Submission to the Productivity Commission

Review of the *Prices Surveillance Act 1983*

June 2000

EXECUTIVE SUMMARY

The principal Commonwealth legislation regarding prices is the *Prices Surveillance Act 1983* (PS Act). The PS Act was introduced as part of prices and incomes policy and applied mainly to oligopolistic industries. It has had at most a limited role in relation to monopolies in the utility area. Its principal focus needs to be monopolies, mainly in the public utility area and it needs to encompass a range of new procedural measures that will support this changed focus. However, as the PS Act was designed for a quite different circumstance it now needs substantial revision.

There is also a role for a limited prices oversight power in some specific circumstances where an industry is characterised by high market power, where the benefits of prices oversight exceed the costs and where there is no other appropriate policy measure that can be taken. However, any such power should be circumscribed. Finally there is a need for the PS Act to contain some power upon reference by the Minister to allow some monitoring and even to hold public inquiries into some pricing areas where prices are a matter of high public concern.

These pricing powers must of course be seen in context. It is broadly acknowledged that pricing powers are a "last resort". They do not deal with the underlying problems of market power and therefore are a last resort where other pro-competitive reforms cannot be implemented. There is an extensive literature pointing to the inappropriateness of regulation in some cases and the distortions that it can create. Specifically pricing regulation is difficult. Price setting that is either too low or too high can either stifle innovation or reduce a firms incentive to increase efficiency.

Nevertheless there are certain limited circumstances where some pricing powers are required.

Currently the overall picture of pricing regulation is a complex jigsaw with a range of pricing regimes at both the Federal and State level.

Chapter One provides a brief history of the evolution of these pricing regulations in Australia, as well as an overview of current diverse and complex pricing powers at the Federal and State level.

Chapter Two sets out the three main phases in the history of the operation of the PS Act. While the PS Act has over time been a flexible instrument accommodating significant changes there is now an incompatibility between the initial objectives of the Act and current needs. This is being accentuated by the increasingly complex and adversarial nature of economic regulation today.

Consequently, a number of procedural and administrative difficulties in administering the PS Act have arisen which will continue if the regime is not amended. These difficulties are discussed in Chapter Three.

The ACCC therefore recommends that the price oversight regime be amended. A broad overview of the amended legislation is discussed in Chapter 4. and includes the following elements:

- ***The pricing powers should include provisions to regulate prices mainly in relation to monopolies***

In the case of price regulation, decisions should be court enforceable. The need for price regulation should be subject to review from time to time. This does not relate to access pricing as such but the need for final price regulation. These pricing provision are an adjunct to access legislation and other pro-competitive reforms. Generally, these powers would be used in relation to markets of national significance.

- ***A monitoring function would also be required as part of these new pricing provisions***

Independent of price regulation, Government should be able to determine that certain entities or industries be subject to price monitoring. Monitoring is most likely to be appropriate for those areas of the economy where there is high market power and high community concern about public detriment.

In addition, the ACCC should be able to continue to make preliminary informal inquiries in order to make recommendations about when monitoring should be conducted. Monitoring should take place for a prescribed period and its continuance be subject to review by the relevant Minister.

- ***The new pricing provisions should be supported by appropriate procedural measures.***

A range of procedural reforms to the PS Act are suggested in the submission. These modified procedures should support the new focus of the PS Act – regulating prices for monopoly utilities. The ACCC should have some discretion to choose an appropriate methodology for assessing prices and this should allow for incentive price regulation which could take the form of a CPI –X regime.

CHAPTER1: PRICING POWERS IN AUSTRALIA

In reviewing pricing regulation in 1993 the Trade Practices Commission (TPC), in its submission to the National Competition Review, argued that "the overall picture is one of a fragmented and inconsistent approach to price regulation across the national economy".[1] Subsequently much has changed in the area of pricing regulation with the developments recommended by the National Competition Policy Review report (Hilmer Review). A number of State and Territory independent and expert pricing bodies have been set up[2] and regulatory bodies at both the State and Federal levels are involved in access pricing. However, even with these changes, pricing powers in Australia make up a complex jigsaw which does not fit together to form a coherent picture.

1.1 Pricing Powers in Australia: A Short History

The Federal Government's early involvement in price control

During the first and second world wars the Federal government imposed price controls. In both cases the Federal government's defence powers were used as a source of power. From 1939, before the war began, the Federal government exerted controls over profits in munitions and armaments. Following this, the Government moved into prices generally and then into specific price regulations.[3] Initially the prices of "essential goods" were controlled, and then goods and services generally. A Commonwealth Prices Commissioner and Deputy Prices Commissioner was set up in each State and Territory. The powers of these officials were extensive, "including the power to enter and search premises, summon witnesses, and require the production of documents."[4]

Over the war years the system was adjusted and on the whole became more stringent. The system was changed in 1942 so that profit margins were pegged to the actual money margin of profit as at a specific date (15 April 1942). Prices could be increased by passing on

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[1] TPC: Submission to the National Competition Policy Review, 1993 p 52

[2] Report by the Independent Committee of Inquiry: National Competition Policy, Australian Government Publishing Service , Canberra , August 1993, p 291

[3] Scott R : Prices Justification in Australia, A guide to the Prices Justification Act 1973-1974 and to the development and procedure of the Prices Justification Tribunal, Butterworths (1975), p.4

[4] Ibid p. 4

(permitted) increased costs but not profit on those increased costs. Later, regulations were introduced which required prices to be reduced when costs were reduced.

These measures operated for the duration of war. Their underlying justification, which involved measures for both price control and price fixing, was that an uncontrolled increase of prices would have produced grave social and economic effects.[5]

The process of dismantling these powers was lengthy. *The National Security Act 1946* dismantled much war time legislation. However, the *Defence (Transitional Provisions) Act 1946*, introduced in the last months of 1946, allowed some of the regulations (including the pricing powers) to continue. Amending legislation continued to be introduced annually. On 1 January 1950, the pricing regulations ceased to operate altogether.

Prior to this date, the Commonwealth Government had proposed to change the constitution to give the Commonwealth permanent power to control "rents and prices, including charges". The Government was overseeing an economy in which there were both war time shortages and growing new areas of demand. Despite the threat of inflation the referendum was soundly defeated on 28 May 1948 with no State giving the referendum majority support. Sawer has argued that the defeat of the referendum seems to have been in part a reaction against the Government as well as a concern that price control could be used to undermine the private sector.[6]

Price control powers move to the States

From the beginning of World War II the States had cooperated with the Federal Government in introducing war time price control measures. At a Premier's conference in late 1939, agreement was reached on the price control measures to be introduced, the administrative arrangements to be used and the areas in which complementary state legislation was to be passed. The States also cooperated in introducing supporting legislation when the Federal Government price controls extended beyond the cessation of World War II. However, in 1948 all States and Territories passed new legislation giving themselves pricing powers.

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[5] Ibid p. 6

[6] Sawer G: Australian Federal Politics and Law 1929-1949, Melbourne University Press. It is now generally recognised that, pursuant to more recent High Court interpretation of the Constitution, the Commonwealth has extensive powers to regulate prices; see Hilmer Review at p.349. See also Hanks P, Constitutional Law in Australia, Butterworths 1996 pp. 340-368.

Thus, as the Commonwealth moved from this area of activity the States developed their own pricing powers. It is from these particular historical circumstances that a fragmented and inconsistent approach to price regulation developed across the national economy. The different States used their pricing powers in different ways. While invariably using a mixture of social and economic rationales, price controls were applied to different products at different times for different purposes.

Under the New South Wales legislation, the Price Commissioner had absolute discretion to fix and declare the maximum price at which any declared good or service could be sold. Petrol and bread were under price control, the latter until the late 1980's. In Victoria, the *Price Regulation Act of 1948* was soon set aside and replaced by a number of statutes which controlled the price of specific goods and services. In Western Australia, the price control legislation ended in 1952 and was not replaced by any general legislation controlling prices in that State. Tasmania also allowed the general price control legislation to expire in 1951. In contrast, in South Australia the 1948 legislation was used to administer a two-tiered system which involved price fixing for specified goods and services and a notification system for price increases of other goods. In 1987 maximum prices and /or margins were set for such products as children's school uniforms and school footwear, and infants' and invalids' foods.

Over time a plethora of price determining bodies came to be established at the State level. A report of the Advisory Committee on Prices and Incomes found that while Tasmania had no general pricing legislation in 1987, nineteen separate bodies were listed that had a role in pricing (for many this would involve setting a minimum price).[7]

Generally, basic foods like eggs, bread and milk were subject to some control and depending upon the individual State, so were a range of other goods and services like taxi charges, rents, building society interest rates, real estate fees and some utility charges. The rationale for these pricing roles were often social. Also, the economic thinking of the time put great weight on Government's role in resource allocation as a necessary corrective to the workings of imperfect markets.

