Queensland Competition Authority

Submission

Competition Policy Review

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FOREWORD

The Queensland Competition Authority (QCA) welcomes the opportunity to provide this submission to the Commonwealth's Competition Policy Review. The QCA is an independent statutory authority established to promote competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements. In 2012, that role was expanded to allow the QCA to be directed to investigate, and report on, any matter relating to competition, industry, productivity or best practice regulation; and review and report on existing legislation.

The Queensland Office of Best Practice Regulation (OBPR) was established within the QCA by the Queensland Government in 2012. OBPR is responsible for ensuring best practice regulation (including building the capability of departments to produce good quality regulatory impact analyses) as a key initiative of the Queensland Government's commitment to reduce red tape.

Finally, the QCA is responsible for investigating competitive neutrality complaints lodged against state and local government owned enterprises.

Given its multiple roles, the QCA has experience with many of the competition and productivity issues raised in the Competition Policy Review's 14 April 2014 Issues Paper.

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1 INTRODUCTION — COMPETITION POLICY PRINCIPLES

This competition review is timely as the Australian economy has changed significantly since the Hilmer review. Hilmer focussed on the ownership, provision and restructuring of government services (largely infrastructure) at a time of excess capacity. Reform was prompted, in part, by the need to lift the productivity of these services in support of trade exposed industries adjusting to trade liberalisation. The benefits of the original competition policy reforms are well documented (Productivity Commission 2005). However, the QCA agrees with the review team that the reform agenda needs to be reinvigorated as there are significant areas of unfinished business.

This submission addresses government policies that can encourage competition and productivity in the infrastructure sectors subject to QCA regulation: water, rail, ports and retail energy. In line with the QCA's role as the home of the Queensland Office of Best Practice Regulation (OBPR) and given experience with inquires conducted at the request of the Queensland Government, the submission offers views on the broader competition and productivity issues raised in the Issues Paper. As the QCA also has a role in investigating competitive neutrality complaints in Queensland, the submission offers views on that subject.

1.1 Objectives of the inquiry

The Issues Paper correctly recognises that a wide range of government polices impact competition. In other words, competition policy is much broader than competition law:

> *Competition policy reform is not just examining the laws that protect and encourage competitive behaviour in key markets—that is crucial—but also removing regulations and restrictions that may impede competition, as well as reforming government businesses and leveraging market-based benefits in goods and services provided by government. (p. 1)*

The issues Paper is also correct that encouraging competition can be essential to improving productivity (Box 1, p. 9). The emphasis on the broader issue of microeconomic reform is also important. Regulation at all levels of government needs to be tested by rigorous cost-benefit analysis to assure that net public benefits are achieved at the least possible cost. It is important to recognise that the presence of market failure alone does not justify regulation if the costs of regulation exceed the benefits.

1.2 Reform priorities

The Issues Paper asks the following key question:

> *What should be the priorities for a competition policy reform agenda to ensure that efficient businesses, large or small, can compete effectively and drive growth in productivity and living standards?*

The QCA suggests that a key priority for competition policy is for all Australian governments (Commonwealth, state and local) to recommit to the fundamental principle identified in the Issues Paper (Box 2, p. 11):

> *Legislation should not restrict competition unless it can be demonstrated that:*
>
> *(a) the benefits of the restriction to the community as a whole outweigh the costs, and*
>
> *(b) the objectives of the legislation can only be achieved by restricting competition.*

As noted in the Issues Paper, the term legislation 'includes Acts, enactments, ordinances or regulations'.

The requirement to assess the costs and benefits of restricting competition applies to both existing and new legislation. The original Competition Principles Agreement required periodic reviews of the stock of regulation. However, adverse impacts on competition resulting from the current stock of Commonwealth, state and territory legislation (broadly defined) are readily identifiable.

Specific examples of direct restrictions on competition include pharmacy ownership restrictions, taxi and hire car licensing policies, and regulations supporting a monopoly of property conveyancing by solicitors. The Productivity Commission and other public policy studies have demonstrated that many such restrictions on competition have a significant net social cost.[1]

A fresh review of the stock of legislation to identify and remove unnecessary restrictions on competition is essential. However, additional competition policy concerns discussed in the Issues Paper are also important to improving productivity. Significant efficiency and productivity improvements are likely to follow from:

- reducing red and green tape that delays or increases the cost of new development or expansion
- reform of occupational health and safety regulations to reduce cost burdens on business
- increased use of market-based mechanisms when regulation is necessary
- reducing competitive distortions from government subsidies and Community Service Obligations (CSOs)
- revising competitive neutrality requirements to make them more effective
- reforming the way monopoly infrastructure is regulated.

Additional potential priority reforms are discussed in the QCA's Final Report for the Queensland Government on Measuring and Reducing the Burden of Regulation (QCA 2013b).

Many government programs or policies may not restrict competition *per se*, but can distort the competitive process and reduce economic welfare. For example, industry subsidies and assistance schemes can distort competition and result in productivity-reducing waste. The QCA is investigating industry assistance programs in Queensland at the direction of the Queensland Government (see QCA 2014b). Another example is restrictions on retail trading hours, which can reduce economic efficiency by increasing retailer costs and reducing consumer choice.

Given the productivity challenges faced by Australians and the powerful boost to productivity that can be generated by microeconomic reform of all types, it is important to pursue reform across the full spectrum of issues raised in the Discussion Paper. These reforms will require:

- changes in government priorities
- devoting adequate resources to the reform process

[1] See Productivity Commission (1999) and (2011). Also see Centre for international Economics (2012), Wilkinson, W. (2000) and Ralph, J. (1979). Recommendation 19 of the Commonwealth Commission of Audit recommends 'opening up the pharmacy sector to competition, including through the deregulation of ownership and location rules'.

- institutional changes to provide governments with the incentive and ability to implement the appropriate balance between market and non-market solutions
- recognition that even as economy-wide productivity improves there will be individual winners and losers
- appropriate transition mechanisms to reflect individual and investor expectations based on prior government actions.

Summers (2014) describes the case for reform in these terms:

> *In areas ranging from local zoning laws to intellectual property protection, from financial regulation to energy subsidies, public policy now bestows great fortunes on those whose primary skill is working the political system rather than producing great products and services. There is a compelling case for policy measures to reduce profits from such rent-seeking activities...*

A renewed commitment to policies that promote economic efficiency rather than narrow interests will assist in the job of putting Australia back on the track to improved productivity.

2 RECOMMITING TO REDUCING REGULATIONS THAT RESTRICT COMPETITION AND REDUCE PRODUCTIVITY

Government can restrict competition by directly limiting the nature and number of firms allowed to compete. Indirect government impact on competition can take a number of forms. New entry, or the threat of new entry, can be deterred or delayed by burdensome regulatory approvals. Government assistance programs may entrench existing competitors to the disadvantage of entrants. Government supply of services at subsidised prices may crowd out more efficient private suppliers. Licensing, certification, and government imposed standards may advantage incumbents.

2.1 Direct legislative and regulatory barriers to entry

The Hilmer reforms made substantial progress in changing the way key monopoly infrastructure services are provided. Corporatisation and/or privatisation of government monopoly infrastructure businesses have produced documented productivity improvements. However, there are significant sectors in the economy where government restricts entry into potentially competitive markets.

As noted above, taxi licensing and pharmacy ownership restrictions place limits on the number of competitors. In Queensland, monopoly regional airline routes, limits on bottle shop licensing and the legal profession monopoly on property conveyancing are examples of government restrictions limiting entry. The results are likely to be higher prices, economic rents, or reduced consumer convenience. Previous studies and analyses have demonstrated that the costs of such restrictions exceed any claimed public benefits[2]. In many cases, the public benefits the restrictions are supposed to promote can be achieved by alternative, competition-friendly means.

