Submission to Productivity Commission on

Draft Report of the

Review of the Prices Surveillance Act 1983

May 2001

1: Introduction

The Productivity Commission's (PC's) Draft Report on the *Review of the Prices Surveillance Act 1983* was released in March 2001. This report contains a draft proposal for amending the generic national prices oversight regime currently embodied in the Prices Surveillance Act. (PS Act). A summary of the PC's proposal is:

> The Prices Surveillance Act should be repealed. Instead a new section should be inserted in the Trade Practices Act for inquiries and prices monitoring in nationally significant market where there may be monopolistic pricing. This new section would be light handed in its application.

The Australian Competition and Consumer Commission (ACCC) welcomes the opportunity to comment on this proposal.

In formulating its proposal, the PC has relied heavily on theoretical economic arguments about the benefits and costs of price regulation. It has been persuaded particularly of the need to ensure that price regulation is not too onerous. This is based on the belief that the costs of price regulation often exceed the benefits. The ACCC is highly aware of the potential pitfalls of prices oversight and supports the PC's view that it should be a remedy of last resort. Given this, however, it is vital that a prices oversight regime has the appropriate characteristics to ensure that its implementation is likely to be effective. The ACCC's general impression of the PC's proposal is that it would make prices oversight difficult to implement and administer effectively. This would reduce the ability of prices oversight in the Australian context to realise the net benefits that an appropriately structured regime could deliver in certain circumstances.

The PC's proposal accords with much of the ACCC's submissions. However, some aspects of the proposal differ from the ACCC's preferred model. Those aspects reduce the ability of a generic national prices oversight regime to achieve appropriate regulatory outcomes.

The ACCC wishes to comment on the following aspects of the PC's proposal:

1. the proposal does not allow for a generic price regulation function;

2. the proposal provides limited scope for prices oversight of oligopolistic industries. While prices oversight is most likely to be appropriate where there is evidence of monopolistic pricing, it is possible that prices oversight might be justified in certain limited instances of oligopolistic pricing;

3. the effectiveness of the proposed monitoring.

The remainder of this submission will elaborate on the above points with particular reference to the ACCC's experience in administering and implementing the current PS Act. This experience is applied to an assessment of how effective the PC's proposal might be in practice in achieving the goals of prices oversight.

2. The need for a Generic Price Regulation Function

The PC's proposal does not include provision for a generic price regulation function. Instead, the PC proposes that in certain limited instances, price regulation could be implemented through industry-specific legislation or as part of an access regime.

The ACCC's June 2000 submission to the current review detailed the ACCC's reasons for supporting the need for a generic price regulation function. The ACCC's experience with the existing powers of the PS Act lead it to argue for a strengthening of those powers rather than the existing regime of voluntary compliance. While recognising that prices oversight is a remedy of last resort, that submission argued that prices oversight might be justified if:

1. the industry is characterised by both significant economies of scale and little contestability because the source of excessive prices is technological rather than structural or legislative;

2. the industry is a legislative monopoly and further reform is practically unlikely;

3. an access regime and vertical separation have addressed issues of monopoly power upstream or downstream of an essential facility over the longer term. However, in the short run prices oversight might be an adjunct to reform during the transition to competition;

4. a natural oligopoly exists upstream or downstream of an essential facility. An effective access regime would not eliminate the potential for excessive pricing in such circumstances.

The ACCC reiterates that the role of price regulation would be limited to very specific circumstances where the industry is characterised by high market power, the benefits of regulation exceed the costs, and where no other appropriate policy measures can be taken. It is envisaged that the focus of prices regulation would be principally on monopolies although there may be justification for its application to natural oligopolies in some limited instances where there was strong market power.