Within this plethora of price oversight powers, petrol pricing has a unique place with a history of sixty years of price regulation. During World War II the Commonwealth Government controlled petrol prices. However, from 1948 to 1973 this power was exercised by the States. The States gradually withdrew form exercising these powers and in the mid 1950s the only remaining State authority, the South Australian Prices Commissioner, set the maximum petrol

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[7] Advisory Committee on Prices and Incomes: *Prices Surveillance in Australia*, Australian Government Publishing Service, Canberra, 1987. P 78

price in South Australia and effectively set the maximum wholesale price for the rest of Australia**.** While the Commonwealth Government again assumed a petrol pricing function in 1973 (which it maintained until 1998) many of the States even today have access to (but do not currently use) legislation relating to the regulation of petroleum product prices.

Re-establishment of general pricing powers at the Federal level: The Prices Justification Tribunal

In the context of this complex mix of pricing powers, the new Federal Labour Government introduced legislation to establish the Prices Justification Tribunal (PJT) on 1 August 1973. The PJT legislation was to provide the Government with some general pricing powers. These powers were to be in addition to the sector specific pricing powers resulting from the Commonwealth's ownership of monopoly service providers, for example Australia Post. They were also in addition to the Commonwealth's involvement in sectoral specific schemes, such as the Pharmaceutical Benefits Scheme and its involvement in specific rural marketing boards.

The PJT was set up to fight inflation at a time when prices and incomes policies were being used overseas to fight inflation. In Australia, prices oversight was considered to be a necessary corollary if industrial cooperation and some control of wage levels was to be achieved.

Firms with an annual turnover of more than $20 million were required to notify the PJT of any price increase or of the prices of new products. The figure of $20 million was chosen to make the scheme administratively manageable while at the same time bring under scrutiny the prices charged by major companies seen as the "price leaders" whose activities could have a significant impact on price levels generally.[8] The Government argued that the rationale of the legislation was not to replace the market but to improve its functioning. [9]

The PJT both assessed notifications and held inquiries. Later, in 1974, when the powers of the PJT were further strengthened, it also proposed lesser price rises. Businesses would often accept a decision for a lesser price rise rather than embark on an inquiry process. There were significant penalties for administrative non-compliance (a company could be fined $10,000

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[8] Fels A: *The Prices Justification Tribunal*, The Australian Economic Review, 4 October 1974, pp 23-38.

[9] Nieuwenhuysen J P and Daly A E: *The Australian Prices Justification Tribunal*, Melbourne University Press, 1977.

for not notifying the PJT of a price increase). However, a company was not required by law or penalised by fines for not accepting a PJT pricing decision.

The rationale of this legislation was to slow the rate of price increases. Nevertheless, to gain further power over prices and to control inflation, the Government put a referendum to the electorate in December 1973. Again the referendum was not supported by any of the States. In the following year the PJT was further strengthened so that it had the power to inquire and report on prices charged by companies irrespective of their turnover or industry concerned (notification continued to apply to companies with a turnover of $20 million or more). These changes were specifically aimed at retail prices and the price of imported goods.[10]

There is evidence that the PJT had some effect in achieving the objective of slowing the rate of inflation. However, while the Government argued that the legislation was to improve the functioning of the market, those economic organisations with the greatest potential to exercise monopoly, government utilities, were outside the jurisdiction of the PJT. Such were the pricing powers in the Australian Commonwealth that bread prices would have been subject to PJT regulation while at the same time being subject to separate regulation by State bodies in New South Wales, South Australia, the Australian Capital Territory and the Northern Territory.[11] Alternatively, public sector pricing, for post and telephone services, or for State utilities, were outside the jurisdiction of the PJT.[12]

The PJT's role was gradually changed and its coverage reduced from 1975 with the change in Government. Concerns were raised about compliance costs and the effect of PJT decisions on investment. Economic arguments that attributed a stronger role to the market as the mechanism for resources allocation were given increased credence. On 30 April 1981, the Government announced that the PJT would be abolished, while a reduced body (Petrol Products Pricing Authority, (PPPA)) established from the old PJT, maintained the Government's petroleum product pricing policy.

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[10] Whitlam G.; Second Reading Speech, House of Representatives Hansard, 16 July 1974.

[11] Ibid pp.113-114.

[12] Ibid. The Government's reply to the suggestion that public pricing policies should also fall within the ambit of the Prices Justification Act was to argue that there was no need for public scrutiny of prices

The establishment of the Prices Surveillance Authority (PSA) by the new Labour Government in one sense was part of a continuum. Like the PJT, the PSA was set up to be part of an effective prices and incomes policy.

In the second reading speech introducing the Bill, the Minister argued that the Government's policies, based on an effective prices and incomes policy, were directed towards achieving the goals of sustained non-inflationary economic growth. However, in the case of the PS Act the approach was to be selective, for the Government argued the best form of price restraint comes from the effective operation of competitive market forces. The PS Act was to establish a broad framework for the surveillance of prices set by corporations and Federal Government Authorities. The selection of goods and services were to be from those areas of the economy where effective competitive disciplines were not present and where prices or wage decisions would have a pervasive effective though the economy. Generally, the Treasurer argued both conditions had to be met before a body was made subject to surveillance.[13]

The weight given to these different criteria has changed over time. In fact there have been three phases in the operation of the PS Act and the economic rationale for each of these phases is significantly different. A detailed examination of the history and development of the PS Act is contained in Chapter 2.

Throughout the period from 1983 to the present, the PS Act has only been subject to slight amendments, the most significant perhaps being the changes made under the Competition Policy Reform Act 1995. In that year, the PSA and the TPC were amalgamated to form the Australian Competition and Consumer Commission (ACCC). While the PS Act itself has remained largely unchanged, the areas in the economy subject to either surveillance of monitoring have been drastically reduced. However, reducing the areas covered by the PS Act and changing administrative procedures cannot of itself overcome the increasing incompatibility between the PS Act's origins and the current operation of competition policy. This is a major theme of the following submission.

It would appear now to be widely recognised that the Commonwealth has power under the Commonwealth Constitution to create by legislation a prices oversight regime limited to activities carried on by trading and financial corporation in the course of interstate trade and

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determined by government authorities, since the consumer interest was already being closely taken into account. P117

[13] Prices Surveillance Bill 1983, Second Reading Speech, Historical House Hansard , 30 November 1983.

commerce.[14] Section 51(i) of the Constitution gives the Commonwealth Parliament power to make laws with respect to "trade and commerce with other countries, and among the States". Section 51(xx) also gives the Commonwealth Parliament power to make laws with respect to "foreign corporations and trading or financial corporations formed within the limits of the Commonwealth …".

1.2 The Current State of Play

Federal Pricing Powers

The PS Act is the only general Federal pricing legislation. Under the PS Act companies can be declared, in which case they have to notify the ACCC of price increases (the details of the notification process are discussed in Chapter 3). The current prices surveillance role covers areas of economic activity that have substantial market power or monopoly power. The following areas of economic activity/organisations are presently covered:

- **Harbour Towage –** Harbour towage in the major ports - Melbourne, Sydney, Newcastle, Fremantle, Brisbane and Adelaide.
- **Australia Post –** The "reserved services" (those areas where Australia Post has a legislated monopoly). The reserved services includes standard and large letters weighing up to 250 grams or for which the fee is up to four times the standard letter rate ($1.80). It also includes discount products linked to the price of standard products (pre-sort discounts, for example) as well as mail with special services attached (reply paid, for example).
- **Airservices Australia –** Airservices includes airspace management, aeronautical information, radar and communication, radio navigation aids, search and rescue alerting and airport rescue and fire fighting services.
- **Airports –** Includes the newly privatised Commonwealth airports. Price regulation is by a price cap. These arrangements have been put in place as part of the transition process from public ownership to regulated private airports with long term leases. Also some airport arrangements are regulated under an access regime under the Airport's Act. The price cap arrangements cover aeronautical services at Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth and Townsville airports.

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[14] See Hilmer op. cit. p.349 and Hanks P *Constitutional Law in Australia*, 2nd Ed, Butterworths 1996; *Strickland v Rocla, Concrete Pipes Ltd* (1971) 124 CLR 468.

Sydney Airport Corporation, which is yet to be privatised, is a declared company for the purposes of the PS Act.

The PS Act also gives the ACCC the power to monitor prices, costs and profits of a company/industry when so directed by the Minister. This monitoring power is currently restricted to:

- **Stevedoring –** In January 1999, the Treasurer directed the ACCC to monitor the prices, costs and profits of the container stevedoring companies in the major ports of Adelaide, Brisbane, Burnie, Fremantle, Melbourne and Sydney.
- **Airport services** – As part of the regulatory regime covering the newly privatised airports the ACCC collects information on costs, profits and prices of certain airport services which are not covered by the price cap but where airport operators could be expected to exert significant market power. In July 1998, the Treasurer also directed that monitoring be undertaken of a range of services at the Sydney (Kingsford Smith) Airport.