Despite overwhelming evidence that competition would provide net public benefits, necessary reforms in these areas have for the most part failed to materialise. Perhaps one explanation for the persistence of these productivity-reducing policies is that investments in these market sectors have been made in reliance on the anticompetitive polices being maintained. In many cases the economic rents generated by the anticompetitive policies have been capitalised into the purchasing price paid by subsequent investors.

Fairness considerations may require phase-ins or transitions for opening markets to more competition. Temporary levies on products or services to compensate current owners may be considered if the future productivity benefits from more competition exceed the cost of a levy. For example, a 'Dairy Industry Adjustment Program' was used in deregulating milk marketing restrictions:

> *It was decided that a consumer levy was the fairest way to fund the Adjustment Program, given that consumers were considered the main beneficiaries of deregulation through lower retail prices and greater product choice. Funding for the Program was therefore provided through the Dairy Adjustment Levy (DAL), an 11 cent per litre levy imposed on the retail sale of drinking milk. This levy commenced on 8 July 2000 and was removed on 22 February 2009 when enough money had been collected to repay loans and borrowings associated with the Program (Australian Government 2014).*

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[2] See PC (2005) and Centre for international Economics (2012).

The relationship between fairness and achieving economic efficiency is discussed in the QCA's recent Statement of Regulatory Pricing Principles (2013a, pp. 20-30).

2.2 Regulatory barriers to entry and impediments to competition

Entry and competition in many markets may be limited by the indirect effects of laws or policies rather than on direct restrictions on entry. Regulations can create uncertainty and prevent market entry, resulting in reduced competition even in markets that are potentially structurally competitive.

The experience of Costco in entering the Brisbane market is an example. Costco's entry was delayed many years due to the need to overcome planning and zoning objections from incumbents. The Queensland Government had to intervene to stop legal proceedings against Costco's entry. Costco described the process of gaining approval after legal challenges by incumbent retailers as 'long and arduous' (Fraser, K., 2013).

The cost of regulatory compliance (including defending an application from objections made by incumbents) may deter some potential competitors from even attempting entry. In some cases these problems may be exacerbated by the need to comply with (possibly conflicting) requirements from more than one jurisdiction.

2.3 Regulation and productivity

Apart from direct and indirect competitive effects, unnecessary or poorly implemented regulation can be a significant drag on productivity. The Chamber of Commerce and Industry Queensland (CCIQ) has compiled case studies to demonstrate how red tape burdens raise cost and reduce the competitiveness of Queensland businesses. For example, one case study found that a Queensland horticultural business was subject to 117 separate acts, regulations and codes. Workplace health and safety rules accounted for some of the most significant compliance costs. Small business may be disproportionately affected by regulatory requirements as compliance may impose fixed costs that larger businesses may more easily absorb.

Performance of the retail sector provides an example of the role of government in reducing productivity. Restrictions on the products firms can provide and the hours they may trade limit opportunities for retailers to become more efficient (Productivity Commission, 2012).

The impact of regulation on market performance was considered in a recent QCA inquiry into the pricing of medical aids and devices. A basic finding of the report is that reducing regulatory barriers could improve retail competition and productivity generally, and thereby reduce the prices and increase the availability of medical aids and devices (see Box 1).

Box 1: QCA investigation of medical aids and equipment pricing

The QCA was asked by the Queensland Government to investigate disparities in prices paid for medical aids and devices between Australia and international markets (QCA 2013d). The investigation found that consumers in the United States and the United Kingdom often pay substantially less than Australians for many medical aids and equipment products. The price differences are such that it is often possible for Australian consumers to save money by ordering from overseas suppliers, paying the substantial delivery charges and wearing the risk of not having an Australian warranty.

The investigation did not uncover significant market power problems in the pricing of disability aids and equipment. Nevertheless, some wholesalers or retailers may have a degree of market power for certain types of products or in some geographic locations, particularly in regional areas where multiple competitors cannot be sustained.

Medical aids and devices red tape

Excessive red tape for medical aids suppliers does not appear to be a substantial factor in explaining price disparities in the disability aids and equipment business. However, suppliers are often required to meet multiple product safety and quality assurance requirements. For example, although Australian Standards are continuing to align with International Standards Organisation (ISO) standards, submissions suggest that further acceptance of overseas certification for a product rather than re-testing in Australia could reduce costs without putting people with disabilities at risk.

Enhancing retail productivity

A basic premise of the National Disability Income Scheme (NDIS) is that consumers with disability should be given more choice and control in decisions regarding their support needs. With or without the NDIS it is likely that a substantial portion of individuals with disabilities will be looking to retail outlets for disability aids and devices. The PC 2011 Report on retail pricing recommends a number of reforms for enhancing efficiency in retail markets, including reforms to the regulation of planning and zoning, retail trading hours, and workplace relations. Pharmacy deregulation can be added to this list.

The steps recommended by the PC to enhance general retail productivity, as well as other regulatory reforms relating to pharmacies and taxi licensing, would likely enhance the welfare of individuals who purchase medical aids and equipment.

The solution to these problems is a 'root and branch' review of regulation designed to identify unnecessary regulation or to replace existing regulations with less restrictive ones. In Queensland, the QCA proposed, and the government accepted, a plan to identify regulatory requirements in state legislation and establish targets for reduction. While some States have set similar reduction targets, Queensland appears to be the only State to have made its target meaningful by producing a definitive audit of its regulatory obligations with transparent public reporting. This approach has worked with some success in British Columbia (see QCA 2013b).

If government intervention is necessary, the burden of regulation on productivity and competition may be reduced by reforming regulatory designed and administration. Among the possible reforms are[3]:

- use of market based instruments to achieve regulatory objectives (e.g. cap and trade mechanisms)
- voluntary standards and disclosure and industry codes of conduct as an alternative to command and control regulation
- performance-based regulation to allow firms to find the most efficient technology to accomplish regulatory objectives rather than regulatory specification of how the outcomes are to be achieved
- consumer education and product disclosure to encourage socially desirable results without government restrictions on individual choice.

Water sector dam safety requirements provide an example of how market-based regulatory reform can improve productivity. The current regulations are based on risk-based processes where the nature of the risk is difficult to establish, rather than outcome-based regulations or risk-based regulations where the relationship between the risk and potential cost is more evident. This is demonstrated by the application of the Australian National Committee on Large Dams (ANCOLD) guidelines, which transfer significant, difficult-to-assess risks to the service provider. The result is a bias towards high-cost risk minimisation initiatives that must be paid for by users. Moreover, the cost of life estimates to be applied under this scheme differ from those used in other sectors and can distort budget priorities and allocations (increasing their cost). A similar example would be the previous Queensland government's use of prescriptive reliability standards for energy networks which deliver marginal improvements to reliability at, arguably, disproportionate cost.

A key lesson for the design of legislation and enforcement of regulation is that government solutions to address market failure are not cost-free and may not work as intended (government failure). Therefore, not every market failure justifies a government intervention. In some cases a regulatory response to a market failure may make it more difficult for entrants or existing firms to use new and better technologies to improve market performance.

2.4 Harmonisation

Harmonisation of regulation across jurisdictions may alleviate some of the regulatory burdens discussed above. However, harmonisation should not be an end in itself (Ergas, 2012). Harmonisation may increase the regulatory burden for certain jurisdictions and stakeholders without producing a net benefit. Moreover, differences between jurisdictions may be justified by genuine differences in circumstances. Premature harmonisation may prevent implementation and testing of alternative approaches.