For price regulation to be effective there would need to be amendments to the current regime. These include:

- the introduction of legislative criteria for the imposition of prices oversight to ensure that it is applied in a consistent and transparent manner;

- discretion for the regulator to choose the most appropriate method for setting prices, including incentive based regulation;

- a reasonable time frame for assessing proposed prices and provision for public input to the process;

- the need for mandatory compliance with ACCC decisions which would be court enforceable;

- the need for regulation should be subject to review from time to time.

An effective price regulation regime, or a monitoring regime, must be supported by strong information gathering powers. The PC has argued that one of the potential causes of regulatory failure is information asymmetry between the regulator and the regulated firm. Such asymmetry can not be addressed if the regulator does not have power to compel relevant information to be provided.

The PC envisages that price regulation would be available to Government in limited circumstances following a public inquiry that recommends such regulation and the passage of industry-specific legislation. In certain circumstances industry-specific legislation could be more appropriate than a generic regime. However, this will not always be the case. It is not clear that there is anything to be gained in many instances from reinventing the regulation function that could be embodied in a generic national prices oversight regime. For example, a range of procedural items would need to be specified with each application, including information gathering powers, confidentiality requirements, reporting procedures and penalties for non-compliance. It would appear preferable to get these procedures right in a generic model. This would reduce administrative and legislative costs as well as ensuring transparency and consistency in the application of a prices oversight regime. A generic model can also be more flexible and adaptable than an industry specific regime.

The existence of a generic price regulation function, even if applied sparingly, may also act as an incentive for self regulation for some industries by providing a clear alternative if their own pricing is excessive or not transparent.

The PC has presented theoretical arguments about the potential for price regulation to have adverse consequences such as distorting price signals and investment. The PC also notes that time lags involved in making decisions under the PS Act are likely to involve costs on declared firms and that in recent times the notification process has tended to exceed the statutory period of 21 days specified in the Act. The PC concludes that the approval process has taken considerably longer to complete than was originally envisaged by Government (p.63).

The ACCC agrees with that general proposition. In particular, the ACCC submits that the existing statutory time frame needs to be amended to taken account of changes to the types of price notifications that are now received. Recent increases in the time taken to assess proposed prices under the PS Act relate primarily to the changing focus of prices oversight in the two decades or so since the PS Act was introduced. Initially, the Act was an instrument of the Government prices and incomes policy under the Accord with a focus on moderating inflation. Today, the role of prices oversight is as an instrument of competition policy. This changing focus means that the notifications submitted under s.22 of the PS Act are, in general, far more complex, than those submitted in the 1980s and early 1990s. The ACCC's pricing decisions can have significant economic and financial consequences for the firm and there are likely to be many views as to the appropriate prices.

Given this complexity, it is very difficult to reach a decision within the 21 day period. The ACCC has introduced administrative procedures to address this problem but these are not binding on declared firms.

The ACCC submitted previously, and is still of the view, that the existing prices oversight regime needs to be amended to include procedural reforms to support the new focus of prices oversight. These include reasonable time limits for the assessment of prices and a public consultation process during the assessment phase. The need for such reforms is demonstrated by the ACCC's recent experience with complex price notifications.

The ACCC is crucially aware of the potential for price regulation to have adverse consequences and has implemented procedures to minimise the likelihood of such distortions given the deficiencies of the existing PS Act. It is significant that despite the potential pitfalls of price regulation being widely discussed and understood, including by participants in this inquiry, there has been very little evidence presented to show that the theoretical distortions have actually occurred in practice. Given this, there is not a strong case for abolishing the generic prices regulation function. Rather there are grounds for amending and strengthening the generic pricing regime.

The PC's view that it is the *threat* of price regulation that induces firms not to abuse their market power is a strong argument for retaining a generic price regulation power. Such a power could be implemented easily if monitoring detected that firms are abusing their market power. The *Commerce Act 1986* (NZ) allows the Commerce Commission to recommend to the Minister that specific goods or services be subjected to price regulation in limited circumstances. The ACCC understands that this power is rarely used and expects that a similar power in the Australian regime would also be seldom invoked. However, the threat of its imposition would be a powerful incentive to firms not to abuse their price setting power. The ACCC considers that an existing generic regime provides a greater immediate threat than the PC's proposed model which only permits price regulation after a possibly lengthy parliamentary process. Under that model, the threat of price regulation is remote.