- **Milk** - In April 2000, the ACCC was directed to monitor the costs, prices and profits associated with the sale of leviable milk products. Monitoring is part of the dairy industry de-regulation package and is to commence in April 2000 and to occur for 6 months after the imposition of the levy on 7 July 2000.

The *Australian Postal Corporation Act, 1989* gives the Board of Australia Post the power to set and change all postal prices. However, price rises for the reserved services have to be notified under the PS Act and a recommendation made to the Minister. Air Services and the Sydney Airport Corporation have comparable pricing provisions. In the case of Telstra, the *Telstra Corporation Act 1991* imposes a range of price controls on Telstra and the ACCC has review powers only under specific telecommunication amendments to the Trade Practices Act (TPA).

Otherwise, pricing functions at the Federal level stem from various provisions under the TPA. With regard to gas and electricity, the ACCC's role in tariff determination is a consequence of the codes for these two industries that have been developed under Part IIIA. Generally, Part IIIA confers on the ACCC a range of pricing roles in the context of undertakings and arbitrations.

Most recently the ACCC has been provided with new temporary pricing regulation powers under Part VB of the TPA which prohibits price exploitation in relation to the New Tax System (NTS). The ACCC has produced and distributed guidelines that set out the circumstances when price exploitation can occur, that is when prices contravene section

75AU of the TPA. These powers relate to the transition period (8 July 1999 to 30 June 2002) and cease after that point**.**

Price determination at the State Level

As the Hilmer Review argues, firms with the greatest potential to engage in monopoly pricing are those protected by legislated monopolies. Many of these monopolies are State monopolies. The Hilmer Review acknowledged a number of reasons why a national price oversight mechanism would be advantageous. Against the advantages of a national market approach concerns were raised about the impact of national regulation on the revenue of the States and state specific community service obligations, as well as more general sovereignty issues.[15] As a result, the Hilmer Review recommended that State and Territory Governments should consider establishing independent and expert pricing bodies along the lines of the then NSW Government Pricing Tribunal.[16]

Post Hilmer, the NSW Tribunal has become the Independent Pricing and Regulatory Tribunal (IPART). IPART pricing powers relate to government monopoly services which are declared. Eight declarations are currently effective. For these services IPART conducts periodic reviews of pricing policies and determines maximum prices that the agencies must charge unless they have the Treasurer's approval to charge lower prices.

For gas and electricity, IPART regulates distribution and retail prices while the ACCC regulates transmission. The other States, in response to the restructuring and access arrangements in gas and electricity, have set up a range of independent regulatory bodies. The nature of these bodies varies between States. In South Australia and Western Australia there are separate regulatory bodies for gas regulation. The South Australian Independent Industry Regulator regulates distribution and retail prices for electricity and may acquire other regulatory functions. In Tasmania, a Government Prices Oversight Commissioner (GPOC) was set up to investigate the pricing practices of Government Business Enterprises (GBE's). However the responsibility for electricity prices is with the Tasmanian Electricity Regulator (part of GPOC), which is responsible for setting maximum prices for the sale and supply of electricity services including charges for generation, transmission, distribution and retail supply.

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[15] Hilmer op cit. Pp. 284-6.

[16] Hilmer op cit. P. 291

The pricing power and scope of these State bodies also varies. The Queensland Competition Authority (QCA) publishes recommendations about pricing practices but does not set prices. The Independent Pricing and Regulatory Commission in the ACT provides price directions for electricity, water and sewage services. In the case of Victoria, the Office of the Regulator General (ORG), has responsibility for overseeing rather than setting the initial price paths set by the Government on the sale of a number of their utilities (when these price paths have expired ORG will have the role of setting tariffs for gas and electricity distribution). ORG also monitors standards as well as oversees access issues.

However, in addition to these newly formed pricing bodies the State Governments exercise a range of other pricing powers. In Victoria for example, in addition to the ORG a number of other parts of the Victorian Government oversee prices. The Office of the Director of Public Transport regulates the franchise agreements for trains, trams and buses in Victoria. This includes the price cap adjustments for these services. The Department of Natural Resources under the *Water Industry Act 1994* and *Water Act 1989* regulates water prices in Victoria. The Victorian Taxi Directorate carries out regulatory functions relating to taxis, hire cars, and special purpose vehicles, although actual taxi hire rates are determined by the Secretary to the Department of Infrastructure. A Victorian Tow Truck Directorate regulates the licensing and operation of tow trucks and their drivers. This includes determining the amounts that may be charged by operators. The Victorian Government also has power under *the Fuel Regulation Act 1981*, to declare any fuel and then set the maximum price for that fuel although other pricing powers over agriculture goods no longer exist.

1.3 Conclusion

As can be seen from the brief history outlined above, price powers in Australia have evolved from an historical base which attributed a different role to the market than current economic thinking which emphasises the role that competition can play in the efficient allocation of resources. Pricing was seen as a social issue rather than a resource allocation issue. Also, pricing at the State level has had a separate path of development with different developments in the different States. Historically, State pricing policies for public sector enterprises have been outside both the PJT and the PS Act. State owned government utilities in Australia have been outside Federal oversight and until recent times outside any independent scrutiny of their pricing decisions. In this way, the Australian experience has been quite different from the American experience, which has a long tradition of independent scrutiny of utilities.

While independent regulatory bodies have been put in place in the States their roles differ between the States. Also, the States have a range of sectoral specific legislation administered outside these independent regulatory bodies, while other pricing powers rest with the Minister and/or the Minister's department. The States have access to legislation which, while currently not in use, could allow them to regulate (re-regulate) prices – for petroleum products for example.

The review of the PS Act as part of the legislative review process under the Competition Principles Agreement provides the opportunity for an assessment to be made of how the PS Act, reviewed by Hilmer and modified by the Competition Policy legislation, is currently operating. The argument of this submission, outlined in Chapters Two and Three, is that the PS Act is outdated and that it poses difficult procedural problems causing the ACCC to have significant concerns about the future administration of the PS Act unless the act is significantly modified.

In addition, the economy has changed as a result of the application of competition policy over the last five years. There has been a growth in national markets, privatisation has occurred in certain utility markets and the application of access provisions has brought about major structural changes in the economy. Considering the complex jigsaw of pricing provisions currently operating in Australia a new regulatory approach to pricing is required. These arguments are developed in chapter 4, which also sets out the broad principles which should underlie a new pricing regime to replace the PS Act.

CHAPTER 2: THE CHANGING ROLE OF THE PRICES SURVEILLANCE ACT .

2.1 Introduction

There have been three phases in the operation of the PS Act. The economic rationale for each of these phases is significantly different. However, throughout the period from 1983 to the present, the PS Act has only been subject to slight amendments, the most significant perhaps being the changes made with the Competition Reform Bill. Rather, while the PS Act itself has remained largely unchanged, the areas in the economy subject to either surveillance or monitoring have been drastically reduced. Also, the ACCC's *Draft Statement on the Regulatory Approach to Notifications*, distributed in 1998, attempts to use *administrative* procedures to update the operation of PS Act.

This indicates that the PS Act has been used flexibly. Indeed this has been one of the advantages of the legislation. However, there is now increasing evidence of an incompatibility between the PS Act's origins and the current operation of competition policy. There is a conflict between using the PS Act as a last resort facility, that is, for those limited parts of the economy where market discipline does not operate and where pro-competitive reforms are ineffective, and the PS Act's reliance on moral suasion and cooperative compliance. Acceptance of the ACCC's decision on a price notification is voluntary, the information gathering powers and penalties under the PS Act are slight and the PS Act indicates a short sharp process of price determination (for price increases) of 21 days (these issues are taken up in Chapter 3). Such provisions were important to the circumstances operating at the time of the inception of the PS Act, but are less appropriate when applied to that part of the economy that is least influenced by market discipline in 2000.

Over the last few years there has been increased concern about whether the PS Act can effectively deal with the type of pricing issues that the ACCC has to analyse in assessing pricing proposals by declared companies . The PS Act was developed to slow the rate of price rises in the economy generally, not as a regulatory instrument for either Government monopolies or for newly privatised Government infrastructure.

This chapter details how the economic rationale for Government's role in pricing has changed since the Prices Surveillance legislation was first introduced to Parliament. A separate

chapter (chapter Three) outlines the practical difficulties that the ACCC has had to encounter in administering the PS Act, and the adjustments that have been attempted.