The guiding principle should be to harmonise regulations only where net economic benefits can be shown. Duplicative and overlapping regulation across jurisdictions can generally be removed. However, harmonisation for the sake of conformity may not always be productive.

[3] The United States Government Office of Management and Budget (2011) discusses regulatory analysis and best practice regulation techniques.

The QCA recently questioned the relevance for Queensland to adopt national trade licensing reform (QCA 2014a). The reform proposed only piecemeal changes that did not justify the implementation costs. As discussed in the next section, comprehensive reform of trade licensing to reduce artificial barriers to the ability to provide trade services could provide substantial benefits.

Finally, harmonisation in practice does not always deliver the promised benefits. Box 2 describes how state by state variations to proposed harmonised customer protection rules in the energy sector can reduce the benefits of harmonisation.

Box 2: Implementation of the National Energy Customer Framework

The National Energy Customer Framework (NECF) is a national customer protection framework that will operate in place of customer protection frameworks in Queensland, New South Wales, the Australian Capital Territory, Victoria, Tasmania and South Australia. The NECF was developed to reduce regulatory compliance costs and promote competition by making it easier for retailers to operate across state borders.

So far, the NECF has commenced in all states, except Queensland and Victoria. No state has adopted the NECF without variations. While some variations may have been considered necessary to reflect the particular circumstances in that state, the higher costs of retailers complying with additional obligations and the potentially negative impacts on competition should be carefully considered against the benefits. Nevertheless, in this case partial harmonisation may be better than the status quo.

In some circumstances, pursuing amendments to the National Energy Retail Rules (that underpin the NECF) could possibly result in better outcomes, particularly because it would preserve the benefits of the national framework. The Australian Energy Market Commission (AEMC) is consulting on the first rule change request.

2.5 Licensing

The services sector is the largest sector of the Queensland and Australian economies. Therefore, a focus on liberalising overly restrictive licensing and self-regulation by various professions on a social net benefit test should be a priority. A recent study of professional licensing in the United States has demonstrated that the conflict of interest inherent in putting members of a profession in charge of establishing certification and licensing standards leads to the expected consumer welfare losses:

> *Licensing boards are largely dominated by active members of their respective industries who meet to agree on ways to limit the entry of new competitors. Some boards use their power to limit price competition or restrict the quantity of services available. (Edlin & Haw, 2014, pp. 1095-1096, citations omitted)*

There would appear to be restrictions in many sectors that prevent increased market entry. For example, in the health sector significant impediments exist to greater employment of nurse practitioners.

Humphries et al (2010) also explain the dynamics that may result in excessive licensing:

> *For the members of the occupation, obtaining licensing is generally the objective, because it imposes state sanctions on new entrants from within a state or for those moving in from another jurisdiction. For the administrators of the professional association, the resulting increase in responsibility and revenue from dues and continuing education usually results in an increase in pay. Moreover, most licensing provisions require continuing education classes for fees, which raise the revenue of the occupation association. Revenue of the occupation association increase*

> *in responsibility and revenue from dues and continuing education usually results in an increase in pay for leaders of the occupational association. (p. 3)*

Kleiner and Krueger (2013) investigate the impact of licensing on pay in the United States labour market. They draw a contrast between licensing and certification:

> *A major policy issue for the governmental regulation of occupations is the role for certification, which permits noncertified workers to perform the work but enables individuals to earn a title that signifies that they achieved certain requirements. Unlike licensing, for certification there are no restrictions other than titling for doing the relevant task for pay. (p. 188)*

Their finding is 'that licensing is associated with about 18% higher wages but that the effect of governmental certification on pay is much smaller' (p. 173). This suggests that if the risks are low and consumers are able to make informed decisions, governments should investigate replacing licensing schemes with certification, or even simple registration.

The Queensland Government (2014) recently investigated licensing in the construction industry. The construction industry is hampered by myriad restrictions on the tasks that a particular trade is allowed to perform. The intent may be to insure that critical safety related tasks are performed by individuals with the appropriate training. However, qualifications and eligibility requirements should be set at the right level – that is, no higher than necessary to maintain safety standards and protection for consumers. The Queensland Government (2014) recently undertook a series of building industry reforms in the *Water Supply Services Legislation Amendment Act* to cut red tape, including provisions that primary water meters do not have to be installed by licensed plumbers.

2.6 Standards and certification

Standard setting is a difficult area. Standards can facilitate competition and consumer protection. However, standards can stifle innovation and regulatory imposed standards can raise costs and increase entry barriers. Regulatory costs and competitive effects should be considered when governments set standards. Private standards should be subject to public and competition authority review. Finally, performance (outcomes) based standards are preferable to design or process standards that do not allow for optimisation when technology improves.

2.7 Improving economic regulation of monopolies

In those cases where natural monopoly over a significant piece of infrastructure justifies economic regulation, the challenge is to design regulatory tools that accomplish public interest objectives without imposing excessive burdens on the regulated firm. The building blocks form of economic regulation used by many Australian regulators can be intrusive to the regulated firm and costly for both the regulator and the firm. This form of regulation requires the collection and analysis of a great deal of operating and capital expense data.

The pure form of price cap regulation addresses this issue by focusing directly on the prices charged rather than the costs incurred. The problem is that, if competition does not develop, prices and costs can diverge substantially over time, requiring regulatory resets. The resets typically rely on the building blocks approach.

Other forms of incentive regulation that rely on penalty and reward mechanisms can address the information asymmetry between the regulator and the firm that leads to large information requests and the need to second guess business decisions. Yardstick competition, whereby prices are set based on the performance of benchmark firms is even less intrusive, but finding comparable firms on which to base the benchmarks can be problematic.

In the case of regulation of the water businesses of Southeast Queensland local governments, the Queensland Government has directed the QCA to develop a light-handed regulation approach (see Box 3). This approach recognises that although these businesses are now and will likely remain monopolies, they are managed by governments subject to performance evaluation – namely the electoral process.

Box 3: Light-handed regulation of retail water supply

The QCA has been directed to investigate and report on a long-term regulatory framework for the monopoly distribution and retail water and sewerage activities of the Southeast Queensland distributor-retailers. The direction requires that the form of prices oversight should minimise the administrative burden on the entities and facilitate a move to a more light-handed framework over time.

The QCA Draft Report on a long term regulatory framework for monitoring the performance of water retailers in south east Queensland (2014c) recommends an annual performance monitoring scheme. The QCA would monitor and report upon performance against a range of measures including prices, revenues, certain costs, recommended procedures and policies (including strategic investment and customer engagement practices), service quality standards and the application of appropriate pricing principles.

A prudent and efficient cost base would be established and annual efficiency targets would be set by reference to a CPI-X price cap. Further cost reviews would only be triggered by breaches of CPI-X and/or service quality performance targets.

3 GOVERNMENT-PROVIDED GOODS AND SERVICES AND COMPETITIVE NEUTRALITY

Privatisation of the remaining government owned infrastructure monopolies is being considered by the Commonwealth and state and territory governments. Contestability, which is a term used to refer to outsourcing government activities, is also being considered as a potentially more efficient way to deliver a broad array of government services.

Both privatisation and contestability must be subjected to a set of principles designed to deliver a result in the public interest. The purpose of these programs should be to increase labour and capital efficiency, provide improved levels of service at efficient prices and provide a substantial contribution to public sector finances. The overarching framework needed to implement privatisation of monopolies and contestability for government services must be designed and written to protect consumers and taxpayers.

3.1 Privatisation and contestability

Privatising government owned businesses and outsourcing government services to private firms can improve productivity. However, in the case of privatisation, while governments will seek to maximise the sale price, this should not be at the expense of promoting long-term competition and an efficient market structure. A framework is required to ensure that economic efficiency is the goal when privatising.