The ACCC submits that a generic price regulation function, with the characteristics outlined above and detailed in earlier ACCC submissions to this review, should be part of a national prices oversight regime.

3. Emphasis on Monopolistic Pricing

The PC's proposal is that prices oversight could only be applied by the relevant Minister after a public inquiry has recommended that such a policy is appropriate because it found evidence of monopolistic pricing. The Minister could initiate an inquiry only if the pricing issue is material to the Australian economy and prima facie evidence of monopolistic pricing exists.

This mechanism would reduce ministerial discretion to apply prices oversight. While not wishing to comment directly on the appropriateness of this, it is noted that the requirement for a public inquiry to be held prior to the imposition of prices oversight may not always be appropriate. This could occur in several circumstances: the first is where the Government requires a quick response to perceived excessive prices or price rises. This might occur, for instance, where moral suasion is insufficient to deter industries with substantial market power from charging excessive prices. The requirement for a public inquiry significantly increases the time required to implement prices oversight and reduces the potential deterrent effect of the threat of swift price

regulation action. The second instance is where a public inquiry may not add anything new to knowledge of the relevant industry. This might occur, for instance, where an industry is subject to deregulation. During the decision and implementation phases of deregulation it is likely that considerable information would have been gathered about the industry, including an assessment of whether participants in that industry may need to be subject to prices oversight. If this is the case, then the need to undergo a further public inquiry would simply add another layer of administrative cost to the deregulation phase.

The requirement that prima facie evidence of monopolistic pricing exists before a public inquiry can be initiated may be unduly restrictive in some circumstances. In particular, it may mean that some instances of inappropriate oligopolistic pricing behaviour may go unchecked. It also forces prices oversight to be backward looking with the focus on existing excessive prices. The requirement would make it difficult to monitor industries where it is possible that inefficient pricing may occur as a result of significant changes to industry structure or the regulatory environment. For instance, the PS Act has recently been applied to the dairy industry with the ACCC required to monitor price changes along the production chain from farm gate prices to final consumer prices in response to the Government's reform package for the industry. In this instance, there was no prima facie evidence of monopolistic pricing. However, given the structure of the industry, there were concerns that deregulation may not ultimately lead to lower prices for consumers. The application of generic prices oversight, even in its current state, has assisted the government to monitor the pricing outcome of reform and potentially to reduce the likelihood of more stringent regulation being reintroduced. Such monitoring exercises could potentially facilitate tacit collusion among oligopolistic participants. However, such *potential* costs need to be carefully balanced with the *known* benefits of increasing transparency and consumer information.

The PC has identified the types of evidence that may be prima facie evidence of inappropriate pricing (p.83). These include persistent excessive profits, evidence of excessive cost padding, a lack of new entry over time even though industry profits appear high and substantiated complaints from buyers that prices are inappropriate. The ACCC considers that this type of evidence may support a finding of inappropriate pricing. However, it will often only be available as a result of a public inquiry, not prior to it. The available preliminary evidence is likely to vary from industry to industry. A requirement for prima facie evidence of excessive pricing should not be so prescriptive or onerous such that the conditions required to initiate a public inquiry are seldom met.

4. The Proposed Monitoring Function

There is a continued need for a price monitoring function as part of a generic prices oversight regime. Several important aspects of the PC's proposal, however, are likely to reduce the effectiveness of such a regime. In particular:

- the absence of a strong information gathering power to support the monitoring regime;

- the requirement that monitoring can only be implemented following a public inquiry;

- the requirement that a body independent of the regulator be required to nominate the indicators to be monitored;

- the inability of the regulator to make determinations or recommendations using information gathered as part of the monitoring exercise; and

- the lack of a review process after the initial monitoring period has passed.

