Supplementary Submission to the Productivity Commission

Review of the *Prices Surveillance Act 1983*

February 2001

1. Introduction

The Productivity Commission's Interim Report on the *Prices Surveillance Act* 1983 (PS Act) was released in October 2000. The Australian Competition and Consumer Commission (ACCC) understands that the Interim Report is an assessment of the preliminary issues while the draft report, which will be released early in 2001, will contain the Productivity Commission's draft recommendations. While the Interim Report is only an assessment of the preliminary issues further comment seems to be warranted:

- In the Productivity Commission's comments on both State based pricing legislation and industry specific regimes a number of references are made about the ambiguity of the Commonwealth powers over pricing. The ACCC would like to make supplementary submissions on this important issue.

- The Productivity Commission specifically invites comment on the issue *of the advantages and disadvantages of national (compared to state and territory) prices oversight regulation*. The ACCC has made clear it views on the issue of national regimes compared to state and territory prices oversight regulation in its initial submission. However, in this brief supplementary submission it would like to again restate these views.

- The ACCC would like to correct the Interim Report's seeming misunderstanding about the lack of transparency of the new post 1998 notification procedures and make some comment about the time involved in assessing notifications when such procedures are utilised.

- Finally, the Interim Report seems to suggest that the functions of the PS Act -price notifications, monitoring and inquiries – would be able to be performed elsewhere by government if the PS Act did not exist or if a generic prices surveillance regime was not to exist in the future. The ACCC would like to indicate some reservations that it has about this position.

Also, since the ACCC's submission on the PS Act was provided to the Productivity Commission the review of the national access regime has commenced. The supplementary submission sets out the ACCC's views on the relationship between Part IIIA and a reformed PS Act.

2. Background

The ACCC provided a submission to the Productivity Commission's review of the PS Act in June 2000. In this submission the ACCC argued that while the PS Act had been a flexible instrument in accommodating change there was now an incompatibility between the initial objectives of the PS Act and current needs. In addition there are now a number of procedural and administrative difficulties in administering the PS Act.

The submission provided a detailed explanation of these points and outlined in detail some of the procedural and administrative difficulties that the ACCC experienced with the PS Act.

The ACCC therefore recommended that the price oversight regime be amended. The amendment proposed by the ACCC is based upon some fundamental premises:

- pricing powers are a last resort policy when other pro-competitive reforms are not able to be used. In specific circumstance there may also be a role for pricing powers as an adjunct to access provisions or to other pro-competitive reforms.

- the focus of an amended PS Act should be upon regulating prices for facilities with monopoly characteristics.

3. ACCC's Response to Comments on the Productivity Commission's Interim report

3.1 Basis of Commonwealth's pricing powers

In its submission, the ACCC commented that it is "widely recognised that the Commonwealth has the power under the Constitution to create a prices oversight regime limited to the activities carried on by trading and financial corporations or in the course of interstate trade and commerce".

In the Interim Report the Productivity Commission expresses significant doubt about the Commonwealth's powers to regulate prices. It has stated that there "may have been some doubt about the constitutional power of the Commonwealth Government to control prices directly other than in war time, as referenda on this had been defeated in 1948 and 1973".

In the ACCC's view this statement greatly misstates the limitations of the Commonwealth's powers in relation to prices regulation. On the contrary, there is little doubt that the Commonwealth has extensive powers to regulate prices.

Its power to pass "prices" legislation derives from the plenary heads of power set out in section 51 of the Constitution.

On the basis of developments in the law since the early 1970s, it now seems clear that the Commonwealth has power to make laws with respect to the prices charged -

(a) by foreign corporations (section 51(xx) of the Constitution);

(b) by or to trading and financial corporations formed within the limits of the Commonwealth in so far as the regulation of prices is sufficiently related or incidental to the trading and financial activities of such corporations (section 51(xx) of the Constitution); and

(c) **by any person in the course of inter-state trade and commerce or in relation to matters incidental thereto (section 51(i) of the Constitution).**

In addition, the Commonwealth has power under the Constitution to enact regulation regulating prices in respect of postal, telegraphic, telephonic and other like services including radio, television and electronic communications (section 51(v)), and banking and insurance services other than those provided by State bodies (sections 51(xiii) and (xiv)).

