some service providers in sectors subject to price regulation argue that existing prices for infrastructure services are not ‘sustainable’. Their major concern is that prices are not sufficient to justify new investment required to refurbish existing assets and to provide additional capacity needed to meet growing demand. This view has been challenged by some regulators and service users. However, it is clear that future investment requirements could be substantial and that it is important to strike an appropriate balance between the short-term interests of users and long-term investment requirements. For example, the Electricity Suppliers Association of Australia (ESAA) estimates investment of some \$40 billion will be required to meet demand over the next 10 to 20 years (sub. 94, p. 6). The ESAA said:

... every jurisdiction in this country has taken action to place caps on retail prices for domestic customers, in some cases at levels below the cost of long-run supply ... whilst almost all of these actions are taken by governments “to protect the consumer”, it is our submission that they are also having a negative impact which may ultimately end up costing consumers more. (sub. 94, pp. 7-8)

This issue is discussed further in chapters 8 and 10.

4.2 Has infrastructure service quality improved?

As well as providing incentives to operate efficiently and pass on cost savings to consumers, competition also encourages producers to compete for customers by offering better service quality (for example, improved reliability and timeliness of service) and by expanding their product range. However, there have been concerns that in sectors where even after reforms have been implemented competitive pressures are limited, cost reductions associated with the reforms may have been at the expense of service quality. These concerns were echoed by a number of participants to this inquiry.

While it is again difficult to distinguish between NCP and other factors that affect service quality, there is little evidence of any deterioration over the last decade or so. Indeed, service quality seems to have improved somewhat in a number of key infrastructure areas as markets have become more contestable and the incentives have increased for suppliers to be more innovative in their product offerings. That said, caution is needed in drawing strong conclusions.

The subsequent examination of trends in service quality over the past decade or so focuses on the reliability of supply and supplier/product choice and innovation. It is largely based on an analysis of outcomes across Australia as a whole.

Trends in service quality and user choice

Has reliability improved?

Notwithstanding fluctuations since the early to mid 1990s and variability across jurisdictions, service reliability appears to have been sustained or improved in most key infrastructure sectors.

The average reliability of *electricity supply* across Australia has remained relatively stable for much of the past decade, with some improvements evident over the last year or so (figure 4.2):

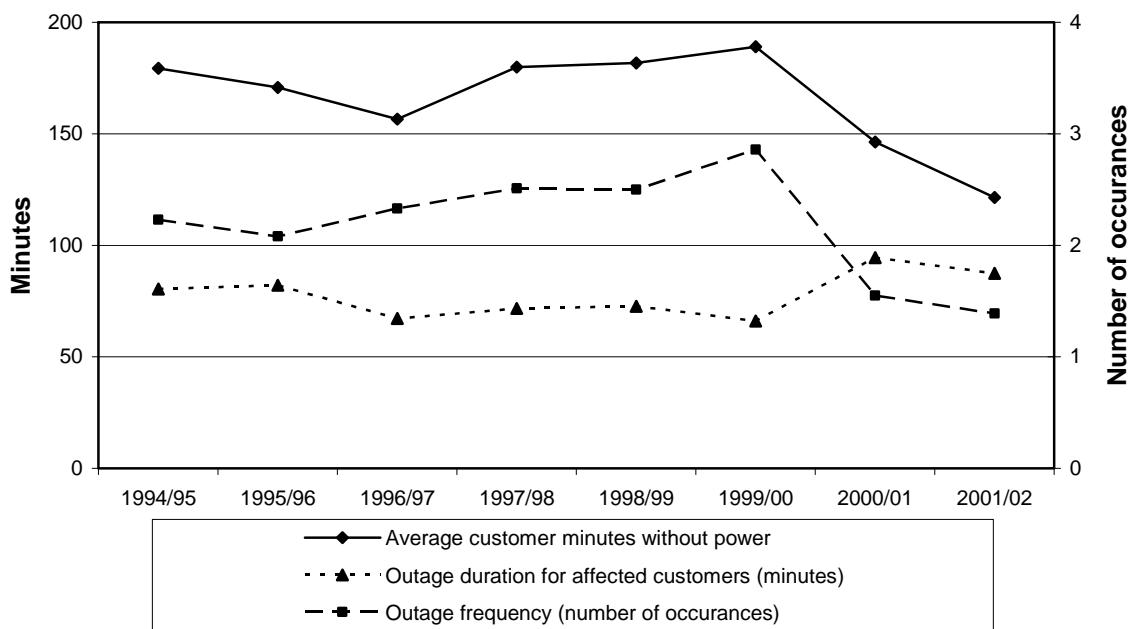
- in 2001-02, customers experienced an average of 2 hours without electricity, compared with 3 hours or more during the late 1990s; and
- the frequency of supply outages across Australia has declined significantly since 1999-2000, although the average duration of each outage has increased slightly (ESAA 2003 and prior years).

In *telecommunications*, Telstra's Australia-wide network performance has improved since the early 1990s:

- Telstra's local call and long distance network performance — measured as the proportion of calls that cannot be connected due to network congestion — has improved significantly since 1991 in both metropolitan and country locations (PC 2002h); and
- in 2003, 99.1 per cent of services were fault free and, on average, services were available 99.9 per cent of the time across Australia (ACA 2004).

After a significant decline between 1991-92 and 1997-98, Telstra's fault repair performance also improved significantly between 1998-99 and 2002-03 (table 4.1).

Figure 4.2 Electricity supply reliability, Australian average



Data sources: ESAA (2003 and prior years).

Table 4.1 Faults repaired by Telstra within required timeframe
Percentage^a

Timeframe	Urban: business	Urban: households	Rural and remote
	1 day	1 day	1 day
1991-92	85	81	76
1997-98	81	56	63
Urban: business and households		Rural	Remote
Timeframe	1 day	2 days	3 days
1998-99	76	82	65
1999-00	82	86	72
2000-01	88	93	84
2001-02	87	94	95
2002-03	86	93	94

^a Pre and post-1997 data are not directly comparable for rural and remote regions due to a change in the timeframe for fault repairs.

Data sources: ACA (2003 and prior years); PC (2002h).

Differences remain in the access to, and quality of, communication services between urban and regional locations. That said, in an earlier study requested by the Australian Government (PC 2001c), the Commission found that rural and remote telecommunications users were generally no worse off relative to urban users than their counterparts in other comparable countries. Box 4.3 outlines some other findings from that study.

Box 4.3 Telecommunications services — city vs country benchmarked

In 2001, the Commission conducted an international benchmarking study on the accessibility and quality of telecommunications services between urban and rural locations in some broadly comparable countries. Some of the key findings were:

- The distance between the user and the local exchange is a major determinant of data transmission rates over the PSTN. Longer line lengths in remote and rural areas tend to result in lower data transmission rates in these areas.
- The extent of PSTN (traditional telephone) quality advantage for urban over rural users in Australia was similar to that in Canada (the only other country with comparable data).
- Deployment plans are more far reaching for ADSL services (high speed services over traditional telephone lines) in Australia than in most other countries studied.
- Mobile coverage of Australia's rural population appears to be similar to that in New Zealand and greater than in the USA, but less than that in Europe. However, no country appears to regularly monitor the quality of mobile services in remote, rural and urban areas.

Source: PC (2001c).

Rail freight on north-south corridors is one of only a few examples where service quality seems to have deteriorated. However, on east-west routes, where there has been significant new investment, improved reliability and reductions in transit times have been evident. Additional examples of service quality impacts are provided in box 4.4.

More choice or innovative service delivery?

Some infrastructure service providers now offer greater product choice and/or have introduced innovations in service delivery. For instance:

- The expansion of *gas distribution networks* has broadened availability and consumer choice.
 - Over 3.5 million households had access to gas in 2001, compared with 2.7 million in 1995. Over the same period, the number of commercial and industrial customers increased from 84 000 to 105 000 (AGA 2003 and multiple years).
 - Tasmania is the most recent beneficiary of expanding gas networks, with initial plans to connect 100 000 households.

Box 4.4 Examples of changes in service quality

In 2002-03, *Australia Post* met or exceeded all of its legislated performance standards for its standard letter service, achieving record on-time delivery of non-bulk letters (96.5 per cent compared with 93.9 per cent in 1996-97) (*Australia Post* 2003 and prior years).

In Victoria, *urban transport* franchisees operate under incentive-based contracts to promote better service quality. All train and tram services delivered performance improvements (measured as passenger weighted minutes of delay) between 1998-99 and 2002-03, although punctuality and reliability results varied among operators (Department of Infrastructure (Victoria) 2003).

Crane rates and berth availability improved at major *container terminals* between 1997 and 2003. Conversely, other delays, such as crane breakdowns, late ship arrival or waiting for labour, were longer in 2003 than in 1997. Ship turnaround times generally improved in most, but not all, container ports (BTRE 2004b and prior years). However, as discussed in chapter 8, capacity constraints are now causing problems in some ports.

Between 1997 and 2000, *rail freight* reliability and transit times improved on east-west corridors, but deteriorated on north-south corridors (Booz-Allen & Hamilton 2001). Some participants also commented in general terms on areas of quality improvement for rail freight services. For example, Pacific National contended that:

Pacific National built on the efficiency gains already achieved by its public sector forerunners, National Rail and FreightCorp, to improve productivity and service quality. Pacific National has driven innovation in rail to take share away from its closest modal competitor, road. (sub. 61, p. 4)

And the Australian Rail Track Corporation (ARTC) noted that it:

... has strategically invested in infrastructure improvements designed to reduce rail transit times and increase service reliability (longer crossing loops, capability for heavier axle load operations) as well as enable more efficient above rail operations. On these corridors rail transit time has reduced (by around 2.5 hours, Melbourne – Perth), and service reliability has increased since 1997. (sub. 49, pp. 6-7)

However, the ARTC also reported evidence of an initial deterioration in service reliability for rail following the sale of the National Rail Corporation and FreightCorp:

During the first year following the purchase [of these entities by Toll Holdings and Patrick Corporation], ARTC noted some deterioration in service reliability on its part of the interstate network as PN [Pacific National] sought to maximize other aspects of its business (eg holding back departure from schedule in order to maximize loading on a train). (sub. 49, p. 9)

Australia-wide, while there was little change in the number of unplanned *water supply* interruptions between 1995-96 and 2000-01, the average duration of each interruption fell (WSAA various years).

- The choice of *telecommunications* service provider and the range of products has expanded rapidly since the early 1990s.

-
- In 2002-03, there were more than 700 different mobile service plans on offer and around 200 internet service providers offering broadband services (ACCC 2004a).
 - Expanded mobile coverage and broadband internet access have raised business productivity and provided households with wider product offerings. Although broadband penetration in Australia remains lower than in many OECD countries, broadband connections have more than doubled over the past year (ACCC 2004d). Other telecommunications products that are now commonplace include email, video conferencing, short messaging services and virtual private networks.

Additional examples of widening product choice and innovation in infrastructure service provision are provided in box 4.5.

Drivers of change

Changes in service quality reflect a number of factors. Some are outside the direct control of providers. For example, drought has increased the probability of water mains breaking, and floods and bushfires affect the reliability of electricity and telecommunications services. The availability of new technology has also affected service quality over the last decade or so. And service quality is, of course, closely linked to the way in which infrastructure service providers manage their businesses and respond to changing conditions.

Nonetheless, NCP reform is generally regarded by participants as having contributed to improvements in quality and reliability, although its contribution clearly varies between infrastructure services. For example, in the case of gas, NCP reforms — in particular, the removal of barriers to interstate trade and the introduction of access arrangements for pipelines — have enhanced both reliability and availability. The ability to maintain emergency supply following the 1998 accident at the Longford refinery highlights this improvement:

The suspension of Victorian gas supplies following the Longford disaster ... would have left Victoria without gas for emergency services in the absence of NCP reform. But implementation of the National Gas Pipelines Access Code, a centrepiece of NCP gas reform, was a critical factor underpinning the construction of a \$50 million ‘interlink’ pipeline between New South Wales and Victoria, which allowed emergency supplies of gas to flow into Victoria from interstate throughout the crisis. (NCC 1999a, p. 8)

Box 4.5 Expanding choice and innovation

Retail competition in *energy markets* has given many users the opportunity to choose their supplier. In many instances, this has also given users scope to select from a range of new and innovative product and service options, including:

- bundling of products (such as common billing procedures);
- bill smoothing (averaging bills over a year);
- specialised tariff structures (for example, options to remove seasonal peak tariffs for households and service guarantees for small business); and
- rebates (loyalty rebates or rebates for direct debit payment of bills).

To keep pace with competitors in contestable markets, *Australia Post* has introduced internet tracking for certain classes of parcel delivery and expanded its retail product and service range. And its outlets now provide a range of financial services (including money transfers, travellers cheques and business banking in some rural areas); undertake passport and citizenship interviews; and, at some outlets in Victoria, issue drivers' licences.

Similarly, the New South Wales Government noted that:

... a significant upstream benefit [of the Gas Access Regime] for New South Wales has been the diversification of supply sources. In 1996, the Cooper Basin, via the Moomba pipeline, supplied around 98% of NSW gas consumption. With the addition of the Eastern Gas Pipelines, the Cooper Basin now provides around 75% of New South Wales gas consumption. This increase in competition has increased security of supply and put downward pressure [on] input costs for business and prices for consumers. (sub. 99, p. 9)

NCP reforms have been accompanied by a greater focus on monitoring and regulating service quality in some jurisdictions, with compensation payments to customers accompanying poor performance in some cases. The Pastoralists and Graziers Association of WA stated:

... without telecommunication reform there would never have been the establishment of the Universal Service Obligation and the Customer Service Guarantee, which ensures regional and rural telephone users' rights are protected. (sub. 74, p. 19)

In energy markets, industry players support the view that service reliability has improved in the more competitive environment brought about by NCP reforms, and that retail contestability has promoted a business culture that is more responsive to customers. For example, the ESAA noted:

While the massively increased reliability of generators has improved availability, so too has distribution reliability improved considerably in recent years. As an example, in Victoria ... there has been a continuing trend of improvement in the State's supply

reliability. ... A similar improvement has been seen in most other jurisdictions. (sub. 94, p. 4)

And Origin Energy said:

Energy market competition, spurred by this transition [to a competitive and nationally integrated energy market], has undoubtedly contributed to ... consistent levels of energy system reliability and service quality, and greater innovation in energy product offerings. (sub. 89, p. 2)

The cultural shift brought about by competition associated with NCP reforms is likely to encourage ongoing improvements in service quality over time.

Is service quality sustainable?

Competitive forces will tend to encourage better service quality outcomes. However, as noted previously, some providers have voiced concerns about the longer term reliability of key infrastructure services unless there are changes in the way prices of those services are regulated. In this context, the ESAA drew comparisons with electricity supply failures overseas:

... every jurisdiction in this country has taken action to place caps on retail prices for domestic customers, in some cases at levels below the cost of long-run supply. Whilst we fully understand the reluctance of governments to pass through significant energy price increases to consumers, this is extremely short-sighted and can have catastrophic consequences, as seen in California. (sub. 94, p. 7)

Similarly, Energex stated:

Also pertinent is the recent House of Commons review of blackouts in the UK, which found the root cause to be the intrusive form of regulation applied by the regulator, a form identical to that applied here. (sub. 60, p. 3)

Against a backdrop of electricity supply failures, in March 2004 the Queensland Government commissioned a review of supply security and service quality for the State's electricity industry. The report of the review group illustrates the interaction between regulatory arrangements and service performance (see box 4.6).

The important role of regulatory authorities in achieving the 'right' balance in prices between encouraging the efficient use of existing services and providing appropriate incentives for new investment to sustain or enhance service quality and reliability is discussed in chapter 10.

Box 4.6 Some key findings from the Somerville Report on electricity distribution

- 'ENERGEX has not spent sufficient amounts in recent years on maintaining its system and, in particular, has not had an adequate focus on preventative maintenance, such as on vegetation management and cross arm inspections. This has significantly contributed to the number and duration of outages across ENERGEX's system.'
- 'The Panel has doubts about whether the current regulatory regime provides appropriate incentives to deliver reliable supply to Queensland customers. The Panel recommends that the Government and the QCA consider alternative arrangements for increasing ENERGEX and Ergon Energy's investment certainty during a regulatory period ...'
- 'There are currently no mandatory service standards for distribution services in Queensland as there are in other states. This has resulted in the distributors not having sufficient focus on the quality of service they deliver to end customers.'

Source: Department of Natural Resources, Mines and Energy (Queensland) 2004, pp. 28-29.

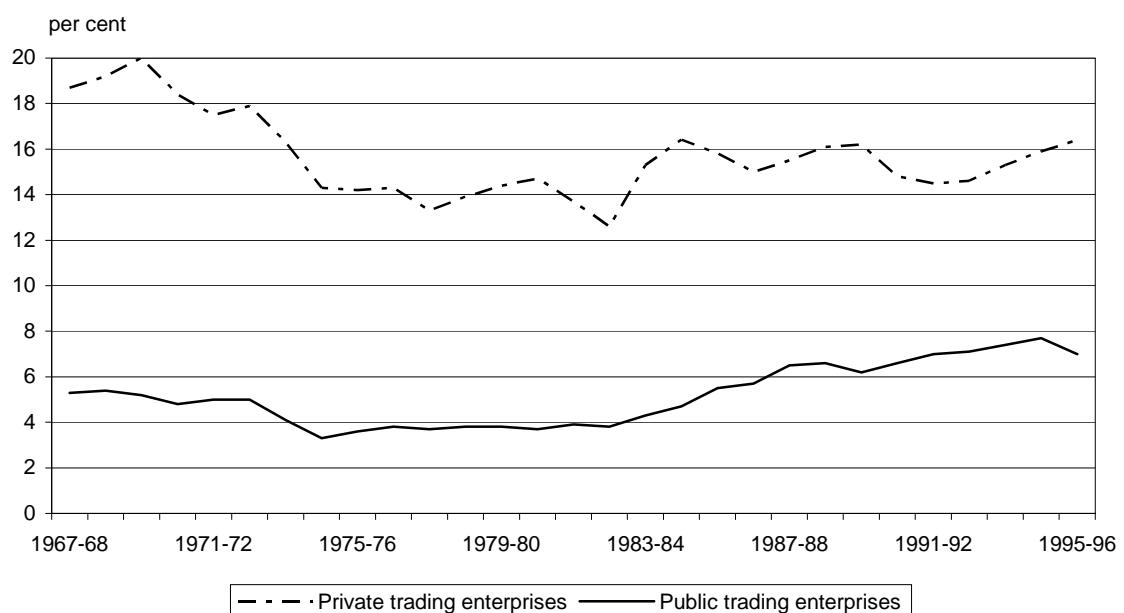
4.3 The financial performance of GBEs

On behalf of the community, governments invest significant capital in GBEs to provide economic infrastructure services to businesses and households. This investment is subject to competing demands for funding in areas like education and health. Moreover, in many areas of economic infrastructure, services are provided by, or could be provided by, private firms. Hence, the community has a right to expect that GBEs will operate efficiently.

In this regard, a key indicator of GBE performance is the rate of return on capital (assets). Historically, these rates were very low and sometimes negative, even when adjusted for unfunded community service obligations. However, over the last two decades, rates of return across GBEs have improved markedly (see figures 4.3 and 4.4), although they remain well below comparable private businesses.

Much of this improvement can be attributed to governance reforms, such as commercialisation and corporatisation, which pre-dated NCP in several key GBE sectors. However, as a number of commentators have noted (see, for example, Marsden 1998 and Morton 1999), further changes under the auspices of NCP and related reforms have also played an important role.

Figure 4.3 Gross rates of return: public and private trading enterprises, 1967-68 to 1995-96^a



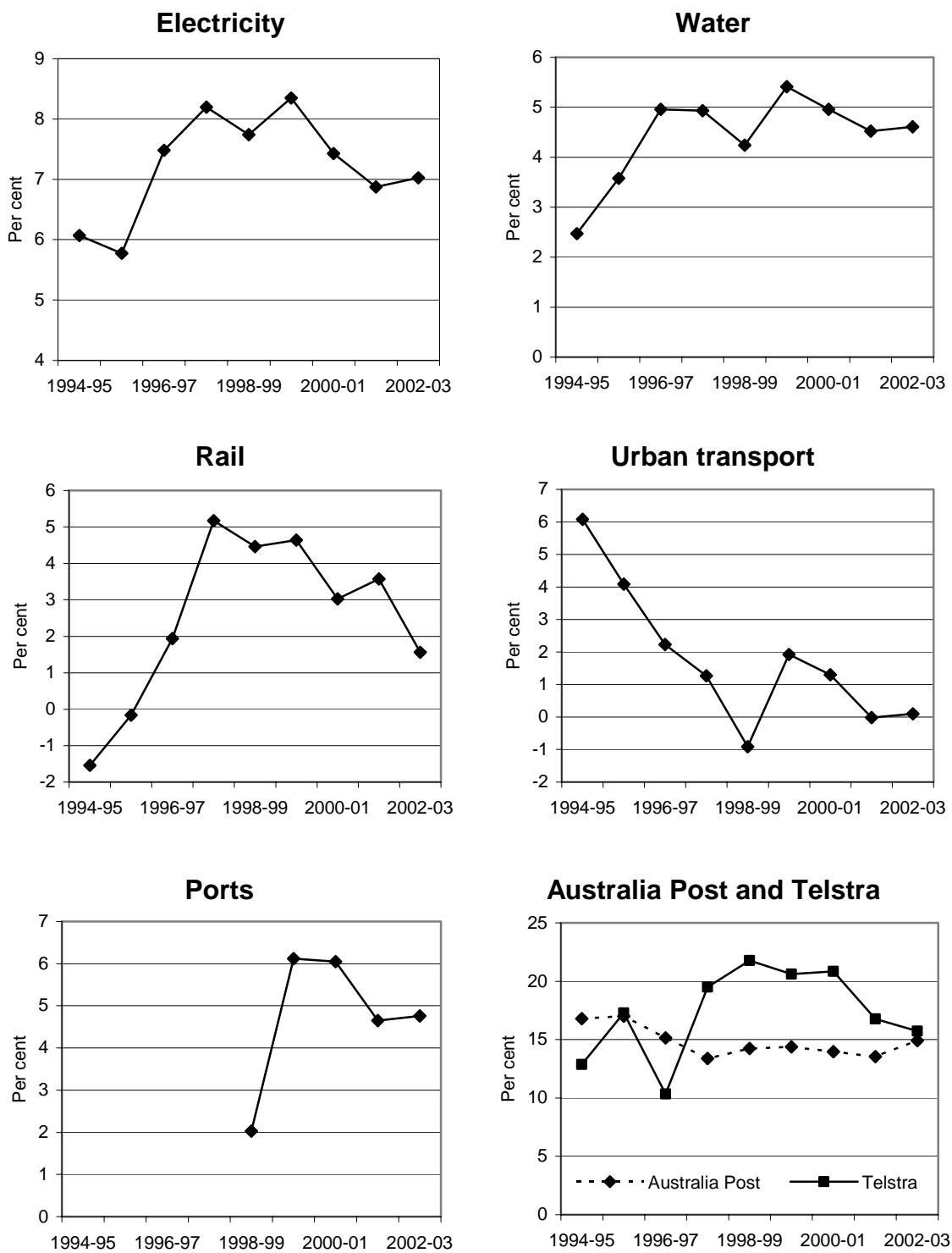
^a Rates are for public and private enterprises engaged in comparable activities. Gross rates of return are the ratio of gross operating surplus to gross capital stock. For both public and private enterprises, gross capital stock is restricted to non-dwelling construction and equipment. Data that allow for comparison between comparable public and private enterprises are not available beyond 1995-96.

Data source: ABS (*Australian National Accounts: Capital Stock*, Cat. No. 5221.0).

That said, there has been considerable variation in rates of return across infrastructure sectors, not all of which can seemingly be explained by different levels of risk attaching to service delivery, or variations in the extent of unfunded community service obligations. Moreover, since the mid to late 1990s, rates of return have declined in a number of sectors (see figure 4.4). Indeed, of the 84 GBEs monitored by the Productivity Commission in 2004, only half earned nominal pre-tax returns above the risk-free return on 10 year Commonwealth Government bonds (5.4 per cent in 2002-03) (PC 2004c, p. 7). In the light of the underlying market risks for many GBEs, this is a very conservative benchmark.

In some cases, sector-specific or short term factors have influenced performance. For instance, drought conditions have adversely affected the financial performance of some water authorities. The regulation of monopoly service providers may have unduly suppressed prices charged by some GBEs. And measures to ensure equitable access to some public transport services will have impacted on returns in that sector. However, these factors do not offer a convincing explanation for such widespread underperformance.

Figure 4.4 Trends in average returns on GBE assets^a, 1994-95 to 2002-03



^a The ratio of pre-tax operating profit plus gross interest expense to the average value of assets at the beginning and end of each year.

Data source: PC (2004c and prior years).

It has also been suggested that the recent downturn in rates of return can be at least partly attributed to excessive dividend payouts imposed by owner governments that have reduced the capacity of GBEs to invest in maintaining and expanding their networks, and thus, undermined their financial performance.

There is an obvious need for caution in drawing links here given, for example, long lead times between some investments and the ensuing effect on financial performance. However, on the basis of available evidence, it seems hard to sustain a general argument that excessive dividend payouts are compromising rates of return and the sustainability of services in the long run.

- Average dividend payout ratios (DPRs) have been quite high (at around 80 per cent of net profits) in recent years and for several individual GBEs more than 100 per cent. Some GBEs have actually been required to make dividend payments after reporting operating losses (PC 2004c) — though this has also been a practice of certain private infrastructure entities.
- In aggregate, the DPRs do not appear to be unduly high relative to those prevailing in the private sector. For instance,
 - NECG (2002) found that the 2000–01 median DPR for 18 water GBEs was broadly consistent with the mean and median payout ratios for the top 50 ASX listed firms. Furthermore, the individual water authority data showed no short-term correlation between high DPRs and low rates of return. Rather, a reasonably strong relationship was evident between the comparatively low gearing of many water authorities and low rates of return; and
 - Somerville (DNRME 2004) concluded that the payment of special dividends by electricity distributors in Queensland had not affected their ability to spend on their networks.

That said, in noting a much greater percentage of DPRs in excess of 100 per cent among water authorities than for private firms, NECG pointed to the likelihood of financial problems in the future if such ‘excessive’ dividends were to be sustained for long periods:

Since water businesses are characterised by the need for lumpy investment, consistent and continued application of very high dividend payout ratios could lead to unacceptable levels of financial stress for the affected businesses at some stage in the future. (NECG 2002, p. 21)

In the absence of ‘mitigating’ factors, the rate of return data presented in figures 4.3 and 4.4 raise questions about GBE management and the efficacy of current governance arrangements. They also suggest that, in this area, the NCP reforms and previous governance initiatives have not been entirely successful. This raises the issue of the merits of continued public ownership of some service providers —

especially where service provision is contestable. As the Australian Treasury (1990, p. 1) argued:

If the investment in a government business enterprise is not realising an adequate return (after allowing for the cost of any government-enforced non-commercial services provided) the question can rightly be asked why the community should not demand that at least some of the assets of the enterprise be sold and the resulting funds used in more productive activities or possibly to pay off public debt.

Governance issues are discussed further in chapter 10.

4.4 Price and service quality impacts for other goods and services

NCP has directly affected the price and/or service quality of many other goods and services, mainly through the LRP and the extension of the anti-competitive conduct provisions of the TPA to unincorporated businesses.

Because many of the changes arising from the LRP have occurred only recently, information on reform impacts is limited. Accordingly, this section focuses on outcomes in three areas: retail trading, professions and occupations, and statutory marketing arrangements for agricultural commodities.

Retail trading

Prior to NCP, State and Territory regulation of retail trading hours differentiated between retailers on the basis of location, size and products sold. The primary intent of the regulation was to give small businesses an opportunity to trade without competition from large retail chains and to reduce the need for employees to work outside traditional working hours. However, the restrictions prevented many consumers from shopping at times most convenient to them, or forced them to pay the higher prices often charged by smaller retailers.

While there is continued opposition to deregulation in some quarters, it has been met with strong support from shoppers. For instance, the NCC reports:

In Victoria, local councils may hold a plebiscite to determine if a community wishes to reimpose limits on shop trading hours. To date, only the City of Greater Bendigo exercised this option. The voluntary poll, conducted in 1998, attracted 72 per cent of voters, of which 77 per cent voted to support the continuation of Sunday trading.

An attempt by the ACT Government to reinstate trading hours restrictions, after consumers had experienced a trial period of deregulation, failed after a public outcry. (NCC 2003b, p. 4.4)

The NCC (sub. 71, p. 11) also referred to a study by Jebb Holland Dimasi (2000) pointing out that:

In Sydney and Melbourne around 35 per cent of consumers buy groceries on Sunday where supermarkets are permitted to open. In Perth and Adelaide, where only small food stores can trade on Sundays, the comparative figure is 7–8 per cent.¹

And, in a report prepared for the Shopping Centre Council of Australia, Access Economics noted that:

... the survey evidence consistently shows a strong consumer preference for deregulated trading hours. ... the strong preference data available from consumer surveys, and the marked shift in consumer behaviour post-deregulation, suggest that the community values deregulated trading hours very highly, and any dollar value on the resulting ‘consumer surplus’ is therefore likely to be very large. (2003, p. 29)

Notably, as discussed further in chapter 5, it does not appear that these benefits to consumers have come at the cost of reduced employment in retailing overall — though obviously the distribution of that employment has changed. Some comments from other participants about the benefits of deregulation in this area are provided in box 4.7.

Professions and occupations

The professions are an important segment of the economy. In 2001, professionals — including in the health, legal and building sectors — accounted for 18 per cent of total employment (ABS 2003a).

Professional and occupational regulation has a long history in Australia and overseas. It often involves fee scales and limits, restrictions on certain forms of advertising, codes of practice and related disciplinary procedures. And market structure can be affected by the use of titles, entry and ownership restrictions, and various other constraints on who can compete with, or within, a professional group.

The LRP reviews have provided an opportunity to assess whether such restrictions are in the public interest. They have found that many were not justified, or that they should be modified to achieve their underlying objectives more cost effectively. At the same time, the review process has affirmed that some regulation is often required to protect consumers and underpin appropriate service quality.

¹ South Australia has subsequently liberalised its trading hours regulation.

Box 4.7 Some views on the benefits of deregulated retail trading hours

Tasmanian Government

... a major benefit of the removal of restrictions on shop trading hours is the increased convenience to consumers, in terms of when they choose to do their shopping at the formerly restricted stores. (sub. 109, p. 4)

Shopping Centre Council of Australia

There is no doubt that Sunday trading is something consumers want. In those states and territories with Sunday trading, Sunday has become the second most popular trading day of the week.

Sunday trading in South-East Queensland has been an outstanding success. Overall retail sales have increased and the disaster for small retailers that was predicted by some has not occurred. It is overwhelmingly popular with consumers. (sub. 47, p. 2)

Coles Myer

Deregulation of shopping hours has given all customers access to the choice of a wide range of products and prices at all times. (sub. 107, p. 12)

Woolworths

The States and Territories which have reviewed and reformed shop trading hours have enjoyed overwhelming economic benefits, to retail sector employment, consumer convenience, consumer choice and prices. (sub. 115, p. 1)

As noted above, NCP also required the States and Territories to enact legislation to bring unincorporated businesses within the purview of the TPA. This has constrained the capacity for professionals — who typically operate in partnership arrangements rather than as incorporated companies — to engage in anti-competitive practices.

Several participants commented on the benefits of these reforms for consumers (see box 4.8). But perhaps the best summary — in an area where relevant information is difficult to come by — was provided by the New South Wales Government:

- ... Reviews have resulted in the abolition of licensing for employment agents, replacement of the hairdressers' licensing system with a requirement that those who practice hairdressing for a fee must be suitably qualified and the streamlining of licensing requirements for driving instructors. As a result, it is easier for people to enter into these occupations and transaction costs have been lowered for businesses;
- NCP legislative reviews have delivered greater consumer choice and opened up new business opportunities. ... For example:
 - the removal of the legal profession's monopoly on conveyancing services has increased choice of conveyancing service providers. Consumers now pay lower conveyancing fees — conveyancing fees in New South Wales fell by 17 per cent between 1994 and 1996;

Box 4.8 Some views on benefits of NCP reform to the professions

Professions Australia, a national organisation of professional associations, contended that in overall terms:

... NCP has delivered some positive outcomes in terms of price, improved quality of service and innovation to consumers of professional services. While a number of the professions were initially resistant to NCP, it is clear that as a result of competition reforms there has been significant attitudinal and cultural change across the professions. ... A number of poor practices which delivered limited value to consumers have been eliminated, for example, the legal profession in some states has made significant progress in reducing anti-competitive practices through the reform of various regulations and structures. (sub. 65, p. 6)

The Real Estate Institute of Australia pointed to the benefits of the deregulation of real estate commissions in all jurisdictions, except Queensland:

The major benefit of deregulation of commissions is that it provides an opportunity for the industry to become more price competitive and to deliver flexible services appropriate to the needs of individual clients. (sub. 17, p. 2)

The Victorian Government noted:

There is increased competition in the market for conveyancing services by removing fee scale regulation, permitting fee advertising and reductions in restrictions on entry into the market for conveyancing services. (sub. 51, p. 35)

And, the Victorian Branch of the Australian Dental Association indicated that deregulation of ownership restrictions applying to dental practices in that State has resulted in the establishment of more than 100 non-dentist owned practices. (NCC 2003c, p. 3.16)

- people now have the option of obtaining certain foot treatments from nurses and medical practitioners, instead of exclusively from podiatrists following the NCP Review of the *Podiatrists Act 1989*;
- the monopoly held by the veterinary profession over all acts of veterinary science was recently replaced with a specific list of veterinary practices that, on health, welfare and trade grounds need to be restricted to licensed practitioners. This arrangement will enable a wider range of animal health care services to be provided by both vets and non-vets. (sub. 99, p. 10)

Agricultural commodity marketing

Historically, a broad range of legislative restrictions applied to the production and marketing of a variety of agricultural commodities including dairy products, eggs, grains, potatoes, poultry meat, dried fruit, rice and sugar. Such restrictions — which were administered through statutory marketing authorities (SMAs) — sought to:

- boost farm incomes by taking advantage of perceived market power in export markets; and

-
- provide farmers with countervailing market power in dealing with processors and retailers.

However, compulsory acquisition powers afforded to SMAs, and various other controls implemented to pursue these objectives, imposed significant costs on local consumers. For example, the Industry Commission (IC 1997b, p. 47) estimated that, in 1994-95, domestic pricing arrangements and import tariffs needed to support the activities of SMAs provided gross assistance to producers of about \$590 million. This was effectively paid for by household and business users. In addition, the controls often reduced the scope and incentives for innovation, to the detriment of both consumers and producers.

As a result of the LRP, many of these controls have been removed. For example, the tariff on imported sugar was removed in July 1997; all States and the ACT removed their controls on the pricing and supply of drinking milk in 2000; and grain marketing restrictions have been removed in most States.

Although some changes have occurred relatively recently, there is already evidence of benefits for consumers. For example, despite the imposition of an 11 cents a litre levy on consumers to fund an assistance package for dairy farmers, across Australia, the average retail price of drinking milk has fallen by 5 per cent in real terms since full deregulation in 2000 (ABS 2004b and prior years). And, as noted by the Victorian Government (sub. 51, p. 54), the range of milk products available to consumers has broadened with the introduction of new products to meet various dietary and health needs.

Changing retail sector practices have had a key influence on milk prices, as supermarkets bid for a larger share of the drinking milk market. The introduction of supermarket (or house) brands, in competition with the traditional company brands provided by processors and farmer co-operatives, has produced innovation in packaging and marketing and reductions in the prices of key drinking milk products. Price reductions have been reinforced by supermarkets' use of milk as a 'loss leader' — a strategy designed to draw shoppers into the store by reducing the price of a staple item. In the three years to June 2003, supermarket brands doubled their share of the supermarket packaged milk market (NCC 2004d, pp. 37-38).

It is also important to recognise that a key feature of the dairy market (and many other SMA) reforms was the removal of inefficient consumer-funded subsidies to producers. In a general sense, such subsidies were little different from the high tariff and other assistance previously provided to Australian manufacturers. These tended to impair efficiency and impose significant costs not just on consumers but also on other primary producers. In this context, the Victorian Government (sub. 51, p. 54) noted that dairy deregulation has promoted greater efficiency in the farm and

processing sectors, resulting in ‘a higher level of specialist production of dairy products, such as cheeses, produced through groupings of farmers at the local level’. The impacts of dairy deregulation on farmers and regional areas is explored further in chapter 5.

In the case of grain, and specifically barley, the removal of compulsory acquisition and marketing arrangements in some states has delivered a range of benefits for growers without undermining export prices — suggesting that SMAs had not been securing price premiums in global grain markets (NCC 2004f). Moreover, in States where full or partial deregulation has occurred (for grains such as barley, canola and lupins), growers have more selling options and greater flexibility in financing and risk management. For example, farmers still have the option of pooling produce and income, but can also take advantage of cash offers, thereby receiving payment on delivery rather than waiting until pool sales are finalised. Commenting on these matters in the context of recent changes in Western Australia that have allowed more than one entity to export canola, the National Farmers Federation (sub. 100, pp. 22-23) said that the beneficial outcomes had included increased grower choice (including an opportunity to increase the cash component of a crop), more flexibility in borrowing and a greater choice of selling contracts.

In addition, more flexible marketing arrangements facilitated by deregulation in some of the States are expected to attract new investment into the sector, leading to greater efficiency in areas such as transport and storage (by, for example, moving from a storage system to a ‘transport and ship’ system). However, there are claims by some that the ongoing regulation of export wheat marketing — Australia’s dominant grain commodity — is constraining investment in grains more generally (NCC 2004f, p. 12 and p. 31). This issue is taken up in chapter 9 with further discussion of the benefits to farmers from recent grain market liberalisation provided in box 5.5.

4.5 Summing up

Reforms in governance arrangements and NCP and related initiatives to increase the exposure of GBEs to competitive pressures were intended, among other things, to promote more efficient pricing practices, improve the financial performance of GBEs and help ensure that the quality and range of infrastructure services better reflected users’ needs. While data constraints preclude definitive analysis, the available information is broadly consistent with these objectives being met.

It is difficult to separate the impacts of NCP from those of other factors, but for Australia as a whole:

-
- real prices for several key infrastructure services have fallen significantly in aggregate;
 - by and large, businesses have benefited more than households; and
 - real prices for household users have risen in a number of service areas.

However, the adverse impacts on households from such price increases would have been partially offset by price reductions for other goods and services, made possible by the cost savings for businesses from lower charges for key infrastructure inputs. As outlined in chapter 5, the Commission's modelling of the *net* impacts of productivity and price changes in key infrastructure sectors during the 1990s suggests that, while higher income households derived the largest benefits, lower income households also received a boost to their incomes (see chapter 5).

The available data further suggest that service quality has generally been maintained, and has even improved in some areas. And there is evidence that many users have benefited from a wider range of services. While NCP and related reforms have not been the sole drivers of these beneficial changes, they seem to have been significant contributors.

Reforms resulting from the legislation review program have also affected prices and quality of service outcomes. As many of the reforms have been implemented only recently, in most cases, it is too early to identify their precise effects. However, there is evidence of price and quality benefits stemming from the removal of restrictions on competition in retail trading, professional and occupational services, and the marketing of some agricultural commodities.

At the same time, the financial performance of government infrastructure service providers has improved considerably. Nevertheless, many GBEs still have a long way to go to generate commercial rates of return. In some cases, this raises questions about the effectiveness of governance arrangements and the sustainability of service provision.

5 Social, regional and environmental impacts

Key points

- While causality is difficult to establish, NCP is likely to have contributed to the rise in average household incomes evident in most parts of Australia over the past decade.
- Inevitably, the benefits of NCP will not have been evenly spread across income groups. However, modelling work by the Commission suggests that:
 - Price and productivity changes in the infrastructure industries have increased the purchasing power of households across the entire income spectrum.
 - The impacts on overall income distribution of differential outcomes across income groups have been small.
- Many of the negative influences on economic activity and employment in parts of country Australia, such as declining terms of trade for primary products and population drift from smaller rural communities, are of long standing and unrelated to NCP.
- Indeed, many producers, consumers and communities in country Australia have benefited from NCP reforms.
- NCP may have had some unanticipated adverse effects on the environment — in particular, higher greenhouse gas emissions associated with reform-related increases in demand for electricity. However, in those areas where reforms have explicitly targeted better environmental outcomes (such as in the water sector), the effects have been positive.
- It is inevitable that reforms designed to remove sources of inefficiency in the economy will create some ‘losers’ as well as ‘winners’. For example, NCP has led to job losses and reduced incomes in some regional communities, though it is apparent that other regional centres have often gained from the reforms.
- The costs experienced by some individuals or communities, while an important consideration, are not sufficient reason to forego reforms that are of substantial net benefit to the community as a whole.
- But governments should ensure that the implementation of reform takes account of any significant transitional and distributional impacts and, where appropriate, involves the provision of adequate and well targeted support to adversely affected individuals/groups.

Economic reform is intended to increase overall living standards. However, reforms inevitably have transitional costs, involve some redistribution of income and impact differentially across regions. Some also affect environmental outcomes.

NCP recognises that some such negative impacts are intrinsic to reform and has provisions designed to address them. Thus, public interest tests to help ensure that the benefits of particular reforms outweigh the costs are an integral part of NCP (see chapter 6). The NCP framework also allows for a variety of transitional arrangements to alleviate some of the adjustment burden or modify, in part, the distributional impacts of reform.

While these safeguards are generally seen as a key part of NCP, many argue that they have not worked effectively. Some contend that NCP has sacrificed social and environmental objectives for economic goals and that most of the benefits have accrued to those living in the major cities (box 5.1).

Box 5.1 Some negative perceptions of NCP

While the ‘big end of town’ and shareholders in the main have benefited, it is the worker, the ‘little man’ who has suffered and who, in spite of promises that things will improve, continues to suffer. Social, rural and environmental needs are not being met. (Country Women’s Association of NSW, sub. 16, p. 4)

The wider community is expected to trust that benefits will eventually flow outwards and be shared by everyone as improved living standards. Even if this trust can be justified, the distributive outcomes across society are an even greater concern. (Australian Council of Social Service, sub. 106, p. 1)

... competition reform in electricity and gas has resulted in a wide distribution of costs yet succeeded in delivering benefits (and modest gains at that) to a tiny proportion of the community We cannot see that this has served the public interest. (Public Interest Advocacy Centre, sub. 32, p. 8)

The outcomes of NCP in the forestry sector are disappointing. The failure to fully implement competitive neutrality and legislation review reforms to forestry has meant that the environmental issues have not been addressed. (Australian Conservation Foundation, sub. 54, p. 16)

Whilst recognising the intent of the concept, it is considered that the policy does not appear to take into account the impact of NCP on rural and regional areas. In that respect, larger urban economies can benefit from NCP outcomes, however, issues such as dairy deregulation have a significant impact on both the social and economic issues of rural/regional areas. (Richmond Valley Council, sub. 6, p. 1)

In this wide-ranging inquiry, the Commission has not attempted to provide a detailed micro level assessment of the impacts of NCP by industry and region.

Accordingly, this chapter examines the social, regional and environmental impacts at a relatively broad level.

Also, as noted in earlier chapters, it is difficult to disentangle the impacts of NCP from other factors that have been driving recent outcomes. Some caution is therefore required in drawing conclusions about its effects on social welfare, employment, regional Australia and the environment. Nonetheless, as the analysis in the remainder of this chapter indicates, many of the concerns that have been raised about NCP in these contexts appear not to be borne out by the available evidence.

5.1 Social welfare and equity considerations

As noted above, NCP acknowledges that governments have specific social welfare and equity objectives that need to be taken into account in the reform process. Two important issues in assessing how well NCP has performed in this regard are:

- how the gains from NCP-related reforms have been distributed among different consumer and household groups; and
- whether NCP has undermined community service obligations used by governments to promote social objectives — such as reducing the costs of essential services for disadvantaged groups.

However, it is important to recognise that NCP operates alongside policies which specifically aim to promote social and distributional goals, including taxation arrangements, the social security safety net and the employment services network. Such policies will tend to ameliorate any immediate adverse impacts of NCP on social and distributional outcomes.

Distributional impacts of NCP-related reforms

Australia's much improved productivity performance in the 1990s (see chapter 3) has underpinned the recent acceleration in the growth of *average* incomes. A number of studies have examined how this income growth has been distributed (see box 5.2).

Although differing on the extent of change, most commentators agree that, by nearly all measures, inequality has increased in recent years. And while this trend pre-dates NCP, the dispersion of incomes and earnings appears to have widened since the mid-1990s.

Box 5.2 Perspectives on the distribution of recent economic gains

Labour and capital shares

According to previous Commission research (Parham et al. 2000), income growth in Australia during the 1990s, unlike the period from the mid-1970s through to the end of the 1980s, was distributed evenly between labour (wages and salaries) and capital (profits). The research was at a highly aggregated level, however, and acknowledged that the distribution of income gains between labour and capital is only part of the distributional picture. For example, while the study also found that productivity gains had mainly been passed on in the form of lower prices, it did not examine the ensuing impacts on income distribution of these price changes.

Earnings

The ABS (2000), as reported by the Senate Community Affairs References Committee inquiry into poverty (SCARC 2004), concluded that inequality in the distribution of wage and salary earnings of full-time adult employees increased in the 1980s and that this trend continued through the 1990s. The SCARC also referred to a study by the Department of Family and Community Services (FACS 2003), which found that:

- between 1990 and 1996, real earnings at the bottom of the income spectrum initially rose and then remained stable, while earnings for those at the top of the spectrum consistently increased; and
- between 1996 and 2000, real earnings grew across the income spectrum, although the increase was most rapid for the highest earners.

Incomes

Data on the distribution of income in Australia take into account government taxes and transfers as well as earnings. Recent studies all indicate an increasing dispersion of incomes. For example, the ABS (2003b), as reported in (SCARC 2004), and Saunders (2003) both concluded that there has been some increase in income inequality since the mid-1990s. And, a NATSEM study (AMP-NATSEM 2004) reported that over the five years to 2001 there was a modest increase in household income inequality between the richer and poorer postcodes in Australia.

Distribution of wealth

According to a NATSEM study (Kelly 2001), the overall distribution of wealth remained stable between 1986 and 1998. While the distribution of most types of wealth — home equity, business assets and cash deposits — became more unequal over the period, this was neutralised by the accrued superannuation of lower income groups, associated with the introduction of the Superannuation Guarantee.

Some participants (for example, VCOSS, Brotherhood of St Laurence and The Centre for Public Policy) suggested that there may be a link between NCP and increased inequality. And though not suggesting a link, ACOSS commented:

... the extent to which NCP has contributed to or ameliorated the level and shape of contemporary poverty in a rich country, against a backdrop of rapid industry, trade and workforce reform, remains a valid question. (sub. 106, p. 5)

In broad terms, it would be surprising if the NCP and related reforms had not contributed somewhat to the increasing dispersion of household incomes. This is because productivity improvements and consequent growth in ‘factor incomes’ generally favour those in employment, who tend to be ‘over-represented’ at the higher end of the household income spectrum.

However, the more pertinent question is whether the contribution of NCP has been significant, relative to the many other factors that would have influenced income distribution over the 1990s.

To help shed light on this issue, subsequent to the release of the Discussion Draft, the Commission incorporated a distributional component into its modelling of productivity and price changes over the 1990s in key infrastructure sectors (see box 5.3). Some key results from that modelling are:

- higher national production associated with productivity and price changes would have increased real household purchasing power by around 1.2 per cent;
- household incomes are projected to have risen across the income spectrum; and
- as would be expected, the boost to purchasing power is estimated to have been larger for higher income households (see figure 5.1).

As outlined in earlier chapters, the Commission’s modelling does not differentiate between changes induced by NCP and other factors. Nonetheless, it suggests that the impacts on income distribution of productivity improvements and price rebalancing in the infrastructure sectors — and by implication the effects of NCP and related reforms — have been small. In particular, the magnitudes of the projected changes in income levels relative to actual income growth during the 1990s are small. Hence, even had the income benefits of the projected changes been more evenly allocated across household groups, the implied impacts on broader distributional trends over this period would have been minor. Moreover, support for low income and other disadvantaged groups provided through community service obligation arrangements applying to infrastructure services (see below) or other income support payments would have potentially ameliorated some of the projected impact on distribution.

Box 5.3 Modelling the distributional impacts of infrastructure industry changes

The Commission's modelling of the distributional effects of productivity and price changes in key infrastructure sectors incorporates the feedback effects on wages, business income and subsequent changes operating through the tax and social security systems. It uses a tops down framework, whereby the increased real purchasing power of households generated by the projected growth in national output (see chapter 3) is disaggregated to household income groups using household characteristics reported in the 1993 Australian Bureau of Statistics Household Expenditure Survey (ABS 1993, *Household Expenditure Survey - Australia*, Cat. no. 6257.0). Details of the methodology are provided in the modelling supplement to this report.

The aggregate modelling suggests that higher national production would increase real household purchasing power by around 1.2 per cent, mainly as a result of the price and productivity changes in the electricity and telecommunications sectors. This projected increase in purchasing power is equivalent to around \$6 billion in current (2003-04) values.

Moreover, while the projected increases in income at the household level are largest for higher income households, the modelling indicates that the purchasing power of households across the entire income spectrum is higher as a result of the modelled changes in the infrastructure industries (see figure 5.1 in text).

The Commission notes that the projected increase in aggregate household disposable income is considerably less than the projected rise of 2.5 per cent for national production reported in chapter 3. The difference mainly reflects a decline in the terms of trade as net exports increase, but also higher investment. Such investment would contribute to the income flowing to households at some stage in the future — though its likely distribution across the income spectrum is unclear.

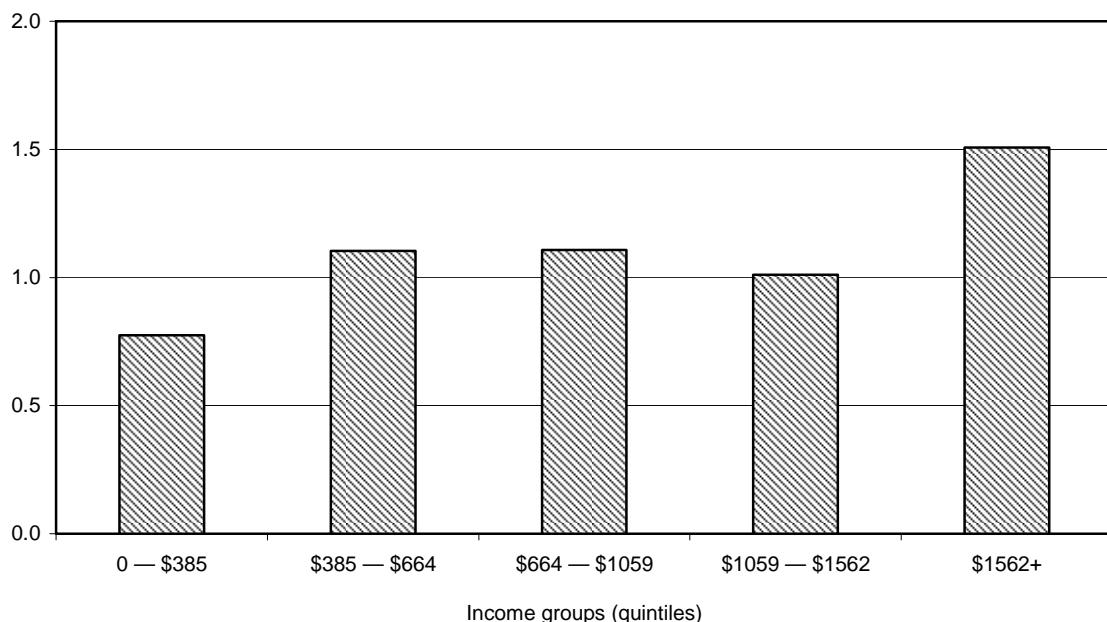
As well, the modelling assumes that increased net revenues to government, resulting from the growth in national incomes, are distributed to households in a 'neutral' fashion — that is, in proportion to the income of households before the price and productivity changes in the infrastructure industries. (The government revenues are net of increased public spending in areas such as health and education, which is not distributed in the model). While this is the approach conventionally adopted in this sort of modelling, clearly governments could elect to distribute their additional revenue from higher national income in other ways. Were, for example, most of the additional revenue used to fund services mainly used by lower income households, or to increase social security payments, then the ultimate income benefits of the modelled infrastructure changes would be more evenly distributed than indicated in figure 5.1.

Similarly, the modelling results reflect distributional changes for households classified according to their *actual* gross incomes. If the analysis had been conducted using *equivalent* household income (that is, with adjustments to take account of the varying make-up of households) — as is sometimes the case in such studies — the projected income gains would again have been somewhat more evenly distributed than in figure 5.1. This is because high income households tend to have more members.

Source: Commission estimates using the MMRF-CR and Income Distribution models.

Figure 5.1 Projected effects of price and productivity changes in infrastructure industries on the purchasing power of households^{a b}

Per cent



^a Changes estimated over the period 1989-90 to 1999-00. ^b Households have been allocated to five gross income groups or quintiles — group 1 and group 5 represent the lowest and highest income groups respectively. The income ranges are indicative of household income groups in 2003-04 and were derived by rebasing average weekly earnings in the 1993-94 Household Expenditure Survey to average weekly earnings in 2003-04.

Data source: Income distribution model estimates.

What impact on community service obligations?

CSOs in the NCP context

An important category of transfers in the context of this inquiry, which could be expected to have a bearing on distributional outcomes, is community service obligations (CSOs).

CSOs are government requirements for service providers to engage in non-commercial activities to meet affordability and access objectives. They apply in a range of sectors and take two principal forms:

- direct funding by governments, including concessions targeted at low-income earners (for example, in energy and water) and the provision of ‘uneconomic’ services (for example, certain rail — mainly freight — services); and

-
- universal service obligations (standardised service requirements for some basic postal and telecommunication services).

NCP did not require governments to remove or reduce CSOs. Rather, the main thrust of NCP was to have governments review their CSO policies to improve their identification, costing, funding and delivery, with a view to helping decision-makers assess the appropriate level and type of CSOs to be provided.

A number of significant changes have subsequently ensued, the most important being that all governments have adopted a commonly agreed definition of CSOs and have accepted the principle that the costs of CSOs should be transparent and funded directly from consolidated revenue. However, a few major CSOs continue to be funded by cross subsidies, including the Australian Government's universal service obligations in postal services and telecommunications.

A range of concerns about CSOs were raised by participants in this inquiry. Many related to perceived deficiencies and inconsistencies within and across jurisdictions in the groups targeted by CSOs. For instance, the Council of Social Service of New South Wales noted:

Community Service Obligations (CSOs) policies in NSW utilities tend to focus on pensioner concessions on energy and water bills and “one-off” emergency type assistance for households facing disconnection or serious hardship. These CSOs, like many other concession regimes, are inconsistent and do not explicitly target other people on very low fixed incomes and the growing number of working poor. (sub. 86, p. 2).

And, the Western Australian Council of Social Service (sub. DR230) claimed that clients were often unaware they were eligible for concessions or rebates. In this context, it said that utility service providers do not readily volunteer information regarding concessions and rebates to customers.

However, perhaps the main issue in this area is whether the NCP initiative to make CSOs more transparent through direct (budgetary) funding, coupled with increased competition pressures, has resulted in a decline in the level of CSO support provided, and thereby reduced the affordability of key services for disadvantaged households. In this regard, several participants, including VCOSS, Brotherhood of St Laurence and the Centre for Public Policy claimed that, under NCP, there has in fact been an erosion of CSO funding leaving some low income users worse off. For example, in relation to electricity market outcomes, VCOSS said that:

In Victoria ... low consumption customers (who tend to be low income households) have uniformly faced price increases without adequate compensation from government. (sub. DR155, p. 9)

How have NCP changes impacted on the level of CSOs?

In broad terms at least, the contention that NCP and other reforms may have materially diminished the overall value of CSOs seems difficult to sustain. Based on the explicit or direct payments made by governments to 51 government trading enterprises monitored continuously by the Commission between 1998-99 and 2003-04, real direct funding of CSOs has increased substantially (table 5.1). While funding through cross-subsidy for the universal service obligations of Australia Post and telecommunications has declined in real terms, the dollar value of this reduction is much less than the total increase in payments for directly funded CSOs.

Table 5.1 Changes in funding of CSOs in infrastructure services

Sector	1998-99	2003-04 ^a	Nominal change	Real change
	\$ million	\$ million	%	%
<i>Direct funding^b</i>				
Electricity	93	178	+ 91	+ 63
Water	410	496	+ 21	+ 3
Rail ^c	1 037	1472	+ 42	+ 21
Urban Transport	207	291	+ 41	+ 19
Other ^d	16	15	- 6	- 20
Total ^e	1 763	2 452	+ 39	+ 18
<i>Cost to provider of USO^f</i>				
Post	70	79	+ 13	- 4
Telecommunications	280	232	- 17	- 30

^a Preliminary data. ^b Data are for 51 Government Trading Enterprises continuously monitored by the Commission. ^c Latest available data are for 2002-03. Data for 2003-04 are not comparable with 1998-99 data due to industry restructuring in NSW and WA. ^d Includes ports and regional air services. ^e Rail component of the total comprises 2002-03 data. ^f Australia Post and telecommunications service providers are responsible, through cross subsidies, for funding the Australian Government's Universal Service Obligations.

Sources: PC (2005b); Australia Post, *Annual Report* (various issues).

Another perspective is provided by comparing changes in the value of CSO funding with changes in service prices. As the examples in box 5.4 illustrate, in some cases, increases in funding for CSOs have not kept up with price increases (for example, electricity in Melbourne and gas in Sydney). But in others, the effective value of the concessions has increased (for example, water in Melbourne). Similarly, the fall in the value of the telecommunications universal service obligation (see table 5.1) needs to be viewed in the context of a significant real decrease in average service prices over this period (see chapter 4).

At a more disaggregated level, there will clearly be instances where particular disadvantaged consumers, or consumers living in specific regional locations, will have seen CSO transfers fall or withdrawn as a result of the reform process.

However, overall, NCP reforms do not appear to have had any significant impact on the degree of redistribution effected through CSO arrangements.

Box 5.4 The changing value of energy and water concessions

Since the inception of NCP, changes in the value of concessions for energy and water services relative to movements in the price of those services have been mixed.

For energy:

- In Victoria, the estimated value of the average energy concession declined by 14 per cent in real terms between 1996-97 and 2000-01. Over the same period, electricity prices for Melbourne households declined by 10 per cent and gas prices by around 8 per cent (both in real terms).
- In New South Wales, the estimated value of the average energy concession declined by 2.7 per cent in real terms between 1996-97 and 2000-01. Over the same period, electricity prices for Sydney households declined by around 1 per cent, while gas prices increased by nearly 8 per cent (in real terms).
- In South Australia, the annual electricity concession for pensioners increased from \$70 to \$120 in January 2004, a 22 per cent increase in real terms since the concession was last changed in 1990. Between 1990-91 and 2002-03, electricity prices for Adelaide households increased by 24 per cent in real terms.

For water:

- The value of average household water and sewerage concessions in Victoria increased by just over 1 per cent in real terms between 1996-97 and 2000-01. Over the same period, water and sewerage prices for Melbourne households declined by around 20 per cent in real terms.

Sources: DHS Concession Unit Annual Report (various issues); New South Wales Government (2004); PC (2002h); Rann (2003).

5.2 Employment effects

Over the longer run, the stimulus to economic growth and incomes provided by competition and other reforms (see chapter 3) can be expected to result in potentially sizeable employment increases. However, much of the immediate impact of NCP reforms has involved reallocating labour to more productive uses. Hence, the short to medium run impacts on economy-wide employment levels are likely to be small.

Of more interest, therefore, are changes in the *distribution* of employment across sectors, types of business and localities. These depend on such things as the pattern of activity in particular cities and regions.

This section examines recent employment changes within two key sectors, namely infrastructure industries and small businesses. Again, these changes reflect the collective impact of a variety of factors, not just NCP reform. However, in the infrastructure industries at least, much of the employment change has seemingly been heavily influenced by NCP and related reforms. Regional aspects of these employment changes are discussed in section 5.3.

Infrastructure industries

Large employment changes in the infrastructure industries are not new. For example, in the 1980s, recognition of considerable overmanning led to substantial labour shedding in the rail, electricity and telecommunications sectors.

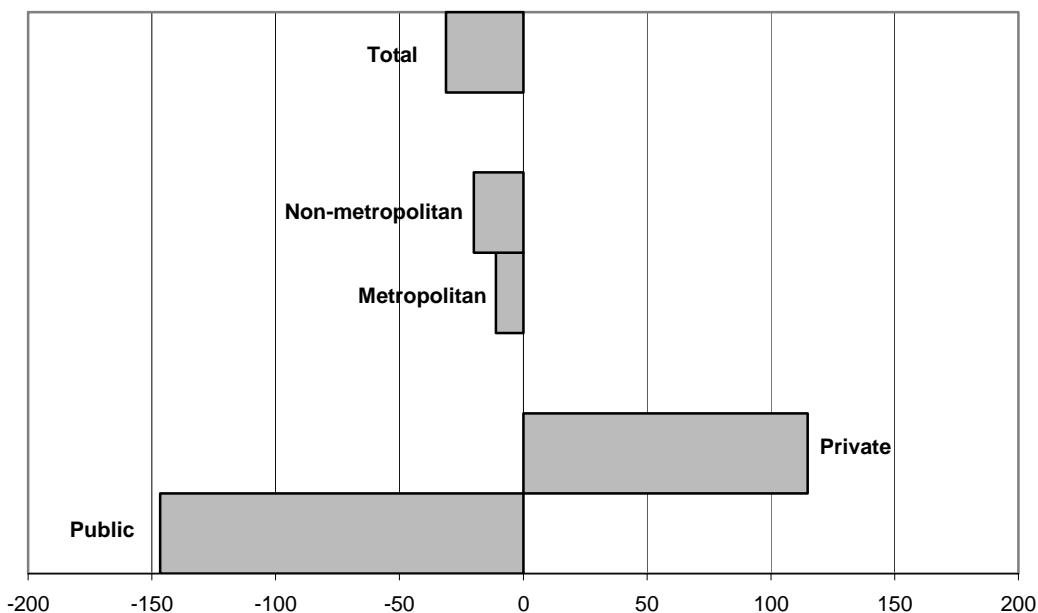
More recent productivity improvement and restructuring in these industries, to which NCP and related reforms have been important contributors, has similarly resulted in some large direct employment impacts.

- Between 1990 and 2003, there was a net employment reduction across all infrastructure sectors of 31 000 (figure 5.2).
- Over this period, employment losses were recorded in all of the key infrastructure sectors except communications and road transport. Job losses were most significant in the rail and water sectors.
- However, the bulk of the employment reductions occurred in the first half of the 1990s, prior to the introduction of NCP. Indeed, after declining by 50 000 jobs between 1990 and 1995, total employment in the infrastructure sectors actually increased by 19 000 in the subsequent eight year period.

Accompanying these aggregate infrastructure employment changes, has been a more significant change in the distribution of employment between the public and private sectors.

- Between 1990 and 2003, public sector infrastructure employment fell by 147 000 (figure 5.2). But this was largely offset by the creation of 116 000 new private sector jobs, mainly in communications, electricity and road transport.
- Part of the decline in employment in the public sector reflected continuing improvements in labour productivity. However, privatisation of some services and contracting out of aspects of service provision that remained in public hands, led to a transfer of other jobs to the private sector.
- Private sector infrastructure employment was also boosted by growth in demand for existing privately provided services and the entry of new players to the market (especially in areas such as telecommunications).

Figure 5.2 Employment changes in infrastructure industries^a, 1990 to 2003
 '000 employees



^a Comprises electricity, gas, water, road transport (including passenger services), rail, telecommunications, and postal and courier services.

Data source: ABS (*Survey of Employee Earnings, Benefits & Trade Union Membership*, Cat. no. 6310.0, unpublished data).

Small business employment

Given its size, over the longer term, the small business sector could be expected to account for a substantial proportion of the employment gains from improved economic performance induced by NCP and other reforms. However, there have been more immediate concerns that small business has borne much of the burden of the short-term adjustment associated with competition policy reforms, with adverse consequences for employment in the sector.

Competition reforms have targeted some areas where small businesses were previously sheltered from competition. In particular, various legislation reviews have led to the removal of regulatory restrictions benefiting small business in the retail and services trades — for instance, constraints on the range of goods that competing larger businesses could sell and on the hours they could trade. A number of participants contended that such market liberalisation has led to substantial job losses in the small business sector. For example, the Council of Small Business Organisations of Australia observed:

Small businesses and families have felt the brunt of changes in the past. Independent retail shops, gift and home wares stores, hairdressing salons, taxi drivers, bakers and soon it seems, pharmacists have found reductions in their revenue due to the introduction of unlimited free trade in their sector due to large more powerful companies operating in their market and buying increased market share. (sub. 53, p. 5)

However, while the fortunes of the small business sector are clearly important to Australia's overall economic health, the removal of regulations which constrain more efficient providers — whether large or small — will, in most cases, be of benefit to consumers and Australia's economic performance more generally. Also, the impacts of NCP on small businesses must be viewed in the context of broader structural pressures that are driving greater market concentration in many industries. As the Business Council of Australia noted:

... relatively high levels of market concentration in Australia are not the result of obstacles to competition but are related to the smallness of domestic markets and the need for firms to achieve scale economies. (sub. 84, p. 5)

Moreover, not all of the impacts of NCP on small business will have been negative. For example, while putting pressure on small businesses in some suburban areas, liberalisation of retail shopping hours in most jurisdictions has provided new opportunities for small business operators within the major retail centres. In commenting on this matter, the Shopping Centre Council of Australia said:

Those who oppose giving consumers greater choice in trading hours claim it will lead to everything from higher prices to the demise of small business and a decline in retail employment. Yet when tested none of this has occurred. (sub. 47, p. 3)

Indeed, despite broader structural pressures and the impacts of NCP and other reforms, both the number of small businesses and the number of people employed by them continued to grow throughout the 1990s. Accordingly, the most that could reasonably be said about NCP in this context is that it may have made some contribution to the slowdown in growth in small business employment apparent in the second half of the 1990s (table 5.2).

The impacts of NCP on regional small businesses are considered further below.

5.3 Regional impacts of NCP

The key concern about NCP in rural and regional Australia is that it has generally been much less beneficial to residents in non-metropolitan areas than those living in the major cities. Allied to this is the perception that particular rural regions have been significantly disadvantaged by the reforms.

Table 5.2 Trends in small business numbers and employment^a

	1990-91	1995-96	2000-01 ^b
	('000)	('000)	('000)
All industries			
Number of small businesses	726	899	1 122
Numbers employed	2 518	3 195	3 259
Retail trade			
Number of small businesses	149	155	163
Numbers employed	544	605	596

^a Excludes agricultural businesses. Includes working proprietors and partners of unincorporated employing and non-employed businesses. Working directors of incorporated businesses are classified as employees.

^b Most recent available data.

Source: ABS (*Small Business in Australia*, Cat. no. 1321.0, various issues).

The same concerns were evident during the Commission's earlier inquiry that dealt specifically with the regional impacts of NCP (PC 1999b). In that inquiry, the Commission found that while there were inevitably costs associated with implementing a reform program of this kind, it would bring net benefits to the nation over the medium term, including to rural and regional Australia as a whole. That said, it acknowledged that the early effects appeared to have favoured metropolitan areas more than rural and regional areas, and that there was likely to be more variation in the incidence of benefits and costs of NCP among country regions than in metropolitan areas.

NCP in context

The Commission's earlier inquiry showed the importance of considering NCP in the context of broader forces driving change in country Australia — a requirement which is equally valid today. NCP reforms have coincided with a range of other economic and social influences that have, collectively, brought about changes in output, employment and living standards in regional and rural areas.

For one thing, NCP has come on top of other policy changes and reforms, including tariff reductions, financial market deregulation, industrial relations reforms, local government amalgamations and wider rationalisation of functions within the public sector.

In addition, and outside the policy sphere, many other changes have affected farmers, miners and regional businesses over the last two decades or so. Indeed, most of the key influences on country Australia have been of a long-term nature and largely beyond government control (box 5.5).

Box 5.5 Long-term drivers of change

In its earlier inquiry (PC 1999b), the Commission observed that the circumstances of country Australia had been influenced strongly by longer-term forces, including:

- changes in the overall structure of the Australian economy, with agriculture, mining and manufacturing declining in relative importance and the services sector accounting for a growing share of GDP;
- a downward trend in world prices for agricultural commodities, which has been reflected in a decline in farmers' terms of trade;
- technological advances, such as improved transport and telecommunications, agronomic developments and adoption of new mining techniques. (In some cases, increased mechanisation and other technological change has made farming less labour intensive and resulted in population drift from some rural communities.);
- changes in consumer tastes, such as the decline in the demand for wool and increased expenditure on tourism, which have had markedly different regional effects;
- rising incomes and changing lifestyle preferences, reflected in increased internal migration to coastal areas; and
- government policy changes, such as the lowering of trade barriers, deregulation of the financial system and increased regulation to protect the environment.

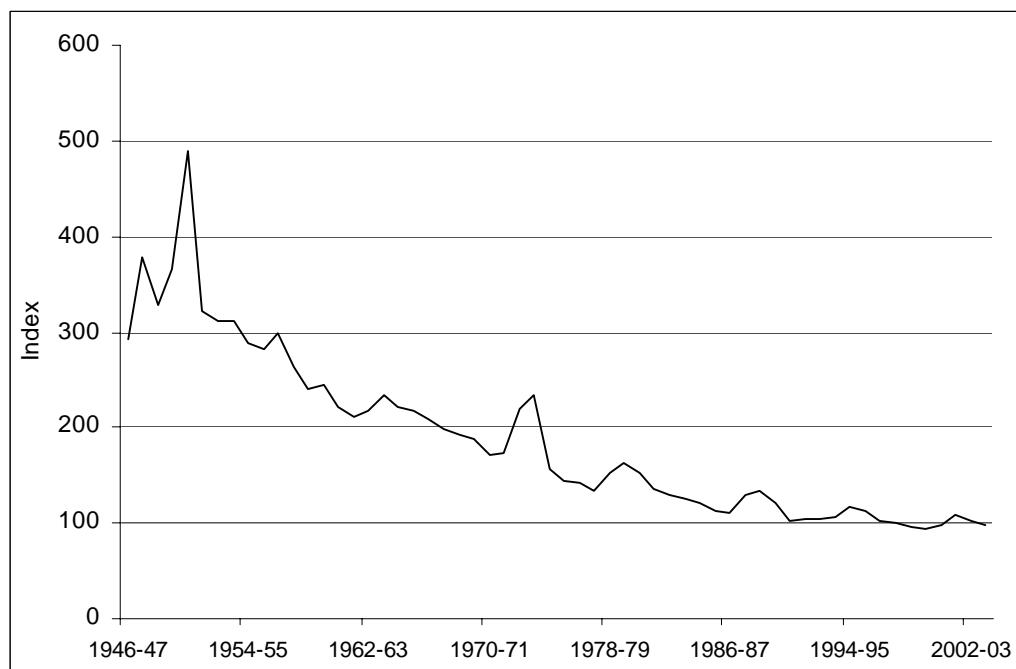
The role of these influences is equally apparent today.

For example, over the last half-century, world prices for many commodities — including a variety of agricultural products — have declined significantly in real terms. As a consequence, the terms of trade for agricultural products have been trending downwards since the early 1950s and today are around one-third of their level 50 years ago (figure 5.3).

Farmers have responded well to these pressures by raising their productivity through the use of better technology and greater realisation of scale economies. However, while helping to sustain the competitiveness of Australia's agricultural sector, an inevitable consequence has been that farming has become much less reliant on labour, with obvious employment implications for surrounding communities.

Of course, the impacts of these long-term pressures have not been uniform, depending heavily on the characteristics of, and pattern of economic activity in, particular regions. For example, regions with above average reliance on agriculture have generally experienced lower rates of employment growth than regions with more diversified activity bases (PC 1999b).

Figure 5.3 Declining terms of trade for agricultural products, 1946-47 to 2003-04^a



^a Ratio of index of prices received by farmers, in Australian dollars, to index of farmers' input prices.
Data source: ABARE (unpublished data).

Aspects of NCP have added to the pressures facing parts of regional Australia. However, in most cases, they are likely to have played a minor role relative to these broader influences — a point acknowledged by some rural and regional interests in both this and the Commission's previous inquiry, and reinforced by the modelling undertaken for this inquiry (see below).

Some broad regional trends

In assessing the implications of NCP and related reforms for regional communities, and in particular the significance of the associated adjustment pressures, it is also helpful to have a picture of what has been happening recently to activity and employment levels in these communities. That is, adjustment to the reforms and other pressures will generally be easier for regions that are performing relatively strongly.

Recent changes in population, employment, unemployment and income in some broad regional groupings — based on ABS data — are shown in tables 5.3 and 5.4, and figure 5.4.

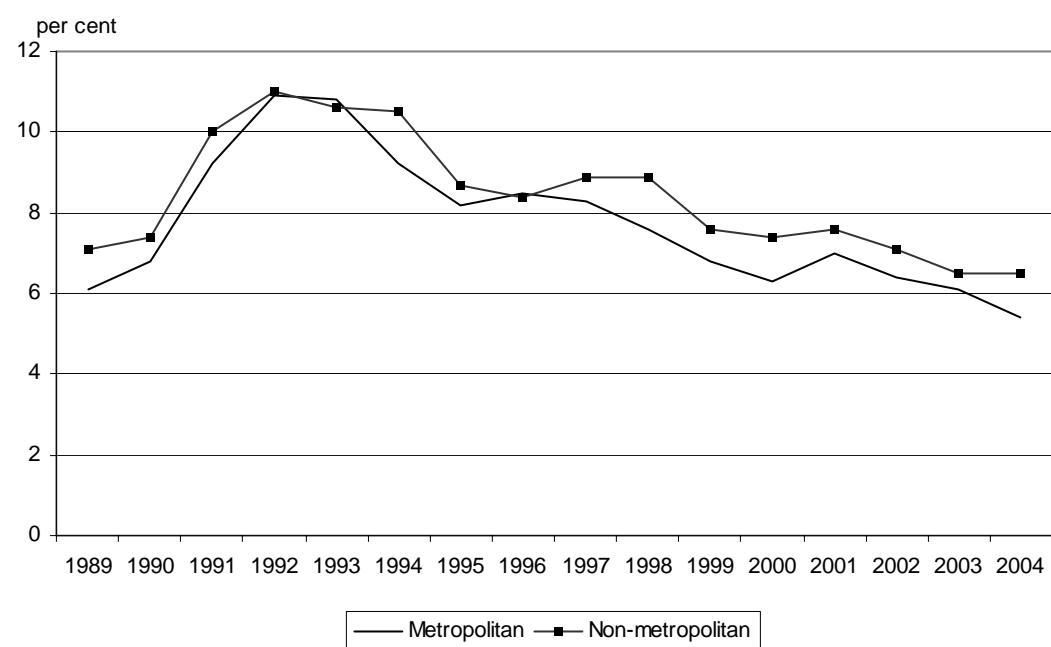
Table 5.3 Population and employment growth, 1991–2001^a
Per cent

Region	1991–1996		1996–2001		1991–2001	
	Population	Employment	Population	Employment	Population	Employment
Metropolitan	6.7	8.0	7.1	9.8	14.3	18.5
Regional - coastal	9.0	9.7	5.3	7.2	14.8	17.6
Regional - inland	-2.3	-0.1	1.7	5.7	-0.6	5.1
Remote	17.3	16.9	2.7	3.5	20.5	21.3
Australia	6.2	7.4	6.0	8.7	12.6	16.7

^a Most recent available Census data. Classification of regions used in this table is based on a system proposed by ABARE.

Source: ABS (Census data).

Figure 5.4 City and country unemployment rates, 1989 to 2004^{a b}
Per cent



^a Excludes the Northern Territory and the Australian Capital Territory. ^b As at June in each year.

Data source: ABS (*Labour Force, Australia*, Cat. no. 6202.0, various issues).

Table 5.4 Average weekly gross household income, by region^{a b}

Regional area	Income (2001)	Change 1996-2001	Proportion of all persons
	\$	%	%
Major cities	1 291	17.1	66.9
Inner regional	1 034	15.1	20.7
Outer regional	1 013	13.3	10.1
Remote	1 154	14.7	1.5

^a Gross income adjusted on the basis of the household's size and composition to allow the relative standard of living of different households (eg couples with and without children) to be compared. ^b Derived from latest available Census data.

Source: Siminski and Norris (2003).

Though the high level of regional aggregation means that some caution is required in drawing general conclusions, the data suggest that many regions are growing and have shared in Australia's increased prosperity of late.

- Population growth has been strong in all identified areas except inland regional Australia. Population in remote areas and coastal regions has grown more strongly than in the cities.
- Employment has been growing faster than population, with all of the regions sharing in the national job gains. Moreover, as in metropolitan areas, unemployment rates in non-metropolitan areas have trended down since the early 1990s.
- While those living in the major cities recorded the greatest increases in incomes between 1996 and 2001, the difference in income growth between the cities and other areas was relatively small.

NCP-related reforms have benefited many regions

In examining the regional impacts of the NCP reforms in the context of these long-term drivers of change and broad regional trends, the Commission has drawn on economic modelling. As outlined in chapter 3, Commission staff modelled the regional as well as the Australia-wide impacts of productivity and price changes in key infrastructure sectors over the 1990s. Though these productivity and price changes are not attributable just to NCP, in several sectors the reforms have been a key driver of recent changes. (Details of that modelling work and the full results are presented in a modelling supplement available on the Commission's website.)

Of course, the modelling provides only a partial perspective of the impacts of NCP and related reforms. For example, it does not pick up the effects of some key reforms of relevance to country Australia, such as the abolition of statutory

marketing regimes for many agricultural products and the road transport reforms. And, though encompassing 57 regional areas, it is not sufficiently disaggregated to illustrate the impacts of NCP on smaller rural communities. Accordingly, in exploring the NCP's regional impacts, the Commission has also drawn on a range of other data and input from participants. A broad profile of the 57 regions included in the analysis is presented in table 5.5.

Collectively, the modelling and other information support the conclusion in the Commission's previous inquiry that many regional areas have benefited from the NCP reforms (PC 1999b). Also, while some mainly smaller communities have been adversely affected (see next section), reforms such as the liberalisation of grain marketing in some States have arguably led to a more even distribution of overall benefits between country and city areas than at the time of the Commission's last inquiry.

Positive impacts from infrastructure changes

A number of participants commented in general terms on the benefits for rural and regional Australia of NCP reforms in the infrastructure sectors. For instance, the New South Wales Government said:

In some cases, NCP has helped industries to cope with long term external pressures and to manage the transition to a more competitive environment. For example, competition reforms have helped rural industries by reducing major input costs such as energy, rail, transport and communications... Lower costs of transport and communications are of particular importance for remote areas since the "tyranny of distance" imposes significant costs for businesses and individuals in such areas. (sub. 99, pp. 13, 16)

Reductions in prices paid for electricity by many farmers provide a specific illustration of these benefits. Between 1996-97 and 2003-04, average real prices for this group fell in all jurisdictions, with the declines ranging from 2 per cent in South Australia to 34 per cent in Victoria (ESAA 2004). As noted, it is widely acknowledged that NCP and related reforms have been major contributors to price reductions in the electricity sector.