2.2 Changes in the Economic Landscape

There have been three phases in the operation of the PS Act. The PS Act has operated as:

- the price restraint arm of the Prices and Incomes Accord (1983 to the late 1980's);
- part of an expanded micro-economic reform agenda (1989/90 to 1995); and
- as a last resort facility where other pro-competitive reforms cannot feasibly be used (1995 to 2000).

Phase 1 - Prices and Incomes Policy

The PS Act was passed in 1983 and the PSA was set up to administer the PS Act in 1984. The PS Act relied upon the Commonwealth's Corporations power and provided specific exemptions from goods and services supplied by the States.[17] The PS Act, and the PSA, were part of the Government's Prices and Incomes Policy, based on the Accord with the Australian Council of Trade Unions (ACTU) following the National Economic Summit in April 1983. The PSA was to use the PS Act to encourage price restraint as a counterpart to the wage restraint being exercised by wage and salary earners under the wage fixation principles established by the Australian Industrial Relations Commission.

Under the PS Act, the PSA received notices of proposed price increases from companies declared by the Treasurer. The criteria within the PS Act against which notifications for price increases were to be assessed reflect the alignment of the PS Act with the prices and incomes policy of the time. Subject to any directions under section 20, the PSA was to have particular regard to the following considerations section 17(3)):

(a) the need to maintain investment and employment, including the influence of profitability on investment and employment;

(b) the need to discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices; and

[17] Also exempt were bodies (other than an incorporated company) established for a public purpose under a law of a State and companies in which a State has a controlling interest.

(c) the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The two general section 20 directions are:

- The Government policy of generally not supporting price increases in excess of movements in unit cost (1985); and
- The Governments policy that increases in executive remuneration in excess of those conferred under wage fixing principles should generally not be accepted as a basis for price increases (1988).

Penalties under the PS Act relate to failure to comply with procedural requirements. Compliance with the PSA's decisions is voluntary. This voluntary compliance or reliance on moral suasion was consistent with the consensus approach on which prices and incomes policy was based.

When the PSA was established it subsumed the operations of the Petroleum Products Pricing Authority and the responsibility for the surveillance of petroleum product prices. In addition, it was immediately charged with surveillance over the main services provided by Telecom (in 1989 Austel assumed responsibility for this function) and Australia Post. The inclusion of Commonwealth Public Sector Enterprises within the scope of the PSA's operations was a feature of the legislation that made the PSA different from the PJT. State Authorities, however, continued to be outside the reach of the PS Act.

The focus of activity for the PS Act was upon areas of the economy where competition was perceived to be weak and where price and wage decisions would have more pervasive effects throughout the economy. However, the PS Act did not specify criteria for selecting goods or services or persons for surveillance.

In June 1986, following an address to the Nation calling for prices and incomes restraint, price surveillance was extended to breakfast cereals, biscuits, toothpaste, toilet soap, tampons, canned pet foods, cement and ready mixed concrete. In April 1987, jams, marmalade, chocolate and sugar confectionary, cordials, soft drinks and mineral waters produced by Cadbury Schweppes and Tarax drinks were added broadly reflecting trade union concerns that the coverage of the PS Act was too narrow.

During this initial period of the operation of the PS Act there were 63 companies in 23 industries declared under section 21 of the PS Act.[18] All the declared companies, with the exception of Australia Post and Telecom, were private sector companies, and the majority were in the final goods market.

Phase 2 - Micro economic reform Agenda

From 1989/90, the PSA area of activity increasingly expanded to that of micro-economic reform. A review of notifications commenced in 1990 and a number of declarations were revoked. With the achievement of low inflation and low wage growth the income restraint focus of the PSA was less relevant. With the micro-economic reform agenda, the emphasis moved to an equitable sharing of the fruits of reform.

Reforms in trade policy through the 1980's increased the exposure of the internationally traded goods sector to competition. However, many sectors of the economy, such as government businesses, remained sheltered from competition. It was realised that increasing competition and efficiency in these sectors required more sustained attention to the domestic constraints on competition.

In March 1991, the Government asked the PSA to review its likely role in price determination in the 1990's considering the move to a low inflation environment and the movement to a productivity based enterprise agreement of wage determination.[19] The PSA flagged its increasing role in the Government's micro economic reform agenda.

The PSA's involvement in micro economic reform has been described as taking four forms:

- Recommending the removal of barriers to competition on both the demand and supply side of the market following inquiries into the prices of books, records, computer software and credit cards.
- Monitoring the pricing effect of Government micro-economic reform including in the waterfront, shipping, airlines, childcare, textile clothing and footwear sectors.
- Promoting competitive pricing through prices surveillance by preventing firms from inflating prices and contracting output.

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[18] PSA , Annual Report 1987 88, pp 39-40

[19] A public report resulted from this review process PSA: *A Review of the Prices PSA's Role*, July 1991

- Promoting the reform of GBE's with inquiries into the FAC, the Australian Government Publishing Services and Australia Post.[20]

During this second phase, the inquiry function of the PS Act was more heavily utilised. Inquiries were used for a range of purposes. Both Australia Post and the newly declared FAC were subject to inquiries that looked closely at pricing and efficiency issues. There was some overlap in this type of inquiry role with the work of the Industry Commission (IC). The PSA argued that public inquiries played a role in promoting competition by placing structural reform and efficient pricing on the agenda of public policy.

A considerable amount of informal monitoring also occurred. However, there was no formal power within the PS Act for this monitoring.

From the 1990s the Australian economy moved to a low inflationary environment. There was a growing emphasis on competition policy in part influenced by the work of Michael Porter and the argument that an industry cannot be successful in world markets if it is uncompetitive domestically. An extensive program of tariff reductions had opened up the traded goods sector to competition. Increasingly it was realised that the non-traded goods sector had to be subject to reforms. If Australia was to compete in the international economy it needed an efficient non traded good sector to reduce input prices to business.

Competition policy was increasingly recognised as a key element of national economic policy culminating in the inquiry into national competition policy, following agreement by Australian Governments on the need for such a policy.

The essential argument of the Hilmer Review is that increased competition is the driver to increased efficiency. The first best method to improve an economy's performance is to increase the level of competition - that is, to look to ways in which the level of contestability can be increased. As price regulation does not solve the underlying problem, it can therefore be seen as a policy of last resort. The review also noted the costs of prices intervention.

The Hilmer Review argued that the application of prices oversight should be restricted by explicit legislative criteria and transparent and independent processes; that oversight should be limited to monitoring and surveillance; and that the basis for assessing prices should be confined to efficiency and competition considerations.

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[20] David Cousins: *The Role of the PSA in Micro-Economic Reform*, Paper prepared for the Office of EPAC, December 1993.

Prices oversight should be carefully targeted (which should not include political and social objectives), transparent, streamlined and should follow a flexible process. Price monitoring should be adopted as a less intrusive form of price oversight in carefully specified circumstances.

> ..... *firms should be subject to prices oversight in only limited circumstances defined by statutory criteria and after independent inquiry has investigated the market situation, alternative pro-competitive reforms and recommended that prices oversight is appropriate.*[21]

The criteria for price oversight recognised by the Hilmer Review were where a firm has a substantial degree of power in a substantial market.[22] Price oversight should only occur where the conditions for effective competition were lacking and where pro-competitive reforms (such as access provisions) were not feasible.

The Hilmer Review suggested a role for the National Competition Council (NCC) at the inquiry stage to recommend to the Minister when price oversight was appropriate. The NCC could also, as part of their inquiry, specify whether movements in firms costs, movements in the general price level or so-called "yard-stick" competition, should be used to assess the appropriateness of a firms proposed price increases.[23] Declarations were to lapse after three years unless renewed following an inquiry.

The review was critical of the criteria in the PS Act (section 17(1)(3) and the section 20 directions) against which price rises were to be assessed. The Committee suggested a principle that would be more appropriate:

> … *the promotion of long term economic efficiency, taking into account the desirability of fostering investment, innovation and productivity improvement, and the desirability of discouraging a person who has a substantial degree of power in a market from using that power to set prices above efficient levels.*[24]

The Hilmer Committee was not persuaded of the merits of price control. Price control was seen to be too intrusive. There should be a consistency with the strong stand against price fixing by firms [although amendments to the TPA in 1995 allowed price-fixing agreements to

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[21] Hilmer op.cit. p.273

[22] Ibid p. 274

[23] Ibid p. 279

[24] Ibid p. 279

be subject to authorisation]. To the maximum extent possible price determination should, it was argued, be made by individual firms rather than regulators or cartels.[25]

The voluntary compliance conditions of the PS Act had always been effective in the past and on the basis of this argument the Hilmer Review considered that voluntary compliance should continue. Nor did the review consider that the PS Act should have a more significant information gathering capability.