On this basis, the ACCC would argue that the limitations of the Commonwealth's constitutional powers are insignificant. Because the overwhelming preponderance of economic activity in Australia is carried out by corporations, the Constitution supports the introduction by the Commonwealth of a legislative regime that allows valid and effective prices oversight in respect of all significant economic activities within Australia.

3.2 The advantages and disadvantages of national (compared to state and territory) prices oversight regulation.

This is the only issue in the Interim Report where the Productivity Commission calls for further comment. As the Interim Report notes the ACCC has made clear its position (ACCC submission page 39) .

> 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.
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> 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.
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> 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.

In juxtaposition to these views the Productivity Commission suggest that as the Commonwealth's constitutional power over prices is ambiguous there is less uncertainty as to the validity of state-based price control arrangements compared with any which may be introduced by the Commonwealth (Interim Report p. 63). However, as is suggested above, the ambiguity of the Commonwealth's pricing powers has been overstated.

Notably some of the industry submissions to the Productivity Review comment on the importance of national based regimes if national rather than state based markets are to develop.[1] **State regulation has been responsible for thwarting the development of national markets**.

The Interim Report also highlights a number of other concerns about the impact of a national regime compared to a state jurisdiction. These concerns include those originally raised by Hilmer -the possible revenue impact on states, the potential impact on community service obligations by state GBEs and more general issues about individual state sovereignty.

These are issues of considerable political sensitivity. However, these issues occur at a national level. In telecommunications, for example, due weight has to be given to community service obligations in pricing decisions. The rationale for reform, particularly for the reform of utility pricing, is to remove pricing decisions from the political domain and to allow pricing to be determined by economic criteria rather than by political and social considerations.

3.3 Transparency of new notification procedures

In the Interim Report comment is made about the new ACCC procedures (effective from 1998) for complex notifications. The procedure is modelled on the authorisation process and involves draft notifications and consultation with consumers and users before the 21 day time period specified in the PS Act for a decision commences.

The ACCC notes the Productivity Commission's conclusion that this creates the risk that decisions may appear to be made in a non-transparent manner, thereby lessening the accountability of the ACCC. Here the Productivity Commission's reasoning appears to be that while the official notice and decisions are on the public register there is no requirement that the documentation relating to the draft notification, draft decision and submission from interested parties be placed on the public register.

The ACCC's proceedings have been introduced in order to improve the lack of transparency and openness of the regime under the PS Act. Under the PS Act ,while the notice (of price increases but not the submissions supporting the notification) does have to be placed on the public register this does not occur until after the ACCC's decision has been made and the prescribed period (either 7 or 14 days) has elapsed. In contrast the new procedures require a much more public process, which enhances transparency and brings users more fully into the process.

In airport price notifications for example the most usual pattern has been to publish the draft proposals, call for submissions on the draft proposals, to widely distribute the draft decisions (they are routinely placed on the ACCC's website) and to then call for further submissions before the final decision is made.

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[1] Cement Industry Federation submission to the Productivity Commission review of the PS Act, p 5.

However, these types of processes designed to enhance transparency and to allow the ACCC to tap into community knowledge come at a cost. The cost is the time taken between the initial draft notification and the actual finalisation of a decision. If users and other industry views are to taken into account they must be given time to make a considered submission. The Interim report indicates that there were some concerns raised by airport owners about the time taken to make pricing decision. It is difficult to achieve a final decision in less than a four months turn –around time when an intensive consultative process is involved.

The context of introduction of these amended procedures must be understood. They were introduced to bring more transparency to the notification process under the PS Act as an interim measure until the PS Act was reviewed and amended. The ACCC initial submission detailed the procedural difficulties with the PS Act and argued that a range of procedural reforms are required. These modified procedures should support the new focus of the PS Act – regulating prices for monopoly utilities.[2]

3.4 Advantages of an established generic regime like the PS Act

There is a suggestion in the Interim Report that the functions of the PS Act -price notifications, monitoring and inquiries can be performed elsewhere by using alternative but already existing powers of government. Furthermore, some of the alternative ways of covering the PS Act functions have the additional advantage of overcoming deficiencies of the PS Act – industry specific pricing legislation could for example include stronger instruments for price control.