The Commission's modelling similarly suggests that price and productivity changes in several key infrastructure sectors during the 1990s — that were at least partly attributable to NCP and related reforms — have boosted output in most parts of Australia and thereby contributed to the recent income growth evident in both city and country Australia. Specifically:

- as a result of the changes, output is estimated to be higher than otherwise in all but one (Great Southern in Western Australia) of the 57 regions across Australia in the model;

Table 5.5 Regions included in the Commission's analysis^a

Region	State	Main centre	Other urban centres
Sydney	NSW	Sydney	Campbelltown, Gosford, Katoomba, Parramatta, Sutherland
Hunter	NSW	Newcastle	Cessnock, Maitland, Muswellbrook, Port Stephens, Singleton
Illawarra	NSW	Wollongong	Kiama, Mittagong, Moss Vale, Shellharbour, Shoalhaven
Richmond-Tweed	NSW	Lismore	Ballina, Byron Bay, Casino, Tweed Heads
Mid-North Coast	NSW	Coffs Harbour	Grafton, Kempsey, Port Macquarie, Taree
Northern	NSW	Tamworth	Armidale, Glen Innes, Gunnedah, Inverell, Moree, Tenterfield
North Western	NSW	Dubbo	Bourke, Cobar, Coonabarabran, Gilgandra, Mudgee, Walgett
Central West	NSW	Orange	Bathurst, Blayney, Cowra, Forbes, Lithgow, Oberon, Parkes
South Eastern	NSW	Queanbeyan	Bega, Bombala, Cooma, Crookwell, Goulburn, Yass, Young
Murrumbidgee	NSW	Wagga Wagga	Cootamundra, Griffith, Gundagai, Hay, Narrandera, Tumut
Murray	NSW	Albury	Balranald, Deniliquin, Holbrook, Tumbarumba, Wentworth
Far West	NSW	Broken Hill	Tibooburra, Wilcannia
Melbourne	VIC	Melbourne	Altona, Dandenong, Lilydale, Mornington Peninsula, Sunbury
Barwon	VIC	Geelong	Apollo Bay, Colac, Lorne, Queenscliff
Western District	VIC	Warrnambool	Camperdown, Hamilton, Portland
Central Highlands	VIC	Ballarat	Ararat, Bacchus Marsh, Daylesford
Wimmera	VIC	Horsham	Dimboola, St Arnaud, Stawell
Mallee	VIC	Swan Hill	Kerang, Mildura, Ouyen
Loddon	VIC	Bendigo	Castlemaine, Maryborough
Goulburn	VIC	Shepparton	Benalla, Echuca, Kyabram, Rochester
Ovens-Murray	VIC	Wodonga	Beechworth, Bright, Mount Beauty, Rutherglen, Wangaratta
East Gippsland	VIC	Sale	Bairnsdale, Omeo, Orbost
Gippsland	VIC	Traralgon	Moe, Morwell, Wonthaggi
Brisbane	QLD	Brisbane	Beenleigh, Logan, Mount Gravatt, Redcliffe
Moreton	QLD	Coolangatta	Burleigh Heads, Caloundra, Ipswich, Noosa, Surfers Paradise
Wide Bay-Burnett	QLD	Maryborough	Bundaberg, Gympie, Hervey Bay, Mundubbera
Darling Downs	QLD	Toowoomba	Dalby, Goondiwindi, Stanthorpe, Warwick
South West	QLD	Charleville	Quilpie, Roma, St George
Fitzroy	QLD	Rockhampton	Emerald, Gladstone
Central West	QLD	Longreach	Barcaldine, Blackall, Winton
Mackay	QLD	Mackay	Clermont, Proserpine
Northern	QLD	Townsville	Ayr, Bowen, Charters Towers, Ingham
Far North	QLD	Cairns	Atherton, Cooktown, Innisfail, Mareeba, Mosman, Weipa
North West	QLD	Mount Isa	Cloncurry, Hughenden, Normanton
Adelaide	SA	Adelaide	Glenelg, Henley, Hindmarsh, Marion, Salisbury
Outer Adelaide	SA	Mount Barker	Barossa Valley, Kangaroo Island, Onkaparinga
Yorke and Lower North	SA	Yorketown	Bute, Riverton, Wallaroo
Murray Lands	SA	Renmark	Murray Bridge, Pinnaroo
South East	SA	Mount Gambier	Bordertown, Kingston, Naracoorte
Eyre	SA	Port Lincoln	Ceduna
Northern	SA	Whyalla	Coober Pedy, Port Augusta, Port Pirie, Woomera
Perth	WA	Perth	Armadale, Fremantle, Joondalup, Rockingham, Stirling, Wanneroo
Peel	WA	Mandurah	Mandurah
South West	WA	Bunbury	Busselton, Collie, Manjimup, Margaret River, Pemberton
Great Southern	WA	Albany	Denmark, Katanning
Wheatbelt	WA	Northam	Merredin, Moora, Narrogin
Goldfields-Esperance	WA	Kalgoorlie	Boulder, Coolgardie, Esperance
Mid West	WA	Geraldton	Meekatharra, Mount Magnet
Gascoyne	WA	Carnarvon	Exmouth
Pilbara	WA	Port Hedland	Karratha, Newman, Tom Price
Kimberley	WA	Broome	Derby, Kununurra, Wyndham
Greater Hobart	TAS	Hobart	Clarence, Glenorchy, Sorell
Southern	TAS	Geeveston	Bicheno, Huonville, Triabunna
Northern	TAS	Launceston	Deloraine, Georgetown, St Helens
Mersey-Lyell	TAS	Burnie	Devonport, Queenstown, Smithton, Ulverstone, Zeehan
Northern Territory		Darwin	Alice Springs, Katherine, Nhulunbuy, Tennant Creek
Australian Capital Territory		Canberra	

^a Regions included in the Monash Multi-Regional Forecasting – Competition Policy Review model.

Sources: Adams and Dixon (1995); ABS 1995 (*Australian Standard Geographic Classification (ASGC)*, Cat. no. 1216.0).

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- regions specialising in mining and related processing activities (for example, Goldfields-Esperance and the Pilbara in Western Australia, and the Hunter and Illawarra in New South Wales), are generally projected to experience growth in output above the national increase of 2.5 per cent; and
 - regions with diversified industrial bases are generally projected to experience output growth close to that national increase.

In the modelling, *national* employment is assumed to be determined by broad economy-wide factors and not influenced by the productivity and price changes in the infrastructure sectors. However, these changes do affect the *distribution* of that employment across industries — for example, improvements in labour productivity in an infrastructure industry can release labour for use in other activities. Such redistribution of labour will in turn have implications for employment in individual regions, according to their patterns of economic activity.

Specifically, the Commission's modelling projects that the productivity and price changes in the infrastructure sectors will have led to higher employment than would otherwise have prevailed in 16 of the 57 regions, and lower employment levels than otherwise in the remaining 41 regions (table 5.6). Half of the regions where employment is projected to be higher are in New South Wales. However:

- in the large majority of the 57 regions, the projected total employment effects (up or down) are equivalent to less than one year's actual average employment change in those regions; and
- in three of the eight regions experiencing actual employment declines during the 1990s, changes in the infrastructure industries were projected to provide a boost to employment levels.

Viewed in conjunction with the projected growth in output in all but one of the 57 regions, this suggests that the regional adjustment pressures associated with the redistribution of employment from changes in the infrastructure industries have generally not been great.

Table 5.6 A comparison of the modelled employment effects with actual changes in regional employment^a

Regions with actual employment declines but employment gains from infrastructure changes

New South Wales

Far West, Northern

Western Australia

Pilbara

Regions with actual employment declines and employment losses from infrastructure changes

Victoria

Gippsland, Loddon

South Australia

Northern

Tasmania

Mersey Lyell, Southern

Regions with actual employment increases and employment gains from infrastructure changes

New South Wales

Sydney, Hunter, Illawarra, Mid-North Coast, North Western, Richmond-Tweed

Queensland

Mackay, North West

South Australia

Adelaide

Western Australia

Goldfields-Esperance, Kimberley, Mid-West

Australian Capital Territory

Regions with actual employment increases but employment losses from infrastructure changes

New South Wales

Central West, Murray, Murrumbidgee, South Eastern

Victoria

Melbourne, Barwon, Central Highlands, East Gippsland, Goulburn, Mallee, Ovens-Murray, Western District, Wimmera

Queensland

Brisbane, Central West, Darling Downs, Far North, Fitzroy, Moreton, Northern, South West, Wide Bay-Burnett

South Australia

Eyre, Murray Lands, Outer Adelaide, South East, Yorke and Lower North

Western Australia

Perth, Gascoyne, Great Southern, Peel, South West, Wheatbelt

Tasmania

Greater Hobart, Northern

Northern Territory

^a Modelled employment changes are those projected to result from productivity and price changes during the 1990s in the electricity, gas, urban water, telecommunications, urban transport, ports and rail freight sectors.

Sources: PC estimates based on the MMRF-CR model; ABS (*Population Census*, Cat. no. 1502.0).

Other benefits for rural and regional areas

The Commission was provided with various examples of benefits for rural producers and surrounding regional communities from other aspects of the NCP reforms. For example, while participants such as the South Australian and WA Farmers Federations (subs. 28, 83 and DR 195) questioned whether liberalising statutory marketing arrangements would be of overall benefit to rural communities, their partial deregulation or abolition in several states has often facilitated the expansion of rural activities and provided opportunities for new and innovative activities. Thus, the Pastoralists and Graziers Association of WA observed:

On the whole, the PGA supports the National Competition Policy reforms, as the PGA supports a free market system without Government interference to allow Australian producers to obtain the top market price from their own property. The PGA believes deregulated production and marketing through individual enterprises is the key to the future sustainability of Australian agriculture. (sub. 74, p. 3)

The experiences in the grain and lamb sectors in some States (see box 5.6) provide specific examples of the benefits of introducing competitive markets. And, though deregulation in the dairy industry has disadvantaged some regional communities (see below), the negative impacts on farm profitability have been short term and transitional in nature (Harris 2005). Notably, a recent NCC-commissioned study concluded that in the period following deregulation, total dairy farm income across Australia had risen:

At a national level, taking account of effects of the change in farmgate income from the loss of market milk premiums, better returns from manufactured products and the industry's adjustment package, gross farm income is about \$300 million per annum better off (including an element of DSAP payments) across the national industry compared to the year prior to deregulation. This is based on total output which, in 2003-2004, was smaller than that in 1999-2000. (NCC 2004d, p. 6).

Indeed, even excluding support from the industry adjustment package (estimated at around \$215 million between 2000 and 2004), aggregate returns appear to have increased. Farmers that mainly supply 'manufactured milk' markets have been the main beneficiaries.

This increase in industry-wide income reflects a combination of increased output, innovative practices and adjustment assistance. As Harris (2005, p. 10) observes about the post-deregulation period:

Some farmers decided to exit the industry. Others have made a variety of on-farm changes according to their individual circumstances. They have increased their scale of operation, increased productivity by adopting new technologies and improved management practices, diversified their farm businesses and increased off-farm income.

Box 5.6 The benefits to farmers of reform in the grain and lamb sectors

Grain

- The Australian Grain Exporters Association (sub. 75) said that since deregulation of barley marketing in Victoria, growers are getting full world market price (or better domestic bids). In addition, since 2001, Victorian cash prices for feed barley have regularly been the highest of all the major barley exporting states.
- The Victorian Government (sub. 51) said that the reforms to barley marketing had resulted in considerable innovation and structural change in the sector, including:
 - the entry of new competitors and innovation in related services, such as financing for growers;
 - considerable rationalisation and vertical integration across the grain industry to achieve benefits of scale and scope; and
 - increased investment by growers in on-farm storage and segmentation, to take advantage of niche market opportunities.
- The Grain Growers Association (sub. 37) similarly contended that NCP reform has resulted in benefits for grain growers, domestic users, exporters and the broader industry — such as the emergence of new markets and professional development. Furthermore, it said that competition in the wheat finance market has provided wheat growers with millions of dollars in savings.

Lamb

- Both the National Farmers' Federation (sub. 100) and the Pastoralists and Graziers Association of WA (sub. 74) said that since deregulation and the abolition of the single desk for domestic and export lamb marketing — for which the industry received \$5 million in compensation — the lamb industry has thrived, along with the rural communities that support the industry. According to the PGA, deregulation of the Western Australian lamb industry has resulted in a 'win-win situation' for both sides of the market (producers, processors, marketers and consumers):
 - exposure to clearer market signals has made producers more conscious of market needs (breeds etc.), leading to higher returns and more incentive to continue producing better lambs;
 - there has been significant investment in the industry, including in more efficient abattoirs; and
 - new and lucrative markets have emerged.

Some regions have experienced adverse impacts

While at a broad level, most regions have enjoyed generally favourable economic conditions in recent years, a number of smaller regional communities have endured difficult circumstances. Job losses in particular can have significant consequences in these communities as alternative employment prospects are generally more limited.

As discussed above, the adjustment pressures and costs emanating from NCP generally appear to have been small relative to the wider pressures causing structural change in rural and regional Australia. However, the effects of NCP reforms in adding to other pressures should not be ignored.

Some negative impacts from infrastructure changes

The Commission's modelling projects that productivity and price changes in key infrastructure sectors over the 1990s have boosted output (and by implication average incomes) in virtually all major regional areas (see above). Moreover, the projected employment impacts (up or down) are generally small in relation to actual recent changes in employment levels in the majority of these regions, with job losses projected in some capital cities as well as in certain country areas. These projections are seemingly consistent with the infrastructure employment data reported in figure 5.2 which show:

- a relatively modest net loss of 31 000 actual jobs in the infrastructure industries over the period between 1990 and 2003 — less than 7 per cent of employment in these industries at the beginning of the period; and
- a reasonably even distribution of that net loss between metropolitan and non-metropolitan areas.

That said, the Commission's modelling indicates that there are a few regions — Gippsland and Loddon in Victoria, Northern in South Australia, and Mersey Lyell and Southern in Tasmania — where the changes in the infrastructure industries are likely to have compounded other pressures and contributed to an overall decline in employment during the 1990s (see table 5.6).

In Gippsland, the projected reduction in employment of more than 11 per cent from the infrastructure changes is nearly three times greater than the next largest projected decline of 4 per cent in the Wheatbelt in Western Australia. Hence, the modelling confirms that change in the electricity sector in particular, much of which has been due to NCP and related reforms, has imposed significant adjustment pressures on the Gippsland region. A broad indication of how the region has managed these and other adjustment pressures is presented in box 5.7.

Box 5.7 Aspects of the adjustment experience in Gippsland, Victoria

The Gippsland region is located in south-eastern Victoria and encompasses the Latrobe Valley (which includes the cities of Moe, Morwell, Sale and Traralgon, and accounts for slightly less than 50 per cent of both the region's population and employment). Major industries in the wider region are based on the availability of natural resources. In particular, extensive brown coal resources led to the establishment of a large electricity generation industry in the Latrobe Valley area. Other significant activities in the region include, agriculture (dairy and beef) and up-stream processing, other energy production (oil and natural gas), forestry and tourism.

Structural reforms in the electricity industry during the 1990s had a particularly severe impact on economic activity in the region.

- The Commission's modelling indicates that the adverse employment effects of changes in the electricity sector far outweigh the positive effects of the other infrastructure changes, leading to a projected fall in employment in Gippsland (relative to what it would have been in the absence of the infrastructure changes) of 11.3 per cent.
- The projected employment results are broadly consistent with actual employment data for the Gippsland region, which show a net decline in employment in the infrastructure industries (electricity, gas, water and transport) of around 4400 persons over the decade to 2001, or some 7 per cent of total regional employment at the start of that decade.
- However, the modelling also projects that the negative effects of changes in the electricity sector on regional output were offset by the effects of changes in other infrastructure industries.

The significant loss of employment in Gippsland's electricity industry had flow-on effects to other areas of regional economic activity. For example, VCOSS claimed at the public hearings that:

... there is a job multiplier effect from SECV jobs — every one SECV job had a multiplier effect in the wider economy, creating 2.6 jobs. (trans., p. 225)

According to a number of regional studies (such as: Birrell 2001; Gibson, Cameron and Veno 1999; Kazakevitch and Enzinger 1999; People Together Project 1996), the job losses, which were particularly evident in the first half of the 1990s, were found to have had a number of adverse social impacts including:

- high unemployment rates in some locations;
- welfare dependency among working age males twice the Melbourne average;
- lower household incomes leading to reduced business activity; and
- barriers to mobility caused by the initial 'collapse' and subsequent weak state of the housing market in the region.

(Continued next page)

Box 5.7 (continued)

VCOSS further contended that a significant loss of apprenticeships following privatisation of the electricity industry has been a major contributor to current skill shortages, notably in the electrical and engineering trades.

Against a backdrop of declining infrastructure-related employment (and lower employment in 'government administration and defence', 'agriculture, forestry and fishing', and 'mining') and associated social impacts, economic diversification to promote new job opportunities has been the major challenge for the region.

To this end, Gippsland has been the recipient of considerable adjustment assistance from the Australian and Victorian Governments. For instance, it is one of eight regions identified for support under the Australian Government's *Sustainable Regions Program*. Support at the State level has ranged from grants to encourage industry relocation in the region, to re-training, further education and a fast rail link project. A key initiative was the Latrobe Valley Ministerial Taskforce 2000, one outcome of which was a \$106 million package of new and previously foreshadowed social and development initiatives, announced by the Victorian Government in June 2001.

Such initiatives have contributed to the strong employment growth evident in the wider Gippsland region since the mid-1990s. Following a decline of 11.8 per cent between 1991 and 1996, employment grew by 7.3 per cent between 1996 and 2001 — primarily as a result of expanded job opportunities in the services sector. Job growth has continued apace since then, with the number employed rising by a further 27.6 per cent between 2001 and 2004. (This compares with employment growth of just 3.7 per cent for regional Victoria over the same period.) The unemployment rate in Gippsland has fallen over the same period (from 8.2 to 7.0 per cent), while it has risen slightly for regional Victoria as a whole (from 6.6 to 6.9 per cent).

Sources: ABS (Census data – various years); Birrell (2001); DEWR (2004a); DOTARS (2004b); Gibson, Cameron and Veno (1999); Kazakevitch and Enzinger (1999); Latrobe Valley Ministerial Taskforce (2004); People Together Project (1996).

Also, in a few areas where employment has been growing very slowly — Wimmera in Victoria, South West and Central West in Queensland, Yorke and Lower North in South Australia and the Wheatbelt in Western Australia — declines in employment associated with NCP reforms may have created considerable adjustment pressures. In this context, the Commission's modelling projects that the employment reductions in these regions from changes in infrastructure industries were equivalent to more than five years' actual employment growth.

Adverse impacts from SMA reform

It is commonly perceived that Statutory Marketing Authority (SMA) reforms have been of limited benefit to consumers and detrimental to the interests of regional

Australia. For instance, the Milk Industry Liaison Committee quotes Ross Fitzgerald in *The Australian* as contending that:

The NCP's gift to the major retail chains and others can be summed up neatly: Eggs \$416 million a year; Sugar \$334 million; Milk \$1.13 billion – conversely, farmers, workers and consumers are every year \$1.879 billion poorer. (sub. DR169, p. 10)

And the Grains Council of Australia said that:

The effects of deregulating primary industries impact disproportionately on rural and regional Australians, due mostly to their higher dependence on income derived from primary production. (sub. DR171, p. 9)

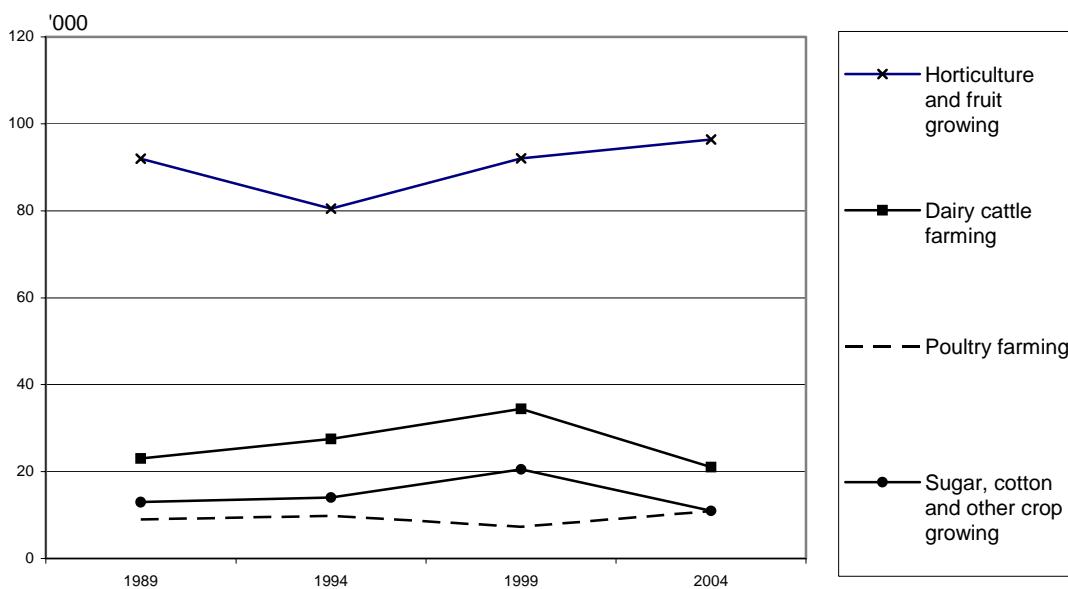
However, these perceptions are misleading:

- SMA reforms *have* delivered price benefits for consumers (see chapter 4); and
- as discussed above, in some cases, they have been of considerable benefit to primary producers and surrounding regional communities.

Not surprisingly though, some of the SMA reforms have had adverse effects for particular regional areas. For example, although total dairy farm income across Australia has risen since deregulation (see above), the income changes have been uneven across major dairying regions. As noted in a number of studies (see, for example, ABARE 2001, NCC 2004d and Harris 2005), the negative impacts of dairy deregulation have been greater for those regions most highly dependent on the dairy sector for employment and whose farmers relied heavily on supplying the previously protected ‘drinking milk’ market (for example, in areas of northern NSW and southern Queensland, and parts of WA). Where those farmers have been unable to improve their productivity and/or diversify, they have seen their incomes fall — though the payment of adjustment support has moderated the magnitude of the fall for some.

More broadly, productivity improvement driven by the more competitive market environment has also put pressure on employment in a number of primary industries. Thus, while employment levels in four of the key agricultural sectors subject to SMA reforms have changed little since 1989, dairy farming and sugar/cotton recorded significant declines between 1999 and 2004 (figure 5.5). Yet even here, it would be inappropriate to attribute all of these employment reductions to NCP. Indeed, in the case of the sugar industry, developments in world markets have clearly been highly influential (see box 5.8).

Figure 5.5 Agricultural employment in selected sectors, 1989–2004



Data source: ABS (*Labour Force, Australia*, Cat. no. 6202.0, various issues).

The cumulative impacts of NCP and other pressures

A number of participants also drew attention to the collective impact of NCP reforms and other pressures confronting regional communities. A particular concern was that reduced employment and subsequent population decline can sometimes threaten the viability or availability of key social services, including educational and health facilities (see box 5.9).

A lack of social infrastructure and services may have significant impacts on the local communities concerned. Social capital has been ascribed many benefits, including enhanced health, better educational outcomes, improved child welfare and lower crime rates. It has also been linked to productivity improvements and income growth (PC 2003f).

But as only one of many factors contributing to employment reductions and ensuing population drift from some regional areas, NCP cannot be held primarily responsible for the difficulties confronting those areas. As Canegrowers observed:

... Competition Policy cannot be blamed for a number of the changes in service level that have occurred in regional areas in the last ten years. The closure of banks, the rationalisation of privately provided services etc. are not the result of National Competition Policy. (sub. 78, p. 4)

Box 5.8 Factors influencing the performance of the sugar industry

While most of the deregulation in the sugar industry occurred in the late 1980s, its deteriorating performance in recent years — flat sales and falling incomes — has been attributed by some to NCP-related reforms. In reality, however, the problems facing the industry are primarily due to low world prices, exacerbated by unfavourable weather conditions in Australian growing regions.

Returns to Australian sugar growers depend primarily on conditions in world markets (the Australian industry exports around 80 per cent of its raw sugar output). World prices are significantly influenced by production and export subsidies provided by the United States and the European Union. Increased production by low-cost producers, such as Brazil, has also put downward pressure on prices. The collective result has been declining prices (down around 30 per cent over the decade to 2003-04) and reduced returns to Australian producers.

NCP reforms have affected the industry in two main ways.

- First, is the requirement that the statutory marketing authority, Queensland Sugar, sells sugar on the domestic market at the export parity price. According to the industry, this has reduced returns to growers by between \$4 million and \$8 million a year.
- Second, NCP infrastructure reforms have apparently resulted in higher prices for electricity and water used by canegrowers.

However, such impacts have not been large in the context of broader pressures confronting the industry. For example, the reduction in the value of domestic sales attributable to export parity pricing is a mere fraction of the industry's total sales value of more than \$1 billion a year. Moreover, much of the NCP-related change has arisen from the withdrawal of subsidies previously provided by consumers and taxpayers — through inflated prices and through the input subsidies inherent in prices for services such as power and water which did not cover the costs of service provision.

Sources: ABARE (2004); Hildebrand (2002); Robson (2004); Whitehall (2004); NFF (sub. 100).

Furthermore, it is important to recognise that not all people leaving small rural communities are lost to the country. Some of them move to larger regional centres where there are greater employment opportunities, and where a wider and cheaper range of goods and services is typically available. Indeed, some regional centres have grown quite rapidly, partly by drawing population from surrounding districts. As noted in the Commission's earlier inquiry on competition policy (PC 1999b), the growth of these 'sponge cities' is probably helping to strengthen the long-term growth prospects of the regions in which they are located by providing an economic and social environment more comparable to metropolitan areas. Recent population changes in selected sponge cities are shown in table 5.7.

Box 5.9 **Loss of social amenity in some rural communities**

Employment reductions in rural and regional Australia, due to reduced economic activity or industry restructuring, can have repercussions for the social infrastructure of some communities.

Job losses in small communities, where alternative employment opportunities are limited, often lead to population decline. This may have adverse flow-on effects for local businesses and service provision and may threaten the population threshold necessary to sustain the continued provision of important social services (such as schools and medical facilities).

The potential for multiple adjustment impacts was described by the Regional Development Council of Western Australia:

... in regional communities — particularly smaller regional communities — the flow-on impacts from the closure of a small business or public facility can be widespread. Hence, the cost of reform is not confined to the few but is borne by individuals and businesses other than those directly affected, as well as families and entire regional communities. Moreover, the dynamics of the impacts of reform are likely to be different in regional communities than for large urban centres. The second and subsequent rounds of adverse impacts in smaller rural communities may not be dampened but instead are likely to be amplified as they spread throughout the community ... (sub. DR199, p. 2)

Some participants contended that these effects are the typical outcome of the increasing centralisation of functions in regional centres and capital cities, and contribute to the social dislocation of those left behind. Some also claimed that competition policy has played a significant role in this process. For example, the Combined Pensioners and Superannuants Association of NSW contended:

The results of competition, deregulation and rationalisation has seen the movement of most young people from rural and regional areas to the large cities seeking work, training and occupations. This has caused an imbalance of the demographics in rural and regional areas, putting greater strain on infrastructure to service an older population. (sub. 8, p. 4)

And Gulf Savannah Development Inc said:

...implementation of competition policy in remote regions has ... in some cases ... led to significant disadvantages through the loss of services and social capital. (sub. 34, p. 1)

However, as discussed in the text, NCP has been only one of many factors contributing to such changes.

At the same time, it is important not to underplay the significance for the communities involved of employment losses and population drift. For this reason, the Commission is arguing that adjustment costs — and in particular the cumulative impacts of reforms and broader pressures — be afforded greater policy attention in the future (see chapter 12).

Table 5.7 Growth in selected regional ‘sponge cities’

Local Government Area	Population 2001	Average annual growth 1991-2001	Population, surrounding district 2001	Average annual growth 1991-2001	Number of surrounding municipalities with declining population	
					persons	%
Dubbo	37 659	1.1	40 864	-0.4	5 of 6	
Wagga Wagga	55 056	0.3	40 494	-0.3	5 of 8	
Albury-Wodonga ^a	80 832	1.1	35 650	-0.2	7 of 8	
Horsham ^a	17 807	0.2	40 116	-0.9	8 of 8	
Mildura	44 194	1.2	17 863	-0.9	4 of 4	

^a The ‘surrounding district’ differs from that in table 2.6 of PC 1999b.

Source: Derived from ABS Census of Population and Housing data for 1991 and 2001.

Mixed impacts for regional small business

As in the major cities, small business is a major employer in regional areas. Hence, the health of the sector is an important issue for most regional communities.

A number of participants referred to negative flow-on effects for regional small businesses from NCP and related reforms. For example, where particular agricultural industries have been adversely affected by SMA reforms, or where local infrastructure facilities have been wound back, it was argued that the loss of regional income has adversely affected small and other businesses in the retail and service industries. A related concern was the perceived failure of NCP to ensure that small businesses in rural and regional areas have the ability to compete on a ‘fair’ basis with larger firms (box 5.10).

Small businesses in rural and regional areas may face some additional difficulties in responding to the demands of a more competitive market place. For example, the Commission was told that smaller firms in many of these areas do not have the ability to react as quickly to changed market conditions and new opportunities as their counterparts in metropolitan areas. Also, as is the case with employment, there are often likely to be fewer alternative opportunities for displaced small business operators than in the major cities.

However, while many small businesses in country Australia are undoubtedly facing testing times, this is also the case for their counterparts in the cities. In essence, businesses everywhere — small and large — are facing greater competition from both domestic and international sources. To help meet this competition and the

demands by consumers for better value for money, many businesses are looking to achieve greater economies of scale through rationalisation and consolidation.

Box 5.10 Some participants' concerns about competition between small and large businesses in country Australia

During this inquiry, several participants voiced concern about the impacts of competition policy and structural pressures more generally on small businesses operating in country Australia.

The effect of the structural changes experienced in the Australian economy due to NCP, which has the stated aim of fostering efficiency and lowering consumer prices, has, in reality simply seen a transfer of market share, profits and income from small business to larger ones. Businesses have been allowed to grow large through mergers, deregulation and globalisation through successful commercial strategies to the detriment of small business and regional and remote business communities. (*Commerce Queensland*, sub. 35, p. 3)

During the term of the NCP operation, there has been a steady movement of financial gains towards larger businesses, institutions and industries away from their smaller counterparts, particularly in regional areas. Many of the latter have been either absorbed into larger concerns or else becoming unviable and going out of business altogether. (*Combined Pensioners and Superannuants Association of NSW*, sub. 8, pp. 1-2)

Small businesses in rural and remote areas that are locally owned and rely on a low population base are struggling to survive under the umbrella of "fair competition" from the massive retail outlets that have a wider scope to choose where they obtain their produce, including imports, thus undercutting the smaller corner stores and in some cases removing them altogether ... The ability of the larger retail outlets to swallow up the competition and be the major players will eventually eliminate all competition. (*Hon Bob Katter MP*, sub. 30, p. 3)

While such industry deregulation may allow large and powerful corporations to artificially drive down prices in a large regional centre, there is a real danger that smaller competitors in surrounding rural communities are driven out of business by the ability of the large and powerful corporations to cross-subsidize the lower prices at the regional centre through higher prices at other less competitive centres. In this way, cross-subsidization can be used by large and powerful corporations in a devastating manner to destroy smaller rural competitors and, in turn, the small communities that they help keep alive. (*National Association of Retail Grocers of Australia*, sub. 11, p. 7)

But in the Commission's view, many of the presumptions and arguments underlying these concerns are not borne out by the facts (see text).

Thus, as alluded to above, additional competitive pressure on (large or small) businesses, whether in regional or city areas, should not of itself be a reason to change public policy (though it is clearly relevant in a transitional or adjustment context). As some participants at the Commission's regional round table in Wagga Wagga observed, such competitive pressures in the retail sector, in particular, are delivering significant benefits to consumers, including those living in country areas.

Moreover, a conclusion that could be drawn from ‘experimental’ ABS data on the performance of small businesses in city and country areas (table 5.8), is that recent competitive pressures confronting small businesses have not been universally greater in regional areas. Specifically, in the four-year period following the introduction of NCP:

- while not growing as fast as in metropolitan areas, the number of small businesses outside the capital cities increased by 3.4 per cent, or more than 20 000; and
- average incomes for small businesses grew at much the same rates in city and country areas.

Cost savings from NCP and related reforms, as well as income growth resulting from the reforms, will have helped to cushion the impact of the broader pressures on the regional small business sector.

Table 5.8 Growth in the small business sector: the regional dimension

Increase 1995-96 to 1999-00 (per cent)		
	Number of businesses	Average real income
Capital and other major cities	11.3	5.2
Regional areas	3.4	5.1

Note: This ‘experimental’ data set is based on information supplied to the ABS by the Australian Tax Office and thus is not directly comparable with the ABS survey data used to compile table 5.2. Data are also available from this source for 2000-01, which show a marked decline in the number of regional small businesses in that year. However, the ABS has cautioned about the use of these data. Specifically, it has indicated that the introduction of the GST may have delayed the lodgement of many business tax returns and therefore ‘impacted on the number of business returns on the 2000-01 file’. Later data will not be available from this source until July 2005.

Source: ABS (*Experimental Estimates, Regional Small Business Statistics, Australia 1995-96 to 2000-01*, Cat. no. 5675.0).

5.4 Environmental considerations

Aside from water, reforms which specifically target improved environmental outcomes have not been a major focus of NCP. As the ACF commented:

Most of the NCP reforms (with the exception of the water reform program) were designed to increase competition, improve efficiency, and provide consumers with better quality goods and services at lower prices. They were not designed to achieve environmental objectives. (sub. 54, p. 1)

Indeed, there were initially some concerns that the environment could be sacrificed to achieve efficiency improvements.

However, notwithstanding its primary focus on efficiency, NCP has not ignored environmental issues. Consideration of the environment is explicitly embodied in the ‘public interest test’ component of the *Competition Principles Agreement*. Specifically, in assessing the merits of reforms in relation to competitive neutrality, the review of anti-competitive legislation and the structure of public monopolies, governments agreed to take into account, amongst other things, legislation and policies relating to ‘ecologically sustainable development’ (box 5.11).

Box 5.11 ‘Ecologically sustainable development’ policy

The original concept of ‘sustainable development’ emerged from the 1987 World Commission on Environment and Development (the Brundtland Commission) (WCED 1987, p. 8) and was defined as:

... development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

The concept of ‘*ecologically sustainable development*’ (ESD) was brought to the fore in Australia through the National Strategy for Ecologically Sustainable Development (NSESD), endorsed by all governments in 1992. This followed growing concern through the 1970s and 1980s about the impacts of prevailing patterns of economic growth and development on the environment. The Strategy (CoA 1992, p. 6) states that ESD:

... aims to meet the needs of Australians today, while conserving our ecosystems for the benefit of future generations.

The three core objectives articulated in the NSESD are to:

- enhance individual and community wellbeing and welfare by following a path of economic development that safeguards the welfare of future generations;
- provide for equity within, and between, generations; and
- protect biological diversity and maintain essential processes and life support systems.

The NSESD also outlines a number of guiding principles, including:

- the need for decision making processes to effectively integrate long term and short term economic, environmental and social considerations; and
- that a lack of full scientific certainty should not be used as a reason for postponing action to promote environmental amenity — known as the precautionary principle.

Sources: CoA (1992); PC (1999c); WCED (1987).

Such issues have been important considerations in several legislation reviews, including those covering fisheries, forestry, agricultural and veterinary chemicals, transport, water, planning approvals and building and construction regulations and approvals. For instance, a review of the *Water Resources Act* in South Australia in

1995 recommended the retention of restrictions on competition primarily because they reduced the risk of environmental damage (NCC 1999a, p. 71). Equally there has been at least one instance — potato marketing in Western Australia — where restrictions on competition claimed to be harmful to the environment have been retained. According to the NCC (2003b, vol. 1, p. 4.4), the review of those restrictions found that production area quotas encouraged high fertiliser application (to increase yields), with adverse impacts for groundwater quality.

Beyond this, the NCP Implementation Agreement included a number of reforms in water, and to a lesser extent in energy and road transport, which explicitly targeted better environmental outcomes, and some others, which produced ‘incidental’ environmental benefits (box 5.12). While progress in advancing reforms in these areas has often been slower than intended, the significance of the benefits for the environment should not be underplayed. Thus, the Western Australian Government stated:

In addition to raising Australia’s productivity and economic growth, NCP reforms, have either already, or will in the future, contribute to the achievement of environmental policy goals. (sub. 117, p. 16)

Indeed, the benefits for the environment inherent in the NCP water reform process underscore the ACF’s proposal that natural resource management (as a whole) be subject to an NCP-type program (see chapter 11). In elaborating on this, the ACF said:

The ACF’s involvement with NCP has highlighted … the benefits that a process like the NCP assessment process could have for other key national environmental reform priorities. … the NCP water reform program … [has] demonstrated how a program such as the NCP can incorporate and address environmental issues. (sub. 54, pp. 2-3)

The Commission has only been able to identify a few instances where the NCP reform process has arguably been associated with a deterioration in environmental outcomes. In this regard, several participants voiced particular concern about the recent increase in greenhouse gas emissions from electricity generation.

This increase has been exacerbated because the most cost-efficient way to meet higher demand for electricity resulting from lower prices and economic growth has been to use existing excess capacity, much of which was in coal-fired plants. In fact, between 1999 and 2002, the level of CO₂ emissions per unit of output in the Australian electricity generation sector, as distinct from its total volume of emissions, declined by a small amount (AGO 2004). Also, coal-fired generators — particularly those using brown coal — are very costly to build. Thus, when future increments in demand necessitate the construction of new power stations, there could be a greater reliance on gas-fired plants, which in turn would lead to further reductions in the ‘greenhouse intensity’ of Australia’s generation activity.

Box 5.12 Examples of environmental benefits arising from reforms in water, energy and road transport

In the water area:

- *structural reforms* (specifically, separation of regulator and service provider functions), in concert with *allocation reforms* (where the environment has formally been recognised as a legitimate user of water), have led to improvements in the way agencies operate and manage Australia's water systems, with benefits for the environment. For example, in 1997 and 1998, the New South Wales Government introduced reforms to promote a better balance between river health and use, and better management of stressed river systems. This has resulted in increased diversions for the environment. In addition, increases in allocations for environmental uses have increased opportunities for native fish breeding and migration, improved the success of bird breeding in wetland areas, helped to suppress algal blooms and exotic species, and improved the health of in-stream ecology;
- *pricing reforms* (by, for example, greater resort to consumption-based pricing) have encouraged water conservation — savings of around 20 per cent have been recorded in many regional urban areas of New South Wales and Queensland — as well as recycling initiatives, thereby freeing more water for other uses, including (potentially) the environment;
- *trading reforms* (involving the introduction of tradeable water allocations) have created opportunities for water to be transferred to higher value, more water efficient and less polluting (including environmental) uses; and
- *investment reform* (which requires all new water infrastructure to satisfy the twin tests of 'economic viability' and 'ecological sustainability') has injected environmental criteria into the assessment process for new facilities, including dams. According to the NCC, this has led to a significant reduction in the number of dams and other (non-environmentally friendly) water infrastructure being built.

In the energy area:

- *the creation of wholesale trading arrangements* under the NEM has allowed suppliers to sell 'green energy' into the peak-load market and made it easier for consumers to buy energy from renewable sources;
- *the growth in interstate trade in electricity* has encouraged the more efficient use of existing generating capacity by, to some extent, allowing States with shortfalls to acquire power from those with surplus capacity, thereby reducing the adverse environmental effects of the premature construction of new power stations;
- *the national 'access' codes for electricity and gas* have encouraged the more efficient use of power lines and pipelines and thus discouraged the wasteful and environmentally damaging duplication of these facilities; and

(continued next page)

Box 5.12 continued

- *the removal of regulatory barriers to trade in gas* has promoted an expansion of the network and resulted in substitution of gas for electricity in many residential and industrial uses. This has reduced the level of increase in overall greenhouse gas emissions in Australia (as natural gas emits less carbon dioxide per unit of energy).

In the road transport area:

- *the national implementation of more stringent vehicle emission standards, new cleaner fuel standards (reduced sulphur and lead levels) and restrictions on air brake usage* have had beneficial impacts on air and noise pollution; and
- *improved regulation of the transport of dangerous goods* has, through their safer carriage, reduced the potential for environmental damage.

Sources: NCC (1999b); OECD (2004b); participants' submissions.

More broadly, it is important to recognise that any inherent ‘over-reliance’ on electricity generation with high CO₂ emissions is a reflection of the failure to price for externalities, rather than from the introduction of greater competition. That is, as Hamilton and Denniss (2001) argue, prices for electricity from whatever fuel source do not fully reflect the social costs of provision.

Similarly, pricing inefficiencies also underlie concerns about the environmental impacts of greater road use — to which the NCP road transport reforms may have made some contribution. Specifically, some participants claimed that the failure to address broad competitive neutrality issues across transport modes has led to excessive use of road transport and thereby higher levels of pollution and growing congestion problems. For example, Pacific National commented that:

Rail is more efficient, has lower associated costs and is characterised by lower externalities than road. However, rail pricing is unable to reflect these advantages over road because of current distortions. (sub. 61, p. 8)

The contention that road transport is subsidised relative to rail freight has been the subject of some debate (see chapter 8). But this does not undermine the basic proposition that further reforms to the pricing of services such as transport and energy, to include all costs, could have significant environmental benefits. For example, a recent EU study estimated that if externalities were fully accounted for, the cost of coal-generated electricity would double, while that of gas-generated electricity would increase by only 30 per cent (EC 2003). As discussed in chapter 8, the Commission sees externality pricing as an important element in the future infrastructure reform agenda — though there are limits on what price-related solutions can achieve.

5.5 Summing up

In assessing the social and regional impacts of NCP, it is important to recognise that the package has operated against the backdrop of some major ongoing economic, social and regional pressures affecting outcomes for various groups in the community. For example, longer-term structural changes have been the major factor influencing rural economic activity and causing population shifts away from smaller regional communities over the years. Failure to acknowledge the role of these broader factors has sometimes given rise to false impressions or misrepresentations about the influence of NCP.

Indeed, since the inception of NCP, most parts of Australia have enjoyed strong economic growth, higher household incomes, higher employment and lower rates of unemployment. While there are problems in disentangling the impacts of NCP from other factors that have been contributing to these outcomes, it is hard to sustain a case that the social, regional or environmental impacts of NCP have been generally detrimental.

- The Commission's modelling of productivity and price changes in key infrastructure industries suggests that the impacts of NCP on overall income distribution have been small relative to other influences. Moreover, although higher income households are projected to have benefited the most, the modelling also suggests that NCP has increased household incomes across the board.
- While there have been undeniable adverse impacts in some regional areas — especially in smaller communities — many producers, consumers and communities in country Australia have benefited from the NCP reforms.
- Though there may have been some unanticipated adverse impacts on the environment — in particular, increased greenhouse gas emissions from the reform-related stimulus to demand for electricity — in those cases where NCP has explicitly targeted better outcomes for the environment (such as in water reform), the effects have been positive.

This is not to downplay the adverse impacts on particular individuals or smaller communities, or the impact of NCP in adding to other pressures. Accordingly, the Commission has recommended that more attention be given to adjustment and distributional issues in any future program of nationally coordinated reform (see chapter 12).

6 Lessons from NCP

Key points

- NCP represented the consolidation and natural extension of a reform process that began with the systematic opening of the Australian economy from the early 1980s.
- That such an ambitious program received support from all governments can be attributed to much pre-existing evidence of the potential gains from reform, to broad agreement on the means of achieving those gains and to effective political leadership.
- Almost a decade of experience with NCP points to a number of lessons with potential relevance to any future nationally coordinated reform agenda.
 - A broadly-based reform program improves the prospect that those who might lose from a specific reform still gain overall. This can make it easier to progress reforms that might be difficult to implement on a stand-alone basis.
 - A reform framework which embodies agreed principles, while providing for some flexibility in implementation, is well suited to a multi-jurisdictional reform agenda.
 - Reform is likely to progress more effectively where commitments are specified in advance and there is prioritisation of the reform task.
 - An effective public interest test is essential to secure beneficial reform as well as community acceptance of the reform process.
 - Independent and transparent review and assessment processes are critical to secure good outcomes, especially on contentious issues; they help prevent backsliding and promote public understanding of the justification for reform.
 - In any reform program, the potential adjustment and distributional implications should be considered at the outset, with decisions about transitional assistance guided by appropriate principles.
 - Where reforms involve the establishment of new regulatory arrangements, it is important that those regulations be well scrutinised in advance and periodically reviewed to ensure the benefits continue to exceed the costs.
 - Providing financial incentives for jurisdictions to follow through with agreed reforms can be very useful in promoting effective outcomes, although the rationale and value of such payments clearly depend on the nature of the reforms.

National Competition Policy (NCP) has been a distinctive innovation in economic policy reform. Prior to NCP, many of Australia's microeconomic reform initiatives were limited in scope and the result of governments acting largely independently. In contrast, NCP has involved a comprehensive and integrated national approach to reform with coordinated actions from the Australian and eight State and Territory governments.

As evident from the overview provided in chapter 2 and the wider profile of NCP initiatives presented in appendix B, NCP has notched up substantial achievements since 1995.

Against this backdrop, and reflecting almost a decade of experience with NCP, this chapter comments briefly on some factors which provided a foundation for the NCP reform process. It then draws out various lessons from this process that are relevant to the consideration of institutional arrangements for a future nationally coordinated reform program (see chapter 12).

6.1 The underpinnings of NCP

Underlying the inception of NCP was a recognition by all governments of the need for competition policy reform, broad agreement on the main problem areas and a solid conceptual framework and information base to guide policy prescriptions.

A key building block for the development of NCP was the growing recognition by governments, from the mid to late 1980s, that the international competitiveness of Australian industries and the living standards of the community were being impaired by policy-related impediments within Australia. Earlier reform efforts had concentrated on reducing barriers at Australia's borders to expose trading industries to greater international competition. As trade liberalisation initiatives progressed, they in turn exposed significant performance problems in the non-traded sector of the economy. Notable amongst these were inefficiencies in infrastructure industries dominated by public monopoly suppliers, costly regulation of many other product markets and rigidities in labour markets which impaired enterprise competitiveness and productivity growth.

From the late 1980s, governments started to tackle some of these problems through a variety of commercialisation and corporatisation reforms to government business enterprises, liberalisation of some product markets and making a start on labour market reform.

Even so, reviews of Australia's performance at the time highlighted the need for a shift from a piecemeal to a more systematic national approach to microeconomic

reform. In particular, it had become plain that, in many areas, separate jurisdictional reforms lacked the coherence and consistency needed to build an efficient national market. This saw the emergence of the Special Premiers Conference process in the early 1990s. It provided a forum at the highest political level within which to explore improved ways of tackling domestic barriers to efficiency and competition within the economy as a whole. In October 1992, agreement was reached within this forum about the need to develop a national approach to competition policy reform.

A major independent inquiry — now known as the Hilmer inquiry after its Chairman, Fred Hilmer — was launched in Australia in 1992 with the support of all Australian governments. According to Hilmer (1993), the imperative for developing a national competition policy rested on three main factors:

- increasing acknowledgment that Australia was for all practical purposes a single integrated market;
- the fact that many goods and services provided by public utilities, professions and some areas of agriculture remained sheltered from international and domestic competition despite the existence of the Trade Practices Act (TPA); and
- recognition that the domestic pro-competition reforms implemented previously had been progressed on an inefficient sector-by-sector basis, without the benefit of a broader policy framework or process.

As the Victorian Government noted in its submission (sub. 51, pp. 1-2), the Hilmer Report provided clear and comprehensive support for the implementation of the NCP framework. Moreover, the framework comprised a reform agenda (see chapter 2) well matched to tackling key domestic impediments to improved international competitiveness and living standards.

The report by the Industry Commission to CoAG on the *Growth and Revenue Implications of Hilmer and Related Reforms* (IC 1995) provided a detailed assessment of the potential benefits of a broadly based competition reform framework. The Industry Commission's analysis demonstrated that NCP offered the prospect of substantial gains in income (and government revenue) which helped to galvanise political support for the reforms.

As a result, the Australian and all State and Territory governments were able to agree, in April 1995, on what has been a highly innovative approach to competition policy reform. Distinguishing features of NCP were its national focus, extensive agenda, agreed framework of reform principles, commitments and time frames, with contingent financial payments from the Australian Government to the States and Territories.

NCP has been operating now for almost a decade. It is clearly an enduring policy innovation. Indeed, the NCC (sub. 71, p. 35) has characterised it as ‘the most extensive economic reform program in Australia’s history’. However, though delivering many good outcomes, as the discussion in chapters 4 and 5 illustrates, NCP has not been an unqualified success. Hence, in a forward looking context, it is useful to explore both what features of the NCP framework have contributed to its success to date and at aspects that could be improved in any future reform program of this type.

6.2 Some lessons from the NCP experience

The value of a broadly-based and integrated reform program

The broadly-based and integrated reform agenda encompassed within NCP provided a clear signal about the role of competition policy reform in creating incentives for improved performance across large parts of the economy and, often, the desired direction of change. Australia was formally recognised as a single market rather than a series of markets defined by state borders. Moreover, many of the elements of NCP, outlined in chapter 2, provided governments with incentives to systematically review and reform unwarranted impediments to competition.

In its report on the *Growth and Revenue Implications of Hilmer and Related Reforms* to CoAG, the Industry Commission (1995) commented in the following terms:

... the benefit of reforms are widely distributed. Very few industries are projected to lose from the reforms. The majority of industries are quite clear winners. With a broad base of reforms, the losses from one reform tend to be offset by gains from other reforms and the small impacts of individual reforms add up to widespread, substantial gains. (p. 83)

Commenting on this aspect, in its submission to this inquiry, the New South Wales Government echoed the views of a large number of participants in observing that:

... it must be recognised that ‘losers’ from one area of NCP reform may have received ‘wins’ from another area of reform.

Despite the difficulties in measuring the impact of NCP, the total value of reform needs to be taken into account in assessing whether the net outcomes have been positive or negative for sectors of the community, and the community as a whole. Many pro-competitive reforms have helped rural industries cope with external pressures by reducing the costs of major inputs such as energy, transport and communication.

... The improved competitiveness of businesses which supply small regional firms is likely to be of indirect benefit to country communities. Costs of adjustment, often short

term, need to be weighed against benefits generated from other NCP-related reforms. Importantly, NCP will have enduring, economy-wide benefits on output, incomes and employment. (sub. 99, p. 16)

Thus, a key lesson from the NCP experience is that a broadly-based and integrated reform agenda improves the prospect that those who might lose from a specific reform can benefit from others and gain overall. As such, a broadly-based program is more likely to moderate adjustment costs and adverse distributional effects. This can make it easier to progress reforms that might be difficult to implement on a stand-alone basis.

The importance of a ‘flexible’ reform framework

The NCP process combined agreed principles with some jurisdictional latitude or flexibility in their application. Many participants commented favourably on this feature. For example, the NCC observed that:

A major strength of the NCP agreements is their reliance on the ‘spirit’ of reforms and the flexibility afforded to governments in meeting their commitments and to the Council in assessing progress. The agreements extend over many years, yet are flexible enough to cope with changing circumstances and different approaches while remaining sufficiently clear to facilitate an objective assessment.

The Council has no doubt that rigid highly prescribed agreements set down in black letter law would have been an inferior model. (sub. 71, p. 35)

Underlying NCP is the notion that, in many circumstances, competition can create incentives for improved economic performance. Reflecting this, the aim is to facilitate effective competition to promote economic efficiency, while accommodating situations where competition does not have that effect, or where it conflicts with other objectives.

Thus, while the NCP agreements provide a framework of agreed principles for a number of reforms — including competitive neutrality, the reform of public monopolies and the legislation review program (LRP) — each jurisdiction has been free to determine its own reform agenda consistent with these principles.

- For example, in relation to competitive neutrality, the Competition Principles Agreement (CPA) identifies some broad requirements with which government businesses should comply. Jurisdictions are, however, free to determine their own implementation mechanisms, but only to the extent that application of competitive neutrality yields benefits which outweigh the costs.
- A similar reference framework applies to the reform of public monopolies and the LRP. Thus, rather than having to mechanistically apply a rigid tops down

model, governments are free to use different mechanisms to meet the different reform agendas and have been assessed on the basis of outcomes relative to the guiding principles.

In the context of a federation, with responsibilities for reform split between sovereign governments, there was obviously a need for flexibility. This flexibility has in turn harnessed the benefits of ‘competitive federalism’ to advance the reform process. That is, the NCP framework has provided opportunities for governments to learn from the outcomes of different approaches to reform in other jurisdictions.

Beyond this, in areas of NCP which included specific commitments as part of a reform program, there has been scope for modifications to adapt commitments, including scheduling, over time. The sector-specific component of the program — that is, electricity, gas, water and road transport — and the LRP provide good examples of this aspect of NCP.

The reform program has also allowed governments and the NCC (in its assessment role) to take account of particular circumstances, such as the different starting points of individual jurisdictions, the complexity of the reform task, the desirability of extending reform commitments in some areas (such as water and road transport) and the need to provide more time to develop transitional mechanisms.

Of course, the advantages of the flexibility provided by NCP have not come without costs or criticism. For example, reflecting on future institutional arrangements and processes, the Victorian Government observed:

Victoria is concerned at the potential for ‘scope creep’ in obligations. In the past this has arisen from the broad interpretation of obligations imposed upon jurisdictions. In all cases, any increase in jurisdictions’ reform obligations must require explicit CoAG endorsement. (sub. 51, p. 16)

Nonetheless, the Queensland Government, amongst others, affirmed the desirability of retaining the flexibility of the existing institutional framework in any future arrangements noting that:

Under any extended or new arrangements, CoAG (or an enhanced equivalent) should be the prime driver (through Ministerial Councils where appropriate) and the rightful role of individual governments in setting and implementing policy should be fully recognised. (sub. 119, p. 2)

In sum, experience with NCP affirms the importance of building some flexibility into a multi-jurisdictional reform agenda, while ensuring that principles and objectives are clear and generally accepted, and that there is sufficient detail about desired outcomes to enable effective monitoring of reform progress.

A need for clarity and prioritisation

The ambitious nature of the initial timetables for NCP reforms placed a premium on clear specification of reform commitments and priorities. In the event, weaknesses in this area caused several problems and demonstrate the need for any reform program to be realistic about what can be achieved.

In the case of infrastructure related reforms, while the initial reform commitments for electricity and gas were quite specific, those for water and road transport were more general. The need to clarify what was to be done, to resolve differences between the States/Territories in their approaches to implementation, and to put in place institutional arrangements to support agreed initiatives, led to considerable delays.

Further, notwithstanding the priority status afforded infrastructure reform under NCP, formulating the reform agenda, assigning priorities and managing them effectively did not prove straightforward.

- The CoAG reform commitments for road transport have captured only a relatively small proportion of the reform proposals developed by the (then) National Road Transport Commission in concert with the Australian Transport Council. Beyond this, as noted by some participants, delays in organising funds for the upgrading of roads and bridges delayed regulatory approvals to raise mass limits for heavy vehicles in some jurisdictions, even though a large proportion of the gains from road transport reform were estimated to come from mass limit increases.
- Priorities for rail transport reform were left with individual jurisdictions to determine as part of the generic reform components of NCP — namely, structural reform of public monopolies, third party access and implementation of competitive neutrality. This approach effectively accorded a lesser priority to rail reform, despite earlier model-based assessments of the potential gains being double those for road transport and water (IC 1995). Moreover, with rail being handled generically and separately from road, there was less scope to ensure that reform initiatives in these two areas were consistent with the broader and important objective of achieving a more integrated and competitively neutral transport system (see chapter 8).

Under the LRP, the initial target date for completion of the 1800 or so items of legislation listed for review was June 2000. Individual jurisdictions were left to determine their priorities for the reviews. However, the absence of clear guidelines in relation to coverage and priority setting seems to have given rise to some anomalies. For example, divergences across States in the approach taken to listing legislation for review arose from differences in the cut-off points for recently

reviewed legislation, as well as from variations in assessments about whether legislation included anticompetitive restrictions. That said, the opportunity for jurisdictions to amend their lists over time, and for the NCC to review these lists in consultation with jurisdictions, helped to address some coverage anomalies.

Perhaps more importantly, variations in the jurisdictional sequencing of reviews led to some questionable prioritisation. Some jurisdictions (such as Victoria and New South Wales) elected to schedule reviews involving more significant restrictions on competition early in the review process. But others focused on less difficult areas of legislation and adopted a somewhat slower lead-in to the review process. The NCC (1996a, p. 19) expressed concerns about this aspect of the LRP early in the process, noting:

... the Council also questions the priorities being placed on important reviews by some governments ... one example of a government failing to schedule important reviews early is the Commonwealth's planned examination of the *Wheat Marketing Act 1989* in 1999-2000.

To some extent, these variations reflected differences in the time taken to set up review processes, as well as in strategic judgements about the risks associated with tackling challenging reviews sooner rather than later. However, with limited resources to undertake reviews, the upshot has been that many reviews involving areas with potentially large pay-offs for the community have only recently been completed, or have yet to be completed (see chapter 2).

A number of participants suggested that these problems could have been avoided had relatively minor legislation been excluded from the LRP. For example, the Australian Council for Infrastructure Development observed:

... everything was to be examined, otherwise states would lose their competition payments. The application of the consultants '80-20 rule' in seeking 80 per cent of the benefits for 20 per cent of the effort could have led to greater community acceptance. Also, the wide ranging nature of the review process enabled governments to avoid (or at least delay) the issues where there were strong vested interests. (sub. 76, p. 7)

Similarly, the Western Australian Government stated:

With the benefit of hindsight there has perhaps been too much emphasis placed on legislation reviews that were not material, and that this issue could be resolved by the inclusion of a materiality test in deciding if legislation review is warranted. (sub. 117, p. 34)

A stronger focus on legislation involving potentially large restrictions on competition would also have helped to address some other concerns raised by jurisdictions about the process, including the time and costs of undertaking reviews (see, for example, the ACT Government sub. 112, p. 7). This has been particularly

problematic for minor areas for which the transaction costs are often disproportionate. Also, as the costs of undertaking many of the reviews are unlikely to vary appreciably between jurisdictions, the LRP has tended to place a heavier burden on smaller jurisdictions. For example, in its submission on the Discussion Draft, the Northern Territory Treasury observed that:

... the Territory experiences significant diseconomies of small scale in public administration due to its relatively small population. These scale-related cost disabilities have been most prevalent in undertaking the legislation review program, where the Territory had the highest per capita review burden of all jurisdictions. (sub. DR204, p. 2)

At least from this perspective, focusing on high pay-off reviews and exploiting opportunities for inter-jurisdictional cooperation — joint reviews — where common issues arise, should have facilitated more cost effective outcomes.

It is, however, important to recognise that a large number of individually small reforms can collectively deliver significant benefits to the community. Hence, while an initial focus on areas where the pay-offs from reform were likely to be large would have been desirable, this does not diminish the importance of reviewing many of the other areas on the LRP schedule. Indeed, in establishing a program as broad ranging as the LRP, it was inevitable that the significance of the regulation included would vary. But with such an arrangement now up and running and much case history available on the more significant types of anticompetitive regulation, the case for, and capacity to, prioritise in this area is now much greater.

It is also important to note that the prioritisation problems experienced with the LRP were not solely a function of the inclusion of some relatively minor items of legislation. The very ambitious initial timetable for the LRP was also a contributing factor. The deadline for completing the LRP has now been revised on three occasions. In recognition of slippage and weaknesses in prioritisation, in 2001, the NCC nominated ten priority areas, namely legislation covering: primary industries; planning, construction and development; fair trading and consumer legislation; finance, insurance and superannuation; retail regulation; communications; professions and occupations; social regulation; transport services; and water (see box 2.5).

At the time of the latest published tranche assessment of the LRP by the NCC (2004b), 87 per cent of the non-priority legislation had been reviewed, whereas the completion rate for the 800 priority reviews was only 74 per cent (see table 2.1).

Experience with progressing reform under NCP attests to the value of specifying reform commitments in advance and effectively prioritising the reform task. Where the reform agenda includes challenging elements, monitoring of progress allows for

the modification, as appropriate, of reform commitments and associated priorities, as well as the consideration of alternative reform strategies.

An effective public interest test is fundamental to good outcomes

A core principle of NCP is a presumption in favour of competition, notwithstanding that competition is seen as a means to an end rather than an end in itself. Hence, in the case of the LRP, the public interest test (see box 2.4 for a description) places the onus of proof on those benefiting from a restriction on competition to demonstrate that it should be retained.

An evidence-based approach to reform is consistent with good public policy making in the broad and should be seen as a strength of NCP. However, the presumption in favour of competition along with the scope and application of the public interest test have attracted considerable criticism. As noted in earlier reviews of NCP, some of this criticism reflects a poor understanding of the public interest test (Quirke 1999, PC 1999b). But, it is also apparent that aspects of the way in which the test has been applied in some reviews have not been particularly helpful in ensuring good outcomes and effective participation by interested parties.

The reversal of the traditional burden of proof

The requirement for governments to demonstrate that regulations are in the interests of the community is, in itself, unexceptionable. Further, the presumption in favour of competition — and against regulation that restricts competition — can be seen as a logical extension of the approach taken in the TPA in relation to anticompetitive business practices. The TPA prohibits anticompetitive conduct, but allows the ACCC to authorise such conduct where it can be shown to yield public benefits which exceed any anticompetitive detriment. (Factors taken into account as ‘public benefits’ by the ACCC are set out in box B.1.) Examples of such authorisations by the ACCC are provided in box 6.1.

Even so, the extension of this approach under the LRP to established regulations restricting competition has proven contentious because it reverses the traditional onus of proof in policy reform. Traditionally, the proponents of a policy change have had to demonstrate that the change is worthwhile. Given the costs and uncertainties associated with policy changes, it is not unreasonable to require a good case to be made for change.

Box 6.1 Examples of ‘anticompetitive’ authorisations granted by the ACCC

Professions and occupations

Fourteen professional/occupational related authorisations have been finalised since 1996 — seven for health-related groups, three for building-related groups, two for real estate agents and one each for employment agents and showmen.

Only one of these applications was unsuccessful. An application by the Australian Society of Anaesthetists to enter into agreements with health funds covering standard and agreed rates and conditions for the supply of services was denied. In the ACCC’s assessment, the proposal was likely to lead to the creation of an effective minimum price scheme for these services, to the detriment of the community.

Of the thirteen authorisations granted, four involved unconditional authorisations (although with provision for a review within three to five years) and nine involved modifications to the original proposal.

- Three of the unconditional authorisations related to the building sector, where the ACCC found that while charging a membership levy to assist with the training of apprentice bricklayers would probably raise the price of bricks, it would also generate public benefits by alleviating skill shortages and moderating cyclical fluctuations in bricklaying costs. The other unconditional authorisation involved the employment services industry, where a Code of Conduct of the Recruitment and Consulting Services Association was judged as unlikely to restrict competition.
- None of the nine conditional authorisations were granted indefinitely. The conditions are case specific and are designed to ensure that the public benefits likely to arise from the authorised conduct outweigh the anticompetitive detriment.

Rural industries

The ACCC has dealt with applications for authorisation in many rural industries and recognised important public benefits in granting authorisations.

- *Collective bargaining schemes* in several rural industries were authorised to facilitate the transition to a deregulated environment. In the case of dairying, the ACCC argued that the industry would suffer if efficient producers were not able to counteract the power of processors by collectively negotiating terms and conditions of supply.
- *Export enhancement* was recognised as a public benefit in the authorisations granted to the Australian Wool Exchange and CSR in the sugar industry.
- To the extent that being able to collectively negotiate may stop efficient producers leaving an industry, rural communities may benefit from the *maintenance of employment and commercial activity*. This was accepted as a public benefit in the authorisation applications of CSR and the Oyster Growers Association.

Source: ACCC (2004c).

However, in the case of NCP, governments endorsed the approach proposed by Hilmer (1993, p. 190) and reversed the onus of proof on the grounds that theory and evidence strongly suggest that removing restrictions on competition will typically be in the public interest. Also, requiring those who benefit from legislative restrictions on competition — and thus who typically have most incentive to see them retained — to address the wider community effects, can act as a counterweight to political pressure to ignore the less readily identifiable costs. The Western Australian Government recognised this motivation noting that:

The influence of vested interests is often not recognised by the community and those groups are often skilled in presenting arguments which can gain wider public support. Vested interests in some cases maintain that legislation that prevents the entry of new competitors is for protecting the community from a social harm that will arise if new competitors are allowed to enter the market, without disclosing their interest in avoiding competition. (sub. 117, p. 31)

In public policy, it is, of course, often hard to ‘prove’ anything. Consequently, in general terms, it would seem desirable to put the onus of proof on those favouring the more ‘problematic’ *a priori* outcome. For most regulation of product or factor markets the current onus of proof in NCP is unexceptional. However, for regulation where social or environmental considerations loom large, judgements about the onus of proof are more finely balanced. In this context, the Council of Social Service in New South Wales submitted that for liquor retail outlets and gambling:

... the existing public interest test in NCP is not robust enough to ensure that the social impacts and the public interest are effectively addressed . . . (sub. 86, p. 1)

Even so, the current onus of proof arrangement in NCP has not prevented consideration of important social issues or the retention of restrictions on competition in appropriate circumstances. Various restrictions on competition have, for example, been retained on the basis of consumer protection and/or public health and safety considerations (table 6.1). In commenting on the use of the public interest test for this purpose, the then President of the NCC, Wendy Craik (2004) stated:

... State and Territory Governments are in control of how they reform their ... laws and can ensure that they continue to retain controls that serve the public interest. (p. 55)

In responding to the Discussion Draft, a number of participants endorsed the notion that the traditional burden of proof has a stronger justification in the more ‘complicated’ areas of social or environmental regulation. For example, TasCoss observed:

We welcome the recognition in the Discussion Draft that the presumption in favour of competition should not apply in all cases . . . (sub. DR219, p. 2)

Table 6.1 Examples of LRP reviews where anticompetitive restrictions have been retained

<i>Area of activity</i>	<i>Public interest grounds for retention</i>
Child care	Consumer protection (competence, good character) public health and safety
Teachers	Consumer protection and public safety (competence, good character)
Electricians	Public safety (information asymmetry and negative externalities)
Plumbers	Public health and safety
Health professions	Public health and safety, consumer protection (information asymmetry, conflict of interest)
Veterinarians	Consumer protection (competence, information asymmetry)
Vocational education and training	Consumer protection (minimum standards, certainty about nature of courses)

Source: Derived from NCC (2003c).

Other participants, however, questioned the workability of the two tiered approach that this would imply. For example, the Western Australian Department of Treasury and Finance submitted that:

Having two different approaches, each dependent on the significance of social or environmental objectives, may lead to confusion for agencies carrying out reviews as to which approach is the most appropriate for their particular review. It is also unclear how using the traditional onus of proof in legislation reviews where a range of factors are impacted upon (by removing a restriction on competition), will necessarily lead to better outcomes. (sub. DR236, p. 16).

It is important to recognise that the existing public interest test encompasses a broad list of illustrative criteria which include efficiency, equity and environmental considerations. The reference criteria are not intended to be exhaustive and can be augmented as appropriate (see box 2.4). Notwithstanding an in principle case to vary the onus of proof depending on the nature of the regulation in question, in practical terms, this would be very confusing. To avoid the sort of problems raised by the Western Australian Department of Treasury and Finance, it would be most appropriate to continue to apply the existing NCP onus of proof to all legislation reviews under the existing and any future LRP.

Importantly, regardless of where the onus of proof formally lies, it is incumbent on reviewers of legislation or regulation to demonstrate that their proposals — whether for change or to retain the status quo — are likely to yield a net benefit to the community.

The scope and application of the public interest test

Despite the wide range of factors that can be taken into account in applying the public interest test, there have been various calls for it to be more broadly based and for better guidance to be provided on the appropriate handling of costs and benefits and the weighting of public interest criteria.

As noted above, governments are free to augment the non-exhaustive list of considerations specified in the test to ensure that relevant costs and benefits are included in the evaluation framework for particular reviews. There are also no defined weightings attaching to the public interest criteria, thus providing flexibility to reviewers and governments to take into account the individual circumstances of particular legislation.

However, according to several participants, the absence of adequate explanations or guidelines on the application of the public interest test has impaired the effectiveness of the LRP. For example, the Australian Local Government Association claimed that:

The public interest test has had a significant impact on local government. During the introduction of competition reforms, inadequate explanations of the public interest test and its method of application led to negative public perceptions. (sub. 105, p. 8)

Even so, the Association went on to observe that:

Local government considers the public interest test broad enough to enable consideration of all relevant issues during the assessment of a particular restriction on competition against the public interest test. (p. 8)

And, in responding to criticisms of the public interest test, the Chamber of Commerce and Industry of Western Australia maintained that:

This criticism [of the public interest test] is largely misguided because it does not recognise that public interest is defined broadly in the NCP agreements, to allow a wide range of community benefits to be considered, including social, environmental, employment as well as economic objectives. Any failure in the public interest test would appear to be a result of its poor application in some reviews, rather than being constrained by narrow definition in the *Competition Principles Agreement*. There is also a tendency for those whose interests are threatened by the conclusions reached by applying the test to blame the test itself for failing to give their own interests and concerns sufficient weight. This is not a failing of the test, but evidence that it works as intended. (sub. 66, p. 6)

In its earlier inquiry into the *Impacts of Competition Policy on Rural and Regional Australia* (PC 1999b), the Commission similarly concluded that the problem was more with the application than the scope of the test.

As noted by the NCC, the task of effective application has been made more difficult in some jurisdictions by the lack of guidance provided to review bodies. For example, in commenting on the operation of the LRP, the Council noted that, while in some jurisdictions, the guidelines provide considerable details about most elements of the review process, in others they are little more than expansions of the relevant clause in the CPA. Moreover, while guidelines in each jurisdiction note the need to demonstrate a net community benefit where restrictions on competition are to be maintained, they vary in their treatment of how to undertake the supporting analysis and what is acceptable in particular cases (NCC 1998a). In an attempt to address this problem, the NCC (1999a) released a paper designed to provide guidance on how to use the public interest provisions to weigh up the costs and benefits of particular reform initiatives.

The Commission acknowledged the usefulness of that paper during its earlier review of NCP (PC 1999b), but called on governments to both publish and publicise guidelines which outline the purpose and scope of the public interest test, and to provide additional guidance on how the provisions of the test should be interpreted and applied. In line with a number of participants, the Commission also supported the development of national rather than state-based principles to ensure that reviews gave sufficient attention to the interests of the wider Australian community, particularly where anticompetitive legislation may have significant impacts extending across jurisdictions.

Concerns about the application of the test were also expressed by a Senate Select Committee reporting in 2000, which said that there had been:

Inconsistent application and interpretation of the public interest test with its domination by economic assessment ahead of harder to measure intangible attributes in the social and environmental areas. (p. xiii)

Later in 2000, CoAG (p. B.1) agreed to several measures to clarify and fine-tune implementation arrangements for NCP, including a provision that it ‘undertake an enhanced role in guiding the NCC in relation to its role in explaining and promoting NCP policy to the community’. CoAG also agreed that in applying the public interest test, governments ‘should give consideration to explicitly identifying the likely impact of reform measures on specific industry sectors and communities, including expected costs in adjusting to change’.

Notwithstanding these CoAG initiatives and efforts by the NCC and State and Territory governments to seek to improve understanding of the public interest test and its role within NCP, criticisms and misunderstandings continue. This has been clearly evident in submissions to this inquiry, as well as during discussions at the Rural and Regional Roundtable held in Wagga Wagga in July 2004. That said, some of the continuing criticism is not without foundation. For example, in its submission

on the Discussion Draft, the NFF, (echoing the views of several participants), was particularly critical of the effectiveness of the CoAG directive of 2000, observing that:

While commending the intent of this CoAG directive, it is clear that implementation of the directive has failed, . . .

. . . if the future reform agenda is to be successful it will be necessary to take stronger measures to ensure CoAG policy implantation than in the past. (sub. DR183, p. 9)

In the Commission's view, the public interest test is a critical part of the reform process. However, it is also apparent that its role has not been effectively promoted and, that insufficient attention — particularly in the earlier years of NCP — has been given to ensuring that it is appropriately applied. While greater specification and guidance on matters to be considered in applying the test may be helpful, there is only so much that can be achieved via this route. This in turn puts a premium on ensuring that mechanisms are in place to promote the quality of the review process. As discussed in the next section, transparency and effective monitoring are central in this regard.

Good processes are needed to secure good outcomes

Processes which systematically review the rationales for regulatory and other restrictions on competition, and the merits of different options for better meeting underlying objectives, are critical to informed decision making by governments. They can also play a useful role in promoting public awareness of the issues and trade-offs associated with different policy approaches. Effective monitoring and assessment of procedural arrangements is also important for promoting good outcomes. Of course, as noted earlier, good processes require resources and involve costs.

The review and assessment processes associated with the LRP, in particular, have attracted considerable criticism in this as well as past inquiries (see, for example, Hawker 1997, Quirke 1999, PC 1999b). The criticisms primarily relate to:

- the composition and independence of review panels;
- the transparency of review processes;
- the limited use of national or joint reviews;
- the effectiveness of the assessment process; and
- the limited understanding about the processes involved.

The composition and independence of review panels

Effective reform outcomes depend in large part on review groups making well-informed assessments about the effects of change from the perspective of the broader community. This can obviously be difficult to achieve if review panels are dominated by interests that benefit from the anticompetitive legislation that is being assessed. In this context, the NCC (1999c), in an earlier assessment of governments' progress in implementing the LRP, indicated that it had:

... various concerns about the reviews conducted to date. For example, the split along industry and government lines of recommendations from the New South Wales [dairy] Review Group highlights the Council's concerns about the need for review panels, particularly in sensitive areas such as dairy, to be independent from industry. Industry should participate in reviews via submissions ... rather than direct representation on review panels. (p. 104)

The issue of the appropriate roles of producers, users and other interested parties in reviews was also raised in the Hawker (1997) inquiry. It recommended that, 'where possible, reviewers should be independent of the existing arrangements with more significant, more major and more sensitive reviews demanding greater independence'.

During this inquiry, several participants (for example, the Australian Chicken Growers' Council, South Australian Farmers' Federation and National Farmers Federation) indicated that lack of independence of review panels and weaknesses in approaches to reviews, especially in relation to the application of the public interest test, had led to poor outcomes. Synthesising these concerns, the Chamber of Commerce and Industry of Western Australia observed:

... a number of significant NCP reviews have suffered from a lack of independence and a lack of rigour in the review process. As a consequence, there has not been a strong incentive for those agencies conducting reviews to ensure that the quality of the analysis undertaken is high. (sub. 66, p. 3)

The varied nature of legislation included within the LRP, together with the costs of undertaking independent public reviews, suggest that it would be appropriate to use a range of review models. However, where legislation involves significant restrictions on competition and/or has far reaching effects on the community, full scale independent and public reviews involving a substantive analysis of the issues would clearly be preferable to internal reviews. Moreover, while it will be generally desirable for industry to participate in the review process, this would normally best be achieved by allowing industry representatives to make submissions to reviews.

The transparency of review processes

The importance of transparent processes was summarised by the Western Australian Government:

Transparent processes are crucial when assessing the public interest. Without transparency it is extremely difficult to gain the community's confidence that public interest considerations have been examined in an impartial manner and that it is the community's interest that is the overriding concern rather than any particular sectional interest group when deciding whether a reform should or should not be progressed. (sub. 117, pp. 5-6)

However, aspects of the LRP lack transparency. In particular, there is no formal requirement under NCP for review reports to be made public, or even to be made available to the NCC. While many reviews have been made public, some have not been — often where the review outcome and the government's response involve controversial issues.

In November 2000, CoAG partially addressed this issue by agreeing that 'governments should document the public interest reasons supporting a decision or assessment and make them available to interested parties and the public' (CoAG 2000, Attachment B, p. B.1). However, if a program of legislation review is implemented beyond the current NCP — as the Commission is proposing (see chapter 9) — an explicit requirement for governments to make review reports publicly available would be highly desirable. Where relevant, it would also be desirable for governments to undertake to provide the reasons for adopting a position different from that recommended by a review.

National or State-based reviews?

Under NCP, reviews of legislation can be conducted by individual jurisdictions or as multi-jurisdictional or national reviews. In principle, national reviews are likely to be preferable in instances where there is Federal and State involvement in the area concerned; the extent of cross jurisdictional activity is significant (meaning that differences in regulatory approach can have significant implications for national markets); and the objectives of regulation and related issues are broadly common across jurisdictions. Reviews involving two or more governments where the objectives of legislation and related issues are similar are also an option.

Several participants commented on the potential benefits of national or joint reviews where these circumstances are evident, including that they are likely to lessen the overall resource costs of conducting reviews and offer the prospect of a uniform and/or consistent regulatory position emerging across relevant jurisdictions. Even

so, there have only been 12 national reviews to date¹ and, as at 30 June 2004 (the latest published assessment of governments' progress in implementing NCP), the overall review process had not been completed for any of these reviews.

The limited use of national reviews appears to reflect a number of recurring problems with this form of review. In this regard, the Victorian Government observed that:

Fewer national reviews of legislation have been undertaken than were anticipated. Those that have been undertaken have tended to be protracted and often difficult exercises. The slowness of inter-jurisdictional reviews and processes, and the overlaps between related processes have delayed the delivery of reforms and, therefore, the anticipated benefits. (sub. 51, p. 14)

In a similar vein, the NCC (2004b) recently observed:

Although a national process can improve regulatory consistency across jurisdictions, progress has been unacceptable in many cases. ... In many cases, governments have not yet implemented the recommended reforms because delays have arisen from protracted intergovernmental consultation: some national reviews have taken several years to be completed.

The robustness of a national review process is critically important. National reviews that are not independent of the executive arm of governments potentially encourage the least reform effort by setting compromise reform targets that all jurisdictions can reach. This has been the experience of some of the national reviews conducted by Ministerial Councils. (p. 9.21)

Some including the NCC, have also observed that State-by-State reviews may offer an advantage relative to a national review because:

A standardised national reform model carries an attendant risk of large scale regulatory failure, whereas a competitive model facilitates policy learning. The Council has encountered areas where innovative approaches in one jurisdiction have been adopted by others. Indeed, often reforms in some jurisdictions have provided the spur for others to move in areas that were seemingly (politically) intractable. (sub. 71, p. 42)

Common sense suggests that there is a role for national (or joint) as well as single jurisdictional reviews. National reviews would seem preferable where there is Federal and State involvement in the area concerned and where a common approach is likely to be important in facilitating the development of national markets. However, for such reviews to be effective, changes to current processes are

¹ These reviews cover the following legislation: the Agricultural and Veterinary Chemicals Code Act and related Acts; the Mutual Recognition Agreement and the Mutual Recognition (Commonwealth Government) Act; the Petroleum (Submerged Lands) Acts; Drugs, poisons and controlled substances; Food Acts; Pharmacy regulation; legislation regulating the architectural profession; radiation protection legislation; trustee corporations legislation; travel agents legislation; consumer credit legislation; and trade measurement legislation.

definitely required. There would also need to be much greater leadership from governments in initiating and undertaking national reviews, as well as in responding to proposed changes.

The effectiveness of the assessment process

The NCC acts as an independent monitor and assessor of governments' progress in implementing NCP reforms. Several participants saw this as important to the effectiveness of NCP. For example, the New South Wales Government observed that:

A strength of the NCP agreements has been the establishment of a framework in which governments are made accountable for implementing reforms and an external body is made responsible for monitoring governments' compliance with the framework, particularly with agreed review processes. (sub. 99, p. 21)

This accountability framework has established pressures, via inter-jurisdictional demonstration effects, to maintain a commitment to reform over time and to adhere to agreed review processes. (As discussed later, incentives to meet reform commitments have undoubtedly been reinforced by the competition payments mechanism.)

As a by-product of the assessment/monitoring process, the collection and dissemination of information on reform processes and outcomes has promoted 'learning by doing' experiences across jurisdictions. It has also aided the process of fine-tuning implementation processes — such as the development of better guidelines for the LRP — as well as identifying problem areas in need of follow-up work to progress reform satisfactorily — such as for road and water reform.

Notwithstanding the general soundness of this accountability framework, several participants were critical of how the NCC has performed its assessment role in practice. In this context, the New South Wales Government observed that in recent years it:

... has been concerned that the NCC has sought to impose its own weights in policy factors, implying preferred outcomes. ... It is considered that the NCC should examine governments' compliance with the reform requirements established under the NCP Agreements and the processes specified under those Agreements rather than pre-empt public policy aims. The NCC is not elected and, unlike governments, not accountable to the public. (sub. 99, p. 22)

Another view of the NCC's assessment activities is that it has simply been seeking to promote the integrity of NCP processes — which is one of its key roles — rather than pre-empting or dictating outcomes. Calls by the NCC for governments to make public the grounds for their decisions on LRP reviews are consistent with a decision

taken by CoAG in November 2000 directed at encouraging this outcome. So too are calls for governments to demonstrate that where an anticompetitive restriction is retained, its cost-effectiveness relative to alternative less restrictive approaches has been properly investigated. Indeed, some disquiet about the Council's assessment role is inevitable, especially in view of the linkage to its recommendations covering competition payments to the States and Territories.

The Heads of Australian Governments agreed to amend the CPA in 2000 to provide greater guidance to the NCC's assessment of governments' compliance with their reform obligations. The amendment specified that (CoAG 2000):

In assessing whether the threshold requirement of Clause 5 has been achieved [covering the two tests for the LRP reviews], the NCC should consider whether the conclusion reached in the report is within a range of outcomes that could reasonably be reached based on the information available to a properly constituted review process. Within the range of outcomes that could be reasonably reached, it is a matter for Government to determine what policy is in the public interest. (p. B.2)

In its submission to this inquiry, the NCC indicated that as a result of this amendment it looks for evidence that reviews:

- had appropriate terms of reference supported by publicly available documentation such as an issues paper;
- were conducted by an appropriately constituted review panel able to undertake an independent and objective assessment;
- provided for public participation through appropriate consultative processes;
- assessed and balanced all costs and benefits of restrictions on competition and considered alternative means of achieving the objective of the legislation;
- considered all relevant evidence and reached reasonable conclusions and recommendations based on the evidence before the review; and
- demonstrated a net public benefit when recommending that a government introduce or retain restrictions on competition. (sub. 71, p. 5)

This evidence-based approach by the NCC is consistent with the spirit of the CoAG (2000) decision aimed at promoting the integrity of NCP processes more generally.

Another aspect of the assessment function relates to ensuring that unwarranted anti-competitive restrictions are not removed from existing legislation only to re-emerge in new legislation. The NCC handles this reform commitment by assessing the effectiveness of governments' regulation review processes. Some governments (such as the ACT Government) supported a continuing role for oversight of completed NCP reforms to ensure those reforms or related processes are not unwound. Other governments (such as the New South Wales and Queensland

Governments) considered that state-based processes provide an adequate gatekeeping mechanism.

However, differences in approach to this gatekeeping function across jurisdictions have created scope for backsliding. For example, while some jurisdictions have subjected all primary and subordinate legislation to their gatekeeping processes, New South Wales excludes direct amendments to legislation from its processes. Beyond this, many jurisdictions use cabinet processes to apply gatekeeping mechanisms for primary legislation and, as a consequence, often do not make impact assessments public. The relatively loose framework which has evolved for managing the gatekeeping process does not seem to reflect its significance in ensuring effective outcomes from the LRP. The need for effective gatekeeping mechanisms, including to guard against backsliding, is explored further in chapter 9.

Finally, consistent with the original provisions in the NCP, the NCC conducted some early reviews of Federal or nationally significant State legislation. However, the potential for conflict with its assessment/advocacy roles was highlighted by the Commission in its earlier review of NCP (PC 1999b) and the review function has since been withdrawn.