With regard to Government businesses, the review acknowledged that the firms with the greatest potential to engage in monopoly pricing were those owned by Commonwealth, State and Territory Governments. Again where pro-competitive reforms were not practical, some price oversight could be required. The new price oversight mechanisms advocated by the Hilmer Review were seen to be appropriate for those Commonwealth businesses like Australia Post and the FAC, already under the PS Act. Also, the application of a single national prices oversight process would be particularly desirable where a government business had a clear interstate dimension.

However, as has been set out earlier, rather than a single national body looking at pricing issues, the Hilmer Review also recommended that the States establish their own independent pricing bodies but with scope for national involvement. National involvement was either on the recommendation of the States or on advice from the NCC, having found that insufficient reform had been achieved by the owning government in an area that was likely to impact on interstate or overseas trade.

In response to the recommendation of the Hilmer Review that declarations under the existing PSA arrangements should lapse within two years, the Government asked the PSA in December 1993 to undertake a systematic two year public review of all declared goods and services (other than services provided by Australia Post, FAC and Air Services). The review covered 50 companies in 19 industries.

Guidelines for the PSA's review were published and the criteria for continued declaration were whether the declaration was in the public interest and the organisation subject to declaration had "substantial market power in substantial markets".[26] These criteria were taken from the Hilmer Review, although the PSA suggested that the criteria were little different from that which had been in operation. The public inquiries were divided into four groups with the first reports due by 2 October 1994.

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[25] Ibid p. 277

[26] PSA Guidelines for the PSA's Review of Declarations Under the PS Act 1983

In a press statement in November 1994 "New Directions in Pricing Policy" the Government announced their decision on the first group of reviews that had been completed by the PSA.

Specifically, in explaining the decision to maintain the declaration on cigarette companies and the two major beer companies the Assistant Treasurer argued that:

> *These are substantial consumer markets. Beer accounts for almost $10 of weekly household expenditure and cigarettes around $6.50 a week. I consider that there is sufficient concern about the prices of these products to retain their declared status.*

The press release also highlighted the expanded role for both formal monitoring (to be introduced into the PS Act with the Competition Reform Bill) and the existing practice of informal monitoring. Informal monitoring was to be extended to a wider selection of consumer goods with more focus being placed on services.

The Government's press release was issued more than 12 months after the completion of the Hilmer Review. The new pricing arrangements were in preparation for the new national competition regime. A review of declarations, a monitoring function within the PS Act, and a movement away from cost based pricing had all been flagged by the Hilmer Review. There was also agreement that the PS Act should not incorporate price control powers.

However, despite the seeming acceptance of the Hilmer Review recommendations, there was some disjuncture between the wide ranging role for pricing activities indicated in the press release and the conclusion of the Hilmer Review that price regulation is a policy of last resort. The criteria for determining which firms should be subject to surveillance implied that social as well as economic objectives were to be called upon.

With the industries in the second and third tranche of review, de-declaration was recommended and the monitoring was to be informal rather that formal. Of the reviews that had been completed by December 1995, only Monier concrete roof tiles and welded steel pipes were to be totally exempt from surveillance and formal and informal monitoring.

Substantive criticism of the criteria and methodology used in the review of declarations was made by the Industry Commission (IC) in their paper on the future of price surveillance in September 1994.[27] Generally the IC's argument was that the reviews had:

- used market definitions that were too focussed upon the domestic market;

[27] Industry Commission: What Future for Prices Surveillance Information Paper, AGPS, September 1994.

- the impact of concentrated markets on pricing was at best ambiguous; and
- barriers to entry had been overstated.

The IC also argued that prices surveillance had had a detrimental long-term effect on consumer choice and industry investment. There was concern that price oversight could impede innovation. There are steep information requirements if the regulator is to make a considered judgement. Compliance costs can subsequently be high.

Given these concerns the overall position of the IC was that prices oversight should be used sparingly and only when other pro-competitive reforms are inappropriate. On this basis the IC suggested that prices surveillance should be limited to settings where a single firm:

- has a greater than two-thirds market share: *and*
- has no major rival; *and*
- faces sporadic or trivial imports (import penetration persistently below 10 per cent of the market); *and*
- is sheltered by substantial barriers to entry (and expansion by rivals).

Using this type of criteria the IC suggested that of the then 19 declared industries only services provided by the Civil Aviation Authority (CAA) and FAC, harbour towage and postal services reserved to Australia Post would satisfy all proposed conditions for continued surveillance.[28] Later work by the IC added various glass products of ACI to this list.

The PSA was highly critical of a number of the Hilmer Review recommendations. However the debate about the appropriate role of pricing policy was to some extent finalised with the introduction of the Competition Policy Reform Bill into Parliament in early 1995.

The Bill was introduced to amend both the TPA and the PS Act. The second reading speech noted that the prices surveillance process would be streamlined. The criteria for those firms that were to be subject to surveillance was defined as:

> *…substantial market power in substantial markets where there is strong reason to believe firms will use their market power to increase prices.*[29]

The inquiry function was to involve studies of limited duration of matters relating to prices for the supply of particular goods or services. Monitoring was introduced which was to be "less intrusive and involve less administrative burden for business than prices surveillance". In

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[28] Ibid p.10

accordance with the limited conditions set out by the Hilmer Review, the NCC could recommend for declaration State and Territory Government businesses.

In addition to these amendments flagged in the second reading speech a number of other changes were made, many of them administrative changes suggested by the PSA, over a number of years. The PS Act was to specify a time period (12 months) after which a previous highest price would lapse. In areas where there had been extreme fluctuations in prices, a declared company had not been required to lodge a notification for a price increase until their previous maximum price had been exceeded. Often the previous maximum price might have little to do with the operating market conditions of the time.

To achieve greater transparency, the reasons for a decision on a price surveillance issue were to be made public. Some amendment was made to the information gathering powers of the PS Act. As the PS Act and TPA were to be administered by the same body, an amendment was made to the PS Act (section 32 (2A)), allowing an individual to refuse to supply information "on the ground that the information or production of the document might tend to incriminate the individual or to expose the individual to a penalty".

These changes were adjustments to the workings of the PS Act and certainly did not demonstrate a major re-think of the price surveillance function. The Hilmer Review recommendations were only partly taken on. Significantly, there was no change to the criteria in the PS Act (section 17(1)(3) and the section 20 directions) against which price rises were assessed, although the Hilmer Review was highly critical of these criteria which were seen as reflecting the social and political objectives associated with price restraint under the Accord. The Hilmer Review had argued that the basis for assessing prices should be confined to efficiency and competition considerations only.

Nor were explicit legislative criteria to determine the application of prices oversight introduced into the PS Act. The Hilmer Review argument for independent processes, with the ACCC (ACC) administering the surveillance function, and the NCC conducting inquiries and recommending to the Minister which firms should be under prices surveillance, was not adopted (except in the limited case of State Government Enterprises and then under very particular circumstances). The Hilmer Review also recommended that the NCC should, as part of their inquiry, specify whether movements in firms' costs, movements in the general

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[29] The Parliament of the Commonwealth of Australia, Senate -*Competition Policy Reform Bill 1995*, Second Reading Speech, p 8

price level or so - called "yard-stick" competition should be used to assess the appropriateness of a firm's proposed price increases.[30]

The TPC/PSA merger was to enable closer co-ordination of prices and competition policy with a better balance weighted towards competition.

Phase 3 - Last Resort Facility.

The TPC and PSA amalgamated in December 1995. At the time a broad proposed agenda of pricing work existed under the PS Act which had been modified but not fundamentally changed by the Competition Reform Act. However, with the Federal election in March 1996 the pricing agenda changed.

In September 1996, the Commonwealth Government announced "sweeping reform in the scope of prices surveillance activity undertaken by the Commonwealth Government".[31] While the PS Act would be retained it would only be applied to "those markets where competitive pressures are not sufficient to achieve efficient prices and protect consumers". Further, the reduction of price surveillance activity was consistent with the Government's policy of reducing compliance costs on business, allowing business to focus on its real purpose - "doing business, creating jobs and making the Australian economy more competitive".

The Government rescinded the decision to continue the declaration of beer and cigarettes, although with some undertakings from these companies for the first 12 months. Harbour towage and certain ACI products not subject to competition, 300 - 600ml food jars and wine bottles, were to have their declarations continued. A program for reducing Commonwealth oversight of petroleum products was announced and was later confirmed with the deregulation of the petrol industry planned for August 1998. Only ACI was to be subject to statutory monitoring.

After the Treasurer's press statement of September 1996, few private sector firms were subject to surveillance. Surveillance of the Air Services Australia (formerly CAA), FAC and postal services reserved to Australia Post continued. This outcome was similar to that proposed by the IC in 1994. The same firms/businesses were selected for surveillance with the exception of ACI. A later IC report recommended that certain ACI containers should be subject to surveillance.[32]

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[30] Ibid p. 279

[31] Treasurer's Press Release "Prices Surveillance Reform", 19 September 1996, reproduced in full in *ACCC Journal*, Issue No 5, October 1996, pp1 - 3.