The Interim Report argues that monitoring can be done under Ministerial Directions outside the Act. The example used is the direction to monitor the Bass Strait Passenger Vehicle Equalisation Scheme by the Bureau of Transport Economics. Also the NCC and the ACCC can be directed to undertake monitoring and inquiries under their own enabling legislation. Parliamentary Committees at both Commonwealth and state and territory levels may undertake inquiries into pricing issues and may monitor prices. Monitoring can also be conducted by various industry bodies.

The ACCC does not agree with these arguments. The PS Act is used sparingly but it is used in a range of ways by Government. It is used actively – the monitoring directions for stevedoring and leviable milk products occurred in 1999 and 2000. It is also used by Government indirectly to encourage some industries to make a more robust attempt at self-regulation. From time to time there can be significant public dissatisfaction with the pricing policy of certain highly concentrated industries. Some explanation needs to be given to the public for what may seem to be aberrant pricing outcomes. Pricing legislation like the PS Act which contains a monitoring function that is prescribed within the legislation allows industry to be aware of the regime and therefore of the alternative to transparency about there own pricing outcomes.

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[2] ACCC: Submission to the Productivity Commission Review of the *Prices Surveillance Act 1983*, June 2000, p. 40.

While industry specific legislation and other Commonwealth powers can be used from time to time to cover those functions of the PS Act it is not clear that there is an efficiency gain in re-inventing these functions with each new piece of legislation. With the notification, monitoring and inquiry functions a range of procedural items - information collection powers , confidentiality, reporting procedures, penalties - have to be specified. There is likely to be some gain in attempting to get these procedures right in a generic model than to have them re-invented each time an industry pricing issue threatens to be subject to some type of government action.

The Productivity Commission suggests that the ACCC and National Competition Council could be directed to undertake monitoring and inquiries under their own enabling legislation. In the ACCC's view there are significant limitations to this approach. Most importantly, to conduct these activities the ACCC must have specific information gathering powers. The Trade Practices Act 1974 does not currently confer such powers on the ACCC with respect to such informal functions. Without adequate information gathering powers, the monitoring and inquiry function could not be adequately performed.

Finally, it is clear that Government has a preference to have the generic powers available to it in legislation like the PS Act. Nor is there evidence from the submissions by industry or the broader community to the Productivity Commission that these generic powers should be abolished. Given this, the onus is upon the Productivity Commission to clearly explain why this preference should not be available to the Federal Government.

4. Relationship between a reformed PS Act and Part IIIA

As argued by the ACCC's submission to the Productivity Commission's review of the National access regime[3] the economic theory underpinning economic regulation and the access regime is well documented. It broadly shows that under a range of circumstances effective competition will not be sustainable and some form of economic regulation is required.

In particular this is the case when there are:

"Essential" or "bottleneck" facilities - Where a service is a necessary input into the production of another service, and an alternative source of supply is not available then the service is described as a "bottleneck" or "essential" facility. Where the owner of the "essential facility" is vertically-integrated with potentially competitive activities in upstream or downstream the potential to charge monopoly prices may be combined with an incentive to inhibit competitors' access to the facility. Even the prospect of such behaviour may be sufficient to deter entry.[4]

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[3] ACCC: Submission to the Productivity Commission Review of the National Access Regime, December 2000. Pp54 –57.

[4] Independent Committee of Inquiry into a National Competition Policy (1993), *National Competition Policy* (F. G. Hilmer, Chairman), AGPS, Canberra, p.241

Network externalities - Network externalities arise when the value of a service to a customer is positively related to the number of users of the service. As an example, a telephone service is more valuable to a user if more people can be called using the service. Network externalities give rise to economies of scale on the demand side, with increased willingness to pay for the service as the number of users increases. They can act as a deterrent to entry in a similar way to economies of scale and scope.