Overall, providing for ongoing independent assessment of governments' progress in implementing reform commitments has been a major strength of the NCP framework. It has helped to make governments accountable for their actions and lessened the risk of reform slippage.

The NCP and its processes need to be better understood

Submissions to this and earlier inquiries, and discussions with participants at the Rural and Regional Roundtable, reveal continuing public misunderstanding of NCP and its processes. Given the complexity of the processes and issues, some misunderstandings are unavoidable. However, as the NCC commented in relation to the water reform element of NCP:

The water reform program contains formal public education and consultation requirements which are absent in other areas of reform. Governments are also required to explain the benefits of reforms. It is incumbent on governments to meet consultation obligations (beyond claiming that reforms are only being introduced to avoid unfair penalties). The education and consultation model for water reform may be applicable elsewhere. (sub. 71, p. 41)

The issue of disseminating information to promote public understanding of the rationales for reform, the expected benefits and the processes for handling its implementation is an important one. Had the approach referred to by the NCC in the

context of water reform been more widely applied, implementation of NCP may well have involved less public disquiet than has actually been the case.

At the public hearings, several participants emphasised the role of government in explaining to the community why further reform is needed and what benefits it will bring. For example, the Western Australian Department of Treasury and Finance observed:

Without question, governments do have a role in elevating the community interest above sectional interests, publicly supporting reform processes and explaining the reform and the public interest reasons why it is necessary. (sub. DR236, p. 24)

It is also important that governments avoid actions which have the potential to undermine public confidence in the reform process or acceptance of the benefits of reform. This can be an issue when governments claim they are only introducing changes to avoid penalties under NCP, or when they choose to disregard the recommendations of independent reviews without good reason. As noted earlier, explaining and documenting the basis for decisions either to accept or reject review recommendations is therefore essential to good process, as well as to public understanding of the issues at stake.

Timely consideration of adjustment and distributional issues

While reforms under the NCP have contributed to the generally higher productivity and output growth experienced in Australia over the last decade, not surprisingly, it has been the *distribution* of the benefits and the transitional or adjustment costs of reform that have attracted the most attention. As a result, understanding the adjustment and distributional implications of NCP has been a key issue for governments. As the Victorian Government observed:

One of the challenges with implementing the NCP, faced by all governments, has been how to manage change. Even where a reform is clearly in the overall community benefit, there may be negative impacts on specific individuals or groups. Frequently, the costs of reforms are acute, localised, identifiable and immediate, while the benefits are longer term and more dispersed. (sub. 51, p. 13)

A number of participants were critical of the handling of adjustment and distributional issues under NCP. For example, the Western Australian Farmers Federation commented:

One thing that seems to be lost frequently in the debate of deregulation is the human cost. Behind the arguments of choice and of free markets are people, farmers and their families who are trying to build a viable business in rural Western Australia in communities that are disappearing around them. Western Australia has a rich tradition of farmers and the bush. Let's not forget them in this process! (sub. 83, p. 21)

Recognising these concerns, governments have provided a variety of adjustment assistance measures to aid adaptation to change by groups adversely affected by economic reforms and other structural pressures (see box 6.2).

Box 6.2 Some examples of the provision of adjustment assistance by Australian governments

- The Victorian Government indicated that it has provided a variety of forms of adjustment support throughout the course of the NCP, the leading example being the Latrobe Valley Ministerial Taskforce which tackled the impact of changes in the electricity industry on a regional community. (sub. 51, p. 13)
- The NSW Government observed that it had provided a range of structural adjustment assistance including assistance for the Hunter and Illawarra regions; funding for the Regional Economic Transition Scheme (a general program for assisting regions and towns suffering from economic setbacks); the Meat Processing Industry Restructuring Program; the Forestry Industry Structural Adjustment Package; assistance to dairy farmers and communities following the deregulation of the dairy industry; and assistance to groundwater users in the Namoi. (sub. 99, p. 16)
- The Department of Transport and Regional Services pointed to several recent examples of adjustment support provided by the Australian Government including: the sugar industry reform package (\$444m), the Dairy Structural Adjustment Program (\$1.63b), Sustainable Regions Program (\$100m), Namoi Valley Structural Adjustment Package (up to \$20m), and the Rail Reform Transition Program (\$20m). (sub. 116, p. 6)

The NCC pointed out that the NCP was initially largely silent on the issue of adjustment assistance and managing the implementation of reform. This has given rise to various weaknesses in the management of the reform process, which were identified in the earlier Commission report that examined the impacts of NCP on rural and regional Australia (PC 1999b, p. 30):

In many areas, governments have failed to address adequately the social dislocation that can accompany change. Managing reform — including the provision of adjustment assistance — is a legitimate concern for many people in country Australia, as country areas often have borne the brunt of adjustment from, for example, employment losses associated with reform of government electricity and rail businesses, many of which pre-date NCP.

As noted earlier, in response to such concerns, CoAG (2000) agreed that:

When examining those matters identified under Clause 1(3) of the CPA [the application of the public interest test], Governments should give consideration to explicitly identifying the likely impact of reform measures on specific industry sectors and communities, including expected costs in adjusting to change. (p. B.1)

But, as the earlier discussion of the application of the public interest test indicated, this directive from CoAG does not seem to have had much practical effect on the conduct of legislation reviews.

Based on NCP experience in this area, explicit recognition up-front of a requirement to manage the adjustment and distributional consequences which inevitably accompany a reform process would be beneficial for any future reform agenda. In commenting on this matter, the South Australian Farmers' Federation argued that:

When an assessment is made during NCP reviews of the net aggregate community benefit accruing from increased competition, NCP reviews should also take into account the geographical distribution of the benefits and costs. For those communities bearing the costs of any change, an assessment needs to be made of their ability to adjust, the alternative opportunities available to them and the necessity for relevant governments to provide appropriate adjustment assistance. (sub. 28, p. 13)

And, at the Discussion Draft hearings, the NFF indicated that it:

... is vital to ensure that the objective of adjustment costs — and in particular the cumulative impacts of reforms and broader pressures — be afforded greater policy attention in the future.

This is particularly important for regional communities that may already be experiencing social drift to metropolitan centres.

... NCP has been perceived to have ignored issues of social capital and community cohesion in favour of unfettered competition. NFF believes that these problems have arisen through poor implementation of NCP, ... and inadequate assistance given to those groups worse off for the greater public good. (sub. DR183, p. 5)

While decisions about the forms and extent of any transitional assistance are best left to the relevant jurisdictions, agreement up-front on some general principles to guide the provision of such assistance would increase the likelihood that the process of change is managed well and lessen perceptions that responses are ad hoc. Such an approach could also help to improve the efficiency, effectiveness and the underlying equity of any transitional assistance provided. In this regard, the ACT Government observed that:

... reform benefits can take a long time to flow through the economy and this aspect of structural change also inhibits the undertaking of reforms.

Mechanisms to speed up the flow on of benefits or otherwise address the time lag between reform costs being incurred and benefits being experienced would expedite deregulatory undertakings. Upfront, or additional, payments provide the most effective incentive in this regard. (sub. 112, p. 2)

The Commission has undertaken a number of analyses of relevant issues since the commencement of NCP, both as part of a review of NCP (PC 1999b) and its supporting research program (PC 1999h and 2001e), and in the context of some

specific industries (PC 2002e, 2003e). This work indicates that the social security and tax systems, as well as generally available adjustment measures, will usually be the most appropriate vehicles for assisting the adjustment process and moderating adverse distributional impacts. However, these systems and measures are not designed to handle all contingencies.

In some circumstances, there is a role for additional measures to promote equitable outcomes and improve the efficiency of the adjustment process. Such measures include direct compensation and specific adjustment assistance. It may also be appropriate to modify a proposed policy change, either before or after its implementation, to lessen adjustment pressures and/or moderate adverse distributional impacts.

In sum, experience with NCP reinforces the importance of ensuring that the potential adjustment and distributional implications of reform are considered at the outset. In the reform framework, it will also be desirable to include agreed principles to indicate when the provision of transitional support may be warranted and to specify attributes of such assistance that will help to ensure that change is facilitated rather than frustrated. A number of possible criteria that could help in this regard are spelt out in chapter 12.

Ensuring effective regulation of prices and access regimes

Under NCP and related competition policy reforms, Australian governments have radically transformed regulatory, governance and ownership arrangements for essential economic infrastructure services — such as electricity, gas, water, rail transport and telecommunications.

As outlined in chapter 2, this transformation has involved the development of a supporting regulatory framework involving the establishment of:

- arrangements in each jurisdiction to oversee prices charged by utilities and other bodies with substantial market power; and
- rules to enable potential competitors (or third parties) to gain access to essential infrastructure services.

Given the complex nature of these regulatory arrangements, particularly those relating to access, and the potential for them to generate costs as well as benefits, it was envisaged at the outset that they would need to be independently reviewed after a few years. In this context, it is important to recognise that the task of regulating monopoly infrastructure is challenging due to, among other things:

- the large information asymmetries between regulators and service providers;

-
- the incentive effects created by regulations that may encourage gaming or discourage cost minimisation;
 - uncertainty about technology and future demand;
 - the risk of regulatory capture; and
 - interactions between different regulations.

Consequently, regulations designed to reduce the adverse effects of market power can themselves produce economic distortions and incentive problems. These include the risk that errors in pricing and access determinations may deter or distort investment in major infrastructure facilities.

The Commission has undertaken a number of inquiries in this area in recent years, including reviews of the Prices Surveillance Act, telecommunications competition regulation, airport services pricing, rail reform, harbour towage services, the national access regime and the gas access regime (1999g, 2001d,f, 2002a,d,g and 2004i). To promote the development of effective regulatory regimes and ensure that appropriate adaptations are made over time, the Commission has, on a number of occasions, stressed the need for follow-up reviews to reassess the performance of revised arrangements. For example, in its *Review of the National Access Regime*, (PC 2001d) the Commission noted:

Given the complexity of the access problem and the imperfect nature of the solutions to it, ongoing monitoring and periodic review of the national access regime is essential. The Commission is recommending that the NCC be charged with reporting annually on the operation and effects of the revised arrangements and that there be a further independent review of the regime five years after the first group of changes emerging from this inquiry is put in place (p. xxix).

Several infrastructure service providers as well as user interests expressed concerns about the effectiveness of pricing and access regimes developed under NCP — including the costs of complying with regulations, perverse incentive effects, and the need for a better balance between incentives for efficient consumption of existing service capacity and future investment. As discussed in chapter 10, achieving the ‘right’ balance in price and access regulation is a priority going forward.

Providing incentives to progress reform

The role of the competition payments regime in providing an incentive for progressing reform was endorsed by many participants, including State and Territory governments. In general, they saw the regime as a core element of NCP

and as an appropriate mechanism to share the revenue benefits of the reforms with the States and Territories. For example, the Queensland Government observed that:

The payments were crucial to reaching agreement on the introduction of NCP and they remain crucial if States and Territories are to continue with the current arrangements. (sub. 119, p. 9)

The regime has also added another dimension to the accountability framework for governments by including provision for penalties (in the form of suspensions or deductions from competition payments) where progress by a State or Territory in implementing its reform commitments is unsatisfactory. Indeed, the NCC identified the regime and its related incentives as a key reason for the success of NCP noting that:

Using competition payments to leverage reform outcomes in areas of State and Territory responsibility has proven highly effective.

... Reform would have been far slower and less comprehensive without competition payments. These payments (now at around \$800 million per year) may not be large relative to State and Territory budgets, but nonetheless represent a significant source of incremental funds. Apart from the magnitude of the funding, tying performance to financial rewards has enabled governments to eschew pressure from lobby groups by claiming that they have no option other than to meet their NCP commitments. At the officials' level, the effect of competition payments has been to empower jurisdictional competition policy units to a far greater extent than otherwise. The benefits of strong competition 'watchdogs' at the coalface should not be underestimated. (sub. 71, p. 36)

In general, State and Territory governments called for the continuation of competition payments, arguing that the benefits of the reforms carried out by them are ongoing, as are the revenue flows, which they contended are disproportionately captured by the Australian Government. Most also thought that any new competition-based reform commitments should attract additional payments from the Australian Government.

The Commission concurs with the view that competition payments have played a pivotal role in maintaining reform momentum within the States and Territories.

However, the payments regime has not been without shortcomings. Competition payments have sometimes been a distraction from the reform process, such as during the periodic debates about whether withholding of some payments ('penalties') has been justified. A focus on payments and penalties has from time to time almost certainly misled the community as to the main rationale for reform — namely, to achieve improvements in productivity and household incomes, not simply to increase government revenue through these payments. Moreover, the configuration of the payments regime and the associated procedural requirements

have not been problem free. In this latter regard, participants commented on a range of possibilities for improving the current regime, including by:

- providing for greater transparency in relation to the nature and extent of financial penalties imposed for reform slippage or failure;
- ensuring that local governments receive a share of the payments reflecting their contributions to the reform process; and
- addressing a perceived inconsistency in the treatment of the Australian Government whereby its failure to meet reform obligations does not attract a penalty.

Improving the transparency of NCC assessment recommendations

Inevitably, the assessment process underlying NCC recommendations on competition payments, including the possibility of suspensions and deductions, involves an element of judgement. However, one requirement for an effective payment incentive scheme is for the assessment process to be sufficiently transparent to avoid outcomes which appear to be arbitrary or inherently difficult to predict.

Following an earlier review of NCP, CoAG (2000) provided further guidance to the NCC in relation to future assessment processes. Specifically, when assessing the nature and quantum of any proposed financial penalty or suspension, the NCC is required to take into account the extent of the relevant State or Territory's overall commitment to the implementation of NCP, the effect of that State or Territory's reform efforts on other jurisdictions and the impact of failure to undertake a particular reform.

Nonetheless, a number of State and Territory governments questioned outcomes in relation to the 2003 assessment by the NCC. For example, the NSW Government submitted that given its:

... leadership in, and demonstrated commitment to, completing NCP reforms, a penalty of 20 per cent of New South Wales' competition payments in 2003-04 for a handful of comparatively minor matters was excessive and inappropriate. (sub. 99, p. 18)

Similarly, the Northern Territory Government, in commenting on a penalty it received in relation to its failure to reform liquor regulations noted:

... the substantial and intractable social impacts associated with the consumption of alcohol in the Northern Territory, relative to other jurisdictions, and the comprehensive measures being developed by the Territory Government to ameliorate these effects, was not adequately recognised. (sub. 130, p. 3)

And the ACT Government maintained that there is a need to enhance the transparency, detail and quality of NCC assessments to ensure that jurisdictions are aware of the details of decisions affecting NCP payments. It emphasised that this is particularly important where there are differences of opinion between the NCC and the jurisdiction on the quality of a reform in relation to public interest considerations. The ACT Government went on to observe that:

While the assessments provided general information on the rationale for the NCC's recommendations, they were lacking in detail as to how individual reform items contributed to an overall decision on payment suspension/deduction amounts. (sub. 112, p. 10)

The suggested solution involved the provision of information by the NCC to give jurisdictions a better idea, prior to payment recommendations being finalised, of where reform efforts were likely to be judged inadequate. In the ACT Government's view:

This could occur through the provision of greater detail in the NCC's forward work program provided to CoAG at six-monthly intervals and be reinforced through officer level discussions between NCC officials and competition policy unit staff (p. 10).

In the Commission's view, transparency in this area is no less important than in other aspects of NCP processes. The proposal by the ACT Government could help to improve the transparency of the payments regime somewhat, and is therefore worth considering if CoAG decides to have some form of financial incentives beyond 2005.

Many local governments have missed out on competition payments

Several participants argued that local governments (and/or local councils) have been treated inconsistently by the States under the competition payment regime. Central to their argument was the view that local governments have incurred costs in implementing reforms in the areas of competitive neutrality, prices oversight, water reform and the LRP, and are thereby entitled to a share of the competition payments paid to State and Territory governments. For example, the Local Government Association of Tasmania said:

Local government has made a direct contribution to the reform process and is responsible for a significant proportion of the benefits accruing from the implementation of effective competition reform.... Nevertheless, Local Government in Tasmania is not receiving its share of the financial benefits. (sub. 36, p. 1)

State and Territory governments are, of course, free to share a proportion of their competition payments with local governments, to aid them in offsetting the costs of

implementing NCP reforms and/or to share some of the resulting benefits. To date, Queensland, Victoria and Western Australia have elected to do so.

However, as a number of participants emphasised, competition payments under NCP were not intended to compensate jurisdictions for the costs of implementing reform. Rather, their role was to provide State and Territory governments with a share of the higher tax revenues generated by the NCP reforms that would not otherwise have accrued to them because of vertical fiscal imbalance.

This is not to deny that it may be desirable for State and Territory Governments to share some future payments with local governments/councils. Such sharing could be appropriate, for example, were local governments to incur disproportionate costs relative to the benefits of reform, or where there is a marked fiscal imbalance at the State-Local Government level. However, the incidence of costs and benefits between these two levels of government will vary with the nature of reforms. Hence, it is not possible to draw a generally applicable conclusion on this matter.

No financial penalties for the Australian Government

Under NCP, there is no formal requirement for the NCC to assess the progress of the Australian Government in relation to its reform commitments. This is because there are no monetary transfers via the competition payments regime to the Australian Government. However, to enhance the transparency of the NCP process, the Australian Government agreed, from the outset, that the NCC would assess its performance as well as that of State and Territory governments.

A number of participants, including most State and Territory governments, were critical of the Australian Government's performance in relation to its reform commitments under NCP and highlighted the fact that, unlike the States and Territories, it is not penalised for unsatisfactory progress. For instance, the New South Wales Government observed that:

... the effectiveness of the NCP framework has been hampered by the lack of an accountability framework for the Commonwealth Government. While the States and Territories are subject to significant penalties if they do not undertake reforms in a timely manner, there are no similarly transparent incentives to perform by the Commonwealth. In its 2003 assessment of government's progress in implementing NCP and related reforms, the NCC found the Commonwealth Government to "have set a poor example" for other Australian governments in legislation review and reform.

... The Commonwealth Government withheld competition payments from the States and Territories in 2003 due to non-completion of reforms. Despite its own lack of compliance with NCP, the Commonwealth retained competition dividends generated by State and Territory reforms. (sub. 99, p. 20)

While not subject to any formal payments or penalties under the competition payments regime, the Australian Government is effectively penalised or rewarded in accordance with its progress in implementing its reform commitments. For example, in failing to undertake growth-inducing reform, its tax receipts are lower than they would otherwise have been.

Moreover, whether the Australian Government retains any tax revenue dividends from State reforms (as suggested by some State governments) is unclear. It depends on the extent to which the competition payments agreed to in 1995 correspond to the actual increment to Commonwealth tax revenue resulting from reforms implemented since then. This is very difficult to determine and has been complicated further by the subsequent introduction of the GST as a ‘growth-related’ revenue source for the States.

Equally, as noted by the Tasmanian Government, the costs of the Australian Government’s below average performance under NCP to date have not been borne by it alone:

... the costs are also borne by the states and territories in terms of economic growth and employment in these jurisdictions being lower than otherwise, and also in terms of taxation receipts from the Goods and Services Tax and from State taxes being lower than otherwise. (sub. 109, p. 5)

Various State and Territory governments singled out a number of areas where they judged significant benefits could be achieved through a more rigorous application of NCP at the Federal level, including telecommunications, broadcasting and pharmacy. And some participants, such as the ACT Government and the NCC, canvassed the idea of developing a financial incentive mechanism for placing greater discipline on the Australian Government to progress its reform commitments. Others simply pointed to the need for ‘effective’ mechanisms to achieve this outcome. For example, the Queensland Government stated that:

Any new NCP arrangements should include some effective mechanism to ensure the Commonwealth Government improves its poor performance (as assessed by the NCC) in delivering on its reform obligations, particularly in relation to legislation review and reform. (sub. 119, p. 20)

Drawing on experience to date, it is apparent that providing financial incentives for the States and Territories to proceed with agreed reforms has been very useful in sustaining reform momentum in those jurisdictions. As discussed in chapter 12, this argues for some role for financial incentives in future programs of national reform, although their rationale and value would clearly depend on the nature of the reforms. While it appears impracticable for a system of payments and penalties to apply to the Australian Government, the economic and fiscal costs of its failure to meet particular reform commitments are not borne by it alone. Accordingly, in the

Commission's view, there would be merit in the Australian Government exploring the scope for further disciplines in relation to its own reform performance in the context of the COAG review.

7 The importance of continuing reform

Key points

- While there has been a marked improvement in Australia's overall economic performance, there remains considerable scope to do better.
- Australia faces significant economic, social and environmental challenges that will put pressure on living standards in coming years.
 - Ageing of the population will simultaneously increase demands for services such as health and aged care and, by reducing labour supply relative to our population, constrain Australia's growth potential.
 - There will be pressure both domestically and internationally to improve environmental outcomes and encourage more sustainable resource use.
- Addressing these challenges will require multi-faceted responses. However, competition-related and other microeconomic reform can make a valuable contribution by:
 - generating additional wealth to help meet the aspirations of the Australian community and to defray the costs of ageing; and
 - reducing the impacts of ageing through easing constraints on labour supply and facilitating more cost-effective delivery of health and aged care services.
- Economic reform which enhances productivity and sustainability can be compatible with, and contribute to, social and environmental objectives.
- The notion that adjustment pressures can be avoided by abandoning reform is unrealistic. Indeed, measured and ongoing reform can facilitate the development of a more resilient economy that is less susceptible to shocks and also reduce the need for 'reactive' and potentially costly policy changes.
- Any unwinding of the reform achievements of the past two decades (or failure to pursue further reform) would reduce Australia's competitiveness relative to countries that are continuing to improve, and thereby detract from future living standards.

The quantitative and qualitative information presented in the previous chapters illustrates how economic reform in general, and National Competition Policy (NCP) in particular, have served to improve the standard of living of most Australians. NCP, for example, has helped to reduce the overall cost to the community of delivering key infrastructure services and often the prices paid for those services by businesses in particular. The more competitive market environment induced by NCP has increased the onus on suppliers to provide quality goods and services and

to be more responsive to the changing needs of customers. And, as part of the wider economic reform program, such improvements in productivity and reductions in input costs have allowed Australia to pursue higher economic growth with less fear of inflationary pressure. Moreover, contrary to some perceptions, the recent shift up in Australia's growth performance has benefited the large majority of households and regions, albeit variably.

Such reform has not, of course, been easy or costless. For some businesses, individuals, families and communities, the required adjustments have been substantial. Not surprisingly, after a prolonged period of policy-induced change to economic rules and institutions and ways of doing business, there is evidence of 'reform fatigue'. Moreover, perceptions in parts of government and the community that the reform task is largely complete and it is now time to relax and enjoy the dividend, are contributing to a growing 'reform malaise'.

However, Australia faces a number of significant economic, social and environmental challenges that will put pressure on living standards in coming years. While a variety of strategies will be required to address these challenges, further competition-related and other economic reform will be an important part of the policy armoury. Indeed, as this chapter seeks to explain, the nature of some of these challenges means that the 'mainstream' reform agenda should desirably extend beyond traditional areas. For example, taking advantage of opportunities to improve efficiency, equity and cost-effectiveness in the delivery of human services should be a high priority as part of a broad agenda designed to raise productivity and enhance sustainability.

7.1 The significant challenges ahead

Increasing integration of the world's economies will provide significant rewards to countries able to respond efficiently, flexibly and innovatively to changing patterns of demand, technological change, shifts in underlying comparative advantage and the increasing mobility of global capital to take advantage of those shifts. For example, though a resurgent China is viewed by some as a threat, strong economic growth in that country is opening up a myriad of new export opportunities, as well as giving businesses and households in Australia and other countries access to a range of better and cheaper goods and services.

Equally, these changes in the global economy mean that the competitiveness of particular sectors will change over time. Thus, as noted in chapter 5, Australia's terms of trade for agricultural products has been in long term decline. And, in the future, Australia's mining sector — currently our largest export earner and

benefiting from historically high global commodity prices — is likely to face increasing competition in overseas markets from new sources of supply. Countries which do not have economies capable of readily adapting to such changes in competitiveness will see their standards of living fall, at least in relative terms.

Compounding these ongoing ‘globalisation’ challenges is the growing emphasis on bilateral and regional trade agreements relative to multilateral trade reform. This has created a more uncertain trading world, with significant potential downsides (see, for example, Adams et al 2003; PC 2004j). In particular:

- countries that are excluded from preferential deals are exposed to terms of trade and income losses; whereas
- those engaging in such deals are exposed to other potential negatives, such as efficiency losses from the diversion of resources into less competitive activities and higher transaction costs, including from administering complicated rules of origin and multiple safeguard arrangements.

This more complex trading environment reinforces the importance of striving to be internationally competitive. Countries which are able to match it with the world’s best are more likely to benefit from participation in regional arrangements and be better able to cope with exclusion from them.

There will also be pressure both domestically and internationally to improve environmental outcomes and encourage more sustainable resource use. Problems such as land degradation and salination continue to be a drain on Australia’s productive capacity, with a substantial commitment of resources likely to be required to rectify past mismanagement. Community demands to preserve biodiversity and enhance environmental amenity in urban and non-urban areas are becoming stronger. And, as in other countries, reducing output of greenhouse gases is likely to involve substantial adjustments in the pattern and nature of economic activity, with the ratification of the Kyoto Protocol reinforcing those adjustment pressures even in countries which are not signatories.

But perhaps the biggest challenge facing Australia in the next 50 years is the ageing of the population, as a consequence of falling fertility and, more importantly, increasing life expectancy. This phenomenon is not unique to Australia and involves some significant benefits. However, it will substantially increase demands for services such as health and aged care and simultaneously reduce the growth in labour supply (see box 7.1). The combination of greater service demand and reduced productive capacity relative to population will in turn put pressure on government budgets and suppress growth in household incomes. The Commission’s projections indicate that without offsetting policy initiatives these impacts could be large and disruptive (PC 2005a). Concerns to provide for an appropriate balance

Box 7.1 Challenges from Australia's ageing population

Over the next 40 years, the number of Australians aged 65 or more will increase by more than 70 per cent. Conversely, the numbers of those aged under 15 is set to *fall* by about 6 per cent. This change in the age structure is predominantly a reflection of beneficial trends — voluntary reductions in fertility and improved life expectancy. These developments have facilitated, among other things, greater access to education and higher workforce participation by women, as well as increased leisure and voluntary work opportunities for retirees. However, an ageing population also raises some major policy challenges:

- It will significantly reduce the growth in labour supply. For example, the addition to the labour force in the 7 years to 2011-12 will be more than the expected cumulative addition in the 21 year period from 2023-24 to 2044-45. Total hours worked relative to population are expected to decline by 10 per cent over the next 40 years.
- Slower labour supply growth will in turn constrain economic growth. Per capita GDP growth rates are projected to fall to as low as 1.3 per cent a year in the 2020s — around half the current rate. Without ageing, cumulative GDP from 2003-04 to 2044-45 is projected to have been more than \$4000 billion greater in 2002-03 prices.
- This reduction in the productive capacity of the economy will coincide with greater demands on the health, aged care and social security systems. In particular, older people consume more health care services.

While these challenges do not at this stage constitute a crisis, their future significance should not be underplayed. Governments will inevitably remain responsible for many of the costs that are strongly age-related (such as health) and will have to respond to the budgetary consequences as these costs rise relative to (tax) income. Indeed, by itself, ageing of the population could add as much as \$1000 billion to the government-funded component of health care spending over the next 40 years, with continued technological change and greater use of services further increasing budgetary outlays.

In dealing with these fiscal pressures, general productivity growth has a key role to play — though because it raises real wages and expectations about service levels as well as tax revenues, its net fiscal dividends may be smaller than is sometimes assumed. However, productivity improvements in areas of major projected expenditure growth, such as health and aged care, will provide a direct means to help finance the unavoidable increase in the costs of servicing an ageing population, and will therefore also be very important in a fiscal sense.

This in turn highlights the importance of reform in the human services area (see text) — though as the Victorian Government's recent (Department of Treasury and Finance 2003) report *Shaping a Prosperous Future* emphasises, reform programs must be broad ranging and include consideration of the role of greater clarity of responsibilities across levels of government in improving the efficiency and effectiveness of services such as health care. Other policy approaches also need to be explored, including opportunities that higher incomes and wealth will provide to make some individuals responsible for meeting a greater share of the costs of services such as health and aged care. These issues are taken up in chapter 11.

between work and family responsibilities against a backdrop of much slower growth in labour supply, will add to the difficulty of responding to this major demographic change.

7.2 How will further reform help?

A higher standard of living is the goal

Achieving further improvements in standards of living and, ultimately, in community well-being, is a goal to which virtually all Australians would aspire. But the emphasis given to the array of individual factors that contribute to living standards, and the way in which aspirations to improve quality of life in Australia are expressed, vary considerably.

Traditionally, increasing the size of the economic cake has been the primary goal of economic policy. In the context of microeconomic reform, this has seen a heavy focus on removing impediments to efficiency and competition that have constrained productivity and economic growth.

However, as the economy has grown, there has been increasing concern in both the community and policy circles to ensure that:

- the benefits of economic growth are shared equitably across the community;
- that initiatives to boost economic growth give due regard to regional diversity;
- the environment is not jeopardised in pursuit of higher growth; and
- in seeking to advance the interests of the current generation of Australians, the well-being of future generations is not put at risk.

This has led to greater emphasis within government on a more holistic analysis of factors and policies influencing community well-being. Thus, for example, the various public interest test requirements in the NCP require governments to have regard to a range of efficiency, distributional, regional and environmental considerations. In monitoring outcomes in the social and community services area, the Steering Committee for the Review of Government Service Provision has adopted an ‘equity, effectiveness and efficiency’ framework (SCRGSP 2004a, 2005). And, most broadly, reference is now often made in policy circles to the so-called ‘triple bottom line’ — in essence, an integrated assessment of economic, social and environmental impacts. Box 7.2 elaborates on issues involved in measuring and assessing wellbeing.

Box 7.2 Measuring and assessing wellbeing

The ultimate aim of public policy and policy reform is to improve the welfare, or wellbeing, of the community. There are many indicators of wellbeing, including (but not limited to): income, health, education, relationships, leisure, environmental amenity, choice, equality, security and liberty. If achievable, a single holistic and measurable indicator of wellbeing would obviously be an extremely valuable policy tool. However, the subjective nature of many of the components of wellbeing, and the different weights that individuals attach to them, means that a robust measure is difficult, if not impossible, to construct.

Even so, some researchers have attempted to assess the extent to which wellbeing has changed over time using ‘happiness’ as a proxy for wellbeing. Based on surveys in developed countries, they have concluded that — despite much higher real incomes — ‘happiness’ levels have remained relatively constant over the last fifty years. They explain this result in terms of people adapting to changes in their incomes and caring more about relative incomes than about their absolute level.

Based on this research, some economists have proposed ‘corrective policies’ to try to ensure that the fruits of higher productivity and economic growth are channelled to areas that would increase wellbeing. Others have argued that the pursuit of economic growth should not be a high priority, or have even advocated limiting growth.

Whilst the ‘happiness’ literature raises some important policy issues, the pursuit of a simple growth-limiting agenda would almost certainly jeopardise, rather than enhance, wellbeing:

- Attaching a low priority to growth in any one country would lead to an ever widening gap in living standards between its citizens and those of other countries (assuming they did not choose the same path). Even within the framework of ‘happiness’ studies, this would imply an increasingly unhappy population.
- Similarly, to the extent that people expect that their incomes and consumption possibilities will continue to rise, not fulfilling those expectations by constraining growth would itself create unhappiness.

Further, as noted in the text, the fiscal burden of an ageing population will necessitate ongoing productivity improvements simply to maintain current living standards. And addressing other elements of wellbeing, such as income distribution, is easier in a growing economy.

This is not to say that the pursuit of economic growth should be the sole aim of policy — just that growth can be a key facilitator of improved wellbeing. In this context, the Australian Treasury has developed a framework for considering the nature and scope of wellbeing which is intended to inform the policy advice it provides to government. The framework consists of five elements: opportunity and freedom; consumption possibilities (to which the concept of economic growth is most closely aligned); distribution; risk; and complexity. Importantly, the framework recognises trade-offs (as well as complementarities) both within and among the various dimensions of wellbeing. For example, the policies required to expand consumption possibilities can pose distributional challenges. Indeed, most policy proposals will involve such trade-offs.

Sources: Frey and Stutzer (2002); Bates (2004); Layard (2005); Henry (2004c).

The need for a holistic approach is also evidenced by the wide range of issues that are typically canvassed by Australians in identifying what changes would help to enhance community wellbeing. Many have in common a stated desire to:

- reduce economic and social disadvantage;
- ensure that all members of the community have ready access to high quality health care services;
- provide the sort of education that will allow young Australians to take best advantage of emerging opportunities in a ‘knowledge nation’;
- provide relatively well-paid and satisfying jobs to Australian workers;
- ensure that older Australians can live in dignity, with their needs adequately met;
- achieve more sustainable development within cities and a better balance of development between cities and regions; and
- ameliorate the significant environmental problems confronting Australia.

Notwithstanding the diverse nature of these goals, the key policy implication that emerges is a simple one — namely, that economic growth will be essential to generate the additional wealth required to meet the substantial and wide ranging aspirations of the Australian community.

Of course, continuing economic growth will not automatically translate to higher living standards for all. The distribution of the benefits of growth, and indeed the way in which growth is pursued, also matter. However, economic growth is undeniably a key facilitator of broadly-based improvements in wellbeing. Ross Garnaut (2002) recently observed:

Effective measures to promote distributional equity make large demands on a country’s fiscal resources. Economic growth is therefore a necessary underpinning of progress towards distributional equity. For these reasons, it remains likely that Australia will have all of productivity-raising economic reform, progress towards greater distributional equity and stronger economic growth, or none of them.

According to Garnaut, economic growth a lower priority is similarly not a viable option. As discussed in box 7.2, such a policy shift would have a range of adverse consequences for living standards and wellbeing more generally.

There is scope for Australia to do better

Notwithstanding the large improvement in Australia’s performance against a range of economic and non-economic indicators over the last decade or so (see chapter 3), in many areas, there are still sizeable inefficiencies or other performance gaps.

At a broad level, while Australia's productivity has increased rapidly since the early 1990s, absolute productivity *levels* still remain below those in many other developed countries. One simple indication of this productivity gap is the difference in GDP per hour worked — a measure of labour productivity (see figure 7.1). In this regard, the OECD's most recent country assessment commented:

Productivity measures consistently show that output per hour worked in Australia, while rising briskly, remains well below that in technologically leading countries. This suggests that there is further scope for catch up. (OECD 2004a, p. 13)

Clearly, such 'high level' indicators must be interpreted with caution. For example, GDP per hour worked is influenced by the resources available to a country, as well as on how effectively those resource endowments are employed. Also, differences in labour productivity do not necessarily translate into differences in per capita incomes. Western European countries, for example, tend to have higher levels of labour productivity — mostly because of greater capital intensity of production rather than greater efficiency — but lower participation rates and lower average hours worked (McGuckin and van Ark 2004). Higher capital intensity and associated lower participation and hours worked in these countries are often attributed to more rigid labour markets.

But there are also a range of more specific indicators of sizeable performance gaps:

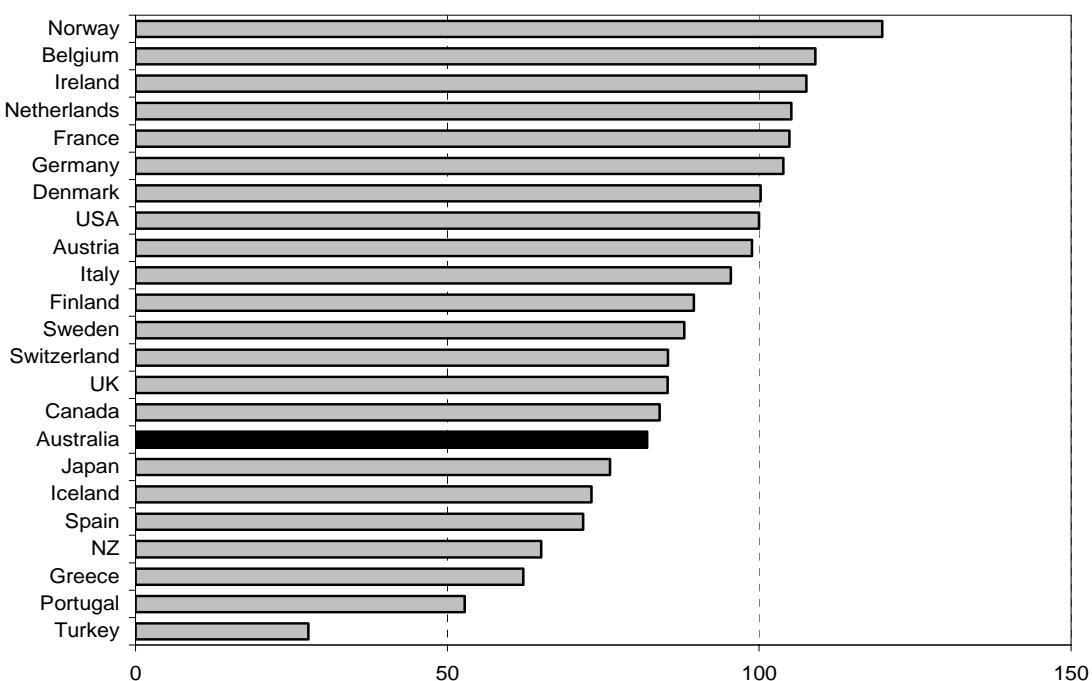
- As discussed in the following chapter, there are still significant inefficiencies in many key infrastructure sectors.
- And, though broad outcomes achieved in key human service areas such as health and education are comparable with many other developed countries, the potential to get better value from the community's major resource commitment in these areas is widely acknowledged (see chapter 11).

A study by the Allen Consulting Group commissioned by the National Competition Council (NCC 2004e) comparing the level of reform undertaken in Australia with that in other OECD countries, identified similar opportunities for beneficial change in these areas.

That Australia still lies well inside the performance frontier in many sectors is a source of opportunity for raising living standards further in the future. For example, were it possible to achieve the same labour productivity levels as in the United States — still well below the world's best performance levels — Australian gross household income would rise by 20 per cent or some \$22 000 a year. Whether or not achieving US levels of productivity is realistic, the benefits for Australia from realising our productivity *potential* are nonetheless likely to be very significant.

Figure 7.1 GDP per hour worked in OECD countries, 2003

Index^a : United States=100



^a Index calculated in 'purchasing power parity' terms.

Data source: GGDC (2004).

How will reform help to meet the challenges?

To meet the various domestic and global challenges outlined above, and to improve standards of living generally, action will be required on many fronts. While unlikely to be sufficient in most areas, further competition-related and other microeconomic reform can still play a key role in raising productivity and improving sustainability.

In various ways, carefully developed and well implemented reform will boost Australia's growth potential and thereby generate additional wealth to help meet the costs of ageing, environmental remediation and other social and environmental goals. For example:

- Reform-induced improvements in productivity will enable the delivery of more and better quality goods and services from available resources (or allow a given bundle of goods and services to be produced with fewer resources).
- Lower costs for infrastructure services (see box 7.3) and other inputs will enhance the capacity of Australian firms to operate successfully in more competitive and complex global markets.

Box 7.3 Why are infrastructure services a continuing reform priority?

Infrastructure services — energy, communications, transport and water — are a large part of the Australian economy, accounting for more than 10 per cent of GDP. But their significance to Australia's economic performance and standard of living involves much more than size.

- Infrastructure services are key inputs for many Australian businesses, with service costs, reliability and quality having a major bearing on Australia's international competitiveness. Because Australia is a large country with dispersed population centres and remote from major overseas markets, access to reliable and efficient transport and communication services is especially important in this regard.
- For most households, affordable and reliable services such as power, water and telecommunications are central to basic quality of life.
- Infrastructure services are highly capital-intensive, requiring large investments in long-lived assets. Poor investment decisions leading to wasteful over-capacity or the installation of assets ill-suited to the needs of users, or alternatively lack of investment resulting in service gaps and bottlenecks, could constrain Australia's growth and standard of living for many years.
- Investment choices can also have pervasive impacts on the future uptake of new technologies. For example, today's decisions will determine the technology in place over the next 30 to 40 years to tackle problems such as congestion in our cities, greenhouse gas emissions and environmental degradation.

Reforms to promote greater competition in the provision of infrastructure services have been a key element of NCP and have contributed to substantial improvements in outcomes in most service areas (see chapters 3 to 5). However, significant performance gaps remain. As outlined in chapter 8, taking advantage of further opportunities to encourage efficient competition in service provision is likely to be an important avenue for closing or eliminating those gaps.

- So too will the greater flexibility, innovativeness and responsiveness to customer needs that ongoing microeconomic reform can engender in businesses and their employees.
- By facilitating the development of emerging export industries, further reform is likely to reduce the extent to which any loss of competitiveness in traditional export sectors will weigh upon the economy.

Also, competition-related and other reforms can directly assist in offsetting the adverse economic impacts of ageing. For instance, reforms which reduce constraints on labour supply will ameliorate one of the important aged-related brakes on Australia's future growth potential. And, as illustrated by various recent policy initiatives in the human services sector (see chapter 11), market-based approaches can often be employed within a managed framework to improve the cost-

effectiveness (including quality) of services such as health and aged care. Given the large projected increase in coming decades in health care expenditure in particular, inefficiencies that are not addressed now will become particularly costly in the future.

More generally, the very large resource commitment involved in meeting community needs across the spectrum of human services, suggests that improvements in efficiency and cost-effectiveness are likely to be of major benefit to the community. In this regard, it is important to recognise that the dividend from such improvements can be returned to the community in various ways, including through better levels of service or more widely accessible services. Notably, participants representing the social welfare sector at the Commission's policy roundtable (see appendix A) observed that reforms in the human services area may well be of greater benefit to lower income Australians, and to those in regional areas, than the more 'traditional' targets for reform. In other words, reform which enhances productivity and sustainability can be compatible with, and can contribute to, social goals.

In the Commission's view, these are compelling reasons for encompassing the human services area within the 'mainstream' reform agenda (see chapter 11). In some senses, this would simply formalise what has already been happening. However, a more explicit focus on the role of reform in these areas in meeting the ageing challenge and enhancing standards of living more generally, could add momentum to the reform process and hence hasten the introduction of necessary changes. Indeed, early policy action to address the impacts of ageing on the provision and financing of human services will reduce the likelihood that 'reactive' and potentially costly interventions — such as excessive tax hikes or the rationing of health and aged care services — will be required at a later date. Hence, both the recent Intergenerational Report (Australian Treasury 2002) and the Hogan Report (2004) into aged care, as well as earlier superannuation and pension reforms, explicitly recognise the advantages of appropriately phased pre-emptive policies.

Similar observations can also be made in relation to natural resource management. As in the human services area, there is growing recognition in policy circles that the creation of managed markets can reduce the cost of meeting some important environmental and sustainability goals. Recent or mooted initiatives to allow for trade in water and greenhouse gas emissions are cases in point. Again, therefore, incorporation of this area within the mainstream reform agenda would seem highly desirable.

The Commission emphasises that in positioning Australia to take best advantage of new opportunities, and in addressing population ageing and other challenges,

competition-related and other microeconomic reform is not the only policy game in town. A range of other initiatives and actions will be required. For example:

- Microeconomic reform will not obviate the need to commit additional resources in some areas. Apart from the previously noted examples of health, aged care and environmental remediation, there are legitimate concerns about the capacity of some of Australia's economic infrastructure to service future needs. Also, many have suggested that additional resources should be expended on education and training to help build our innovative capacities. For example, commenting on the need for an efficiently managed and well-funded university sector, the Business Council of Australia said:

In a global economy that increasingly values knowledge, universities play a vital role in providing training and skills development, and creating and diffusing R&D, innovation and knowledge throughout the economy. (sub. DR234, p. 4)

- In some cases, new or enhanced regulatory regimes will be required to cater for changing community preferences, or to respond to technology-driven changes in markets. Hence, demand for more environmentally friendly and sustainable outcomes will inevitably give rise to the need for new environmental regulation. And in the communications area, technological convergence is already leading to profound reconfigurations of markets that have rendered some traditional modes of regulation obsolete.
- By themselves, labour market and other microeconomic reforms are unlikely to deliver the increase in workforce participation required to counteract the impacts of population ageing on labour supply. Tax, social welfare and retirement incomes policies — all typically viewed as separate from 'microeconomic' reform — will also be important. So too will be: 'family friendly' workplace initiatives to increase female participation rates; efforts to change community attitudes towards older workers; and measures to provide more options for older workers seeking to remain in the workforce on a part time basis.

Further, though governments have an important role to play in ensuring that all sections of the community have the opportunity to benefit from reform and economic growth more generally, much of the responsibility for taking advantage of those opportunities will lie with businesses, their employees and individuals.

But such complementary requirements do not negate the proposition that competition-related and other microeconomic reform will be a key part of the policy armoury for increasing productivity and delivering sustainable outcomes for the community in some challenging times ahead. As the Business Council of Australia argued:

... now is not the time to rest on our laurels. ... the ability of the Australian economy to remain competitive, flexible and innovative will determine how well Australians

continue to improve their lot in life. There is a need to re-invigorate and broaden the reform agenda. Not doing so spells danger for the Australian economy and our quality of life. (sub. 84, p. 1)

7.3 No change is not a viable option

Adjustment pressures cannot be avoided

Despite the widely acknowledged role of competition-related and other microeconomic reform in improving living standards, as noted at the outset of the chapter, reform ‘fatigue’ and ‘malaise’ appear to have been growing. In part, this reflects an understandable desire at both the community and political levels to escape the pressures and adjustment costs that attach to reform.

However, the notion that adjustment pressures can be avoided by holding back on reform is unrealistic. There are a range of other factors that will necessitate major adjustments in the Australian economy and society in coming years. Economic growth in developing countries, technological developments, attitudinal change and demographic factors (including population ageing) are but some examples. In other words, the community will have to deal with ongoing and often significant change, irrespective of the approach taken in relation to reform.

Moreover, other countries will not be standing still. Indeed, in an increasingly integrated global economy, policy inefficiencies in particular countries will be more heavily punished. Were Australia to abandon a commitment to reform, the magnitude of the required adjustments and their associated costs might well be larger not smaller. That is, ongoing reform can facilitate the development of a more resilient economy that is less susceptible to shocks — a point illustrated by Australia’s capacity to ‘ride-out’ the recent Asian economic crisis.

But building support for reform will be very important

At the same time, evidence of growing resistance to reform cannot be ignored by governments and others involved in the decision-making process. While broadly-based reform can internalise some adjustment costs — those who are disadvantaged by some reforms benefit from others — there are limits on both the community’s capacity to cope with change and the number of reforms that governments can implement effectively at any one time. This is one of the reasons why a future reform agenda should be focussed on those areas likely to provide the largest pay-offs for the community. In counteracting reform fatigue, access to effective social

‘safety nets’ for those who are significantly disadvantaged by particular reforms will also be very important.

In addition, a diminished appetite for change increases the onus on those responsible for formulating and implementing competition-related and other microeconomic reforms to explain to the community why Australia cannot afford to rest on its laurels. It is also important to acknowledge that reform will inevitably involve transitional costs for some groups in the community. Hence, consultation with those parties directly affected by particular reforms will be very important, not only in ensuring that those reforms give appropriate weight to competing interests, but also in helping policy makers to determine whether some sort of adjustment support is required. Some specific requirements to give effect to these goals as part of a future nationally coordinated reform program are explored in chapter 12.

Finally, explicit recognition by those responsible for developing and implementing reforms that one size does *not* fit all could also help to build support for further change. NCP has addressed many of the systemic inefficiencies in the delivery of infrastructure services. Hence, in the future, service-specific reforms are likely to be increasingly important. Similarly, the complex nature of human services and their role in furthering a range of social objectives, will require careful adaptation of generic reform approaches to the particular circumstances at hand. Indeed, the diversity of services and objectives encompassed within sectors such as health care and education and training will call for the tailoring of reforms within, as well as across, sectors.

Avoiding ‘backsliding’ will also be critical

Just as Australia cannot afford to forgo opportunities for further competition-related and other reform, so too must it avoid backsliding on the many beneficial reforms undertaken over the last two decades, or those that are still in the process of being implemented. For example, any unwinding of competition policy would increase costs, undermine incentives for future productivity improvement and reduce the flexibility and adaptability of the economy to changing circumstances. The ensuing reduction in Australia’s competitiveness relative to countries that are continuing to improve, would in turn detract from our future standard of living.

Moreover, backsliding would send an unfortunate signal about the commitment of governments to resisting pressure from sectional interest groups. Hence, mechanisms that can help to lock-in the gains of previous competition-related and other reforms should be a central component of the procedural framework attaching to any future reform agenda.

7.4 Delineation of a future reform agenda

Given the focus of this inquiry, much of the commentary in submissions on the future agenda related to sector-specific competition-related reforms, or to systemic approaches to promoting efficient competition across the economy. In this latter context, for example, the ACCC (sub. 111, pp. 4-5) referred to the need to protect competition in ‘functioning’ markets; promote competition in ‘non-functioning’ markets; and support competition through regulatory certainty and efficient pricing.

However, in addressing the agenda that might emerge from this inquiry, some participants also drew on other distinctive features of NCP — especially its focus on the development of national markets, and on areas where nationally coordinated reform frameworks have a key role to play in facilitating effective reform. For instance:

- In commenting on future reform contexts, the NCC (sub. 71, p. 29) emphasised the value of national consistency and a focus on national best practice.
- The ACCC (sub. 111, p. 5) referred to the importance of developing contestable national markets through coordinated and consistent regulatory frameworks.
- And, in mapping out some core procedural requirements for a new agenda, the Victorian Government said:

The reform agenda should focus on issues that have general applicability across a number of Australian jurisdictions, thereby making them appropriate for a CoAG framework. Reforms must be ‘CoAG friendly.’

... Also, continuing the theme of previous reforms, any new national reform agenda should encourage and reward the development of competitive national markets and closer harmonisation between jurisdictions. (sub. 51, pp. 17-18)

Against this backdrop, and in keeping with the terms of reference, the Commission has sought to delineate an agenda that provides an element of continuity with, and builds on, the NCP. That said, the Commission has not focussed on competition per se. Rather, it has first sought to identify reform areas:

- that are inherently national in character and which offer the prospect of a significant pay-off for the community; and
- where competition-related measures and other market-based instruments and approaches would be potentially beneficial — though not necessarily the primary vehicles — for building a more productive and sustainable Australia.

From within this group, it has then identified areas where nationally coordinated reform frameworks overseen by CoAG or another national leadership body could be

particularly helpful in facilitating effective reform and where the lessons from NCP are therefore likely to be most relevant. Specifically:

- Chapter 8 focuses on further reform to the provision of infrastructure services. In these areas, competition-related reform is likely to be a key element in delivering more efficient, equitable and sustainable outcomes. Moreover, the desirability of achieving integrated markets for major infrastructure services in particular, makes effective nationally coordinated reform frameworks a high priority. In many respects, the agenda identified by the Commission in these areas simply represents an extension to NCP.
- Chapter 9 discusses options for improving legislation review and gate-keeping processes for new and amended legislation. It also highlights some important legislation reviews that have yet to be undertaken, as well as indicating some priority ‘second round’ reviews that should form part of a modified legislation review process.
- Chapter 10 explores other ways to improve the broader institutional and regulatory architecture in place to promote efficient competition across the economy. While much of what has been implemented under NCP remains appropriate, shortcomings and gaps in aspects of that architecture are apparent. Here too, much of the agenda proposed by the Commission can effectively be viewed as ‘NCP plus’.
- Chapter 11 looks at reform needs and opportunities in the human services and natural resource management areas. For the reasons outlined above, there is a compelling case for encompassing these areas within an agenda for nationally coordinated reform. And, while there are obvious constraints on the use of competition-related and other market-based approaches in both areas, there is widespread agreement that such approaches can nonetheless help to achieve more equitable, cost-effective and sustainable outcomes.

In summary, though the proposed agenda envisages further competition-related reforms it has a much broader focus — namely: to harness national coordination and cooperation to help build a more productive and sustainable Australia. In essence, the latter requires that policy settings are consistent with, and help to promote, the economic, social and environmental needs of future as well as current generations.

The Commission acknowledges that its approach to delineating such a future reform agenda involves a degree of arbitrariness. As the many and varied reform proposals from participants serve to illustrate, there are no clear cut boundaries between competition-related and other microeconomic reforms. Further, the extent to which national coordination would facilitate reform efforts in particular areas is obviously a matter for judgement. Not surprisingly, therefore, while broadly supportive of the

Commission's approach, several participants differed on the precise scope of the future reform agenda proposed in the Discussion Draft.

The Commission stresses that the exclusion of a particular policy area from the proposed agenda does not imply that reform in that area is seen as unimportant. Accordingly, in chapter 11, it has also dealt briefly with some other high priority reform areas that participants suggested should be added to the proposed agenda, or which will otherwise be important in helping to improve future living standards.

Some respondents to the Discussion Draft also differed on the priorities attached by the Commission to particular items on the proposed agenda, or requested that it highlight some especially high priorities within that agenda. Guidance on priorities can clearly be useful, especially given limits on the amount of reform that a body such as CoAG could effectively oversee at any one time. Thus, in the final chapter, the Commission has identified a sub-group of the 'new' areas on its proposed agenda where the pay-offs from nationally coordinated reform approaches are judged to be very high and where coordination problems, or past coordination failures, have been particularly acute. The final chapter also comments on the merits of different broad institutional and procedural approaches to give effect to its proposed agenda, drawing on lessons from NCP identified in chapter 6.

8 Further infrastructure reform

Key points

- There are significant opportunities to improve the efficiency of economic infrastructure through further competition-related reforms.
- The energy and water sectors remain priorities for nationally coordinated reform. CoAG has already sponsored the development of new reform agendas for each of these sectors. These agendas should provide the basis for further performance improvements, though much detailed policy development, and leadership to overcome delays is still required. In addition:
 - In the energy sector, there is a need to enhance the operation of the National Electricity Market. Addressing regulatory fragmentation and policy uncertainty in relation to greenhouse gas abatement is also critical to the sector's future performance.
 - In the water sector, a key challenge is to better integrate the rural and urban water reform agendas and to achieve more effective management of environmental externalities.
 - In both sectors, the next phase of reform has effectively been removed from current NCP arrangements. Progress would be facilitated by the re-instatement of effective independent review mechanisms.
- Two dimensions of transport infrastructure would also benefit from the development of comprehensive reform agendas at the national level.
 - There is a need to work towards achieving an efficient and sustainable national freight system that does not distort activity in favour of individual transport modes.
 - A national review of passenger transport would provide a means to assess the impact of recent reforms and what is required to achieve more cost-effective, accessible and environmentally sustainable passenger transport services.
- Although not a matter for collective action by CoAG, further reform in the communications sector is of national importance.
 - Coordinated action to address anti-competitive aspects of broadcasting regulation identified in the NCP's legislation review program is a short term priority.
 - Prior to any sale of Telstra, the Australian Government should conduct a comprehensive review of telecommunications regulation, including assessment of: the merits of further operational separation and an access regime for telecommunications content; and whether current regulations adequately address concerns about Telstra's entry into new markets.

Through the NCP reforms, considerable progress has been made in creating integrated and efficient national infrastructure markets. However, most participants considered that, despite some significant gains, there is considerable scope to do better. Apart from completing ‘unfinished business’ in the current NCP program, many pointed to opportunities to extend recent reforms and thereby enhance performance across a wide range of infrastructure and economic activities. The Commission concurs with this assessment.

8.1 The priority infrastructure sectors

As outlined in chapter 7, in identifying a reform agenda, the Commission has targeted areas that meet three tests: being inherently national in character; offering the prospect of significant gains; and likely to benefit from a nationally agreed reform framework under the stewardship of CoAG or another national leadership body.

Against these benchmarks, within the infrastructure area, it is clear that further nationally coordinated reforms in the energy and water sectors should continue to be a high priority. However, the Commission considers that developing nationally coordinated reform frameworks and programs for the freight transport and passenger transport sectors would also provide a high return to the community.

In nominating these areas, the Commission is not suggesting that other infrastructure services do not require further reform (see, for example, box 8.1). However, in the Commission’s view, they are of lesser priority and are less likely to require high level inter-jurisdictional coordination of the reform process. That said, even though here nationally coordinated approaches are not required to progress reform, the Commission has also nominated communications as a priority area because of its manifest national importance and the opportunities for further performance improvement evident from the NCP legislation reviews in this sector.

The remainder of this chapter looks at each of the priority infrastructure sectors in turn:

- Energy (section 8.2);
- Water (section 8.3);
- Freight transport (section 8.4);
- Passenger transport (section 8.5); and
- Communications (section 8.6).

Box 8.1 Some areas excluded from the Commission's proposed infrastructure reform agenda

Postal services

Australia's postal system is generally recognised as being amongst the best in the world. Moreover, Australia Post's statutory monopoly is now restricted to only two 'reserved' services:

- the collection and delivery of standard letters within Australia; and
- the delivery of incoming international mail.

The significance of these restrictions on competition is being eroded by increased competition from new technologies (such as e-mail and the Internet). Also, the Australian Government has recently introduced a number of changes designed to further increase competition in the sector, including:

- giving the ACCC the power to hear disputes about the terms and conditions of Australia Post's bulk mail services; and
- requiring Australia Post to keep records about the financial relationship between different parts of its business, and to publish reports to 'assure competitors' that it is not cross-subsidising its competitive services with revenue from its reserved services.

At least compared to sectors such as energy and water, further reform to postal services therefore appears to be a relatively low priority.

International aviation services

Since the late 1990s the Australian Government has been pursuing a range of measures to liberalise international air services, including:

- the negotiation of reciprocal 'open skies' arrangements with like minded countries where this is in the national interest;
- offering international airlines unconstrained access to international airports other than Sydney, Melbourne, Brisbane and Perth for both freight and passenger services; and
- offering unrestricted access to all international airports for dedicated freighters.

While efficient international air services are extremely important to the tourism industry and to the freight costs of some Australian businesses, further reform in this area is most usefully pursued as a bilateral (or multilateral) trade issue rather than as a core competition policy issue. This is because liberalisation of international air services is one of relatively few areas where there is value in pursuing reciprocity rather than undertaking unilateral reform.

8.2 Energy

Reliable, affordable and sustainable energy services are critical to Australia's economic and social wellbeing. They are important inputs for most businesses and are essential for supporting basic quality of life.

Over the last ten years, the Australian energy sector has undergone considerable reform. As outlined in chapter 2, the NCP electricity and gas reforms have been central to efforts to create an efficient national energy market in Australia. Governments have now largely implemented the NCP energy reforms, although there are outstanding issues for particular jurisdictions (see chapter 2).

In responding to the Discussion Draft, a number of participants emphasised the importance of governments completing all outstanding NCP electricity and gas reforms. For example, Origin Energy contended that:

... it is a matter of urgency that Governments complete all outstanding NCP electricity and gas reforms. While the NCP reform program is largely complete in most jurisdictions the failure on the part of one or two jurisdictions to complete critical reform tasks, such as full retail contestability, seriously jeopardises the delivery of a fully competitive national energy market. (sub. DR197, p. 2)

The Commission notes that the benefits from completing the NCP electricity and gas reforms are not restricted to those jurisdictions that are part of the National Electricity Market (NEM). For example, the Western Australian Government cited research suggesting electricity reform in that State:

... could see an 8.5 per cent fall in electricity prices, \$300 million per annum increase in Gross State Product and 2900 additional jobs created by 2010. (sub. 117, p. 28)

RECOMMENDATION 8.1

Governments should complete all outstanding National Competition Policy electricity and gas reforms, including the introduction of full retail contestability.

Further reform is needed

Moreover, despite the progress made under NCP, there is still some way to go in order to realise CoAG's vision for the national energy market. Hence, the CoAG Energy Market Review (the Parer Review), reporting in December 2002, found that the NEM is still largely a series of regional markets with limited interconnection, and the gas market is immature and developing.

The key deficiencies identified by the Parer Review as contributing to this situation include:

-
- confused governance arrangements and excessive regulation;
 - inadequate competition between electricity generators to allow Australia's 'gross pool' system to work as intended;
 - inadequate transmission links and transmission arrangements that prevent the NEM becoming truly national;
 - impediments to the demand side playing a more significant role in the NEM (including retail price caps that limit the extent to which residential customers are encouraged by price changes to adjust their pattern of electricity consumption);
 - an illiquid financial contracts market that in part reflects substantial regulatory uncertainty;
 - insufficient upstream competition in the east coast gas market;
 - uncertainty surrounding new gas pipeline development; and
 - ad hoc and poorly targeted greenhouse gas policies.

The new energy reform program

In response to the Parer Review, the Ministerial Council on Energy (MCE) has agreed to a new energy market reform program (see box 8.2). In essence, this program is designed to deliver a regulatory environment that facilitates national market development in both electricity and gas and improved planning and development of the electricity transmission network.

Since the MCE finalised the details of the energy market reform program in December 2003, there have been a number of important developments.

The gas element of the energy market reform program was expanded in May 2004 with a view to accelerating the development of a reliable, competitive and secure natural gas market. The program covers gas market development, gas infrastructure issues, the review of the gas access regime and upstream gas issues.

- In December 2004 the MCE agreed to a set of principles for gas market development to: encourage transparency, new market entrants, investment in gas infrastructure such as pipelines and storage facilities, and provide a market mechanism to assist in managing supply and demand interruptions (MCE 2004d).

Box 8.2 The energy market reform program

In December 2003, the MCE announced a major energy market reform program to be implemented in the period to 2006, intended to strengthen competition and encourage investment in Australia's energy market.

The key elements of the MCE energy reform program include:

- The establishment of the Australian Energy Regulator (AER) with responsibility for market regulation and enforcement. The AER, though part of the ACCC, will be a separate legal entity. This means that the AER will make decisions on regulatory matters independently of the ACCC.
- The AER will exercise powers under the new national energy legislative framework, and undertake the sector-specific regulatory functions currently performed by the ACCC and the National Electricity Code Administrator (NECA).
- The establishment of the Australian Energy Market Commission (AEMC) with responsibility for rule-making and market development. The AEMC is also to be a separate legal entity, accountable to and subject to the policy direction of the MCE.
- The core functions of the AEMC include rule-making (code changes) and undertaking reviews, as directed by the MCE. It will undertake all code change and market development functions currently performed by the NECA, National Gas Pipelines Advisory Committee and Code Registrar. The AEMC has no regulatory enforcement responsibilities.
- Both the AER and AEMC are expected to be fully operational by mid-2005.
- NECA will be abolished once the AER and AEMC become operational.
- Retention by the ACCC of responsibility for competition regulation under Part IV of the *Trade Practices Act*, for competition-related code-change authorisations under Part VII, and for industry access code approvals under Part IIIA.
- Provision for consultation and co-operation between the AEMC, AER and ACCC to avoid regulatory duplication.
- In-principle agreement to develop a national approach to energy access under the *Trade Practices Act*, covering electricity and gas transmission and distribution.
- A package of reforms to improve the planning and development of electricity transmission networks.
- The alignment of retail price caps with costs and the periodic review of the need for price caps.
- Examination of a demand-side response pool in the NEM and interval metering.

Source: MCE (2003b, 2004a,c)

- The MCE has endorsed the decisions of the Ministerial Council on Mineral and Petroleum Resources (MCMPR) on those upstream gas issues arising from recommendations of the Parer Review. Amongst other things, the MCMPR has

agreed to undertake a review of the gas industry's upstream third party access principles (MCE 2004e).

- The MCE has indicated that it expects to finalise its response to the Productivity Commission's review of the National Gas Access Regime in the second quarter of 2005 (MCE 2004c).

In June 2004, the Australian Government released its energy white paper *Securing Australia's energy future* that positions the MCE's reform program within a broader energy policy framework. All CoAG members have signed the Australian Energy Market Agreement which sets out the new governance and institutional arrangements for the national energy market. And, in July 2004, the first Annual National Transmission Statement (ANTS) was released as part of the new national planning process for electricity transmission. ANTS provides an integrated overview of the current state and potential future development of the major national transmission flow paths.

In August 2004, the MCE also agreed to implement the first stage of the National Framework for Energy Efficiency (NSEE). This package includes provision for: mandatory energy efficiency opportunity assessments and energy disclosure by Australia's 250 largest businesses; more stringent minimum design and energy performance measures for buildings; and improvements to the energy efficiency of major energy using appliances and equipment. These measures will be implemented over the period 2005-07, with consideration to be given to further possible measures, under a Stage Two NSEE, in the context of the current Productivity Commission inquiry into energy efficiency, due to report at the end of August 2005 (MCE 2004b).

An appropriate next step towards achieving an efficient national energy market

Generally, participants endorsed the MCE's energy reform program as providing a way of working through many of the outstanding issues. In particular, the creation of a national energy market regulator was seen as a positive step towards achieving regulatory harmonisation across jurisdictions.

The Commission broadly concurs with this assessment and considers that the transmission reforms and measures to improve user participation in the NEM are particularly important to the development of an efficient national energy market. That said, much hard work, detailed policy development and cooperation between jurisdictions will be required to translate what are still general reform directions into more specific, agreed, options for change. And, as the Australian Gas Light Company (AGL) noted, it is critical that the new energy reform program is fully implemented (sub. DR231).

A key test of the effectiveness of the MCE energy market reform program will be its impact on investment over the next decade. The energy industry estimates that over this period, investment of \$37 billion will be required to ensure that energy needs are met (MCE 2003a). Investment on this scale has significant implications for the efficient allocation of resources across the economy. Given the long lead time involved in bringing new generating capacity online, it is also important to get the timing, location and nature of investment decisions right.

In this context, several participants pointed to the need for the MCE to:

- provide greater clarity about the development and implementation of the next phase of energy reform; and
- address gaps in the energy market reform program that are likely to have a material impact on the quality of investment decision-making.

Providing greater clarity about the reform process

To provide greater certainty about the reform process, several market participants suggested that the MCE should articulate some ‘best practice’ principles to help guide the process. For example, in responding to the Discussion Draft, the Energy Retailers Association of Australia (ERAA) argued that:

... certain fundamental principles are not clearly incorporated into elements of the MCE reform program. These principles include transparency, appropriate consultation, appropriate governance and institutional arrangements, strong appeal rights and accountability for market funded institutions. (sub. DR167, p. 10)

Further, there is already considerable concern about lack of progress in implementing key elements of the new energy market reform program. For instance, AGL suggested that implementation delays have resulted in truncated and less meaningful consultation, and that there is a need for the MCE to consider:

... whether the current timetable, work program, and resources will achieve outcomes that are best suited to delivering the desired objectives. (sub. DR231, p. 1)

Arguably, however, the most pressing issue is the delay in the establishment of the AER and AEMC and clarifying their respective roles and responsibilities. These organisations are intended to play a central role in rationalising energy regulation and rule making across Australia, and thereby enhancing regulatory certainty and lowering barriers to competition. However, there appears to be considerable uncertainty about what functions they will actually perform and their degree of independence from the ACCC.

In the Commission's view, some degree of uncertainty is inevitably associated with the implementation of complex reform agendas. However, uncertainty of this nature can impose significant costs, for example, by increasing market perceptions of regulatory risk and potentially increasing the cost of investment. The Independent Competition and Regulatory Commission (ICRC) of the Australian Capital Territory observed that uncertainty about the AER and AEMC has:

... created wider uncertainty not only within the market place but also within regulatory agencies. This uncertainty may be affecting investment decisions of regulated firms and the administrative decisions of regulatory agencies. (sub. DR213, p. 1)

To a large extent, the current uncertainty about the implementation of the energy market reform program is likely to disappear once the AER and AEMC become fully operational. The MCE should therefore seek to resolve any outstanding issues concerning the commencement, operation and governance of the AER and AEMC as soon as possible. As discussed below, however, even with these new institutional arrangements in place, other initiatives are required to ensure there is an effective process for monitoring the implementation and outcomes of the energy market reform program.

RECOMMENDATION 8.2

The Ministerial Council on Energy should give high priority to resolving any outstanding issues concerning the commencement, operation and governance of the Australian Energy Regulator and the Australian Energy Market Commission.

Some gaps in the reform agenda

Participants also identified a number of gaps in the energy reform program that, without policy attention, could have a material impact on investors' willingness to invest in the NEM and the nature of the investments made. In particular, there is a perceived need in some quarters to:

- strengthen competition in the generation sector;
- resolve some emerging market structure issues;
- achieve a coordinated national approach to greenhouse gas abatement; and
- dispense with regulatory constraints on prices in circumstances where competitive markets have been established.

Ensuring there is effective competition in the generation sector

The Parer Review found that there was insufficient competition among generators to allow the NEM's 'gross pool' system to work as intended. According to Parer, generators in some jurisdictions are able to exert market power at certain times, thereby increasing pool price volatility. Further, the review cited evidence from the ACCC suggesting that, in all NEM jurisdictions, market concentration is sufficient to give rise to market power (Parer 2002). To strengthen competition among generators, the review recommended a package of measures, including:

- structural reforms involving the disaggregation of government-owned generation businesses (such as in New South Wales and Western Australia) and their subsequent divestiture;
- encouraging more efficient levels of inter-regional trade and transmission development (through its proposed package of transmission reforms);
- removing 'market distorting' mechanisms (such as the Electricity Tariff Equalisation Fund in New South Wales); and
- tightening the ACCC merger guidelines by including specific criteria to guide decisions in relation to mergers between generators.

However, the MCE's energy market reform program has adopted only a part of this package. In effect, it relies largely on the facilitation of inter-regional trade in electricity through transmission development to promote sustainable competition between generators across the NEM.

A number of participants expressed concern about the limited nature of the MCE's response and the impact of excessive price volatility on investment decision-making. For example, the Energy Users Association of Australia (EUAA) argued that:

Unhealthy levels of price volatility created by gaming activity in the wholesale market distorts investment signals. NSW and Victoria face the possibility of further base load capacity within the next five to six years and combined with the high sunk costs and lead time required with base load generation investment there is a real risk for end users that appropriate generation investment will not occur or will be delayed. (sub. 123, p. 16)

The cost to the community of such outcomes could be very significant. Accordingly, in the Discussion Draft, the Commission proposed that the MCE should resolve whether generator market power in particular regions is still excessive and if there is a need for further disaggregation of government-owned generation businesses.

In responding to the Discussion Draft, a number of industry participants argued strongly against the need for any further investigation of generator market power (for example, Enertrade, sub. DR168; and the National Generators Forum, sub. DR220). These participants contended that:

- Electricity prices are consistent with the operation of a competitive market and the short term price volatility in the spot market is not necessarily indicative of an abuse of market power by generators. Price movements have an important role to play in eliciting short term supply and demand responses and, over the medium term, in signalling the need for new investment.
- The ability of generators to exercise market power is overstated. The National Electricity Code contains a number of prescriptive requirements for withdrawal of capacity or rebids, including broad powers for NECA to investigate and substantiate the reasons for such activities.
- The wholesale electricity market is continuing to evolve, including through the development of a more diversified mix of supply side options (such as peaking generators, embedded generation capacity and the transmission interconnectors).
- Significant investment in generation capacity from new entrants over the next decade may reduce market concentrations.
- An MCE sponsored review of generator market power would add to the profile of market risks facing new investors and potentially deter investment.

Effective competition among generators is clearly essential to secure efficient market outcomes and the lowest possible prices for energy users. Moreover, in the Commission's view, the potential for further significant gains from strengthening competition in the generation sector has been clearly established by the Parer Review.

Within the broad regulatory framework in place to promote and protect competition in the electricity market, there are two major options for enhancing competition among existing generators: increasing the capacity of the state interconnectors; and further disaggregation of government-owned generation businesses. In time, investment in additional generation capacity by new entrants is also likely to strengthen competition.

However, there are limits on the extent to which the state interconnectors can be relied upon to ensure there is effective competition in the generation sector — including capacity constraints of the existing interconnectors and the likely prohibitive costs of installing sufficient capacity to avoid the possibility of price surges.

The Commission therefore reaffirms its position in the Discussion Draft that relevant governments should consider further disaggregation of their generation businesses, where the benefits from increasing competitive pressures are likely to exceed the transaction and other costs associated with disaggregation. As noted by the Queensland Government (sub. DR189, p. 4) these costs potentially include foregoing economies of scale and scope, and increased governance and corporate overheads.

Notwithstanding such costs, in the Commission's view, further disaggregation of government-owned generation businesses is likely to be the most cost-effective means of promoting stronger competition in particular regions. In this regard, the Commission concurs with the Parer Review's assessment that the New South Wales and Western Australian governments should examine opportunities for the disaggregation of their publicly-owned generation assets.

As a general rule, in promoting competition, the question of public versus private ownership is in most respects secondary to ensuring that there are efficient market structures in place. However, once efficient structures have been established, governments should assess whether continued public ownership of their generation businesses is warranted. In this regard, the Commission also agrees with the Parer Review's assessment that divestment of publicly-owned generation assets may have wider benefits, including reinforcing the confidence of private generators in the integrity of the market, thereby providing greater certainty for new investment.

RECOMMENDATION 8.3

Consistent with the findings of the Parer Review, the New South Wales and Western Australian Governments should further examine opportunities for the disaggregation of their publicly-owned generation assets. Once efficient market structures have been established, governments which currently own generation businesses should consider divesting them.

Resolving market structure issues

A major issue of contention in this inquiry has been the adequacy of current institutional arrangements in screening the competition implications of merger and acquisition activity in the electricity industry. Some have suggested that, for this particular industry, the economy-wide regulatory safeguards embodied in section 50 of the TPA are not sufficient to protect competition and that some additional policy response is required.

Section 50 of the TPA prohibits a merger or acquisition which would be likely to 'substantially lessen' competition, unless it is authorised by the ACCC on public

benefit grounds. It also provides a framework for assessing the likely competition effects of a merger or acquisition, that is generally applicable across the economy.

The ACCC has developed a set of guidelines in applying section 50. These set out a five stage evaluation process, starting with definition of the relevant market and moving through to consideration of market concentration thresholds; import competition; barriers to entry; and other structural and behavioural market features.

As noted, the Parer Review recommended tightening the merger guidelines to include sector-specific criteria to guide decisions in relation to mergers between generators. However, the recommendation appears to have been overtaken by events with, in particular, recent moves towards vertical reintegration of generators and retailers.

Significantly, in response to the Discussion Draft, there was broad agreement among participants that no change is required to section 50 and that it should continue to apply to the electricity industry as it does to other industries (see for example, the Law Council of Australia, sub. DR237).

Those concerned about the adequacy of section 50 in protecting competition in the electricity industry, saw a need to introduce additional mechanisms — in particular, sector-specific cross ownership restrictions. There are two precedents for such a policy.

- At the national level, section 44 of the Airports Act 1996 prevents an airline holding a stake in a major airport of more than five per cent.
- In Victoria, the Electricity Act 2000 currently prohibits holders of electricity transmission, distribution or generation licences from acquiring certain interests in other licensees. (Exemptions are available, including through the ACCC merger clearance and authorisation processes, and for the construction of new generation facilities.)

In the Discussion Draft, the Commission contended that it is currently unclear whether a significant problem exists in relation to screening the competition implications of mergers in the electricity industry, particularly on the basis of merger activity to date. However, the Commission was concerned that uncertainty created by continuing debate about this issue could deter investment. Accordingly, it proposed that an independent process be established to assess whether current institutional arrangements for screening the competition implications of any reintegration in the electricity industry needed strengthening.

The adequacy of section 50 as a stand alone mechanism was canvassed extensively in submissions responding to the Discussion Draft. The opposing views

encompassed in the extensive commentaries provided on this issue by the ACCC (subs. 111, DR145, DR165, DR261, DR263 and trans., pp. 258-281); and Charles River Associates (formerly the Network Economics Consulting Group, subs. 134, DR250, and trans., pp. 69-89) are summarised in box 8.3. Those arguing that section 50 was intrinsically adequate, also maintained that commissioning a review in this area would create uncertainty in the electricity market and potentially deter investment (see, for example, Enertrade, sub. DR168; and AGL sub. DR231).

Mergers between generators?

Notwithstanding its view that initiatives are required to promote competition in the generation sector (see above), the Commission is not convinced that a review of the adequacy of section 50 in relation to mergers between generators is warranted. Put simply, there does not appear to be anything inherent in mergers between generators that section 50 would not be able to handle. The prospect that some market power currently exists does not preclude a useful role for section 50 in preventing mergers that would exacerbate this situation. Similarly, the authorisation provisions remain relevant to assessing whether such mergers may still be warranted on efficiency grounds.

That said, it is acknowledged that electricity generation has some unusual characteristics which, in combination, may mean the industry-wide concentration ratios specified in the ACCC merger guidelines, are too high to be effective as an initial screening device for market power in this sector. However, even if this were the case, it would be an issue for the ACCC merger guidelines rather than necessarily indicating there is a problem with section 50.

Common ownership of transmission and generating assets?

In considering the issue of the adequacy of section 50 in relation to vertical mergers, it is important to distinguish between mergers involving contestable elements of the electricity supply chain (such as generators and retailers) and mergers of contestable and non-contestable elements (such as generators and transmission entities). In the Commission's view, section 50 should be able to effectively screen the competition implications of mergers between generators and retailers. What is far less clear is whether section 50 is adequate to protect competition in the case of mergers involving transmission entities and generators.

By their nature, mergers involving transmission entities and generators would be more problematic than mergers between generators and retailers. This is because common ownership of transmission and generation assets raises the possibility of the integrated entity exercising market power to stifle or prevent competition in the

Box 8.3 Opposing views on the adequacy of section 50 of the TPA

The ACCC argues that it is presently unclear whether section 50 of the TPA can deal with reintegration issues in the electricity industry. It is particularly concerned that vertical mergers of contestable and non-contestable elements of the industry and horizontal mergers of generators could unwind the benefits of the structural reforms undertaken during the 1990s.

The key elements in the ACCC's case include:

- There was a presumption in the Hilmer report in favour of structural separation. This reflected concerns about the ability of a vertically integrated service provider to use its market power in one part of the supply chain to stifle or prevent competition in other potentially competitive segments. The costs associated with diminishing competition are as relevant today as at the time of the Hilmer review, as is the need for a cost-benefit analysis of the benefits of structural separation.
- Section 50 is not designed to promote competition by separating out contestable and non-contestable elements of the supply chain. Structural separation in the electricity industry did not occur through the application of the TPA; rather electricity-specific policies were required. Going forward, the merger provisions will not be sufficient to ensure the continued separation of the contestable and non-contestable elements.
- Section 50 is not designed to promote competition in markets that are not already competitive, rather, it is designed to protect competition in contestable markets where there is effective competition. Competition among generators in particular regions (for example, New South Wales) is inadequate. While new entrants could increase competition in these regions over time, section 50 is a poor tool for preventing capacity augmentation coming from expansion in existing generation businesses rather than new entrants.
- There are limits to the extent to which interconnection between regions can be relied upon to ensure there is effective competition between generators. There are capacity constraints on the existing interconnectors and the cost of expanding that capacity to ensure effective competition at all times would most likely be prohibitive. And, even in the absence of interconnector capacity constraints, it may still be possible for generators to exercise market power.
- Electricity generation has some special characteristics that mean the application of typical concentration ratios to proposed mergers of generators may not give a complete picture of the merged entity's ability to exercise market power. These special characteristics include a high degree of price variability (accentuated because electricity cannot be stored), constraints on the inter-state trade of electricity and highly inelastic demand.
- It is questionable whether the courts are in a good position to deal with the complexities of the generation market.

(Continued next page)

Box 8.3 (continued)

In contrast, Charles River Associates (CRA) argue there is no reason to suppose that the provisions of section 50 are not sufficient to deal with mergers in the electricity industry.

The key elements of the case made by CRA are:

- There should be no presumption in favour of structural separation. If there is a presumption, it should be in favour of allowing corporate boundaries to be determined by market forces rather than by regulators.
- A presumption in favour of structural separation could lead to the loss of important integration efficiencies. In many cases, this could significantly increase costs and reduce the ability of firms to innovate. Thus, maintaining a policy preference in favour of structural separation could put at risk private sector investment and the next round of productivity improvements.
- Circumstances have moved on since the Hilmer review and the case for structural separation is not as strong as it once was. In particular, with substantial new investment now required in the electricity industry, the risk management advantages of vertical integration loom larger than they did when there was significant over-capacity in the generation sector. Imposing industry-specific restrictions on reintegration, increases the risk and cost of investment by potentially denying firms the ability to coordinate investment between functionally related activities.
- The task of introducing competition does not fall to Part IV of the TPA, rather, it rests with Part IIIA and associated instruments.
- If existing structural regulations prove to be insufficient, there are a variety of conduct regulations that could ameliorate any resulting anti-competitive impacts. These include the access provisions contained in Part IIIA and Part XIC of the TPA, as well as the prices oversight provisions contained in Part VIIA of the TPA. A claim for further structural regulation would have to explain why these existing regulations are insufficient or otherwise inefficient.
- Extensive case law and analysis overseas shows that standard concepts of merger controls are well capable of being applied in the electricity market.
- While it is true that electricity has some unusual properties, the mere existence of those properties does not invalidate the principles underlying merger regulation, nor alter the analytical approach adopted to merger evaluation. These special features of the electricity industry should simply be taken into account when assessing barriers to entry and the impact of the merger on competition and (where authorisation is being sought) welfare.
- Given the courts are tasked with some of the most complex commercial disputes (for example, in terms of tax and corporations law matters), at times with very substantial penalties (including criminal), it would be surprising that they could not deal with section 50 matters involving electricity.

generation sector through its control of the transmission network, which provides an essential link between generators and distributors. Consequently, the Commission considers that the common ownership of transmission and generation assets involves significantly more risk for the efficient operation of the NEM and electricity users.

In this broader context of the common ownership of transmission and generation assets, section 50 would not be applicable in circumstances where a transmission entity chose to construct generating capacity of its own. Yet, common ownership achieved in this fashion could have similar effects on competition as a merger between a transmission entity and an existing generation business.