[32] Industry Commission Report No 49 into Packaging and Labelling, February 1996

Price surveillance was to be confined to those markets where market discipline did not operate - actually or potentially. However, the sweeping reforms referred to in the press statement were with regard to the coverage of the PS Act and **not** to the PS Act itself.

Since the 1996 statement by the Treasurer there have been some changes to the declared firms. ACI and petrol have been de-declared, and both stevedoring and liquid milk is now subject to a monitoring program. (Chapter One, 1.2, provides a detailed account of those companies that are currently subject to the PS Act for either price surveillance or for price monitoring.)

The ACCC also substantially modified it own internal procedures connected with the notification process. The 1987 Guidelines were rescinded and the draft *Statement of Regulatory Approach to Price Notifications* (1998) issued by the ACCC updated the interpretation of Section 17(3) in light of the current economic environment. The Statement of Regulatory Approach suggested a more transparent procedure that would allow a greater role for users. It operates from the expectation that with additional information and comment from users, the information asymmetry with which the ACCC suffers would be diminished.

However, these procedural changes are outside the legislation. Increasingly procedural difficulties arise in administering the PS Act. The incompatibilities between the ACCC's current role in administering the PS Act, the intent of the PS Act and the administrative processes of the PS Act are discussed in the next chapter.

2.3 Conclusion

In this most recent phase of the operation of the PS Act, there are few declared firms and the firms which are declared are all monopolies in significant markets. The coverage of the PS Act is substantially less now than it has ever been before. The ACCC has also attempted to provide clear direction as to the procedures that it will adopt in assessing a notification. These procedures are in alignment with the transparent and consultative process required by other parts of the TPA. Nevertheless, there are increasing procedural and administrative difficulties in administering the PS Act. While the PS Act has proved to be a very flexible instrument, it was set up to meet a purpose quite different from that which is required in the current regulatory environment. This argument is taken up in the following chapter which outlines the procedural difficulties in administering the PS Act.

CHAPTER 3: ADMINISTRATION OF THE NOTIFICATION REGIME UNDER THE PRICES SURVEILLANCE ACT

3.1 Introduction

Increasingly there are difficulties in the administration of the notification regime under the PS Act. In general terms, it would appear that these difficulties with the PS Act are being accentuated by a growing conflict between the original context and objectives of the PS Act on the one hand, and the increasingly complex and adversarial nature of economic regulation on the other.

The relevant provisions of the PS Act

Pursuant to section 17(1)(a) of the PS Act one of the ACCC's functions under the PS Act is "to consider notices given to the Commission under paragraph 22(2)(a) and to take in relation to such notices such action in accordance with this Part [ie. Part III of the PS Act] as it considers appropriate".

Under section 22 of the PS Act, the ACCC has an implicit power to serve a notice on a person who has served a notice under section 22(2)(a) within 21 days[33] stating that it does not object to the proposed price or terms: section 22(2)(b)(ii). The effect of section 22(2)(b)(i) is that the notifying entity is not obliged to comply with any notice issued by the ACCC under section 22(b).

Sub-section 17(3) provides that "in exercising its powers and performing its functions under this Act, the ACCC shall, subject to any directions under section 20, have particular regard to:

(a) the need to maintain investment and employment, including the influence of profitability on investment and employment;

(b) the need to discourage a person who is in a position substantially to influence a market for goods or services from taking advantage of that power in setting prices; and

[33] Unless this period has been extended by the Commission pursuant to the procedure set out in section 22(6). This procedure requires the consent of the person who has given the notice.

(c) the need to discourage cost increases arising from increases in wages and changes in conditions of employment consistent with principles established by relevant industrial Tribunals."

Section 20 of the PS Act provides –

"The Minister may, by instrument in writing delivered to the Chairperson, direct the Commission to give special consideration, in exercising its powers and performing its functions under this Act, to the matter or matters specified in the instrument, and the Commission shall comply with such a direction".

It follows from both section 17(1) and section 23(2)(a)(iii) (requiring the ACCC to place on its public register a "statement of reasons for the outcome of the consideration by the Commission of the relevant notice") that the ACCC is both obliged and empowered to consider notices submitted to it under section 22(2)(a).

Apart from the provisions outlined above there are no other provisions in the PS Act prescribing how the ACCC is to exercise its functions under section 17(1)(a) and 22(2).

3.2 Voluntary compliance with ACCC's decisions under the PS Act

Under the PS Act a declared company must notify the ACCC of a price rise (if the proposed price is higher than the price level which has been operating for the previous twelve months). If a notification is not submitted to the ACCC, the PS Act has been breached and the declared company can be fined $1,000. However, while a declared company is required to observe the procedures of the PS Act, there is no obligation to comply with decisions made by the ACCC in response to price notifications. The Hilmer Review, in arguing for the continuation of voluntary compliance with the pricing decisions, states -

> *Moreover, firms have accepted all price recommendations of the PSA to date. In these circumstances, the Committee favours reliance on less intrusive powers unless and until serious compliance difficulties are encountered*.[34]

In fact this perfect record no longer holds. On 8 February 1998 Waratah Towage Pty Ltd (managed by Adsteam Marine and jointly owned by Adsteam Marine and Howard Smith Industries) increased charges for tug services by 15 per cent in Port Jackson. The ACCC had

[34] Hilmer op cit p.277

decided to object to the price increase, in part based on the difficulties it had in obtaining the necessary information from Adsteam Marine (discussed below).

In the current regulatory climate the ACCC would expect to experience increasing resistance to its decisions to object to a proposed price increase.

If price surveillance is a measure of last resort, to be applied according to the Treasurer to "those markets where competitive pressure are not sufficient to achieve efficient pricing and protect consumers", then a regime of voluntary compliance would seem to be an anomaly. Firms that are subject to the regime are often monopoly providers of a strategic services. An objection to a proposed price increase is likely to be based on a view that the proposed level of price increase was not warranted. This suggests that in a competitive market no such price increase would occur. Therefore a monopoly provider, by increasing prices regardless of an ACCC decision, is thus taking advantage of its monopoly power. Under the PS Act this behaviour is exempt from penalties.

The inquiry function is not an appropriate tool for compelling firms to comply with the ACCC's recommendations. This function under the PS Act is now rarely used. The ACCC's *draft Statement of Regulatory Approach to Price Notifications* was developed by the ACCC in part in response to the difficulties with the Waratah notification. Nevertheless declared companies are not required by law to follow the procedures set out in this document.

3.3 The ACCC's information gathering powers

The ACCC is very dependent upon the entity making the notification for the provision of information. The ACCC has taken steps to introduce more transparent procedures in relation to price notifications that allow for a greater role for users[35]. This has limited to some extent the ACCC's reliance on information from the regulated firm. Nevertheless, at the end of the day, much of the information required to consider a price notification must be provided by the firm. In this context, the ACCC's powers to gather information are not strong.

In particular, while section 32 enables the Chairperson to require a person to furnish information or produce documentation relevant to a notification, an inquiry or monitoring, the sanction for failure to comply is merely $1,000.

[35] See the Commission's draft *Statement of Regulatory Approach to Price Notifications,* February 1998.

The ACCC has experienced difficulties in obtaining information from some of the declared companies. The information provided to the ACCC regarding the Waratah harbour towage notification (26 June 1997) was inadequate and inconsistent. As a result the ACCC objected to the price increase. A second notification was subsequently lodged in September 1997. The ACCC again had difficulty in obtaining the data which it considered relevant for its decision. This was one of the reasons why the ACCC objected to the general price increase sought by Waratah.

A further limitation on the ACCC's powers is provided by paragraph 32(2)(a) of the PS Act, which provides that a person shall not "without reasonable excuse, refuse or fail to comply with a notice" issued by the ACCC under subsection 32(1). Subsection (2A) of the PS Act provides that:

> "*It is a reasonable excuse for the purposes of subsection (2) for an individual to refuse or fail to give information or produce a document on the ground that the information or production of the document might tend to incriminate the individual or to expose the individual to a penalty. This subsection does not limit what is a reasonable excuse for the purposes of subsection* (2)".

In the ACCC's view such a restriction on its powers to access relevant information has the potential to impede the effective administration of the regime. While it is recognised that some limitation must be placed on the scope of information gathering powers, it is submitted that paragraph (2A) goes further than is necessary to meet this concern. A more appropriate solution may be to require the ACCC to have reason to believe that a person may have information or a document that may assist the ACCC in the performance of its functions under the regime (see, for example, section 155 TPA and section 41 *Gas Pipelines Access Law*).