4.1 The absence of a strong information gathering power to support the monitoring regime

The ACCC submits that the effectiveness of a prices oversight regime is likely to be reduced if it is not backed by strong information gathering powers and a requirement for industries subject to monitoring to comply with information requests. The reasons for this view have been discussed in detail in the ACCC's earlier submissions. Generally, however, the argument that moral suasion is sufficient to ensure that industries comply with information gathering requests is no longer appropriate to the Australian context. Already, one firm has refused to comply with such a request and the ACCC has been virtually powerless to respond.

The PC considers that an information gathering power is unnecessarily onerous. However, the ACCC's view is that the regulator must be able to perform its functions as envisaged by Government. If the need for price monitoring has been established then by implication the benefits of regulation exceed the costs. If industries are able to circumvent the regime by refusing to cooperate, then a monitoring exercise would simply impose administrative costs on the regulator with no offsetting benefits to the economy.

The absence of an information gathering power for prices oversight in the proposed regime is especially significant given the potential overlap between the generic prices oversight regime and Parts IIIA, XIB and XIC of the Trade Practices Act. The PC has called for comment on the proposal for price monitoring under the generic prices oversight regime to be a substitute for declaration under an access regime in certain circumstances. The ACCC will comment on this proposal in detail in its submissions to the PC's concurrent reviews of the national access regime and telecommunications regulation. For this submission, it is sufficient to note that the price monitoring option under the current proposal is unlikely to be a good alternative to declaration.

4.2 The requirement that monitoring can only be implemented following a public inquiry.

This issue has been addressed above. To reiterate, the ACCC is of the view that this requirement may unnecessarily reduce the flexibility of the prices oversight regime.

4.3 The requirement that a body independent of the regulator be required to conduct the public inquiry, report its findings and nominate the indicators to be monitored

The underlying principal of this requirement is to separate the policy formulation and policy implementation processes to ensure the independence of the processes. However, this requirement in its entirety may not always result in the best regulatory outcome. In particular, the requirement for an independent body to nominate the indicators to be monitored may result in inappropriate indicators being selected if that body does not have expertise and experience in the implementation of prices oversight. Consequently, the effectiveness of the monitoring regime could be undermined.

The ACCC's experience is that a monitoring regime can be difficult to establish and often involves negotiation and discussion between the regulator and regulated firm(s) as to the types of information that are available and the usefulness of that information in achieving the goals of prices oversight. For instance, the generic and simple sounding 'prices, costs and profits' indicators can generate considerable debate about what is an appropriate price, cost and profit. The answer often varies from industry to industry. Sometimes it may be appropriate to monitor quality standards and the question arises as to the definition and measurement of quality.

Such issues can not easily be addressed by a public inquiry conducted by a body independent of the regulator. One reason is that the PC envisages that public inquiries will be of limited duration, generally no longer than 6 months. The ACCC's experience is that it would generally take at least that long to assess the competitiveness of the industry, let alone to consider the appropriate indicators to be monitored if prices oversight is warranted.

The regulator should have full responsibility for implementing the regulatory policy decision. The selection of appropriate indicators to be monitored is a task for regulatory implementation rather than regulatory policy. In addition, the ACCC has extensive experience with establishing prices oversight regimes, often in highly complex industries. The ongoing use of this experience will minimise the administrative costs of establishing the regime. It will also ensure that the appropriate indicators are monitored and reported on and assist with consistency of regulatory approach.

4.4 The inability of the regulator to make determinations or recommendations using information gathered as part of the monitoring exercise

The rationale for this aspect of the proposal is a desire to prevent price monitoring from becoming *de facto* price regulation. The ACCC considers that this possibility is remote and that the regulator must be able to comment on the information gathered as part of the monitoring exercise and to make recommendations where appropriate. The ability to comment would help the Government and the public to understand the information presented. The ability to make recommendations would provide an important feed-back mechanism for an ongoing assessment of the appropriateness of prices oversight.