That said, it is important to recognise that the merger provisions of the TPA are only one part of the overall regulatory framework. Thus, were a ‘questionable’ vertical merger approved, or were common ownership to be achieved through the ‘construction’ route, the entity would still be subject to the access provisions of the National Electricity Code (which has been accepted by the ACCC as an industry-specific access code under Part IIIA of the TPA). The Code includes rules governing access to and pricing of transmission and distribution services.

As a general principle, it is desirable to let market forces determine market structure issues, subject to there being generally applicable rules and criteria for protecting and promoting competition across the economy. However, ensuring third party access to essential infrastructure assets is a difficult issue and it is a moot point whether relying on access provisions to promote competition is preferable to imposing structural rules.

Moreover, the current regulatory regime for the electricity market was developed on the basis of structural separation of the transmission network. In this regard, it is questionable whether current regulatory safeguards are sufficient to deal with anti-competitive behaviour arising from the common ownership of transmission and generation assets. Given the potential costs associated with such behaviour, further assessment of this issue would seem prudent.

The Commission emphasises, however, that any review in this area should consider the adequacy of the regulatory regime as a whole in protecting competition, and not be limited to the question of the adequacy of the merger provisions. Examination of the possible need for national or state legislated cross-ownership restrictions proscribing some forms of integration that involve the transmission network would clearly be a component of such an assessment.

An independent national review should be initiated by the Australian Government, in consultation with State and Territory governments, into the competition implications of cross-ownership of transmission and generation assets in the electricity industry. This review should consider the adequacy of the current regulatory regime impacting on such integration, including the access, prices oversight and merger provisions of the Trade Practice Act 1974. It should also consider the need for new legislated cross-ownership restrictions proscribing some forms of integration that involve the transmission network.

Reducing regulatory fragmentation and uncertainty around greenhouse gas abatement

The production of energy is a major and growing contributor to Australia's greenhouse gas emissions. In 2002, electricity generation accounted for 69 per cent of stationary energy emissions and 33 per cent of net national emissions (AGO 2004). Moreover, projections suggest that by 2020 greenhouse gas emissions from the stationary energy sector could be 64 per cent higher than the 1990 level (Australian Government Interdepartmental Greenhouse Projections Group 2003).

In this context, the energy sector obviously has a major role to play in greenhouse gas abatement. Indeed, the Australian, State and Territory governments have implemented a broad range of measures that seek to reduce all types of greenhouse gas emissions, but especially from energy generation.

However, the Parer Review found that these measures are poorly targeted, uncoordinated, and compete with each other — thereby creating uncertainty for the energy sector and the wider economy (Parer 2002). It recommended replacing many of the existing Federal and State greenhouse gas abatement schemes with an economy-wide emissions trading system. This system would involve capping total emissions; issuing permits to allow holders to release prescribed emission volumes; and providing scope for holders to trade their permits. However, the Parer Review also recommended that energy intensive users in the traded goods sector be exempt from the operation of the emissions trading system, until Australia's major international competitors introduce similar schemes.

In responding to the Parer Review, the MCE proposed to work closely with the CoAG High Level Group on Greenhouse in order to address greenhouse gas emissions by the energy sector on a national basis, observing that:

A holistic, integrated policy approach is required to give energy sector investors reasonable certainty about their greenhouse obligations, while maintaining the international competitiveness of Australian industry. Any abatement measures should be designed to be nationally consistent, and consistent with a future international scheme to the extent this can be predicted, and should utilise market mechanisms where this would be most efficient and effective. (MCE 2003b, p. 13)

As yet, however, this commitment has not translated into a firm process for dealing with the concerns raised in the Parer Review.

However, since the release of the Parer Review, the State and Territory governments have been working independently of the MCE to develop a model for a multi-jurisdictional emissions trading scheme founded on State and Territory powers and actions (see, The Cabinet Office of New South Wales, sub. DR185, p. 5).

In the Discussion Draft, the Commission proposed that the MCE should give priority to contributing to the development of a more effective process for achieving a national approach to greenhouse gas abatement. In reaching this view, the Commission took particular account of concerns raised by industry participants that:

- regulatory fragmentation across jurisdictions in the area of greenhouse gas abatement is imposing a high compliance burden on energy producers (particularly those operating in more than one jurisdiction);
- there is considerable uncertainty about future policy directions, including, for example, the role and nature of any carbon tax regime; and
- uncertainty (and the lack of coordination across jurisdictions) is impeding decision-making and potentially deterring new investment.

In response to the Discussion Draft, there was broad support among participants for much greater effort to be devoted to the development of a national approach to greenhouse gas abatement. For example, the Australian Chamber of Commerce and Industry (ACCI) considered that:

To deliver substantial, least-cost greenhouse gas abatement it is essential that a national approach be applied. The effect of piecemeal measures is that certain industries, dependent upon location and output, will bear a disproportionate cost burden placing pressure on their domestic and international competitiveness. (sub. DR198, p. 15)

And, Origin Energy pointed to the need to ensure that a market-based mechanism is in place to accommodate the further cuts in greenhouse gas emissions that are likely to be required in the longer-term.

Investment certainty for the near and medium term will be provided if all industry knows upfront that a framework for valuing carbon will exist in the longer term, and

that no “carbon holiday” can be assumed by new entrants. While investors will need to take a view on the actual quantum of the carbon signal, just as they will need to take a view on all other costs and benefits of their proposals, it will be on the basis of a stable and practical greenhouse policy. (sub. DR197, p. 9)

In the light of this support, the Commission reiterates the importance of reducing regulatory fragmentation and improving certainty about future policies in this key area (whatever the most appropriate responses might be). Australia can ill-afford regulatory arrangements that discourage efficient and timely investment in the energy sector, particularly at a point in the investment cycle when considerable new expenditure is required. Ultimately, however, the issue of greenhouse gas abatement goes beyond the energy sector and requires an economy-wide (if not global) perspective.

But whatever broad framework is most appropriate, the capacity of current CoAG greenhouse processes to deliver efficient policy outcomes in a timely manner is questionable. For example, there appears to have been little progress in further developing the National Greenhouse Strategy. Similarly, the Commission has concerns about the development of a State and Territory based national emissions trading scheme that lacks Commonwealth support or involvement.

Accordingly, the Commission considers high priority should be given to developing a more effective process for achieving a national approach to greenhouse gas abatement (see chapter 11). Such a process could draw on current policy developments — for example, the National Framework for Energy Efficiency being developed and implemented under the auspices of the MCE might have a role to play in this regard. Also, some of the issues that would be relevant to achieving better outcomes in this area are currently being considered as part of the Commission’s inquiry into energy efficiency.

The MCE would obviously have an important role to play in the development of a national approach to greenhouse gas abatement. In particular, its involvement could help to ensure that adequate attention is given to the implications for the energy sector of any new initiatives in this area.

Is there still a need for regulatory constraints on prices?

One of the challenges of regulating retail energy prices is ensuring that prices are still able to reflect changing market conditions and to induce appropriate responses from consumers and producers. It is particularly important that prices efficiently signal the need for consumers to adjust their consumption patterns in response to changing supply conditions and the need for producers to invest in new capacity.

However, across most of Australia, retail price caps in the electricity industry mean that the role of prices in signalling the changing balance between supply and demand is muted. Some participants argued that such regulation is thus a barrier to improving demand side responsiveness and innovation. The Energy Retailers Association of Australia observed that:

Whilst retail price controls remain, efficient market outcomes will be distorted and effective competition inhibited. For example, demand side responses require flexible and innovative pricing structures to be effective. Price controls prevent these innovations from developing, and thus frustrate the very objectives that governments are seeking from demand side response. (sub. 62, p. 5)

But even more importantly, if regulated prices are unduly suppressed, the longer term sustainability of supply could be compromised. The electricity crisis experienced by California in 2000-01, including rolling blackouts, highlights the dangers of (amongst other things) an undue focus on containing consumer prices (see, for example, Congressional Budget Office 2001 and Wolak 2004). Within Australia, recent electricity supply failures in Queensland have similarly raised questions about whether the current regulatory regime in that jurisdiction provides appropriate incentives to ensure reliable supply (see box 4.6).

The risks associated with unduly suppressing retail electricity prices were also canvassed in the Parer Review:

Regulating retail prices in an unregulated wholesale price environment inevitably means that retailers are exposed to substantial risk in the marketplace. Retailers must manage this risk as best they can, in an environment where pass through of additional costs to consumers may not be possible. This has very substantial risks for electricity supply. (Parer 2002, p. 177)

The Parer Review went on to recommend that full retail contestability should be introduced into all markets and retail price caps removed as soon as practical, but in any event before 2006 (Parer 2002, p. 178). However, in its response, the MCE was more equivocal, adopting the position that in those jurisdictions where full retail contestability applies, each jurisdiction should align its retail price caps with costs, and periodically review the need for the price caps (MCE 2003b).

The Commission notes that getting the right balance in price regulation between preventing abuses of market power and providing sufficient incentives for new investment is far from easy. With the transmission and distribution segments of the industry subject to access arrangements and the transition to full retail contestability now largely complete, the question arises as to whether regulatory constraints on prices are still required.

Some of those responding to the Discussion Draft argued that, at the conclusion of the current regulated retail price paths, competition will be effective in all markets and there will be no ongoing need to continue to regulate prices. For example, AGL contended that there is an expectation among market participants that retail price controls are only a transitional measure intended to provide a safety net for consumers during the introduction of competition (sub. DR231, p. 6).

But some other participants were concerned that the removal of retail price regulation could lead to price increases. The Public Interest Advocacy Centre, for instance, argued that households often have little discretion in their demand for energy services and that some could face considerable financial stress as a result of higher prices (sub. DR191, p. 2). Further, the Western Australian Department of Treasury and Finance cautioned that in removing retail price caps, proper consideration must be given to whether there is effective competition in the retail market (sub. DR236, p. 5).

The Commission agrees that until effective competition has been achieved in retail energy markets, removing regulatory constraints on prices could lead to inefficiently high prices. However, with effective competition in place, it sees no good reason for continuing to regulate prices and the potential for significant costs if such price constraints are maintained. It further notes that the work the MCE is doing in the areas of consumer advocacy and interval metering could make an important contribution to improving the participation of residential consumers in the electricity market. This would strengthen the competition made possible through the introduction of retail contestability.

To the extent that retail energy prices have been unduly suppressed by regulators, removing or easing price controls could lead to higher average prices and have an adverse impact on some users at least in the short term. However, ensuring that low income users have affordable access to power (and other services) is best handled through transparent community service obligation (CSO) payments, or other support, rather than through the general suppression of prices. Indeed, an emphasis on providing support through transparent CSOs is one of the key principles of NCP. That said, it is very important the funding of such CSOs (or other appropriate measures) is adequate and the effectiveness of these arrangements is regularly monitored.

The issue of regulating retail prices is also relevant to a number of other sectors of the economy. In chapter 10, the Commission gives broader consideration to the continuation of regulatory constraints on prices and makes a specific recommendation in this regard.

Independent monitoring and stocktake

As discussed in chapter 6, a robust reform process requires a mechanism for monitoring progress towards achieving clearly specified outcomes. With the MCE energy reform program now sitting outside the NCP arrangements, a separate independent monitoring process is therefore needed. Monitoring the implementation and impact of the transmission reforms and measures to improve user participation in the NEM, will be especially important given the central role of these reforms in developing an effective national market. In the Discussion Draft, the Commission therefore proposed that it would be highly desirable for there to be periodic and broader independent assessment of the implementation and outcomes of the energy market reform program.

In its response to the Discussion Draft, the South Australian Government argued that an independent review process was unnecessary, stating that:

The MCE fills the role as an energy market policy-making and oversight body, responsible for the current reform program, and which is accountable to CoAG and to Commonwealth, State and Territory Governments for these outcomes.
(sub. DR224, p. 14)

However, other participants such as the Western Australian Department of Treasury and Finance (sub. DR236) and the ACCI (sub. DR198) saw considerable value in establishing independent monitoring arrangements for this program.

In the Commission's view, there is a potential conflict of roles in the MCE both overseeing policy development and implementation for Australia's energy markets and also being responsible for assessing reform progress and the need for further action. Given the importance of this sector's performance to Australia's future economic and social wellbeing, and the lessons from the NCP reform process over the last decade (see chapter 6), the Commission reaffirms its view that the MCE should commit to establishing a process for independent monitoring of the implementation and outcomes of the reform program, with a stocktake of progress being undertaken in 2010.

RECOMMENDATION 8.5

The Australian Government, in consultation with State and Territory governments, should: re-establish a process, independent of the Ministerial Council on Energy, to monitor the implementation and outcomes of the energy market reform program; and undertake a stocktake of progress in 2010.

8.3 Water

Water is crucial to Australia's natural and economic wealth, sustaining biodiversity and a wide range of productive activities (such as irrigated agricultural production, mining and tourism). However, Australia faces a significant challenge in using its limited water resources productively and sustainably.

By the early 1990s, it had become apparent in a number of areas of Australia that some of the arrangements for managing and using water were neither efficient nor sustainable. This led to a general shift in public policy in many jurisdictions away from developing infrastructure to enable greater exploitation of the water resource, towards sustainable development. In addition to improving the productivity and efficiency of water use, policy making has focused on improving the health of river and groundwater systems.

Through the NCP water initiatives, governments have been pursuing a complex and ambitious reform agenda. As outlined in chapter 2, much has been achieved under this reform agenda, including urban pricing reform, significant institutional reform and the progressive establishment of defined and tradeable water entitlements separate from land title. Nevertheless, important elements of the NCP water reform program are still being implemented in some regions. Moreover, that reform program does not exhaust the need or opportunities for performance enhancement in the water area. Thus initiatives to further improve water pricing, expand trade in water and achieve appropriate allocations of water to the environment, could be of considerable benefit to the community.

- Modelling undertaken by Commission staff in relation to water trading in the southern Murray-Darling basin provides an indication of the potential gains from water reform. Specifically, it indicates that in the five years to 2001-02, moving from no trade to net inter- and intraregional water trading would have boosted gross regional product by one per cent or around \$1.4 billion (Peterson et al 2004, p. 44).

The next phase of water reform

Against this backdrop, in August 2003, CoAG recommitted to completing the NCP water reform agenda and developing the next phase of water reform. This led to the development of the National Water Initiative (NWI) and the Murray-Darling Basin water agreement, both of which have a focus on rural water reform and are outside the current NCP arrangements.

- The NWI continues the development and implementation of a market framework for better managing Australia's water resources in both rural and

urban settings and the adjustment issues associated with reform. In particular, it focuses on areas in which greater compatibility across jurisdictions in the approaches adopted to water management would enhance outcomes (see box 8.4). Importantly, the NWI includes a commitment by jurisdictions to complete the return of all currently over-allocated and over-used river and groundwater systems to environmentally-sustainable levels of extraction — which is crucial for efficient and sustainable water trading.

- Implementation of the NWI will be overseen by the Natural Resource Management Ministerial Council in line with detailed implementation plans developed by each participating State and Territory.
- The package includes the establishment of a National Water Commission (NWC) which will undertake the 2005 assessment of the NCP water reform program and, beginning in 2006-07, biennial assessments of progress in implementing the NWI agreement.
- A comprehensive review of the NWI is planned for 2010-11.
- In a separate agreement, the Australian, New South Wales, Victorian, South Australian and the Australian Capital Territory Governments have agreed to participate in a \$500 million venture over five years to reduce the level of water overallocation in those states and achieve specific environmental outcomes in the southern Murray-Darling Basin.

Further, in September 2004, the Australian Government announced it would establish the Australian Water Fund (AWF), with funding of \$2 billion over five years. Investments made under the AWF are intended to be consistent with, and help to facilitate initiatives under the NWI and Living Murray Initiative (which is funded under the Murray-Darling Basin water agreement).

Governments should recommit to the NWI

There is broad acceptance in the community and in policy circles of the urgency of pursuing a comprehensive national water reform agenda. Reflecting these views, the Australian Conservation Foundation (ACF) noted:

Effective management of Australia's water resources is critical to the health of our ecosystems. Australia has not managed its water resources well. The problems are clearly illustrated in the Murray-Darling Basin ... But these concerns are not isolated to the Murray. The damage to the environment caused by over-use and poor management is replicated in river systems across Australia. (sub. 54, p. 3)

Box 8.4 The National Water Initiative

In June 2004 CoAG agreed to a new water reform program to be implemented over the next ten years – the National Water Initiative (NWI). All governments other than Western Australia and Tasmania signed the agreement. The key elements of the NWI include:

- State and Territory preparation of water plans, which include provision for environmental and other public benefit outcomes.
- Broadening the coverage of the existing arrangements to deal with over-allocated or stressed water systems.
- Allocation of tradeable water entitlements, separate from land, as perpetual or open ended rights in accordance with water plans.
- A formula for sharing the costs of reductions in water access entitlements between users and governments.
- Measures to deal with interception of water flows that reduce entitlements.
- The introduction of public registers of water entitlements and trades and development of standards for water resource accounting.
- Provisions to facilitate and further reduce barriers to interstate trade in water.
- More detailed pricing principles for water storage and delivery.
- Actions to improve demand management of water use in urban areas.

In this regard, most participants were supportive of the NWI and Murray-Darling Basin water agreement. Nevertheless, some concern was expressed that under the NWI the timeframe for completing water management plans for river and groundwater systems that are not yet approaching full allocation has been extended to 2009.

For its part, the Commission sees the current and prospective water reform program as providing a substantive response to the requirement for more effective management of Australia's water resources. It is therefore unfortunate that the future of the NWI is now uncertain following the reaction by the States to the Australian Government's recent announcement that it will not be extending the designated competition payments to the States and Territories beyond 2005-06.

The Commission notes that the impasse on the NWI is delaying the implementation of potentially worthwhile projects under the Living Murray Initiative. In November 2004, the Murray-Darling Basin Ministerial Council approved a range of projects submitted by the New South Wales and Victorian Governments to save 240 gigalitres of water for the initiative (Truss and Campbell 2004). However, as

the Murray-Darling Basin water agreement is dependent upon agreement by the parties to the NWI, progressing these water saving projects has stalled.

There is, of course, scope for jurisdictions to pursue water reform agendas unilaterally. Indeed, in some policy areas this may be the most sensible approach, particularly given that there are marked differences across regional Australia in the environmental issues that need to be addressed. However, in other areas, such as water pricing, defining water property titles, water trading, allocating water to the environment, and assigning financial risks for future changes in the allocation of water — a fragmented approach to reform is unlikely to deliver the broader economic and environmental benefits offered by a comprehensive national approach.

Ensuring good value from the Australian Water Fund

The AWF has the potential to make a significant contribution to supporting worthwhile reforms in the water sector, particularly through investments to improve Australia's national capacity to measure, monitor and manage water resources over the longer term. However, the potential benefits from the AWF will only be realised if funding decisions are soundly based. In this regard, the Commission notes that in the past, there have been serious problems with the quality of investment decision-making in the water sector.

Hence, in the Commission's view, it is important that prospective projects under the AWF are subjected to rigorous and transparent cost benefit analysis, and that funding is allocated so as to maximise the economic and environmental benefits potentially on offer from the NWI and the Murray-Darling Basin water agreement.

Better integrating the rural and urban water reform agendas

While carrying forward the reform process begun under NCP, the NWI and Murray-Darling water agreement do not exhaust all of the potential reform opportunities in the water sector.

The Commission observes, for example, that little attention appears to have been given to the scope to better integrate the rural and urban water reform agendas. Given the manifest inefficiencies and problems in both of these areas when the reform process began, there was much that could be achieved on a compartmentalised basis. However, as Australia's past experience with freight transport reform starkly illustrates, an overly compartmentalised approach to reform

in related areas over the longer term can put at risk the economic, environmental and social benefits that may only be realised by taking a more holistic approach.

In the Commission's view, if water is to be allocated to its highest value use in the future, the urban and rural water markets will need to become increasingly integrated. Indeed, as discussed later, water trading is already opening up opportunities for some Australian cities to purchase water from irrigators in order to ease the pressure on existing urban water supplies. Wider application of this approach could potentially reduce the need for the sort of prescriptive demand management approaches that have become increasingly common in urban areas in recent years.

Effective integration of the rural and urban water reform frameworks will in turn put a premium on the quality of reforms in a number of key areas. For example, it will require the development of clearly defined property rights and efficient water trading regimes. Efficient water trading will in turn depend on reforms to ensure that the externalities associated with the delivery and use of water are properly taken into account. As the next section explains, there are a number of possible approaches that can be used to achieve this goal.

Dealing with externalities

Some participants suggested that pricing could play a greater role in managing environmental externalities associated with the supply and use of water. For example, the Brisbane City Council argued that:

Prices for water in all parts of Australia, rural and urban, should be set at full financial cost as a minimum. Accounting for externalities, particularly environmental externalities should be systemised and included in pricing. Some of the major environmental costs associated with water such as the impact of dam construction and electricity required for treatment and transport of water or sewerage should be included in the costings and flow through to prices. (sub. 22, p. 2)

Other commentators have argued that larger volumes than already agreed upon should be allocated to the Murray-Darling system in order to improve the health of the Murray River (see for example, Jenkins 2004).

The Commission considers that the key issue that must be effectively addressed in future water reform, including in relation to externalities, is the scarcity of water itself. That is, there is a need to ensure this scarcity value is reflected either in the initial price of water; through water trading arrangements that reveal the opportunity costs of using water in different ways; or in the 'shadow prices' of water implicit in

regulatory controls on the pattern of water use. The relative merits of these approaches would need to be assessed on a case-by-case basis.

Beyond this, prices that provide for full cost recovery of infrastructure services and that include a component for the externality costs associated with the delivery of water will not be sufficient to guarantee efficient allocation of a limited water resource. To achieve efficient outcomes, prices would also need to reflect externalities associated with the *use* of water in different applications. These are likely to vary considerably, thus making such pricing very difficult.

Accordingly, as in the energy sector, full externality pricing is at best a longer term goal. Indeed, given the information requirements and administrative logistics associated with environmental pricing, it cannot be assumed that price measures are inherently superior to other market-based instruments, or even to regulatory controls governing levels and patterns of water use. It needs to be recognised that even market-based instruments typically have a range of regulatory conditions attached, especially where unfettered trade could prejudice environmental goals. For example, in New South Wales, the Hunter River Salinity Trading Scheme involves capping environmentally damaging activities and then using trading to deliver the most efficient mix of production activities within the cap (Department of the Environment and Heritage, sub. 97, p. 5).

In sum, effective management of environmental externalities is likely to require the application of an integrated suite of policies that draws on pricing, regulatory and other mechanisms. In this context, administrative water allocation may often be one of the more efficient policy instruments available to governments. However, the mix of instruments is likely to evolve over time as knowledge about externalities increases and case history on the effectiveness of particular approaches expands.

Further, the Commission recognises that effective management of environmental externalities will require that jurisdictions be given flexibility to tailor policies to the particular circumstances of different regions and water catchments. As the Queensland Government noted:

Because externalities and water scarcity differ vastly between different regions, catchments and towns, any move to incorporate these elements into pricing will need to be based on robust and flexible principles. This is particularly the case in Queensland, where urban water supply is the responsibility of local governments. For many councils, particularly small councils, the costs of determining the value of externalities would not be worthwhile. (sub. DR189, p. 6)

Equally, the Commission emphasises that the provision of flexibility in the management of environmental externalities reinforces the importance of effective monitoring arrangements (see below).

Water recycling

Currently, Australia makes only limited use of recycled waste water in the urban sector. According to Engineers Australia, less than ten per cent of water available to Australia's cities and towns is being reused (sub. 82, p. 19).

Some consider that non-potable recycled waste water has an important role to play in meeting the future needs of Australian cities for reliable water supplies. For example, Professor Peter Cullen, in a paper discussing the water challenges facing Adelaide noted that:

There is abundant recycled water available from the sewage treatment plants of Adelaide, and this can be used to reduce the demands on potable water if it is made available for appropriate uses in industry, garden watering and perhaps toilet flushing. We do have the technologies available to treat such water to the level it could be added directly to potable water storages, but this is not necessary at this stage. (Cullen 2004, p. 9)

However, greater use of recycled waste water is only one of a number of possible strategies for easing the pressure on existing urban water supplies. Other possibilities include building new storage capacity, storing and treating storm water, desalination of seawater and (as noted above) facilitating the transfer of water from rural to urban areas. In this latter context, an independent working group reporting to the Prime Minister's Science, Engineering and Innovation Council noted the opportunities arising from water trading:

Approximately 75-80% of the water used in Australia is used for irrigation and the CoAG Water Reforms of 2003 seek to establish water rights that can be traded in a National water market. This opens up the opportunity in some jurisdictions where dams are shared or are reasonably close for the city to purchase irrigation water from willing sellers. It is probably the cheapest source of new water for several cities, and it is already taking place to some extent. (PMSEIC 2003, p. 6)

Accordingly, there is a need to evaluate waste water recycling projects in the urban sector on a case-by-case basis, having regard to the costs and benefits of alternative strategies for augmenting the water supply.

Equally, it is important that potentially cost-effective waste water recycling initiatives are not suppressed by the underpricing of non-recycled potable water. For example, failure to incorporate in water charges a component for the negative externalities associated with the delivery and use of water, is likely to lead to sub-optimal levels of recycling.

What this suggests is that waste water recycling needs to be carefully considered as part of a holistic water management framework. As the City of Melbourne argued in responding to the Discussion Draft, one task in this regard is:

... to ensure water recycling does not result in other environmental problems, such as increased greenhouse gas emissions. The purpose of water recycling should be to substitute potable water (for appropriate uses), rather than stimulating demand for more water. (sub. DR182, p. 3)

The evaluation and development of urban waste water recycling projects is, of course, largely a matter for individual jurisdictions to progress rather than CoAG or another national leadership body. Indeed, there is already considerable activity in this area in some jurisdictions. For example, the Victorian Government has set a target of recycling 20 per cent of Melbourne's waste water by 2010 and there are already a number of committed projects that will contribute towards achieving this target. And, in Western Australia, the State Water Strategy has set a recycling target of 20 per cent use of treated wastewater by 2012.

Nevertheless, there is the potential for CoAG to make a useful contribution in this area by facilitating the sharing of knowledge and expertise across jurisdictions. For example, CoAG could sponsor the development of a set of best practice principles for evaluating the costs and benefits of urban waste water recycling proposals and to help prevent the use of recycling in inappropriate circumstances.

Implementation issues

The Commission notes that even presuming the very substantial prospective benefits from the NWI will see the current uncertainty resolved and the reforms proceed, not all governments are party to the agreement. The June 2004 CoAG communiqué indicated that:

Western Australia declined to sign the NWI Agreement because there was no real benefit for Western Australia. Tasmania is not able to sign the NWI Agreement at this stage, but will continue to seek productive discussions with the Australian Government on opportunities for cooperation on water reform. (CoAG 2004b, p. 2)

It is clearly the case that jurisdictions differ in terms of the nature and extent of the economic and environmental challenges they face in the water sector. Further, the river systems of Western Australia and Tasmania do not raise any 'common property' issues with other jurisdictions.

Nevertheless, many of the principles set out in the NWI are likely to be relevant to all jurisdictions in progressing worthwhile water reforms. This is also true of the opportunities participants have identified for further reform in the water sector. The Commission is also concerned that the decision by some jurisdictions not to be party to the NWI potentially undermines the effectiveness of national monitoring arrangements post 2005. In the absence of such scrutiny, there is a risk that reform

efforts in the jurisdictions not party to the NWI could stall or even unravel, with adverse demonstration effects for those jurisdictions that are covered by the agreement. Hence, in the event that the NWI proceeds, all parties should work towards the NWI being national in coverage through re-assessing the possibility of involvement by Western Australia and Tasmania.

But even with all jurisdictions party to the agreement, there is still the issue of whether the new institutional arrangements envisaged under the NWI will provide sufficient discipline on governments to progress the agreed reforms. For example, the ACCI argued that:

... arrangements should be put in place to ensure discipline on the implementation of proposed reforms and to prevent backsliding by participants. Some options to achieve this include bringing the NWI within the scope of the NCP arrangements or making payments from the Australian Water Fund conditional upon State governments proceeding with the NWI, in the same manner that NCP payments are conditional upon progress made towards implementing NCP arrangements. (sub. DR198, p. 13)

The advantages and disadvantages of different broad institutional approaches for implementing reforms in this and other sectors are considered in chapter 12. In the Commission's view, water is one area that would benefit from arm's length monitoring, desirably under a 'whole-of-program' approach within a broadly based successor to NCP.

In implementing future water reform, it will also be important for governments to continue to pay close attention to adjustment issues. Such reforms, and especially higher water charges, can have significant impacts on particular groups and communities. For example, the Canegrowers observed that:

... the impacts of water reform on cane growers in Queensland have been significant. Many of the negative elements of NCP water reform have been implemented, leading to much higher water charges but many of the positive elements have not been fully implemented yet, including water trading. (sub. 78, p. 5)

As outlined in chapter 7, adjustment costs are not a reason to eschew reform — particularly in an area such as water where the potential economic and ecological benefits are likely to be large. However, to secure the longer-term benefits of water reform, governments must ensure that adequate attention is given to managing any significant short-term adjustment costs borne by particular groups in the community. In that regard, every effort should be made to minimise adjustment costs — through, for example, careful and staged implementation.

RECOMMENDATION 8.6

All governments should complete outstanding NCP water requirements and give high priority to resolving the current uncertainty about the future of the National

Water Initiative. Moreover, all parties should work towards the National Water Initiative being national in coverage through re-assessing the possibility of involvement by Western Australia and Tasmania.

RECOMMENDATION 8.7

The CoAG water reform process should also give close attention to:

- *better integrating the rural and urban water reform agendas, including through facilitating water trading between rural and urban areas;*
- *developing ways to better reflect the scarcity value of water and achieve more efficient and effective management of environmental externalities;*
- *developing a set of best practice principles to help ensure that urban waste water recycling proposals are cost-effective and environmentally sustainable; and*
- *ensuring that monitoring arrangements post-NCP provide a discipline on all governments to progress agreed water reforms.*

8.4 Freight transport

As the Australian economy grows and becomes more closely integrated into the global economy, the demand for efficient and cost-effective freight transport services will also continue to increase. Indeed, forecasts suggest that Australia's freight task will almost double over the next 20 years (DoTaRS 2004a).

Given Australia's size and distance from major overseas markets, an efficient and cost-effective freight transport system is particularly important to the competitiveness of Australia's manufacturers and exporters, and ensuring consumers benefit from the lowest possible prices. A cost-effective and efficient freight transport system can also help to ameliorate the consequences of market fragmentation, which can arise because of the wide dispersion of Australia's population centres.

Furthermore, there is increasing recognition of the need to better manage the externalities associated with transport activity — particularly in Australia's cities.

- The movement of urban freight is dominated by road transport, reflecting its inherent suitability for door-to-door pick-up and delivery. It is forecast that urban road freight tonnages in Australia will increase by over 70 per cent between 2000 and 2020 (DoTaRS 2004a). Growth of this magnitude has significant implications for road congestion, noise pollution, greenhouse gas emissions and local area pollution.

Such problems are not of course unique to Australia. Hence, the OECD has identified the need to move towards sustainable transport services (including passenger services) as one of the principal policy challenges facing member countries (OECD 2002, p. 11).

There have been significant reforms in the freight transport sector

Over the last 30 years, governments have undertaken significant investment to improve Australia's transport infrastructure. For example, the Australian Government has invested more than \$15 billion in the National Highway System over this period (DoTaRS 2002). This investment has been important in facilitating national markets for many goods and services.

Governments have also pursued a wide range of reforms to improve the efficiency and productivity of the freight transport sector, including as part of NCP:

- As outlined in chapter 2, road transport was encompassed under NCP as a separate sector-specific reform package. Beyond these changes, the National Transport Commission (through the work of its predecessor the National Road Transport Commission) has developed a further tranche of national heavy vehicle reforms.
- The general provisions of NCP — the extension of the *Trade Practices Act* to government business enterprises (GBEs), competitive neutrality, the structural reform of GBEs, third party access arrangements for infrastructure services and the legislation review program — have been important influences on the timing and direction of reform in the rail, ports and aviation industries. And, governments have undertaken various other competition-related reforms in parallel with NCP. For example, contracting out and privatisation have been used to improve the performance of several transport services.

One notable development encouraged by competition and other reforms has been the emergence of so called 'intermodalism' — the restructuring of traditional modal freight operators into third party service providers of a range of integrated functions across the entire logistics chain (Everett 2002). The development of intermodal freight transport systems can lead to improved productivity through, for example, the elimination of bottlenecks.

The next phase of freight transport reform

With the exception of the scheduled legislation review of cabotage restrictions (see below), virtually all of the remaining NCP freight transport agenda has been

assessed by the NCC to have been completed. However, there is clearly much more that needs to be done.

Moreover, the next phase of transport reform in Australia will be much more challenging than what has gone before. When the reform process began, a lot could be achieved by simply focusing on improving the efficiency and productivity of individual transport modes. But, going forward, there needs to be a much stronger focus on lifting the performance of the national freight transport system *as a whole* and achieving outcomes that are economically, environmentally and socially sustainable in the longer term.

To some extent, the shift from a compartmentalised approach to a more integrated multi-modal approach is already occurring (see box 8.5). However, while participants generally welcomed recent moves in this direction, many saw a pressing need for further policy initiatives of this sort. For example, the Association of Consulting Engineers Australia (ACEA) argued that:

... Australia must move away from development and investment decision-making based on segmented modes (rail, road, sea and air) and management (three tiers of government) to an integrated nationally consistent multimodal approach based on freight and passenger flows and logistics, and strategic transport corridors incorporating rail, road, air and maritime sectors. (sub. DR193, p. 25)

Indeed, in the Commission's view, recent initiatives have merely scratched the surface of opportunities for integrated reform in the freight transport sector. In particular, further pricing, access and regulatory reform is needed to achieve a freight transport system that encourages an efficient mix of transport modes and provides for the seamless movement of freight along the entire logistics chain. Importantly, these sorts of reforms also have a role to play in encouraging the provision of freight services that are sustainable in the longer-term.

As submissions have served to highlight, there are a range of major impediments to Australia achieving an efficient, integrated and sustainable national freight transport system. Key impediments include:

- the lack of competitive neutrality across transport modes;
- continuing barriers to efficiency and productivity within individual transport modes;
- the quality and capacity of inter-modal connections; and
- institutional arrangements that are arguably not capable of supporting the multi-modal approach necessary to develop, implement and monitor the next phase of freight transport reform.

Box 8.5 A more integrated approach to freight transport reform

The potential for productivity gains from improving the efficiency of the freight transport system as a whole has underscored the importance of adopting an integrated approach to reform in this area.

Yet unlike the energy and water sectors, there has not been a comprehensive and integrated national reform agenda for Australia's freight transport sector. Rather, reforms have traditionally been developed and implemented in a piecemeal fashion across transport modes and jurisdictions.

However, a more integrated approach to reform is evident in three recent initiatives:

- the creation of the National Transport Commission in January 2004 to progress regulatory and operational reform for road, rail and intermodal transport in ways that would promote uniform and nationally consistent outcomes;
- the Australian Government's land transport white paper, *AusLink: Building our National Transport Future*, which was released in June 2004. AusLink is intended to achieve better national land transport planning, funding and investment decision-making, and provides additional funding for transport programs of \$3.6 billion over the next five years. The key elements of AusLink are:
 - a defined National Network of important road and rail infrastructure links and their intermodal connections;
 - the National Land Transport Plan which outlines the Government's approach to improving and integrating the National Network, and the investments it will make;
 - a single funding regime for the National Network;
 - separately earmarked funding for local and regional transport improvements; and
 - new legislative, intergovernmental and institutional mechanisms; and
- the development of a new set of transport infrastructure planning guidelines to support investment decision-making across Australia, which were endorsed by the Australian Transport Council in November 2004. Importantly, the new guidelines provide for a more holistic, multi-modal approach to transport planning, appraisal and evaluation that seeks to provide a framework for comparing all feasible solutions and take full account of all relevant social, environmental and economic factors (ATC 2004).

The need for a freight transport system that is neutral across modes is widely recognised

The compartmentalised approach to decision-making that has characterised much of Australia's transport policy to date has left a legacy of distortions that create modal biases in the movement of freight. The most commonly cited example is overuse of, and excessive investment in, road transport at the expense of rail, though the extent and significance of such distortions are contested.

In the Discussion Draft, the Commission proposed that CoAG sponsor the development of a longer-term strategy that would help to ensure that the mix of transport modes reflects the intrinsic efficiency of the different options, rather than government policies and regulations that favour one mode over another. It also pointed out that, while the focus of debate has been on neutrality issues between road and rail transport, a ‘whole of system’ perspective should desirably be taken that encompasses road, rail, coastal shipping and aviation.

In response to the Discussion Draft there was broad support for the need to work towards achieving competitive neutrality across transport modes. For example, in commenting on the role of coastal shipping in the Australian freight transport system, the Maritime Union of Australia (MUA) indicated that:

... the MUA strongly endorses the principle of neutrality between modes. It believes that coastal shipping has much to offer, and supports patterns of regional development which take advantage of the low cost and good safety record of sea transport. A modally-neutral transport policy will utilise these advantages of shipping, just as it will utilise the advantages of the other modes. (sub. DR146, p. 1)

Most also acknowledged the complexities and challenges of moving towards a more neutral system and the need for consideration of a potentially wide range of government policies and institutional arrangements. For example, as the Queensland Government noted, in progressing a coordinated reform agenda in this area, there will be a need to consider:

- establishing a set of freight-related policy objectives for the development and management of an increasingly integrated transport and logistics system more directly linked to supporting agreed economic, land use, environmental and social objectives;
- developing an evaluation framework for assessing the full costs and benefits of investment in transport infrastructure, incorporating land use, safety, environmental, noise and urban amenity considerations into modal decision-making; and
- establishing regulatory and pricing regimes that encourage balanced modal choice and provide for the recovery of the cost of damage and externalities caused by freight transport. (sub. DR189, p. 8)

Some specific policy requirements

While the development of a well-integrated and modally neutral freight transport system will require an overarching policy framework, a number of specific policy issues need detailed consideration.

- *The pricing of freight transport infrastructure.* As a general principle, the pricing arrangements for such infrastructure should ensure that the freight task flows to the transport mode which in the long run will deliver the transport

services concerned at the lowest overall cost to the community. Further, prices should desirably reflect not only the financial cost of providing these services, but also any externalities associated with their provision and use. Non-neutrality in the pricing of road and rail infrastructure is a particular issue in this regard (see box 8.6).

- *Disparities in the standard of infrastructure across transport modes.* Such disparities can reduce the ability of particular transport modes to compete in terms of price, transit times and reliability. During this inquiry, concerns of this nature were again prominent in relation to road versus rail freight transport (see box 8.7).
- *Investment planning and evaluation.* Competitive neutrality across transport modes requires consistency in investment planning and evaluation frameworks to ensure that funds are allocated to those projects likely to provide the highest net return to the community. In applying a cost-benefit framework to prospective infrastructure projects, it is important that, to the extent possible, all relevant social, environmental and economic factors are taken into account. This goal is not currently achieved for any of the individual transport modes. Moreover, the extent to which wider (non-commercial) benefits and costs are taken into account varies, reinforcing other distortions in the modal mix.
- *Regulatory frameworks.* Governments regulate the provision of freight transport services in order to achieve broader social, economic and environmental objectives (for example, in relation to safety and operating standards, border protection and national security considerations, greenhouse gas emissions and local area pollution). But again, however, it is far from clear that such regulatory requirements are imposed consistently across modes or have regard to possible unintended consequences within an integrated transport regime.

The Commission further notes that these longstanding impediments to achieving competitive neutrality across transport modes potentially raise significant transitional issues (including for intergovernmental financial relations and for those involved in supplying particular freight transport services). Such issues add to the difficulties of reform in what is an intrinsically complex area.

Addressing barriers to efficiency and productivity within individual transport modes

The longer-term policy objective of achieving competitive neutrality across the freight transport system as a whole does not preclude separate but compatible initiatives to improve the efficiency and productivity of individual transport services. In this regard, the Commission considers that its proposed review of what

Box 8.6 Road and rail infrastructure pricing

In seeking to promote an efficient modal distribution of Australia's freight transport task, one of the more difficult issues is achieving greater neutrality in the pricing of road and rail infrastructure. In this regard, rail interests presenting to this inquiry claimed that four main aspects of current pricing arrangements promote over-use of road transport.

- While current road pricing regimes may result in full or even over-recovery of costs at an aggregate level, there is under-recovery in relation to the largest vehicles that travel the longest distances. It is with these vehicles that rail principally competes.
- Even if, in aggregate, the costs attributed to road freight transport are recovered, the instruments used are blunt and not very efficient in signalling the marginal costs associated with specific road use. In particular, the current road pricing regime relies on an annual registration fee and a fuel-based excise. In the case of the former, the effective charge can be reduced by using the vehicle more intensively, while in the latter case, the charge bears limited relationship to the marginal costs associated with road use (as opposed to fuel efficiency).
- While road pricing only seeks to recover the cost of each year's investment in road construction and maintenance, the rail pricing regime provides for a return on past 'sunk' investment and depreciation.
- Although neither road nor rail infrastructure is explicitly priced to take account of the externalities associated with the provision and use of these services, such externalities are typically higher for road use.

These claims are not uncontested. Nevertheless, it is clear that the scope for, and likely significance of, non-neutrality would be greatly diminished were it cost-effective to charge individual road users based on their actual imposts on the road network. In essence, such an 'individual user' road pricing regime would require the ability to measure and monitor distance, mass, road type, and time of day.

In the Discussion Draft, the Commission observed that although technological change is rapidly expanding the possibilities of what is 'priceable', it still seems likely that for a mix of technical and cost reasons, most of Australia's road network will remain unpriced for the foreseeable future.

In response, some participants argued that this was an overly cautious assessment that failed to take account of recent developments overseas in the use of mass-distance road pricing. For example, Pacific National argued that:

... simple mass distance charging already exists in several countries; more sophisticated systems are being rolled out around the world; and Australia is already trialling related vehicle management systems with many of the features required for mass-distance charging. (sub. DR241, p. 7)

The company went on to suggest that, technological uncertainty notwithstanding, there is the potential to develop a preliminary rudimentary mass-distance pricing system that could be improved upon as technology develops.

(Continued next page)

Box 8.6 (continued)

However, this view does not appear to be shared by the National Transport Commission (NTC), which is currently working through the details of the Third Heavy Vehicle Pricing Determination (THVPD) due to be implemented by jurisdictions in 2006. As part of this process, the NTC has assessed the applicability of individual road user pricing systems currently being implemented in Europe. Importantly, the NTC has concluded that these systems do not offer an appropriate model for Australia, particularly in the timeframe of the THVPD:

The international systems ... are expensive to adopt, require wholesale change to national heavy vehicle pricing systems, require participation by all or a large part of the heavy vehicle fleet, and, above all, do not have the technical capability to measure all of the key aspects that would be ideally measured in an Australian heavy vehicle road pricing system. (NTC 2004b, p. 5)

Moreover, technological uncertainty is not the only barrier to the introduction of mass-distance pricing for heavy vehicles. As several participants pointed out, a shift from the current system of heavy vehicle charging would have significant implications for the distribution of road-related revenues between the Australian and State and Territory Governments. And, the ensuing redistribution of charges could also impose sizeable transitional costs on some freight transport operators.

Against this backdrop, there appear to be two broad options for moving forward:

- continue to refine the current road pricing methodology with a view to reducing any undercharging of heavy vehicles, while monitoring overseas developments in the use of mass-distance pricing (essentially the current approach); or
- firmly commit to introducing a mass-distance road pricing regime in Australia within a clearly defined timeframe, accepting the need for some degree of policy experimentation and uncertainty of outcome.

For this inquiry, the Commission has not been able to do the detailed analysis that would be required to determine which approach would be preferable. Rather, it is a matter for the review the Commission is proposing into the national freight transport system (see text). Nevertheless, it is worth noting that if the review were to find in favour of committing to the short-term introduction of mass-distance road pricing, an immediate ensuing priority would be to examine options to address the concomitant intergovernmental financial issues.

The proposed review would also need to look at practical measures for accounting for the externalities associated with road and rail use. Some pricing initiatives may be feasible. However, as in the other infrastructure sectors discussed in this chapter, full externality pricing may be an elusive goal. In this regard, the NTC has indicated that it will not be pursuing individual externality charges as part of the THVPD, though it intends to report on the integrity of the data currently available on externalities, and mechanisms that could be used to incorporate such charges into future road pricing arrangements (NTC 2004b).

is required to deliver an integrated freight transport system would also provide an opportunity to assess progress in improving the performance of the road, rail, aviation and coastal shipping industries; and to develop (complementary) reform agendas for each of them.

The Commission notes that even in the road freight industry, which has been the subject of an extensive sector-specific reform program under NCP, there appear to be opportunities for further significant gains. For example, the Commission was told by the Australian Trucking Association that regulatory reform in relation to such matters as higher mass limits, incremental mass charging, and environmental regulation, has the potential to increase the productivity of the road freight industry (trans., pp. 340-352).

However, most participants commenting on intra-modal freight transport issues focused on opportunities for further beneficial reform in the rail and coastal shipping industries.

Rail

Although there has been considerable reform in the rail industry over the last decade, it has largely occurred jurisdiction by jurisdiction, resulting in the development of a multiplicity of access regimes and overlapping regulatory bodies. This regulatory fragmentation has been likened to the break in the rail gauge at State borders in inhibiting the efficient operation of trains across Australia.

Several participants commented on the need to achieve greater national consistency in rail access regimes, pricing and other regulatory frameworks. For example, the Department of Transport and Regional Services (DoTaRS) pointed to:

- differing requirements and conditions for rail safety accreditation between various jurisdictions;
- differing accreditation requirements within the same jurisdiction;
- interstate rail operators being faced with the need to comply with several differently based access regimes across the national rail network; and
- the tendency for governments to retain jurisdiction rather than cede safety and operational responsibility to separate or a central organisation owing to concerns over public accountability. (sub. 116, p. 5)

In the Discussion Draft, while recognising that work is underway to address many of the outstanding reform issues in the rail sector, the Commission argued that there would be value in pulling these initiatives together into a coherent and comprehensive national reform agenda with clear timelines for implementation. It also noted that a national rail reform agenda should not be limited to the defined

Box 8.7 Disparities in the standard of road and rail infrastructure

A potentially significant barrier to achieving competitive neutrality across transport modes is the marked disparity in the quality of road and rail infrastructure along some transport corridors. Several participants claimed that on some routes, the poor quality of rail infrastructure relative to road, undermines the ability of rail to compete in terms of price, transit times and reliability (see, for example, the Australian Rail Track Corporation, subs. 49 and DR228; and the Railway Technical Society of Australasia, subs. 7 and sub. DR157).

Such problems appear to be most pronounced on the north-south transport corridor and reflect the cumulative effects of under-investment in rail infrastructure relative to the road network over many years. For example, the New South Wales Minerals Council pointed to the alignment and condition of the main rail freight lines in the Hunter Valley and between the east coast capital cities, which it said were generally inferior to the standard of roads serving the same points (sub. 59, p. 3).

Against this backdrop, several participants welcomed recent commitments to provide additional funding for rail infrastructure, including as part of the AusLink program. However, like the Australian Water Fund, the potential benefits of this additional funding will only be realised if prospective investment projects are subject to rigorous and objective cost-benefit analysis.

Going forward, as discussed in the text, it is also important that there is greater consistency in the evaluation of prospective transport infrastructure projects. At least some of the current disparity in the quality of road and rail infrastructure can be attributed to differences in the investment evaluation requirements for the two modes. Specifically, proposed road investments have tended to be assessed in a cost-benefit framework, whereas rail projects have more commonly been evaluated in a narrower financial framework.

The Commission considers that both cost-benefit and financial evaluation frameworks are useful tools in evaluating prospective transport infrastructure projects. But they must be applied consistently across modes. As the Commission noted in its 1999 report on progress in rail reform:

Cost-benefit analysis is especially relevant for large transport projects relating to both rail and road infrastructure which have significant network and/or external effects (whether positive or negative) and for projects requiring funding to meet social objectives. However, financial evaluation may be more appropriate for smaller projects where externalities or network effects do not figure prominently. (PC 1999g, p. 241)

The Commission therefore welcomes the recognition in the new national guidelines for transport system management, endorsed by the Australian Transport Council in November 2004, that:

As far as investment is concerned, competitive neutrality should be achieved, if investment projects on both modes are identified and evaluated on an equal basis. Once projects for appraisal have been identified, the Benefit-Cost Analysis methodology is well suited to ensure equal treatment in principle. In practice, it requires assumptions and parameters to be aligned and appraisals to be undertaken in an objective manner, which is what these Guidelines are aiming to promote. (ATC 2004, p. 48)

interstate rail network, but should also consider the intrastate network which is similarly very important for the efficient movement of agricultural commodities such as grain and for passenger movements.

Reflecting the importance of an efficient rail system to Australia's international competitiveness, the need for further and substantive rail reform was endorsed by a number of those responding to the Discussion Draft, including the ACCI (sub. DR198); the Australasian Railway Association (sub. DR214); the Chamber of Commerce and Industry (Western Australia) (sub. DR248); the Minerals Council of Australia (sub. DR227); and the National Farmers Federation (sub. DR183). Apart from stressing the importance of reducing regulatory fragmentation across jurisdictions (particularly in relation to rail access regimes), some also commented on the need to develop efficient and sustainable solutions to the movement of grain and other rural commodities and improve the interface between rail and the other transport modes (see below).

However, the main focus of comments on the Discussion Draft was on how the current industry structure and regulatory environment is impacting on investment decision making. Three particular factors were noted as giving rise to potential under-investment in both the track network and above-rail operations:

- Where there is vertical separation of the track network and above-rail operations, a significant part of the benefit from investment in the network flows to the above-rail operator, those using rail freight services and the broader community.
- Pacific National claimed that uncertainty about the scope for track operators to increase access charges also deters above-rail investment:

Intermodal access prices have been deliberately set below the [permissible] ceiling because of the strength of competition from road. As above-rail operators make further investments and growth occurs, track providers enjoy the benefits of increased utilisation at constant prices, while also having the option of increasing access prices to capture a greater share of the overall returns. (sub. 241, p. 12)

- Pacific National further claimed that often it is only possible to get five years certainty in relation to access pricing, which is insufficient given the much longer investment horizons typically associated with expanding above-rail capacity (trans., p. 18).

Similar and other concerns are also raised in a report recently released by the Australasian Railway Association. The report argues that there is a need to accelerate internal industry reforms in three areas:

- The Australian Rail Track Corporation must ensure it quickly captures the expected operational cost savings by bringing New South Wales track under its management.

-
- Above rail operators must overcome their legacy of poor customer service.
 - Track owners and train operators must quickly achieve improved vertical coordination. (Australasian Railway Association 2005, p. 61)

Such commentary has served to reinforce the Commission's view that developing a national reform agenda for the rail industry is a high priority. Some of the important issues raised by participants do not appear to have featured prominently on the reform agenda to date. And, progress in addressing issues where coordinated reform effort is critical — such as regulatory fragmentation — appears to have been very slow. A nationally coordinated reform agenda that seeks to maximise the contribution of the rail industry to Australia's national freight system, and ensure rail services are sustainable in the longer-term, could therefore be of great benefit to rail freight customers and the wider community.

Coastal shipping

Coastal shipping is an important component of Australia's national freight system, carrying mostly bulk commodities (such as coal, bauxite, alumina, iron ore and crude oil) over long distances. Arguably, it also has the potential to capture a larger share of the long distance freight task if competitive neutrality is achieved across transport modes.

Over the last twenty years, governments have implemented a number of reforms to improve the efficiency of the coastal shipping industry, including through encouraging: a reduction in Australian crew sizes; investment in more modern vessels; and the introduction of more flexible work practices. However, as in the rail industry, there appears to be scope for further significant gains from improving the performance of this key freight transport sector.

In the Discussion Draft, the Commission noted that a key piece of unfinished NCP business under the legislation review program (LRP) was a commitment by the Australian Government to review cabotage restrictions. These restrictions and related regulations require foreign-flagged vessels to obtain a licence and to employ crew under Australian conditions and rates of pay while in Australian waters. In cases where licensed ships cannot meet all coastal shipping demand, the Minister can issue single or continuous (lasting up to 3 months) voyage permits, which allow foreign vessels to operate without having to satisfy cabotage requirements.

The case for cabotage is primarily based on preventing competition from foreign flagged vessels with lower labour costs from undermining the conditions and rates of pay of Australian seafarers. However, by limiting access to potentially more cost-effective coastal shipping services, cabotage reduces the competitiveness of

Australian firms that rely, or otherwise would rely, on coastal shipping. (This especially affects mineral exporters who are large users of this mode of transport.)

In recent years, the impact of cabotage restrictions on users has been ameliorated by the growth in the number of single and continuous voyage permits. For example, while the total coastal shipping tonnage has been relatively stable since 1999, the tonnage carried under these permits has increased from 7 to 20 per cent of the market (Webb 2004). Nonetheless, reliance on these permits without a definitive judgement on the future of cabotage is said to be creating uncertainty within the industry and, according to a recent review commissioned by the Australian Shipowners Association, hampering investment (Sharp and Morris 2003).

In the Discussion Draft, the Commission proposed that the Australian Government should conduct the review of cabotage legislation through the LRP process or as part of a broader review of the coastal shipping industry. In canvassing the possibility of a broader review, the Commission was mindful that cabotage raises wider immigration and border security issues and that there are potentially other opportunities to improve the performance of the industry.

In responding to the Discussion Draft, some participants saw value in a self-contained review of cabotage legislation provided it was an independent exercise that adequately took account, amongst other things, of the benefits of cabotage restrictions and wider border security/defence considerations. (See for example, the Department for Planning and Infrastructure of Western Australia, sub. DR256; and the Sea Freight Council of Western Australia, sub. DR174).

However, others highlighted the need to take a broader perspective of reform opportunities in the coastal shipping industry. Thus, the Australian Shipowners Association (ASA) argued that in addition to cabotage, a number of other legislative impediments that apply only to Australian ship operators prevent them from competing in terms of cost, innovation and responsiveness to customer needs (sub. DR166). Like the Maritime Union of Australia (sub. DR 146), it also suggested that consideration should be given to broader competitive neutrality issues that arise between coastal shipping and other modes of transport.

Such feedback has strengthened the Commission's view that a wider review of coastal shipping would have important advantages over a narrower assessment of cabotage restrictions alone. And, while some of the impediments to better outcomes in the industry could be pursued through a self-contained reform program, coastal shipping is an integral component of the national freight transport system. Hence, to ensure that reform efforts in the industry are compatible with achieving competitive neutrality across transport modes, those reforms would be better pursued as part of

the nationally coordinated and multi-modal approach to freight transport reform which the Commission is proposing.

Enhancing intermodal connections

Intermodal connections provide the means of transferring freight from one mode of transport to another at key points along the logistics chain. In seeking to maximise the efficiency of the national freight system as a whole, and to encourage efficient investment to cater for particular transport tasks, it is important to identify and address any bottlenecks that may detract from the seamless transfer of freight across transport modes.

One intermodal issue that has been the subject of much recent commentary is emerging capacity constraints at Australia's major ports. Elaborating on the reasons for such constraints, the Minerals Council of Australia observed that:

Unprecedented demand for Australia's coal and iron ore exports is placing pressure on our bulk commodity ports. In addition, Australia's major container port authorities have recognised that container throughput will grow significantly in the medium term testing the ability of land transport infrastructure to service that growth. (sub. DR227, p. 15)

While such constraints raise infrastructure adequacy issues (see above), they also reinforce the importance of efficient industry structures and regulatory arrangements in facilitating the movement of freight along the logistics chain. For example, the Reserve Bank of Australia noted recently that:

One feature hindering investment in both the New South Wales and Queensland coal industries is the fragmented ownership of the supply-chain assets; a large number of mines share mostly state-government-owned rail and port infrastructure. Transport infrastructure is generally operated not by coal mining companies, but by public or privately owned third parties who are responsible for new investment, some of which are subject to regulatory control owing to the monopolistic nature of the assets. (RBA 2005, p. 50)

Accordingly, the Commission considers that identifying barriers to the efficient transfer of freight across modes, and the most appropriate policy response to address those barriers, should be another important component of the proposed review of the national freight transport system.

Effective institutional arrangements are required to support the next phase of transport reform

Notwithstanding the contribution to recent reform efforts by the Australian Transport Council and the National Transport Commission, the Commission

considers that it is questionable whether current institutional arrangements are adequate to support a ‘whole of system’ approach required to develop, implement and monitor the next phase of transport reform. It notes, for example, that the ambit of the National Transport Commission does not extend to aviation or coastal shipping. Further, the NTC does not have a role in considering rail access pricing arrangements, even though charges for the use of rail infrastructure influence demand for road transport (just as charges for infrastructure use in the road sector have an influence on demand for rail freight) (NTC 2004a).

More generally, current institutional arrangements do not appear to have provided the level of coordination and cooperation between jurisdictions needed to address many long standing anomalies in the freight transport system. For example:

- Varying state regulations govern the access of higher mass limit trucks to the arterial road network.
- Multiple rail access regimes operate across Australia, with two jurisdictions recently conducting separate reviews of their access regimes despite the potential benefits of a more coordinated approach.
- There are seven rail safety regulators in Australia compared with one in the United States.

A further illustration was provided by the Australasian Railway Association which said that a train travelling between Sydney and Perth requires eight different radio sets to complete the journey (trans., p. 381).

Moreover, for the reasons outlined earlier in this section, the next phase of freight transport reform will place an even higher premium on achieving better coordination and cooperation between jurisdictions. Without modification (and effective leadership from government), it seems unlikely that the current institutional regime will be capable of meeting this need.

The Commission also notes that in considering the adequacy of current institutional arrangements, particular attention should be given to the importance of independent and transparent review and assessment processes. As discussed in chapter 6, one of the key lessons from NCP over the last decade is that independent and transparent review and assessment processes are critical to secure good outcomes, especially on contentious issues; prevent backsliding; and promote public understanding of the justification for reform. In this regard as well, current institutional arrangements in the freight transport sector fall short.

The Australian Government, in consultation with State and Territory governments, should initiate an independent national review into the requirements for an efficient and sustainable national freight transport system (encompassing all freight transport modes). Taking account of reforms to date by the Australian Transport Council and individual jurisdictions, this review should map out what is required to:

- *achieve competitive neutrality across all transport modes;*
- *address barriers to competition and efficiency in individual modes; and*
- *enhance interfaces between modes.*

It should also examine what future institutional arrangements would give best effect to the next phase of freight transport reform.

8.5 Passenger transport

Passenger transport serves a variety of economic and social goals, including providing people with the mobility needed to access employment, goods and services, and opportunities for social and cultural interaction. However, Australia's geographic size, relatively small population, and generally low-density urban development, pose significant challenges in providing efficient, sustainable and affordable passenger transport services.

In Australia, as in most other developed countries, governments play an important role in shaping passenger transport through the funding and provision of infrastructure and public transport services; through their urban planning and regulatory roles; and through taxation policies (such as fuel taxes).

Since the early 1980s, reforms in the passenger transport sector have included the deregulation of some transport services; the corporatisation and privatisation of certain public transport services (including as part of governments' implementation of the generic NCP governance reforms); and achieving greater private sector involvement in the provision, maintenance and operation of transport infrastructure. Generally, these reforms have resulted in increased competition between and within transport modes.

Nonetheless, it is widely acknowledged that some significant challenges remain in delivering a system that meets the needs of commuters in a cost-effective and sustainable fashion.

Some consequences of the high use of private motor vehicles

A key feature of passenger transport in Australia is the high usage of private motor vehicles. Amongst other things, this reflects the rapid expansion in personal car ownership after the Second World War and urban planning decisions that favoured low-density configurations.

- Private vehicles are the dominant mode of travel for domestic passenger trips up to 400 kilometres.
- While public transport remains important in urban areas, cars have increasingly provided the most convenient means of travel between home and work and for travel to social and recreational activities.
- In regional and rural areas, low population densities tend to preclude alternatives to the use of cars for business and personal travel.
- Private vehicles now account for 93 per cent of total urban passenger kilometres travelled via all transport modes, and over 80 per cent of total passenger kilometres travelled (DoTaRS 2002, p. 4).

Moreover, the dominant role of private motor vehicles is unlikely to change in the foreseeable future, notwithstanding various initiatives to make public transport more attractive. For example, DoTaRS has noted that even if public transport were to reverse its long-term decline and double its share of the urban passenger market, private motor vehicles would still account for 86 per cent of the urban passenger task in 2020 (DoTaRS 2002, p. 16).

Hence, one immediate policy challenge is better managing the negative aspects of heavy private vehicle use:

- In Australia's major cities, the combination of a growing passenger task, the dominance of private motor vehicle use and a growing road freight task, is placing existing transport infrastructure under increasing pressure. In particular, road networks are becoming more congested, the most visible manifestation of capacity limitations. In 2000, the Bureau of Transport Economics estimated that the total cost of traffic congestion in Australia's major cities was around \$13 billion a year, and predicted that if nothing was done to address this problem, the cost could rise to almost \$30 billion a year by 2015 (BTE 2000, p. 2). Though seeking to eliminate congestion completely would not be realistic or cost-effective, high and growing levels of congestion are a drain on productivity and community welfare.
- High rates of private motor vehicle usage contribute to high levels of energy consumption and to considerable air and noise pollution in some urban areas. Notwithstanding improvements in the fuel efficiency of new vehicles, the total

energy consumption of cars in Australia's major cities is expected to rise substantially over the next 20 years (BTRE 2003). This reflects increasing urban population levels (and consequent demand for travel) and increasing congestion levels. While improvements in the average emission performance of the vehicle fleet mean that noxious pollutant emissions (other than carbon dioxide) are expected to decline steadily over this period, they will remain significant. Moreover, this decrease will not be evenly distributed across the urban environment, with congested sections of the road network likely to experience increasing ambient pollutant concentrations.

- Urban configurations premised on high levels of private vehicle use may disadvantage those reliant on public transport. Without adequate access to such services, those without cars may face mobility problems and have difficulty accessing some key services (see box 8.8). The groups most likely to be disadvantaged through their reliance on public transport include the aged, the young, those on low incomes, migrants, and people with a disability. In coming decades, Australia's ageing population is likely to bring such mobility and accessibility issues into sharper focus.

Optimising the contribution of other forms of passenger transport

Given the costs associated with Australia's high rates of private motor vehicle use, it is not surprising that there has been considerable reform effort directed at improving the efficiency and accessibility of alternative passenger transport options. In that regard, public transport and taxis provide an alternative to private vehicle travel, and in the case of the former, can reduce pressure on road networks, especially during peak traffic periods. Accessible and affordable public transport and taxi services can also improve social outcomes by providing essential mobility to people who do not have or cannot use a car. For these sorts of reasons, the Victorian Government is targeting an increase in public transport's share of motorised trips in Melbourne from the current level of 9 per cent to 20 per cent by 2020 (Department of Infrastructure 2002, p. 135).

Although reforms that could enhance the delivery of public transport and taxi services are discussed separately below, as in freight transport, achieving an efficient and sustainable mix of these services in any particular location will also be an integral part of the future reform task. Taking advantage of synergies between the two modes will be important in this regard.

Box 8.8 Social equity considerations in passenger transport

Social equity looms large in any consideration of passenger transport services. At issue, is people's ability to make routine journeys within their local area — an essential component of a normal standard of living (Nutley 2003).

As Australia's cities have grown and reliance on private motor vehicles has increased, the wide variety of activities and facilities people want and need access to, have become more dispersed. At the same time, there are often marked disparities in the level of public transport services available in different parts of our cities. Groups who are disadvantaged in other respects, are often also disadvantaged in terms of mobility and access to services.

In regional Australia, recent research has questioned the common perception that there are few mobility problems or transport-related difficulties in accessing services (Nutley 2003). For example, that research suggests in remote areas vehicle ownership is not as high as is commonly perceived. Moreover, with services increasingly concentrated in the larger inland provincial cities, people from smaller nearby towns are having to travel further to access essential services.

Commenting on the need for an integrated policy approach to passenger transport reform, the Australian Taxi Industry Associated (ATIA) observed:

Public policy makers must move beyond simplistic tinkering with the components of the public transport system considered in isolation and develop a sophisticated and comprehensive strategy for redressing the imbalance between public/private passenger transportation. (sub. DR245, p. 2)

Public transport services

As travel has become more diverse and flexible, Australia's public transport systems — in common with those in many other countries — have struggled to compete with private motor vehicles. Further, as in New Zealand and the United States, the provision of cost-effective public transport services has proven to be particularly difficult in Australia's low-density urban environment, and in the context of planning that has often been premised on very high levels of vehicle ownership.

For governments, optimising the contribution of public transport services raises a number of important policy issues. Most fundamentally, there is the need to clearly define the role of public transport services within the passenger transport system. In this regard, some consider that the role of public transport is largely as a provider of services to particular (if ever changing) niche markets (Hensher 2002). Viewed in this light, policies that aim to achieve large scale shifts from private motor vehicle

usage to public transport may be neither efficient or cost-effective. As Professor Peter Stopher notes:

Too little attention is paid to the specific markets that public transport can serve well, and too much time, effort, and money is wasted on trying to make system-wide improvements in public transport, or in trying to raise system-wide ridership, rather than concentrating on the appropriate markets where public transport is a good alternative to the car. (Stopher 2003, p. 20)

Governments also face the challenge of balancing the economic, social and environmental objectives of providing public transport services. Most public transport services in Australia rely on a high level of taxpayer support (in the form of operating subsidies and community service obligation payments). For example:

- In 2002-03, CSO funding accounted for 77 per cent of the revenue of ACTION buses in the ACT, and 46 per cent of the revenue of the New South Wales State Transit Authority (PC 2004c).
- In 2004-05, it is expected that CSO funding will account for just over half the operating expenditure of the Brisbane City Council Bus Service (Brisbane City Council 2004).
- In Victoria, subsidies provided by the Victorian Government to private transport operators account for about half the cost of these services (The Age 2004).

Taxpayer support for public transport services reflects judgements about the wider social and environmental benefits associated with these services. However, it is essential that services are delivered as efficiently as possible to contain the costs of meeting these goals. Also, high rates of subsidy render investment decision-making more difficult, as demand responses cannot be taken as indicative of the value of these services to the community. This reinforces the need to ensure that subsidies are not inflated by inefficient service delivery.

In commenting on the scope for performance improvement, the recent Ministerial Inquiry into Sustainable Transport in New South Wales (the Parry Review) noted that:

... there is considerable potential for public transport operators to reduce their overall costs by improving the efficiency of their operations — essentially delivering more value from the public funds they already receive. (Parry 2003, p. 22)

Moreover, in some overseas countries, attention is turning to ‘unconventional’ funding mechanisms outside the domain of passenger fares or general tax revenue — such as parking revenue — that both provide an alternative dedicated funding source and deliver better price signals. For example, Ubbels and Nijkamp (2002) note that:

A wide variety of schemes is available to fund public transport via hypothecated charging. These schemes are interesting not only as a means of raising financial support for public transport systems, but also as a method of sending appropriate pricing signals to transport users with the possibility of their being integrated with more traditional general fiscal and regulatory instruments. (p. 327)

Efforts to improve the viability of public transport must also have regard to quality issues. Indeed, providing an alternative means of transport that is affordable, reliable, comfortable and safe could see reliance on private motor vehicles reduced somewhat. As recent problems with some urban rail services have highlighted, there appears to be considerable scope for improvements in service quality in Australia's public transport systems.

Taxis

Taxi services are a small but nonetheless important component of the urban passenger transport task. Their flexibility — in terms of operating hours and, more particularly, their pick-up points and destinations — complements regular scheduled public transport services. Taxi services enhance the mobility of groups for whom alternative public transport is not suitable — such as some elderly and disabled people. They are also important for tourism and business travel.

As in other countries, taxi services throughout Australia remain highly regulated, through a combination of supply restrictions (licensing), price setting and service quality standards.

Taxi services were identified by the NCC as a priority area under the NCP's legislation review program. The reviews undertaken by Queensland and South Australia supported continuation of existing regulatory arrangements. In contrast, the Victorian, Western Australian, ACT and Northern Territory reviews recommended removing restrictions on taxi licence numbers and compensating incumbent operators (in most cases through licence buy-backs), while the New South Wales and Tasmanian reviews proposed transitional approaches involving annual increases in licence numbers.

However, progress in implementing review outcomes has been slow. Only Victoria, Western Australia and Tasmania have been assessed by the NCC as having complied with their NCP obligations in this area. In the case of the Northern Territory, moves to deregulate service provision were subsequently reversed with the reinstatement of licence restrictions.

For governments, a major barrier to removing regulatory restrictions on competition has been the substantial value of taxi licences and therefore the need to find

acceptable ways of dealing with the losses that would be incurred by licence holders in a less regulated environment. In the industry's view, deregulation would also have negative flow-on effects for vehicle quality and safety, customer safety and service quality. Thus, in responding to the Discussion Draft, the ATIA contended that:

... the fundamental and overwhelming barrier to the deregulation of taxi markets is that it delivers substantially inferior outcomes for all affected stakeholders — the community, governments, taxi customers, drivers, operators, licence holders, and despatch companies. (sub. DR245, p. 2)

More specifically, the industry cited research commissioned by the ATIA, which found that in the case of taxi deregulation in the Northern Territory:

The dramatic increase in supply of taxis with no compensating increase in demand resulted in a dramatic decrease in productivity and profitability. The flow-on effects to public benefit issues including vehicle quality and safety, customer safety, driver quality, price-gouging, assaults, no-shows and fare refusals has resulted in the NT Government capping entry ... (Nicholls 2003, p. 4)

However, the Commission notes that, in its latest tranche assessment, the NCC cites evidence from a study in the United Kingdom which suggests that ensuring effective quality regulation, not restricting taxi numbers, is the optimal way of ensuring taxi and driver quality and safety (NCC 2004b, p. 9.15).

Such issues and complexities are not of course unique to Australia. Other countries have also experienced difficulties in reforming their taxi services. Service provision has been liberalised in New Zealand, Sweden and several cities in the United States. However, the results of liberalisation have been mixed, with Darryl Biggar observing in work undertaken for the OECD Competition Committee Roundtable that:

As a general rule, liberalisation has substantially increased the number of taxis operating, reducing waiting times. On the other hand, where liberalisation included deregulation of prices, prices have generally not come down. In some markets prices appear to have risen following deregulation. Innovation in the provision of new services has been limited. These studies therefore emphasise the importance of paying particular attention to the characteristics of the taxi market in each city and tailoring regulatory reform to the context. (Biggar 2003, p. 89)

In responding to the Discussion Draft, the Canberra Taxi Proprietors Association, similarly emphasised the importance of local authorities tailoring reforms to suit the particular characteristics of the local market (sub. DR160, p. 7).

There is little doubt that progressing worthwhile reform in the taxi industry has proved more of a challenge than many first envisaged. However, in the Commission's view, this does not obviate the need for further reform. As the NCP

reviews have illustrated, the current restrictions on competition reduce efficiency and impose costs on consumers. Hence, the task will be finding ways to eliminate or ameliorate these costs without giving rise to the sort of problems that have been evident under many deregulatory initiatives to date. In this regard, the Commission notes the OECD Secretariat's observation that the liberalisation of taxi markets needs to be accompanied by certain safeguards to promote competition.

Possible safeguards include elimination of the first-in-first-out rule at taxi ranks, physical redesign of ranks to allow customers to choose between taxis, requirements that prices be posted outside the taxi to facilitate price comparisons and requirements that taxis operate the same prices in the taxi-stand market and the phone-booked market. Some cities promote competition by distinguishing between taxi services which are allowed to be hailed on the street and taxi services which can only be booked by phone. The latter are subject to little or no regulation (as in London where there is a distinction between taxis and minicabs and in Ireland, where there is a distinction between taxis and hackneys). In those markets where these safeguards prove inadequate (such as the airport stand market) some form of limited price cap may be necessary. (OECD Secretariat 2003, pp. 42-43)

A number of these safeguards would seem relevant in the context of developing the next phase of taxi reform in Australia.

The way forward

Achieving more cost-effective, accessible and environmentally sustainable passenger transport services in Australia will require a variety of reform initiatives and necessarily a degree of policy experimentation and risk. Some reform initiatives will involve removing barriers to competition or the application of other market-based reforms. However, others will be of a quite different nature. Thus, a menu of reform options *might* encompass:

- improving the efficiency of the existing road network, for example through intelligent transport systems;
- improving the interface between different modes of passenger transport in order to achieve more integrated and efficient transport networks;
- greater use of demand management policies to target congestion problems;
- greater use of road pricing, though as noted above there are still technical and cost constraints on what is possible in this regard;
- further changes to vehicle performance, safety and emission standards;
- genuine reform in the taxi sector, drawing on experiences domestically and in overseas countries to avoid unintended consequences, and ensuring such reform is tailored to the circumstances of particular taxi markets; and

-
- reconfiguring and augmenting public transport systems to better meet the needs of public transport users, including more innovative ways of providing transportation alternatives (such as subsidised taxis or call-and-ride minibus services).

The Commission's concurrent inquiry into energy efficiency will provide an opportunity to explore the merits of some of these options in detail.

Beneficial reform in this area will also require more effective integration of land use planning with planning of transport infrastructure. As the Brisbane Institute observed:

Failure to understand the consequences of poor land use planning for costs of access and mobility has meant less than benign neglect of issues that hamper productivity and international competitiveness while raising firms' and households' costs of using the transport system. (sub. DR180, p. 2)

Similarly, there needs to be effective integration of passenger and freight transport planning frameworks — particularly in relation to shared transport infrastructure such as the road and rail networks. Amongst other things, it will be important to ensure that policy initiatives in the passenger transport sector do not unnecessarily detract from the efficient movement of goods and services.

An effective reform package for passenger transport services will also need to address the consequences of Australia's ageing population. For example, as Alsnih and Hensher (2003) observe, the mobility and accessibility requirements of the elderly need to be better understood to:

... ensure that governments in particular direct resources to support the needs of seniors in an ageing population in a way that is the best use of the increasingly scarce dollar spent on transportation services. (p.10)

Suffice to say passenger transport is a complex area and much work will be required to produce an effective reform package.

The need for a national review

Although some significant changes in this area are continuing to be made at a jurisdictional level, there would be advantages in pursuing reform within a nationally coordinated framework.

- There are strong links between passenger and freight transport through, for example, the shared use of much of Australia's transport infrastructure. Consequently, there are likely to be synergies in pursuing concurrent and integrated reform agendas in these two areas.

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- Passenger transport reform has an important role to play in reducing greenhouse gas emissions. As noted earlier in this chapter, greenhouse gas abatement is itself an area that would benefit from better national coordination (see chapter 11).
 - Both the Australian Government and State and Territory Governments have funding responsibilities in relation to transport infrastructure and services.
 - A coordinated approach would promote learning from the experience of other jurisdictions. Indeed, such sharing of information is likely to be an important part of mapping out the best way forward in this area.

As a first step in the development of a coordinated reform framework and agenda, an independent national stocktake of the performance of the passenger transport sector could be particularly helpful. This would provide an opportunity to assess the impact of recent reforms and to identify what is needed to achieve more cost-effective, accessible and environmentally sustainable transport services in urban and regional Australia.

RECOMMENDATION 8.9

The Australian Government, in consultation with State and Territory governments, should commission an independent national review of the passenger transport sector, to assess the impacts of recent reforms and determine what is now required to deliver further performance improvements in both urban and regional areas.

8.6 Communications

Technological developments in communications technology have proceeded at a rapid pace over the last decade, blurring the traditional distinction between broadcasting and telecommunications. Digital television, combined with the internet, now allows consumers to send information back to broadcasters and to third parties, such as advertisers, directly from their television; and high-speed internet connections allow TV and radio broadcasts to be sent using telecommunications infrastructure. Greater television interactivity and faster internet connections offer large benefits for both households and businesses.

Yet there are continuing concerns that the current regulatory environment is restricting the uptake of these new technologies. For example, broadcasting restrictions that limit the number of commercial free-to-air television licences, as well as the services television stations can offer, dampen incentives for innovation and may have contributed to the hitherto limited uptake of digital television. And although the telecommunications sector has been subject to extensive reform over

the last decade, there remain concerns that Telstra's dominant market position is limiting the usage and development of broadband networks.

The communications sector clearly has national implications and yet, unlike the previously discussed reform areas, communications policy is almost exclusively the province of the Australian Government. Thus future communications reform does not require nationally coordinated reform frameworks. Nonetheless, the importance of the area to Australia's future competitiveness and standard of living means that it should occupy a prominent position on the microeconomic reform agenda. It is also an area where NCP legislation reviews have pointed to opportunities for some substantial performance improvements. Against this backdrop, the following section outlines some key elements of future communications reform.

A broadcasting reform agenda has been mapped out

During 1999, as part of the legislation review process under the NCP, the Commission reviewed anti-competitive restrictions in the broadcasting sector. It found that the restrictions imposed significant costs on the Australian community and, in some instances, conflicted with other government policy aims (such as promoting diversity of media opinion and not unduly disadvantaging regional communities). Consequently, the Commission proposed changes to free up broadcasting spectrum, promote digital conversion and improve competition in the broadcasting sector (see box 8.9).

Few of the Commission's recommendations have been implemented, leading the NCC (2003b) to conclude that the Australian Government has failed to meet its NCP obligations in this area. Similarly, the ACCC (2003) has expressed concerns about the continuing restrictions on competition:

... many of the Productivity Commission's concerns about the regulatory framework have been borne out in practice. Examples of these concerns include that narrowly defining the services that can be provided by datacasters and prohibiting multi-channelling decreases opportunities to develop business cases to entice customers to use digital services (p. xxiv).

Furthermore, where the Government has acted, it has done so selectively. For example, proposed legislation, currently before the Senate, seeks to repeal foreign ownership restrictions and to liberalise cross-media merger rules. However, measures that the Commission identified as necessary precursors to the reform of cross-media rules — such as the removal of entry restrictions so as to promote greater media diversity — have not been introduced.

Box 8.9 The Productivity Commission's broadcasting report

As part of its legislation review program, in 1999, the Australian Government asked the Productivity Commission to 'advise on practical courses of action to improve competition, efficiency and the interests of consumers in broadcasting services'.

The Commission found that the regulatory regime imposed significant costs on the community. Amongst other things, it observed that:

- barriers to entry reduce the diversity of views and opinions in the 'market for ideas' and may also lead to higher prices or reduced service quality;
- regulations on the broadcasting of digital television limit its attractiveness and thereby restrict the uptake of this technology;
- restrictions deliver inferior outcomes to regional areas, for example, constraints on datacasting prevent it being used as a low cost method of broadcasting regional sporting events;
- spectrum is not efficiently priced; and
- anti-siphoning rules potentially reduce consumer access to broadcast sport.

The Commission went on to recommend a number of changes, including:

- the separation of access to spectrum from broadcasting licences, to enable broadcasters to provide services using the most efficient platform, and the replacement of broadcasting licence fees with spectrum-based fees;
- a firm date for analog switch-off, the removal of restrictions on multi-channelling and datacasting, and the removal of the high definition transmission quotas;
- the removal of anti-competitive legislation (including restrictions on new television stations and foreign investment) and the addition of a new public interest test to the *Trade Practices Act 1974* to deal with cross-media mergers;
- the abolition of local content quotas relating to advertising and pay TV and an inquiry into the relevance of Australian content quotas in the new digital age; and
- the limitation of anti-siphoning to events of national significance and a prohibition on the granting of exclusive rights to these events.

Source: PC (2000a).

What are the highest priority reform areas?

While the ACCC has called for a further 'across-the-board' review of broadcasting regulation, the Australian Government has already initiated separate reviews on multichannelling and the number of commercial free-to-air television licences, which will be completed over the next few months. Hence, the merits of another broad review would be better judged when the outcomes of those reviews are

apparent. Moreover, the Commission considers that the bulk of its 2000 reform agenda remains relevant and could be implemented without further investigation.

Accordingly, in the Discussion Draft the Commission recommended that, unless the current reviews provide a compelling public interest case to the contrary, high priority should attach to removing the restrictions on:

- *the number of commercial free-to-air television licences* — new entrants to free-to-air markets would stimulate innovation in the delivery of digital TV and could help to limit the market power of incumbent broadcasters in their dealings with advertisers;
- *multichannelling* — allowing free-to-air broadcasters to provide more than one channel, over their existing spectrum, would increase the attractiveness and uptake of digital TV; and
- *datacasting* — removing restrictions on datacasting would enhance the potential for new digital broadcasting services to emerge, including in regional areas.

Some participants disagreed with the priority placed by the Commission on these particular reforms. For instance, Free TV Australia (sub. DR207) opposed the removal of restrictions on the number of free-to-air television stations or datacasting. It argued that the free-to-air sector is already competitive and further regulatory change, at a time when technological developments are transforming the sector, would jeopardise the financial viability of some existing stations. And Foxtel (sub. DR217) argued that allowing greater access to multichannelling would only serve to increase the market power of free-to-air providers. Given the interconnections between many aspects of the broadcasting restrictions, Foxtel went on to contend that reform should only proceed on a broad front.

For its part, the Commission does not consider that further reform would cause undue disruption in the broadcasting market. Evidence presented by Foxtel (sub. DR217, p. 7) shows that the profitability of Australian free-to-air television stations has not ostensibly been affected by recent technological developments. And although the introduction of greater competition has led to difficulties for some broadcasting firms overseas, such competitive pressures are part of any normal market environment.

Moreover, as the Commission argued in its report on broadcasting regulation, reform is necessary to increase the availability and use of new technologies. Relative to other countries, Australia has been slow to take up digital services. Evidence from overseas suggests that a prime reason for upgrading to digital is access to a greater range of channels; a benefit that current restrictions deny to Australian consumers (DCITA 2004 and ACCC 2004e).