It should be noted that the PS Act appears to provide adequate protection for parties concerned about the disclosure of confidential information. Subsections 23(2A) and (2B) provide a mechanism for parties to ensure that confidential information that is disclosed to the ACCC is not publicly disclosed. This provision is broadly similar to provisions in the TP*t* and other legislation governing the ACCC.

3.4 Procedural difficulties

Requirement to assess price notifications within 21 days

Many notifications submitted to the ACCC under section 22 of the PS Act involve complex issues. In many cases resolution of these issues requires a process of public consultations. In such cases the requirement in section 21 to assess such notifications within 21 days is very difficult to achieve.

It is important to note that in general the nature of notifications has changed radically since the inception of the PS Act in 1983. Price notifications for infrastructure-based utilities are now likely to involve complex economic issues, to which there are likely to be differences in views as to the right answer. The outcome of the Commission's decisions in such cases can have significant economic and financial consequences for the firms involved. The Commission is often required to obtain expert economic advice from independent consultants before reaching a decision; this is very difficult to achieve within a 21 day time frame.

In complex cases, in order to satisfy the legislative constraints, the ACCC's approach is to receive a draft notification from the declared entity and to conduct its processes in relation to that draft. This involves the conduct of consultations with third parties, and the issuance of a draft decision. Once completed, the entity is requested to submit a notification for formal consideration under section 22, and a decision is normally made within 21 days. These are the ACCC's preferred administrative procedures. They are not legally binding upon the declared company. Some declared companies have shown considerable reluctance to provide the ACCC with additional time to assess notifications.

Possible regulatory action in response to notifications

The PS Act does not set out clearly the actions that the ACCC can take in response to a price notification. It also seems to limit the scope of possible responses beyond what may be necessary or desirable.

Upon receipt of a notification under section 22 of the PS Act, the ACCC may, pursuant to section 17(1)(a) of the PS Act, "take in relation to such notices such action in accordance with this Part as it considers appropriate".

Section 22 expressly refers to the ACCC either:

- not objecting to the proposed increase (section 22(2)(b)(ii)), or,
- not objecting to a price that is lower than the proposed price (section 22(2)(b)(iii)).

The Act does not expressly confer on the ACCC power to take any other action in relation to a notification. However it may fairly be implied from section 17(1)(a) that the ACCC has power to request or recommend to the Minister that he/she approve the holding by the ACCC of an inquiry (see also sections 18 and 19). It must also be implicit in the regime that the ACCC has power to decide to object to the proposed increase. It is unclear whether the ACCC is entitled to take any other action, such as to approve the proposed increase subject to conditions.

Even if the ACCC has such power, the effect of section 22(2)(a)(i) is that any decision to object or to approve subject to conditions will have no binding effect. In other words, with the exception of suggesting a lower price, the ACCC has no power to require that a proposed price increase should not be implemented or should be implemented at a particular time or a particular way.

Thus the PS Act potentially severely limits the scope of the ACCC's powers to frame a response to the notification that best ensures the fulfilment of the objectives of the Act in the particular circumstances of the case.

There are strong arguments why the ACCC should have a wider range or powers. Even where the Commission is prepared in principle to approve the proposed price increases, there may in certain cases be good reasons for approving them only if certain conditions are satisfied. This issue arose, for example, in relation to a 1999 Australia Post notification. The ACCC in its decision recommended that the proposed price increase be delayed. However, this recommendation could not be binding. After negotiation, Australia Post agreed to a limited delay.

3.5 Drafting of the PS Act and outdated notification assessment criteria.

The PS Act was drafted in 1983, prior to the introduction of the principle of "Plain English" drafting at the Commonwealth level. The PS Act would not be able to be read by an intelligent member of the community without significant professional legal guidance.

The criteria of the PS Act to assess notifications and the section 20 directions reflect the economic thinking and the political reality of a different era. In its draft *Statement of Regulatory Approach to Price Notificatio*ns the ACCC has attempted to provide a more contemporary interpretation of this criteria. The ACCC's interpretation is of course not binding. It would be more appropriate for the criteria to be updated, not by interpretation, but on a statutory basis.

3.6 Incentive Regulation

Over the years it has come to be recognised that there are a range of means of assessing prices which may include CPI-X or rate of return regulation. The PS Act is not well structured to enable these mechanisms to apply.

The notification procedure set out in section 22 of the PS Act applies only where a declared person proposes to increase the nominal price applicable to the supply of a good or service (s22(1)). Under a CPI-X price cap regime, it is possible (depending on the value of "X" and the CPI rate) that the entity subject to the regime will be required to reduce nominal prices over time. As a result, a notification regime applicable to price increases would seem in principle to provide an inappropriate mechanism for monitoring compliance with CPI-X price caps or other regimes in circumstances where it is intended to ensure that nominal prices decrease over time.

Particular difficulties arising from the administration of the airports price cap regime

It is generally recognised that the administration of the airports price cap regime under the PS Act raises a number of particular difficulties. These relate to a number of areas including the following –

- the tension between the mandatory character of the Treasurer's Direction No. 13 (dated 22 May 1998) and the scope of the ACCC's discretion under the PS Act; and
- inconsistencies between the activities necessary to implement and administer the specific nature of the price cap regime set out in the Direction, on the one hand, and the ACCC's powers in relation to price increase notifications under the PS Act on the other.

3.7 Conclusion

In this and the previous chapter we have set out the main reasons for the difficulties experienced in administering the PS Act in the current regulatory environment. In the ACCC's view the price oversight regime set out in the PS Act should be significantly amended. Amendments are required that will better enable the prices oversight functions to focus upon monopoly utilities.

CHAPTER 4: AN AMENDED PRICING REGIME

4.1 Introduction

Since the finalisation of the Hilmer Review in August 1993 many of the report's recommendations have been implemented and have changed the Australian commercial landscape. In particular, reforms have been carried out under the *Competition Principles Agreement*, the *Conduct Code Agreement* and the *Agreement to Implement the National Competition Policy and Related Reforms*, signed by the Prime Minister and the leaders of all State and Territory governments on April 11 1995. Federal and State legislation, such as the *Competition Policy Reform Act 1995*, has been passed modifying existing laws and introducing new laws to improve competition. The reforms have established access regimes for industries like electricity, gas and rail; increased the emphasis on corporatisation and competitive neutrality in GBEs; led to the restructuring of state infrastructure facilities and resulted in progress towards seamless national markets in electricity, rail and gas.

At the same time, structual reforms have resulted in the creation of a range of new regulatory authorities and laws that restrict business behaviour. There has been recognition that reform is not a spontaneous process and that when competition is introduced to a market, it is often desirable to carefully stage the reform. For example, movements towards contestable markets in the Victorian and New South Wales gas and electricity industries have involved staged deregulation. In particular, prices for certain customer classes have been regulated during the transition phase. Similarly, reforms in industries such as telecommunications have led to new price regulations for a variety of access services. Reforms have also created new arms-length price controls. For example, the privatisation of Australian airports has led to explicit controls on a variety of aeronautical services.

This chapter analyses the new economic role for prices oversight in Australia. Here it concludes that structual reforms have not eliminated the role of prices oversight, but rather the reforms have partially changed this role. With this changed role there is a keen recognition of the cost of regulation.

Pricing powers are a "last resort". They do not deal with the underlying problems of market power and therefore are a last resort where other pro-competitive reforms cannot be implemented. There is an extensive literature pointing to the inappropriateness of regulation

in many cases and the distortions that it can create.[36] Specifically pricing regulation is difficult. Price setting that is either too low or too high can either stifle innovation or reduce a firms incentive to increase efficiency. Price regulation can involve significant costs to the business if the business is required to meet complex information requirements. There is a risk that the regulated business could focus its energies upon gaming the regulator rather than improving its own efficiency or meeting consumer needs.

Nevertheless, the following chapter discusses circumstances where prices oversight powers may be appropriate to constrain excessive pricing and the consequent effects of excessive pricing.

4.2 Circumstances where prices oversight may be required

The Hilmer Review noted that there would still be an important role for price oversight even if all the pro-competitive reforms recommended by the report were accepted. The Review noted potential sources of excessive pricing – where there is either a legislated or a natural monopoly or where an industry is "poorly contestable, though largely unregulated".[37]

Even in an unregulated market, there is likely to be little competition in the final market for a good or service if :

- the minimum efficient scale of operation in the industry is large relative to demand; and
- there are significant sunk costs associated with entry into the industry or exit from the industry and there are no reasonable alternative sources of competitive supply.

If an industry is characterised by both significant economies and little contestability then there might be a role for prices oversight. The source of excessive pricing in these industries is technological rather than structural or legislative. Structural reform of the industry might help to isolate the problem of excessive pricing and may make it easier to deal with through either prices oversight or regulation.[38] However, structural reform will not eliminate the need for prices oversight, particularly if the relevant economies of scale and scope exist in the production of final goods and services. Such industries have technology that is incompatible with strong competition, so that prices oversight might provide a socially desirable form of government intervention.