Contestability and privatisation decisions should be made within a framework that requires both a preference for solutions that allow for more competition and a requirement to carefully consider the efficiency implications of the contracts that are signed with suppliers.

Decisions with regard to privatisation and contestability need to be made transparently, with opportunity for informed debate. The same problems that make government a less than optimal supplier of services may result in less than optimal contracts between the government and private sector suppliers.

Ball (2014) describes problems with public-private partnerships in the United States. In general, contracts can be difficult to write and enforce. Large corporations agglomerate disparate activities in a hierarchical, command and control structure precisely to avoid problems with writing and enforcing contracts.

The decision to outsource the provision of government services may need to be accompanied with reviews of:

- the potential for competitive supply of services
- regulations that have restricted competition or have simply increased the costs of service delivery
- alternative ways to fund services – for example, rather than providing subsidies to the providers of services, provide funds/vouchers to the consumers who, by exercising choice, then impose the disciplines of efficiency and quality of outcomes on providers.

When unregulated government monopoly business enterprises are privatised, it will be necessary to ensure that the potential for declaration, as well as the means to avoid declaration in the private negotiation portion of the negotiate-arbitrate access model, are both well

understood. In this regard, it would be useful to eliminate 'double-jeopardy' by insulating firms from declaration under the Commonwealth scheme when an effective state scheme is in place.

Governments should consider whether the conditions of access to privatised infrastructure monopolies should be established as part of the privatisation process. To do so would have the benefit of reducing uncertainty for both the potential buyers and their future customers.

In the case of a privatisation of a monopoly infrastructure business where a diffused customer base would prevent effective negotiation over the prices and conditions of sale of the monopoly service, it is especially important that the appropriate regulatory framework is put in place at the outset (well before privatisation), or any existing framework be modified to fit the new circumstances. Monopolists seek to constrain capacity to create scarcity in order to earn monopoly profits. The current regime is weak as it does not realistically create the right balance between the rights and obligations of the facility owner and the power of the regulator to address the exercise of market power by the monopolist.

Finally, it is important to recognise that contestability for government services is not a magic bullet. Competition for the market may provide efficiency benefits where there is a natural monopoly. But where the underlying economics allows multiple competitors, competition is likely to provide a better result for consumers. Moreover, the benefits from competition for the market may fail to materialise after the first contract expires. The winner of the first competition enters the second round of bidding with substantial advantages of incumbency that may allow economic rents to be captured.

Governments are heavily involved in service delivery in health, education and many other services. Introduction of greater private sector service delivery (competition) and allowing current public service providers to compete wherever opportunities arise should promote cost-effective service delivery.

Service delivery by government agency dominated providers can result in little opposition to regulations that increase the costs of service delivery as costs are passed through. Entry costs for potential new entrants are also therefore unnecessarily higher. Regulations in these areas therefore require particular scrutiny.

Alternative models of providing services aimed at improving competitive outcomes (including international examples) should be investigated. For example, under the current public healthcare system, governments fund hospitals which then provide a level of service that meet their budgets. There is no competitive discipline in the public health system that would normally flow from consumers exercising greater choice of healthcare provider. An alternative model (e.g. the Netherlands) is based on governments funding individual consumers – who by exercising choice, then impose disciplines of efficiency and quality of outcomes on providers. However, due to unique characteristics of health markets (See Arrow 1963) these reforms require regulation to ensure that providers are not allowed to price discriminate against individual purchasers of medical services.

Education takes up a substantial portion of Australian government budgets and has been the subject of many reform efforts, including recently the Gonski reforms. Replacement of direct government provision of services with a system whereby schools compete with one another for students funded with government issued vouchers has long been discussed (see Friedman 1955). In this system parental choice rather than government departments channel education funding. The proposal has long been controversial, but has been implemented in some form in many countries, which provides an opportunity for comparative analysis. Böhlmark and Lindahl (2012) found that under the voucher system as implemented in Sweden:

> *...an increase in the share of independent-school students has caused an increase in average educational performance. This increase is evident for both short- and long-run measures and the estimates remain very similar if we control for changes in a number of demographic, family background and municipality-level characteristics. We also find that these positive effects are not driven by differential pre-reform trends in educational outcomes and that they are very robust to a number of other issues that might bias the estimates (such as grade inflation and the increased choice opportunities between public schools). Interestingly, it appears that the positive effects are primarily due to external effects (e.g., spill-over or competition effects) and not that independent-school students gain significantly more than public school students. We are also able to show that a higher share of independent-school students in the municipality has not generated increased school expenditures. Hence, our positive educational performance effects are interpretable as positive effects on school productivity. (p. 4)*

3.2 Community service obligations (CSOs)

If CSOs are required to ensure that services are delivered in some communities, the CSOs should be designed to allow competition. CSO's are often only applied to existing government service organisations, which allows them to lower their fixed costs when compared to other potential private sector competitors.

Governments need to think carefully about how they deliver CSOs. For example, as discussed below in section 3.4.2, the Government's choice to equalise electricity prices across Queensland requires a CSO. But the design of the current CSO mechanism unnecessarily restricts competition. The Queensland Government is addressing this issue.

3.3 Competitive neutrality

The QCA has responsibility for investigating certain competitive neutrality complaints against state owned enterprises and the significant business activities of local governments. There are significant constraints in both schemes. The current regime for state owned enterprises only applies to advantages from taxation, regulatory arrangements and cost of debt.

The scope for finding a competitive neutrality violation on the part of local governments is broader, but the QCA has no power to enforce its recommendations for addressing a violation. Local governments are free to reject the QCA's findings and recommendations. The Queensland Commission of Audit Report has recommended changes in the competitive neutrality provisions for state owned enterprises. The Queensland government is considering legislative changes to respond to these recommendations.

The importance of competitive neutrality has been highlighted recently by the emphasis the Queensland Commission of Audit Report gave to implementing contestability for many government services. Revisions to the definition of competitive neutrality and the guidelines for the application of the definition may therefore have to be considered, to ensure government services are made contestable on a competitively neutral basis.

The QCA recently conducted a competitive neutrality investigation into the role of a local council in the commercial waste recycling business. The local government's mandatory levy authority was used to charge an average recycling fee to all commercial ratepayers, effectively preventing independent waste recyclers from competing with the Council's designated contractor. The QCA's recommendations for implementing less restrictive options for achieving the environmental goals used to justify this policy were rejected by the Council. It is apparent that public findings of a violation are insufficient in some cases to force Council's to address the issues and thought must be given to adding enforcement power to the regime. Requiring at

least an opportunity for affected customers to provide the Council with views and alternatives before rejecting the QCA recommendations may have produced a different result.

In the case of non-significant business enterprises, defined by a revenue threshold, the QCA does not even have the power to make recommendations. The revenue thresholds may not be met on a council by council basis, but the impact could be significant if the same problems are recurring for the same types of businesses across the state. This is particularly problematic for small businesses that compete, or would like to compete, to provide services.

The QCA receives inquiries from the public regarding a variety of potential competitive neutrality violations by state and local government business units. However, when the potential complainants are advised of the constraints under which the QCA operates, most choose not to pursue the matter. As a result of these issues, the QCA has only investigated two competitive neutrality complaints since 2007.

Competitive neutrality is an effort to prevent government owned businesses from abusing their government status. However, at the end of the day, recommendations to address competitive neutrality violations require a form of economic regulation on the business units. A better solution may be for governments to leave business activities to the private sector wherever possible.