The Commission agrees that reform should desirably proceed on a broad front. Accordingly, its earlier report on broadcasting outlined a wide-ranging reform agenda reflecting the extent of the restrictions on competition and the many *quid pro quos* between them. Indeed, because of these inter-relationships the Commission specified some preconditions for giving competition a greater role in the domestic market:

- the abolition of the *Broadcasting Service Act*'s restrictions on foreign investment, ownership and control (to enhance the pool of owners and protect against market concentration); and
- amendment to the *Trade Practices Act*, inserting a media-specific public interest test, applying to mergers and acquisitions (to alleviate concerns that the generic provisions would be unable to deal effectively with the fast-changing nature of broadcasting).

But to the extent that implementation of the wide ranging reform agenda identified in that report is not an immediate option, the Commission remains of the view that priority should be given to addressing the three restrictions identified in the Discussion Draft, since these are prime constraints on consumer choice and the uptake of digital television. Removing restrictions on entry, multichannelling and datacasting would therefore be a first, and important, step in facilitating the emergence of new and innovative ways to deliver more content and more choice to consumers.

That said, the Commission emphasises that these three priority reform areas should be implemented as a package. In particular, without action to allow new players entry into free-to-air television, merely easing restrictions on multichannelling could simply entrench the market position of incumbent free-to-air providers.

RECOMMENDATION 8.10

Unless the reviews currently in progress provide a good case to the contrary, the Australian Government should simultaneously remove the restrictions on the number of commercial free-to-air TV stations, multichannelling and datacasting.

RECOMMENDATION 8.11

Any future liberalisation of cross-media ownership rules should have regard to these and other pre-conditions set out in the Productivity Commission's review of broadcasting regulation.

Concentration in telecommunications markets remains an issue

When telecommunication markets were liberalised in the 1990s, the hitherto wholly government-owned Telstra was left in a dominant position. It was the provider of choice for most Australians and it owned the local loop, access to which was, and still is, necessary for the provision of most telecommunication services. Telstra has subsequently rolled out a cable network that passes approximately 2.5 million Australian households, which largely duplicates an Optus-owned cable network.

To guard against the possibility that Telstra could use its ownership of the network to disadvantage its rivals in retail markets, the Australian Government introduced two telecommunications-specific regulatory measures:

- an anti-competitive conduct regime that is based on a lower threshold (of ‘effect or likely effect’) than the general TPA provisions and which places the onus of proof on the service provider, rather than the ACCC, to demonstrate that it is not engaging in anti-competitive conduct; and
- a sector-specific regime enabling service providers to gain access to ‘non-contestable’ network facilities.

These arrangements have since been refined with some of the changes ensuing from a Commission report into telecommunications regulation (PC 2001f and Alston 2003). Also, the Government has, since 2003, required Telstra to produce separate wholesale and retail accounts.

Notwithstanding Telstra’s continued dominance of the telecommunications market, liberalisation has delivered a much more competitive environment. For example, since 1997, the number of carriers has increased from 3 to over 100, with new players significantly eroding Telstra’s market share in the long distance and mobile call markets (ACA 2005 and ACCC 2004a).

Structural changes have been mooted

As a vertically integrated entity, Telstra is not dissimilar from the integrated entities that operated in sectors such as electricity at the outset of NCP. However, unlike integrated entities in these other sectors, the efficacy of Telstra’s structure has not been subject to review in accordance with NCP principles. Consequently, and despite the entry of new players into the telecommunications market, there are concerns that Telstra still has considerable capacity to hinder the emergence of greater competition in both wholesale (network services) and retail markets.

Most recently, these concerns have been manifested in complaints about the relativity between Telstra's wholesale and retail broadband prices, which led the ACCC to issue a competition notice. (As a result, Telstra has changed its wholesale pricing structures and the competition notice has been revoked.) There have also been concerns that Telstra's ownership of both copper and cable networks may thwart the development of new competitive networks.

These concerns have led to renewed calls for changes to Telstra's structure, including:

- vertical changes, which would involve the further division of Telstra's wholesale and retail arms, with a view to preventing anti-competitive collaboration between the two; and/or
- horizontal changes, for example requiring Telstra to divest its cable network — with a view to creating more competition *between* networks and thus lessening Telstra's market power.

Box 8.10 outlines these approaches in more detail.

Vertical changes would have some benefits

In this inquiry, the ACCC (sub. DR165, pp. 18-19) has claimed that the current regulatory regime is not sufficiently restraining Telstra's ability to disadvantage its retail competitors. Specifically, it has argued that the recently introduced accounting separation regime is not providing the intended observable evidence of whether Telstra is discriminating against those competitors. Accordingly, though indicating that the case for full vertical separation is unclear, the ACCC has recommended more stringent 'operational' separation of Telstra.

In the Commission's view, vertical changes would have some benefits. For example, they might make it easier for regulators to identify anti-competitive behaviour. In turn, this may discourage such behaviour and facilitate greater reliance on commercial negotiation (between Telstra and its customers); as distinct from the current dependence on regulatory controls. And if, as a result of vertical changes, the regulatory regime is perceived by retail service providers to be more effective, their greater participation in the development of rival telecommunication networks may be encouraged. Over the longer term, this could lead to a more competitive marketplace.

Box 8.10 Structural options for increasing competition in telecommunications

During the 1990s, many countries exposed their incumbent and integrated telecommunication firms to competition. However, recently, some regulators have argued that without structural changes to these incumbent firms, effective competition is unlikely to emerge.

Proposals for such change fall into two broad groups:

- Vertical changes, which separate the provision of network and retail services, include:
 - *Full vertical separation* into distinct legal entities, with each subject to relevant generic legislation governing competitive conduct.
 - *Club ownership*, whereby downstream retail service providers *all* have a share in the non-contestable network.
 - *Operational separation* of the network and retail activities of an integrated provider; creating separate divisions, under different management structures, located in different premises, and with transparent arms-length ‘transfer’ prices for network services. And though the two divisions would remain under common ownership, communication between them would be regulated.
 - *Accounting separation* to oblige the integrated provider to produce separate accounts for its network and retail divisions, with the goal of helping regulators compare ‘internal’ prices with those charged to retail competitors.
- Horizontal changes, which constrain the range of network activities in which an incumbent firm can be involved, include:
 - *Intra-network separation*, to split a specific non-contestable network into smaller regional parts, controlled by different owners.
 - *Inter-network separation*, to place the ownership of competing telecommunication networks (such as copper and cable) in separate hands.

Box 8.11 outlines the overseas experience with some of these measures.

Source: OECD (2001)

The ACCC has also argued that, by increasing access to Telstra’s network services, a greater degree of vertical separation could more immediately:

... facilitate increased competition in downstream markets, thereby driving further efficiency gains, innovation and reduced prices, to the benefit of consumers. (sub. DR165, p. 18)

However, the Commission observes that significant benefits of this sort would seemingly only arise if there are inadequacies in the current telecommunications access regime. More broadly, like the costs (see below), the magnitude of the benefits associated with vertical solutions are likely be correlated to the ‘stringency’

of the particular option employed. Hence, the potential benefits of operational separation are likely to be smaller than those from full vertical separation.

But there would also be efficiency costs

As noted, Telstra is already obliged to provide ‘fair’ access to its network, with the company also subject to a range of other regulatory controls. Indeed, Telstra’s recent modification of its wholesale broadband prices (following the imposition of a competition notice), and rapidly falling telecommunication prices documented in chapter 4, suggest that the current regime has helped to promote more competitive market outcomes.

Moreover, vertical solutions have their own offsetting and potentially sizeable efficiency costs. In particular, they can reduce or remove opportunities to exploit economies of scope and create significant hurdles to further innovation and investment. For example, Telstra’s integrated structure may help it more readily identify opportunities for worthwhile innovation to its network (due to its greater knowledge of downstream markets), and provide greater certainty in regard to the likely returns from investments in network infrastructure. In this latter regard, at the Sydney hearings, Charles River Associates (formerly the Network Economics Consulting Group) said that Telstra’s original plan for a vertically separate cable network had failed because content providers were uncertain about the profitability of placing content on a network that they could not control access to (trans., p. 78).

In addition, rapid and ongoing technological developments are complementing the role of the sector-specific access regime in increasing the contestability of network service provision. Telstra’s competitors are already able to lease parts of the copper network and thereby provide wholesale services. Future technological developments — especially the development of new network ‘platforms’ — are likely to further narrow the non-contestable elements of the market.

In such a rapidly changing environment, were full vertical structural separation to be pursued, it could be very difficult to determine precisely where the split should be made. Consequently, the scope for regulatory error, and its attendant costs, would be high.

The transaction costs of full vertical structural separation would be large

Also, full vertical structural separation in particular would be costly to implement. It would inevitably be expensive and time consuming to reorganise a company as large as Telstra; firms would need to adapt to changes in the regulatory regime consequent upon the change in the company’s structure; and the issue of possible

compensation for Telstra's current shareholders would need to be addressed. Such a substantial change would also be a major new complication to the proposed full privatisation of Telstra.

Such considerations have weighed heavily in the decisions of other countries not to proceed with full vertical separation of their major telecommunication entities. And they have caused the OECD (2001 and 2003e) to make an exception to its usual preference for vertical separation in integrated infrastructure activities (see box 8.11). A concern to contain transaction costs is also one reason why the ACCC (sub. DR165, p. 18) has proposed a less costly operational separation option.

In the Commission's view, such transaction cost considerations now tip the balance against the full vertical separation of Telstra, regardless of the intrinsic merits of a separated structure in a 'greenfields' situation. However, given the continuing concerns about Telstra's capacity to discriminate against its retail competitors in the provision of network services, greater operational separation is worth further consideration (see below). Though the potential benefits would be smaller than those on offer from full vertical separation, so too would be the attendant efficiency and transaction costs.

Would horizontal structural changes be beneficial?

As outlined above, the perceived need for vertical solutions in the telecommunications sector stems from a presumption that the scope for competition between different networks is, and will continue to be, limited — thereby providing opportunities for an integrated provider such as Telstra to undermine competition in the retail market through inhibiting access to its network.

However, as the previous discussion also illustrates, this presumption is questionable. For example, while the recent introduction of broadband services over copper wire (using DSL technology) may further inhibit the viability of competing network services, other technological developments could work in the opposite direction:

- The continuing growth in mobile phone networks could see the emergence of a legitimate competitor to Telstra's local loop.
- Increasing competition is also likely from the provision of low-cost telephone calls via broadband networks, including over relatively new wireless and pure fibre networks.

Box 8.11 Overseas experience with structural separation of telecommunications providers

While the issue of structural separation of incumbent telecommunication firms has been a prominent policy issue around the world, only a few countries have actually proceeded with separation initiatives. The main example has been the United States, where the incumbent, AT&T, was broken into seven regional firms (or Baby Bells) in 1985. The Baby Bells initially focused on local call services only, while the rump of AT&T became responsible for long-distance services. New Zealand and Japan also implemented similar regional break up solutions in the 1990s.

However, in both the USA and New Zealand, these structural changes have since been reversed. In the USA, legal complications over the definition of a long-distance service contributed to changes introduced in 1996 that allowed the Baby Bells back into the long-distance market, in exchange for the imposition of an access regime. And in New Zealand, where regional separation had not been mandated, re-integration occurred after only two years.

More recently, vertical separation options have again been actively considered in a range of countries. However, mainly due to the large transaction costs involved, regulators in the UK, Japan, Norway and 20 US states have all decided not to proceed — though Pennsylvanian regulators subsequently required the network and retail divisions of the local Bell to operate at arms length. Likewise, the OECD (2001 and 2003e) has made an exception to its general position on vertical separation in network infrastructure activities and concluded that full vertical separation is unlikely to deliver a net benefit in telecommunication markets.

That said, a number of countries have sought to enhance competition by restricting the entry of vertically integrated telecommunication providers into new markets. For example, Canadian telecommunication firms are prohibited from owning cable networks, with some attributing Canada's very high accessibility to cable and broadband to this policy (OECD 2003a and Willet 2004). In the USA, telecommunication firms were similarly prohibited from owning cable networks prior to 1996, by which time a competitive cable market had emerged.

Sources: OECD (2001, 2003a,e); and Willet (2004).

Yet the very threat that these new networks pose to Telstra's market position may give it incentives to thwart their development. In this regard, the ACCC (Willet 2004) has pointed to Telstra's roll-out of its cable network in the late 1990s in the same areas where its sole competitor, Optus, had already laid cable. Allegedly, this strategy diluted the available customer base for both companies and made cable a largely unprofitable investment, at least in the short term. Currently, cable only passes around one third of Australian households — one of the lowest rates in the developed world — with no immediate further roll-outs of cable by either Telstra or Optus in prospect (OECD 2003a).

Overseas evidence suggests that preventing common ownership of copper and cable networks can facilitate the emergence of new cable services and thereby the development of a more competitive telecommunications market (see box 8.11). This evidence has led both the ACCC (sub. DR165, p. 17) and the OECD (2004a) to recommend that Telstra be required to sell its cable network and its 50 per cent share in Foxtel. The latter component of this structural option is directed at preventing Telstra from impeding the development of competing networks, by restricting their access to Foxtel's content.

But like vertical structural separation, forcing Telstra to divest its cable network and/or its shareholding in Foxtel would have a range of efficiency costs that would need to be set against the potential benefits from increased competition in the provision of network services. In particular, precluding Telstra from direct involvement in cable networks could potentially deprive the market of its experience in network development in an Australian context, and also the investment capital that it could bring to the process. There is also a risk that recourse to divestiture could reduce general investor confidence and thereby retard, rather than enhance, the rate of new network development.

Splitting the cable network from Telstra's other assets would again raise a range of technological issues. And like vertical structural separation, it could be a procedurally complex and time consuming process with major implications for the proposed privatisation of Telstra.

Even a more limited option of requiring Telstra to divest its shareholding in Foxtel would be far from costless. As well as the loss of synergies between access to content and network development, the adverse demonstration effects of forced divestiture would again be a highly relevant consideration.

In the Commission's view, these trade-offs are complex. Hence, though the overseas evidence suggests that the case for horizontal structural changes is stronger than that for full vertical structural separation, it is still far from clear that such changes would deliver a future net benefit in an Australian context.

A way forward

In the Discussion Draft, the Commission recommended that, in line with NCP obligations, the Australian Government should investigate the structure of Telstra prior to its full privatisation.

However, responses to that proposal have reinforced the notion that seeking to make major structural changes to Telstra at this time would be very costly. This has led

the Commission to conclude that the potential benefits of full vertical separation of Telstra's wholesale and retail arms are not sufficiently large to justify the efficiency and transaction costs that would be entailed. For similar reasons, the Commission is unconvinced that major horizontal structural changes would be worth pursuing. Moreover, as discussed below, it may be possible to encourage the emergence of new network services through other less costly mechanisms.

That said, the Commission remains mindful of the competition concerns that have underscored the recent debate on the structure of Telstra. Hence, while full vertical structural separation of Telstra, and most probably major horizontal separation initiatives, do not seem warranted, this does not preclude other policy initiatives to promote network competition and encourage the future development of new network services.

Operational separation

As outlined above, the ACCC has proposed further operational separation of Telstra's wholesale and retail divisions. Specifically, the proposal envisages the creation of separate divisions, under different management structures, located in different premises, and with transparent arms-length 'transfer' prices for network services. And though the two divisions would remain under common ownership, communication between them would be regulated.

The extent of the competitive benefits provided by such a split relative to those potentially on offer from full vertical structural separation would depend very much on the detailed implementation. Clearly the potential benefits would not be as large. And, though the attendant costs would also be smaller, their likely significance should not be underplayed. Nevertheless, in the Commission's view, an approach which would build on recent accounting separation initiatives by the Government, and Telstra's recent moves to 'managerially' separate its wholesale and retail arms, is worthy of further consideration.

Access to content

International experience suggests that access to 'premium' content is essential to the economic viability of telecommunications networks, allowing providers to offer customers phone, broadband internet and television services (ACCC 2003). Thus, an inability to access premium content is likely to be a significant barrier to the emergence of new networks, even if network competition is feasible on cost and technological grounds. Accordingly, Telstra's 50 per cent shareholding in Foxtel, which in turn has exclusive access to much premium content, does raise some important competition concerns.

However, as outlined above, forcing Telstra to divest its stake in Foxtel could have significant costs. Moreover, it is far from clear that such divestiture would necessarily increase scope for network competition. This would depend in part on who purchased the share in Foxtel.

The latter observation serves to illustrate that, in many respects, an equally important issue to Telstra's shareholding in Foxtel is also the terms and conditions on which rival networks can, or could, access Foxtel's premium content. Conceivably, such issues could also arise in relation to other content providers at some stage in the future.

Hence, in the Commission's view, options to ensure effective access to content warrant further consideration. Given the nature of content provision, it seems highly unlikely that an individual content service could be declared under the telecommunications-specific or national access regimes, both of which focus on monopoly services.

The Commission notes that undertakings between Foxtel and the ACCC provide for general access to some of the company's content. Even so, the ACCC has proposed the introduction of a formal access regime for content, noting that the undertaking arrangements are not sufficient to address underlying competition concerns (ACCC 2003). Though the scope for, and efficacy of, such an access regime would require further investigation, at face value, it could be a more cost-effective way of facilitating competition between telecommunications networks than horizontal structural initiatives.

Screening the competition implications of merger and acquisition activity

The preceding discussion of structural separation options highlights the difficulties of 'unscrambling the structural egg' in the telecommunication sector. Significant vertical or horizontal separation options may have been feasible and desirable when the company was still in full public ownership or before new investment (for example, in the cable roll out). However, partial privatisation and the impending full privatisation have significantly increased the likely costs and difficulty of major structural changes. (For this very reason, a basic element of the Competition Principles Agreement is that governments should review structural issues *before* proceeding with privatisation.)

The additional difficulties of forced divestiture in a privatised environment in turn raise the question of whether the current regulatory regime provides sufficient scope to take effective pre-emptive action where proposed acquisitions by Telstra, or its expansion into new activities, could impede the development of a more competitive

telecommunications market. As in the electricity sector, where a similar issue arises in relation to common ownership of generation and transmission assets (see section 8.2), the need for new mechanisms is by no means clear. The current telecommunications regulatory regime already embodies a range of measures to prevent the misuse of market power, including sector-specific access and anti-competitive conduct regimes. In addition, generic provisions in the *Trade Practices Act 1974*, provide additional protections and, in the case of the merger provisions, a prospective screening device in some situations.

Nevertheless, it is conceivable that the current regulatory regime might still allow acquisitions or expansions by Telstra that could impede the entry of new players to the market and which would again see costly ‘after-the-event’ structural proposals on the policy agenda. Accordingly, the Commission considers that the case for an additional pre-emptive tool in the telecommunications policy armoury cannot be ruled out.

The Commission notes that the Australian Government has announced it will investigate the telecommunications regulatory regime prior to the sale of Telstra. As it indicated in the Discussion Draft, the Commission supports this commitment, especially if it encompasses the full review of the anti-competitive conduct regime, currently scheduled for 2007. This review would also provide the opportunity to examine the other issues outlined above.

RECOMMENDATION 8.12

The Australian Government should bring forward the scheduled review of telecommunications regulation prior to the sale of Telstra. The terms of reference should provide for an assessment of:

- *whether further operational separation of Telstra’s wholesale and retail arms would yield net benefits;*
- *the merits of an access regime for telecommunications content; and*
- *whether the current regulatory regime is adequate to address any future acquisitions or entry into new activities by Telstra, that could threaten the development of a more competitive telecommunications market.*

9 The legislation review program

Key points

- The legislation review program (LRP) has played an important role in winding back barriers to competition and efficiency across a wide range of economic activities.
- Though much of the current LRP is or will shortly be completed, there are some important outstanding items. And the outcomes from a number of key review areas have been problematic.
- Governments should complete the existing program before continuing with a more targeted regime following the conclusion of the NCP. The new mechanism should be better focussed on significant anti-competitive legislation, and involve increased transparency and independence of review processes.
- Priorities for future legislation review should include:
 - undertaking the previously recommended review of the ‘single desk’ marketing arrangements for export wheat; and
 - a ‘second-round’ review of pharmacy regulations, covering all restrictions on competition in the sector.
- A national review of compulsory third party and workers compensation insurance may also be warranted (though opportunities to build on the foreshadowed development of a national framework for the reform of workers compensation insurance may render such a review unnecessary).
- Effective mechanisms for monitoring the efficacy of new and amended regulations that contain restrictions on competition are very important, including to guard against backsliding.

The terms of reference for this inquiry specifically ask the Commission to report on a possible further legislation review and reform program. This chapter considers the operation of the existing program and a range of modifications which could improve its effectiveness, as well as opportunities to strengthen gate-keeping arrangements for new or amended regulations containing restrictions on competition. It also identifies some priority legislation reviews which would provide the basis for future reforms likely to be of significant net benefit to the Australian community.

9.1 The legislation review process

In the Commission's view, the legislation review program (LRP) has proven a valuable process for testing whether a plethora of anti-competitive regulation was in the public interest. A variety of anecdotal and case study evidence suggests that, in many areas, the legislative reforms which have resulted from the process have delivered significant benefits to the community including (but not limited to): increased consumer choice; improved access to services; lower prices; new business, employment and occupational opportunities; a reduction in 'red tape'; greater certainty for market participants and improved national consistency across a range of regulatory activities.

As noted in chapter 2, however, the current program remains incomplete with around 20 per cent of reviews either yet to be conducted, or involving outcomes deemed inconsistent with NCP principles. And while participants were generally supportive of the benefits brought by the LRP, many commented that procedural arrangements could be improved. A few even considered that a further program was now unnecessary.

Against this background, two broad questions arise:

- Should all outstanding pieces of legislation on the original program be reviewed, or only those where changes offer the prospect of significant benefits for the community?
- Once all, or the significant parts of, unfinished business are concluded, is there any need to retain a generic legislation review mechanism and, if so, how could existing arrangements be improved?

The current schedule should be completed

Several participants pointed to the 'inconsequential' nature, from a national efficiency perspective, of some of the reviews that have been conducted under the LRP. Thus, the Tasmanian Government (sub. 109, p. 7) suggested that less emphasis should be placed on reforms 'that merely redistribute gains between stakeholders within a jurisdiction'. And some went on to propose that a 'materiality test' be invoked in deciding whether to proceed with outstanding items.

The Commission acknowledges that the transactions costs of undertaking some of the more minor LRP reviews may have largely offset or even outweighed the benefits of change. Accordingly, it sees a strong case for focussing a future review schedule (see below) on areas where reform of anti-competitive regulation offers the prospect of a significant pay-off for the community.

However, to remove some previously scheduled reviews on the grounds of ‘non-materiality’ could have adverse demonstration effects for other areas of unfinished business where the potential gains are much larger. As the Western Australian Government observed:

The Productivity Commission should reaffirm the need to complete the unfinished business of NCP, in particular structural reform and the legislation review program. This will send a clear signal to vested interests that they should perhaps start to focus on competition and innovation rather than rent-seeking behaviour. (sub. 117, p. 31)

Also, there are still significant differences across jurisdictions in completion rates for ‘non-priority’ legislation reviews (see chapter 2). Hence, any move to excuse scheduled, but yet to be completed, ‘minor’ reviews could raise concerns about procedural fairness.

A modified review program should be retained

Once the current LRP is completed, however, it would be possible to dispense with the mechanism and rely on:

- ad hoc reviews of anti-competitive regulation retained as a result of the LRP process, or not encompassed by that process;
- regulatory impact statement (RIS) and other ‘gate-keeping’ processes to ensure that restrictions on competition in new or amended legislation are in the public interest.

In some circumstances, incorporating assessments of the benefits and costs of anti-competitive regulation within broader reviews of impediments to performance improvement may be preferable to examining that regulation in isolation. The Commission’s proposed review of cabotage arrangements within a broader review of impediments to efficiency and competition in coastal shipping (see chapter 8) is a case in point.

Nonetheless, in the Discussion Draft, the Commission noted there were good reasons for retaining a (modified) LRP process as part of Australia’s competition policy architecture. In particular, it is not clear that reviews of some pieces of anti-competitive regulation under the LRP have generated the best possible outcomes for the community (see section 9.3). Retention of an LRP process could be helpful in ensuring that such regulations — and regulatory arrangements in other sectors where circumstances have changed significantly, or which were excluded from the current review schedule — are reassessed in a timely fashion. It would also bring an element of consistency to the assessment framework, which could be lacking under an approach where reviews were conducted only on an ad hoc basis. Moreover, a

generic mechanism to periodically audit and review existing anti-competitive regulation would complement RIS processes focussing on the efficacy of new and amended legislation (see section 9.2).

A number of modifications would improve its effectiveness

In the Discussion Draft, based on the lessons from the operation of the current LRP, the Commission canvassed a number of modifications to deliver better outcomes from reviews and reduce the program's transactions costs:

- Limiting the review process to areas where reform of anti-competitive regulation is likely to be of *significant net benefit* to the community, taking account of the costs of operating independent review procedures (see below), as well as any costs imposed on those currently benefiting from the regulations concerned. Priority review areas would include those:
 - important regulations excluded from the current LRP because, for example, they had only recently been reviewed (such as government procurement, export marketing assistance and R&D support), or while impacting on business were judged not to be restricting competition (such as regulations serving social policy objectives in health and education); and
 - second-round reviews in *key areas* such as ‘single desk’ export wheat marketing and pharmacy services (see section 9.3).

The Commission further suggested that relatively minor anti-competitive regulations retained as a result of the LRP need not be subject to periodic reassessment requirements.

- *Greater flexibility in the timing* of reviews. The Commission noted that this could involve providing for second-round reviews to be held earlier than the current 10 year requirement where, for example, there has been a material change in circumstances since the previous review, or where the external monitoring agency has assessed a review outcome to be ‘problematic’.
- *Greater emphasis on independent reviews*; public reporting of review outcomes (including making review reports publicly available as a matter of course and requiring governments to explain the reasons for any divergences in their decisions from review recommendations); and public consultation on the impacts of regulations and changes to them.
- A commitment by governments to *well coordinated national reviews* where regulatory arrangements in individual jurisdictions have a *significant* impact on the scope to create national markets for the goods or services concerned.

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- More *emphasis on monitoring* whether review outcomes are within the range of those ‘that could reasonably have been reached’.

The Commission also argued that there was a need to look at options to improve confidence in the public interest test noting that, for different reasons, there is considerable scepticism about the effectiveness of the current arrangements in ensuring that review outcomes do in fact reflect what is in the overall public interest. It observed that some see the current test as having provided governments with a means to pander to vested interest groups at the expense of the wider community. Others see the constitution of the test — and particularly the fact that the onus of proof falls on those seeking to retain anti-competitive regulation — as giving insufficient weight in practice to non-efficiency considerations.

The Commission went on to suggest that in addressing concerns about the onus of proof in the public interest test, some changes to the detailed constitution of the test might be warranted. Specifically, it saw value in encapsulating the essence of the 2000 CoAG directive on transitional issues in the test. As noted in chapter 6, that directive requires governments to ‘give consideration to explicitly identifying the likely impact of reform measures on specific industry sectors and communities, including expected costs in adjusting to change’.

That said, the Commission stressed that the degree of confidence in the public interest test will depend on how the agreed requirements are applied in practice and the adequacy of consultation with those affected. Thus, it saw initiatives to enhance the independence and transparency of the review process, and to strengthen the external monitoring regime, as being critically important to the effective operation of the test.

There was considerable support among participants for both a continuation of the LRP and for the modifications proposed by the Commission in the Discussion Draft. The Housing Industry Association, for example, said:

Retention of a legislation review process is essential to discourage the introduction of new anti-competitive legislation. HIA believes it is equally important to regularly audit and review existing legislation to ensure that such legislation continues to be in the public interest. To be effective, both these processes must be public, transparent and independent. (sub. DR208, p. 11)

The Western Australian Department of Treasury and Finance concurred:

The proposed modifications to the legislation review process, in particular, those initiatives aimed at targeting significant anti-competitive legislation, enhancing the independence and transparency of the review process, and strengthening the external monitoring regime, are strongly supported. (sub. DR236, p. 15)

Similarly, the South Australian Government argued:

South Australia agrees that legislation review must be far better targeted and prioritised than has been the case previously. Legislative review should only focus on major issues where there is a clear potential net public benefit, taking account of long term environmental and social impacts. ... The Discussion Draft acknowledges the shortcomings of the legislative review process caused by a lack of planning and prioritisation. This should be addressed as a matter of urgency to ensure the remaining legislative review program is timely and effective. (sub. DR224, p. 9)

Commenting specifically on the prioritisation issue, the National Competition Council (NCC) said that any successor organisation could assist governments in setting legislation review priorities in a more focused LRP. In this regard, it noted that the Council had informally played this role through its input to the two-tiered classification system developed under the current NCP.

Finally, while the Queensland Government questioned the need for the LRP to continue, it nonetheless expressed support for most of the Commission's proposed modifications if CoAG decides that a more targeted program of legislation review should be retained.

The Commission accordingly reaffirms its view that CoAG should look to implementing a more targeted successor to the LRP incorporating the modifications outlined above. It further notes that it would be desirable to formalise the role of a future monitoring and assessment body in helping to set priorities and timeframes within this more targeted program.

RECOMMENDATION 9.1

Governments should complete the existing legislation review program and agree on a more targeted program of legislation review to continue thereafter. The modified mechanism should:

- ***be limited in its scope to areas where reform of anti-competitive legislation is likely to be of significant net benefit to the community;***
- ***include provision to bring forward second-round reviews where circumstances have changed significantly, or where the external monitoring agency has assessed a previous review outcome to have been ‘problematic’;***
- ***give greater emphasis to independent reviews; provide for adequate public consultation; and require governments to make review reports public;***
- ***give explicit recognition in the public interest test to distributional, regional adjustment and other transitional issues;***

-
- *involve effectively constituted national reviews where legislation in individual jurisdictions has a significant impact on the scope to develop national markets;*
 - *give more emphasis to monitoring whether review outcomes are within the range of those ‘that could reasonably have been reached’; and*
 - *provide for the monitoring body to be involved in helping to set priorities and timeframes within the more targeted program.*

9.2 Better gate-keeping arrangements are also required

The Competition Principles Agreement obliges governments to ensure that new legislation that restricts competition is in the public interest. The intention is to prevent unwarranted anti-competitive restrictions re-emerging in new or amended legislation.

In keeping with the flexibility provided by the NCP, individual jurisdictions have adopted different approaches to this gate-keeping function. Notably, not all jurisdictions require the preparation of regulatory impact statements (RISs) for new legislation containing restrictions on competition. The types of legislation subject to scrutiny, and the extent of monitoring and public reporting of the outcomes of gate-keeping activity, vary considerably across jurisdictions (see chapter 6 and table 9.1).

In the Discussion Draft, the Commission emphasised that a key requirement for ensuring good policy making is effective independent scrutiny of, and public reporting on, the performance of departments and agencies in implementing new and amended regulations. To this end, it argued that there should be independent bodies with responsibilities for regulatory gate-keeping in each jurisdiction. At least in larger jurisdictions, the Commission noted that these could be similar to the Australian Government’s Office of Regulation Review, or the newly created Victorian Competition and Efficiency Commission. And it contended that, even in smaller jurisdictions, a degree of independence for such bodies was needed to promote confidence in the integrity of assessments and to create greater pressure for compliance. Other options for improving gate-keeping processes canvassed by the Commission in the Discussion Draft included:

- strengthening the monitoring arrangements (currently undertaken by the NCC) of the gate-keeping processes and outcomes in individual jurisdictions; and
- extending gate-keeping processes to a wider range of new or amended legislation.

Table 9.1 Coverage and nature of RIS processes across jurisdictions

Jurisdiction	Covers restrictions on competition ^a	Wide application ^b	RIS required for community consultation	RIS for decision maker	Mandatory publication of decision-making RIS	Independent assessment body and public compliance reporting ^c
Australian Government	✓	✓	-	✓	✓ ^d	✓
NSW	✓	-	✓	✓	✓ ^e	-
Vic	✓	-	✓	✓	-	✓
Qld	✓	-	✓	✓	✓ ^e	-
SA	✓	✓	-	✓	- ^f	-
WA ^g	-	-	-	-	-	-
Tas	✓	✓	✓	✓	✓	-
ACT	✓	-	-	✓	✓ ^e	-
NT	✓	-	-	✓	-	-

^a The requirement to prepare a RIS is not triggered by competition impacts in NSW, Qld, SA and WA. However, competition impacts may be assessed within a RIS. ^b The RIS process is considered to have wide application if it covers proposals to be implemented via primary/subordinate legislation and quasi-regulation, and contains analysis of impacts on stakeholders and the community as a whole. In some jurisdictions, for example Queensland, RIS processes are supplemented by public benefit tests which are applied to primary legislation identified as containing restrictions on competition. ^c The Australian Government and Victoria are the only jurisdictions with formally established independent regulatory gate-keepers. The Office of Regulation Review and the Victorian Competition and Efficiency Commission are both independent statutory bodies. NSW and SA provide independent reports on departments' and agencies' compliance with their RIS requirements. ^d Mandatory publication of RISs for primary/subordinate legislation; not mandatory but encouraged for quasi-regulation. ^e RISs required to be tabled for subordinate legislation only. ^f Publication of RISs with regional impacts. ^g WA does not have formal RIS requirements.

Sources: PC (2003d); unpublished Office of Regulation Review data.

In this latter regard, it noted that the Australian Government's regime encompasses proposed legislation that impacts on business as well as legislation with anti-competitive effects.

While respondents to the Discussion Draft generally supported the need for gate-keeping arrangements, some questioned the need for current processes to be strengthened. The Queensland Government, for example, contended that:

... jurisdictions should be free to determine their own arrangements for monitoring new and amended legislation, including whether some form of "independent" agency is warranted. (sub. DR189, p. 17)

Similarly, the South Australian Government did not consider that establishing independent assessment bodies in each jurisdiction was warranted. In support, it cited a recent Western Australian review which judged the effectiveness of such initiatives to be marginal.

However, the Department of Treasury and Finance in Western Australia supported the use of independent bodies (including in its own jurisdiction) particularly to guard against pressure from vested interest groups to reintroduce restrictions on competition:

Perhaps jurisdictions that do not have a sufficiently robust gate-keeping mechanism in place should work towards establishing independent bodies with relevant expertise to advise agencies on when and how to conduct regulatory impact assessments. (sub. DR236, p. 17)

And in endorsing the need for more effective gate-keeping processes, the Business Council of Australia pointed to a range of emerging problems with current arrangements including:

- governments introducing new regulation to neutralise potential political issues without assessing the adequacy of existing laws, considering how new regulation interacts with existing regulatory frameworks, without adequate regard for compliance and other costs, and/or without regard for the ability of the regulation to impact outcomes or behaviour; ...
- existing cost-benefit analysis processes, such as regulatory impact statements, being honoured more in the breach rather than the observance;
- regulators applying rules in a bureaucratic or legalistic way, without regard to the actual policy objectives underlying the regulation; and
- lack of any formal process for assessing regulation once it is in place to ensure it is achieving its stated policy objectives effectively and efficiently. (sub. DR234, p. 3)

The NCC had similarly alluded to such problems in its initial submission stating that it had:

... already found that some governments are under pressure from interest groups to reintroduce restrictions on competition, ostensibly to mitigate adjustment pressures. (sub. 71, p. 18)

It has also previously cited the Australian Government's regime (see box 9.1) as providing a best practice model for others to follow:

The Commonwealth Government's gate-keeping procedures represent best practice as they require impact assessment for all regulatory proposals and are underpinned by detailed guidelines on the conduct of impact analysis. An independent Office of Regulation Review is empowered to examine agencies' impact assessments and to advise Cabinet on their adequacy. The Office also monitors and reports annually on compliance with the regulation impact analysis guidelines. (NCC 2003b, p. xxii)

Box 9.1 The Australian Government's quality control processes for new or amended regulation

History

In 1985, the Business Regulation Review Unit was established by the Hawke Government, with specific responsibilities for improving the quality of regulation and reducing red tape. Its role was progressively strengthened and in 1991 it was relocated to the then Industry Commission and renamed the Office of Regulation Review (ORR). In 1997, in response to a report from the Small Business Deregulation Task Force, the Howard Government released the statement *More Time for Business* which announced a range of initiatives, including enhancing Regulation Impact Statement requirements.

Regulation Impact Statements (RISs)

RISs formalise and document the steps in formulating good regulation. These include specifying the policy problem and rationale for government intervention; identifying feasible options for dealing with it; and analysing their costs and benefits. Public consultation is a key requirement, with any compliance costs (particularly on small business) to be specified. They are prepared for all forms of regulation that impact on business or restrict competition and apply at the Australian Government level to about 120 regulatory proposals each year.

RISs are prepared by the department/agency developing regulation and seek to ensure that the regulation achieves its objectives in the most effective and efficient way. RISs are integrated with, and reinforce, other quality control systems, including regulatory performance indicators and regulatory plans. They are made publicly available when legislative bills or disallowable instruments are tabled.

The Office of Regulation Review

The ORR provides independent input into the preparation of RISs. It plays an advisory and monitoring role on process and does not advocate particular policies or regulatory outcomes. The ORR reports to decision makers and the community on compliance with the RIS requirements.

Trends in Compliance

Compliance with the RIS requirements has improved in recent years, with about 90 per cent being assessed by the ORR as adequate in the past year. However, there is scope for some departments and agencies to do better. RIS compliance has generally been lower for regulatory proposals with significant impacts across the community. And RISs are sometimes prepared too late in the policy development process to adequately inform decision-makers.

For its part, the Commission acknowledges the need for flexibility in determining the most appropriate form of gate-keeping arrangements in each jurisdiction. For example, it may not be cost effective for smaller jurisdictions to establish stand-alone gate-keeping entities. But like the WA Department of Treasury and Finance and others, it remains of the view that independent arrangements are necessary to help guard against backsliding on previous reforms and the potential for inappropriate outcomes from the introduction of new or amended legislation. The Commission also considers that the general approach to gate-keeping in jurisdictions such as Victoria and at the Australian Government level are robust processes and thus would be potentially useful in a wider range of regulatory areas.

That said, as the NECG (sub. 134, p. 64) amongst others pointed out, there is still scope to improve on these arrangements. Indeed, the Office of Regulation Review (PC 2003d, 2004f) has itself identified a number of potential areas for improvement in the Australian Government's regulatory gate-keeping processes, including the need for:

- greater transparency in the making and administration of regulations;
- better integration of RIS processes into Agency regulatory policy development processes;
- provision of better quality information regarding compliance costs and administrative burdens associated with options considered in RISs; and
- greater attention to be paid to effective implementation of regulations and ensuring greater accountability of regulatory decision makers.

RECOMMENDATION 9.2

All Australian governments should ensure that they have in place effective and independent arrangements for monitoring new and amended legislation.

Governments should also consider widening the range of regulations encompassed by gate-keeping arrangements and strengthen national monitoring of the procedures in place in each jurisdiction and the outcomes delivered.

9.3 Some priority legislation reviews

Distinct from the institutional framework of a future LRP, the Commission has also identified a number of areas where specific reviews would offer the prospect of substantial gains to the Australian economy. They are:

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- some key areas of unfinished business under the current LRP — in particular, anti-dumping arrangements; and
 - some important economic activities where restrictions on competition have been reviewed, but the reform process remains incomplete or outcomes have been problematic — namely, pharmacies, grains marketing and insurance services.

Anti-dumping

As noted in chapter 2, two key areas of unfinished business from the current LRP are anti-dumping arrangements and cabotage. However, in the Commission's view, cabotage issues would most appropriately be addressed as part of the proposed review and reform program for freight transport (see chapter 8).

Anti-dumping arrangements have always been a contentious issue (see box 9.2). Such arrangements are employed both to promote 'fair' trade and to guard against predatory pricing behaviour that may be inimical to longer term efficiency in affected industries. However, as a barrier to imports, anti-dumping measures, including the resulting countervailing duties, may also serve to restrict competition and, through higher prices, penalise consumers and user industries.

Over the last decade, there have been some changes to Australia's anti-dumping regulations. Indeed, the scheduled legislation review of anti-dumping was initially postponed pending the full implementation of new administrative arrangements resulting from the Willet Review (completed in 1996).

However, despite the new arrangements now being in place for a number of years, the review is yet to take place. Consequently, in the Discussion Draft, the Commission proposed that the previously scheduled NCP review of anti-dumping arrangements occur at the earliest possible date.

Many participants supported the call for a review, including the Australian Industry Group (sub. DR201); the Australian Chamber of Commerce and Industry (sub. DR198); the Minerals Council of Australia (sub. DR227); Western Graingrowers (sub. DR 242); and the Independent Paper Group (sub. DR137).

More specifically, the ACCC (sub. DR165, p. 9) suggested that there should be provision for it to make submissions to anti-dumping investigations in circumstances where mergers had been approved having regard to the extent of import competition. However, the Australian Customs Service (sub. DR254, p. 2) indicated that under present legislation there is already scope for such submissions to be made.

Box 9.2 What is ‘dumping’?

‘Dumping’ is defined as the sale of imported goods at below the ‘normal’ price they sell for in their country of origin. While benefiting consumers and user industries, such practices can adversely affect competing local producers in the markets concerned.

World Trade Organisation (WTO) rules do not prohibit dumping, but constrain how governments can react to it. The legal definitions are more precise, but broadly speaking, the WTO agreement allows governments to act against dumping where it can be shown to have given rise to ‘material’ injury to the competing local industry. In order to take action, the government has to be able to show that dumping is taking place, calculate the extent of dumping (how much lower the export price is compared to the exporter’s home market price) and show that it is causing injury.

However, there are a range of commercial reasons why producers might choose to sell at lower prices in export markets; for example, quitting excess stock, filling capacity and developing new markets. Hence, as in other areas of competition law, distinguishing between normal competitive pricing behaviour and predatory behaviour is very difficult.

Source: PC (2003e).

Suffice to say that the interface between trade and competition policy that the ACCC’s proposal serves to illustrate, also underlines the need for a review as soon as possible. Indeed, in the Commission’s view, the potential for the inappropriate application of anti-dumping arrangements to jeopardise the benefits that wider trade and competition reform have delivered, makes this one of the more important remaining trade policy issues to be addressed.

RECOMMENDATION 9.3

The Australian Government should, as soon as practicable, initiate the independent review of anti-dumping arrangements previously scheduled under the NCP.

Pharmacies

The community pharmacy sector is an integral part of Australia’s health care system. For most Australians it is the shopfront for a range of medicines and health care products such as:

- prescription drugs, including those supplied through the Pharmaceutical Benefits Scheme (PBS), and over-the-counter drugs available only from pharmacies; and
- non-scheduled drugs, healthcare and other products, such as cosmetics, that are also available from other retail outlets.

In addition, pharmacies provide advice to consumers on the safe and effective use of medicines and other health care issues. Partly to help ensure that such advice is accurate, there are a variety of licensing, ownership, location and advertising restrictions (see box 9.3).

These restrictions have been the subject of much review during the LRP process:

- The Wilkinson Review, in 2000, investigated State and Territory licensing and ownership regulations, and the location restrictions embodied in the Australian Community Pharmacy Agreement (ACPA). It recommended removing the restrictions on how many pharmacies a pharmacist can own, but supported the retention of the regulations prohibiting non-pharmacist ownership or control. In addition, the Review recommended that location controls be replaced by a restriction on the total number of pharmacies and proposed the introduction of an alternative remuneration system to pharmacists for dispensing PBS drugs (to encourage rationalisation in the sector).
- In response, a CoAG Working Group (CoAG 2002a) criticised the Wilkinson Review for ignoring evidence from other health sectors and overseas, which suggested that ownership restrictions were unnecessary. Nonetheless, they backed the limited recommendations of the Wilkinson Review, arguing that more radical reform would create excessive adjustment pressures.
- A separate national review, chaired by Rhonda Galbally (2001), examined pharmaceutical advertising restrictions; as well as regulations on the handling, packaging and labelling of drugs and poisons. The review recommended that the Australian Government should assume sole responsibility for advertising regulations and that there should be more scope for the provision to consumers of informational (but not promotional) material on prescription pharmaceuticals.
- The Department of Health and Aging is currently reviewing the location restrictions prior to the re-negotiation of the ACPA later this year.

However, few of the recommendations for change from these recent reviews have been implemented. The proposed changes to ownership restrictions were withdrawn after intervention by the Prime Minister; the Australian Government did not publicly respond to the Wilkinson Review recommendations relating to the ACPA; and most governments are awaiting the recommendations from the Australian Health Ministers' Advisory Council before implementing changes to advertising restrictions.

Box 9.3 Restrictions on competition in the pharmacy sector

Restrictions on competition in the pharmacy sector are ostensibly in place to:

- help ensure that consumers receive effective advice on the use of potentially harmful drugs;
- facilitate access to pharmaceuticals for all Australians; and
- contain the cost of the PBS so as to maintain its future financial viability.

Restrictions are imposed by both Australian and State and Territory Governments.

State and Territory Governments are responsible for licensing and ownership restrictions. For example, pharmacists are required to complete a four year degree followed by on-the-job training before they can be registered as a pharmacist. More restrictively, State and Territory regulations mean that generally only pharmacists can own and control pharmacies, with each pharmacist limited to owning no more than four pharmacies in most jurisdictions. There are some exceptions for Friendly Societies.

Through the ACPA, the Australian Government, in negotiation with the Pharmacy Guild, places restrictions on the location of pharmacies able to dispense subsidised PBS medicines. For example, new pharmacies can only locate within areas of 'definite community need', while existing pharmacies can only relocate once every two years and not leave behind a community need. The ACPA also sets remuneration levels to pharmacists for dispensing PBS medicines, based on average industry costs rather than industry best practice. Pharmacists must also collect co-contributions on certain drugs, which they are prohibited from discounting (ACPA 2000).

The Australian and State and Territory Governments place restrictions on the advertising of pharmaceuticals to end consumers.

- The direct-to-consumer promotion of prescription drugs (and some pharmacy-only drugs) is prohibited. While 'informational' advertising is allowed, the Galbally Review found that there is some ambiguity over the definition.
- Though the promotional advertising of over-the-counter drugs is generally permitted, print and television advertisements must seek pre-approval.

State and Territory Government regulations also restrict the sale of prescription and a range of other medicines to pharmacies.

The regulatory regime contains numerous internal tensions. For example, ownership restrictions reportedly raise the cost of capital for pharmacists, leading to higher dispensing costs and putting further financial pressure on the PBS. In addition, by making a re-location irreversible in the short term, location restrictions can potentially restrict access to pharmaceutical services.

Moreover, overseas evidence suggests that Australian restrictions are relatively stringent and that some restrictions may be unnecessary to achieve their stated objectives. For example, based on evidence from a number of countries, the OECD (2000) has reported that relaxing constraints on competition in professional services (including pharmacists) does not generally reduce service quality.

Not surprisingly, the lack of action on these recommendations concerned several participants. Woolworths (sub. 115), for example, suggested that the restrictions protect the livelihood of pharmacists at the expense of consumers. Similarly, the Australian Medical Association (sub. DR251, p. 13) argued that regulations in the current ACPA impose costs on the wider community and taxpayers, and could serve to ‘validate’ a number of restrictions on competition in other parts of the health sector. And pharmacist Robert Lee (sub. DR 259) claimed that current restrictions, by increasing returns to pharmacy owners, inflate the costs of purchasing a pharmacy and effectively lock-out many young pharmacists from owning their own business. Mr. Lee went on to suggest that:

Whether a pharmacy business is economic or not should be decided by competition, not by restricting business licences via the closed PBS approval number. (sub. DR259, p. 1).

Furthermore, the Australian Consumers’ Association (2004) recently contended that, on the basis of its investigations, despite the claimed rationale for much of the regulations being to guard against sub-standard service provision, the quality of service that consumers actually receive in pharmacies is often poor.

The Pharmacy Guild of Australia (sub. 64) disputed these contentions, arguing that a relaxation of restrictions would result in large retail pharmacies undermining the existing community pharmacy network. In addition, in a study commissioned by the Pharmacy Guild, the NECG (sub. DR149) argued that non-pharmacist owners would place greater emphasis on profit. The NECG went on to suggest that — notwithstanding professional codes of ethics and prescription requirements for most PBS medicines — this could result in an increase in unnecessary consumption of pharmaceuticals, potentially lowering health outcomes and increasing the cost of the PBS to taxpayers.

The divergence in views and review effort to date illustrates the complexity of this area and the different interests involved. But equally, the underlying issues raised in this inquiry and previous reviews are not going to disappear: there seems little doubt that whatever the benefits, pharmacy restrictions potentially impose large costs on consumers, taxpayers and the wider community.

Moreover, continuing escalation in the costs of the PBS will necessitate an increased focus on ways of improving cost-effectiveness in the pharmacy sector. In this regard, the Commission notes that Australian pharmacy restrictions appear quite stringent relative to several other countries and compared to the remaining restrictions on competition in other health sectors.

The Commission also observes that previous reviews have been of a piecemeal nature and thus have not been able to explore fully the linkages among the different

regulations. For example, one key issue for the future is whether increased competition — resulting from an easing of say ownership or advertising restrictions — would reduce the need for location controls, or would increase the scope for PBS dispensing fees to be set according to the costs of the most efficient pharmacy, rather than linked to average industry costs.

The Commission recognises that such a holistic review could not be conducted before the renegotiation of the ACPA later this year. Accordingly, it recommends that a new and broad review of pharmacy restrictions should take place in 2008, in time to inform the renegotiation of the subsequent ACPA in 2010. However, there may still be opportunities for some more limited beneficial changes to the 2005-10 Agreement. For example, replacing the average cost method of indexing PBS dispensing fees with a CPI-X approach could provide much stronger incentives for efficiency improvement in the future. Such an approach has been widely used in other regulated industries.

RECOMMENDATION 9.4

The Australian Government, in consultation with the States and Territories, should initiate a broad review of all of the restrictions on competition in the pharmacy sector no later than 2008, in time to inform the re-negotiation of the Australian Community Pharmacy Agreement in 2010.

In re-negotiating the 2005-10 Pharmacy Agreement, the Australian Government should consider introducing a CPI-X indexing arrangement for PBS dispensing fees.

Grains marketing

Grain production is an important part of Australian agriculture and a major contributor to Australia's exports. Total Australian grain exports are worth over \$5 billion annually, the most important being wheat, which accounts for around 4 per cent of the total value of Australia's exports (DFAT 2003).

Like a number of other agricultural commodities, grains marketing in Australia was historically undertaken by statutory marketing authorities (SMAs). Under this system, grain producers were constrained to sell their output through a 'single desk' arrangement. The intention of such arrangements was to provide farmers with a degree of market power, thereby raising the prices they received — especially in export markets.

In reviewing such arrangements in the past, the Commission (see, for example, PC 2000d) has generally concluded that the potential benefits of 'single desk'

marketing are likely to be small relative to the costs (for example, through discouraging product and marketing innovations and imposing higher prices on domestic customers). The NCP legislation reviews of grain marketing arrangements at both the Federal and State levels have generally confirmed this assessment.

However, while considerable progress has been made in liberalising grain marketing arrangements at the State level, the Australian Government's decision to retain single desk marketing for export wheat has generated controversy. A review of the *Wheat Marketing Act 1989* (Irving et al. 2000) found that while introducing competition was likely to deliver net benefits, it would be premature to remove the export controls. Accordingly, the review recommended that the Australian Wheat Board's export monopoly be retained until a further inquiry was undertaken in 2004.

As it transpired, the 2004 Wheat Marketing Review (Williams et al. 2004) differed from a conventional, transparent NCP review in that it provided two reports: a comprehensive but confidential report to the Minister for Agriculture, Fisheries and Foresteries and a highly summarised public report. Also, the terms of reference for the review explicitly excluded analysis of whether the 'single desk' should be retained, instead focusing on improving the operation of the existing arrangements — it was indicated that the review was not intended to fulfil NCP requirements (Truss 2003). Nevertheless, though not charged with commenting on the future of the 'single desk', the review argued in the public document that ongoing reviews of wheat export arrangements were costly, created uncertainty and impacted on the strategic management of the 'single desk' arrangements.

Commenting on the Discussion Draft's proposal for an immediate review consistent with NCP principles, the Grains Council of Australia (sub. DR171) endorsed the argument that a further review would be costly. It also contended that the 'single desk' arrangements are intrinsically beneficial:

... the current wheat export marketing arrangements are delivering a premium to producers of between AUD \$80 million and \$200 million per annum, or an average benefit to pool participants of \$13 per tonne ... any moves to strip away the current wheat marketing arrangements will lead to direct losses on the part of wheat producers and subsequently rural and regional Australia (sub. DR171, p. 5).

However, other participants, including Western Graingrowers (sub. DR242), were supportive of a review. In this regard, a number pointed to the impacts of the abolition of 'single desk' arrangements for other commodities in some of the States and Territories, with the Grain Growers Association claiming that, 'clear benefits have emerged and can be observed in both Victoria and Western Australia' (sub. 37, p. 2).

Similarly, a recent study commissioned by the NCC (2004f) found that grains marketing reform in some States had led to no material reductions in prices obtained in export markets, calling into question the ability of ‘single desk’ arrangements to increase gross returns to farmers. The study further found that deregulation has led to the development of new selling methods for farmers providing for potentially higher returns in some situations, as well as enhanced risk management options. Other studies, including the Commission’s own previous work (2000d), have also highlighted the potentially significant gains from wheat marketing reform:

- A study by Allen Consulting suggested an increase in national welfare of between \$56 million and \$223 million a year (Australian Grain Exporters Association, sub. 75).
- Research by the Centre for International Economics estimated supply-chain savings of between \$120 million and \$360 million (Australian Grain Exporters Association, sub. 75).

Notwithstanding the Grains Council’s contention (sub. DR271, p. 10) that evidence from other grain industries cannot be applied to the wheat market, the Commission remains of the view that such evidence, and the findings of the 2000 review, provide a compelling reason for immediately holding an independent, transparent review into the future of the wheat ‘single desk’. It also notes that an early review, if it leads to liberalisation, would have spin-offs to other grain areas. For example, full deregulation in Western Australia has been made contingent on action at the Federal level.

RECOMMENDATION 9.5

The Australian Government should initiate an independent, transparent review of the future of the ‘single desk’ export wheat marketing arrangements in accordance with NCP principles as soon as practicable.

Insurance services

In all States and Territories, compulsory third party (CTP) insurance and workers’ compensation insurance are mandatory. Consequently, these insurance markets are nationally significant — the total value of the workers’ compensation market is around \$6 billion and the CTP market is worth just under \$4 billion (PC 2004e; APRA 2003).

Premiums for these insurance services are subject to regulatory oversight and, in some jurisdictions, services are delivered by a publicly-owned monopoly insurer. Premium controls can limit the connection between the riskiness of an activity and the premium incurred; potentially diminishing incentives to minimise risk. And the

lack of competitive disciplines associated with monopoly provision of these services is likely to result in higher costs, and therefore higher average insurance premiums. Regulatory differences across jurisdictions also add to the compliance costs of multi-state employers. It is these aspects of the current regulatory regime — rather than the requirement for mandatory acquisition of such insurance — that have been the focus of recent policy attention. Synthesising current concerns, the Insurance Australia Group observed in its initial submission:

Workers' compensation and to a lesser extent compulsory third party insurance are key drivers of economic prosperity and international competitiveness. While most of Australia's infrastructure has undergone substantial reform in recent times to support a single open market economy, Australia's workers' compensation and compulsory third party insurance markets remain testimony to a bygone age (sub. 87, p. 1).

As part of the NCP process, all States and Territories have conducted separate legislation reviews of monopoly insurers and premium controls. However, moves to implement the recommendations arising from these reviews have been slow, with no action occurring in some cases. For instance, despite all of the initial reviews into the monopoly provision of CTP insurance recommending that more competition be introduced — and three out of the five workers' compensation reviews reaching the same conclusion — no jurisdiction has, as yet, amended legislation to allow this to happen. In some instances, governments have commissioned further reviews that have overturned the initial findings and recommended retaining monopoly insurers.

In addition, the Australian Government asked the Commission (PC 2004e) to advise on potential national frameworks for workers' compensation and occupational health and safety regimes. The Commission found that the different workers' compensation arrangements in each State and Territory impose significant compliance costs on employers operating in more than one jurisdiction. It therefore recommended that national self-insurance and premium-paying schemes be established as an alternative to the State-based schemes.

The Commission acknowledges that the arrangements in these insurance markets are complex and, through their involvement in these markets, governments are exposed to significant risk. Hence, progressing reform is unlikely to be straightforward.

Nonetheless, the significance of the CTP and workers' compensation markets, the lack of action on the recommendations of reviews, and the inconsistent developments across jurisdictions, led the Commission to propose in the Discussion Draft that restrictions on competition in these markets be the subject of further review.

Some respondents to the Discussion Draft, such as the South Australian (sub. DR224) and Queensland (sub. DR189) Governments, rejected the need for a review, referring to the social objectives of these insurance arrangements and the fact that there have already been reviews.

Others, such as the Australian Industry Group (sub. DR201) and the West Australian Department of Treasury and Finance (sub. DR236), supported a review, with the latter stating that:

A re-examination of the insurance services issue would be beneficial, given the current lack of clarity over whether public monopoly or private competitive provision of compulsory third party (CTP) and workers' compensation insurance delivers greater benefits to the community (sub. DR236, p. 12).

For its part, the Commission reiterates that this is an area where the reform process to date has failed to take advantage of opportunities to deliver better outcomes for those requiring these insurance products and for the community more generally. It is also an area in which agreement on national frameworks might provide the reform momentum that has been lacking under the jurisdiction-by-jurisdiction approach. Notably, while rejecting the Commission's specific proposal to develop an alternative workers' compensation scheme, the Australian Government endorsed the benefits of a national approach in the workers compensation area (DEWR 2004b). To this end, it has tasked a new non-legislative Advisory Council with building nationally consistent frameworks.

In the Commission's view, this initiative could provide a useful starting point to energise the reform process in the wider insurance market. More specifically, given the commonality of issues in the workers' compensation and CTP insurance areas, the proposed Advisory Council could also be charged with the development of national frameworks for CTP. An immediate task for the Advisory Council could be to determine whether a further (national) review of restrictions on competition and efficiency in these two areas is a necessary precursor to worthwhile policy initiatives, or whether the previous reviews have provided a sufficient basis for the development of new national reform frameworks.

RECOMMENDATION 9.6

The remit of the foreshadowed Advisory Council to develop nationally consistent frameworks for workers' compensation insurance should be expanded to encompass the development of national frameworks for compulsory third party insurance. As part of that process, the Council should consider whether a further (national) review of restrictions on competition and efficiency in workers' compensation and compulsory third party insurance is required to facilitate the development of these frameworks.

10 Other aspects of the future competition framework and regulatory architecture

Key points

- Consideration should be given to legislative changes to the TPA to ensure that all government procurement activities are covered by the Act.
- Given the important role of consumer protection legislation and apparent shortcomings in the development and administration of standards regimes and other protection measures, a broad national review of this area would be desirable.
- Though the tariff reduction program is now largely complete, there are still some assistance-related arrangements that may impede efficient competition.
- Although most States and Territories have now signed an agreement to limit ‘bidding wars’ for projects, more could be done to ensure that the provision of selective assistance to firms does not distort location decisions and produce ‘negative sum’ outcomes nationally.
- The competitive neutrality regime is generally working well and no major changes are required.
- Inadequate or inappropriate investment in infrastructure networks could have major ramifications for Australia’s future economic performance and standard of living.
- In encouraging efficient outcomes, clear and nationally consistent objectives and principles to underpin the regulation of monopoly service providers have an important role to play.
- Specific price setting arrangements for regulated services should give more emphasis to facilitating investment.
- Consideration should be given to the use of lighter-handed alternatives to access regulation, such as price monitoring, where there is evidence that the level of competition is more developed.
- In currently regulated retail markets where effective competition has been established, regulatory controls on retail prices should be removed. Well targeted and transparent support mechanisms should then be used to ensure that disadvantaged groups have adequate access to services at affordable prices.

As well as establishing reform programs for some key infrastructure sectors, NCP provided for ‘systemic’ reforms to promote greater and more efficient competition across the economy. Apart from the legislation review program and related gate-keeping arrangements for new and amended regulations, these included: extensions to the coverage of the Trade Practices Act (TPA); implementation of a national access regime; GBE governance reforms, including the introduction of competitive neutrality (CN) requirements; and prices oversight of monopoly service providers.

While much of the revamped competition framework and regulatory architecture appears to be operating effectively, there are shortcomings in some particular aspects. Moreover, in assessing the scope to build on the systemic reforms put in place under the NCP, it is relevant to consider whether other legislative frameworks affecting competition across large parts of the economy — for example, consumer protection regulation — are broadly appropriate.

10.1 Some remaining trade practices issues

There have been several significant changes to the TPA in recent years. Apart from the NCP reforms extending the coverage of the Act to State and local government businesses and unincorporated enterprises, and the introduction of a national access regime (Part IIIA), changes have ensued (or are pending) from Commission inquiries into Part 2D (local government exemptions — PC 2002f); Part X (international liner cargo shipping — PC 1999d); and Parts XIB and XIC (telecommunications competition regulation — PC 2001f).

Changes to the competitive conduct and authorisation provisions (Parts IV and VII) are also in prospect following the Dawson Review (see box 10.1). And, in its response to the Commission’s review of the national access regime (PC 2001d), the Australian Government has signalled its intention to make a range of changes to ‘clarify the Regime’s objectives and scope, encourage efficient investment in new infrastructure, strengthen incentives for commercial negotiation and improve the certainty and transparency of the regulatory processes’ (Costello 2004a). Also, the Commission has recently completed another review of the Part X provisions (PC 2005c), and a study into the merits of pursuing greater integration of Australian and New Zealand competition and consumer protection policy and law (PC 2004a).

With all of this change, it might be presumed that there is not much left to do in the area of trade practices regulation. However, in submissions to the inquiry, several matters have been raised that warrant examination in the context of efforts to further improve the effectiveness and efficiency of the TPA. For example:

Box 10.1 The Dawson review

The review, chaired by Sir Daryl Dawson a former Justice of the High Court of Australia, was initiated in 2002 to examine the operation of the conduct and authorisation provisions of the TPA (Parts IV and VII). Amongst other things, the terms of reference requested the review to examine whether these provisions:

- inappropriately impede the ability of Australian industry to compete locally and internationally;
- provide an appropriate balance of power between competing businesses and, in particular, between businesses competing with or dealing with businesses that have larger market concentration or power; and
- are flexible and responsive to the transitional needs of industries undergoing, or communities affected by, structural and/or regulatory change and to the requirements of rural and regional areas.

In its report (Dawson 2003), the review panel broadly endorsed the current architecture and operation of the TPA. It emphasised that the provisions of the Act should remain focussed on protection of the competitive process and not be used as a vehicle for industry policy or to preserve uncompetitive corporations. And it rejected calls for new regulation to promote competition in specific markets, such as grocery retailing, where structural change has resulted in a high degree of concentration, noting that 'Concentrated markets can be highly competitive.' (p. 36)

However, the panel recommended a range of specific changes to aspects of Parts IV and VII and the processes for applying them, including: a greater onus on the ACCC to explain its decisions in relation to the informal clearance process for mergers; the introduction of a formal voluntary clearance process; the forwarding of applications for authorisation of mergers direct to the Australian Competition Tribunal with a decision required within three months; relaxation or an end to some of the 'per se' prohibitions on particular forms of market conduct; increased pecuniary penalties for breaches of the Act; the introduction of criminal sanctions for 'serious cartel behaviour' (subject to certain provisos); and various administrative changes to make the ACCC more accountable.

The Government accepted most of the review's key recommendations and has recently introduced enabling legislation to the Parliament. Amongst other things, this legislation will: establish the voluntary formal clearance system for mergers proposed by the review; impose time limits on the ACCC for the consideration of non-merger authorisation applications; provide a joint venture defence to the exclusionary and price-fixing provisions; replace the outright prohibition on third line forcing with a substantial lessening of competition test; provide for a notification process for collective bargaining by small business as an alternative to the authorisation process; increase the maximum fine for corporations engaging in anti-competitive conduct to the greater of \$10 million or three times the benefit from the anti-competitive conduct, or where this cannot be determined, 10 per cent of the annual turnover of the corporation and its related entities. More recently, the Government also announced its intention to introduce criminal penalties for individuals involved in serious cartel behaviour of up to five years imprisonment and a fine of \$220 000 (Costello 2005).

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- Several participants argued that, in addition to the Government's intended changes, there is a need to further modify the price setting and regulatory arrangements within the national access regime (Part IIIA) so as to minimise the risk of deterring desirable investment in essential infrastructure. This issue is addressed in section 10.4 as part of a broader discussion on the efficacy of current arrangements for overseeing the activities of monopoly providers of infrastructure services.
 - Some participants also questioned whether the exemption from the TPA for various labour market matters is conducive to the development of more flexible and competitive workplace arrangements (see chapter 11).

In addition, reference was made to the treatment of small businesses under the TPA and to the efficacy of exemptions from the Act for certain government business activities (such as statutory marketing authorities).

Addressing the concerns of small business

There have been longstanding concerns about whether Section 46 of the TPA — Australia's main law protecting the competitive process from the misuse of market power — provides sufficient protection for small businesses against larger rivals. However, some recent High Court decisions on the interpretation of these provisions, and increasing concentration in parts of the economy, have heightened those concerns. Thus, the Council of Small Business Organisations of Australia argued in its submission:

It is also cruel to expose small businesses and families to totally unfettered competition against huge companies that are the result of mergers caused by the economic necessities of a free market, when these large and powerful corporations are not constrained in their behaviour by effective Trade Practice laws which deter anti-competitive and unconscionable conduct. (sub. 53, p. 7);

This issue was canvassed by the Dawson Review, as well as being the explicit focus of a recent Senate Inquiry (Senate Economics Committee 2004).

The Commission endorses the view of the Dawson Review that the TPA should focus on promoting competitive processes, rather than the interests of particular sectors. To the extent that specific support for the small business sector is warranted, this is an industry policy rather than a competition policy issue. Indeed, the pursuit of multiple objectives through the one instrument could give rise to significant problems if individual objectives were pushing in different directions. This concern was raised specifically by the Law Council of Australia in relation to the overlap between consumer protection and small business protection provisions (see below).

This is not to suggest that complementarity between different policy objectives should be ignored. Thus, some prospective changes to the TPA designed to address small business concerns may well serve to enhance competitive processes more generally, or to improve the procedural efficiency of the Act. Specifically, in its response to the Senate inquiry, the Government has indicated that:

- Section 46 should be amended to provide additional guidance to the courts in the consideration of predatory pricing cases to ensure it can prevent anti-competitive leveraging of market power by firms; and to ensure arrangements between firms are taken into account in the assessment of market power.
- Section 51AC (covering unconscionable conduct in business transactions) should be amended so that it applies to the supply or acquisition of goods or services by businesses up to a value of \$10 million (compared to \$3 million at present); and to make it clear that courts, in assessing whether unconscionable conduct has occurred, are able to consider terms enabling the unilateral variation of a contract.

Also, in the legislation currently before the Parliament in response to the Dawson review (see box 10.1), there is provision for a notification process for collective bargaining by small business as an alternative to the authorisation process.

However, the Commission reiterates that the case for such measures must rest primarily on their capacity to enhance the overall efficiency and effectiveness of the TPA, rather than on their specific benefits for the small business sector. It also notes that in addressing legitimate small business concerns, ‘targeted’ responses that are separate from, but which complement the general provisions of the TPA, may be valuable. For example, the Retail Grocery Industry Code of Conduct was established to help address some potentially adverse impacts on primary producers of increasing concentration in the retail sector.

Should some government businesses be exempt from the TPA?

As noted, the NCP extended coverage of the TPA to several previously exempt sectors, including unincorporated enterprises and State and local government business activities. However, as elaborated in box 10.2, in its initial submission the ACCC raised a number of ‘residual’ issues relating to the coverage of government activities under the Act:

- legislative exemptions for statutory marketing schemes;
- exemptions granted by governments for anti-competitive conduct under section 51(1) of the TPA;

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- the interpretation of what constitutes a business activity of government and is therefore subject to the TPA; and
 - derived immunity for parties engaged in business dealings with an exempt government entity.

Box 10.2 ACCC views on TPA exemptions for government bodies

Statutory marketing schemes

The activities of SMAs are included on the list of government activities specifically exempted from the anti-competitive provisions of the TPA. As a result of the legislation review program, which has led to the abolition of many statutory marketing regimes (see chapter 4), the impact of this exemption has declined. Nevertheless, the ACCC contended that where such restrictions on competition may be in the public interest, ‘the validity of these exemptions is best assessed through the authorisation provisions of the TPA which seek to ensure that restrictions on competition provide a public benefit.’

Section 51(1) exemptions

Section 51(1) of the TPA allows the Australian and State and Territory governments to regulate/legislate to exempt conduct that would otherwise breach the TPA.

In practice, these exemptions have been mainly used as a transitional measure, such as for specific events like the Sydney Olympics. Indeed, section 51(1) specifies that a State or Territory cannot make a regulation exempting an activity for longer than 2 years or remake the regulation. Moreover, the clear intention of the NCP Conduct Code Agreement is that section 51(1) is to be used sparingly (Steinwall 2002). Again, however, the ACCC argued that consideration ought to be given to whether the authorisation provisions of the TPA would be a more appropriate vehicle for affording exemptions to such activities.

Interpretation issues

The application of the TPA to the business activities of the Australian and State and Territory governments is subject to the proviso ‘in so far as the Crown carries on a business’. However, the Act does not specify what constitutes a business activity, which has resulted in several court cases on this coverage aspect. For example, procurement activities of the Australian Government have been interpreted as falling outside the Act (see text).

The ACCC also alluded to the related issue of derived immunity for parties engaged in business activities with government entities that are subject to ‘shield of the crown’, before concluding that:

... other than contracts protected by transitional provisions of the Competition Policy Reform Act 1995, any immunity from the TPA conferred in relation to Crown entities should not extend beyond that provided to the Crown where it is not carrying on a business and, in particular, should not extend to parties engaging in business dealings with Crown entities.

Source: ACCC (sub. 111, pp. 8-9)

In the Discussion Draft, the Commission indicated that there may be a case for legislative changes to ensure that particular government business activities do not ‘inadvertently’ fall through the coverage net. However, the recent High Court decision in the case involving NT Power Generation Pty Ltd and the Power and Water Authority of the Northern Territory appears to have substantially (though not completely) clarified this issue. As the ACCC noted in a subsequent submission:

The recent decision of the High Court in *NT Power Generation Pty Ltd v Power and Water Authority* confirms and expands the application of the TPA to government businesses. As a result, there is no need for legislative change to bring government businesses within the scope of the TPA. However, there is still uncertainty as to whether a private firm contracting with government is covered by the TPA. (sub. DR165, p. 7)

But while the Court’s decision has largely clarified the coverage issue, it did not specifically deal with the applicability of the TPA to government procurement practices. In the Discussion Draft, the Commission noted the case involving the procurement by the Australian Government of services for its detention centres, where the Court found that the department concerned was not attempting to trade in goods or services. Moreover, the Court went on to say that:

It is in any event difficult to see how the process of selecting a person to provide services to the Commonwealth can be described as conduct that has a commercial flavour, when looked at from the point of view of the Commonwealth. (*Corrections Corporation of Australia Pty Ltd v Commonwealth of Australia [2000] FCA 1280*)

Given such uncertainties, several participants supported the Commission’s draft proposal outlined above. For example, the Western Australian Department of Treasury and Finance commented:

There would appear to be some merit in examining whether the coverage of the Trade Practices Act (TPA) should be more clearly defined. Some government procurement policies (e.g. buy local) aim to support regional and local businesses winning government work, primarily by imposing a cost penalty on non-regional or non-local suppliers and weighting the qualitative evaluation in favour of higher local content. It is unclear whether such businesses are subject to the TPA. (DR236, p. 13)

The Australian Chamber of Commerce and Industry contended that it was ‘undesirable’ for the courts to determine what constitutes a business activity and that legislative clarification is required. And the Association of Consulting Engineers Australia (ACEA) argued that the nature of some government procurement practices is tantamount to unconscionable conduct and has a significant anti-competitive effect.

The client organisations, by their nature, tend to have major market power in our area.
... the effect is that the contractual terms are so harsh and oppressive that it raises the height of the barrier of entry to the market. (trans., pp. 43-45)

The Law Council of Australia, on the other hand, saw no need for legislative change. Moreover, it said that extending coverage of the Act to explicitly include procurement would not address the sort of concerns raised by the ACEA because State and Territory governments are exempt from the unconscionable conduct provisions in Part IVA:

... The point made by the ... ACEA is that a Government purchaser may use its power as buyer to damage competition or otherwise infringe the Act.

It would seem very unlikely that a Government would infringe the provisions of Part IV in this way; but the possibility raised by the example is that it may infringe the provisions of Part IVA. We note that, as currently drafted, s2A provides that Part IVA applies to the Commonwealth – to the extent that it carries on a business; but s2B does not make the States and Territories subject to the provisions of Part IVA. (sub. DR237 pp. 2-3)

In the Commission's view, given the role of governments as major (and in some cases the sole) purchasers of a range of goods and services, the manner in which procurement activities are conducted could potentially have substantial impacts on competition within markets. Hence, lack of clarity in the current arrangements may be frustrating the intent of the NCP reforms. In this regard, the Commission notes that the New Zealand Fair Trading Act specifically defines the activities, including government procurement, that are subject to the provisions of that legislation. A similar inclusion in relation to procurement in the Australian legislation, that would apply to both the Australian Government and the States and Territories, could therefore have merit.

However, the Commission is not convinced of the need for change in relation to the legislative exemptions for the activities of SMAs, or activities covered by section 51(1). Many of the exemptions under section 51(1) are of a 'transitory' nature (see box 10.2), while some of the permanent exemptions under the section, as well as the enabling legislation for SMAs, were encompassed by the legislation review process. Moreover, where such restrictions on competition have been retained, provisions in the LRP — which in the Commission's view should continue in a modified form beyond the current NCP (see chapter 9) — will require periodic re-assessment of whether those restrictions continue to be in the public interest. Hence, the question arises as to whether any benefits from using the generally applicable authorisation process to make this assessment would outweigh the transactions and other costs of change.

RECOMMENDATION 10.1

The Australian Government, in consultation with the States and Territories, should give consideration to amending the TPA to ensure that all Federal, State and Territory government procurement activities are covered by relevant sections of the Act.

10.2 Other competition ‘framework’ issues

The role of consumer protection regulation

Competition typically serves to benefit consumers by providing the mix and quality of goods and services required by them at the lowest practicable price. However, under certain circumstances, competition for the consumer dollar can lead to inefficient or inequitable outcomes. For this reason, appropriate standards and other consumer protection regulation are often necessary to ensure that market competition benefits consumers and the community more generally (see box 10.3). Hence, as the Deputy Chair of the ACCC (Sylvan 2004, p. 5) recently observed, competition laws and consumer protection regulation are in many respects complementary.

But just as consumer protection regulation can promote socially beneficial competition, it can also impose various costs, especially if poorly designed or applied in inappropriate circumstances (see box 10.3). Accordingly, it is important that existing measures are periodically subject to a benefit cost assessment and that such assessment is a pre-requisite for the introduction of new measures.

At least in theory, the legislation review and regulatory impact statement processes provide a means for setting the benefits of regulated standards against the costs entailed through accompanying restrictions on competition. But in practice, many existing standards were deemed by governments not to restrict competition and were therefore not subjected to the legislation review process.

Also, concern has been expressed that such assessments have sometimes focussed unduly on impacts in the domestic market. Clearly, standards which are incompatible with those applying in other countries can reduce the scope for Australian firms to realise economies of scale, or to source inputs more cost effectively from overseas. But the absence of internationally recognised standards can be a problem as well. For example, the Australian Council of Professions said:

Gaining access to many of our most important overseas markets will rely on increasing the international recognition of qualifications and practice competency and the negotiation of professional accreditation and reciprocity agreements.

It is important that any future reform processes recognise that international mutual recognition agreements will be under threat unless we can achieve national registration or mutual recognition arrangements for the relevant professions. (sub. 65, p. 19)

More broadly, a range of systemic shortcomings in Australia’s standards and other consumer protection regimes were drawn to the Commission’s attention, including:

Box 10.3 The benefits and costs of consumer protection regulation

The potentially important role of consumer protection regulation in facilitating the efficient functioning of markets has long been recognised. Areas covered by this regulation include product safety standards; disclosure requirements in relation to both goods and services; conduct deemed to be unfair, deceptive or misleading; and the scope and nature of conditions and warranties. The primary rationale for protecting consumers is information deficiency that can variously prevent them from: effectively signalling their requirements to producers; properly judging the quality of goods and services; or otherwise making ‘rational’ purchasing decisions. Where health and safety issues or major financial outlays are involved, the adverse consequences for consumers of ill-informed purchasing decisions can be very significant.

Some have also argued that, in the absence of effective pressure from consumers, regulation can help to overcome ‘short sighted’ production choices by firms and thereby promote longer term competitive advantage. For example, Porter (2000) contends:

It might seem that regulation of standards would be an intrusion of government into competition that undermines competitive advantage. Instead the reverse can be true. Stringent standards for product performance, product safety, and environmental impact contribute to creating and upgrading competitive advantage.

Of course, consumer protection regulation is not without costs:

- If poorly designed, it can stifle efficient market competition, investment and innovation and thereby be detrimental to the longer term interests of consumers.
- Though product standards that reduce the range of market offerings may ease the ‘burden of choice’ for some consumers, for others, they may represent an unwanted constraint on purchasing decisions.
- Regulatory compliance and enforcement costs can often be significant.

Moreover, it is important not to overstate the extent of the problems that arise from the informational ‘market failures’ that underpin much consumer protection regulation. For example, in many markets, the actions of a small number of well-informed consumers may be sufficient to deliver good outcomes for most consumers. From this perspective, what matters most is the information available to the ‘marginal consumer’, rather than the average level of knowledge across all consumers in the market concerned. Also, suppliers will often have strong commercial incentives to overcome the adverse consequences for their customers of poor purchasing decisions. Hence, voluntary standards and accreditation regimes are observed in many markets. And where information problems are more severe, consumers can often use private intermediaries — such as financial advisers — to assist in their purchasing decisions.

The upshot is that the need for standards and other forms of consumer protection regulation must be considered on a case by case basis, having regard both to the significance of the problems for consumers and hence the likely benefits of addressing them, and the costs of doing so.

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- ineffective mechanisms for coordinating the activities of the plethora of Australian Government and State and Territory bodies involved in policy development and application, leading to:
 - duplication of effort; and
 - inconsistencies in approaches across jurisdictions that increase compliance costs and impede the development of national markets.
 - insufficient attention given to the scope for self-regulatory and co-regulatory approaches; and
 - tensions between the administrative role of consumer affairs bodies and their commonly adopted role as advocates for consumers.

In the Discussion Draft, the Commission suggested that the time is now right for a broad national review into consumer protection policy and administration in Australia. In some senses, such a review would represent a natural follow-on to recent reviews of other aspects of trade practices regulation and the current review of product safety legislation (see box 10.4). As such, and amongst other things, it would provide an opportunity to examine whether such policies are continuing to meet the needs of consumers in the more competitive market environment, as well as to look at complementarities between competition and consumer protection laws and how these might be most appropriately facilitated. And, as noted in the Commission's recent study into trans-Tasman competition and consumer protection regimes, a review could also serve to address whether aspects of the Australian and New Zealand consumer protection regimes are impeding the long-term objective of a single economic market between the two countries.

Respondents to the Discussion Draft generally voiced strong support for the proposed review. The ACCC, for example, noted the need for greater national consistency in the approach to consumer protection:

The proposed review's consideration of mechanisms for coordinating policy development and application across jurisdictions and for avoiding regulatory duplication provides an opportunity to assess related issues, including:

- information sharing between regulators
- areas of jurisdictional uncertainty or overlap
- gaps in regulatory coverage
- inconsistency of regulation
- costs to businesses of inconsistency or uncertainty.

Adjustments to the consumer framework in these areas could assist in achieving a more consistent and national approach to consumer protection. (sub. DR165, p. 6)

Box 10.4 Review of product safety regulations

Australia's product safety laws aim to minimise the physical and financial costs of unsafe consumer products in a way that enhances the welfare of the community. They also help to promote confidence in Australian consumer products. The promotion of the efficient operation of consumer product markets and the efficient use of government regulatory resources are further important objectives.

Product safety regulations have developed over time on a jurisdictional basis. At the Australian Government level, the safety of consumer products is regulated under provisions contained within Part V and Part VC of the *Trade Practices Act 1974*. Those provisions provide for product bans, recalls, or the establishment of mandatory safety or information standards for products. The TPA also contains a product liability regime which complements common law rights under which consumers can seek redress and compensation for the harm caused by unsafe products.

The application of the TPA is, however, generally restricted by the limits on the Australian Government's constitutional powers. In terms of the product safety provisions, the Act only applies to corporations and those unincorporated enterprises engaged in inter-state trade or operating within the ACT and Northern Territory. The States and Territories have Fair Trading Acts containing product safety provisions that apply to entities not covered by the TPA. But while these provisions are similar to those of the TPA, there are inconsistencies in the laws of the different jurisdictions and the manner in which they are administered and enforced. The involvement of multiple jurisdictions in product safety regulation has also resulted in duplication of effort and inefficient use of regulatory resources.

In a Discussion Paper prepared for the review of the Australian consumer product safety system — initiated by the Ministerial Council on Consumer Affairs — a number of options to deal with these problems were outlined. They include proposals for the harmonisation of product safety legislation, its administration and enforcement across jurisdictions.

While the Ministerial Council called for submissions on the proposals outlined in the Discussion Paper (by 5 November 2004), as yet, a cost-benefit analysis of these proposals has not been conducted.

Source: MCCA 2004.