Monitoring is most likely to be justified for those areas of the economy where there is high market power and high community concerns about public detriment.

The PC acknowledges that monitoring may have a role in easing public concerns about the exercise of market power in some industries. This is especially important where industries have been deregulated or privatised. Monitoring may help measure progress against the expected outcome of reform without unduly interfering in the market. However, the PC recognises that it is the threat of price regulation that acts as an incentive for firms not to abuse market power, rather than monitoring itself (p.45).

Given this understanding, it essential that the monitoring provisions enable the regulator to comment on the appropriateness of prices and in some instances to make recommendations to government. Otherwise, the threat of price regulation could be substantially reduced by weakening the feedback mechanism between monitoring and price regulation.

The ability of the regulator to comment on prices and to make recommendations where appropriate should be a fundamental component of the PC's proposal for a price monitoring regime to be an alternative to declaration under an access regime in some circumstances. Under that proposal monitoring could be introduced if the appropriate regulator considers that there might be scope for the essential facility to extract monopoly profits but that overall the market for the service showed signs of being contestable or if the facility owner is exercising or has the potential to exercise some market power but the regulator is uncertain whether the associated costs are sufficient to warrant declaration (p. 148 of Part IIIA Position Paper). Clearly, under either scenario the regulator is uncertain whether market power is likely to be misused. Therefore it is essential that a monitoring regime can establish if such abuse is occurring, and if so, recommend appropriate action. The ACCC considers that the power to compel participants to provide information and the ability to comment and, where appropriate, recommend further action, are basic characteristics of an effective monitoring regime.

4.5 The lack of a review process after the initial monitoring period has passed

The PC's prices oversight proposal is based on a so called 'best practice process for prices oversight'. This process is designed to improve policy formulation and implementation. The final step in the process is the implementation of prices oversight for a finite period of time.

The PC recognises that circumstances can change over time and that initial pricing problems may be rectified so that prices oversight is no longer justified. To facilitate the removal of unnecessary prices oversight, the PC envisages that the declaration would be automatically revoked at the end of the declaration period (p. 87).

Automatic revocation overlooks the alternative scenario that the initial pricing problem has not been rectified and that the potential for the abuse of price setting powers remains. This is likely to be the case if there are technological, structural or legislative barriers to competition. Given that prices oversight is to be applied as a last resort, where other pro-competitive options are not feasible, it is reasonable to expect that in a significant number of instances the initial pricing problem may persist. Consequently it is essential that a prices oversight regime contain a review process to assess the continued need for prices oversight at the expiry of the monitoring period.

5. Conclusions

The ACCC submits that a generic prices oversight regime is justified. It should contain price regulation, price monitoring and public inquiry functions. This view differs from the PC's draft proposal which excludes price regulation from the regime.

An effective prices oversight regime should have the following characteristics:

- legislative criteria for the imposition of prices oversight to ensure that is applied in a consistent and transparent manner;
- prices oversight of oligopolistic industries in certain circumstances;
- implementation of prices oversight without a prior public inquiry in certain circumstances to maintain flexibility and to minimise administration costs;
- full responsibility for the implementation of the regime by the regulator, including the selection of appropriate indicators and/or method for setting price, including incentive based regulation;
- a reasonable time frame for assessing proposed prices;
- provision for public input to the process to assist transparency;
- public comment by the regulator on the appropriateness of monitored prices and to allow the regulator to make recommendations where appropriate;
- mandatory compliance with the regime by regulated firms. The focus of prices oversight would be on monopolistic firms with market power. Such firms can afford to ignore voluntary prices oversight. Strong powers are needed to ensure such firms comply with the regime;
- review of continued need for prices oversight at the expiry of the monitoring period.