Finally, state or local governments involved in business activities should be subject to full compliance with *Competition and Consumer Act 2010* requirements. The ACCC may be reluctant to investigate complaints about anticompetitive conduct by government businesses if a competitive neutrality investigation, however unlikely to be successful in changing behaviour, is possible or if a local government attempts to justify its actions on public interest grounds, even though less competitively restrictive alternatives may be available.

3.4 Government participation in key sectors

The Issues Paper asks whether there is a need for further competition-related reform in infrastructure sectors such as water and energy.

3.4.1 Water

Most water businesses in Queensland remain under government ownership or control. The Council of Australian Governments' (COAG's) 1994 Water Reform Framework required states and territories to undertake reform, in the following areas, by 2001:

(a) pricing

(b) water allocation/entitlements

(c) trading in water allocations/entitlements

(d) institutional reform

(e) consultation and public education

(f) environment.

In 2004, the federal, state and territory governments signed onto an intergovernmental agreement on a national water initiative (NWI) that complements and extends the reform agenda in the following areas:

(a) water access entitlements and planning framework

(b) water markets and trading

(c) best practice water pricing

(d) integrated management of water for environmental and other public benefit outcomes

(e) water resource accounting

(f) urban water reform

(g) knowledge and capacity building

(h) community partnerships and adjustment.

Unfinished business in the water sector in Queensland remaining from COAG and the National Water Initiative includes: application of appropriate water pricing principles (including tariff structures) by less significant local government water service providers and water boards has not been addressed - independent economic regulation is constrained to significant service providers. The less significant service providers affect the competitiveness of regional-based industries and the cumulative effect of poor pricing policies in state budgets can be material.

Third party access markets in water are not well developed. Part of the impediment is that potential alternative service providers are required to seek access. Smaller potential entrants may find the cost of seeking access prohibitive. A more systematic opening of potential markets (regional by nature) through designated regimes may provide one means for addressing the impasse.

Other issues in water regulation include:

- full cost recovery has not been fully achieved
- pricing of externalities requires further consideration. New metering technology and peak period pricing could be considered
- the appropriate balance between burdensome water restrictions and scarcity pricing during droughts needs to be resolved
- water allocations in some small schemes are yet to be resolved, but this is underway
- trading in water (see Box 4) - some barriers remain (e.g. intersector trade)
- institutional reform - integrated catchment management principles not fully in place
- economic regulation not applied to all significant water businesses.

Box 4: Tradeable Water Rights

The development of tradeable water rights in Australia provides an example of how property rights can be assigned and markets developed to provide more efficient allocation of resources than would be possible with a pure administrative solution. The National Water Commission (2011, p. ix) points out that:

> *The development of efficient, flexible and sustainable approaches to allocating scarce and variable water resources between competing uses is . . . vital for continued economic and social development. Yet, in most countries, flexible market-oriented mechanisms play little or no role in allocating water. Water is often allocated based on political mandate or outdated administrative arrangements.*

This description applied to Australia in the early 1980s. However, water for irrigation uses was becoming increasingly scarce to due to growth and development of the economy. This led to government imposed limits on total usage. As a result:

> *...the only way existing or new users could gain access to more water to commence or expand their activities was by getting it from someone else who already held a licence. However, because water licences were tied to land, there were no readily available mechanisms to transfer water or licences from one user to another. Those wishing to secure more water were often forced to purchase the land to which a water licence was attached, incurring considerable costs and delays. (National Water Commission 2011, pp. ix-x)*

There was resistance to creating markets for water – a previously 'free' good. However, initial steps were taken to allow trading of water rights during the 1980s. At that time trading was limited to temporary sales and by geographic areas.

Reform packages in 1994 and 2004 expanded the coverage of water trading markets. The subsequent experience demonstrates that water markets are feasible and can deliver significant benefits relative to administrative solutions to water scarcity (National Water Commission 2011, p. 118).

A number of steps were taken by Commonwealth and state governments to facilitate market trading of water. For example, tradeable water access entitlements were given a secure statutory basis and governments began to publish information to assist traders in making decisions. Property rights were established and transactions costs were reduced. In particular, the Queensland Government provides water trading data to market participants and has established a set of business rules. (See Queensland Government Department of Environment and Resource Management, 2013). These measures are designed to allow the market to perform more efficiently.

3.4.2 Retail electricity competition in regional Queensland

Competition in Queensland's retail electricity markets has developed unevenly since the introduction of full retail competition in 2007. Competition has developed considerably in south-east Queensland, where customers can choose between many retailers offering a number of different products and it is likely to develop further with the expected deregulation of retail electricity prices by mid-2015.

However, the vast majority of customers in regional and rural areas do not have a choice of retailer and are supplied by the Government-owned retailer, Ergon Energy Queensland (EEQ). Competition is weak because of the subsidy arrangements underpinning the Queensland Government's uniform tariff policy (UTP). Under the UTP, regulated retail prices for most regional customers reflect the costs of supplying customers in the south-east of the state and

EEQ receives a subsidy to enable it to charge prices that are lower than costs. These arrangements effectively preclude the development of competition and entrench EEQ's monopoly position.

The Queensland Government is considering options to improve competition in regional areas, while maintaining a UTP. This includes an option of transferring the subsidy from Ergon Energy's retail business to its distribution business. This would provide all retailers with access to subsidised network charges and remove the key barrier to retail competition. However, subsidised network charges would continue to promote inefficient consumption and investment and may preclude the development of more cost-effective alternatives to network supply in certain circumstances. We recently provided advice to the Queensland Government on matters relating to the UTP and regional price regulation.

4 THE NATIONAL ACCESS REGIME

The national access regime deals with the problem of vertical integration as it has the duel objective of ensuring the efficient operation of a monopoly (like) service with the effect of encouraging efficient competition in other markets.

The underlying purpose of an access regime should be to improve economic efficiency. The Pilbara Case private profitability test is inconsistent with this goal. The natural monopoly test and the Productivity Commission's market-based approach are superior to the existing private profitability test.

The national and the Queensland access regimes constrain the regulator's ability to require a facility owner to expand or extend a facility. This was not an issue at the time of the Hilmer reforms given substantial excess capacity in government infrastructure businesses. In today's capacity constrained environment, at least in rail in Queensland, a way must be found to ensure that dependent customers of monopoly providers are able to gain access to the capacity they need to justify investment and expansion of their own businesses.

4.1 The national access regime

The national access regime and Queensland access regime both originated from the Competition Principles Agreement signed by all jurisdictions in 1995. Those arrangements provided for access to the services of essential infrastructure to be regulated either through:

(a) the national regime embodied in Part IIIA of the *Competition and Consumer Act 2010* (CCA)

(b) a state-based regime (e.g. Part 5 of the *Queensland Competition Authority Act 1997* – QCA Act)

Relevantly, the objectives of both Part 5 of the QCA Act and Part IIIA of the CCA are broadly similar and focus on:

(a) promoting the economically efficient operation of, use of, and investment in, significant infrastructure by which services are provided

(b) with the effect of (thereby) promoting effective competition in upstream and downstream markets.

There is a particular elegance in the way these arrangements have developed and have been enacted.

Part IIIA is inextricably linked to Part IV of the CCA through the Queensland Wire Industries v BHP case. The Competition Principles Agreement then links the national access regime to the state based access regimes (e.g. Part 5 of the QCA Act).

It is essential to maintain this consistency in the way access principles can, and should, be implemented, tested and interpreted – whether that be through Part IIIA or IV of the CCA, Part 5 of the QCA Act or any other similar state based legislation.

The QCA's concerns with aspects of the national regime were raised with the Productivity Commission (PC) in submissions to the National Access Regime Inquiry. The QCA commented on two specific aspects of the PC report:

(a) the uneconomic to duplicate criterion in Part IIIA of the CCA

(b) expansions of regulated facilities.