The Consumer Law Centre Victoria also supported a review and highlighted the fact that the consumer protection provisions in the TPA have not kept pace with developments in other countries and in some Australian states:

At the time the ... Act was introduced, it set an international standard in the regulation of anti-competitive conduct and the protection of consumer rights. However, the consumer protection provisions in Part V of the Act have arguably not kept pace with international developments in the area of consumer protection regulation. This is particularly concerning given the fundamental changes to the Australian economy and opening up of markets such as the supply of energy, financial services and telecommunications following more than a decade of micro-economic reform.

During this decade there has been no review of Part V of the Act, despite considerable reform to consumer protection laws in Australia as well as overseas. ... It is time to consider the effectiveness of our current consumer protection regulations, particularly in markets that have been deregulated over the past decade. (sub. DR209, pp. 1-2)

And in supporting a review, the Law Council of Australia contended that, over time, some amendments to the consumer protection provisions of the TPA have been contrary to the original objectives of the Act:

The original design of the TPA dealt with two (complementary) matters: the promotion of competition and the protection of consumers. In the two decades since 1974 this structure has been complicated by the addition of provisions dealing with the protection of small business. So that the Act now deals with three sets of objectives rather than the original two. Whilst no specific recommendations have been made by the Commission in relation to small business, often the principles and issues to be addressed in this area can be linked to the critical issues arising in the context of consumer protection. (sub. DR237, p. 6)

Such broadly based support confirms the Commission's view that the time is now right for a review of consumer protection policy to take place. It is also clear that such a review should cover a wide agenda.

RECOMMENDATION 10.2

The Australian Government, in consultation with the States and Territories, should establish a national review into consumer protection policy and administration in Australia. The review should draw on, rather than replicate, the findings of recently completed and current reviews into aspects of trade practices and product safety legislation. It should focus particularly on:

- *the effectiveness of existing measures in protecting consumers in the more competitive market environment;*
- *mechanisms for coordinating policy development and application across jurisdictions and for avoiding regulatory duplication;*
- *the scope for self-regulatory and co-regulatory approaches;*
- *ways to resolve any tensions between the administrative and advocacy roles of consumer affairs bodies, or introduced by the inclusion of measures to protect small business from unfair competition; and*
- *possible impediments in the current arrangements to greater economic integration between Australia and New Zealand.*

Protecting intellectual property

For ‘high wage’ countries like Australia, success in the international marketplace will increasingly depend on the capacity of businesses to innovate to gain and maintain a competitive advantage. Hence, innovativeness will be a key requirement in sustaining and enhancing Australian living standards.

In building and supporting Australia’s innovative capacities, a quality education and training system will be of paramount importance (chapter 11). So too will be efficient capital markets that are able to direct funds to soundly-based investments. And, effective mechanisms to address divergences between the private and social benefits of research and development and other innovative activity will also be required. In this latter regard, intellectual property laws have a key role to play. Without appropriate protection for intellectual property, the incentives to invest in research and innovation will be greatly diminished.

However, innovation is a sequential process that draws heavily on previously developed knowledge. Hence, the restrictions on competition inherent in patent protection, copyright laws and trademarks etc, can themselves impede innovation. Therefore, a delicate balancing act is involved when determining the appropriate scope of intellectual property protection, the terms and conditions under which it is provided, and its duration.

The Australian Government’s intellectual property legislation was encompassed by the legislation review process:

- The NCC (1999b) reviewed the exemption of certain intellectual property arrangements from the Trade Practices Act (Section 51(3)).
- The Intellectual Property and Competition Review Committee (IPCRC 2000) examined various intellectual property legislation including the *Copyright Act 1968*, *Patents Act 1990*, *Trade Marks Act 1995* and *Designs Act 1906*, as well as revisiting the Section 51(3) exemption issue.

In keeping with recommendations in the IPCRC report, the Government implemented a number of changes to these arrangements, including amendments to copyright legislation to allow for the parallel importation of books, periodicals and software products. However, though accepting the Committee’s recommendation to rewrite Section 51(3) to open the way for the application of the anti-competitive conduct provisions of the TPA to intellectual property arrangements that result in a substantial lessening of competition, the government has yet to introduce the enabling legislation.

In responding to the Discussion Draft, the Law Council of Australia commented on the impact of this legislative delay on the business community:

The Law Council Committee is concerned at the lack of speed with which governments have implemented reforms to the TPA where these have been subject to a rigorous evaluation by specialist organisations such as the Commission and others. So, for example, the Law Council Committee notes that the recommendations of the Ergas Committee ... have yet to be implemented by the Federal Government. Whilst the Law Council Committee accepts that there may be some difficulties in governments obtaining appropriate parliamentary time for the consideration of certain legislation, these delays have had a negative impact on the expectations of the business community. (sub. DR237, p. 4)

Another participant in this inquiry, Charles Lawson (sub. 114, sub. DR139), contended that the review process had not adequately assessed (in terms of the requirements set out in the CPA) the appropriate scope and allocation of patent protection in Australia. He also expressed concern about Australia's adoption of more stringent intellectual property protection regimes than are required under WTO agreements. The Head of the IPCRC review, Henry Ergas (2004) has similarly suggested that some extensions to intellectual property protection under the recently concluded Australia-US Free Trade Agreement (AUSFTA) could have potential costs for Australia as a net importer of intellectual property. A paper by Dee (2004) prepared for the Senate Select Committee on the AUSFTA, estimated that the cost to Australia of extending the term of copyright protection under the agreement could be as high as \$700 million (in discounted present value terms).

In the Commission's view, it is important that intellectual property laws continue to be scrutinised to ensure that they are not unduly restrictive. Retention of a legislation review mechanism, including provision for periodic re-review (see chapter 9), would give effect to this requirement.

The Commission observes that such assessments cannot be divorced entirely from Australia's international trade interests and obligations. Viewed in isolation, the appropriate stringency of Australia's intellectual property protection may well differ from some of its trading partners. But in facilitating beneficial trade and investment across the board, and in negotiating reductions in other trade barriers that impose significant penalties on Australia, some compromises in relation to intellectual property policy settings may well be warranted. Indeed, in an increasingly globalised trading and investment environment, further cross-country convergence of intellectual property regimes is almost inevitable.

That said, as a net importer of intellectual property, there would clearly be downsides for Australia in being too compliant in this regard. It is therefore important that decisions regarding the scope and length of intellectual property

protection in Australia are predicated on what is in the best interests of the community as a whole, rather than *solely* on what is required to secure a trade agreement. There may also be opportunities to minimise the risk of adverse outcomes associated with trade policy driven increases in the stringency of Australia's intellectual property regime. For example, as noted above, the agreed but yet to be implemented changes to Section 51(3) of the TPA would potentially provide for greater scrutiny of anti-competitive behaviour associated with intellectual property arrangements.

The interface between trade policy reform and competition policy

The last two decades have witnessed a gradual, but marked, reduction in Australia's previously very high levels of import protection. Quantitative restrictions have been abolished, tariffs for most products have been removed or reduced to low levels, as have most discriminatory subsidies to local producers. In addition, foreign investment restrictions have been greatly liberalised.

Moreover, as protective barriers in the traded goods sector were wound back, the costs of inefficiencies in the infrastructure area in particular became much more apparent. The reforms that followed were therefore akin to a domino effect. The removal of protection was thus also the first step in changing the culture of Australian industry from one focussed on seeking government preferment to one of self-reliance. The role of the ensuing attitudinal shifts in facilitating ongoing improvements in performance should not be underestimated.

The increasing internationalisation of the Australian economy has also had some important implications for the application of competition policy. In particular, by directly exposing large parts of the economy — including some previously non-traded activities — to much greater competition from overseas suppliers, Australia's trade liberalisation program has reduced the risk that concentrated local production will provide scope for anti-competitive behaviour.

Indeed, in many cases, increasing concentration in the local economy has been a desirable outcome of trade liberalisation, rather than a new problem which competition policy must address. That is, increased international competition has served to drive out much inefficient small scale and fragmented production.

The upshot is that if the application by the ACCC of the TPA in particular does not give due regard to global market imperatives and the disciplines of competition from abroad, Australia's longer term economic performance may well be impeded.

Eliminating assistance-related impediments to efficient competition

Though the tariff reduction program is now largely complete, there are still some assistance-related arrangements that may impede efficient competition and that therefore warrant policy attention. For example:

- As discussed in chapter 9, Australia's anti-dumping regime is one of the more important pieces of legislation still to be reviewed under the Legislation Review Program. The Commission notes that, nearly two decades ago, the Gruen Review (1986) of Australia's anti-dumping regime argued that the efficacy of using selective tariffs to deal with predation and unfair pricing was essentially a competition policy issue.
- Australia's general tariff arrangements impose duties of 3 or 5 per cent on a range of goods for which no close substitutes are produced in Australia. As such duties have no protective impacts, they simply amount to a tax which impedes the capacity of local firms to compete with overseas suppliers. The Australian Government has previously signalled its intention to remove these duties. While the impacts may not be major, the Commission (PC 2000c) has recommended addressing such imposts by reducing general tariff rates to free.

Procurement practices

Government procurement is also relevant in this context. Given the scale of government purchases, efficiency in this area is important in its own right. In this regard, there was discussion at the policy roundtable (see appendix A) about the need to once again review the cost effectiveness of Australia's defence procurement. But as discussed earlier, procurement policies also directly impact on the competitive process. In addition, both the Australian and State and Territory governments continue to accord preferences to local (and New Zealand) suppliers of a range of products and services.

While Australia has not signed the WTO agreement on government procurement, its free trade agreement with the United States includes a requirement to review the government procurement chapter every two years. The Australian Government has also recently updated the procurement guidelines for its agencies (DoFA 2004). Such review processes could be valuable in facilitating efficient competition — particularly if they look beyond procedural matters to consider the benefits and costs of retaining preferences for local suppliers.

Competition for investment between the states

Another important assistance-related issue is how to ensure that competition between the States and Territories to attract activity to their jurisdictions enhances rather than detracts from national welfare. Competition that occurs through *improvements* in the policy environment — for instance, removing inefficient taxes, streamlining regulations, efficient administration etc — is clearly beneficial and is at the heart of ‘competitive federalism.’ But State and Territory governments have also provided an array of selective assistance to attract firms and investment projects to their jurisdictions. This has sometimes led to unproductive and costly bidding wars (IC 1996 and Banks 2002).

In recognition of the deleterious impact that selective assistance can have on efficient competition and national welfare, all State and Territory governments except Queensland have recently signed an agreement to reduce cross-border bidding and to restrict the use of financial incentives to attract investment. In its submission to this inquiry, the Tasmanian Government canvassed the possible extension of the NCP to cover such assistance, suggesting that this could:

... reduce the costs and misallocation of resources that arise from “bidding wars” between jurisdictions to attract investment and employment. (sub. 109, p. 10)

But pending any change of this nature, it would be desirable to address some of the deficiencies within the current agreement. In particular, there are no sanctions for non-compliance with the agreement, nor a formal mechanism for its policing. Also, the agreement does not address the provision by the Australian Government of assistance to new businesses, or assistance to retain activity in particular jurisdictions or regions.

In the Discussion Draft, the Commission proposed that provisions in the current agreement be strengthened — a proposal supported by the Western Australian Department of Treasury and Finance:

State and Territory governments have, in the past conducted costly ‘bidding wars’ based on financial incentives (e.g. tax breaks, interest-free loans, etc) aimed at attracting investment projects, which has detracted from the net national economic benefits of the projects. This has led to the States and Territories (with the exception of Queensland) signing the *Agreement between States and Territories on Investment* in September 2003.

However, there are no sanctions for breaking the agreement or any monitoring mechanism to enforce the agreement, so it remains to be seen how effective the agreement is. The DTF supports the proposed strengthening of provisions to ensure compliance, and the extension to include all jurisdictions. (sub. DR236, p. 14)

Conversely, the Queensland Government — the only non-signatory to the current agreement — did not see a need for strengthened provisions and questioned how such an agreement could be policed:

The provision of incentives or other policy instruments to attract investment is entirely a matter for each jurisdiction to determine in light of its individual circumstances. The workability of such agreements is problematic. How would potential breaches of the agreement be identified and who would investigate any allegations? What possible sanctions could be put in place and who would enforce them? Clearly, such roles could not be allocated to any non-elected body as this would impinge on the legitimate authority of Parliament(s). (sub. DR189, p. 12)

Options to strengthen the operation of cooperative arrangements, such as the current investment agreement, have been the subject of a previous Commission inquiry (IC 1996). That inquiry identified various avenues for improving the effectiveness of an agreement among jurisdictions to limit specified interventions. A progression of possible disciplines could range from basic transparency and accountability requirements, to include independent monitoring and reporting of compliance, formal dispute mechanisms and mutually agreed financial or other sanctions.

Accordingly, in the Commission's view, compliance and enforcement requirements do not negate the inherent value of the current investment agreement between most of the States and Territories, or provide a compelling reason to forgo opportunities to improve its operational effectiveness. Indeed, the concerns that have led to the signing of the agreement by most jurisdictions are significant enough to suggest that priority should be accorded to rendering it more effective. Hence, the Commission reaffirms the view it expressed in the Discussion Draft.

RECOMMENDATION 10.3

The recently signed State and Territory agreement aimed at preventing investment ‘bidding wars’ should have strengthened provisions to encourage compliance and be extended to cover all jurisdictions, including the Australian Government.

10.3 Governance arrangements

The NCP included a range of measures to improve the governance of public sector entities engaged in business activities (see chapter 2). These have included:

- corporatisation of major government businesses;
- introduction of competitive neutrality requirements;

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- structural separation of integrated infrastructure providers (a discussion of the efficacy of this measure is presented in chapter 8); and
 - the introduction of measures to regulate or oversight the activities of monopoly service providers.

With the privatisation of a significant number of GBEs, many of these initiatives are no longer specific to public sector business activities.

While some aspects of the new governance framework for GBEs have worked well, others have not been overly successful. In particular, while many businesses and households have benefited through lower prices and improved service quality for key infrastructure services, rates of return earned by most government businesses continue to be well below commercial norms (see chapter 4). A range of factors have undoubtedly contributed to such under-performance — including some that are outside the direct control of the businesses concerned. Requirements to pursue non-commercial objectives without recompense from owner governments, or undue suppression of prices by regulatory agencies, would be two such examples. Nonetheless, continuing commercial under-performance across a wide sweep of GBEs does raise the question of whether further privatisations are warranted (see box 10.5), particularly where those businesses operate in contestable markets.

For those businesses which remain in public ownership, there is scope to improve both external and internal governance arrangements, as well as some opportunities to fine tune the competitive neutrality regime. Improved regulatory oversight of monopoly service providers (see section 10.4) is also an important requirement for the efficient delivery of some key infrastructure services and therefore a key part of the governance regime.

Improving general governance arrangements for GBEs

The Commission's annual monitoring of the performance of GBEs indicates that there are still some shortcomings in the governance framework (see PC 2003b, 2004a, 2005b) stemming mainly from:

- a lack of clarity and consistency in objectives attaching to service provision;
- Ministerial intervention in the day-to-day operation of GBEs which has weakened accountability for outcomes achieved and possibly increased conflicts in decision-making processes;
- inadequate performance indicators which do not allow for meaningful assessments of outcomes achieved against particular objectives; and
- the lack of regular performance auditing.

Box 10.5 The impact of ownership on GBE performance

As outlined in chapter 2, NCP did not require governments to privatise their infrastructure assets. In part, this reflected the considerable scope that then existed to improve the performance of publicly provided infrastructure services by putting in place better governance structures.

But a decade on, the ownership issue looms larger:

- In the GBE sector, many of the NCP governance reforms have now been implemented.
- Yet despite these and other governance reforms, many GBEs are still earning rates of return well below comparable private businesses and even below the risk free cost of capital (see chapter 4).
- The Commission was told in more than one jurisdiction that public ownership is often a barrier to implementing desirable organisational change — especially workplace reform.
- In some sectors, the government's dual role as both a provider of services and a regulator of competing private businesses may give rise to perceptions of conflict of interest.

However, privatisation should be seen as a complement to, rather than a substitute for, competition reform. In markets where the scope for competitive service delivery is limited or non-existent, the decision to privatisate a monopoly service provider can become a trade-off between improved productive efficiency and allocative losses due to reduced constraints on monopoly pricing. The net result may be little overall benefit for the community. In such situations, effective governance together with efficient regulatory or overseeing arrangements (see section 10.4), are likely to remain the key to achieving performance improvement.

These deficiencies have potentially serious consequences, particularly to the extent that they may distort the management of an asset base valued at around \$170 billion for the GBE sector as a whole, as well as investment needed to ensure the sustainability of services over the longer term and dividend distribution decisions.

If such businesses are to remain in public ownership, it is therefore important that governance arrangements in these areas be improved. There are a range of possible changes that could be introduced including: a commitment to clear, transparent and assessable objectives; guidance on how conflicts between objectives are to be resolved; greater public reporting of performance against objectives; greater separation of Ministerial (external) and Board (internal) governance; appointment of independent boards; and routine independent performance audits. In the Commission's view, these matters deserve systematic consideration by all governments in coming years.

Achieving better outcomes for local government goods and services

Contrary to some perceptions, there has been considerable change in the local government sector directed at improving its delivery of goods and services and the conduct of its regulatory functions. Some of these changes were in train before NCP and are separate from it — for example, various administrative reforms, contracting out of some service delivery, and council amalgamations. However, the corporatisation and structural change provisions of the NCP, the legislation review program and competitive neutrality requirements have also had significant impacts on local government business activities. In commenting on these impacts in Queensland — where local government is responsible for providing a wider range of services than in most other jurisdictions — the Queensland Government said:

The level of reform achieved by Queensland local governments ... has been impressive:

- altogether, 573 local government businesses have been assessed by the [Queensland Competition Authority] as applying at least some of the full cost pricing requirements of competitive neutrality. Of these, 465 have adopted all or most of the elements of full cost pricing ...;
- over 90 percent of urban water connections are now subject to consumption-based charging using a two-part tariff; and
- the application of legislation review resulted in over 4000 superseded and anti-competitive local laws being repealed. (sub. 119, p. 8)

Though participants from the local government sector saw these changes as having delivered significant benefits, they also pointed to various, and in some cases substantial, implementation costs. For example, the Townsville City Council (sub. 46, p. 4) estimated that it had incurred one-off establishment costs of \$700 000; that the ongoing annual costs associated with business information systems to support NCP-driven activities are around \$200 000; and that the direct labour costs of its NCP-related activities are around \$3.4 million a year. According to the Council, the latter expense results from increased administration requirements and the creation of purchaser-provider structures that have led to reduced resource sharing across individual service activities and/or greater resource duplication.

Other concerns raised by local government participants, and in the recent House of Representatives Standing Committee report looking at governance and financial arrangements for local government in Australia (Hawker 2003), included:

- the impacts of water and other NCP reforms on the rating bases of local government entities;
- adverse impacts of NCP reforms on some regional communities and hence on the financial viability of councils; and

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- the failure of most of the States and Territories to pass on a share of competition payments to local governments meeting their NCP obligations.

As discussed in chapter 12, adjustment issues — including impacts on local government operations — should be explicitly recognised when implementing a future reform agenda. Thus, transactions costs are clearly relevant in looking at what further general changes to governance arrangements for local government are warranted and how such changes are best implemented. In this context, the Commission sees one potential role for financial transfers in a future nationally coordinated reform program as being to assist governments (including local governments) to meet transitional and adjustment costs.

It is also self evident that the benefits from improved governance do not come without some ongoing costs. Even so, there still appears to be scope to significantly improve the overall cost-effectiveness of much local government service provision through governance and other reforms. For example:

- In certain areas, a greater onus on local governments to market test the efficiency of the services which they currently provide in-house would potentially deliver sizeable benefits.
- In parts of Australia, further council amalgamations and/or shared service provision arrangements would allow for greater realisation of economies of scale and lead to considerable cost savings.
- As discussed in the Hawker report (2003, chapter 2), the costs of duplication and poor coordination associated with overlapping Australian and State and Territory government responsibilities for service provision, spill into the local government arena.

These are all issues that warrant attention as part of any future reform agenda designed to further improve the performance of local government. Some of the approaches that would help to improve the governance of GBEs (see above) would also be relevant at the local government level.

Fine tuning the competitive neutrality regime

For the most part, the CN elements of NCP have been implemented and appear to be working relatively smoothly. There is general agreement that the broad principles underlying the CN regime remain appropriate and that the regime — including complaints' handling mechanisms — should continue into the future.

Against this backdrop, most of the problems raised by participants would not have large efficiency or other impacts. For example, the NCC (sub. 71, pp. 12-13)

referred, amongst other things, to incomplete coverage, including variance across jurisdictions in the application of CN to the health sector and minimal application to universities; and perceptions about lack of independence when Ministers become involved in the complaints handling process.

Indeed, the South Australian Government (sub. DR224, p. 12) thought that CN application had gone too far in some areas, especially in relation to small business activities of government that are essentially community services. However, the Commission notes that the Competition Principles Agreement only requires CN principles to be applied to *significant* government businesses and that considerable flexibility is provided to jurisdictions on how and when to apply those principles.

With relatively few problems evident with the arrangements now in place, the few specific proposals for changes to the architecture of the competitive neutrality regime can be characterised as ‘fine tuning’. In particular, the Tasmanian Government (sub. 109, p. 8), advocated clarification within the Competition Principles Agreement of the objectives of CN and the situations where it applies, as well as consideration of ‘whether any disclosure requirements should be incorporated into the competitive neutrality principles in cases where significant business activities recover revenues that are below full costs’. In its response to the Discussion Draft, the Independent Competition and Regulatory Commission of the ACT (sub. DR213, p. 9) similarly advocated greater clarification on the circumstances under which a CN complaint may be lodged or the process whereby a complaint is made.

Such ‘systemic’ changes may well be worthwhile. However, with the regime generally working effectively, the Commission does not see them as being of high priority. It further notes that, especially in relation to the complaints-handling mechanism, cooperation between the jurisdictions has enabled ongoing improvements in the process. Some of the outstanding specific concerns noted above might also be most effectively handled in an informal cooperative fashion — though in the case of the application of CN requirements to universities, a more formalised approach may prove necessary to create momentum for change.

Going beyond the specific context of CN, formal policy responses are also required to generate more neutral charging regimes for road and rail services so as to promote an efficient overall mix of transport services (see chapter 8). Also, consideration may need to be given to whether the pursuit of neutral pricing regimes for native and plantation timber should be encompassed within a nationally coordinated reform framework in the natural resource management area (see chapter 11). And, as noted, ongoing low rates of return in many parts of the GBE sector focus attention on the extent to which it is possible under public

ownership to achieve the performance improvements required to deliver competitively neutral pricing outcomes.

RECOMMENDATION 10.4

The competitive neutrality regime should be retained beyond the life of the current NCP.

10.4 Oversight of monopoly service providers

The NCP recognised that, notwithstanding opportunities for structural reform, in some markets — especially within the infrastructure sector — service providers would retain significant market power. It therefore made provision for jurisdictions to set or oversee prices in these markets. Regulated pricing of access to ‘essential’ infrastructure networks (see box 10.6) is an important component of this regime. However, regulation or oversight of prices also applies to a range of final services provided to businesses and households.

There are widespread concerns about current regulatory practices

Virtually since inception, a consistent theme from regulated service providers has been that these arrangements have not worked well. This message was again evident in this inquiry, especially from the electricity sector. Generic concerns about current regulatory practice include:

- the intrusiveness of regulatory price setting and overseeing arrangements, leading to considerable transactions costs for both firms and the regulator;
- inconsistencies in approach across jurisdictions, with the plethora of regulators adding further to transactions costs;
- an undue emphasis on encouraging the efficient usage of existing services, rather than providing appropriate incentives for new investment and asset maintenance; and
- over-emphasis on ‘building-block’ approaches to price setting, with inadequate attention given to less intrusive approaches such as ‘yardstick’ competition (linking allowable price increases to average improvements in sectoral productivity) and ‘price service offerings’ (effective removal of controls on prices other than for a ‘baseline’ level of service).

Elaborations from participants on some of these concerns are presented in box 10.7.

Box 10.6 Regulating access to essential infrastructure

Access regimes provide a means for businesses to use the services of ‘essential’ infrastructure (such as gas pipelines) that is uneconomic to duplicate, as well as to regulate the conditions under which access is provided. Without such regulation, service providers might deny access to their facilities or charge monopoly prices for their services. This could be costly for the community.

However, if the application of access regulation leads to undue suppression of returns to facility owners, investment in essential infrastructure could be deterred. Given the importance of such infrastructure to Australia’s economic performance and community well-being more generally, reduced investment in new facilities or the refurbishment of existing assets could also be very costly.

The Commission has examined these trade-offs in several recent inquiry reports (PC 2001b,d; 2004i). Though acknowledging the difficult task facing regulators in achieving the right balance, it has suggested that changes are required to give greater emphasis to facilitating investment so as to ensure the sustainability of service provision over the longer term. For example, in its review of the National Access Regime (Part IIIA), the Commission (PC 2001d) proposed that there be:

- provision in the regime for binding rulings: This would allow investors in a *proposed* essential facility that is unlikely to enjoy substantial market power to seek a ruling that the Part IIIA ‘declaration’ criteria are not met and that, as a consequence, the facility will not be subject to the regime; and
- investigation, through CoAG, of other mechanisms to facilitate efficient investment within Part IIIA and access regimes more generally. The mechanisms to be investigated would include fixed ‘access holidays’ for essential infrastructure that is determined to be contestable, and provision for a ‘truncation’ premium to be added to the agreed cost of capital for a proposed facility.

Similarly, in its report on the Gas Access Regime (PC 2004i), the Commission made recommendations for the introduction (within that regime) of binding ‘no-coverage’ rulings, as well as to provide for price monitoring rather than formal price regulation of covered pipelines in some circumstances (see the text). It also explored further some of the practical issues involved in adjusting regulated rates of return to provide more efficient investment incentives.

The Government (Costello 2004a,b) has indicated that it will consider the ‘practicality’ of these proposals in the context of industry-specific regimes, including the regime for the gas industry, and that the Ministerial Council on Energy will be charged with developing a response to the Commission’s specific recommendations on the Gas Access Regime.

**Box 10.7 Shortcomings in current price overseeing arrangements:
some views from service providers and facility owners**

High transactions and compliance costs:

There must ... be a recognition of the significant cost incurred by the regulators (and thus the community) and service providers (and thus users) in complying with regulation. There needs to be a proper application of the requirement for regulatory impact statements or similar, with meaningful assessments of the costs and benefits of all new regulatory requirements. (Australian Pipeline Trust, sub. 55, p. 3)

Inefficient processes:

In the [NSW Rail Access Regime] case, negotiation of access took 2 ½ years, negotiations were delayed by the raising of objections by the assessor throughout the process and certification [of the access regime as effective] was eventually granted for only 13 months. This was a completely unsatisfactory outcome given the time and resources that went into the application. (New South Wales Government, sub. 99, p. 9)

Intrusiveness and insufficient attention to facilitating investment:

... the original intention of the NCP process was for a light-handed approach to the oversight of monopoly pricing. ... However, in practice, regulation of monopoly prices has proved to be much more intrusive and interventionist than was first envisaged. The prices oversight model was effectively abandoned in favour of a cost of service, building block approach that involved a highly detailed level of scrutiny and justification of infrastructure costs. The objective of removing monopoly rents dominated the regulatory process, while other objectives, such as facilitating investment and meeting customer needs, were given little consideration. (Energex, sub. 60, p. 2)

Regulatory policy needs to focus more on long-term economic efficiency with a better balance between current prices and future investment. (Australian Council for Infrastructure Development, sub. 76, p. 1)

Regulators face a difficult task

The Commission emphasises that regulation of monopoly service providers is intrinsically complex, as the issues involved in setting prices and conditions of access to essential infrastructure highlight. Regulators in this area must have regard to a range of sometimes competing objectives including: short term price efficiency; cost minimisation; and the provision of adequate incentives for future investment by both access providers and seekers. As the discussion of the future telecommunications regulatory regime in chapter 8 illustrates, the investment issue is particularly complicated given that those seeking access may subsequently become capable of investing in competing network infrastructure, thereby promoting competition in that market and even removing the need for regulation. The upshot is that there is no unambiguously superior approach on which policy

makers can draw. Also, policy emphasis and approaches are continually evolving as experience with access regulation increases.

More generally, as the Commission noted in its report on the National Access Regime (PC 2001d, p. xxi), in adjudicating on prices, regulators face significant information problems. The regulatory instruments at their disposal are also imperfect. Hence, there are limits on what even the best resourced and well-intentioned regulator can achieve.

Given these difficulties, there *may* be a case for vertical separation of service providers even if integrated provision is intrinsically more efficient. In other words, if preventing monopoly behaviour by an integrated provider is especially difficult, the allocative efficiency gains from facilitating competition through separation could possibly outweigh any technical efficiency losses and the transaction costs of effecting such separation. (These trade-offs, as they relate to the electricity and telecommunications sectors, were explored in chapter 8).

Furthermore, though diversity in regulatory approach across jurisdictions can increase uncertainty and transactions costs, it can also facilitate the development of more efficient and effective regulatory approaches. For instance, regulatory agencies can learn from the experiences of others. And, ‘best practice’ competition between jurisdictional regulators can serve the interests of both service providers and consumers.

But improvements are possible and warranted

However, this is not an endorsement of the status quo. Based on its experience in a number of inquiries, the Commission considers that more attention needs to be given to providing appropriate incentives for new investment.

In expressing this view, the Commission acknowledges that it is not possible to categorically establish that investment has been deterred by uncertainty created by regulatory diversity, or by the basis on which regulated prices are currently set. (Equally, evidence that spending on infrastructure has been growing strongly in sectors such as gas does not prove that there has been no deterrent or distortionary effect.) The Commission also acknowledges that, in the area of access pricing at least, impacts on investment by new entrants as well as by incumbents are a relevant consideration.

Nevertheless, in the Commission’s view: differences in the principles applied by individual regulators when setting prices for monopoly services; the short term imperatives confronting regulators; and the fact that price regulation ‘taxes’

successful projects but does not subsidise unsuccessful ones; are all likely to militate against efficient longer term investment levels. Moreover, regulatory inconsistency and uncertainty in other areas impacting on infrastructure investment decisions, such as greenhouse gas emission requirements, will serve to compound this likely investment effect.

Providing for efficient investment outcomes does not preclude some variation in specific pricing regimes between jurisdictions or across sectors. However, those regimes must be guided by clear and consistent principles and objectives for setting regulated prices. Hence, in its report on the National Access Regime (PC 2001d), the Commission argued that inclusion of an explicit objects clause in the overarching national regime would provide a framework and guiding principles to discourage *unwarranted* divergence in industry-specific access regimes.

The need for a common set of best practice regulatory principles (covering objectives, pricing, appeals and governance arrangements) was also highlighted by some participants in this inquiry. The Network Economics Consulting Group (NECG) devoted considerable attention to the issue and contended that:

... the current approach, which has relied on precedent and close working of regulators, has failed to effectively provide stability, certainty, and confidence of participants that a nationally consistent approach to regulation could deliver.

... there is an accumulating body of evidence that suggests that development of framework principles and guidance on implementation can enhance the efficacy of regulation if applied on a nationally consistent basis. (sub. 134, pp. 60-61)

More specifically, the NECG highlighted the uncertainty which continues to surround the application of the cost-of service ‘building block’ approach to setting access prices. Inconsistent regulatory approaches to estimating cost of capital parameters were cited as a prime example of the uncertainties facing potential investors in infrastructure projects.¹

But while very important, clear and consistent underlying principles and objectives for regulating prices charged by monopoly service providers are not sufficient to ensure good investment outcomes. Hence, in its recent reports on access regulation, the Commission has proposed a number of specific mechanisms that would reduce uncertainty and increase prospective returns for those investing in essential

¹ The Commission has previously acknowledged the importance of promoting greater certainty in this area. In its review of the Gas Access Regime (2004i), it recommended a study be undertaken by a group of experts to consider whether a robust and consistent method could be developed for setting expected rates of return on capital for regulated businesses. In responding to the Discussion Draft, the NECG claimed that a satisfactory method of dealing with the technical difficulties associated with estimating the ‘true’ cost of capital has subsequently been developed (trans., p. 73).

infrastructure — for example, a period of exemption from regulated price setting through ‘access holidays’ (see also box 10.6).

Inevitably, however, the need for detailed price setting arrangements *in some circumstances* will remain. In ensuring that these arrangements are conducive to efficient outcomes, a number of important issues arise — including the most appropriate form of price regulation and whether more ‘light-handed’ alternatives to formal price regulation can be employed in some circumstances. These issues have been the subject of considerable discussion in recent Commission reports and also featured in participants’ responses to the Discussion Draft.

In its report on the National Access Regime (PC 2001d), for example, the Commission suggested that greater use of productivity-based (or yardstick) approaches for determining access prices (as distinct from cost-based ‘building block’ approaches) could help to facilitate more efficient investment. However, it acknowledged that significant work was likely to be required to pave the way for these alternative approaches.

Since that time, some work has in fact been undertaken in this area. For example, the ESAA reported that:

... the Utility Regulators’ Forum ... have begun consideration of the application of TFP [Total Factor Productivity] approaches to economic regulation in Australia and have sponsored [a consultant] to compare the building blocks approach to TFP. This has been recently reinforced with the Victorian Essential Services Commission flagging in the current Distribution Pricing Review that it will undertake a separate exercise in determining whether they can move to a TFP analysis in the 2010 Pricing Review. (sub. 123, p. 12)

But as that exploratory work has unfolded and more overseas experience with productivity-based price caps has emerged (for example, from the United States and New Zealand), it has become less clear that such approaches would necessarily be a significant step forward. Thus, in its review of the Gas Access Regime (PC 2004i), the Commission found that the potential for regulatory error and inefficient investment outcomes would, in general, remain under a productivity-based pricing approach, and that price setting (where it is warranted) could not be fully divorced from a service provider’s costs. It did, however, advocate an amendment to the gas access arrangements to allow for productivity-based pricing approaches where they could be shown to be beneficial.

In that report, the Commission also found that existing arrangements in the gas industry led to the unwarranted application of formal access price regulation in some situations. Accordingly, it recommended a two-tiered regulatory approach whereby covered gas pipelines would either be subject to regulated access prices or,

where there was evidence that the level of competition was more developed, to a lighter-handed alternative involving price monitoring. In addition, the Commission recommended that service providers subject to formal price regulation be able to apply methods other than a cost-of-service ‘building block’ approach to design reference tariffs (provided this was consistent with the objects clause and pricing principles). Commenting on the merits of those findings at the public hearings for this inquiry, the NECG suggested that a two-tiered approach could potentially be applied to all regulated infrastructure industries (trans., p. 73).

Regulatory constraints on retail prices are potentially costly

In addition to access price regulation, important issues also arise in relation to regulatory constraints on prices (such as through price caps) imposed at the retail level in some sectors. As noted by several participants, unwarranted retail price suppression can have very similar impacts on new investment to those arising from inappropriate access price regulation.

Importantly, the scope for competition in retail markets for infrastructure services will typically be greater than for those services covered by access regulation. Indeed, access regulation is explicitly designed to foster competition in downstream markets. Hence, given the potential costs of inappropriate regulation of prices, a key consideration is whether it is even necessary in many retail infrastructure markets.

As discussed in chapter 8 in the context of electricity, there was widespread support from industry players for the removal of retail price regulation where there is significant competition in the retail market concerned. But as also discussed there, welfare groups argued that price regulation [and the obligation to supply] is critical to protecting disadvantaged groups. In its response to the Discussion Draft, the Victorian Council of Social Services, for example, suggested that retail price regulation prevents exploitation in markets such as electricity and telecommunications and guarantees access to services:

... the eventual demise of the obligation to supply and price caps comprises the final act of reform in which supply becomes a matter of choice on the part of retailers. Complete deregulation opens the way for unhindered market segmentation aimed at exclusion of problem payers, or the imposition of exorbitant charges in cases where the customer has no market power. Arguably, given the essential service nature of electricity all households are price takers, therefore vulnerable and disadvantaged customers are very much at risk of market abuse. (sub. DR155, p. 88)

However, in responding to these concerns in relation to the electricity market, the Commission noted that access and equity objectives are better pursued through adequate, transparent and directly funded community service obligations (CSOs), than by artificially suppressing prices. It therefore recommended that retail price

regulation be removed once full retail contestability has been implemented, or where the market is otherwise judged to be competitive.

In the Commission's view, there is nothing to suggest that this recommendation should not apply more widely. That is, retail price regulation should be removed as soon as effective competition has been established in any regulated retail infrastructure market. To the extent that removal of regulatory controls leads to price increases that adversely affect already disadvantaged groups, it will be important to monitor the adequacy of available CSO support. Moreover, as a transitional step to fully removing retail price regulation, consideration could be given to mechanisms such as 'price service offerings' which would retain price controls for a 'baseline' level of service only.

RECOMMENDATION 10.5

Governments and regulatory agencies should continue to explore opportunities to improve the efficacy of price setting and access arrangements for regulated infrastructure providers. Having regard to approaches outlined in recent Productivity Commission reports into the National Access Regime and the Gas Access Code, particular emphasis should be given to improving incentives for providers to undertake investment to maintain existing facilities and expand networks — including through the implementation of clear and nationally consistent principles to guide regulators.

In retail infrastructure markets, once effective competition has been established, regulatory constraints on prices should be removed. Ensuring that disadvantaged groups continue to have adequate access to services at affordable prices should be pursued through adequate, well targeted and transparent community service obligations (or other appropriate mechanisms), that are monitored regularly for effectiveness.

11 Other areas for national reform

Key points

- The potential for gains from reform extends much more widely than the markets and activities covered by NCP and related reforms.
- There is much scope to achieve better outcomes in human services provision and in natural resource management, both areas being of considerable importance to the community's future wellbeing.
- Competition-related and other market-based reforms, while often only a small part of what is required to deliver better outcomes, can make a useful contribution. However, detailed case-by-case examination of the scope for such reform is required.
- In the Commission's judgement, the 'new' areas that would potentially deliver the largest benefits from a nationally coordinated reform approach are currently, health care, vocational education and training (VET) and aspects of natural resource management.
- An integrated health services reform program within an agreed national framework would add much needed impetus to addressing structural problems of long standing that are preventing the health care system from performing to its potential. The ageing of the population adds to the urgency of initiating reform sooner rather than later.
- Implementation of agreed reforms to VET has been progressing very slowly. The development of a national framework that builds on the new national VET strategy to re-energise and coordinate reform is essential.
- Addressing fragmentation and uncertainty in relation to greenhouse gas abatement policies will require improved national coordination. Also, Australian Governments should initiate a review to identify other areas of natural resource management where the pay-offs from a new or improved nationally coordinated reform program could be high and what is required to reap those gains.
- Continuing reforms in other human services such as aged care, child care, university and school education, as well as in the labour market and tax policy areas, are also important to Australia's future prosperity. But it is not clear that new national initiatives would be necessary or effective in progressing reform in these areas at this time.

Many participants commented on the scope for competition-related reform in a broad range of economic, social, environmental and regulatory activities that, for the most part, lie outside the focus of the NCP. These included human services (such as health care, child care, education and training and housing), the management of various natural resources, regional planning, urban policy, innovation policy, labour markets and tax.

As participants recognised, there are limitations on the effectiveness of competition-related and other market-based approaches in areas such as these. Equally, it is clear that such approaches can play a useful role. Indeed, they are already employed to some extent in most of these areas.

However, in an inquiry of this nature, it is not feasible or sensible to examine all of the areas where such reform approaches might conceivably help to enhance productivity and sustainability. Accordingly, as indicated in chapter 7, this chapter concentrates on just two: the delivery of human services and the management of Australia's natural resources (beyond water). These are areas:

- that are economically and socially very important, as well as being inherently national in character;
- where there is likely to be a significant pay-off for the community from reform, including through helping to deal with some of the key challenges facing Australia; and
- where successful reform is likely to require national coordination through an agreed framework.

These two areas together with those nominated in the previous three chapters should not, of course, be viewed as the only areas for future reform. In particular, reforms that could ease existing and future constraints on labour supply, or facilitate performance improvement elsewhere in the economy, should continue to feature prominently on the future reform agendas of governments. By way of illustration, this chapter concludes with a brief discussion of the importance of ongoing labour market and tax policy reform.

11.1 Why reform of human services?

Importance to Australians' wellbeing

Reflecting their importance to the community and the limitations of private markets in providing them, governments are key funders and providers of human services such as: education and training; health care; aged care; child care; other community

services; and public housing. Collectively, these services are a large and growing part of the Australian economy. In 2003-04, recurrent expenditure by governments in these service areas amounted to around \$84 billion, representing around 60 per cent of total government recurrent expenditure, and around 10 per cent of gross domestic product.

But the importance of most human services extends beyond their economic significance. They are not homogeneous products to be sold at the cheapest possible prices, but rather deal with the physical and emotional wellbeing of individuals, families and communities. Many human services aim to support social justice objectives — the right of all Australians to a basic standard of living and equality of access to education and health services — and to foster a productive, sustainable and cohesive society.

These social objectives add to, rather than detract from, the need for the community to receive ‘best value for money’ — achieving appropriate quality and access, in a cost effective fashion — from the resources it devotes to human services. For example:

- Australia’s growth potential will depend increasingly on making the best use of our human capital. Access by all Australians to an education system of high quality, which fosters the skills, innovativeness and adaptability needed to prosper in an increasingly competitive global market is imperative.
- The benefits of a healthy community are self evident. As well as promoting physical and mental wellbeing, effective health services contribute to a productive workforce.
- An efficient and effective community services sector can increase the level and quality of support available to assist those who are disadvantaged by change and thereby enhance equity.

The reform imperative

These factors alone provide compelling reasons for taking every opportunity to pursue greater equity, efficiency and effectiveness in human services provision. In addition, improved outcomes in this area can directly assist Australia to meet the major challenges that lie ahead. In particular, the ageing of Australia’s population, while alleviating some pressure on education services, will greatly increase the demands on the health and aged care systems. In health care alone, ageing of the population could add as much as \$1000 billion to the government-funded component of spending over the next 40 years (PC 2004b). Continuing to improve the cost-effectiveness of health service delivery will increase Australia’s capacity to

meet growing future demands for these services and to improve quality of care without the need to increase taxation, or shift the burden to future generations through increased public sector debt.

Significantly, there is scope to achieve better outcomes in key human services areas. At the most general level, indications of the scope for performance improvement both within and across jurisdictions are:

- Variations in performance for the same service across jurisdictions (see table 11.1). While the particular circumstances confronting individual jurisdictions mean that some differences are to be expected, the often sizeable variations in performance are suggestive of opportunities for learning how to improve service delivery.
- Inefficiencies associated with the current intergovernmental division of responsibilities for key human services (see box 11.1). Better coordination and cooperation offer the prospect of significant gains to the community.

While there were differences in participants' views as to how reform in the human services area should best be pursued, there was no disagreement that ongoing reform is very important.

11.2 What scope for competition-related reform?

This section examines the scope for competition-related reform in the human services sector. However, this is only one, sometimes small, component of the reform package required to improve the efficiency, effectiveness and equity of service provision. Other important reform ingredients include administrative change, workplace reform, better coordination of service provision and improvements in the regulatory system (see box 11.2).

As emphasised by a number of participants, including NCOSS and VCOSS, funding systems and funding adequacy are also central to the quality of service and achievement of good outcomes. Inevitably, the provision of many human services will remain largely dependent on government provision or subsidy. The scope to achieve better value for money in service delivery does not absolve governments from responsibility for providing sufficient funding to meet reasonable community needs. It is incumbent on governments to specify what outcomes they are seeking from publicly funded human services and, after making appropriate allowance for expected improvements in delivery efficiency, identify what levels of funding are required to achieve those outcomes. As the Commission observed in its report on Nursing Home Subsidies (PC 1999f, p. 4), without a clear linkage between desired

outcomes and funding levels, there is the risk that service quality and/or accessibility becomes a ‘residual balancing item’.

Table 11.1 Performance variations across Australia for key human services^a

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Australia
Year 12 completion rates (per cent)	67	72	72	66	69	67	80	29	69
Percentage of year 5 students achieving benchmarks for:									
Numeracy	91.7	94.7	81.8	90.0	85.9	91.7	93.1	68.8	89.6
Reading	92.0	90.9	83.0	94.5	89.0	94.4	94.6	71.5	89.8
Writing	95.9	92.4	95.8	89.4	95.0	91.9	90.6	77.6	94.0
Real government recurrent expenditure (including user cost of capital) per government school student (\$ per student)	10 139	8927	9031	9901	9431	9555	10 520	14 709	9605
Infant mortality, all Australians (deaths per 1000 live births)	5.0	4.8	6.0	4.6	4.8	6.1	3.5	11.2	5.2
Cost per case mix - adjusted separation from hospitals (\$ per patient)	3283	3285	2885	3284	2796	3136	4128	3603	3184
Percentage of patients waiting more than a year for elective surgery	4.2	4.2	2.6	3.9	3.0	10.9	7.1	7.0	4.0
Public housing occupancy rates (per cent)	98.7	96.6	98.7	95.3	95.4	97.4	97.2	93.8	97.4

^a The performance indicators reported above are fully described in SCRGSP (2005), along with comments on data limitations and other caveats which need to be taken into account in using the data. Even so, the indicators are broadly comparable across jurisdictions.

Source: SCRGSP (2005).

Box 11.1 Some consequences of joint Federal and State responsibility for key human services

Australia's federal system of government is a source of important benefits, but it also gives rise to some significant problems and costs. While evident in several areas, they are especially acute in the delivery of services such as health care, where responsibility for funding and program management is shared between the Australian and State and Territory Governments. The adverse consequences of the continuing failure to achieve effective specification and delineation of roles and responsibilities in areas such as health care have been widely documented. In particular, it has:

- led to costly duplication of effort;
- encouraged cost and risk shifting, especially in the health sector where, for example, the Australian Government is responsible for funding out-of-hospital services, and the States and Territories are responsible for funding inpatient and outpatient public hospital services;
- impeded effective coordination of different components of the overall service package, for example between primary and acute care, and between hospital and residential aged care; and
- reduced the accountability of governments for outcomes achieved and encouraged political point scoring and 'blame-shifting'.

The Commission observes that, in recent months, the issue has again assumed a sense of urgency that it has not had since the mid 1990s. As the New South Wales Government commented:

It is clear that governments must act to achieve the most cost-effective and efficient government service delivery possible. One of the most crucial elements in progressing reform is recognition of the increasing complexity in, and interaction between, areas of Commonwealth and State responsibility. Ignoring these factors leads to inefficiencies, poor outcomes and frustration at both levels of government and in the community. (sub. 99, p. 23)

In responding to the Discussion Draft, the Cabinet Office NSW indicated that similar issues and pressures also exist in other human service areas, including child care, education and training and housing. It went on to say:

As in the health sector, arbitrary division of responsibilities cuts across the continuum of service delivery, undermining efforts to ensure that the most appropriate and cost effective balance of services is provided. CoAG should also consider reforms in these broader human services areas.

Without significant cooperation, neither level of government will be able to provide the best outcomes for Australia over the coming decades. (sub. DR185, p. 4)

Box 11.2 Examples of reform measures in human services

Apart from any competition-related changes, a variety of other reform measures can play a role in achieving better outcomes in the human services sector. Examples include:

Administrative reform

A focus of recent reform efforts has been improving internal management processes. Examples include clarification of responsibilities and desired outcomes; financial management and budgetary reforms; more emphasis on corporate and strategic planning; and the use of performance reporting and monitoring frameworks to improve accountability and client focus.

Workplace reform

As in other parts of the economy, more flexible workplace arrangements can enhance productivity and service quality and increase system responsiveness to client needs. In some areas of human services, workforce planning and training matters also loom large. Thus, there have recently been initiatives to address the shortage of medical and nursing staff in the health and aged care sectors. And a looming shortage of teachers in some key areas is similarly attracting greater policy attention.

Better coordination

In sectors as large and diverse as health and education, effective coordination between the different components of the overall service is essential. In health care, for example, waste of resources and poor outcomes for patients can result from lack of coordination between services provided in a community setting and within hospitals, and between different services in each setting. In the education system, coordination problems can hamper a seamless transition of students from primary to secondary and tertiary education. Better coordination between separate but related services — for instance, health care and residential aged care — can also result in better outcomes for clients.

'Best practice' regulation

Improving the way that regulations governing the provision of human services are developed and implemented is another potential source of performance gain. The potential for wider application of Regulatory Impact Statement requirements that currently apply to new or amended legislation that restricts competition is one consideration here (see chapter 9). As well, it will be important to ensure that regulations and standards do not *unnecessarily* inhibit capacity to respond to significant overseas demand for Australian health and education services. Issues related to the availability and cost of professional indemnity insurance are also relevant.

Human services are different

As noted above, many human services are not ‘normal’ marketable products. They are multi-dimensional in character, with the capacity to contribute to the physical, emotional, social and intellectual wellbeing of individuals, families and communities. This helps to explain why their provision traditionally emphasises social objectives, including equity of access, rather than market objectives of competition, price and choice.

The scope to give competitive market forces free rein is usually less for human services than for many other goods and services. For instance:

- While consumers often need to make choices about products based on quite limited information, the consequences of wrong ‘purchasing decisions’ for services such as health care can be very severe.
- In many cases, people do not choose to use human services — and are thus not ‘consumers’ in the usual market-based sense — but do so because of need, or in response to adverse circumstances beyond their control.
- The ethos of cooperation or social duty can be a particularly important motivator and means for achieving better outcomes in the human services area. Thus, not-for-profit service provision, including by charitable organisations, remains important. While the use of competition to enhance service delivery need not be incompatible with the cooperative ethos, there can be tensions between the two (see below).

For these sorts of reasons, several participants cautioned against a greater role for competition in the human services area (see box 11.3).

There has already been a range of competition-related reform

Many areas of human service delivery have traditionally involved significant competition, even where a share of funding has been provided by government. These include private medical practice, other health services provided by practitioners such as dentists and optometrists, private hospital services, private school education and child care.

Box 11.3 Participants' views on the appropriateness of competition-related reform in human services

Several participants questioned the role for competition in the delivery of health, education and other community services:

... health care does not operate in a competitive market in which market forces determine supply and demand. Health is a right, and the community (and therefore government) has a responsibility to ensure that all its members have access to health and social services according to need. (Royal Australasian College of Physicians, sub. 27, p. 2)

Competition in itself does not produce quality and efficiency savings and the application of competition policy principles needs to take into account public interest issues such as quality and access for people seeking to access the service and wages and working conditions for people providing the service. (Australian Nursing Federation, sub. 103, p. 3)

The distinctive nature of the products and services being supplied in higher education and other cases of market failure mean that it would be totally inappropriate to treat higher education (or education more generally for that matter) as a normal good or service, where questions of what to produce, how much to produce, what price to charge and who gets to consume it would be left to the dynamics of a competitive market. (National Tertiary Education Industry Union, sub. 41, p. 3)

A public health system should not be part of a competition programme. Rather it should be a co-operative system of sharing and caring. (Combined Pensioners and Superannuants Association of New South Wales, sub. 8, p. 4)

[We are] especially opposed to further incursions of market-based reform initiatives into the sphere of welfare and community services. It is our firm belief that the marketisation of many of the essential services and goods has, in effect, kept people in a position of disadvantage by closing the door of opportunity. (St Vincent de Paul Society, sub. 120, p. 7)

However, others considered that competition-related change does have a role to play, not only in improving outcomes for clients, but also in contributing to productivity growth across the economy and in helping to meet the ageing challenge:

... consideration could be given to the application of NCP principles to the health and education sectors. The efficient operation of these markets will be vital for Australia's economic future as we compete in an international economy that increasingly values knowledge and innovation, and we deal with the health system implications of an ageing population. (Business Council of Australia, sub. 84, p. 8)

Some elements of market-based reforms are part of NCOSS's preferred approach to improving the adequacy and effectiveness of human services. (Council of Social Service of New South Wales, sub. 86, p. 3)

In some cases it can be practical and beneficial to increase competition in health-related services, but in other areas regulation remains necessary. Our objective needs to be a sound balance using the least restrictive policy levers that are practical given all other constraints. (Department of Health and Ageing, sub. 80, p. 2)

... the realisation of 'complete competition' would be greatly enhanced by expanding the scope of NCP rules to areas of the economy which have remained relatively untouched by market-based reform. These include the various 'merit good' sectors such as health, welfare, community services and education where private sector alternatives have effectively been 'crowded out' by government provision in these areas. (The Social Market Economy Institute of Australia, sub. 39, p. 8)

Recently, competition or market-based mechanisms have been introduced into a broader range of human services largely or wholly funded and/or delivered by governments.

- Some focus directly on providing better incentives for service providers to improve performance and/or to provide appropriate levels and quality of service — examples include performance benchmarking, performance-based funding and competitive tendering and contracting out.
- Others, such as improving user choice or applying user charges, are more indirect — they seek to improve performance by signalling to providers the value which users place on the services concerned.

Many of these changes have happened independently of NCP, though some have arisen through the LRP process or in response to competitive neutrality requirements.

Demonstrating the overall benefits from such changes is often not easy, particularly where user choice and user payment mechanisms are involved. Like the alternatives, market-based mechanisms have their strengths and weaknesses and often require refinement over time to address unintended consequences and promote improved outcomes.

The Job Network (box 11.4) provides a useful example in this context. Another illustration is provided by the introduction in the early 1990s of a copayment for pensioners and other low-income earners for PBS pharmaceuticals. This was partly intended to encourage doctors to discuss treatment options with patients, rather than simply giving them a sometimes unnecessary prescription. But immediately following the introduction of this copayment, there was a large decrease in the level of prescription of ‘essential’ drugs, as well as of ‘discretionary’ drugs (although prescription numbers subsequently recovered somewhat) (McManus et al. 1996, pp. 385–392).

However, to eschew all competition-related reform because of challenges encountered in particular areas, or on the basis that human services are ‘different’, would not be a prudent approach. There is little doubt that, if *well implemented in appropriate circumstances*, competition-based change can bring overall benefit.

A series of case studies covering competition-related reforms to the provision of a variety of government services support this assessment. These were conducted by the Steering Committee for the Review of Government Service Provision under CoAG. The first group of case studies covered human services in South Australia, public hospitals in Victoria and correctional services in Queensland (SCRCSSP 1997).

Box 11.4 Competition-related reform in employment services

In recent years, services to unemployed people have been provided through the Job Network. It tries to mimic many of the features of normal markets by providing scope for competition between providers through the competitive tendering of service provision contracts, some degree of choice for job seekers, flexibility in the way services are delivered, and rewards for good providers. The Job Network arrangements were intended to address problems of ineffectiveness and inefficiency evident in previous employment services arrangements. These included poor results, high costs and lack of focus on the needs of the individual.

In a recent assessment of the Job Network, the Commission (PC 2002b) found that while its effects on net employment have been small and similar to past programs, the total costs have been much lower. Competition between providers and the use of outcome payments were found to have created incentives for more cost-effective service provision. The Commission therefore concluded that the purchaser-provider framework is a suitable policy framework for the delivery of active labour market programs.

However, it also found that some aspects of the arrangements were not working well:

- Many disadvantaged job seekers received little assistance while on ‘Intensive Assistance’ — so-called ‘parking’.
- Many job seekers effectively had few choices over the services given to them and could be locked into a single provider.
- Competitive tendering arrangements were complex and expensive for providers and disruptive to services.
- Fixed caseloads were frustrating growth of the best agencies and removing incentives to develop and promote superior performance.
- Direction to, and compliance burdens on, Job Network providers were excessive — undermining the inherent flexibility of the system.

The Commission proposed a range of ‘incremental’ reforms to address these problems, including: better targeting of the needs of job seekers; changes to payment systems to providers; expanded options for re-referring job seekers to other programs; better information provision to job seekers about the Job Network; more options for job seekers to choose providers and pathways; eventual opening up of entry to the Job Network to any accredited agency (subject to ongoing assessment of quality); administratively set prices to providers for particular services; and the adoption of a risk management approach to contract monitoring and compliance.

Many of the Commission’s proposals were effectively incorporated into the latest version of the Job Network, with the Government indicating that others will be considered for the longer term (Brough and Campbell 2002).

The second group covered devolved decision making in Victorian government schools, the use of competitive tendering for New South Wales public hospital services, offering Western Australian consumers of disability services choice of provider and pricing court reporting services in Commonwealth Courts (SCRCSSP 1998).

As the following discussion illustrates, both sets of case studies covered reforms that have potentially wider applicability across jurisdictions and across human service areas.

Competition-related reform directions

For the reasons outlined above, tailoring the application of competition or market-based changes in the human services sector to particular circumstances is very important. But even though one size does not fit all, and competition in many service areas should continue to be ‘managed’, several generic reform approaches that have underpinned much of the previous competition-related reform in the sector are likely to continue to be relevant in a range of situations.

Improving value for money for the community

As noted, in many areas of human services provision, governments are likely to remain a significant source of funding. They and the community have an obvious interest in ensuring that this funding is used as effectively as possible.

Where governments also provide the service (for example, public hospitals and schools), improvements in funding methodologies and program management, and outcome monitoring arrangements, can play an important role in achieving better value for money. For example, though not without problems, casemix funding for hospital services is widely acknowledged to have improved the efficiency of service delivery (see, for example, SCRCSSP 1997).

However, in a variety of human service areas, governments have sought to improve the efficiency and quality of services by devolving provision to non-government entities. In the past, such providers were sometimes selected without resort to any formal or transparent selection process. But, increasingly, there has been greater emphasis on selecting providers on the basis of competitive tenders. Apart from evaluation of ability to meet program service quality objectives, such tenders frequently also involve an element of price competition. This is generically referred to as the ‘purchaser-provider’ model (box 11.5) of contracting out.

Box 11.5 What is meant by the ‘purchaser-provider’ model?

Historically, government-funded community services were delivered by public sector agencies in a monopoly environment. However, over the last decade or so, there has been an increasing trend both in Australia and overseas to outsource the delivery of such services. In many areas, government has shifted from both funding and providing the service to a purchaser-provider model.

This model separates the responsibility for funding from the provision of the service. For example, the Department of Veterans Affairs, which previously provided hospital services to veterans through special repatriation hospitals, now purchases services from public hospitals and through contracted private hospitals. Other examples include the Adult Migrant English Program, various employment programs, ambulance services and urban transport in Victoria.

This shift to private provision has been motivated by a view that contestability — competition *for* the market — can improve the cost-effectiveness (including quality) of services that governments fund.

If the process is repeated from time to time, supply of the relevant service becomes contestable. Even if consumers themselves are not given a choice of provider (see below), the purchaser-provider model introduces competition for the right to supply the market, with likely efficiency and effectiveness benefits for the community.

While this model has the advantage of greater cost control, there is some risk that quality of service and equity of access might inadvertently be jeopardised (see box 11.4 on Job Network for an example). Other problems often raised in relation to purchaser-provider contracting arrangements include:

- uncertainty for service providers caused by the need to ‘compete’ with rival providers;
- less scope for collaboration between providers, including across service types;
- reduced capacity to innovate and take risks in seeking to meet the needs of the consumer;
- increased administrative costs, in some cases threatening the continued involvement of non-government organisations in service provision;
- lack of public sector expertise in contract development and management; and
- reduced accountability of government for outcomes.

ACOSS, for instance, commented on some possible adverse effects from the entry under purchaser-provider arrangements of for-profit service providers:

The entry of for-profits erodes social capital, not just by displacing community based organisations, but by changing the character of existing community organisations so that they replicate features of the private business sector. In some cases this improves efficiency, but it can also undermine service quality (given the relatively high priority of the for-profit sector to cost competitiveness), the targeting of the most disadvantaged, and social capital (for example, by forcing a greater concentration of services in the hands of a few large services that are no longer locally based). (sub. 106, p. 7)

On a related point, TasCOSS noted that while a preparedness to share resources and knowledge has been an important characteristic of the not-for-profit human services sector:

The reality of competition (or indeed the prospect of it) has dramatically eroded this feature of the sector. Knowledge is now increasingly ‘commercial in confidence’. Innovation is something to be developed within organisational boundaries, not across them. Any consideration of extending competition further into human services must take into account these dynamics. (sub. DR219, p. 9)

The Australian Nursing Federation went further, claiming that ‘there is little if any public evidence ... on either economic or social advancement criteria’ that ‘a more efficient provision of health services’ has been the result of ‘a policy of contracting out, privatisation and co-location of health services under the guise of competition policy’ (sub. 103, p. 1).

The scope of this inquiry does not extend to an in-depth assessment of such claims. However, in the Commission’s view, whilst undoubtedly having validity in specific cases, they do not invalidate the use, in the right circumstances, of a potentially valuable approach to improving the efficiency and effectiveness of service provision. Rather, what they highlight is the considerable care needed in assessing when to apply the purchaser-provider model and how to apply it. In general terms, the model is likely to be useful where:

- desired program outcomes can be identified;
- those outcomes can be largely specified in measurable terms;
- outcomes can be directly influenced by the efforts of the provider;
- process specifications can be avoided; and
- administrative, compliance and other costs associated with tendering are not excessive relative to the value of the service being provided.

Some participants questioned whether many of these conditions would be met for human services. In practice, they are likely to apply to varying degrees. The success or otherwise of purchaser-provider arrangements will also be shaped by the nature of the contract arrangements and the relationship between the purchaser and provider(s). For example, cooperation and collaboration between the parties in

developing contractual terms and conditions should help to prevent contracts which are of inappropriately short duration, and also facilitate the inclusion of review mechanisms to identify and address unanticipated problems. Thus the sort of cooperative approach that has been very important in the human services sector in the past will also be an integral part of effective purchaser-provider arrangements in the future, as well as in helping to improve the quality of, and access to, human services more generally.

Providing choice for consumers

In general, people appreciate the opportunity to make choices about things that matter to them, whether they be everyday items from the supermarket, or services such as health and education. For most human services, the notion of choice goes well beyond mere choice of provider, to include the location, type and mix of services.

Choice often provides wider benefits as well. When consumers can exercise choice, the disciplines on providers to deliver value for money services and to respond to changing needs, are greatly enhanced. As ACOSS (2001) commented in its submission to the Commission's recent Job Network inquiry:

The power to choose between different service providers is very important for consumers of human services, especially those ... [people] who are economically and politically marginalised. There are many instances of poor quality service provision by organisations that occupy monopoly positions in the provision of human services for vulnerable people. (p. 16)

This is not to suggest that *unconstrained* choice is necessarily appropriate in most or perhaps any of the key human services areas:

- As noted, information problems abound, with poor choice in some areas (such as health) being potentially harmful for both the individual and the community.
- Some vulnerable consumers may not be in a position to exercise choice.
- Externalities arising from choice can reduce the wellbeing of others — the establishment of a new private school, for example, can draw pupils from surrounding public schools, possibly affecting their performance or viability.

Moreover, initiatives to promote choice need to be designed carefully to avoid adverse incentive effects. For instance, in its evaluation of the Job Network, the Commission found that the arrangements then in place underplayed the potential value of choice in empowering job seekers and providing incentives to service providers to improve performance. But it also noted that giving job seekers excessive scope to change providers, or to move to other programs such as Work for

the Dole, could put at risk providers' efforts to improve the employment prospects of the long-term unemployed (PC 2002b).

Further, competitive neutrality between providers is a prerequisite for efficient choice. Where some providers enjoy a competitive advantage by virtue of government ownership or discriminatory subsidies, choice is likely to be biased. As discussed later in the chapter, specific concerns of this nature were raised by participants in relation to VET.

Again, an implication of the preceding discussion is that carefully implemented consumer choice policies can encourage the provision of services that better and more cost-effectively meet the needs of clients. But there will often be limits on the amount of choice that is possible or desirable. Thus, policy makers have to strike an appropriate balance.

A role for user charging

An element of user charging already applies in many parts of the human services sector, both public and private — for example, for schooling, higher education and training, aged care, child care and most health care services.

If well designed and subject to appropriate safeguards, user charges can promote both efficiency and equity objectives:

- Such charges can provide consumers with information on the costs of providing different services and thereby encourage more efficient consumption choices. They can also help to guard against the wasteful and even inappropriate consumption that is likely to occur when services are provided free of charge. This has been demonstrated in the case of court reporting services, where the introduction of user charges encouraged some users to moderate their demand for transcripts, while those valuing quicker turnaround times were able to gain speedier access by paying above the standard rate (SCRCSSP 1998).
- By limiting inappropriate consumption and reducing government subsidies to those in the community well able to pay for services such as education, health, aged and child care, user charges can free up government funds to better assist those most in need. Hence, the perception in parts of the community that user charging inherently transgresses principles of equity is misguided.

Other factors will, however, limit the scope for user charging in key human services. In particular, user charges can reduce desirable as well as wasteful consumption of services:

-
- Without substantial government subsidies, many in the community would be unable to afford necessary health care treatments, to educate their children properly, or to pay for nursing home services.
 - In other cases, inducements may be required to encourage people to willingly consume ‘desirable’ services. For example, if left to their own devices, some unemployed people may not avail themselves of Job Network services.

Moreover, greater emphasis on user pays for those able to do so could conceivably have adverse implications for those dependent on freely provided services. In this regard, in its submission in response to the Discussion Draft, ACOSS commented that requiring those on higher incomes to meet a greater share of the cost of services provided could:

... well lead to the emergence of two separate service systems — a private system for those that can afford to pay for themselves and a residual public system for the rest. The problem with this scenario is that the quality of the public system is likely to decline as the better off lose their stake in the quality of the public system and begin to resist the spending of tax dollars on maintaining a decent public system. (sub. DR239, p. 9)

For these sorts of reasons, user charging may well be a less important component of the ‘policy tool kit’ for delivering better outcomes in the human services sector than either purchaser-provider approaches or user choice. But, equally, it should not be automatically ruled out on the grounds of ‘unfairness’. In the right circumstances, and if carefully applied, user charging can help to promote more efficient, effective and equitable service provision. Successful application requires, amongst other things, accurate information on the costs of provision, assessment of the best method of allocating costs to different users and consideration of any adverse impacts on access to services and how these could be addressed.

Facilitating the sensible use of competition-related reform

As the preceding discussion has sought to emphasise, there is great diversity in the human services sector. Hence, competition-related initiatives that may be appropriate in one area of service provision might be entirely inappropriate in another. And, as a recent article by Porter and Teisberg (2004) on the US health system argues, where competition is focused on the wrong objectives, outcomes can be unsatisfactory (box 11.6).

In any particular case, identification of the scope for beneficial competition-related reform will be made easier if program objectives are clearly specified, together with: the nature of the service or ‘product’ to be provided to clients; the relative roles of government, for-profit and not-for-profit service providers; and the

associated regulatory requirements. This will then allow the potential for competition-related reform to improve outcomes to be assessed against clearly defined benchmarks and in the context of regulatory protections designed to ensure that access and quality of service objectives are not compromised.

Even so, such assessments are unlikely to be straightforward. Judging whether user choice mechanisms could marginalise particular client groups will typically be very difficult in advance. Similarly, when introducing or extending user charges, there are no ‘off-the-shelf’ formulas that can be employed to achieve the right balance between avoiding wasteful or inappropriate consumption and discouraging desirable usage of the service concerned.

Box 11.6 Redefining competition in US health care

In a recent journal article, Michael E. Porter and Elizabeth Olmsted Teisberg argue that while the ‘wrong’ kinds of competition have made a ‘mess’ of the American health care system, the ‘right’ kinds of competition can ‘straighten it out’:

The US health care system has registered unsatisfactory performance in both costs and quality over many years ... We believe that competition is the root of the problem with US health care performance. But this does not mean that we advocate a state-controlled system or a single payer system: those approaches would only make matters worse. On the contrary, competition is also the solution, but the nature of competition in health care must change. Our research shows that competition in the health care system occurs at the wrong level, over the wrong things, in the wrong geographic markets, and at the wrong time. Competition has actually been all but eliminated just where and when it is most important.

Porter and Teisberg advocate shifting the focus of competition away from ‘who pays’ to ‘who provides the best value’. In their view, the future US health system should be characterised by:

- competition at the level of treating specific diseases and conditions;
- distinctive strategies by payers and providers;
- incentives to increase value rather than shift costs;
- information on providers’ experiences, outcomes and prices; and
- consumer choice.

Source: Porter and Teisberg (2004).

Moreover, transactions costs can also loom large, especially if the introduction of competition-related reform requires the simultaneous implementation of additional regulatory protections. In other words, there is a need to ensure that administrative and compliance costs do not outweigh the anticipated efficiency, quality and other benefits of change.

These caveats notwithstanding, and accepting the need for detailed case-by-case examination, the Commission considers that there is considerable scope for competition and market-based change in the human services sector, including in the large areas of health, aged care and education. The recent Hogan review of residential aged care funding provides an example of this scope (box 11.7).

It is also important that the inevitable uncertainty about the precise impacts of reform, or the transactions costs that accompany any reform program, are not used as reasons to preclude competition-related initiatives without consideration. As many participants recognised, given the economic and other challenges confronting Australia over the coming decades, all potentially worthwhile reform opportunities should be explored.

11.3 Competition-related reform and natural resources

Australia has a rich array of natural resources — including land, water, fisheries, forests and minerals. But over exploitation and inappropriate use of these resources, while sometimes bringing short term gains, will cause environmental damage and threaten biodiversity, penalising subsequent generations. Hence, effective natural resource management directed at sustainable resource use is of prime importance to Australia's future.

Growing recognition of the importance of effective resource management and of the need to address the consequences of past management failures has underpinned many policy initiatives in the last decade or so. These include administrative reforms such as clarification of objectives; efforts to improve policy coordination in related areas; the use of performance reporting and monitoring frameworks to improve accountability for outcomes achieved, as well as the application of various market-based instruments (see below).

Also, while not a primary focus, aspects of the NCP have explicitly sought to advance resource management goals. In particular, much of the water reform agenda has been directed at improving catchment management, enhancing water quality, promoting a better mix between consumptive usage and environmental flows and reducing wasteful consumption. Resource management and sustainability issues are also relevant to the energy market reforms under NCP (particularly in regard to greenhouse gas emissions — see chapter 8), as they have been to the legislation reviews of forestry and fisheries regulation.

Box 11.7 The Hogan review of aged care

Aged care is provided by a range of public, charitable, private and community entities. The large majority of funding comes from the Australian Government which also regulates service providers and service quality.

A range of performance problems have been identified including:

- access difficulties, particularly to high level residential care, dementia-specific care, community care services, and services generally outside the major cities and towns;
- cost shifting to the hospital sector;
- inequities in charges/fees between low and high level residential care and between residential and other aged care services;
- regulatory provisions which constrain service choices;
- shortages of aged care workers, especially nurses; and
- question marks about the efficiency and financial sustainability of some providers.

A major recent report, the *Review of Pricing Arrangements in Residential Aged Care* undertaken for the Australian Government by Professor Warren Hogan, put forward a range of shorter term recommendations to help address these sorts of problems. Many of these have been adopted by the Government (DHA 2004).

However, Hogan (2004) argued that more fundamental changes, which give a much greater role for price signals, are the key to securing better outcomes in the medium to longer term:

Price is central to allocation of resources, both for the services provided to residents and for the cost of funds to sustain expansion of productive capacity. The central questions are whether, and how, future older Australians can take greater financial responsibility for their aged care needs in order to relieve intergenerational inequities. All this must be secured in circumstances where the disadvantaged in society are provided with support. (p. 2)

He went on to propose a range of options consistent with this theme, including:

- placing the choice of provider in the hands of the prospective resident or the resident's family through a voucher system;
- establishing a contracting agency to act on behalf of the Government to negotiate prices and conditions for residents;
- making eligibility for subsidised residential aged care subject to the means tests applying to the aged pension;
- developing tax and asset test 'friendly' arrangements governing the sale of the family home to help people pay for more suitable aged care; and
- implementing an auction system for allocating residential aged care places to providers.

Sources: Hogan (2004) and DHA (2004).

In common with human services, issues related to roles and responsibilities and the clarification of objectives are of prime importance in securing better outcomes:

- The failure to achieve effective specification and delineation of roles and responsibilities between governments in such areas as water resources, greenhouse gas emissions and protection of native vegetation continues to have adverse effects.
- There also needs to be a clear linking between desired outcomes and funding levels, to avoid the risk that the *quality* of outcome becomes a ‘residual balancing item’. (There is already some evidence that this has occurred with National Parks and Heritage Conservation, where the task and expectations have grown much more rapidly than funding.)

And like the delivery of human services, natural resource management issues are complex and each particular problem requires examination to determine the best way forward.

But, notwithstanding this complexity, competition and other market-based mechanisms have a role to play in appropriate circumstances:

- Water reform, for example, has been progressed through the creation of property rights and ‘markets’ in which those rights can be traded.
- There has been widespread experimentation with the use of market-based instruments in other natural resource management areas and in environmental protection (see box 11.8).
- There has been some devolution of responsibility for decision making affecting resource management outcomes to private entities — whether for-profit or not-for-profit — and to private resource owners (see box 11.8).

Not surprisingly therefore, several key stakeholders in this area expressed support for the use of competition-related and other market-based reform measures in dealing with particular natural resource management issues (see box 11.9).

11.4 Some key areas for national coordination

For some areas of human services delivery and natural resource management, ongoing reform will best be pursued on a jurisdictional basis. This would be the case, for example, where an activity is not of national significance and where the impacts of policy decisions taken by individual jurisdictions are largely confined within those jurisdictions.

Box 11.8 Market-based instruments and the environment

In its submission, the Australian Government's Department of the Environment and Heritage provided some examples of the use of market-based instruments (MBIs) and commented on further work currently under way.

At present MBIs are being used to achieve environmental outcomes in a wide range of areas, by both Australian and State Governments. Levies have been used to reduce waste and pollution and product taxes have been implemented to encourage a change in behaviour such as recycling (eg product stewardship for oil program). MBIs have also been used for natural resource outcomes such as through input subsidies in the Natural Heritage Trust and National Action Plan for Salinity and Water Quality programs and outcome subsidies through projects such as BushTender in Victoria. MBIs are also being used to manage pollution management problems by capping environmentally damaging activities and allowing trading to most effectively undertake production within a cap eg the Hunter River Salinity Trading Scheme and Nutrient Trading Scheme in the Hawkesbury Nepean, both in NSW.

The application of MBIs to achieving cost effective and socially acceptable natural resource outcomes is being further investigated through the joint State and Australian Government funded National Market Based Instruments Pilots Program (NMBIPP) under the Natural Resource Management Ministerial Council. Pilots under the program are currently investigating ways to use innovative economic arrangements to encourage better land and water management and to reduce salinity in irrigation based agriculture. Pilots under the NMBIPP began in June 2003 and are expected to be completed in early 2006. The NMBIPP should provide an insight into the characteristics (operational and institutional) that result in the successful application of MBIs. (sub. 97, Attachment A)

The Productivity Commission has also undertaken work which highlights the role that MBIs can play in this area. Some key examples include the Commission's inquiry reports on *Ecologically Sustainable Development* (PC 1999c) and *Impacts of Native Vegetation and Biodiversity Regulations* (PC 2004d) and conference/research publications such as *Microeconomic Reform and the Environment* (PC 2000b), *Constraints on Private Conservation of Biodiversity* (PC 2001a) and *Harnessing Private Sector Conservation of Biodiversity* (PC 2001b).

However, where an activity is of national significance, where actions in one jurisdiction affect outcomes in others, or where policy, financing and delivery responsibilities are shared, there will often be value in adopting a national approach to reform. In some cases, the challenge may be to build upon and improve existing national coordination frameworks and institutions. In others, completely new coordination initiatives may be required. Suffice to say that, in some key areas, stewardship of the reform process by CoAG (or another national leadership body) would give impetus to reform, provide a means of coordinating efforts across jurisdictions and between individual components of the services concerned, as well as providing an opportunity for reviewing and reporting on implementation progress across Australia.

Box 11.9 Harnessing ‘the market’ to improve environmental outcomes

The Queensland Government said that it:

... acknowledges the value of competition or market-based initiatives in promoting environmental goals ... (sub. 119, p. 3)

In its submission, following release of the Discussion Draft, Environment Business Australia (EBA) indicated that it:

... is very strongly supportive of market based mechanisms. This approach works in tandem with technology and regulatory approaches and can help to break down silos while educating the marketplace, providing offsets, and catalysing beneficial change. (sub. DR255, p. 8)

And, though sounding a note of caution, the Australian Conservation Foundation observed that:

... reforms with an economic efficiency focus can provide environmental benefits in industries whose use of natural resources or other inputs is environmentally damaging. Improving efficiency can reduce the use of such inputs and provide benefits to the environment. But this link is not guaranteed. Often additional policies would be needed to ensure that such efficiency savings are shared with the environment. (sub. 54, p. 2)

The subsequent discussion examines a number of human service areas, as well as natural resource management, to identify where new or improved arrangements for national coordination could provide a substantial pay-off to the community. The proposed reform agenda which emerges from this discussion, and those reform areas identified in the preceding three chapters, are then drawn together in chapter 12. That final chapter also seeks to highlight those areas where the need for new or improved coordinated reform frameworks is particularly pressing.

Health care

Some of Australia’s overall health care outcomes compare favourably with those in other developed countries. For example, Australians have among the highest life expectancies in the world — including when ‘disability adjusted’ for years of ‘good health’. Yet total spending on health care as a percentage of GDP and per capita is not overly high by advanced OECD country standards (see table 11.2). From this broad perspective, therefore, Australia’s health system, at least to date, appears relatively cost-effective.

Table 11.2 Health care spending in selected OECD countries

Country	Health spending per capita, 2002	Health spending as a share of GDP, 2002	Real growth in health spending, 1992–2002
	\$A 000	%	%
Australia	3.6	9.5	4.5
Canada	3.9	9.6	3.2
France	3.7	9.7	2.7
Germany	3.8	10.9	2.3
Japan	2.8	7.8	3.8
Netherlands	3.6	9.1	3.5
New Zealand	2.5	8.5	4.9
Sweden	3.4	9.2	3.6
United Kingdom	2.9	7.7	4.1
United States	7.1	14.6	4.5
OECD-10 mean	3.7	9.7	3.7

Source: AIHW (2004).

Moreover, it is a system that is evolving and, in many areas, improving over time. For example, in recent years there have been changes to funding arrangements to encourage greater efficiency in the public hospital system (in particular, casemix funding); to provide more effective incentives for people to take out private health insurance through the introduction of lifetime community rating; to ensure more effective performance monitoring and governance mechanisms; and to enhance access to services in rural and regional Australia. Also, improvements to the provision of some professional health services have resulted from the NCP's legislation review program and the application of trade practices legislation to these services.

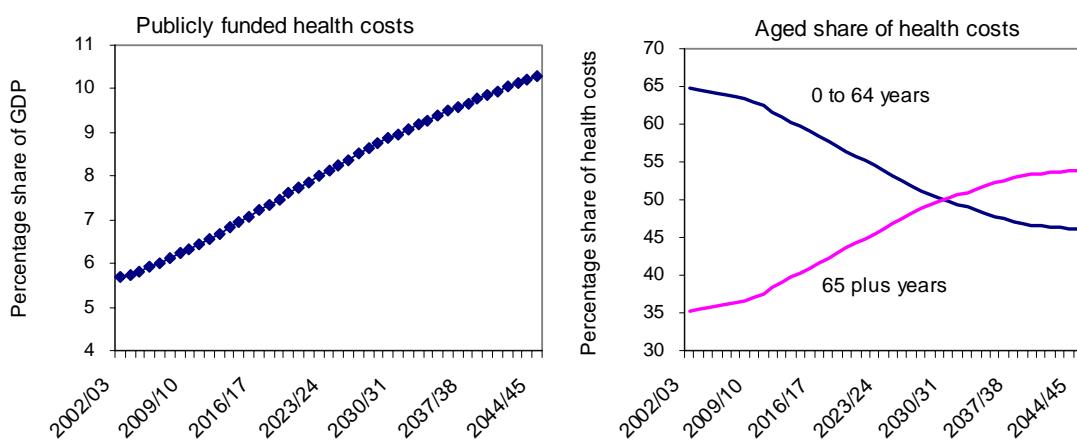
There are significant problems and emerging challenges

In recent years, Australia's real spending on health care has been growing faster than in many other advanced OECD countries (table 11.2) and is expected to continue to rise rapidly in coming decades. For example, projections by the Commission indicate that, as a share of GDP, overall health care spending by all Australian governments (excluding aged care and capital spending), could almost double from around 6 per cent of GDP currently to about 10 per cent by 2044-45.

Recent increases in spending have been driven primarily by rising demand fuelled by higher incomes and community expectations, together with the emergence and diffusion of new medical technologies. The increase in spending on pharmaceuticals since the mid 1980s has been particularly strong, with a growth rate nearly 5 percentage points above per capita GDP growth.

But, in coming decades, ageing of the population will add to these underlying demand and technology drivers, to form a potent cocktail. Thus, by 2044-45, those aged 65 or more are expected to account for nearly 55 per cent of government spending on health care, compared with about a third at the present time (see figure 11.1.)

Figure 11.1 Projected growth in government-funded health care expenditure



Source: PC (2005a).

To these spending trends can be added significant concerns about the health status of Indigenous Australians and (to a lesser extent) of people living in regional Australia, particularly in remote areas:

- Indigenous Australians have much lower life expectancies than other Australians and much higher levels of morbidity from a wide range of health problems and diseases. Overall, Indigenous mortality rates and infant mortality rates are twice the national average (SCRGSP 2004b).
- Other Australians living in remote and rural Australia also have higher than average illness and mortality levels and, like their Indigenous counterparts, often face difficulty in accessing key medical services. In this regard, the Wagga Wagga City Council (in a letter to the Commission welcoming its Rural and Regional Roundtable) contended:

... there has been a failure of both the current policy settings and the market to provide equitable access to medical services. ... Statistics ... reveal that due to lack of access to services, rural and regional Australians ... are subsidising health services in metropolitan Australia. The inequity is further evidenced by the lower ratio of doctors to population, higher prices for services and the extremely low rates of bulk billing in rural and regional Australia.