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[36] Demsetz H : Why Regulate Utilities, *Journal of Law and Economics* (1968) 11, pp 55-65.

[37] Hilmer op cit. p.271

[38] For example, the Hilmer report supported the structural separation of natural monopoly and potentially competitive parts of monopoly enterprises. See chapter 12.

For some legislative monopolies, further reform to limit, dilute or remove their market power might be desirable. However, many of the current legislative monopolies have retained their positions because further reforms may not be practically possible.

If further competitive reform of a legislative monopoly is undesirable or unlikely, then some form of price oversight will be needed to avoid excessive pricing. The need for such oversight for relevant GBEs is likely to have risen rather than fallen since 1993. Many GBEs that have legislated market power, have been corporatised. Profit-related performance measures, such as the return on assets, are now used to evaluate the performance of these firms and their managers. If these firms retain the ability to set excessive prices, then one way to simply improve performance is to raise prices closer to a monopoly level. The increased incentives for price exploitation by GBEs created by corporatisation means that there is an increased role for prices oversight.

Access has been a key reform in many Australian infrastructure industries over the last decade. GBEs in electricity, gas, rail and other infrastructure industries have been restructured. Competition has been introduced in those parts of the industry that are likely to be contestable in the longer term. Where such competition is unlikely in one part of the vertical production chain due to economies of scale or scope, such as in electricity transmission and distribution, legislated rules of access have been introduced to prevent excessive pricing. In some cases, parts of the relevant industry have been privatised.

However, even if an access regime and vertical restructuring with appropriate access pricing rules does provide a solution to monopoly power upstream or downstream in vertical production chains in the longer term, in the short to medium term price oversight could be an important adjunct to reform. Most notably, this is the case during the transition to competition.

Another situation where on-going prices oversight is likely to be desirable despite successful access reforms, is where there exists a natural oligopoly either upstream or downstream of the essential facility. While transmission and distribution represent the obvious bottleneck facilities in electricity, there have been numerous studies in the UK indicating that significant market power remains in generation, despite the relevant reforms being more than a decade old.[39] While some of the problems of generation competition may reflect either inadequate

[39] Recent examples are Wolfram C (1998) Strategic bidding in multi-unit auction: an empirical analysis of bids to supply electricity in England and Wales" RAND *Journal of Economics*, 29, 703-725. Also Wolfram (1999) "Measuring duopoly power in the British electricity spot market" *American Economic Review*, 89, 805-826.

initial restructuring or pool market rules, it is also likely that market power reflects economies of scale in generation and the need for an independent system operator to govern the dispatch of electricity. If there is a natural monopoly or oligopoly either upstream or downstream of an essential facility, then an effective access regime will not eliminate the potential for excessive pricing. In such situations, prices oversight may be a useful and an important adjunct to access reforms.

4.2.1 Circumstances where prices monitoring may be particularly relevant

Realistically from time to time there are likely to be areas of the economy where there is considerable public concern about particular pricing outcomes. Government is likely to want to respond to these community concerns. In this situation a price oversight power is required that allows Government to respond. Price monitoring which requires the firm to provide specific cost, profit and price data at regular intervals can be used in the first instance.

In April 2000 the Government asked the ACCC to monitor the price of leviable milk (fresh milk and some other products) in response to the Government's reform package for the Dairy industry. This reform package will see the implementation of an 11 cent levy (to finance the Dairy industry restructure) on the final consumers prices at a time when there is expected to be a significant reduction in farm gate prices. The ACCC will monitor the changes which occur along the chain from farm gate prices to final consumer prices and provide this information in a monitoring report to the public.

The provision of such data to the regulator places a firm or industry's pricing decisions under public scrutiny. Information is provided to the public that can allow the public to form a better understanding of the workings of that particular market.

Of all areas of regulatory activity pricing has traditionally been the sphere where there has been most political involvement in selecting the areas of the economy to be regulated. Governments' have resisted suggestions of limiting their discretion in this respect, such as attempts in the 1980s to have the TPC provide an independent assessment of the goods/services or firms that should be declared under the PS Act and the Hilmer Committee's recommendations for the NCC to play this type of independent advisory role.

While in principle independent assessment is likely to be desirable, Government are likely to require a pricing power which allows them to respond with sufficient flexibility to community concerns.

4.2.2 Regulation at the Federal level

Most typically it will be public or privately owned utilities that can exercise pricing power and therefore need to be subject to some pricing regulation. As privatisation is increasingly occurring in the utility market there is an increased need for regulation that is arms-length or independent from Government. In the case of private sector companies regulation should be at the Federal level and not at the State level, State specific regulation could distort resource allocation within the private sector.

As State boundaries diminish in importance, both infrastructure and the utilities that provide the services generated by this infrastructure are increasingly operating in national markets. Regulation at the State level has the potential to thwart the growth of national markets which are essential for Australia's international competitiveness.

The States currently have in place an extensive range of regulations relating to pricing. Under community and political pressure these regulations can be used with the risk of segmenting the national market into separate State economies. To counteract this the Federal government needs to have pricing powers available to it which enable national application. These factors create a need for regulation that is independent and national.

4.3 An amended pricing regime

In the ACCC's view the prices oversight regime under the PS Act should be amended and should include the following elements

- ***The pricing powers should include provisions to regulate prices mainly in relation to monopolies***

In the case of price regulation, decisions should be court enforceable. The need for price regulation should be subject to review from time to time. These provisions do not relate to access pricing as such but the need for final price regulation. These pricing provision are an adjunct to access legislation and other pro-competitive reforms. Generally, these powers would be used in relation to markets of national significance.

Decisions about which monopolies and which businesses with significant market power should have their prices assessed would be made by the Treasurer, perhaps with the assistance of an independent review body. Specific legislative criteria would need to be developed to allow such a decision to be made in a transparent fashion.

- ***A monitoring function would also be required as part of these new pricing provisions***

Independent of price regulation, Government should be able to determine that certain entities or industries be subject to price monitoring. Monitoring is most likely to be appropriate for those areas of the economy where there is high market power and high community concern about public detriment. There is a need for the PS Act to contain some power upon reference by the Minister to allow public inquiries to be held in specific circumstances into some pricing areas where prices are a matter of high public concern.

In addition, the ACCC should continue to be able to make informal preliminary inquiries to make recommendations about when monitoring should be conducted. Currently the ACCC makes market inquiries and collects data from the public domain in response to consumer complaints. This information gathering amounts to a preliminary inquiry.

Monitoring should take place for a prescribed period and its continuance be subject to review by the relevant Minister.

- ***The new pricing provisions should be supported by appropriate procedural measures.***

A range of procedural reforms to the PS Act are required. These modified procedures should support the new focus of the PS Act – regulating prices for monopoly utilities. The regulator should have some discretion given the nature of the industry under consideration to choose an appropriate methodology for assessing prices. This should allow for incentive price regulation of which a CPI –X regime is but one example.

In addition the ACCC submits that this regime should include adequate information-gathering powers and reasonable time limits for the assessment of prices. A public consultation processes should be required for the assessment of prices. These procedures could reflect the procedures for authorisation of anti-competitive practices under Part VII of the TPA.

The new pricing provisions should allow the ACCC to consider, where appropriate, proposed price increases well in advance of their implementation.

In reaching a pricing decision the ACCC could specify some conditions of implementation. For example, an approval of a price increase could be made with the binding recommendation that the price increase is only made after a certain period of time.

4.4 Conclusion

The PS Act is the principal Commonwealth legislation regarding prices. While the PS Act itself has remained largely unchanged over this time, the areas in the economy subject to either surveillance or monitoring have been drastically reduced. This indicates that the PS Act has been used flexibly. However, there is now increasing evidence of an incompatibility between the PS Act's origins and the current operation of competition policy. Over the last few years there has been increased concern about whether the PS Act can effectively deal with the type of pricing issues that the ACCC has to analyse. The PS Act was developed to slow the rate of price rises in the economy generally, not as a regulatory instrument for either Government monopolies or for newly privatised Government infrastructure.

As the PS Act was designed for a quite different circumstance it now needs substantial revision. Its principal focus needs to be monopolies, mainly in the utility area and it needs to encompass a range of new procedural measures that will support this changed focus.

There is also a role for limited prices oversight power in some very specific circumstances where an industry is characterised by high market power and where the benefits exceed the costs and where there is no other appropriate policy measure that can be taken. Any such power should be circumscribed. Finally there is a need for the PS Act to contain some power upon reference to the Minister to allow some monitoring and even to hold Public Inquiries into some pricing areas where prices are a matter of high public concern.

APPENDIX I: CONFIDENTIAL APPENDIX