As explained below, the QCA believes the PC Inquiry recommendations for the proper criterion to apply for Part IIIA of the CCA is superior to the existing interpretation of this criterion by the Court. However, the QCA does not support the PC's position of no change to the legal standards for requiring the expansion of facilities as the hurdle to satisfy before a facility can be expanded is unacceptably high.

4.2 Uneconomic to duplicate criterion

The High Court has changed the interpretation of the uneconomic to duplicate criterion for declaration in Part IIIA of the CCA from a test that considered whether the service was supplied by a natural monopoly, such that it was uneconomic from a society's perspective for the facility providing the service to be duplicated.

The new test considers whether it would be uneconomic for anyone to develop an alternative facility on the basis of whether it is privately profitable (i.e. economically feasible) for another firm to develop a separate facility.

4.2.1 QCA is bound by private profitability test

The QCA believes it would be obliged to follow the High Court's interpretation of the uneconomic to duplicate criterion as the provisions in Part IIIA of the CCA and Part 5 of the QCA Act are similar and both stem from the same source – the National Competition Policy reforms and the Competition Principles Agreement.

As a result, the QCA could not recommend, and the relevant Queensland Minister could not decide, to declare a facility where, *inter alia*, it would be profitable for another party to build a duplicate, albeit potentially wasteful, facility rather than either accessing spare capacity at an existing facility or requiring expansion of such a facility.

4.2.2 But the test does not promote economic efficiency

The QCA does not support the private profitability test as it is not consistent with general economic principles – that is, it does not address the problem of the monopoly. It would also seem that the private profitability test is not consistent with the objects of either Part IIIA of the CCA or Part 5 of the QCA Act, both of which are to promote the economically efficient operation of, and investment in, significant infrastructure and increase competition.

The underlying purpose of an access regime should be to improve economic efficiency by improving the allocation of resources. This is consistent with linking the concept of economic efficiency to whether the infrastructure in question is a natural monopoly, meaning that it may be cheaper to provide access to an existing facility rather than duplicating it.

Better utilisation of existing facilities can improve productivity. Productivity growth is one of the key ways in which the living standards of Australians can be improved and in which the competitiveness of Australian industries can be maintained; in particular in the context of a historically and persistently high Australian dollar.

4.2.3 Implications of the High Court decision on criterion (b)for State and Territory regimes

The private profitability test is likely to have substantial implications for both new declarations for access and revocations of existing declarations for access in Queensland.

Harder to get access

The test substantially raises the hurdle for a third party to satisfy before access is granted. To require third party access now requires a showing that it would not be privately profitable for a third party to construct a duplicate facility. There could be any number of circumstances where it could be privately profitable for a party to duplicate a facility but it would be far less expensive to expand an existing facility. Relevantly, this may change with market conditions, creating uncertainty for all parties as to when a facility may potentially be declared.

The private profitability test has implications for potential third party access to a range of current and planned infrastructure projects in Queensland, including those related to rail and export terminal infrastructure. It will now be easier for a facility owner to argue that they should not be required to provide third party access on the basis that it is privately profitable for a competing party to develop duplicate infrastructure. However, the development of multiple and duplicate pieces of infrastructure are likely to impact on the development costs of an access seeker and significantly affect the investment decisions of small miners who may not have the resources to fund the development of mine supporting infrastructure (like railway lines or terminals) themselves.

The unnecessary duplication of facilities is likely to increase the cost of developing new mines which may have long term impacts on economic activity and employment in Queensland more generally.

Unnecessary duplication of infrastructure may also cause environment or social dislocation costs. These may include unnecessary clearing of land, approvals of rail line easements, noise pollution, land resumptions, water flows and run-off.

Easier to revoke access

As the criteria for declaration apply equally to removal of declaration, the High Court's decision also means declaration may be revoked where it is privately profitable to duplicate infrastructure that provides a declared service.

Given this, the QCA may also receive revocation applications for the facilities, or parts of the facilities that are declared under Part 5 of the QCA Act; namely, the intra-state rail network operated by Queensland Rail, the central Queensland coal network operated by Aurizon Network and the coal handling services at the Dalrymple Bay Coal Terminal (DBCT).

Each of these facilities are common user facilities catering for a number of train operators and the whole range of mining customers, from the relatively small to large. In the recent past, when the coal market was more buoyant, a number of new facilities (i.e. additional coal terminals and duplicated tracks) were being planned.

It would then be open for the declared service provider to argue that, as it may be privately profitable to develop a competing facility, it is therefore not uneconomic to duplicate the infrastructure that provides the declared service - i.e. revocation of declaration should occur.

However, the new facilities were likely to be for either a relatively small number of dedicated customers or a single mining company vertically integrating its operations into the transport chain. Under these circumstances, it is difficult to envisage how facility on facility competition could occur as many of the existing users of the rail infrastructure and of DBCT would have no other choice than to agree terms with their existing facility operator.

Revocation of an existing declaration might mean significant dislocation to the activities of the train operators and parts of the coal industry when it came time to renew access agreements.

Demonstrating private profitability through business cases can create issues

Relevantly, satisfaction of the private profitability test is not limited to potential access seekers, but can also include the incumbent operator. This could potentially enable an incumbent infrastructure owner to develop a business case contending that it is privately profitable for it to duplicate the existing facility that it owns. It is also conceivable that the business case could incorporate the monopoly rents that the access holder would be likely to achieve from revocation.

Investments made on the basis of access on reasonable terms now compromised

Both Aurizon Network's rail network and the DBCT facility were privatised (via a long term lease) on the basis that an effective access regime would apply following privatisation. Many coal miners in Queensland have made significant investments on the basis that they would continue to receive access, on reasonable terms, to former government owned infrastructure facilities. The revocation of declaration, particularly to the service provided by aspects of Aurizon Network's infrastructure, would mean these miners would have no choice but to negotiate with a monopolist (i.e. be price takers), with the alternative being the potential stranding of these mine assets.

Such an outcome would clearly be against the intent of Part IIIA of the CCA, Part 5 of the QCA Act and the Competition Principles Agreement. More particularly, it is hard to believe that this should be the purpose of the National Access Regime going forward.

To address this problem, the QCA considers that the relevant test for criterion (b) should focus on economic efficiency and increasing competition. Therefore, in its submission to the PC, the QCA supported the monopoly test as it satisfies this requirement by considering whether access can be provided at lower cost at a single facility (or an expanded facility), rather than through duplication of an existing natural monopoly facility.

4.2.4 PC conclusions on criterion (b)

The PC's final report recommends a modification of the 'natural monopoly test' be applied as the relevant test for the 'uneconomic to duplicate' declaration criterion.

PC's market-based approach is based on a natural monopoly test but also considers substitute services

The PC's modified natural monopoly test (the "market-based approach") continues to focus on an assessment of the costs of providing the relevant infrastructure service, in a manner similar to the natural monopoly test.

However, under the PC's market-based approach, the relevant test now is whether a facility can meet total foreseeable *market* demand for the infrastructure service — *including the demand for any substitute services provided by facilities serving that market* — at least cost. The PC considers that this test reduces the risk of regulatory error under a natural monopoly test

where a facility could satisfy the test but still face effective facilities-based competition in the absence of access regulation.

The PC has also recommended that costs of co-ordinating multiple users of the infrastructure facility be taken into account when determining whether the uneconomic to duplicate criterion is satisfied. Previously, these costs (including costs of reduced operational flexibility and measures taken to coordinate investments to expand the facility) would not have been considered as part of this criterion.