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- The Australian Dental Association (sub. 63, p. 9) similarly argued that:

One of the most significant issues affecting the provision of dental services in Australia is the lack of access to dental services for a significant number of the population. There is a chronic shortage of dentists, especially in remote and rural areas and in the provision of public dental services.

Beyond these examples, there are various other indicators of problems and scope for performance improvements.

- Even within the major population centres, access to public hospital services and bulk-billed medical services has been of increasing concern.
- There is potential for Australian hospitals to improve overall safety and quality of care for patients. Around 4500 preventable deaths are ‘conservatively’ estimated to occur in hospitals each year as a result of mistakes and inappropriate procedures (Richardson 2003). Data collected by the Australian Council on Healthcare Standards reveals potential for Australian hospitals to improve their safety and quality of care by closing gaps on best practice outcomes (ACHS 2003 and SCRGSP 2004a).
- Apparent shortages in key workforce areas such as nurses, general practitioners, some medical specialties and dentists are likely to add to service quality and access pressures in the future. Also relevant here are professional demarcation rules that determine who can do what for whom. While some of these are appropriate, others may become (or already are) redundant with new technologies and better training for health care workers. In recognition of such issues, CoAG (2004a) recently agreed to commission a paper on health workforce issues, including supply and demand pressures over the next 10 years.
- Many areas of the health care system are not subject to an evidence-based approach to assessing the appropriateness of medical procedures and practices. The Cochrane Collaboration (see Cochrane 2005) has shown that many practices and procedures widely accepted in the past are no longer effective.
- A significant share of total health costs arise from preventable diseases such as smoking-related cancer, obesity-related diabetes and cardiovascular disease. This points to opportunities for gains from public health promotion — to lessen the quantum of avoidable health costs.

Finally, it is generally accepted that the design of financing and delivery arrangements give rise to considerable inefficiency and waste in the health system. (The views of one of Australia’s leading health economists are presented in box 11.10.) Fragmentation and lack of coordination is a key contributor. It is manifest in particular between:

- public and private hospital services;

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- health care services provided in hospitals and those provided in the community; and
 - health care and other community services (particularly aged care).

Box 11.10 Richard Scotton on health system inefficiency

The intrinsic difficulties in finding efficiencies in the health system are compounded in Australia:

- (a) by the almost unique division of responsibility for health service funding between Federal and State governments;
- (b) by the multiplicity of separate programs; of which Medicare is only one, through which public sector health services are funded; and
- (c) the lack of articulation and of comparability of incentive systems between public and private sector funders and providers.

The consequences are:

- distortions of consumer choices and provider allocation decision making;
- impediments to efficient substitution between higher and lower cost modalities of care funded under different programs; and
- the generation of opportunities for cost shifting between different payers, which are availed of on a wide scale, at considerable direct and indirect cost.

Source: Scotton (2002), as reproduced in PC (2002c).

Apart from the direct efficiency costs, divided responsibilities for service provision across different levels of government create considerable incentive for cost, risk (and blame) shifting.

A number of recently announced initiatives are likely to lessen problems in some of these areas, notably through provision of additional funding (Howard 2004b). However, underlying tensions and structural problems in the health care system as a whole remain.

A national approach to reform is needed

As elaborated on in box 11.11, there are a number of possible strategies for addressing the deep seated problems that are preventing Australia's health care system from performing to its full potential.

- One approach would involve 'incremental', but nevertheless significant, changes made within the context of the existing roles and responsibilities of the various jurisdictions and of current funding arrangements.

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- Another approach would augment such initiatives with major changes to roles, responsibilities and funding arrangements for health care in Australia.

Box 11.11 Alternative directions for health care reform

Without endorsing any particular approach in the context of this inquiry, the Commission notes that health care reform could proceed in a number of different ways:

- ‘Incremental’, but nonetheless significant, changes could be made in both the public and private sectors, while maintaining the existing roles and responsibilities of the various levels of government and in the context of current funding arrangements.
 - Examples could include: reducing the scope for cost shifting, improving service integration, addressing existing or expected shortages in the health care workforce, addressing shortcomings in private health insurance arrangements, and facilitating choice by providing improved information to patients.
- Major changes could be made to roles, responsibilities and funding arrangements. Possible options include:
 - The States assuming responsibility for a greater range of health services, for example, after-hours GP clinics.
 - The Australian Government assuming direct funding and/or delivery responsibility for public hospital services.
 - Allowing, or obliging, those people who can afford adequate private health insurance to opt out of the public system.
 - Introducing a health savings based system — as proposed by Richard Harper (sub. DR142) — with universal coverage and safety net features but with greater incentives for users and providers to contain costs and enhanced competition between public and private hospitals.
 - Introducing ‘managed competition’ whereby ‘budget holders’ (or competing third party payers) would purchase health care services from competing providers on behalf of client populations. There are various possibilities in this regard:
 - : Richard Scotton has proposed a scheme involving three main elements: the amalgamation of existing health programs; the specification of clear and separate roles for governments; and the integration of private sector funding and service provision into a national program (PC 2002c, p. xiv).
 - : A somewhat different, but related approach, would involve pooling of federal and state funds, with responsibility for service provision devolved to regional health agencies that would purchase the full range of health services (covering acute, primary and community care, dental care, mental care, pharmaceuticals and aged care) for their residents (Allen Consulting 2004, pp. xiv-xv).

The likely advantages and disadvantages of such approaches, and of variants to them, have been canvassed in a variety of studies and reports over the last 10 years or so. As well, the practical experience with such reforms in the health systems of other countries may offer useful lessons for Australia (box 11.12).

Box 11.12 Health care reform abroad

Australia is not alone in facing problems and emerging challenges in the financing and delivery of health care services. And, as in Australia, many other OECD countries, are seeking ways to improve the performance of their health systems. The reform experiences of other OECD countries, many of which have broadly similar policy objectives to those of Australia, can potentially provide some useful insights for Australia.

As part of its contribution to this inquiry, the NCC commissioned the Allen Consulting Group to prepare a paper on *Microeconomic Reform in Australia: Comparison to Other OECD Countries* (NCC 2004e). Health was one of the sectors examined in the paper. Some observations from the paper include:

- Despite the diversity in funding and service provision arrangements, OECD countries are struggling to control expenditure growth and improve the performance of their health care systems.
- There have been a variety of reform initiatives, including a trend towards the greater use of market mechanisms and incentives to organise the financing, purchasing and provision of health care services.
- In this context, experience with competition-related reform emphasises the importance, amongst other things, of strengthening the position of purchasers and improving the information available to consumers and budget holders to make informed choices.
- A recent review of the role of competition in health care markets concluded:
The enduring lesson from the US, British and New Zealand experiences is the importance of *strong purchasing*. What drives good value, integrated care, high quality, and efficiency are purchasers who get their act together and pursue their agenda over several years' time (Light 2000, p. 973).
- In general, market type measures have a much stronger role — and potential to improve social welfare — in the delivery than in the financing of health care.
- There is increasing recognition that good access to primary care can help to control overall costs through health care promotion, illness prevention and better disease management, and thereby help to avoid or reduce the extent of more expensive hospital care.

Source: Derived from NCC (2004e).

Even so, effective health care reform in Australia would require further study of the possible efficiency effects (both short and long term) of the various approaches and their impacts on the effectiveness (including quality) of service delivery, as well as their implications for equity and access to services, especially for lower income or other disadvantaged groups. The services included in any assessment of opportunities for reform need to be all embracing, covering primary health care,

hospital services, mental health services and dental care. Attention to coordination between hospital and aged care services will also be required.

Moreover, a precondition for significant reform is the willingness of governments collectively to address the service interface and funding issues that currently plague Australian health care arrangements. In the Commission's view, what is required is a nationally coordinated approach to health reform under which the Australian and State and Territory Governments tackle the issues within a broad and cooperative framework.

Not surprisingly, given joint responsibility for service provision, there is already some discussion and coordination between governments on health care issues through the existing Ministerial Councils and, on occasion, through CoAG. But, with some exceptions (for example, the recent decision to seek a review of health workforce issues), this appears to have focused largely on 'crisis management', rather than on exploring options for more fundamental and enduring change. Further, although the proposed study of workforce issues will be of considerable value, it would be desirable for the outcomes of that study to be considered within a wider context of reform to the system as a whole.

Similar considerations led the Industry Commission in its 1997 report on *Private Health Insurance* (IC 1997a, p. 384) to observe:

Private health insurance is a cog in a machine. One can burnish the gears of that cog, but ultimately its performance and functioning depends on the rest of the machine. There are grounds, therefore, for looking at other aspects of the health system.

Against this backdrop, in the Discussion Draft, the Commission argued that an integrated health care reform framework and program under the auspices of CoAG would bring much needed impetus to the pursuit of better health outcomes, in the same way that its sponsorship has been a precondition for the success of NCP. It went on to suggest that a first step towards developing such a reform framework and program, would be the establishment of an independent public review of Australia's health system as a whole and options for securing better outcomes, with particular emphasis on:

- key determinants of future demand for and supply of health services;
- health financing issues (including Federal/State responsibilities and their implications);
- coordination of care (including with aged care);
- the interface between private and publicly provided services; and
- information management in health care (such as transferable patient records and use of information in quality assurance).

It also noted that the proposed examination of workforce planning issues — including some specific matters raised in this inquiry in relation to provision of antenatal care to pregnant women, hospital admitting rights for midwives in private practice and the introduction of nurse practitioner roles across the health sector — could possibly be incorporated within this broader review.

Of those jurisdictions which commented specifically on the issue of national coordination of reform in health and other human services prior to the release of the Discussion Draft, only the Tasmanian Government argued against it:

The Tasmanian Government considers that the most efficient and appropriate method of delivery of core government activities, such as education and health services, should be determined by each relevant government. (sub. 109, p. 10)

Also, in response to the Discussion Draft, there was some concern expressed about yet another review, especially in the light of recent State-based reviews and the Australian Government's Health Reform Task Force study (see below). However, the proposed review attracted considerable support from a number of state/territory governments, industry groups, social welfare organisations and others responding to the Discussion Draft. As part of this endorsement, several participants commented on particular matters that such a review should consider (box 11.13).

Given broad support for the review and the urgency of seeking to improve the performance of the health system, the Commission sees no reason to alter the broad thrust of its proposal in the Discussion Draft. Recommendations from the review — akin in a broad sense to the review by the Hilmer Committee that preceded the NCP — could be used to develop an agreed coordinated reform framework and a program and timetable for implementation. This could then be pursued and monitored with regular reporting on progress under the auspices of CoAG (or another national leadership body), though the monitoring task would preferably be delegated to a separate body (see chapter 12), in the same way that the NCP is monitored by the NCC.

The Commission emphasises that the proposed review should not seek to 're-invent the wheel'. It should draw on recent reviews of the health sector in different States and Territories, as well as on the work of the Health Reform Task Force established by the Prime Minister in October last year which is examining how to improve the delivery of health services, including the interface between Federal and State and Territory responsibilities. It is due to report in March.

Box 11.13 Participants views on issues for a health system review

A number of participants offered specific suggestions in relation to the proposed review.

Stephen King suggested that any examination of the health system should consider:

... the interaction between government funding, health insurance and service provision. In particular, any review needs to carefully separate out the roles of the government as a provider of health insurance from any other role through direct provision of health services. (sub. DR158, p. 2)

Commenting on links with other areas of human services, Aged and Community Services Australia argued that:

... it is essential that the links and potential links between health care and aged care, including community care, are kept central to the thinking around health system reform and not dealt with separately as 'interfaces'. (sub. DR178, p. 1)

In relation to information management in health care, Nicholas Marosszky suggested that the coverage of relevant issues include:

... the publication and auditing of aggregated patient data, the measurement of consumer satisfaction and experience, the evaluation of clinical outcomes and the national benchmarking of health services. (sub. DR179, p. 2)

The Victorian Health Promotion Foundation maintained that it is essential that any review should examine the balance in resourcing between treatment and prevention observing that:

... the current health care system limits its focus to treating illnesses and diseases and is not in tune with the additional benefits to both the health and wellbeing and to the bottom line of the economy that are achievable with a stronger health promotion focus. (sub. DR200, p. 1)

RECOMMENDATION 11.1

The Australian and State and Territory Governments should initiate an independent public review of Australia's health care system as the first step in the development of an integrated reform program. The review should include consideration of: the key future determinants of demand for and supply of health services; health financing issues (including Federal/State responsibilities and their implications); coordination of health care services (including with informal and formal aged care services); the interface between private and publicly provided services; information management; and the appropriate balance of resourcing between prevention and treatment.

Aged care services

As outlined in the Commission's recent draft report on the *Economic Implications of an Ageing Australia*, ageing of the population will put considerable pressure on

Australia's aged care system in coming years (PC 2004b). Hence, as in health care, achieving improvements in the efficiency, effectiveness and equity of aged care service delivery will be very important. In particular, sufficient residential places, together with adequate resourcing of informal or community-based care alternatives, must be available to provide an ageing population with an appropriate range and quality of care services.

As noted, future funding arrangements for residential aged care services have recently been subject to review by Professor Warren Hogan (box 11.7). The Australian Government has adopted most of the review's shorter term recommendations and has indicated that it will consult with the community about the proposals for change in the medium to longer term.

The Commission broadly endorses the directions for change outlined by the Hogan review, which could potentially yield significant improvements in the cost effectiveness of service provision, enhance access for disadvantaged clients to high quality care and help to maintain the financial sustainability of aged care services in the face of strongly growing demand.

The short term priority will be to monitor the impacts of the recent changes made in response to the Hogan review and to seriously explore the opportunities for implementing the other options proposed (see box 11.7). Such options, particularly those calling for greater user contributions and related changes to tax and asset arrangements governing the sale of the family home, will undoubtedly be controversial and of concern to some community groups. Aged care is a complex area and one where access, equity and quality issues loom large. However, without greater emphasis on charging those able to pay for residential care, especially for their ongoing accommodation needs, the community may simply be unable to afford the range and quality of aged care services needed in the future. While it will be important to avoid creating a two-tier system based on ability to pay, failing to ensure the sector has access to adequate financial resources would effectively bring about a two-tier system by default.

In the Commission's judgement, given current responsibilities for policy development, funding, and oversight of service delivery, monitoring of recent changes and progression of necessary reforms over the medium to longer term should largely be a matter for the Australian Government. Moreover, the Commission envisages that the important issues to do with the interface between the health and aged care sectors would be examined as part of the national review of the health sector recommended above. Reflecting this, a new national coordination initiative for aged care does not appear to be needed at this time, although it is vital that the reform process for this sector continue.

Child care services

Among feedback on the Discussion Draft, it was noted that reforms to enhance the performance of the child care sector also have a role to play in helping Australia to address the ageing challenge and in improving wellbeing more generally. Apart from its other benefits, cost effective and accessible child care services can enhance opportunities for people to participate in both education and the workforce.

Australian Governments have different but complementary roles in supporting child care services. The Australian Government seeks to assist families to participate in the social and economic life of the community primarily by providing direct financial support to parents using approved child care services or registered informal carers. State and Territory governments are responsible for funding and delivery of educational and development activities, such as preschool services.

Though reforms over the last decade have enhanced access to child care services, the expansion in places does not appear to have kept up with demand. For example, according to the ABS (2002a), additional child care services for children under the age of 12 were reported as being required by nearly 6 per cent of households. Apart from lack of places in convenient locations, the cost of services has also been cited as a barrier to their use (SCRGSP 2005).

The Australian Government has foreshadowed the provision of extra assistance to families to improve access and choice in relation to child care services. This extra assistance includes a new 30 per cent rebate to families for out-of-pocket child care costs, improved access to the child care benefit for grandparents caring for their grandchildren, and an increase in Part B of the Family Tax Benefit.

Such initiatives may help to ameliorate the current imbalance between supply and demand and access problems stemming from the cost of child care services. Nonetheless, further initiatives will almost certainly be required in this important area of social expenditure.

However, in the Commission's view, a new nationally coordinated initiative does not appear to be a prerequisite for effective reform, at least at this stage. Unlike health care, no large scale coordination problems or failures in the children's services area have been drawn to the Commission's attention during the inquiry. The bulk of all government spending on children's services (75 per cent) is provided by the Australian Government and its funding complements rather than competes with that provided by State and Territory Governments. Hence, the Commission has not included child care on its proposed agenda for nationally coordinated reform. That said, monitoring and assessing existing arrangements in

the light of the identified need to raise workforce participation rates will be important.

Education and training

Australia must have an education system of high quality if it is to meet the aspirations of the community and prosper in an increasingly competitive global environment. In a world where success is increasingly reliant on innovation, a highly trained and flexible workforce is vital. For example, work by Dowrick (2002) suggests that an increase of 0.8 years in the average level of schooling of the labour force would increase the economy's annual growth rate by a quarter of a percentage point — arising from an increase in human capital and more rapid adoption of new technologies.

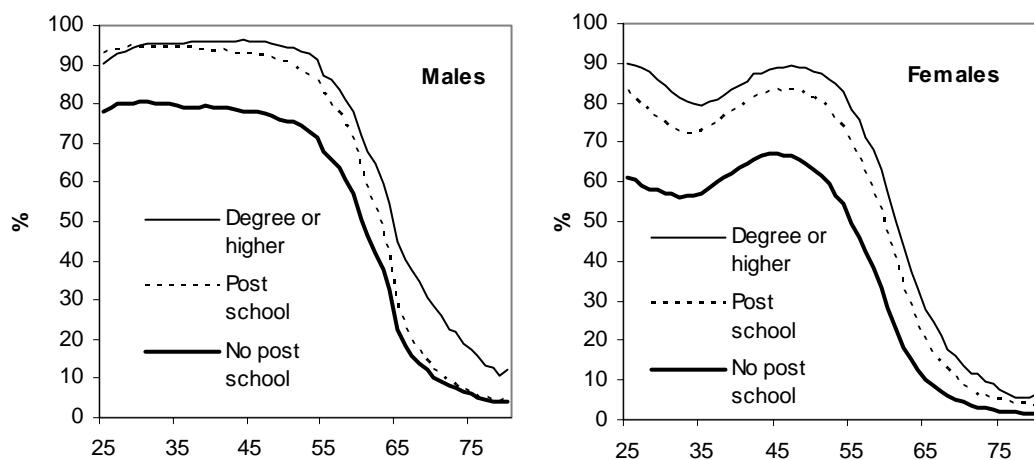
In addition, as some participants noted, there is a strong link between educational attainment and workforce participation. As evident from figure 11.2, better educated people generally have higher participation rates in the labour force. This in turn means that further increases in educational attainment in Australia would help to mitigate the labour supply impacts of population ageing.

Outcomes are generally good, but there is room for improvement

Against a number of national and international benchmarks the Australian education system compares quite well. For example:

- Based on a comparison of average test scores achieved across countries, the literacy, maths and science skills of Australia's 15 year olds are significantly above the OECD average (OECD 2003d). And though there are no international comparisons to draw on, across Australia, 94 per cent of Year 5 students at least achieve the minimum national benchmark for writing skills, with the corresponding figures for numeracy and literacy both being 90 per cent. (SCRGSP 2004a).
- Similarly, the proportion of Australians aged 25 to 34 with completed tertiary training — 34 per cent in 2001 — exceeded the OECD average of 27 per cent (OECD 2003d).

Figure 11.2 Labour force participation by age and highest educational attainment
2001



Source: PC (2005a).

But, again, there is scope to do better. For example:

- The OECD study referred to above, also shows that Australia has a wider dispersion of literacy skills than most other OECD countries. Research for the Australian Council for Education Research suggests that students not reaching basic proficiency levels are likely to experience difficulties in their lives beyond school (Lokan, Greenwood and Cresswell 2001).
- There is considerable variation among jurisdictions in key indicators of educational outcomes (see table 11.1).
- The average writing, literacy and numeracy skills of Indigenous students are well below the average for other student groups (SCRGSP 2004b).
- Australia's secondary school completion rates are lower than the OECD average. Among 30 OECD countries assessed on this measure in 2001, Australia ranked 21st with just over 70 per cent of the population aged 25 to 34 having completed an upper secondary education (OECD 2003d).

Australia's comparatively low secondary education completion rates are of particular concern. The latter years of secondary schooling can make a significant difference in preparing young people for participation in the workforce.

Reforms have been progressing in many areas, though problems remain

In recent years, considerable effort has gone into improving the efficiency and effectiveness of the Australian education system.

In the tertiary sector, enrolments for graduate and post graduate courses have expanded significantly, from around 659 000 in 1997 to 897 000 in 2002 (AVCC 2003). During 1997, a policy of User Choice was introduced to VET intended to provide better and more responsive training services and to promote competitive neutrality between providers (though, as discussed below, its implementation has been patchy). And, in November 2003, Australian, State and Territory Ministers responsible for VET agreed to a new national strategy for 2004-10, which aims to be broader and more clearly focused on client needs than its predecessor (ANTA 2004).

Within the public education system, recent reforms (in at least some jurisdictions) have included streamlining education bureaucracies; making curricula more flexible and responsive to changing needs; devolving more responsibility for management to individual institutions; providing additional funding for numeracy and literacy programs; encouraging parent participation; and enhancing the scope for parents and students to compare outcomes across institutions. Similar changes have been occurring within the private school sector. And increasing attention is being given to the importance of pre-school learning.

Nonetheless, such reforms have not addressed important impediments to better performance in the education system as a whole. In the tertiary sector, for instance, there are continuing issues relating to funding (including discrepancies in funding arrangements for universities and VET institutions (see below)); competitive neutrality problems where universities provide ancillary business services in competition with private providers (see chapter 10); and inefficiencies in workforce arrangements and practices.

In regard to school education, as highlighted in contributions to the *Economic and Social Outlook Conference 2003* (see Dawkins and Steketee 2004) and the *Making Schools Better Summit Conference* (MIAESR and The Australian 2004), there are continuing problems and challenges in a number of areas, including:

- teacher shortages, especially in areas such as physics, chemistry and mathematics and of male primary school teachers;
- insufficient incentives to retain and reward highly experienced teachers, notwithstanding a demonstrated strong link between learning outcomes and the quality of teaching;

-
- costs and other inefficiencies arising from variations across jurisdictions in entry ages to schools and in curriculum design;
 - evidence of dissatisfaction with the public school system, with a recent survey indicating that about one-third of parents whose children attend government schools would prefer to enrol their children in non-government schools (quoted in Caldwell 2004); and
 - concerns about the ‘residualisation’ of the government school system arising, in part, from variations in total resourcing between government and non-government schools.

Though clearly important to Australia’s future welfare, most of these issues have attracted little, if any, comment from participants during this inquiry. However, several participants expressed concerns about the efficiency and effectiveness of the current VET system and the lack of reform progress.

VET reform needs greater impetus

Expenditure in Australia on VET is currently of the order of \$9 billion a year — nearly 50 per cent of it by government, a little over 40 per cent by employers, with the balance provided by individuals. Training is delivered in several ways, including through: schools and TAFEs; private for-profit providers; and public and private employers. The system is national and delivers nationally recognised qualifications. Industry plays a key role in specifying the skill and knowledge outcomes that are assembled into formally recognised ‘training packages’ (see box 11.14).

The importance of the VET sector in ensuring Australia has suitably skilled workers is widely recognised. To promote the responsiveness of the sector to the changing needs of employers and employees, a number of formal and informal mechanisms provide feedback to governments and training providers about those needs. As well, there has been some effort to drive improvement through the adoption of competition-related measures. For example, the disbursement of a portion of VET funding to government providers and private registered training organisations on a competitive basis was introduced in the early 1990s (HRSCEET 1998). Subsequently, in 1997, a formal policy of ‘User Choice’ was introduced for the sector, in the context of the New Apprenticeships arrangements. Specifically, this policy provides for the direction of public funds to individual training providers based on the client’s choice of provider. It aims to enhance the capacity of, and incentive for, individual VET providers to respond to the expressed needs of clients and to deliver competitive neutrality between public and private providers.

Box 11.14 A brief overview of VET arrangements in Australia

Vocational education and training can be defined as 'education and training for work'.

- **Providers of learning and assessment services** are registered by the system and regularly audited for service quality. There are over 4000 registered providers including TAFE institutes, private training and assessment organisations, firms, universities, schools and adult education providers. Registered providers may operate anywhere in Australia and issue nationally recognised qualifications.
- **System clients** comprise the employer and employee. They may agree to authorise a 'broker' to act on their behalf for a range of training programs.
- **Training packages** specify the competencies that training must deliver, requirements for assessment, and the qualifications that result. Accredited courses are used where training packages are not available.
- **Industry** assists in developing recognised training packages. It also provides input through ANTA, although alternative arrangements will apply from July of this year when, as part of the new national VET strategy, ANTA is abolished and its responsibilities taken into the Australian Government Department of Education, Science and Training.
- **Governments** are currently brought together through ANTA which reports to an industry based board and advises the ANTA Ministerial Council on a range of issues including: VET policy, strategy, priorities, and goals; and state and territory VET plans. It also administers national programs and Australian Government funding of the national VET system. With ANTA's abolition later this year, new coordination arrangements will be implemented through a new Ministerial Council on Vocational Education. Its role will be to ensure continued harmonisation of a national system of standards, assessment and accreditation, with goals agreed in a Commonwealth State Funding Agreement.

Source: ANTA (2002; 2004).

However, participants contended that state and territory governments have inadequately implemented these arrangements (see box 11.15). Some went on to query whether, in its current form, the VET system is capable of providing enough people with the skills required by business to operate successfully in the future. A skilled vacancy index compiled by the Federal Department of Employment and Workplace Relations (DEWR, 2005) points to a growing number of vacancies throughout 2004, followed by a modest decline in early 2005.

The Commission notes that the level of vacancies in February 2005, while high, is similar to that recorded in the mid 1990s and still well below that recorded in 2000, notwithstanding the generally lower levels of unemployment today. This illustrates the reality that periodic skill shortages characterise many labour markets.

Box 11.15 User choice in vocational education and training

A User Choice policy in relation to New Apprenticeship training was agreed to by relevant State and Territory Ministers in May 1997. Under this policy, public funding support is to be provided to whichever registered training organisation is chosen by the employer and employee, whether that provider is in the public or private sector. Through promoting competition, choice and flexibility, the policy is intended to deliver better training outcomes.

However, major employer bodies such as the Australian Chamber of Commerce and Industry (ACCI) and Australian Business Limited (ABL) said that industry is becoming increasingly concerned that such arrangements have yet to be properly implemented. ACCI, for instance, commented that:

It is evident that none of the nine principles [underlying user choice] have been fully implemented across the country [and] processes have been established which severely limit the opportunities for employers and restricts the desired outcomes. Processes are also different in each State and Territory. ... Indeed, user choice has suffered a 'freeze' in some jurisdictions, where State/Territory agencies, concerned about the impact of user choice on existing public providers, have attempted to turn back the tide of reform. (sub. 110, pp. 32-33)

Similarly, ABL expressed concern that the:

... management of the User Choice Policy implementation has been via mechanisms to reduce access such as quotas for certain qualifications and activity limits for those training providers eligible to deliver training, rather than through a change management process that clarifies and quantifies demand and the outcome of this demand on raising the skill levels in the Australian economy. (sub. 104, p. 5)

And the Australian Council for Private Education and Training argued that the implementation of User Choice has been inconsistent across the country and now appears to have stalled. It also said that funding has been reduced and, in some states, markets have been closed to new providers (sub. DR187, p. 6).

More specifically, Business South Australia (sub. 15, p. 5) argued that the provision of training for government employees should be put to tender to provide an opportunity for private providers to compete for the delivery of these services. The South Australian Government subsequently indicated that as of 2003-04, the delivery of training to public sector employees is open to all registered training organisations who have signed a current User Choice Funding Agreement with the government. (sub. DR224, p. 20)

That said, there may well be further changes that could be made to streamline the institutional framework, training packages and feedback mechanisms which would help to ensure that such shortages are addressed expeditiously. As in other areas, funding levels are also relevant to outcomes achieved, as recognised in a number of new funding initiatives recently foreshadowed by the Australian Government. These initiatives are, in part, also designed to address a misperception that VET is a 'second best' alternative to a university education (Howard 2004b).

Beyond these considerations, as identified in previous reviews, there are mismatches in the interface between the VET and university sectors (see, for example, West 1998). In particular, differences in user charging arrangements may distort student choices, as well as influence the response of institutions to student and employer needs. For example, unlike undergraduates enrolled in higher education institutions, students attending TAFE are unable to defer payment of tuition charges. On the other hand, the significantly lower student charges in the TAFE system may encourage some students to gain credit towards a degree at TAFE, rather than directly enter a university.

And, finally, there currently appears to be a lack of willingness by some jurisdictions and VET institutions, to implement agreed policies such as User Choice (see box 11.15). It would seem, therefore, that the process of VET reform needs reinvigoration.

Enhanced national coordination would promote aspects of education and training reform

In the Discussion Draft, the Commission emphasised that further reform is clearly required in the education and training sector. However, it judged that the need for ‘high level’ coordination of a new national reform program appeared less pressing than in the health care sector. Central to this assessment were the following considerations.

- The institutional framework seems generally less complicated in the education sector than in health, with less potential for interface problems between different parts of the system and for cost and blame shifting between different levels of government.
- Given the major recent and foreshadowed changes in the university sector, including the introduction of competition-related reform (Australian Government 2003), there would be merit in monitoring and evaluating the outcomes from these changes before pursuing further reform.
- Securing further performance improvement in primary and secondary education, focusing in particular on the quality of teaching and teacher shortages in some key areas, is seemingly more amenable to action on a jurisdictional basis — particularly as State and Territory governments are responsible for delivery and funding of the bulk of education to school aged children, as well as regulating service delivery.

Moreover, while acknowledging the lack of progress in VET reform, the Commission noted that many of the policies required to move forward in the VET area are already in place or recently announced, including those directed at

enhancing competition within the sector. Thus, it judged that much of the broad framework that would allow for emerging skill shortages to be addressed appeared to be in place.

The thrust of these conclusions was broadly endorsed by some respondents to the Discussion Draft. For example, the Queensland Government maintained that education and training matters should not form part of any new nationally coordinated reform program at this stage. And, in relation to VET, the Minerals Council of Australia expressed support for the Commission's preliminary findings that:

... much of the broad framework for addressing skill shortages is in place and that VET reform should not be brought within the purview of CoAG at this stage. (sub. DR227, p. 6)

However, industry groups such as the BCA, CCIWA and ACCI, as well as some educational providers in the VET sector, saw the need to place much greater emphasis on nationally coordinated reform in the training area in particular. Their views and arguments have encouraged the Commission to revisit some of its earlier judgements.

In particular, submissions from these groups have reinforced the fact that the implementation by the States and Territories of agreed reforms to VET have been progressing very slowly. Indeed, increasing concerns about the capacity of the existing funding and delivery regime to address emerging skill shortages has led the Australian Government to announce new funding for extended training arrangements (Howard 2004b). Without a more concerted and coordinated approach, there is a risk that existing reform initiatives could unravel threatening the capacity of Australia's training system to adequately meet Australia's skill needs in the future. The Commission is therefore now of the view that collective action by Australian Governments is necessary to re-energise and integrate the various reform initiatives within the VET area.

Changes foreshadowed in a Directions Paper recently released by the Australian Government outlining proposals for new national training arrangements from 1 July 2005, may effectively address many of the identified weaknesses in progressing VET reform. Consultations are currently being undertaken with industry, training providers and other government departments on the proposals. It is intended that these consultations will help to shape the development of new training arrangements which are intended to:

... ensure the needs of young people, mature-aged Australians and disadvantaged client groups, are met. It will engage more Australians in training than ever before, and will focus on providing the highly skilled workforce that our industry needs to compete in a global economy. (Hardgrave 2005, p. 2).

Hence, the need for any further changes to coordination frameworks and processes will need to be assessed having regard to the success of the foreshadowed arrangements and other recent institutional and policy developments.

In the case of school education, the present inquiry has not attracted any submissions advocating a new set of nationally coordinated initiatives to address performance weaknesses or shortfalls. That said, there do appear to be some areas — such as curriculum development and teacher training — where a more coordinated approach could be helpful in progressing reform.

However, the Commission observes that there have been some recent initiatives designed to improve outcomes at the national level. For example, the Australian Government has recently indicated that the States and Territories will have to satisfy a number of new performance conditions to receive Commonwealth funding over the 2005-08 period. These conditions include requirements for the States and Territories to: publish a range of performance information at the school level, to assist parents to make informed choices and governments to assess their comparative performance; and to achieve performance targets for reading, writing, spelling and numeracy for years 5 and 7 (DEST 2004). The Commission also notes the recent commissioning of a national inquiry into literacy teaching which is due to report in the second half of 2005 (Nelson 2004). Existing mechanisms such as the Ministerial Council on Employment, Education, Training and Youth Affairs and its associated working bodies and joint funding arrangements between the Commonwealth and States are yet other vehicles already available for initiating coordinated reform approaches where necessary.

RECOMMENDATION 11.2

In taking collective action to re-energise the process of VET reform, Australian Governments should examine whether recent changes to institutional arrangements are sufficient to provide for effective national coordination, or whether further changes to frameworks and processes are required.

Natural resource management

As noted above, effective natural resource management directed at promoting sustainable resource use is integral to the living standards and quality of life of both the current and future generations. And many resource management and environmental issues have implications extending beyond individual jurisdictions.

A degree of coordination and cooperation in pursuit of better outcomes is already occurring. Apart from the NCP reforms noted in chapter 8, examples include:

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- the Intergovernmental Agreement on the Environment, signed more than a decade ago;
 - Ministerial Councils on natural resource management and environmental protection and heritage issues;
 - the CoAG High Level Group on Greenhouse;
 - the National Water Initiative and the Intergovernmental Agreement on Energy (see chapter 8); and
 - the White Paper released in June 2004, *Securing Australia's Energy Future* (PMC 2004), which seeks to integrate environmental and energy policy objectives.

Better national coordination would improve natural resource management

However, as the Discussion Draft pointed out, it is widely considered that the extent and quality of coordination in key aspects of natural resource management leaves much to be desired (see box 11.16). Particular areas or issues of concern raised by participants included:

**Box 11.16 Coordination problems in natural resource management:
some views from participants**

It is clear that Australia faces many environmental threats and many of these threats are worsening. The current approach to dealing with environmental issues is not working effectively. To date this approach has been ad hoc and the success of the different initiatives is variable. Decision making is inefficient and slow, implementation is often ineffective and ongoing monitoring and accountability is inadequate. There is very little information on how effective programs, such as the National Heritage Trust, have been in delivering their environmental objectives. (Australian Conservation Foundation, sub. 54, p. 23)

One of the biggest sovereign risk issues facing the energy sector is future Government policy and measures on greenhouse gases ... The current range of existing and proposed State government greenhouse gas policy initiatives constrain a national approach and the consequent operation of an efficient national market in energy supply. (ESAA, sub. 94, pp. 10-11)

Environmental objectives related to climate change have been pursued via a fragmented array of jurisdiction-based greenhouse gas abatement schemes which are not part of NCP. Arguably, if environmental objectives were an explicit part of NCP, a least-cost, nationally consistent approach to greenhouse gas abatement might have been adopted. (Origin Energy, sub. 89, p. 3)

- forestry, where the Australian Conservation Foundation and others claimed that State and Territory log pricing regimes, and the underlying methodologies for valuing forests, favour the harvesting of native forests over plantations;

-
- fisheries, where it was suggested that State Government licensing policies are leading to over-exploitation of the resource;
 - the lack of holistic land use planning, particularly along the eastern seaboard, where ninety per cent of Australians live;
 - the absence of a uniform approach on waste disposal issues; and
 - the emergence of differing jurisdictional approaches to greenhouse gas abatement (see chapter 8).

Accordingly, in their initial submissions to the inquiry, several participants contended that changes to broad institutional and policy frameworks are required — some suggesting that a process akin to the current NCP arrangements (already used for water) would be valuable. The ACF, for example, argued:

The broad-scale environmental challenges facing Australia, land and water degradation, climate change, and biodiversity loss, are very complex and interrelated. A successful reform framework needs to be highly integrated and co-ordinated across governments, over time, and across environmental issues ... Without a truly national approach we are unlikely to successfully manage the enormous broad-scale environmental challenges facing Australia. (sub. 54, pp. 23-24)

The Federal Department of the Environment and Heritage similarly considered that the scope of NCP could be broadened to ‘consider a whole suite of areas in relation to environmental protection that affect the efficiency and effectiveness of policy outcomes’:

Fertile areas for inclusion into NCP are land use planning, new urban developments, transport planning and allocation of rights to access natural resources such as forests and fisheries. These areas primarily fall within State and Territory areas of responsibility but can involve resource allocation decisions that have national impacts and implications. (sub. 97, pp. 1-2)

And the NCC argued that:

Environmental and sustainability matters could benefit from being addressed explicitly with a focus that emphasises national coordination whilst acknowledging regional variations. Having jurisdictions adopting separate approaches to national externality problems would not appear to represent sensible public policy. It may be feasible to bring these matters together into a national resource management reform package. (sub. 71, p. 33)

In its Discussion Draft, the Commission noted that CoAG is already a significant player in the natural resource management area and that its role is to be extended. Specifically, CoAG’s current role covers the NWI and related policy arrangements and the High Level Group on Greenhouse. Beyond this, the Australian Government has indicated that implementation of the recommendations of the recent

Commission inquiry into the *Impacts of Native Vegetation and Biodiversity Regulations* (PC 2004d) will be pursued through CoAG (Costello et al. 2004).

However, the Commission went on to observe that the seriousness of some other national environmental issues, the need for coordinated policy responses and the desirability of promoting best practice principles and outcomes, means that a greater role for CoAG in the area of natural resource management would seem warranted. More specifically, and in keeping with the experience of NCP, it suggested that CoAG sponsorship could be particularly valuable in giving momentum to reform; improving the management of conflicts across and within governments; promoting best practice regulatory regimes while recognising the need for flexible and regionally responsive provisions in some cases; and in making governments more accountable for progress.

At the same time, the Commission recognised that, in an area as diverse and broad ranging as natural resource management, CoAG cannot do everything. Accordingly, it proposed that CoAG should initiate a review to determine in which areas of natural resource management, beyond its current and foreshadowed areas of responsibility, nationally coordinated reform is most urgent and what such coordination effort should entail.

That said, the Commission argued that CoAG should, as a matter of urgency, play a greater role in relation to greenhouse gas abatement policies. Whilst acknowledging that there are currently mechanisms to coordinate policy in this area, it observed that divergent approaches by governments to dealing with greenhouse gas emissions, as well as uncertainty about future policy directions, are impeding necessary investment in many parts of the economy. As discussed in section 8.2, such problems appear to be particularly acute in the energy sector.

In submissions following release of the Discussion Draft, a number of State Governments and several industry groups supported the proposed review, and the need to give immediate priority to handling greenhouse gas abatement policies more effectively. In this latter regard, some State Governments commented that the involvement of the Australian Government in current State level initiatives to develop a national emissions trading scheme would be particularly beneficial. For example, the South Australian Government noted that:

State and Territory Governments, through an Inter-jurisdictional Emissions Trading Working Group, are currently working together independent of the Commonwealth to identify issues and options for establishing an Emissions Trading Scheme that will provide both national coverage and a consistent approach to greenhouse gas abatement across jurisdictions. It would be highly beneficial for the Commonwealth to become involved in this work, with CoAG providing a coordinating role. (sub. DR224, p. 16)

Moreover, the Cabinet Office of New South Wales observed that:

A national emissions trading scheme administered by the Commonwealth would also enable Australia to participate in emerging international trading markets for greenhouse gas reductions. (sub. DR185, p. 5)

Such support has served to reinforce the Commission's view that natural resource management should be a part of any future nationally coordinated reform agenda. While the precise range of areas requiring nationally coordinated reform frameworks is something that needs to be further considered, it is clear that steps to improve coordination in relation to greenhouse gas abatement policies should be taken now.

RECOMMENDATION 11.3

The Australian Government, in consultation with State and Territory Governments, should as a matter of urgency develop a more effective process for achieving a national approach to greenhouse gas abatement. Australian Governments should also initiate a review to identify other areas of natural resource management where the pay-offs from new or improved nationally coordinated reform could be high and what is required to reap those gains.

11.5 Labour markets and tax policy reform

As noted at the start of the chapter, participants advocated reforms in a range of areas beyond those covered thus far. However, in the Commission's view, it is unclear that new inter-jurisdictional action would necessarily be helpful in progressing these reforms. This is especially the case as there are limits on the range of matters that can be addressed via such arrangements at any one time.

Nevertheless, the Commission emphasises the importance of exploring the scope for further reform, including competition-related reform, in two particular areas: labour markets and tax policy. These are both intrinsically very important to Australia's future prosperity. Moreover, as the BCA recognised, the success of reforms in a wide range of other sectors and activities will partly depend on securing improvements in these areas:

The ability of NCP to achieve efficiency gains is inextricably linked to other economic reforms in areas such as taxation, corporate governance and labour markets. For example, without a flexible labour market, the ability of NCP to encourage the efficient allocation of resources throughout the economy is severely reduced. (sub. 84, p. 8)

Labour market reform

Employment, wages and working conditions directly affect the standard of living and quality of life of individuals and their families. Thus, while it is important that labour market arrangements foster the efficient use of labour and promote participation in the workforce, they also need to recognise that labour is a distinctive ‘input’ to production, and that wider social objectives and relationships are involved — including the relationships between work, leisure and family, and providing safe workplaces.

Much reform has occurred

Historically, arrangements for setting wages and conditions and work arrangements were largely centrally determined and provided very limited scope for adaptation to changing market conditions and requirements. In this sense, they were the product of an inward looking culture and policy focus that sought to insulate the economy and players in it from the rest of the world. But, with the opening up of the economy and associated competitive pressures in product and capital markets, came recognition that more flexible and responsive labour market arrangements were also required.

The process began in the late 1980s with award restructuring and the introduction of workplace agreements, before extending to a much greater focus on enterprise bargaining during the 1990s (see box 11.17). There have also been significant changes to: industrial dispute resolution processes and sanctions; regulations governing the dismissal of employees; occupational health and safety provisions; parental and other leave arrangements; as well as the introduction of obligations on employers to contribute to the superannuation entitlements of employees. And there has been complementary reform in areas such as workplace training (see section 11.4).

In the broad, this reform process and changes that have occurred in the workplace are widely acknowledged to have provided significant benefits to many employees, as well as being an important contributor to Australia’s strong productivity performance in recent years. For instance, the ACCI commented that:

Australia’s very significant workplace relations reform to date has, along with major taxation, competition and regulatory reform and prudent economic management ensured that the Australian economy and labour market has weathered various economic challenges. Reforms throughout the past decade have directly delivered Australia’s very impressive employment, interest rate and wider economic performance. (sub. 110, p. 30)

Box 11.17 The shift to enterprise-based bargaining

From the late 1980s, there have been significant changes in the regulations and processes underpinning industrial relations arrangements in Australia. One of the key changes was the shift to more decentralised bargaining structures to determine wages and conditions in Australian workplaces. Previously, the employment conditions of most employees were largely determined by prescriptive industry or sector-based awards. This promoted a high level of uniformity in wage and condition outcomes across enterprises irrespective of the particular circumstances facing individual firms.

But over the last decade or so, collective and individual agreements have replaced awards as the prime mechanism for determining wages and conditions for a significant part of the workforce.

- The proportion of employees whose wages were set by collective enterprise agreements or individual agreements (both formal and informal as opposed to awards) increased from 32 per cent in 1990 to 79 per cent in 2002 (ABS 2002b; DEWR 2002).
- Individual and collective enterprise agreements are most prevalent in highly skilled professions, with over 90 per cent of managers, administrators and professionals working under such agreements.
- But even in areas that traditionally relied heavily on awards, individual and enterprise agreements are now widespread. For example, nearly 60 per cent of clerical, sales and service staff and around two-thirds of labourers are now covered by these types of arrangement (ABS 2002b).

Increased reliance on enterprise arrangements has, in turn, served to focus much greater attention on opportunities to improve productivity within enterprises. For example, a series of Commission studies on workplace arrangements found that inefficient work practices often reflected perverse incentives embedded in industry awards. In the case of stevedoring, for example, these included manipulating work flows to maximise overtime payments (PC 1998b). Similarly, a wide range of restrictive work practices were found to be inhibiting productivity enhancements in black coal mining, meat processing and on large capital city building projects (PC 1998a, 1998c, 1999i).

There are many examples where labour market reform has made a difference to productivity outcomes. For example, as a consequence of the flexibilities which today characterise waterfront enterprise agreements, Australia's ports have largely bridged the productivity gap with their overseas counterparts. This is despite the relatively small trade volumes and throughput at Australian terminals (PC 2003c). Further, a study by Fry et al. (2002) found that firms that have embraced industrial relations reforms have significantly higher self-assessed labour productivity than their competitors.

Similarly, the Chamber of Commerce and Industry (WA) noted that:

The evidence shows that the partial deregulation of Australia's labour market over the past decade has been associated with a dramatic improvement in almost all measures of labour market performance. (sub. 66, p. 50)

This is not to suggest that all aspects of the changes have necessarily been universally beneficial. A case in point is the shift towards casual employment and 'agency' or labour hire employment. Such growth has delivered much needed flexibility in the services sector in particular, and provided jobs to some who otherwise might have missed out. But it has also reduced the proportion of permanent and full time jobs available and consequently reduced employment security and job satisfaction for some people. This illustrates that, as in other areas, trade-offs are often involved when undertaking labour market reform.

The growth in casual and other 'non-traditional' employment is likely to have been influenced by factors affecting the behaviour of firms (such as industrial relations reform and the move towards a more open and competitive economy) as well as by changes in the structure of the economy which have favoured specific industries relative to others. A recent analysis of workplace's demand for labour hire employment suggests that from 1990 to 2002, workplaces increased their use of labour hire workers largely as a response to changes in the industrial relations regime and the competitive environment in which they operate (Laplagne, Glover and Fry 2005).

Efficient labour markets will be even more important in the future

The general case for further labour market reform was advanced in several submissions to the inquiry. For example, the ACCI stated that:

Ongoing reform, and a wider scope and pervasiveness of workplace reform is essential if Australia is to cement and not surrender the gains of economic and competition reform to date. (sub. 110, p. 30)

Similarly, the Chamber of Commerce and Industry (WA) considered that:

The case for more deregulation, ... lies in the expectation that more deregulation will result in more of the benefits already enjoyed as a result of the more flexible labour market. Despite the reforms to date, Australia's labour markets remain highly regulated. (sub. 66, p. 51)

Indeed, in the context of the challenges facing Australia in coming decades, reforms to further improve the efficiency of labour market arrangements arguably assume greater significance than in the past. The ageing of Australia's population will serve to reduce labour force participation rates and thereby 'effective' labour supply — in

per capita terms, hours worked are expected to decline by around 10 per cent over the next forty years. Slow labour supply growth will in turn constrain increases in per capita GDP (PC 2005a). Accordingly, labour market reforms that remove impediments to workforce participation and facilitate a wider range of employment options for older people, or which raise labour productivity more generally, can play an important role in minimising the impact of ageing on future living standards in Australia.

It is apparent that the flexibility of Australia's labour markets continues to be constrained by various restrictions on competition. These include restrictions associated with union coverage arrangements, limits on competition associated with the award system and exemptions for some key labour market arrangements from coverage under the TPA. Specifically, under section 51(2), matters relating to certain employment agreements and arrangements and restrictive provisions in employment contracts are exempt from the anti-competitive conduct provisions of the TPA.

More broadly, as several participants highlighted, issues such as union and workplace rigidities affecting the scope to improve training regimes, the impact of unfair dismissal laws on employment incentives within the small business sector in particular, and the multiplicity and sometimes overlapping rules and regulations in regard to awards and industrial conditions, are all relevant in looking for opportunities for performance improvement.

Workforce participation rates are also influenced by policy settings in other areas including, for example, income support, superannuation, and child care. In this context, the progressive deferral of access to the age pension for females aged less than 65 is expected to slowly raise the participation rate among females aged 60-64. Changes to regulations in the superannuation area, such as the progressive increase in the preservation age for accessing superannuation entitlements, are similarly expected to delay decisions by some mature age workers to exit the workforce. Changes to the cost and availability of child care services can also be expected to affect workplace participation rates, as well as choices between full-time and part-time work.

Does further labour market reform require a nationally coordinated approach?

Given the still significant restrictions on competition in the labour market, competition-related reform clearly has a potential role to play in improving the efficiency and effectiveness of outcomes in this area. Moreover, differences in labour market regulations, both between the States and Territories and between the

Federal and State systems, create complications and impose higher compliance costs on multi-state employers.

Even so, the application of such reform needs to be considered carefully. The human dimension of labour means that some of the forces that shape outcomes in markets for ‘standard’ goods and services do not always operate in the same way in the labour market. And, like human services, labour market outcomes are not just relevant to economic performance — they also have a significant impact on equality of opportunity, the stability of family relationships and social cohesion more generally. Thus, for example, when the NCC reviewed the TPA exemption for certain labour market arrangements under section 51(2), it concluded that the benefits (for the community as a whole) of this restriction on competition outweighed the costs (NCC 1999c).

A number of participants, including the NFF and ACCI, saw merit in extending NCP to cover the labour market so as to provide for a nationally coordinated approach to reform. For example, in advocating a nationally coordinated approach, the ACCI questioned the value of competitive federalism in relation to workplace reform noting that:

Rather than jurisdictions transferring ideas for greater flexibility, productivity, efficiency or deregulation, in Australia most regulatory transfer involves additional regulation and prescription. ...

One of the main reasons why NCP is needed in many policy areas is because jurisdictional competition does not work in these areas . . . (sub. DR198, p. 9)

Others, while also emphasising the importance of further labour market reform, were less certain that national coordination would necessarily represent a step forward. For example, the Chamber of Commerce and Industry (WA) indicated that its:

... priority for ongoing industrial relations reforms is that it should be conducted mainly within the remit of existing jurisdictions — the Commonwealth should review its unfair dismissal and Federal award and agreement provisions, and states similarly should review their own provisions. While the case for nationally coordinated industrial relations regulations has merit, not least in reducing businesses’ compliance costs, it also has risks. The current system allows for diversity and for improvements through the rivalry and demonstration effects that flow from competitive federalism. For all the drawbacks of the inconsistencies of the current system a consistently bad industrial relations framework would be worse. (sub. DR248, p. 8)

Balancing the potential benefits and costs from competition between jurisdictions on the basis of distinctive features of their labour market arrangements is not easy. Moreover, there are also evident differences of view on the extent of the problems and costs arising from having a multi-jurisdictional set of labour market

arrangements and the most effective ways forward, especially at the political level. Hence, it is far from clear that efforts to develop a nationally coordinated approach to reform through a body such as CoAG would be very rewarding.

As the Commission was finalising its report, the Australian Government foreshadowed that it will be considering options to establish a national system to govern workplace relations in Australia by 2010. The package of reforms would be based on the corporations power and, as such, would bring about 85-90 per cent of employees into a national system. In a speech announcing the proposals to the Committee for Economic Development of Australia, the Minister for Employment and Workplace Relations observed:

If a national system of corporate and taxation regulation is desirable and achievable, then there is no reason why a unitary or national system is not just as appropriate to govern how those corporations employ their staff. If we are serious about pursuing a system whose focus is on increasing productivity and reducing complexity, then the issue of a national system must be addressed. (Andrews 2005, pp. 17-18)

At issue in pursuing a national regime is whether it may still be possible to enhance the scope for beneficial jurisdictional competition. For example, consideration could be given to an optional approach like that recently introduced on a more limited scale for workers compensation insurance. Under that arrangement, some multi-State employers are able to opt-in to an alternative national regime. The efficacy of a more broadly-based arrangement of this sort (for employees as well as employers) would, of course, depend on the detail.

Whatever specific approaches to reforms are employed, for the reasons outlined above, taking advantage of opportunities to make Australian labour markets more responsive and flexible is likely to remain important in enhancing future standards of living. Indeed, if Australian labour markets fail to provide the requisite flexibility and responsiveness, reform initiatives in a variety of other areas could be compromised.

It is also very important that the progress already made in this area is not undermined. In particular, any backsliding that reduced flexibility and the capacity to tailor labour market arrangements to the circumstances of particular firms and the needs of an ageing population, would almost certainly lessen workforce productivity and thereby reduce living standards.

Tax reform

‘Non-neutralities’ in the taxation regimes of Australian jurisdictions can have wide ranging and pervasive effects on competition. For example, payroll tax exemptions

for small businesses advantage them in relation to businesses which are not exempt. There are also tax differences between jurisdictions which can have an effect on the locational decisions of firms. While some degree of ‘tax competition’ can be advantageous, it can also have downsides. Thus, the NFF (sub. 100, p. 31) contended that though ‘there is some value in interstate competition with taxes, it would be better for this competition to occur on the tax rates, not tax bases’. Even the current GST arrangements create competitive distortions, for example, through the exemption of certain products.

Perhaps more importantly, as the Queensland Government amongst others noted, the interface between the personal tax regime and social security support can impede workforce participation (sub. 119, p. 3). High effective marginal tax rates produced by the combined effect of withdrawal of government benefits and the progressive rating scale in the income tax system can discourage people on welfare to return to work. Recognition of this problem has led to a number of policy responses, including through the *A New Tax System* and the *Australians Working Together* packages. Even so, the problem has only been lessened rather than substantially addressed.

Like labour market policies, taxation arrangements can also have an important influence on the outcomes of reforms elsewhere, including those encompassed by the NCP. In this context, the Australian Council for Infrastructure Development commented:

It might be asked why tax is an important issue in a review of NCP. The answer is simple. Taxation, in part, determines both the cash flow and equity returns to investors in infrastructure. If infrastructure investment is inadequate then the competitive conditions in downstream markets are impeded, especially if access rights to limited capacity rest in the hands of incumbents. Competition in the provision of infrastructure and breaking the effective monopoly of government supply are vital. If the administration of tax law is at cross purposes to other areas of government policy the result is increased uncertainty in the minds of investors as to the overall stance of government policy ... (sub. 76, p. 3)

For all of these reasons, taxation arrangements and their interface with other social and economic policies need to be firmly placed on the reform agenda.

In a study commissioned by the Productivity Commission for its *Stocktake of Progress in Microeconomic Reform* (PC 1996), Albon (1996, p. 1) nominated five aspects of Australia’s taxation regime as having major perceived problems:

- Inconsistencies in, and non-indexation of, the income tax base;
- Excessive reliance on income tax with its bias against saving;
- Inconsistencies in the tax treatment of different types of investment;

-
- A bias against exports; and
 - Excessive reliance on state taxes with high marginal deadweight losses.

Subsequent reform initiatives, including the *A New Tax System* reform package, have lessened the extent of the problems in some of these areas — namely the second and fourth of those listed by Albon.

Given the division of responsibility between Australian governments in this area, the bulk of the outstanding tax reform agenda (including the interface between the tax and social security system), can seemingly be addressed by the Australian Government or other individual jurisdictions. To the extent that cross jurisdictional issues arise — such as, for example, in relation to reducing reliance on State taxes with high efficiency costs — they could be handled through the Ministerial Council on Commonwealth and State Financial Relations. Indeed, this Ministerial Council is currently reviewing the need for the retention of a number of State/Territory stamp duties as part of the Commonwealth-State financial reform component in the *A New Tax System* package.

A few participants expressed disappointment with the lack of progress in reforming state taxes through this Ministerial Council. The BCA also noted that:

... there are still a number of inefficient state taxes, both within and beyond the Inter-Governmental Agreement, which require further attention. (sub. DR234, p. 3)

That said, there was no strong push during the inquiry to pursue tax reform through a new nationally coordinated reform initiative.

Accordingly, the Commission does not see a need to include taxation on the agenda emerging from this inquiry. At the same time, however, it reiterates that existing reform initiatives in this area need to be progressed in an effective fashion and that further reform is clearly needed to improve the efficiency, equity and effectiveness of the tax system.

12 The way ahead

Key points

- NCP has been a landmark achievement in economic reform. However, further reform is needed to improve living standards in the face of challenges such as population ageing.
- While providing for further competition-related actions, the Commission's proposed reform agenda has a much broader remit — namely, to harness national coordination to raise productivity and improve sustainability.
- As a result of NCP, the frameworks and principles that should guide future reform in many of these agenda areas — for example, energy and water — are well established, as are many of the specific changes that are required.
- But in areas on the Commission's proposed agenda that have not, as yet, been the subject of comprehensive, nationally coordinated, reform programs, more work is needed to lay a platform for reform and to identify the most beneficial actions.
 - Based on their importance, the complexity of the coordination task and the extent of coordination failure to date, the highest priorities among the 'new' areas are: health care; freight transport; greenhouse gas abatement; and consumer protection policy.
- Whatever specific institutional frameworks are used to progress the proposed agenda, they should embody and build on key strengths of NCP, including: clear reform objectives, principles and programs; robust public interest provisions; independent and transparent monitoring; and measures to prevent backsliding. There should also be provision for up-front assessment of adjustment and distributional issues.
- Those reform areas that build on NCP should be brought together in a new broadly-based program, involving common governance and monitoring arrangements. Greenhouse gas abatement and consumer protection policy should also be included in this program.
- Reforms in the health care and vocational education and training areas should be pursued through separate nationally coordinated initiatives.
- Financial incentives under a new national reform program should be oriented towards future reform efforts, though scope to impose penalties for backsliding on past reforms would be desirable.
- Effective communication by all governments of why further reform is needed, and appropriate consultation with affected parties, are central to the reform process.

12.1 Why further nationally coordinated reform?

Though not without defects, NCP has been a landmark achievement in nationally coordinated economic reform. It has provided cost savings to many Australian households and businesses. It has helped to expand the range of goods and services available in the Australian market and, in some areas, has enhanced product/service quality. It has also contributed to better environmental outcomes and to some social objectives.

Moreover, though the outcomes for particular groups have varied, with significant costs for some, the benefits of NCP have nonetheless been widely spread across the community. Notably:

- Benefits have flowed to low income as well as high income households.
- While NCP has added to the pressures facing some regional communities, many parts of country Australia are better off as a result of the reforms.

In short, in overall terms, NCP has helped to raise living standards and thereby enhance community wellbeing.

But the benefits to date are only part of the ultimate dividend from NCP. As a number of those in the ‘firing line’ have told the Commission, NCP and other reforms have had a major impact on ways of doing business, especially within government agencies responsible for providing goods and services. The much greater focus on operating efficiently, and on responding innovatively to the needs of consumers, will be the source of additional gains for years to come. In addition, NCP has demonstrated what can be achieved from a cooperative and coordinated approach to reform by Australian governments.

However, while much has been achieved, the need to continue to pursue reform opportunities across the economy has not diminished. Achieving further improvements in standards of living is a goal to which virtually all Australians would aspire. As has been the case over the past two decades, broadly-based reforms which serve to further raise productivity and improve sustainability will provide a platform for achieving those higher living standards.

Moreover, Australia is facing some major global and domestic challenges. In particular, ageing of the population will reduce our growth potential and increase public expenditure needs. Further coordinated policy initiatives, including competition-related measures, can play an important role in dealing with these challenges and thereby in reinforcing the more general role of reform in enhancing living standards. Indeed, in areas like health and aged care — where the demand for

services will grow rapidly in coming years — the imperative to get best value from each dollar spent is self evident.

That said, much of the core competition reform agenda has been completed, or will be so once unfinished NCP business is concluded. Even in those sectors of the economy which have been the focus of NCP, competition-related reform will increasingly be just one component of a suite of changes required to improve performance outcomes. And, though there has been considerable competition-related reform in areas such as human services that are largely outside the purview of NCP, future reform requirements will be similarly multi-faceted.

Accordingly, in considering future reform priorities, the Commission has not focussed on competition reform per se. Rather it has sought to identify areas where:

- reform is likely to bring significant benefits for Australia as a whole;
- competition-related measures could usefully be a part of the package required to deliver those benefits; *and*
- as for NCP, there is likely to be a high return from using a nationally coordinated reform framework overseen by CoAG or another national leadership body.

In effect, rather than focussing solely on competition, the proposed agenda identified by the Commission in the previous chapters is more appropriately viewed as one which harnesses national coordination and cooperation to help build a more productive and sustainable Australia. As noted in chapter 7, sustainability requires that policy settings are consistent with, and help to promote, the economic, social and environmental needs of both current and future generations, including through ensuring that:

- future generations of taxpayers do not face unmanageable or unfair burdens (so called fiscal sustainability);
- access and equity goals are met and adverse transitional and distributional costs from policy reforms are addressed through appropriate support mechanisms; and
- the capacity of future generations to meet key ecological and biodiversity needs is not compromised.

The remainder of this chapter brings together the various components of the proposed agenda and, in those new areas that lie beyond the purview of NCP, indicates some particular priorities for CoAG attention. It also looks at the pros and cons of different institutional frameworks for implementing the proposed agenda, and highlights some core procedural requirements that should apply whatever particular frameworks are employed. Finally, it examines some considerations for Australian governments in determining the role that ‘competition payments’ or

other financial incentives for the States and Territories should play in a future nationally coordinated reform program.

12.2 What agenda emerges?

A summary of the proposed agenda emerging from the previous chapters of this report is presented in table 12.1. As is clear from the table, the opportunities identified by the Commission for nationally coordinated reform that would enhance productivity and sustainability span most parts of the economy.

There is considerable continuity with NCP

A substantial part of the proposed agenda seeks to continue and extend NCP. Hence, the Commission has identified a range of opportunities for further nationally coordinated reform to enhance performance in the provision of infrastructure services and activities encompassed by the legislation review program. Some of these have already been encapsulated in new coordinated reform initiatives — for example, the National Water Initiative and the Ministerial Council on Energy package to further develop the national energy market.

As well, the Commission has identified opportunities to promote efficient competition across the economy through further improvements to Australia's competition frameworks and regulatory architecture. In this context, it also considers that competitive neutrality requirements and a modified legislation review program focussing on periodic reassessment of significant remaining anti-competitive regulation, should continue beyond the life of NCP. So too should independent monitoring of, and reporting on, progress in implementing the various reforms and the outcomes achieved (see section 12.4), and gate-keeping arrangements for vetting new or amended regulations restricting competition.

But nationally coordinated reform needs to extend more widely

The Commission's proposed agenda also includes three areas that, for the most part, have been outside the purview of NCP — health care, vocational education and training and natural resource management. In each of these areas, there is widespread recognition that:

Table 12.1 A summary of the Commission's proposed reform agenda

Enhancing performance in the infrastructure sectors

Energy	Complete outstanding elements of the NCP and implement the MCE package to further the development of the national energy market. Other reform priorities include: exploring opportunities to increase competition in electricity generation through further disaggregation and divestiture of publicly-owned generation businesses; examining the adequacy of the regulatory regime governing common ownership between generators and transmission entities; and reinstating an independent process to monitor the implementation and outcomes of the energy reform program. A more effective process for reducing regulatory fragmentation in relation to greenhouse gas abatement and the removal of regulatory constraints on retail prices once effective competition has been established (see later), are further key requirements for future performance improvement in the sector.
Water	Complete outstanding elements of the NCP and recommit to the National Water Initiative. Other reform priorities include: examining ways to reduce inappropriate water use, including through more effective management of environmental externalities; developing the property right and trading arrangements necessary to enable the transfer of water between irrigation and urban uses; and ensuring that independent monitoring arrangements provide a discipline on all governments to progress agreed reforms.
Freight transport	Initiate a national review into the requirements for an efficient and sustainable integrated freight system, including the development of strategies to: achieve competitive neutrality across all transport modes; address barriers to efficiency and competition in individual modes; and enhance interfaces between modes. The review should also examine what institutional arrangements would give best effect to the next phase of freight transport reform.
Passenger transport	Initiate an independent national review of the impacts of recent reforms in the sector and what is now required to deliver further performance improvement in both urban and regional areas.
Telecommunications and broadcasting	Undertake a comprehensive review of the regulatory regime that would apply to a privatised Telstra, including assessment of: whether further operational separation of Telstra's wholesale and retail arms would yield net benefits; the merits of an access regime for telecommunications content; and whether the current regulatory regime is adequate to address any future acquisitions or entry into new activities by Telstra, that could threaten the development of a more competitive telecommunications market. Unless the reviews currently in progress provide a good case to the contrary, simultaneously remove restrictions on the number of free-to-air broadcasters, multi-channelling by them, and datacasting. Any future relaxation of cross-media ownership rules to have regard to these and other pre-conditions set out in the Commission's previous review of broadcasting.

Table 12.1 continued

More focussed legislation review

The Legislation Review Program	Complete remaining items on the current legislation review schedule. Retain a more targeted mechanism, focussing on areas where reform of anti-competitive legislation is likely to be of significant benefit to the community, with modifications to: provide greater flexibility in the timing of second round reviews; increase the transparency and independence of review processes; give explicit recognition to distributional and transitional issues in the public interest test; provide for national reviews where legislation in individual jurisdictions has a significant impact on the scope to develop national markets; give more emphasis to monitoring whether review outcomes are within the range of those 'that could reasonably have been reached'; and provide for the monitoring body to be involved in priority setting and timetabling within the more targeted program.
Gate-keeping for new regulation that could have anti-competitive effects	Ensure that each jurisdiction has effective independent monitoring arrangements in place. Consider widening the range of regulations covered by these arrangements and strengthen independent monitoring of gate-keeping measures in place in each jurisdiction.
Priority legislation reviews	Undertake the scheduled reviews of anti-dumping regulation and the future of the 'single desk' for export wheat as soon as possible (with cabotage to be addressed within the proposed freight transport review). Conduct a national review of <i>all</i> restrictions on competition in the pharmacy sector no later than 2008; and investigate whether a further review of legislative restrictions on competition in the delivery of compulsory third party and workers compensation insurance is required to support the development of national reform frameworks.

Improving other aspects of competition frameworks and the regulatory architecture

Application of the TPA to government businesses	Consider the need for legislative changes to ensure that all government procurement activities are covered by the Act.
Consumer protection policy	Initiate a national review of consumer protection policy and administration.
Assistance-related impediments to efficient competition	Extend the recently signed State and Territory agreement aimed at preventing cross-border bidding wars to include all governments, and strengthen provisions to encourage compliance.
Competitive Neutrality	Continue with current arrangements beyond the life of NCP.
Oversight of regulated service providers	Improve price setting and access arrangements for regulated infrastructure providers, giving particular emphasis to enhancing incentives for investment to maintain and augment service capacity. Remove regulatory constraints on prices for retail infrastructure services once effective market competition has been established. Address any significant distributional and access concerns through directly funded support measures, which are monitored regularly to ensure their effectiveness.

Table 12.1 continued

Extending nationally coordinated reform to new areas

Health care	Initiate an independent public review of Australia's health care system, as the first step in the development of an integrated reform program. The review should include consideration of: the future determinants of demand for and supply of health services; health financing (including Federal/State responsibilities and their implications); coordination of individual services (including with aged care); the interface between public and private services; information management; and the appropriate balance of resourcing between prevention and treatment.
Vocational education and training	Take collective national action to re-energise the process of VET reform and examine whether further framework changes are required in the light of recent institutional and policy developments.
Natural resource management	Develop a more effective process for achieving a national approach to greenhouse gas abatement. Initiate a national review to identify other areas where the pay-offs from new nationally coordinated reform frameworks could be high and what would be required to reap those gains.

- there are significant opportunities for further performance improvements to enhance productivity and sustainability;
- such improvements could play a key role in dealing with the ageing and environmental challenges confronting Australia and/or in facilitating the development of the skills and innovative capacities necessary for a country to prosper in increasingly competitive global markets; and
- in the absence of new nationally coordinated reform frameworks and programs (or substantial improvements in existing coordination arrangements), many of the potential benefits of reform will not be realised.

Even within the broad remit of NCP, the Commission has identified some particular new areas in need of dedicated nationally coordinated reform programs — for example, freight and passenger transport and consumer protection policy. And, though not requiring a nationally coordinated approach, a key message emerging from the NCP legislation review process is that further policy initiatives to promote competition in communications and broadcasting should be a key part of any future reform agenda for infrastructure services.

More work is required to develop detailed reforms

As is apparent from table 12.1, the Commission has not spelt out detailed sector-specific reform options. In many of the areas that feature on the proposed agenda, much information collection and analysis will be required before specific options can be developed. Furthermore, in areas like passenger transport, health care,

consumer protection and greenhouse gas abatement, the development of reform options will need to have regard to the distinctive and diverse characteristics of the services and policy objectives involved. This adds to the complexity of the analytical task and will require the development of principles and frameworks tailored to a different set of circumstances than NCP — though many of the lessons from NCP will still be relevant.

Accordingly, beyond broadly endorsing some reform packages that are already in place (including completion of NCP), the Commission has focussed on:

- explaining why reform in areas included on the agenda is likely to be of significant benefit to the community;
- outlining why the use of nationally coordinated reform frameworks and programs could maximise those benefits; and
- highlighting some of the more important issues that will need to be addressed in future reform programs for the policy areas and activities concerned.

As such, this inquiry and the overarching policy reviews that the Commission has proposed in a range of key areas, should be seen as the first steps in the development of a future program of nationally coordinated economic reform directed at building a more productive and sustainable Australia.

The prospective benefits are very substantial

Given this focus, the Commission has not sought to explicitly quantify the potential gains from implementing its proposed reform agenda. Those gains will depend heavily on the specific nature of the reform options that are developed. Hence, quantification would be more feasible further down the track — recognising that putting dollar values on such things as improved access to higher quality human services, more efficient and effective consumer protection, or better environmental outcomes, will inevitably be problematic.

Nonetheless, given the economic, social and/or environmental significance of most of the areas encompassed by the Commission's proposed agenda, and the evident scope for performance improvement, the potential productivity and sustainability pay-offs are likely to be large:

- Modelling of the impacts of NCP for this and previous inquiries highlights the very substantial benefits that can flow from a broadly-based reform program:
 - In 1995, the Industry Commission estimated that implementing the NCP reforms could yield 'outer envelope' GDP gains of up to 5.5 per cent (IC 1995).

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- Analysis undertaken for this inquiry (see chapter 3) indicates that recent productivity improvements and price changes in key infrastructure sectors — to which NCP reforms have directly contributed — have generated a permanent increase of 2.5 per cent in Australia's GDP (around \$20 billion).
 - Related analytical work by the Commission (Parham 2004) indicates that NCP and other economic reforms were key drivers of the marked improvement in Australia's productivity performance in the second half of the 1990s. Implementation of the broad-ranging agenda proposed above could therefore play an important role in enabling the high levels of productivity growth that will be required to improve living standards in the face of population ageing and other challenges.
 - In most of Australia's key infrastructure sectors, there remain sizeable prospective gains that further competition-related and other reforms could help to unlock. For example, Commission estimates suggest that the flow-on benefits to other parts of the economy from a 10 per cent improvement in (multi-factor) productivity in the transport sector alone, could see GDP rise by 1.5 per cent or around \$12 billion annually. And, achieving a more efficient mix of freight services would reduce pollution and other negative externalities arising from the transport of goods within Australia.
 - Health care is a major and growing component of the economy. An efficiency improvement of 10 per cent in service delivery in this sector would provide cost savings equivalent to around 1 per cent of GDP at the present time and, given likely expenditure trends, as much as 2 per cent by 2050. This dividend could be drawn on to help improve service quality and to provide better access to the health care system, including for Indigenous Australians and those living in remote and regional areas.
 - As well as promoting a range of environmental objectives, further improving the efficiency of water use and reducing policy fragmentation and uncertainty in relation to greenhouse gas abatement could increase productivity in a range of agricultural and infrastructure industries.

Other microeconomic reform remains very important

While the proposed reform agenda outlined in table 12.1 is wide ranging, the Commission emphasises that such reforms are only part of what is required to position Australia to continue to improve living standards in the face of population ageing and other economic and social pressures. As alluded to in previous chapters, there are many other areas where reform could boost productivity and enhance sustainability, but where the Commission's judgement is that new (or additional) nationally coordinated initiatives are not a pre-condition to reap most of the

potential gains, or where attempting to pursue coordinated reform through a body such as CoAG could prove counterproductive. For example:

- Australia must have a high calibre school and university education system to imbue the knowledge and skills necessary to meet community aspirations and the demands of the highly competitive global economy.
- Continuing efforts to improve the flexibility of labour markets and to address constraints on labour supply will be particularly important — not only to enhance productivity, but also to increase participation rates and facilitate reform in other areas.
- So too will initiatives to address remaining inefficiencies in the taxation system, and to ensure that the interface between the personal tax regime and social support programs does not create ‘poverty traps’ that impede workforce participation.
- Agreed and mooted reforms to improve value for money in the provision of aged care services will, like health care reform, assist the community to service the needs of an ageing population. And, apart from promoting broad social goals, initiatives to enhance the delivery of child care could help parents to remain in the workforce while raising their families and thereby boost labour market participation rates.

Other important reform areas not included on the Commission’s proposed agenda include: urban and land use planning (though some aspects would need consideration within the recommended reform programs for freight and passenger transport); regional policy; and support for technological innovation. In addition, notwithstanding the dismantling of most of Australia’s tariff barriers, there are still some residual trade policy and industry assistance reform opportunities. Box 12.1 provides a summary of these and some other priority reform areas.

12.3 Some priorities within the agenda

Though not a comprehensive microeconomic reform program, the proposed agenda for nationally coordinated policy change mapped out in table 12.1 is clearly a challenging and complex one, which would be very resource-intensive to action all at once. Accordingly, several respondents to the Discussion Draft suggested that the Commission endeavour to prioritise its proposed agenda.

Box 12.1 Some other reform priorities

Australia's future reform initiatives need to range more widely than the proposed program outlined in table 12.1, which focuses on areas where there would be a high pay-off from nationally coordinated approaches. Other important areas for policy attention include:

- building on recent and current initiatives to improve the quality and responsiveness of primary, secondary and tertiary education and interfaces with the training regime;
- following through on identified measures to enhance the performance of aged care services and monitoring their impacts;
- exploring opportunities to further improve the delivery of child care services;
- extending the scope for workplace flexibility within industrial relations frameworks and addressing constraints on labour supply;
- removing general inefficiencies and perverse work-incentive effects in the taxation system, including by improving its interface with social support programs;
- finishing the job of removing Australia's trade barriers;
- promoting the efficient development of our cities and regions, allowing for their diverse circumstances; and
- ensuring that there are cost-effective mechanisms in place to address market failures in technological innovation, including appropriate intellectual property protection.

Like the items included on the Commission's proposed agenda for nationally coordinated reform, policy initiatives in these areas offer the prospect of significant gains for the community. Indeed, in many cases, they would be complementary. However, the Commission's judgement is that new (or additional) nationally coordinated approaches are unlikely to be necessary, or even effective, in these cases.

As noted, significant parts of the proposed agenda can in fact be categorised as a continuation of, or extension to, NCP which could be accommodated within existing frameworks, and draw on well established reform principles. Indeed, in sectors such as energy, water and broadcasting, and in relation to future legislation review and gate-keeping arrangements, a considerable part of what is required to deliver better outcomes has already been established. Hence, implementing the proposed reforms in such areas would seemingly not involve a major new workload for CoAG (or other bodies with policy leadership responsibilities).

A major additional commitment would, however, be entailed for proposed 'new' agenda items such as health care. In essence, in these areas, the Commission has proposed that CoAG or another national leadership body sequentially initiate a national policy review to identify detailed reform approaches and options; secure

agreement from jurisdictions on a specific reform program; and lead the implementation of the program according to an agreed timetable. Moreover, as noted above, reform in these areas will be complex and will often need to have regard to policy objectives and service characteristics which are different from those that were relevant under NCP.

Given such complexities, CoAG leadership of policy development and implementation in all of the Commission's proposed new reform areas would be intrinsically desirable. However, in view of CoAG's already significant responsibilities in relation to coordinated policy reform, requiring it to immediately action all of the proposed new agenda items would most likely be counterproductive:

- The quality of the review and reform process in individual areas could well be compromised in the face of resource and time constraints.
- There would be a risk that some areas where the need for nationally coordinated reform is most pressing could be pushed to one side.
- There would also be a risk that other, less effective, bodies could be given the task of overseeing the development and implementation of the reform programs.

Accordingly, and in keeping with the suggestion from several key participants, the Commission has sought to identify some particular priorities for CoAG attention.

What are the priority *new* areas for CoAG and why?

Such prioritisation involves considerable judgement. All of the new areas are economically, socially and/or environmentally significant. And in each, there is evident scope for substantial performance improvement through coordinated policy action.

However, based on the complexity of the coordination task and the extent of coordination failure to date, the Commission considers that CoAG should give priority to initiating nationally coordinated review and reform programs for:

- health care;
- freight transport;
- greenhouse gas abatement; and
- consumer protection policy.

Coordination failures in health care are widespread

The case for including health care needs little elaboration. It is already a key sector in terms of both economic and social outcomes, and will become even more important in the future as Australia's population ages and as advances in medical technology expand the range (and cost) of treatment options. And it is also a sector where the complexity and diversity of service provision, and shared responsibility between the Australian and State and Territory Governments for funding and delivering those services, put a premium on effective coordination.

Yet there is general acknowledgement that previous efforts to coordinate delivery between different services and levels of government have been found wanting. This has contributed to sizeable inefficiencies in service delivery, cost and blame shifting and, most importantly, lower quality or less accessible services for the Australian population.

Better national coordination is the key to an efficient freight transport sector

Similarly, the development of an integrated freight transport system has been held back by jurisdictional divergences in policy approaches and an overwhelming focus on modal rather than system-wide performance improvement. This has hampered the seamless movement of freight across State borders and between different modes of transport, as well as resulting in an inefficient mix of freight services and unnecessary externality costs.

Indeed, without considerable cooperation at the national level, the goal of distributing the overall freight transport task according to the intrinsic cost-effectiveness of the different modes will not be achieved. Meeting this goal will require coordinated actions in a range of policy areas and across the different transport modes, some of which are primarily the responsibility of the Australian Government and others the responsibility of the States and Territories. Moreover, one of the key requirements for achieving an efficient freight transport system — the future introduction of mass-distance charging for road use — would have significant implications for the distribution of road-related revenue between the Federal and State and Territory Governments.

Ineffective coordination of greenhouse gas policies could impede investment

The seriousness and intrinsically national nature of some of Australia's major environmental challenges makes natural resource management in the broad an obvious area of focus for CoAG. Though the Commission considers that the appropriate breadth and nature of this involvement requires further assessment,

there are compelling reasons for CoAG to give high priority to achieving much better national coordination of greenhouse gas abatement policies.

Ineffective policy coordination to date has lead to the emergence of divergent approaches in an area where national consistency is critical. Such policy fragmentation and the accompanying uncertainty may in turn impede major new investments needed to improve productivity, and ensure the sustainability of services, in some key infrastructure sectors.

Coordination a key to effective and efficient consumer protection policy

Soundly-based and effective consumer policies are critical to the wellbeing of consumers and to efficient market outcomes more generally. And, given joint Federal and State and Territory responsibilities for administering the very wide range of regulation directed at protecting consumers, effective national policy coordination is also a pre-requisite for achieving good outcomes. However, current coordination mechanisms do not appear to be working well, resulting in regulatory inefficiencies and inconsistencies to the detriment of consumers and businesses.

While of a very different nature to the other three priority areas, the inclusion of consumer protection policy on the Commission's proposed reform agenda in the Discussion Draft produced a groundswell of support from a wide cross section of interests. This has served to reinforce the Commission's view that CoAG should attach high priority to an area which has so far not received the attention befitting its economic and social importance.

Progressing reform in the other new areas

In nominating these four areas, the Commission reiterates that nationally coordinated reform programs for passenger transport, vocational education and training and other new aspects of natural resource management could also deliver sizeable productivity and sustainability benefits. As suggested by the NCC, one option to ensure that such opportunities are not neglected would be for CoAG to commit to picking up these areas at a later date. Alternatively, another national leadership body could be charged with initiating the review and reform programs for these areas, or at least be given initial responsibility as a precursor to later CoAG stewardship. Though not without apparent drawbacks in the past, Ministerial Councils (with strong leadership) are one possibility in this regard.

As well as continuing to provide policy leadership in areas targeted by NCP, CoAG should give particular priority to leading the development and implementation of new national reform programs for:

- *health care;*
- *freight transport;*
- *greenhouse gas abatement policy; and*
- *consumer protection policy.*

12.4 What sort of institutional frameworks are required?

As the discussion of Australia's experience with NCP in chapter 6 demonstrates, the successful implementation of a substantial reform program is heavily reliant on robust institutional frameworks and related procedures and effective leadership from key governing bodies. As the NCC observed:

... while the *reform agenda* is more important than any particular *institution* ..., the *institutional framework* drives the content, and determines the success, of the reform agenda. (sub. DR151, p. 2)

Key features of the 'NCP model' would be generally applicable

In the Discussion Draft, the Commission alluded to a number of broad institutional options for progressing a future nationally coordinated reform program, including broadly-based and stand-alone sectoral models (see below). However, its primary focus was on highlighting some general features of the 'NCP model' that would enhance the effectiveness of any particular institutional framework. Specifically it contended that:

- In areas that have not previously been the focus of a nationally coordinated reform program, there is a need to provide a strong foundation for policy change, through work directed at: building a consensus on why 'no change' is not a viable option; gaining a better appreciation of the 'size of the prize'; and developing specific principles, frameworks and reform options for securing it.
- A reform program — whether implemented in a consolidated or stand-alone fashion — should be supported by:

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- clear objectives and principles to underpin reform programs (including effective public interest tests and provision for up-front assessment of adjustment and distributional issues);
 - a pre-announced timetable for policy changes with transparent and independent assessment of specific reform options;
 - independent monitoring of progress made in implementing changes according to agreed timetables; and
 - mechanisms to lock in the gains of past reforms and prevent backsliding.
- The institutional arrangements and reform program should give jurisdictions some flexibility in how to implement agreed changes, but contain sufficient specification of desired outcomes and priorities to allow for effective monitoring of progress. And, there should be provision, where appropriate, for interim targets and for adjustment to targets as new information emerges or where circumstances change.