Economies of scale and scope -Economies of scale arise when unit production costs fall as the scale of a firm's output increases. Economies of scope arise when the cost of a service declines as the number of services produced by the firm increases. These economies can be a barrier to entry in as much as that new entrant may face higher production costs than the incumbent. In the extreme case it is more efficient to have all of the output in a market produced by a single firm than multiple firms. This situation is described as a natural monopoly technology. In practice significant market power issues may also arise where the economies of scale and scope create barriers to entry and limit the number of firms that can viably operate in a market.

Lumpy and sunk investment - Lumpy and sunk investments may create barriers to entry and limit the scope for competitive conditions in a market. An investment is 'sunk' when its cannot be readily converted to another use. This means that a firm will incur substantial costs in exiting an industry which in turn increases the risks of entry. When an investment is also lumpy entry may give rise to substantial excess capacity relative to current demand. The combination can deter entry and be a source of market power.

Failure to address these types of market power issues can result in higher prices which can affect economic growth by affecting business input costs and the ability of businesses to compete in Australia and overseas. Ultimately artificially inflated prices will result in allocative inefficiency.

The national access regime combined with the other competition reforms provides a means of addressing the loss of economic efficiency that can arise from such outcomes. These major reforms have been put in place to promote competition in Australian markets. While full separation of the "essential facilities" parts of businesses from potentially competitive parts is seen to be the most preferred outcome it is recognised that this does not always occur. In addition, even where separation occurs additional measures can be required as there is still an access pricing issue:

> Where the owner of the "essential facility" is not competing in upstream or downstream markets, the owner of the facility will usually have little incentive to deny access, for maximising competition in vertically related markets maximises its own profits. Like other monopolists, however, the owner of the facility is able to use its monopoly position to charge higher prices and derive monopoly profits at the expense of consumers and economic efficiency.[5]

The national access regime largely followed recommendations in the Hilmer Review. However, 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

[5] Hilmer, pp. 240 – 241.

accepted. Specifically, there is a role for prices oversight where there is either a legislated or a natural monopoly in the final goods market or where an industry is "poorly contestable, though largely unregulated".[6] Structural reform will not eliminate the need for prices oversight 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.

There are also a range of other circumstances where price oversight might be required:

- 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.

- Price oversight might be appropriate during the transition to competition. 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.

- Price oversight might be appropriate as an adjunct to access reforms. On-going prices oversight is likely to be desirable despite successful access reforms, where there exists a natural oligopoly either upstream or downstream of the essential facility. 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.

- As the ACCC submission to the Review of the National Access Regime indicates problems have been identified with the negotiate-arbitrate model of access regulation.[7] While the current access regime goes some way to accommodating alternative to the negotiate-arbitrate model (price caps, tariff settings) one of a number of possible reforms would be to link the access regime to a (reformed) PS Act. The reformed PS Act would have to include court enforceable decisions rather than the current voluntary compliance provisions as well as mechanisms for achieving price reductions. In practical terms this link between Part IIIA and a reformed PS Act could mean that a declaration under Part IIIA could trigger prices oversight. The declaration criteria under Part IIIA would be used to determine whether a particular service should be subject to access while the PS Act jurisdiction would be over the actual pricing element. This could only be considered where service providers are vertically separated unless provisions are made available to address non-price terms and conditions of access. This again would be an example where the PS Act acted as an adjunct to access reform.

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[6] Hilmer op cit. p.271

[7] Op cit pp. 74-76

Also, 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 prices 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 or a public inquiry may be considered to be necessary. In these instances the PS Act has a role to play quite different to that provided by an access regime or by other structural reforms.

In general terms there is an independent role for the PS Act when other pro competitive reforms like access are not able to be implemented and in addition there is a role for an amended PS Act as an adjunct to access reform.

5. Conclusion

The PS Act is the principal Commonwealth legislation regarding prices. It 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. It now needs substantial revision. In its initial submission to this review the ACCC has provided a range of suggestion for these revisions. However, while the PS Act needs substantial revision the ACCC can see no reason for the abolition of the Act in its entirety.