Market-based approach is consistent with economic efficiency

The QCA has not formed a conclusive position on the PC's market-based approach as it is still not clear how the test would be applied in practice.

That said, it is noted the market-based approach seeks to focus on improving economic efficiency by focusing on whether a facility can exert monopoly power. In doing so, it considers the extent to which other facilities that provide substitute services reduce the monopoly power of the facility that is sought to be declared. This does not appear to be unreasonable as a facility has clear monopoly characteristics if it can satisfy foreseeable demand for substitute services as well as the service in question.

Relevantly, the QCA notes that the PC's approach is consistent with the QCA's view that declaration should promote the economically efficient operation of, and investment in, significant infrastructure.

While the PC's test is likely to make declaration more difficult, it is not dissimilar to the previous natural monopoly test that has been applied in the past at the Commonwealth and State levels.

Given this, the QCA is not opposed to the PC's recommendation to adopt a market-based approach.

In any event, for the reasons mentioned above, the QCA considers that both the natural monopoly test and PC's market-based approach are superior to the existing private profitability test.

4.3 Expansions of facilities

The PC's Final Report on the National Access Regime (2013) noted that the economic rationale for an ACCC power to direct extensions (including capacity expansions) is to prevent service providers from deliberately delaying infrastructure investment, or constructing facilities with sub-optimal capacity, in order to limit competition and extract monopoly rents.

The Report also noted that:

- private negotiation is preferable to regulated extensions
- the power to direct extensions also includes power to direct capacity expansions
- a service provider should not be required to pay the upfront costs of the directed extension or expansion.

4.3.1 Statutory framework

The QCA Act and the CCA share similar provisions respecting access. Both Part IIIA of the CCA and Part 5 of the QCA Act set out a negotiate-arbitrate model for providing access to a declared service.

The QCA may make an arbitration determination that deals with any access related matter, including requiring an access provider to:

(a) extend, or permit the extension of, the facility, or

(b) permit another facility to be connected to the facility (section 118),

but any such determination must not:

(a) be inconsistent with an approved undertaking; or

(b) have the effect of:

(i) requiring the access provider to pay some or all of the costs of extending the facility (section 119(2)(c); or

(ii) resulting in an access seeker, or someone else, becoming the owner, or one of the owners, of the facility without the existing owner's agreement (section 119(2)(b)).

As a consequence, Queensland miners in particular have been concerned about Aurizon Network's apparent unwillingness to fund network expansions at the regulated rate of return. Stakeholders have been concerned about protracted access negotiations and have asked the QCA to require Aurizon Network to construct expansions.

It is within the context of this statutory framework, Aurizon Network, the coal industry and the QCA have sought to develop a workable and effective investment framework for circumstances where Aurizon Network chooses not to fund infrastructure expansions. Specifically, all groups have sought to develop an approach whereby users can fund expansions of the rail network where Aurizon Network is unwilling to do so at the regulated WACC.

The negotiation of a Standard User Funding Agreement (SUFA) between Aurizon Network and the Queensland coal industry has been an intractable process for a number of years. This stems from parties being at odds in respect of:

- the incentive for users of the network to drive the cost of rail transportation down (without control over the incidence of costs), and
- the incentive for Aurizon Network to re-allocate all costs associated with the expansion/extension to other parties as it is undertaking the expansion/extension 'at no cost'.

4.3.2 Investment framework

Aurizon Network submitted a SUFA in a 2013 submission to the QCA. It noted the purpose of the SUFA is to provide a standardised approach to what might conceivably be the outcome of an access determination if the QCA required that it extend or permit the extension of its network.

The SUFA developed by Aurizon Network is a set of standard agreements which link: infrastructure financing, construction, access, operation and maintenance of rail infrastructure assets as funded by a party other than Aurizon Network.

The proposal for a new form of what is in effect a new approach to financing regulated infrastructure has introduced a number of challenges:

- tax treatment – Aurizon Network requested a tax indemnity for all incidences of tax respecting the expansion ('at no cost'). Private Binding Rulings will be required from the Australian Tax Office to equip user funders with knowledge of potential quantum of tax

- ownership – ultimate ownership of the rail network infrastructure assets lies with the State of Queensland. Complex lease and sublease arrangements have been developed to allow the parties funding the infrastructure to reap the financial benefit
- construction – users of the rail infrastructure ultimately want control over cost of the infrastructure to ensure it is constructed at an efficient cost to meet the required capacity. The owner/operator wants ultimate control over the scope of the project. The two requirements often conflict
- security over cash flows – third parties will only consider financing a SUFA arrangement if security is provided over cash flows. Aurizon Network was concerned that the provision of such security could negatively impact its own financial metrics.

Notwithstanding the challenges outlined, progress has been made amongst all parties and the QCA considers there is now a proposed SUFA framework, which while still untested, is not only workable and bankable (to third party financiers), but it is also a credible alternative to Aurizon Network funding.

4.3.3 Has the bar been set too high?

The PC noted that regulatory risk associated with access regulation could impede efficient investment in infrastructure facilities. Moreover, because infrastructure investment often involves large, sunk and lumpy capital investments, appropriate safeguards are needed to protect the infrastructure service provider's legitimate business interests, reduce risk and preserve investment incentives. Safeguards to protect the legitimate business interest of the service provider are discussed above.

The QCA considers the safeguards in place provide Aurizon Network with protection respecting their legitimate business interests in the event they are directed to expand their network. For instance, the phrase 'at no cost' has proven to be a significant hurdle to overcome in the development of a user funding agreement as it is unclear what 'at no cost' means in practice. The following questions arose in the development of an alternative form of funding an expansion:

- which costs must be funded by a party other than the service provider relating to an expansion under a full cost recovery model?
- are sufficient controls in place to ensure that costs incurred by the service provider in provision of the expansion are efficient? (i.e. does the service provider have the incentive to manage extension costs it is not funding?)
- where the service provider does not fund an expansion, should it stand to benefit from that expansion?
- is it possible for an expansion funded by a third party to be provided at a lesser cost than the service provider?

On the last point, given that a certain level of administration costs will be required to facilitate third party funding, it is unlikely that a third party funding an investment could happen at a lower cost than the service provider – unless it may be able to fund at a level less than the regulated rate.

In this instance, the regulator will be required to balance the legitimate business interests of the service provider against the public interest. It may well be that third party funding will occur at a higher cost than the service provider would incur (assuming a regulated WACC).

Perhaps this additional cost is required to provide a credible alternative to a service provider attempting to extract profits well in excess of a regulated WACC.

The QCA considers that the 'at no cost' test would be difficult to apply for a multi-user network that is heavily dependent on the access provider for future growth. This can lead to a situation where a reluctance to expand can create uncertainty and delays for the mining sector and is not in the overall interests of the broader economy.

We consider there to be some merit in re-visiting the words of the original Competition Principles Agreement where the bar was set from a more pragmatic perspective of ensuring:

- the legitimate business interests of the owner are protected
- the terms of access for a third party taking into account the costs borne by the parties for the extension and the economic benefits to the parties benefiting from the extension.

4.3.4 Different treatment for different circumstances

The final PC report (2013) noted that while the power to direct an extension under Part IIIA had never been used; requests for expansion had been made in the Pilbara and parties seeking access in the Central Queensland coal rail had accused the service provider of withholding agreement to expand capacity to secure favourable terms.

The PC noted that infrastructure providers expressed divergent views on the power of a regulator to direct extensions. BHP Billiton argued that this power undermines the investment decisions of service providers, whereas Aurizon stated that this power is reasonable, provided the legitimate business interests of the access provider are protected.