The Commission further emphasised that the success of any future nationally coordinated reform program will depend critically on effective leadership from those bodies responsible for overseeing policy development and implementation.

Responses from participants to the Discussion Draft affirmed the importance of these general features in promoting the effective implementation of the Commission's proposed (or a similar) agenda. Indeed, the value of features such as the provision of flexibility to jurisdictions in how best to implement agreed reforms was a prominent theme from State and Territory Governments throughout the inquiry (see box 12.2), and also from the NCC.

Accordingly, the Commission sees no reason to alter the thrust of its proposals in the Discussion Draft on core features that should underpin future nationally coordinated reform frameworks. (Some more specific requirements in relation to the assessment of adjustment and distributional issues, effective communication and consultation and the delineation between monitoring and policy advocacy, are spelt out in later sections.)

RECOMMENDATION 12.2

The institutional framework(s) used to progress future nationally coordinated reforms should be underpinned by:

- ***sponsorship of, and effective leadership by, key coordinating and decision making bodies such as CoAG and Ministerial Councils;***
- ***clearly enunciated objectives and reform principles;***
- ***effective preparatory work detailing the benefits of reform in particular sectors and the specific changes required within jurisdictions to reap those benefits;***

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- *some flexibility for jurisdictions to determine how to implement reforms, but with sufficient specification of desired outcomes and priorities to allow for effective monitoring of reform progress;*
 - *transparent and independent assessment processes, incorporating a comprehensive public interest test and providing scope for consultation with, and input from, interested parties;*
 - *a timetable for the implementation of the review and reform program including, as appropriate, interim targets and provision to refine targets as new information emerges, or if circumstances change;*
 - *independent monitoring and public reporting on progress made in implementing the program; and*
 - *mechanisms to lock-in the gains of past reforms and prevent backsliding including, as appropriate, financial incentive arrangements (see recommendation 12.4).*

A broadly-based program or separate sectoral approaches?

As noted, in the Discussion Draft, the Commission did not express a firm view on whether its proposed agenda should be progressed through a broadly-based successor to NCP or through some other institutional arrangement. Though observing that the diversity of the agenda — and especially the inclusion of human service areas such as health care — suggested that a multi-faceted approach could have important advantages, it argued that these were matters for CoAG to resolve as part of its review of NCP later this year.

However, in their responses to the Discussion Draft, a number of participants (including some State Governments, their Treasuries, various industry and welfare groups and the NCC) requested the Commission to be more specific on the merits of different institutional approaches in the context of its proposed agenda. For example, the Western Australian Department of Treasury and Finance suggested:

It may be useful for the Productivity Commission's Final Report to more fully describe some alternative approaches, identifying their particular advantages and disadvantages in a transparent manner. This work could prove valuable when CoAG reviews the NCP arrangements by September 2005. (sub. DR236, p. 22)

A variety of specific and often overlapping institutional ‘models’ were canvassed by respondents to the Discussion Draft. Indeed, the possible permutations are almost endless. That said, in broad terms, a key choice is seemingly between institutional arrangements which:

Box 12.2 State Government views on institutional frameworks

In commenting on the institutional framework for implementing a future nationally coordinated reform agenda, the Queensland Government emphasised the need to avoid 'template' approaches and to give jurisdictions flexibility:

To preserve flexibility and an individual government's autonomy, any new microeconomic reform program should continue to be based on intergovernmental agreements, not 'black letter' law ...

The existing NCP arrangements do not always recognise the rightful role of individual governments in setting and implementing policy. ... The appropriate governance arrangements, including the role of CoAG, Ministerial Councils, the NCC or new entities will need to be negotiated as part of any new reform agenda package. (sub. 119, p. 8)

More specifically, in relation to the possible inclusion of human services in a future competition reform program, the Tasmanian Government contended:

... that the most efficient and appropriate method of delivery of core government activities, such as education and health services, should be determined by each relevant government.

The Tasmanian Government would also have concerns if a 'one size fits all' approach were adopted and a formal set of obligations were set out. A preferred approach is to allow each jurisdiction to determine the extent to which market-based mechanisms should be applied. (sub. 109, p.10)

And, the New South Wales Government argued that even future reforms in the energy and water sectors should remain outside NCP:

... the 'one size fits all' NCP framework is no longer appropriate for the water sector, given the significant developments that have occurred in the sector since the NCP agreements were signed in 1995. The new National Water Initiative articulates broader objectives, such as promoting water recovery to restore the health of the rivers of the Murray Darling Basin.

... The 'one size fits all' approach is similarly considered no longer appropriate to promote and monitor future reforms in energy. ... The work program being completed by the Ministerial Councils goes beyond the NCP Agreements and represents an entirely new stage of energy market reform.

It also observed that competition-related reform separate from NCP — for instance, the Hunter River salinity trading scheme — had not been hampered by being outside that policy framework. That said, it emphasised the important and continuing coordinating role for CoAG in areas such as energy and water:

New South Wales acknowledges that it is desirable in-principle to have consistency across jurisdictions in areas of reform as a way of enforcing process. In the energy and water sectors, however, it is appropriate that future reform be driven by COAG. All governments clearly recognise the absolute necessity for reforms in these sectors to continue on a coordinated basis and the significant benefits to be gained from the reforms. The continuation of reform in energy and water under the leadership of COAG will not risk the chance of 'backsliding' or loss in the momentum for reform. (sub. 99, pp. 20-21)

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- encompass all or many components of the proposed agenda in a broadly-based successor to NCP, with all of the included reform areas subject to broadly common coordination and governance arrangements; or
 - implementing individual reform programs on a stand-alone basis, with separate coordination and governance arrangements for each program.

Each approach has its advantages and disadvantages (see box 12.3). And the balance between them is likely to vary across the different areas included on the proposed reform agenda. Accordingly, as it observed in the Discussion Draft, the Commission sees considerable merit in a combination of the two approaches.

A broadly-based approach would be appropriate for much of the proposed agenda

To a large extent, the proposed reforms and policy reviews in the areas of infrastructure, legislation review and the economy-wide competition ‘architecture’ represent a continuation or extension of NCP. Hence, in the Commission’s view, there would be considerable merit in continuing to employ the broadly-based approach in these areas. Provision for independent monitoring of implementation progress and outcomes across a sweep of reforms would be particularly beneficial.

The Commission considers that there would also be a good case for encompassing the proposed new coordinated reform initiatives for greenhouse gas abatement and consumer protection policy within the same broadly-based program.

- There are important synergies and linkages between greenhouse gas abatement policies and infrastructure reform that might be difficult to capture adequately if the relevant greenhouse gas issues were addressed through a separate stand-alone program.
- Though having important social objectives, consumer protection policy has significant complementarities with competition policy. Indeed, the Commission has suggested that the proposed policy review in this area would provide an opportunity to explore ways to unify competition and consumer protection laws, or to otherwise harness complementarities between them.

That said, the Commission notes that CoAG’s policy role in the natural resource management area is growing. Apart from its extensive responsibilities in the water area, and the strengthening of its current role in the greenhouse area proposed by the Commission, the Government has signalled that CoAG will also be involved in implementing policy changes in relation to biodiversity and native vegetation regulation.

Box 12.3 Broadly-based versus stand-alone: some key considerations

The arguments for a broadly-based program approach are much the same as those that were influential in the development of NCP. In particular, a broadly-based approach can help to:

- promote policy development that consistently applies agreed reform principles, and which takes advantage of synergies between individual reform areas and commonalities in strategies for improvement;
- prevent undue fragmentation (the ‘silo’ problem) and dilution of reform effort. For example, the NCC characterised the ‘whole of program’ approach to coordination and governance under NCP as the ‘glue’ that binds a disparate set of reform agendas. It went on to say that:

While the NCP may have been better specified and/or implemented, without its institutional framework the reform task would have been disjointed, protracted and incremental with little capacity to exert an effective discipline or incentive on the parties to meet their agreed obligations to promote the national interest. (sub. DR151, p. 3);

- facilitate monitoring of reform progress and outcomes by genuinely independent entities. As the Chamber of Commerce and Industry (WA) observed:
Whether or not the National Competition Council is maintained and the Australian Competition and Consumer Commission retains its current functions, some equivalent institutions are necessary to provide an independent and objective critique of the reform agenda. (sub. DR248, p. 5); and
- aid adequate resourcing of the assessment body.

Also, a system of financial incentives, including penalties for non-compliance with agreed reform commitments or for backsliding, would seemingly be easier to administer as part of a broadly-based program.

But the stand-alone approach has some important advantages in certain situations:

- Self contained reform programs for areas with disparate policy objectives and distinctive service characteristics may help to engender support for policy change. Indeed, as discussed in the text, the inclusion of human service areas in the same program as say infrastructure, could frustrate rather than promote necessary reform.
- The monitoring of reform progress and outcomes in some areas may require specialist skills that could be difficult to provide for within a broadly-based program.

Moreover, if too disparate areas are included in a broadly-based program, policy implementation and monitoring could become unwieldy. It is also important to recognise that where a stand-alone approach is most appropriate, it can still accommodate some of the general requirements for an effective institutional framework set out in recommendation 12.2, including independent monitoring of implementation progress and outcomes.

And, as outlined in table 12.1, the Commission is further proposing that there be a review to explore other natural resource management areas where the pay-offs from

new nationally coordinated reform approaches could be high. Were this review to identify a significant number of such areas, then there could be a case for bringing all of CoAG's natural resource management responsibilities together in a single reform program, with common governance and monitoring arrangements.

But a stand-alone approach would be preferable for health care and VET

The nationally coordinated reform programs proposed for health care and VET could also conceivably be included within a broadly-based successor to NCP. In arguing for an all-encompassing approach, the NCC indicated that as the NCP experience has shown, it is possible to accommodate areas where social and other 'non-competition' objectives loom large:

First, ... appropriate use of the NCP's public interest provisions can accommodate non-competition costs and benefits. Second, competition is a 'proxy' for efficiency and the latter is relevant to promoting the public interest (including quality) in the provision of human services. Third, 'pure' competition matters could be one component of a wider reform agenda under a more embracing name (sub. DR151, pp. 6-7)

The National Farmers Federation (NFF) similarly argued the case for an all-encompassing successor to NCP, though it noted that this should be accompanied by some 're-badging' of the program:

... there is a strong case to drop the current concept of a 'National Competition Policy' in favour of a national approach to reform which emphasises the positive and broader nature of future reforms, such as a *National Productivity and Sustainability Strategy*. (sub. DR183, p. 11)

But even with such re-badging, in the Commission's view, it would not be appropriate to incorporate the proposed reform programs for health care and VET (or any other human services) within a direct successor to NCP. As discussed in chapter 11, competition-related and other market-based mechanisms will have a role to play in delivering better outcomes in these areas. However, the broader equity, access and quality objectives involved mean that such policy approaches will not be the mainstays of reform. Hence, 'packaging' an area like health care with economic infrastructure and the like would probably be counterproductive. In particular, it could send the wrong signal about the motivation for policy reform and thereby increase resistance to change amongst service providers, at the political level, and in the wider community.

Also, inclusion of these two areas in what would already be a very broadly-based program could render it unwieldy. Furthermore, considerable (specialist) resources would be needed to effectively monitor reform progress and outcomes in an area like health care. It is far from clear that these needs could be met under the sort of

monitoring and assessment arrangements that have applied under NCP, or that it could be achieved without detracting from monitoring of other important policy areas.

Accordingly, the Commission considers that the proposed nationally coordinated policy initiatives in these two areas should be implemented through separate, stand-alone programs. Again, however, were nationally coordinated reform approaches to extend to other human services areas in the future, commonality of policy objectives and strategies required to secure desired outcomes, may offer scope for beneficial combination within a separate broadly-based human services program, with common governance and monitoring.

It would, of course, be crucial to ensure that the monitoring and assessment mechanisms employed for the stand-alone health care and VET programs were compatible and consistent with those attaching to the successor program to NCP. As the Western Australian Department of Treasury and Finance emphasised (sub. DR236, p. 22), assessment by bodies independent from those developing and implementing policy, and public reporting of reform outcomes, are key requirements in this regard.

RECOMMENDATION 12.3

Those areas of the Commission's proposed agenda that represent a continuation or extension of NCP, should be brought together in a broadly-based successor with 'whole of program' governance arrangements. The proposed national initiatives for greenhouse gas abatement and consumer protection policy should also be included in this broadly-based program.

The proposed national initiatives for health care and vocational education and training should be progressed through stand-alone sectoral reform programs. However, monitoring of, and public reporting on, the reform process and its outcomes in these two areas should be undertaken by a body or bodies independent from those responsible for policy development and implementation.

A future role for payments or financial incentives

As discussed in chapter 6, financial incentives (competition payments) have played a pivotal role in keeping the NCP reforms on track. While not without draw-backs — such as leading on occasions to a focus on the fiscal compensation implications for jurisdictions of reforms, rather than on their wider economic and social benefits — it seems indisputable that in the absence of payments, NCP would have been much more difficult to progress. Indeed, the threat of even quite small reductions in

competition payments for non-compliance with NCP commitments seems to have had a salutary effect on lagging jurisdictions.

In the Discussion Draft, the Commission acknowledged this role, as well as commenting briefly on some other considerations relevant to a decision on whether financial incentives should be part of a future national reform program. But having regard to the emphasis in the terms of reference on potential reform areas as distinct from institutional matters, and initial input from governments that payments' issues were a matter for CoAG to determine as part of its 2005 review, it did not make any firm proposals.

However, in responding to the Discussion Draft, several participants (including some State governments or their Treasuries) had come to the view that the Commission should be more explicit in this area. Some reiterated the argument made in their initial submissions that competition payments have a continuing role to play in returning the fiscal dividend to the States and Territories from their reform efforts (see chapter 6). And the NCC drew attention to statements from the South Australian Premier and the Western Australian Minister for Agriculture claiming that termination of payments would remove incentives to complete outstanding reforms under NCP (sub. DR151, pp. 9-10).

In the Commission's view, financial incentives could help in progressing a new nationally coordinated reform agenda, as they have done in NCP:

- The vertical fiscal imbalance argument for 'returning' revenue dividends from State and Territory NCP reforms would also apply to some of the reforms on the proposed agenda — though the GST would presumably operate to reduce the magnitude of the initial revenue transfers involved.
- Reforms in areas such as health care where funding and delivery responsibilities are shared between the Australian and State and Territory Governments, will almost inevitably require concomitant adjustments in fiscal transfers.
- In some areas, financial incentives could help the States and Territories to ameliorate transitional costs, or any adverse distributional effects from reform, that were not adequately addressed by generally applicable income support and other mechanisms.
- They could also help to leverage reforms which, in the face of opposition from vested interests, might otherwise be put in the 'too hard basket'.

Hence, the Commission considers that any explicit financial incentives should primarily be directed at prospective reforms. That said, to help lock-in the gains from past reforms, scope to impose financial penalties for backsliding would also be desirable. The next step should be for the Australian Government to seek agreement

with the States and Territories on the sort of regime that would best give effect to these requirements.

RECOMMENDATION 12.4

The Australian Government should seek agreement with the States and Territories on the role and design of financial incentives in a future nationally coordinated reform program, having regard to:

- *the revenue impacts of vertical fiscal imbalance on the distribution of the reform dividend;*
- *the potential role of incentives in leveraging reform and in helping to address transitional and distributional costs attaching to the agreed reform program; and*
- *the need to orient incentives towards prospective rather than past reforms, while including, where appropriate, penalty provisions for backsliding.*

Appropriate recognition of distributional and adjustment issues is important

Whatever institutional frameworks are employed to implement a future reform agenda, distributional and adjustment concerns will continue to loom large. For example, as discussed in chapter 6, a common criticism of the NCP is that too little attention has been given to adjustment costs — particularly, the cumulative effects of individual reforms and other pressures on communities — or to distributional impacts.

This criticism was directly challenged by the New South Wales Government which said that:

Rather than ‘compensation’ for NCP-driven reforms per se, the provision of financial assistance has generally recognised the cumulative impact on individuals and communities of major changes affecting the viability of industries, including global commodity prices, droughts and increased awareness of environmental issues. ... NCP reviews have assisted in providing information for both State and Commonwealth governments in considering whether, and what type, of transitional assistance might be required. (sub. 99, p. 17)

But irrespective of the validity of the criticism, if there is a widespread perception that onerous distributional and adjustment costs are being ignored, resistance to reform will increase, with the prospect that some worthwhile initiatives will be put in the ‘too hard basket’.

The Commission's recommendation (9.1) to encapsulate the essence of the 2000 CoAG directive in the wording of the public interest for a modified legislation review mechanism could help to address such concerns. As discussed in chapter 6, that directive requires governments to 'give consideration to explicitly identifying the likely impact of reform measures on specific industry sectors and communities, including expected costs in adjusting to change'.

More broadly, there would be value in embedding the need to consider distributional and adjustment issues in the guiding principles and frameworks underpinning a future nationally coordinated reform program. For example, though a variety of structural adjustment support has been provided under the NCP (see chapter 6), it has not been conditioned by overarching criteria on the characteristics it should embody to facilitate rather than frustrate change, and to avoid wasteful duplication with generally available measures.

Amongst other things, integration within the implementation framework could therefore reduce the risk of:

- the inappropriate provision of adjustment or distributional support;
- poorly configured support; or
- the failure to consider the case for support in smoothing the passage of reforms likely to be of significant benefit to the wider community, but involving sizeable transitional costs or adverse distributional outcomes for particular groups.

In regard to the latter, the Western Australian Government observed:

Transitional arrangements and/or adjustment assistance should be considered where regional impacts are acute. Such sensitivity will go some way to ensuring that reforms in the interests of the whole community still take place despite any negative local/regional impacts. CoAG ... was cognisant of this relationship when it fine-tuned the arrangements for NCP in November 2000. (sub. 117, p. 25)

In a number of recent reports (PC 2001e; 2002e; and 2003e), the Commission has spelt out some criteria that should guide consideration of the need for, and nature of, adjustment and distributional-related support. In essence, these imply that such support should:

- only be provided where reform will impose a clear and sizeable burden on a specific region or group in the community;
- facilitate not hinder desirable change;
- target individuals and communities for whom adjustment pressures or adverse distributional impacts are likely to be most acute, and who are least able to cope without support additional to that provided through the general social security system and labour market or regional programs;

-
- be of limited duration to encourage transition;
 - augment rather than duplicate general safety net arrangements; and
 - include provision for intervention prior to the implementation of reforms where this would facilitate the subsequent adjustment process.

RECOMMENDATION 12.5

The framework(s) used to progress future nationally coordinated reforms should make explicit reference to the need for up-front assessment of distributional and adjustment issues. It should also include criteria relating to circumstances in which support to ease adjustment difficulties or adverse distributional outcomes is likely to be warranted, and the characteristics such support should embody to facilitate rather than frustrate adjustment and avoid duplication with generally applicable income and other support measures.

Effective communication and consultation are critical

In addition to giving greater recognition to transitional issues, building and sustaining support for further reform will require:

- effective communication by all governments of the need for, and benefits of, change; and
- appropriate consultation and engagement with those parties directly affected by reforms.

As alluded to above, the creation of a consensus for reform, or at least widespread recognition of the deficiencies in previous arrangements, was one of the foundations on which NCP was built. But arguably, this has not been followed through as the reform program has unfolded. For instance, the NFF observed that:

There has been poor consultation with communities during reviews, and poor explanation of the outcomes of NCP reviews after they are completed. As a result:

- NCP has been incorrectly blamed for many things. Some examples include bank branch closures, outsourcing and privatisation.
- NCP is used as a political football between jurisdictions — with each jurisdiction blaming the other for making poor decisions or being too rigid.
- Communities have not felt empowered during NCP reviews, even if the effects on these communities were taken into consideration. (sub. 100, p. 13)

In progressing reforms in the human services area in particular, effective consultation and communication of the importance of change will be especially important. For example, concerns that access to services such as health care might

depend increasingly on means rather than needs, and that service quality might be sacrificed in the pursuit of greater efficiency, will have to be addressed. Indeed, the Western Australian Government (sub. 117, p. 21) suggested that a body such as the NCC be charged with ‘correcting misinformation’ about reform in the community, while the NFF (sub. 100, p. 13) argued that the Council should be given the task of monitoring the efforts of governments in communicating the benefits of reform and consulting with affected parties.

Implementing such proposals would raise some practical difficulties. Nevertheless, the Commission reiterates that governments must take a lead role in spelling out why reform is required to build a more productive and sustainable Australia and what specific benefits it will deliver. In this regard, some recent instances of governments publicly implying that they have only undertaken reforms to avoid the imposition of financial penalties have been unhelpful in maintaining support for necessary change within the community. Consumer advocacy groups (see box 12.4) could also play a greater role in communicating the benefits of reform for the end customer.

RECOMMENDATION 12.6

Governments should take a lead role in explaining to the community why further reform is required and what benefits it will bring. They should also ensure that there is effective consultation and engagement with those parties directly affected by reforms.

Should monitoring and assessment bodies be involved in policy advocacy?

While governments have a very important role in promoting the imperative for, and benefits of, further reform, it is much less clear that monitoring bodies should be actively engaged in policy advocacy. As outlined in chapter 6, this has been an issue under NCP, with some suggesting that the NCC has strayed too far into the advocacy arena and thereby compromised its role as an independent assessor of reform progress and outcomes.

Perfect separation of advocacy and monitoring/assessment is, of course, an unrealistic goal. Inevitably, there will be times when the task of assessing progress in reform implementation will see a monitoring body cast in an advocacy light. For example, in assisting the States and Territories with the prioritisation of their legislation reviews under NCP, the NCC could not have avoided becoming an ‘advocate’ for focusing reform efforts on those areas likely to provide the largest benefits for the community. Similarly, an element of advocacy has seemingly been unavoidable when the NCC has sought to draw lessons from its monitoring activities to assist jurisdictions to better implement remaining reform commitments.

Box 12.4 The role of consumer advocacy in advancing reform

In looking at how to progress desirable competition-related and other reforms, some participants suggested that better-resourced consumer advocacy groups could make an important contribution.

The role of consumer advocacy groups is, of course, broader than this. By acting as 'agents' for consumers in complex markets like energy, such groups can help to overcome market inefficiencies that may arise when purchasing decisions are made on the basis of limited information. In this regard, the Queensland Government (sub. 119, p. 10) argued that 'any new competition policy agenda should pay greater attention to the role of consumers in improving competitiveness', while the Consumer Law Centre of Victoria, contended that:

The creation of the Victorian Consumer Utilities Advocacy Centre, which plays a key role in undertaking research on utilities issues and disseminating information gathered in this research as well as undertaking proactive advocacy on behalf of Victorian consumers, is a prime example of how government can foster robust markets by introducing effective consumer advocacy. (sub. 102, p. 4)

But in a reform-specific context, it is the role of consumer advocates in providing a counterbalance to producer groups seeking to maintain anti-competitive arrangements that lead to higher prices, reduced service quality or less market innovation, that is most relevant.

However, whether this particular role justifies public funding for consumer advocacy groups is not clear. For example, in its report on the National Access Regime (PC 2001d), the Commission noted that the availability of such support would raise questions of which groups should receive funding and how much they should receive.

However, if a monitoring/assessment body strays too far into advocacy, confidence in the monitoring regime can be undermined to the detriment of the reform process as a whole. Such concerns are likely to be especially germane where, as under NCP, the monitoring body is involved in making recommendations on penalties for non-compliance with reform commitments.

Accordingly, in any future nationally coordinated reform programs, there would be value in incorporating specific guidelines on the precise roles of monitoring/assessment bodies, including an indication of matters in which those bodies should not become involved. More broadly, clarity in reform objectives, agreed commitments and the means for achieving them are likely to reduce grey areas in institutional responsibilities, and thereby facilitate a cleaner separation between monitoring and policy advocacy.

Robust institutional arrangements are the key to achieving good outcomes

The agenda mapped out by the Commission is a challenging one. Considerable effort and cooperation among governments would be required to bring it to fruition. In a number of areas, much detailed work is needed to determine the most beneficial reform measures. The present wide-ranging review has focussed mainly on explaining the reasons for change and indicating priorities for reform. The next step in such areas is to develop detailed policy prescriptions.

What is clear, however, is that successful implementation of the agenda will depend crucially on effective leadership and robust and transparent processes that: facilitate the analysis required to develop well-founded guiding principles and specific reform options; provide for rigorous independent monitoring of progress in implementing changes and reform outcomes; avoid fragmentation of reform effort; and prevent backsliding. In this regard, much can be drawn from the processes embodied in the NCP, though some new procedural initiatives are required. For example, strengthened mechanisms to lock-in the gains from past reforms and those in the implementation phase will be important.

The rewards from getting it right would, in the Commission's view, be substantial. Successful implementation of the proposed agenda offers the prospect of more cost-effective provision of a wide range of goods and services, improvements in product and service quality, and expanded consumer choice. It would also help to promote important social and environmental goals. Moreover, by building on the role of past reforms in developing a more resilient economy and a more responsive and innovative business culture, there would be ongoing 'dynamic' benefits.

A more productive and sustainable Australia is the goal

In sum, the Commission considers that successful implementation of its proposed agenda for nationally coordinated reform could play a central role in helping to enhance living standards in the face of population ageing and other major challenges ahead. Though the proposed agenda envisages further competition-related reforms, its remit is much broader — namely, to harness national coordination and cooperation to promote economic, social and environmental goals and thereby help build a more productive and sustainable Australia. All jurisdictions need to work together to develop the institutional frameworks and supporting processes that would allow the nation as a whole to reap these dividends.

APPENDIXES

A Inquiry processes and consultation

In preparing its report, the Commission has provided various opportunities for public input.

Following receipt of the terms of reference on 23 April 2004, the Commission placed advertisements in major newspapers inviting public participation in the inquiry. Soon after, it released an Issues Paper (PC 2004g) providing guidance for those intending to make submissions.

The Commission received 135 submissions prior to the release of the Discussion Draft in October 2004 and a further 131 in response to the Draft. Those who made submissions are listed in section A.5. (Submissions with the prefix 'DR' were received after the release of the Discussion Draft).

To further help in developing its report, the Commission undertook a range of consultation.

- Between April and July 2004, the Commission met with 49 organisations, groups and individuals covering a wide range of interests across all jurisdictions.
- The Commission held two roundtable discussions on specific aspects of the inquiry in July 2004. The first, in Wagga Wagga, focused on NCP impacts on rural and regional communities and was attended by representatives from a broad cross-section of agricultural interests, manufacturing firms, infrastructure service providers, welfare associations, local government, health care and education providers. A second roundtable, in Canberra, covered the future reform agenda and related priorities, and was attended by a group encompassing academic, consulting, social welfare and public policy interests.
- A workshop was held in Canberra in July 2004 to make the Commission's preliminary modelling results available for scrutiny and comment. This was attended by academics, consultants and representatives of the Australian, State and Territory governments. A second modelling workshop was held in Canberra in February 2005 to further discuss the distributional component of the modelling. It was attended by academics, consultants and the ABS.
- Public hearings were held in Sydney, Melbourne, Canberra and Perth during November and December 2004 to provide interested parties with an opportunity to comment on the Discussion Draft.

The inquiry also benefited from feedback at a roundtable discussion on competitive neutrality issues organised by the Australian Government Competitive Neutrality Complaints Office. This roundtable, held in Canberra on 15 June 2004, was attended by various State and Territory officials involved in the development and application of Competitive Neutrality policy, as well as by representatives from the National Competition Council.

The meetings with interested parties, those who participated in the roundtables and the modelling workshops, and who provided submissions, are listed below. Government departments listed are ‘Australian Government’ unless otherwise specified.

A.1 Informal discussions with interested parties

Australian Capital Territory

ACT Government – Chief Minister’s; Treasury
Australian Chamber of Commerce and Industry
Australian Industry Group
Australian Medical Association
Department of the Prime Minister and Cabinet
Department of Treasury
Independent Schools Council of Australia
Law Council of Australia
Minerals Council of Australia
National Farmers Federation
Professions Australia

New South Wales

AusCID
Australian Business Limited
Australian Consumers Association
Australian Retailers Association
Independent Pricing and Regulatory Tribunal
Insurance Council of Australia
Law Council’s Trade Practices Committee
New South Wales Government – Cabinet Office; Treasury
Public Interest Advocacy Centre

Victoria

Australian Competition and Consumer Commission
Aged & Community Services Australia
Australian Conservation Foundation
Australian Council of Trade Unions
Brotherhood of St Laurence
Business Council of Australia
Energy Users Association of Australia
National Competition Council
National Transport Commission
Victorian Essential Services Commission
White (David)

Tasmania

Anglicare Tasmania
Council of Small Business Organisations of Australia
Prices Oversight Commission
Tasmanian Government – Treasury; Premier and Cabinet; Primary Industries, Water and Environment

South Australia

Business SA
South Australian Essential Services Commission
South Australian Government – Premier and Cabinet; Treasury and Finance; Trade and Economic Development; Attorney-General's; Primary Industries; Education and Children Services; Further Education, Employment, Science and Training; Administrative and Information Services; Human Services; Environment and Heritage; Water, Land and Biodiversity Conservation; Environment Protection Agency; SA Water; and, Transport and Urban Planning

Western Australia

Chamber of Commerce and Industry
Economic Regulation Authority
Government of Western Australia – Office of Federal Affairs; Treasury and Finance
Pastoralists and Graziers Association of Western Australia
Taxi Council

Northern Territory

Council on the Ageing – National Seniors
Northern Territory Government – Chief Minister's; Treasury; Infrastructure and Planning; Community Services

Queensland

Australian Taxi Industry Association
Brisbane City Council
Queensland Competition Authority
Queensland Government – Premier and Cabinet; Treasury; Natural Resources and Mining

A.2 Attendees at the roundtables

Regional and Rural Roundtable (Wagga Wagga, July 2004)

Australian Dairy Farmers Limited
Casella Wines Pty Limited
Charles Sturt University
Country Women's Association of NSW
Dairy Farmers Cooperative
Geofabrics Australasia
Macquarie Textiles Group
Murrumbidgee Catchment Management Authority
Murrumbidgee Horticultural Council
Murrumbidgee Irrigation Limited
National Farmers Federation
National Rural Health Alliance
New South Wales Farmers Association
NSW Council of Social Services
NSW Irrigators' Council
NSW Rice Marketing Board
Ricegrowers Association of Australia
Riverina Division of General Practice
Riverina Eastern Regional Organisation of Councils
Riverina Institute (TAFE)
Riverina Regional Development Board
Telstra Country Wide
Toll Regional Transport
Wagga Wagga Chamber of Commerce and Industry
Wagga Wagga City Council

Policy Roundtable (Canberra, July 2004)

Argy (Fred) – Visiting Fellow, Australian National University
Butler (Dr Jim) – Centre for Epidemiology and Population Studies, Australian National University
Disney (Professor Julian) – Centre for Social Justice, University of New South Wales
Ergas (Professor Henry) – Charles River Associates (Asia Pacific)
Fitzgerald (Dr Vince) – Allen Consulting Group
Freebairn (Professor John) – Melbourne University
Hamilton (Dr Clive) – Australia Institute
Nahan (Mike) – Institute of Public Affairs
Trebeck (David) – ACIL Tasman

Competitive Neutrality Roundtable (Canberra, June 2004)

Cabinet Office NSW
Department of Finance and Administration
Department of Premier and Cabinet – South Australia
Department of Treasury
Department of Treasury – New South Wales
Department of Treasury and Finance – Victoria
Department of Treasury – Queensland
Department of Treasury – Northern Territory
National Competition Council
Treasury ACT

A.3 Participants at the modelling workshops

Modelling Workshop (Canberra, July 2004)

Australian Competition and Consumer Commission
Bureau of Transport and Regional Economics
Department of Communication, Information Technology and the Arts
Department of Health and Ageing
Department of Industry, Tourism and Resources
Department of the Prime Minister and Cabinet
Department of Treasury
Department of Treasury – New South Wales
Department of Premier and Cabinet – Victoria
Department of Treasury and Finance – Victoria
Department of Treasury – Queensland
Department of Premier and Cabinet – South Australia
Department of Treasury and Finance – Western Australia
Department of Treasury and Finance – Tasmania
Department of Treasury – Northern Territory
Treasury ACT
Cutbush (Greg) – ACIL Tasman
Murphy (Chris) – Econtech
Madden (John) – Centre of Policy Studies, Monash University
Phillips (Ben) – NATSEM
Ryan (Matthew) – ACCESS Economics
Zeitsch (John) – Charles River Associates (formerly Network Economics Consulting Group)

Modelling Workshop (Melbourne, February 2005)

Dixon (Prof. Peter); Meagher (Tony); Madden (John) – Centre of Policy Studies
Thurect (Linc) – NATSEM
Albon (Robert) – Australian Competition and Consumer Commission
Gatenby (Jan) – Australian Bureau of Statistics

A.4 Public hearing participants

Sydney, 30 November 2004

Association of Consulting Engineers Australia
Australian Council for Infrastructure Development
Australian Telecommunications Users Group
Grain Growers Association
Maritime Union of Australia
Network Economics Consulting Group
New South Wales Council of Social Service
Pacific National
Railway Technical Society of Australasia

Melbourne, 7 December 2004

Australian Council for Private Education and Training
Australian Grain Exporters Association
Governing Ethics
Law Council of Australia
Liquor Stores Association of Victoria
Maternity Coalition
Monash Medical Centre
National Competition Council
Victorian Council of Social Service

Canberra, 13 December 2004

Australian Competition and Consumer Commission
Australian Taxi Industry Association
Canberra Cabs
Care Inc Financial Counselling
Competitive Carriers Coalition
National Farmers' Federation
Real Estate Institute of Australia
Shopping Centre Council of Australia

Canberra, 14 December 2004

Australasian Railway Association
Australian Friendly Societies Pharmacies Association
Australian Shipowners Association
Australian Trucking Association
Balanced State Development Working Group
Energy Retailers Association of Australia
Enertrade
Eros Association
Grains Council of Australia
Insurance Council of Australia and Insurance Australia Group

Perth, 20 December 2004

Australasian Osseointegration Society WA
Council for the National Interest
Dilley (Steve)
Milk Industry Liaison Committee
Pastoralists and Graziers Association of WA
Taylor (Geoff)
WA Retailers Association
Western Australian Farmers' Federation

A.5 List of submissions

'DR' indicates submission received after the Discussion Draft was released.

<i>Participant</i>	<i>Submission number</i>
AAPT Limited	48
ACL	20
ACT Government	112
Aged & Community Services Australia	77, DR178
Alcohol and Other Drugs Council of Australia	14, DR176
Association of Consulting Engineers Australia	79, DR193
Association of Professional Engineers, Scientists and Managers Australia	DR243
AusCID	DR244
Australasian Railway Association Inc.	125, DR214
Australian Associated Motor Insurers Limited	127
Australian Business Limited	104
Australian Chamber of Commerce and Industry	110, DR198
Australian Chicken Growers' Council Limited	23
Australian College of Midwives Inc.	67
Australian College of Midwives and Australian Nursing Council	31
Australian Competition and Consumer Commission	111, DR145, DR165, DR261, DR263
Australian Conservation Foundation	54
Australian Council for Infrastructure Development	76
Australian Council for Private Education and Training	DR187
Australian Council of Social Service	106, DR239
Australian Customs Service	DR254
Australian Dental Association	63, DR229
Australian Federation of Travel Agents Limited	DR258
Australian Friendly Societies Pharmacies Inc.	88
Australian Gas Light Company	69, 124, DR231, DR249
Australian Grain Exporters Association	75
Australian Hotels Association (NSW)	DR162
Australian Hotels Association (WA)	40
Australian Industry Group	DR201
Australian Liquor Stores Association Inc.	DR186

<i>Participant</i>	<i>Submission number</i>
Australian Local Government Association	105
Australian Medical Association	DR252
Australian Nursing Federation	103
Australian Pipeline Trust	55
Australian Property Group	DR247
Australian Psychological Society	DR190
Australian Rail Track Corporation Limited	49, DR228
Australian Shipowners Association	DR166
Australian Taxi Industry Association	DR245
Australian Telecommunications Users Group Limited	DR144, DR188
Australian Wind Energy Association	DR212
Balanced State Development Working Group	12, 21, DR164, DR238
Brisbane City Council	22
Brisbane Institute	DR173, DR180
Business Council of Australia	84, DR234
Business SA	15
Cabinet Office NSW	DR185
Caboolture Shire Council	26, DR211
Canberra Taxi Proprietors Association	DR160
Canegrowers	78
Care Inc Financial Counselling Service and the Consumer Law Centre of the ACT	DR163
CBH Group	44
Centre for Credit and Consumer Law	DR202
Centre for Policy & Development Systems	DR153
Centre of Philanthropy & Nonprofit Studies, Queensland University	38
Charles River Associates (Asia Pacific) Pty Ltd (formerly NECG Pty Ltd)	DR250
Chamber of Commerce and Industry of WA	66, DR248
City of Melbourne	DR182
City of Whittlesea	DR203
Coles Myer Limited	107
Combined Pensioners and Superannuants Association of NSW	8, 33
Commerce Queensland	35
Commonwealth Grants Commission	131
Competitive Carriers Coalition Inc.	29, DR152, DR205
Consumer Law Centre Victoria Limited	102, DR209
Coolum Beach Progress & Ratepayers Association Inc.	13, DR177
Council for the National Interest	85, DR235
Council of Small Business Organisations of Australia Limited	53
Council of Social Service of New South Wales	86
Country Women's Association of NSW	16
CPA Australia	10
CS Energy	50
Dental & Oral Health Therapists Association of Queensland Inc.	133
Department for Planning and Infrastructure (WA)	DR256
Department of Finance and Administration	2
Department of Health and Ageing	80, DR216
Department of the Environment and Heritage	97

<i>Participant</i>	<i>Submission number</i>
Department of Transport and Regional Services	116
Durrant (David)	4
East End Mine Action Group	9, 81, DR136, DR175, DR246, DR260, DR264
ENERGEX	60, DR194
Energy Networks Association	45
Energy Retailers Association of Australia	62, DR167
Energy Supply Association of Australia Limited	94, DR206
Energy Users Association of Australia	123
Enertrade	DR168
Engineers Australia	82, DR226
Environment Business Australia	DR255
Eros Association Inc.	90
ExxonMobil Australia Pty Limited	42
Fitzpatrick (Nigel)	DR172, DR215, DR221
FOXTEL	DR217
Free TV Australia	DR207
Governing Ethics	DR196
Grain Growers Association	37
Grains Council of Australia	DR171
Gulf Savannah Development Inc.	34
Harper (Professor Richard), Monash Medical Centre	DR142
Housing Industry Association	DR208
In Tempore Advisory Pty Limited	98, DR150
Independent Competition and Regulatory Commission	DR213
Independent Liquor Stores Association Inc.	118
Independent Paper Group	3, 5, DR137
Independent Schools Council of Australia	24
Institute of Public Affairs Limited	DR161
Insurance Australia Group Limited	87, DR266
Insurance Council of Australia	70, DR251
Kalamia Cane Growers Organisation Limited	93
Katter (Office of the Hon. Bob) (MP)	30
King (Stephen)	DR158
Lachlan Regional Transport Committee Inc.	25
Laird (Dr Philip)	136, DR170
Law Council of Australia	DR237
Lawson (Dr Charles)	114, DR139
Lee (Robert)	DR259
Liquor Stores Association of Victoria Inc.	68, 122, DR154
Local Government Association of Tasmania	36
Local Government Association of the Northern Territory	58
Manning (Rollo)	DR225
Maritime Union of Australia	DR146
Marosszeky (Nicholas)	DR179
Maternity Coalition	56, DR156, DR253
McIntyre (Col)	DR147
Meridian Connections Pty Limited	108, DR265

<i>Participant</i>	<i>Submission number</i>
Milk Industry Liaison Committee	DR169
Minerals Council of Australia	DR227
Municipal Association of Victoria	73
National Association of Retail Grocers of Australia	11
National Competition Council	71, DR151
National Farmers' Federation	100, DR183
National Generators Forum	DR220
National Institute of Economic and Industry Research	DR148
National Rural Health Alliance Inc.	96
National Tertiary Education Industry Union	41
Network Economics Consulting Group (NECG) Pty Ltd (see also Charles River Associates)	134
Northern Territory Government	130
Northern Territory Treasury	DR204
NSW Department of Housing	57
NSW Government	99
NSW Minerals Council	59
O'Brien (Dr Julian), WA Dental Implant Society	DR181
O'Donnell (Carol)	DR138, DR140, DR141, DR143, DR159
Origin Energy	6, DR197
Orthoptic Association of Australia Inc	72
Pacific National	61, 128, DR241
Pastoralists and Graziers Association of WA	74
Pharmacy Guild of Australia	64, DR149
Pitsikas (Terry)	DR184, DR222, DR240
Port Jackson Partners Limited	DR262
PowerWater	19
Professions Australia	65
Property Council	91
Public Interest Advocacy Centre	32, DR191
Queensland Adult Business Association Inc.	43
Queensland Government	119, DR189
Queensland Rail	121
Railway Technical Society of Australasia	7, DR157
Real Estate Institute of Australia	17, DR233
Redland Shire Council	101
Regional Development Council of Western Australia	DR199
Renewable Energy Generators Australia Limited	DR223
Repatriation Commission	95
Richmond Valley Council	6
Rio Tinto	113
Royal Australasian College of Physicians	27
Royal Australian College of General Practitioners	92
Sea Freight Council of Western Australia	DR174
Shopping Centre Council of Australia	47
Social Market Economy Institute of Australia	39
South Australian Farmers' Federation	28, DR218
South Australian Government	DR224

<i>Participant</i>	<i>Submission number</i>
St Vincent de Paul Society	120
Sugar Industry Reform Committee	126
TAFE Directors Australia	DR192
Tasmanian Council of Social Service Inc.	DR219
Tasmanian Government	109
Taylor (Geoffrey)	1
Townsville City Council	46
Victorian Association of Health & Extended Care	DR210
Victorian Council of Social Service	52, DR155
Victorian Government	51
Victorian Health Promotion Foundation	DR200
Walpole (Alison)	DR257
Water Services Association of Australia	18
Wellington Shire Council	DR232
Western Australian Council of Social Service Inc.	DR230
Western Australian Department of Treasury and Finance	DR236
Western Australian Farmers Federation Inc.	83, DR195
Western Australian Government	117
Western Australian Southsea Pearls	132
Western Graingrowers (Division of the Pastoralists and Graziers Association of WA)	DR242
Windsor (Tony) (MP, Member for New England)	129
Woolworths Limited	115

B National Competition Policy — reforms, institutions and achievements

Substantial progress has been made over the past nine years in implementing the National Competition Policy (NCP) reforms, including in the related reform areas of electricity, gas, water and road transport. That said, there has been considerable variability among governments in their approach to, and the timing of, reform. This appendix provides an overview of the various NCP reforms and the institutional framework which underpins them. It also provides a snapshot of key achievements and unfinished business. More detailed information can be found in the National Competition Council's tranche assessments (NCC 1998c, 1999c, 2001, 2002a,b, 2003b,c,d and 2004b,c).

B.1 The NCP reform package

The NCP reforms focus primarily on improving the delivery of economic infrastructure services, extending the reach of competition law and removing unwarranted legislative restrictions on competition. The nature of the reforms and the framework for their implementation is defined by three inter-governmental agreements. For the most part, the agreements involve broad statements of intent rather than prescribing outcomes. As such, they provide a considerable degree of flexibility to jurisdictions in regard to implementation. The agreements are:

- The *Competition Principles Agreement* (CPA), which sets out principles for:
 - structural reform of public monopolies;
 - prices oversight of certain government business enterprises (GBEs);
 - application of competitive neutrality to significant GBEs;
 - reviews of legislation which restrict competition; and
 - a legal avenue for third party access to ‘essential’ infrastructure facilities.

-
- The *Conduct Code Agreement* (CCA), which establishes the basis for extending the competitive conduct rules of the *Trade Practices Act 1974* (TPA) to government businesses and unincorporated enterprises.
 - The *Agreement to Implement the National Competition Policy and Related Reforms* (Implementation Agreement), which specifies a program of competition payments by the Australian Government to State and Territory governments, contingent on satisfactory progress in implementing the agreed reforms.

In addition to the three inter-governmental agreements, the *Competition Policy Reform Act 1995* established two institutions — the Australian Competition and Consumer Commission (ACCC) and the National Competition Council (NCC). The ACCC is principally involved with enforcement of the TPA and also administers certain access and prices oversight arrangements. The NCC is responsible for monitoring and advising on progress in NCP implementation and making recommendations to the Federal Treasurer on competition payments.

B.2 Reforms under the Competition Principles Agreement

Structural reforms to public monopolies

Australia's infrastructure and utility sectors have historically been dominated by public monopolies. Railways, ports, airports, electricity generation, transmission and distribution, water storage, purification and supply, gas and oil pipelines, telecommunications and postal services provide examples of the breadth of government involvement. These services (as a group) account for a significant share of economic activity and are key inputs to other industries (hence impacting on their ability to develop and compete internationally).

As such, improving the efficiency of these activities has long been recognised as an important pre-condition for enhancing Australia's economic performance. Reforms to improve productivity and financial performance commenced in the mid 1980s, with the major thrust involving a greater focus on commercial objectives through measures such as:

- specifying accounting standards and performance targets;
- ensuring prices more accurately reflected the cost of supply;
- exposure of, and separate budget funding for, community service obligations (CSOs); and

-
- changes to governance arrangements (for example, corporatisation).

Attention later turned to the potential for achieving further efficiency gains from competition-based reforms. NCP commitments are framed against this background.

The CPA outlines principles for the reform of public monopolies in order to establish ‘effective’ competition. Specifically, each jurisdiction agreed that prior to introducing competition to a sector traditionally supplied by a public monopoly, responsibility for industry regulation would be removed from the monopoly provider to eliminate the potential for regulatory instruments (such as the setting of technical standards) to be used to restrict competition. They also committed, among other things, to undertake reviews into the:

- appropriate commercial objectives for their public monopolies;
- merits of separating natural monopoly elements from potentially contestable service elements (to ensure that returns in the monopoly segment do not subsidise prices in the contestable market and thereby inhibit efficient competition, and also to overcome concerns about the potential for vertically integrated providers to deny access to firms in otherwise contestable upstream and downstream markets);
- merits of separating the potentially contestable elements into smaller independent businesses (to further promote competition);
- merits of any CSOs and the best means for their funding and delivery;
- price and service regulations to be applied to the industry; and
- appropriate financial relationships between the owner and the public monopoly (including rate of return targets, dividends and capital structure).

Each government was free to determine its own agenda for the structural reform of public monopolies, including whether or not to privatise these businesses. Reflecting this flexibility, reform outcomes across jurisdictions and service sectors have varied considerably (examples are provided in chapter 2).

According to the NCC (2004b,c), structural reform obligations had been (or were being) met in relation to: the gas sector; the electricity sector except in Western Australia; urban and rural water; the rail sector in New South Wales, Western Australia and Victoria; port authorities except in the Northern Territory; the Sydney basin airports (an Australian Government matter); dairy marketing authorities; and the Queensland Sugar Corporation. Instances of non-compliance with CPA obligations were confined to Western Power (the public monopoly in the Western Australian electricity sector) and instrumentalities under the Australian

Government's jurisdictional power — namely, the Australian Wheat Board and Telstra (see chapter 2).

Prices oversight of government business enterprises

While the introduction of competition to services traditionally supplied by public monopolies was a key element of the NCP, governments recognised that it would not always be possible to achieve this goal. For example, in markets with natural monopoly characteristics, a single firm structure would remain the most likely outcome regardless of attempts to introduce competition.

To constrain the potential for misuse of market power, each jurisdiction was encouraged to establish independent pricing authorities (where they had not already done so) to set, administer or oversee prices for enterprises which remained under monopoly control. Where an enterprise was not subject to State/Territory oversight and its pricing practices were deemed to have a significant impact on trade or commerce, the Australian Government was given the power to 'declare' that enterprise for prices surveillance by the ACCC under the *Prices Surveillance Act 1983*.

All jurisdictions now have independent prices oversight bodies. Their roles include:

- setting maximum retail prices for monopoly services provided by GBEs;
- regulating revenues or prices of electricity networks under the National Electricity Code;
- regulating third party access (see below) to gas networks;
- administering and licensing of water, electricity and gas businesses, and monitoring compliance with licence conditions; and
- registering agreements for access to public infrastructure assets and arbitrating disputes arising from these agreements.

Competitive neutrality

NCP also recognised that effective competition between government owned service providers and private firms would be undermined by any net advantages conferred on the former by virtue of their public ownership. Accordingly, each jurisdiction agreed to adopt a corporatisation model for businesses which remained publicly owned and to impose similar commercial and regulatory obligations on these businesses to those faced by the private sector, including:

- full Federal, State and Territory taxes or tax equivalent payments;

-
- commercial rate of return requirements and an obligation to pay dividends;
 - requirements that prices reflect the full cost of providing services;
 - debt guarantee charges to offset cost advantages of implied government borrowing guarantees; and
 - regulations applying to private sector competitors, such as those relating to the protection of the environment and planning and approval processes.

Each jurisdiction was also required to publish competitive neutrality (CN) policy statements and establish transparent, accessible and independent mechanisms for dealing with complaints that particular government businesses are not meeting CN requirements. State and Territory governments also committed to apply CN principles to local government business activities.

Each jurisdiction has been free to determine its own agenda for the implementation of CN principles and its application has been required only to the extent that the benefits from implementation outweigh the costs. In this latter regard, the CPA allows a range of public interest factors to be taken into account in making such assessments (see box 2.4 in chapter 2).

Implementation of CN principles is an ongoing requirement under NCP. While commitments relating to the publication of CN policy guidelines and establishment of complaints handling offices have been met by all jurisdictions, the NCC (2004b) has suggested that, in a few areas, application of CN has not been fully effective. Formal CN principles, for example, do not apply to business units/activities of public enterprises outside the executive control of government, such as general consulting undertaken by universities and commercial R&D activities in public hospitals. Recent modifications to CN principles have encouraged a ‘best endeavours’ approach to be adopted, but application of CN in these activities remains voluntary (see CoAG 2000).

The Council also raised some concerns in relation to the application of competitive neutrality to local government activities and differences in the CN models adopted across jurisdictions. For example, the criteria used to establish an entity’s significance, and thereby its exposure to competitive neutrality requirements, vary across jurisdictions. That said, in an overall sense, the competitive neutrality arrangements appear to be working relatively well (see chapter 10).

Third party access to essential infrastructure

The natural monopoly characteristics of some infrastructure services (such as transmission and distribution networks for electricity, gas and rail services) posed

additional hurdles to the achievement of NCP objectives. In such situations, service providers can potentially exercise substantial market power by denying access to their facilities or charging access prices significantly above costs. Denial of access was seen to be a particular problem in vertically integrated operations where facility owners were also involved in supplying services to downstream markets. In these situations, attempts to introduce competition to potentially contestable downstream activities could be undermined.

Conceding that the conduct provisions in the TPA would be inadequate to deal with these situations, as well as the structural separation initiatives outlined above, governments agreed, as part of the NCP, to develop a national access regime. This was to provide an avenue for firms to use nationally significant infrastructure services owned and operated by others (on ‘reasonable’ terms and conditions and at ‘fair’ prices) when commercial negotiations regarding access are unsuccessful.

Under the national regime that was subsequently implemented, a party can seek access to an infrastructure service:

- by having the service ‘declared’. This establishes a right to negotiate terms and conditions of access with the service provider. If negotiations fail, declaration also gives an access seeker the right to seek binding arbitration by the ACCC;
- through an existing access regime which has been certified as ‘effective’ (meaning it satisfies certain agreed criteria); and
- under terms and conditions in a voluntary undertaking from the service provider which has been approved by the ACCC.

The legislative basis for the national access regime is contained within the TPA (Part IIIA). It sits alongside a host of industry specific access regimes which have been certified as ‘effective’ under the TPA (see chapter 2).

Review of anti-competitive regulation

Legislation review and reform is a key component of NCP. The Hilmer Committee (1993, p. 184) described restrictions imposed by government regulation or through government ownership as ‘the greatest impediment to enhanced competition in many key sectors of the economy’. Major areas identified by Hilmer included statutory marketing arrangements for many agricultural products, licensing and ownership regulations for various occupations and professions, and legislated monopolies for many public enterprises.

Under the CPA, governments agreed to examine whether around 1800 pieces of legislation restricting competition could be justified on public interest grounds. The

initial target date for this review and reform exercise of June 2000 has been extended on several occasions and the legislative review program (LRP) remains incomplete in all jurisdictions (see below).

The guiding principle in the CPA is that legislation should not restrict competition unless it can be demonstrated that the:

- benefits of the restriction to the community as a whole outweigh the costs; and
- objectives of the legislation can only be achieved by restricting competition.

In addition to the review requirements for existing legislation, the CPA contains two ongoing obligations. They are that:

- all anti-competitive legislation reviewed under the LRP and retained on public interest grounds must be reviewed again at least every ten years, to ensure that the regulation remains relevant in the face of changes in circumstances and/or in government and community priorities; and
- governments must ensure that new legislation which restricts competition is demonstrably consistent with the guiding principle spelt out above.

The LRP has resulted in the abolition or modification of a range of anti-competitive legislation. However, progress in reviewing legislation against the agreed timetable has been mixed both across jurisdictions and sectors. Considerable delays appear to have arisen at a variety of junctures: in completing reviews; in the stage between the completion of reviews and the introduction of amended legislation; and in the passage of legislation through Parliaments. For ‘priority’ legislation, only 74 per cent of government’s nominated legislation had been reviewed and, where appropriate, reformed by mid 2004. This compared with around 56 per cent in 2003 and 20 per cent in 2001. According to the NCC (2004a), the significant increase in compliance during 2004 partly reflected the competition payment penalties imposed in 2003. More detail on LRP compliance is provided in tables 2.1 and 2.2 in chapter 2.

B.3 Reforms under the Conduct Code Agreement

Extending the anti-competitive conduct provisions of the TPA

Prior to NCP, the TPA’s coverage was limited by the scope of the Australian Government’s constitutional power. As a result, State and Territory government business units, GBEs, unincorporated entities (such as sole traders and partnerships)

and various other business activities were generally exempt from the conduct provisions.

Under the Conduct Code Agreement, governments agreed via legislative changes to extend the operation of the anti-competitive conduct rules contained in Part IV of the TPA to government businesses and unincorporated enterprises. However, certain commercial activities of government such as statutory marketing of agricultural products remained exempt.

While the TPA prohibits a range of anti-competitive conduct (see table B.1), the ACCC has the power to ‘authorise’ such conduct, for limited periods, where there is judged to be a net benefit to the public.

Table B.1 Prohibited trade practices^a

<i>Part IV of the Trade Practices Act prohibits:</i>	<i>Which means that under the Act:</i>
Anti-competitive agreements, such as price fixing, market sharing and primary and secondary boycotts (ss 45–45D)	It is illegal for: <ul style="list-style-type: none">• producers to control prices and to divide a market so that they do not compete against each other (if it substantially lessens competition);• competitors to agree not to acquire (or supply) goods and services from (to) a particular person.
Misuse of market power (s. 46)	A firm with a substantial degree of market power cannot use that power to: <ul style="list-style-type: none">• eliminate or substantially damage a competitor;• prevent the entry of a person into any market; or• deter a person from engaging in competitive conduct in any market.
Exclusive dealing (s. 47)	It is illegal to supply goods or services under conditions where the purchaser: <ul style="list-style-type: none">• limits the acquisition of goods or services from a competitor of the supplier; and• will not resupply, or will resupply only to a limited extent, goods or services to a particular person or place.
Resale price maintenance (ss 48, 96–100)	It is illegal for a supplier, manufacturer or wholesaler to specify a minimum price below which goods and services may not be resold or advertised.
Mergers likely to substantially lessen competition in a substantial market (s. 50)	The merger of two firms is prohibited if it is likely to substantially lessen competition — this applies to mergers between competitors and between suppliers and customers.

^a Changes to some of the more detailed aspects of these provisions and the procedures for applying them are contained in proposed legislation currently before the Parliament in response to the Dawson Review (see chapter 10).

Source: Derived from ACCC (1998).

To determine whether anti-competitive conduct should be authorised, the ACCC applies its own public benefit test. There is no standard test — each case is assessed having regard to the special circumstances involved. The Australian Competition Tribunal (the appeal body for ACCC determinations) has in the past described a ‘public benefit’ as:

... anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principal elements ... the achievement of the economic goals of efficiency and progress ... (ACCC 2002b, p. 28)

Some of the factors which have been assessed as providing a ‘public benefit’ under authorisation decisions made by the ACCC (and the former Trade Practices Commission), the Australian Competition Tribunal (and the former Trade Practices Tribunal) and the courts are listed in box B.1.

Box B.1 Factors taken into account as ‘public benefits’

Factors which have been assessed by the ACCC, the Australian Competition Tribunal and their predecessors as providing ‘public benefits’ include:

- business efficiency, especially if it results in improved international competitiveness;
- industry rationalisation resulting in more efficient allocation of resources;
- expansion of employment in efficient industries or employment growth in regions;
- industry cost savings resulting in lower prices at all levels in the supply chain;
- promotion of competition in industry;
- promotion of equitable dealings in the market;
- growth in export markets and development of import replacement activities;
- economic development, for example, development of natural resources through encouraging exploration, research and capital investment;
- assistance to small business, for example, guidance on costing or pricing or marketing initiatives which promote competitiveness;
- improvement in the quality and safety of goods and services; and
- supply of better information to consumers and business.

Source: ACCC (1995).

B.4 Reforms under the Implementation Agreement

Related infrastructure reforms

All governments commenced reforms to key infrastructure services — electricity, gas, road transport and water — in the late 1980s, resulting in several agreements being drawn up in the early 1990s (see chapter 2). The potential gains from reforms in these areas were seen as being substantial given the impact of infrastructure costs and service reliability on industry competitiveness and the well being of Australians more generally.

In April 1995, all governments recommitted to implement these reforms, with the earlier agreements being annexed to the *Implementation Agreement* and referred to as the ‘related reforms’. While extensive reform programs have been pursued under NCP for these sectors, NCP reform requirements for Australia’s other major infrastructure sectors were limited to general GBE ‘governance reforms’ and reviews of relevant regulations under the LRP.

Energy

As the Australian economy became increasingly exposed to global competition during the 1980s, pressure mounted to improve the performance of Australia’s energy sector. By the early 1990s, following various reviews, including an Industry Commission inquiry (IC 1991), there was widespread recognition that significant benefits were likely to accrue from introducing competition to the provision of electricity and gas.

Electricity

Historically, the electricity industry in Australia developed on a State-by-State basis. This resulted in the industry being dominated by government owned, vertically integrated, legislated monopolies in each jurisdiction. It was extensively regulated and there was little if any trade in electricity between jurisdictions. Moreover, investment decisions were often driven by engineering and political concerns rather than economic efficiency.

This frequently resulted in prices that bore little resemblance to the cost of supply and extensive cross subsidies between different customer classes. Also, there was little incentive to improve the level of service provided to customers. Overstaffing was common and there was considerable over-investment in plant and equipment.

In 1991, all governments agreed to work cooperatively to establish a National Electricity Market (NEM), as well as to introduce competition, primarily through structural reforms, in key parts of the industry. Specifically, this involved:

- allowing interstate trade in electricity;
- the creation of wholesale and retail markets for electricity (with retailers and large end users bidding for electricity sold into the wholesale pool);
- ensuring customers have a choice of suppliers;
- separating generation, transmission and distribution activities;
- introducing industry specific third party access arrangements and price regulation in those parts of the electricity sector exhibiting natural monopoly characteristics (such as the transmission and distribution networks); and
- establishing uniform regulation based on an industry code of conduct.

These commitments were subsequently incorporated into the NCP.

The NEM covers all jurisdictions except Western Australia and the Northern Territory. These jurisdictions were not included due to geographical and cost factors (as transmission losses result from transporting electricity over long distances). Tasmania is to join, following completion of the Basslink interconnection.

As well as delivering a more competitive industry structure, the NEM arrangements sought to improve investment outcomes through the sharing of spare capacity between jurisdictions, thereby reducing levels of spare capacity required in any particular jurisdiction. It was also hoped that competition would help to address ‘gold plating’ and reduce reliance on coal fired base load generating capacity — though in the latter case this has not been achieved (see chapter 5).

The NEM commenced operation in December 1998, although Queensland has only been part of the market since 2001. The NEM currently incorporates about 85 per cent of Australia’s total installed electricity capacity. Its operations encompass trading via bilateral contracts, forward trading and through the spot market, which is used to balance supply and demand by establishing a half hourly price for electricity.

The National Electricity Code (the Code) sets out the regulatory and operational framework for the national market and was authorised by the ACCC in 1997 under Part VII of the TPA. In addition to the market rules, the Code deals with access and grid connection, network pricing for transmission and distribution, and system and security matters.

Currently, the Code is jointly administered by the National Electricity Market Management Company (NEMMCO), the ACCC, the Code Administrator and State regulators.

- NEMMCO is responsible for managing the physical operations of the market.
- The ACCC is responsible for assessing applications for changes to the Code under PartVII and regulating network revenues for transmission services.
- The Code Administrator is responsible for the development and enforcement of the access provisions, as part of its overall supervision and enforcement of the Code, managing any changes to the Code and liaising with the ACCC.
- The State regulators, such as the Independent Pricing and Regulatory Tribunal in New South Wales and the Essential Services Commission in Victoria, are responsible for distribution networks, retail licences, safety and environmental standards, and regulating network pricing for distribution services within their respective jurisdictions.

According to the NCC (2004b), structural reform commitments have been met in all jurisdictions except Western Australia. (Differences in the approach adopted by jurisdictions are described in box B.2.) Moreover, in all NEM jurisdictions except Queensland, all customers are now able to choose their supplier. In Queensland, such retail ‘contestability’ is limited to those customers consuming over 100 megawatt hours per year. However, a review is currently underway to assess the merits of introducing contestability for those customers with lesser electricity requirements.

While the agreed reform commitments under NCP have largely been met, the original objective of a fully competitive national market has not been realised. According to Parer (2002), this reflects deficiencies in some reform areas including:

- confused governance arrangements and excessive regulation stemming from the number and overlap of regulatory bodies;
- inadequate transmission links which effectively regionalise the national market (resulting in generators in some states having excessive market power, decreased liquidity in the financial market, and jurisdictions seeking State based rather than national solutions for new generation capacity);
- perceptions of conflict of interest when some governments are energy asset owners and regulators as well as policy makers;
- difficulties in establishing contracts due, for example, to: insufficient transmission links and general regulatory uncertainty;
- impediments to demand management (such as the use of retail price caps) playing a greater role in the NEM.

Box B.2 Structural reform in the electricity industry

In Victoria, the State Electricity Commission of Victoria was split into separate generation, transmission and distribution businesses. Subsequently, Victoria's five distribution companies were sold off to the private sector in 1995, followed by its generation businesses, its share of the Loy Yang B generator and its transmission businesses.

In South Australia, the Electricity Trust of South Australia was separated into three separate generation companies, a transmission company and a single distribution and retail company, with ring fencing between the retail and distribution activities. These government owned corporations were then leased-out prior to being privatised.

Other jurisdictions have split their vertically integrated businesses into separate government owned businesses. In some cases, this has involved creating competing government owned generators.

- In New South Wales, Pacific Power was separated into a transmission business (Transgrid), with its generation activities split into three separate government owned businesses. Distribution boards were amalgamated into six government owned businesses, with monopoly network functions being ring fenced from retail services.
- Queensland similarly separated, then corporatised, the Queensland Electricity Commission into separate generating corporations and a corporatised transmission business, Powerlink. (Gladstone Power Station was however sold). Regional distribution boards were amalgamated into a single corporation, Ergon Energy, with its retail arm operating as a subsidiary.
- Tasmania has separated the previously vertically integrated Hydro-Electric Corporation into a single government owned generation business, a government owned transmission business and a government owned retailer.
- Western Australia and the Northern Territory, which are not part of the NEM, have retained vertically integrated government owned suppliers. In Western Australia, however, transmission and distribution networks have been ring fenced to permit third party access under the Electricity Networks Third Party Access Code. In its 2004 assessment, the NCC noted that Western Australia had failed to implement its previously foreshadowed structural separation of Western Power into generation, network, retail and regional entities.

Source: NCC (2003b; 2004a).

In response, CoAG agreed in 2004 to rationalise regulatory arrangements for the national energy market and committed to developing a National Energy Policy (see chapter 8). The new regulatory arrangements — including the establishment of the Australian Energy Regulator (responsible for market regulation and enforcement) and the Australian Energy Market Commission (rule-making and market development) — are forecast to become fully operational in the first half of 2005. With the establishment of the two new bodies, the Code Administrator will be abolished. The ACCC will retain responsibility for competition regulation under

Part IV of the TPA, and for competition-related code-change authorisations under Part VII.

Gas

The gas supply industry comprises gas transmission which transports gas under high pressure from the gas production fields to major users along the pipeline and to the city gate, and gas distribution and retailing within urban areas. The ‘upstream’ natural gas production industry involves the extraction of raw gas and its processing into either pipeline quality gas for the domestic market or liquefied natural gas for export.

Like electricity, Australia’s gas industry developed on a State basis and typically involved a single gas provider supplying a State’s entire gas needs via a dedicated pipeline to a single gas retailer. Although government ownership of gas assets was not as extensive as in the electricity sector, there were still a number of government utilities and extensive regulation of private gas suppliers, as well as State legislation which restricted the flow of gas beyond State boundaries. Such restrictions were seen as necessary to avoid gas shortages and to underpin the industrial development of particular States.

The dominance of a few gas producers, the existence of monopoly suppliers, the lack of interconnection between regions and the absence of a mechanism to provide access to gas pipelines acted to significantly limit competition in the industry. As a result, costs and prices were well above efficient levels and investors lacked incentives to expand the network.

As with electricity, reforms to the gas supply industry commenced prior to the introduction of the NCP. Following the release of an Australian Government strategy paper in 1991, CoAG put forward a series of reforms as part of the specific CoAG 1994 Gas Agreement involving the:

- structural separation of production, transmission, distribution and retailing;
- introduction of third party access regulation for natural gas pipelines;
- removal of restrictions on trade in gas; and
- provision for all gas consumers to choose suppliers (full retail contestability).

These reforms were reaffirmed under the NCP in 1995 and the majority have been implemented. Structural separation has been completed and all governments have introduced third party access regimes as part of the National Gas Access Code. The previously government owned, vertically integrated businesses, have been restructured and, in some cases, privatised. Interstate trade in gas is occurring with

the removal of constraints on trade contributing to the growth in investment in new transmission pipelines. Existing publicly owned pipelines have been privatised and several foreign companies specialising in gas transmission have established operations in Australia.

The total length of transmission pipelines in Australia nearly doubled between 1990 and 2000, from about 10 000 to 20 000 kilometres (AGA 2003). This new network includes linkages to processing facilities at Longford, in Victoria, to allow for the servicing of customers in New South Wales and the ACT. Further network expansion is under way between Victoria and South Australia, with pipelines linking the Northern Territory and Papua New Guinea in the planning stages. Some other developments are discussed in box B.3.

Box B.3 Some recent developments in the gas industry

Australia has gas reserves equivalent to more than 100 years supply, at current production levels. While the Cooper Basin contains most of the onshore accumulations of natural gas, there have been a number of significant finds and potential developments in the Timor Sea, Otway and Bass Basins.

In recent years, investment in major new pipelines and other related developments have increased the penetration of natural gas and promoted a more competitive market. For example:

- The Goldfields Gas pipeline became operational in 1996 and delivers gas from the North West Shelf to Kalgoorlie and various mining operations in WA.
- The Culcairn interconnect commenced operation in 1998 and connects the Victorian network with the Moomba to Sydney Pipeline.
- The Eastern Gas Pipeline became operational in 2001 and provides gas transfers between Longford in Victoria and Horsley Park west of Sydney.
- The pipeline between Victoria and Tasmania, completed in 2002, has made natural gas available in Tasmania.
- SEAGas, a transmission pipeline completed in 2004, connects Victoria to Adelaide, with the potential to link recent discoveries in the Otway Basin to Victoria and other States.
- Vichub, a gas trading hub at Longford in Victoria, completed in 2003, connects the New South Wales, Victorian and Tasmanian gas markets.

Sources: Parer (2002); AGA (2003).

One outcome of the reforms has been the emergence of integrated energy businesses supplying both gas and electricity to customers in different jurisdictions. For example, AGL — which was previously a gas distributor and retailer operating solely in New South Wales — now retails electricity outside of that State. Similarly,

Energex, previously an electricity distributor in Queensland, now also retails gas and electricity in other jurisdictions.

Legislation to provide for full retail contestability is also in place in all jurisdictions (except Queensland). According to the NCC, gas reform has been a major success with the original NCP agenda now largely in place (Willett 2001).

But while most of the NCP agenda has been implemented, there are concerns in parts of the pipeline industry that access arrangements under the National Gas Access Code are impeding efficient investment in new infrastructure. Against a backdrop of ongoing debate on this issue, the Australian Government asked the Productivity Commission to review the Code. The Commission (PC 2004i) found that while an industry specific access regime should be retained, the current regime is likely to be distorting investment in favour of less risky projects, including altering the nature and timing of expenditure on pipelines. The Ministerial Council on Energy will be developing a response to the Commission's recommendations (see chapter 8).

Road transport

Much of Australia's road transport industry is characterised by competitive markets featuring a large number of operators, and with competitive disciplines reinforced by inter-modal competition, notably from rail. However, it has long operated within a very diffuse and inefficient regulatory framework, which has increased operating, compliance and other costs for service operators and users, and inhibited service flexibility. Concerns have also been raised about road safety issues, the industry's impact on the environment (pollution and congestion) and the perceived underpricing of road infrastructure relative to rail.

Efforts to overcome inefficiencies in the regulatory framework were largely unsuccessful until all Australian governments (except the Northern Territory) signed the Heavy Vehicles Agreement (HVA) in 1991 — a national package of reform measures to increase road transport efficiency, reduce administrative costs and improve road safety. The HVA provided for the establishment of the National Road Transport Commission (NRTC) to oversee and coordinate the development of uniform laws and a charging regime for heavy vehicles. It also created the Ministerial Council for Road Transport (MCRT) to manage the implementation of specific reforms. In May 1992, a Light Vehicle Agreement (LVA) was signed by most governments, extending the objective of national uniformity in road regulation to all other road transport operators/users.

Reforms under the HVA and LVA were grouped into six modules developed by the NRTC and covering:

- uniform heavy vehicle charges;
- uniform arrangements for the transport of dangerous goods;
- vehicle operation reforms (encompassing uniform or more consistent national vehicle standards; road worthiness, mass and loading rules; oversize and over-mass vehicles; driving hours; route restrictions; and, other road rules);
- a national heavy vehicle registration scheme;
- a national driver licensing scheme; and
- a consistent and equitable approach to compliance and enforcement of road transport rules.

The most significant of these reforms involved the implementation of a uniform approach to regulating and charging heavy vehicles. Uniformity was to be achieved through the use of ‘template’ legislation, where the Australian Government enacted legislation to apply the agreed reforms to the ACT, and the States would then apply this template in their own jurisdictions.

In April 1995, road transport reforms were brought within the ambit of the NCP framework — in recognition that full implementation of the HVA and LVA would boost national welfare by improving the efficiency and safety of the industry. Under the NCP, all governments committed to fully implement the agreed road transport reforms by 2001.

However, in contrast to the other ‘related reform’ areas in the NCP, the *Implementation Agreement* provided only very general guidance to governments on their reform obligations in road transport and this resulted in implementation delays. In addition, the emergence of new reform proposals by the NRTC led CoAG to modify the NCP road transport reforms on several occasions. And, reflecting difficulties in achieving appropriate national regulations through the template legislation approach, the HVA and LVA were amended in 1998 to enable jurisdictions to apply national transport law either by ‘template’ or by implementing the ‘substance’ of that law.

Of the 31 NRTC reform initiatives developed by 2001, CoAG had endorsed 25 for implementation and assessment under the NCP. While there has been progress in pursuing the other six NRTC reform initiatives — covering mass limits, speeding, truck trailers, axle mass spacing, noise and compliance and enforcement arrangements — they have not been monitored or assessed by the NCC.

As at 30 June 2004, virtually all the 25 CoAG endorsed reforms had been fully implemented by all jurisdictions (see chapter 2). Nonetheless, there have been widespread claims from the industry of inconsistencies and shortcomings in the implementation process. In responding to these claims, the NCC (2003a) stated that the reform agenda to 2001 had not comprised all of the initiatives needed to develop a nationally consistent regulatory regime. It also noted remaining jurisdictional differences in relation to stamp duty, third party insurance and staggered dates for registration charge updates.

Water

The water industry is one of Australia's largest. In value added terms, it is more than one quarter the size of the manufacturing and agricultural sectors, almost half the size of the electricity industry and three times the size of the gas industry (NCC 2002b). Water is critical to many economic, environmental and social activities. However, it has often been poorly managed and over-exploited. Excessive extraction of water has stressed river systems, resulting in losses of productive land, poor water quality and reduced biodiversity. Accordingly, the potential gains from performance improvements and better water management are considerable.

Reforms to improve pricing structures and the efficiency of water service provision in urban areas were introduced in the early 1980s. However, in rural areas, pricing reforms were limited prior to NCP, with concerns about the economic impacts on irrigators and surrounding communities posing a stumbling block to change. Thus, it became increasingly clear that a nationally coordinated approach to reform would be necessary to achieve significant improvements across the sector as a whole.

In 1994, a CoAG Working Group (1994b) identified a range of water industry problems including:

- the need to refurbish water assets in rural areas where adequate financial provision had not generally been made;
- impediments to the transfer of irrigation water, from low value broad acre agriculture to higher value uses in horticulture, crop production and dairying;
- service delivery inefficiencies;
- pricing regimes which led to over charging of commercial and industrial water users, over allocation of water (especially for irrigators), environmental degradation and misallocation of water infrastructure investment; and
- a lack of clearly defined roles and responsibilities for government bodies involved in the industry.

In February 1994, CoAG agreed to a strategic framework for water reform to be implemented progressively through to 2001. The package sought to improve both the efficiency of water use (and thereby reduce the need for new infrastructure) and the environmental management of the nation's river systems and ground water sources (by formally specifying, for the first time, a water allocation for environmental uses) (CoAG 1994b).

These COAG-endorsed reforms covered several broad areas: institutional measures; pricing reforms (including investment appraisal); specification and separation of water entitlements from land title; water allocation and trading; and environmental management practices. Further, the coverage of the reforms under NCP was extended to include groundwater supplies (both artesian and sub-artesian) and the National Water Quality Management Strategy, covering, amongst other things, drinking water quality standards. Implementation of reforms in these areas subsequently became a formal requirement under NCP.¹ The general GBE governance and monopoly oversight reforms of the NCP also apply to water authorities.

The initial target dates for implementation of the major water reform components — 1998 for urban water pricing, institutional reforms, water trading and allocations for the environment, and 2001 for rural water pricing — proved difficult to meet due to the:

- complexity of some of the reforms, such as the requirement to establish management regimes for handling stressed rivers, to determine appropriate consumption entitlements for different users and to create effective markets for water trading;
- the different starting points in each jurisdiction (for example, in legislative frameworks and the health of their river systems) and their differing interpretation of, and approaches to, implementing some of the reforms;
- need for extensive consultative and educative processes to provide forward notice about the consequent changes and give people time to adapt; and
- demands that the reforms placed on governments, institutions and stakeholders, including financial demands to facilitate adjustment, asset refurbishment and improvements to the health of river systems (NCC 2002b).

As a result, the timetable for 'substantial implementation' of allocation and trading arrangements in rivers and groundwater systems was extended to 2005 (with the

¹ There are also some water reform initiatives which are not formally part of the NCP process — for example, the National Action Plan for Salinity and Water Quality — but which have implications for the NCP-related water reforms.

implementation date for environmental allocations changed to 2001). Milestones were set for considering progress with urban water pricing, institutional reform, intrastate trading and water quality (by 2003), and rural pricing, interstate trading and environmental allocations (by 2004). As a trade-off, there has been a growing tendency to specify reform commitments and implementation paths more fully (demonstrated most recently in the National Water Initiative — see below) and to recognise the integrated nature of the reforms.

In the broad, assessments by the NCC suggest that progress in water reform has been greater with respect to economic objectives. This has largely reflected the long lead times to establish and implement the environmental allocation measures. Areas of reform where progress has taken more time include water quality, water allocation and trading, and rural water pricing. Progress in specific areas is described below.

Institutional reforms

Separation of functional roles is essentially complete and all jurisdictions have introduced independent price oversight of most of their major suppliers. All metropolitan water businesses now have a more commercial focus and undertake annual performance benchmarking against other service providers. In the rural sector, irrigators now have much greater involvement in the management of rural irrigation districts and ownership of some irrigation schemes has been transferred to irrigators. And while progress in implementing integrated resource management has, according to the NCC (2003b), been slower, all jurisdictions are adopting an integrated catchment management approach to water management.

Pricing reforms

According to the NCC, considerable progress has been made in implementing agreed reforms in urban areas, with full financial cost recovery being achieved by larger water suppliers. In those jurisdictions where local government is involved in urban water supply, progress by some smaller entities in implementing agreed reforms has been slower. Jurisdictions are also moving towards achieving cost recovery in their rural systems. In addition, all jurisdictions have arrangements in place for examining proposals for new rural water infrastructure against the dual tests of economic viability and ecological sustainability.

Water entitlements separate from land title

All jurisdictions have established water entitlement systems separate from land title and processes for registering these entitlements. The requirement for clear specification of water entitlements has also been met. The National Water Initiative (see below) has subsequently refined this obligation to specify entitlements as a perpetual or open-ended share of the consumptive pool for the relevant water resource.

Allocation and trading reforms

All jurisdictions have made progress toward the achievement of their environmental allocation commitments, though progress has been slower in areas where water sources are stressed or overallocated. This reflects financial considerations, the still developing science for determining appropriate environmental allocations and the concerns about the impact on water users and surrounding communities.

Water trading operates mainly in New South Wales, Victoria and South Australia and, to a lesser extent, in Queensland and Tasmania. While temporary trading in entitlements is well developed, permanent trading is relatively limited. (Moreover, as discussed in chapter 8, there are other opportunities to refine and expand property rights and water trading regimes.)

Various impediments to intrastate water trading have been identified by the NCC (2003b and 2004c) including: legislative and administrative restrictions, lack of appropriate and timely information (such as data on the price and volume of water being traded) to establish reliable water rights registers, delays in approving trades and the need to develop better trading infrastructure. Nonetheless, the Murray Darling Basin Commission is developing interstate trading arrangements, including systems of exchange rates and tagging of entitlements.

Water quality

All jurisdictions are continuing to implement the *National Water Quality Management Strategy* — involving the adoption of market based and regulatory measures dealing with water quality monitoring, catchment management policies and town wastewater and sewerage disposal — although there is variation in the scope and speed of reform.

The National Water Initiative

Reflecting the complex nature of the water reforms, CoAG (with the exception of Western Australia and Tasmania) agreed in June 2004 to a National Water Initiative (NWI) — though there is currently some uncertainty about whether the agenda will proceed. The NWI covers a range of areas where interjurisdictional consistency and the adoption of best practice approaches to water management are seen to provide substantial benefits.

Key elements of the NWI are shown in box B.4.

Box B.4 Key components of the National Water Initiative

The National Water Initiative aims to provide greater certainty for investors in the water industry and for the environment so as to ‘allow Australia’s water management regimes to adapt to future changes in water availability responsively and fairly in both rural and urban areas’. The key components of the National Water Initiative include:

- water access entitlements to generally be defined as open ended or perpetual access to a share of the water resource that is available for consumption;
- improved specification of the environmental outcomes to be achieved for particular water systems, improved accountability arrangements for environmental managers and statutory recognition for water to ensure environmental outcomes are met;
- return of overused and overallocated water systems to sustainable levels of use in order to meet environmental outcomes, with substantial progress by 2010;
- a framework that assigns the risk of future reductions in water availability arising from natural events (such as climate change, drought or bushfire), improvements in knowledge about water systems and changes in government policy;
- more efficient arrangements to facilitate water trade in connected systems;
- removal of institutional barriers to water trade, including phased removal of barriers to trade out of water irrigation areas in the southern Murray-Darling Basin;
- regional assessments of the level of water intercepted by land use change activities and a requirement for significant new activities to hold water access entitlements where the catchment is at, or close to, its sustainable level of water allocation;
- continued implementation of full cost recovery pricing in both urban and rural water;
- national standards for water accounting, reporting and metering; and
- actions to better manage the demand for water in urban areas, including a review of temporary water restrictions, minimum water efficiency standards and mandatory labelling of household appliances, and national guidelines for water sensitive urban design.

Source: CoAG (2004b).

CoAG also agreed to establish a National Water Commission which will assess progress in implementing the NWI and advise CoAG on actions required to better realise the objectives of the agreement. The National Water Commission is to conduct biennial assessments of progress by jurisdictions in implementing the NWI, commencing in 2006-07. It will also conduct the 2005 NCP assessment of water reform progress. Implementation of the NWI will be overseen by the Natural Resource Management Ministerial Council in line with detailed implementation plans to be developed by each participating State and Territory.

The Australian Water Fund

In September 2004, the Prime Minister (Howard 2004a) announced the establishment of the \$2 billion Australian Water Fund. It involves the provision of:

- \$1.6 billion over five years to accelerate the dissemination and adoption of the latest water use technologies and practices in Australia;
- \$200 million for Raising National Standards to ensure Australia has the best available science and data necessary to manage water resources; and
- a \$200 million Water Wise Communities initiative that will reward a culture of wise water use.

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