The QCA considers that it is not altogether surprising that infrastructure providers had divergent views, given the different circumstances of each service provider. The Pilbara matter involves a third party seeking access (declaration) of a rail line rail line constructed by a competitor. Whereas Aurizon Network is a former government owned rail network designed to service multiple customers railing to multiple ports.

The QCA considers application of power to direct an extension be subject to discretion of the regulator based on the circumstances of the service provider.

4.4 The Declaration process

The Declaration process under the NCC has proved to be cumbersome and time consuming. As the OECD review of economic reforms in Australia noted:

> *Some aspects of the National Competition Policy could merit revisiting. The access regime, which is intended to promote efficient use of essential infrastructure in the context of market competition, is subject to some criticism. The system requires applications for declaration to the National Competition Council. Over the years, over 40 applications have been made in sectors such as rail, airports, water and sewage services. Contested actions are mostly about access to railway lines. Some of the disputes have been time consuming, as there is no deadline for NCC to act. Litigation may also be used as a way of gaming the system. This led the government to announce an intention to revise aspects of the access regime procedures in April 2009, possibly considering the introduction of binding time limits for regulatory decisions. (OECD 2009, p. 82)*

The National Competition Council normally must act on a declaration application within six months. However, as the Pilbara case demonstrates, the process to a final decision can still be long and arduous.

The declaration process needs to be as efficient as possible for the sake of both customers and the infrastructure monopolist. An efficient and timely declaration process may well provide the monopoly access supplier with a better incentive to negotiate the terms of access.

As noted in Section 3.1, when unregulated government monopoly business enterprises are privatised it will be necessary to ensure that the potential for declaration, as well as the means to avoid declaration in the private negotiation portion of the negotiate-arbitrate access model, are both well understood. In this regard, it would be useful to eliminate 'double-jeopardy' by insulating firms from declaration under the Commonwealth scheme when an effective state scheme is in place. Alternatively, specification of the appropriate regulatory regime in advance will reduce uncertainty for both access customers and the firms interested in bidding for the assets. This approach will also help protect consumers from paying excessive prices.

5 ADMINISTRATION OF COMPETITION POLICY

The benefits of pro-competitive polices are well known. At this point, finding the means for governments to accept and implement change is the most critical issue. Institutions and procedures that provide public awareness of the importance of market-based reforms and the enforcement of competition laws are essential. Legislative, administrative and regulatory bodies must be given incentives or directions to identify and implement necessary competition reforms and legislative and regulatory processes to avoid and eliminate anti-competitive restrictions.

5.1 Previous reform efforts

OECD (2010) summarises the evolution of Australian microeconomic reform efforts:

> *This first wave of economic reforms increased Australia's exposure to international markets through the floating of the Australian dollar, the deregulation of financial markets and the (unilateral) reduction and removal of tariffs on protected industries. This wave of reform subsequently created a momentum of competitive pressures and exposed the structural impediments to the creation of national markets. This eventually led to the second wave. (p. 73)*

The second wave of reform was the Hilmer report and the adoption of the National Competition Policy in the early 1990s. Given the exposure to international competition engendered by the first wave of reform, it was necessary to increase the competitiveness of Australian government and private sector businesses.

As discussed above, a review of each jurisdiction's stock of legislation to identify and eliminate anticompetitive regulation was undertaken. One result of this review was the reform of government provided infrastructure monopoly and application of organisational reform (corporatisation or commercialisation), the negotiate-arbitrate access regime and competitive neutrality principles.

OECD (2010) points out that:

> *Although the programme was considered a great success overall, a few areas continued to fail the NCC's test for an adequate public interest case for retaining competition restrictions. These vary to some extent across jurisdictions, but tended to be focussed in the following areas: pharmacy ownership, agricultural marketing restrictions, liquor laws and taxis.... (Box 1.7, p. 74, citing PC 2005)*

Progress has been made on agricultural marketing restrictions, but as discussed above restrictions on competition continue in many areas, including pharmacies, liquor and taxis.

While the Hilmer reforms were successful in a number of dimensions, there is widespread consensus that government regulation in other areas has actually increased. The COAG National Reform Agenda and the National Seamless Economy initiatives can be seen as efforts to address this growing regulatory burden. These more recent efforts to reduce regulation have yet to produce results comparable to the first and second reform waves.

5.2 Whole-of-government regulatory management system

Increasing economic complexity, growing environmental concerns and risk aversion have contributed to the proliferation of regulation. However, as discussed above, improvements in productivity require detailed cost benefit analysis for existing regulations. Where continued regulation is necessary, the most efficient regulatory mechanisms should be applied. In order

to make this happen, governments must be equipped to do the analysis and have the incentive and ability to make and implement the correct choices.

The QCA's report on Measuring and Reducing the Burden of Regulation (2013b) addressed these issues. The report provides a detailed discussion of the desirable features of a 'Whole-of-Government Regulatory Management System designed to '...encourage effective review and reform of existing regulation and to be more disciplined in assessing the need for additional regulation' (p. 51). The idea is to restructure the government decision and review process regarding regulation to focus on reducing regulatory burden and, where regulation is necessary, implement best practice regulation.

A regulatory management system comprises the institutional roles, management processes, accountability mechanisms and evaluation tools that determine how and when regulations are made, administered and reviewed. The regulatory management system must be designed to ensure effective regulatory policy development, prioritisation, coordination, communication, implementation and monitoring.

OECD (2012, p. 7) made a similar recommendation:

> *The regulatory policy should clearly identify the responsibilities of ministers for putting regulatory policy into effect within their respective portfolios. In addition, governments should consider assigning a specific Minister with political responsibility for maintaining and improving the operation of the whole-of-government policy on regulatory quality and to provide leadership and oversight of the regulatory governance process. The role of such Minister could include:*
>
> - *Monitoring and reporting on the co-ordination of regulatory reform activities across portfolios;*
> - *Reporting on the performance of the regulatory management system against the intended outcomes;*
> - *Identifying opportunities for system-wide improvements to regulatory policy settings and regulatory management practices.*

The Queensland Government supported the concept of a whole-of-government regulatory management system and has advised that the Treasurer and Minister for Trade and the Assistant Minister for Regulatory Reform will be responsible for overall regulatory reform, and individual Ministers for regulatory reform in their portfolios, as provided for in administrative orders and Ministerial Charter letters. The Government has also advised that the Queensland Treasury and Trade Department will establish and maintain the regulatory management system.

5.3 Incentives for reform

Payments to state and local governments in exchange for implementing the Hilmer reforms were evidently successful. However, the reforms seem to have stopped when the payments stopped. Re-instituting a payment scheme today is problematic. First, government budgets at all levels are under stress. Second, some states have done better than others at making reforms. Paying the ones who have not done a good job would be rewarding their past failure to make productivity-enhancing changes. However, as the PC noted in 2005, if there is an incentive mechanism put in place '...to help lock-in the gains from past reforms, it would also be useful to have scope to impose financial penalties for backsliding (Productivity Commission 2005, p 382).

An alternative solution may be to institutionalise the reform function, as was done with OBPR in Queensland for red tape removal. A key problem, however, is that the operational Departments need the staffing with capability and resources to understand the competition

problems and devise efficient solutions. Pledging competition reforms without putting reformers in place with the training and budgets to be successful would only give lip service to the concept.

A public awareness and education program should be established where political leaders and policy makers can regularly detail the goals and advantages of competition policy directions, provide information and analysis, involve the public by seeking input and feedback, and establish community recognition of the need for continuous reform.

Many reforms that are needed can only be successfully undertaken by the two major levels of government working together, as they did with the NCP. Consideration should be given to the form of a new inter-governmental agreement to make the Australian economy more efficient, flexible and competitive.

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