HOUSTONKEMP
Economists

Submission to the Competition Policy Review

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Executive Summary

HoustonKemp welcomes the opportunity to make a submission to the Competition Policy Review (the Review) in response to the draft report released on 22 September 2014 (the Draft Report).

Human services

Australia has reaped significant benefits from microeconomic reform in the electricity, gas and water infrastructure sectors. Over the last two decades, we have harnessed both markets and regulatory tools to deliver an enduring increase in productivity. The impressive record of economic reform in these sectors stands in stark contrast to that of the human services and road transport sectors.

We welcome the review panel's (the Panel's) recommendation that Australian governments should craft an intergovernmental agreement establishing choice and competition principles in the field of human services. However, we propose that a guiding principle for governments be included in that recommendation, which focuses on efficient outcomes, such as 'the form of competition and regulation should be implemented based on a market by market assessment of which form will promote the most efficient outcome'. Many of the other principles put forward by the Panel are redundant and can be captured within this broad principle.

We also recommend that the agreement should identify the form of competition and/or regulation that would best promote efficient outcomes for those human services which have the largest revenues. This would be a practical first step to a widespread adoption of competition and choice in human services.

Transport

We welcome the Panel's recommendations about the importance of prioritising the reform of road pricing. Our submission focuses on three practicable reforms that will enhance the efficiency of the road infrastructure sector, so that it ceases to hinder and instead enables Australia's future economic growth. In particular, in our opinion:

- Australian governments should undertake a review of historic road performance, and put in place the systems and processes to provide next day information on road infrastructure performance;
- toll road pricing flexibility and city-specific toll road pricing strategies should be introduced to promote improved road network performance; and
- an entity should be established with responsibility for promoting heavy vehicle productivity through efficient investment in and use of the road network used by B-Doubles and B-Triples, initially as a trial within a single jurisdiction, prior to a wider roll out.

Misuse of market power

There has been a disproportionate focus on the misuse of market power prohibition in commentary on the Draft Report. In our opinion, the proposed changes to the transport and human services sectors have much greater potential to increase productivity than any change to this prohibition. Notwithstanding, in light of our experience in applying the existing unilateral conduct provision, we observe that:

- there is no strong rationale for removing the current 'take advantage' and 'purpose' elements of s.46;
- the Panel's proposed amendments to s.46 will not make the provision a more clear, predictable and reliable means of identifying and prohibiting anti-competitive conduct; and
- a significant change in the misuse of market power prohibition as proposed by the Panel will give rise to a long and costly period of uncertainty as to how the law may be applied, whilst there are limited, if any, apparent benefits of making such a change.

1. Introduction

HoustonKemp welcomes the opportunity to make this submission to the Competition Policy Review (the Review), in response to the draft report released on 22 September 2014 (the Draft Report).[1] The Review has a very wide scope and the review panel (the Panel) has done an excellent job of examining a range of topics in its Draft Report.

We are a firm of economists dedicated to the application of economics to bring clarity to complex problems arising in competition, finance, policy and regulation. Our experts have a long track record in assisting high stakes decision-making through the use of evidence-based economic analysis that is focused, accessible and capable of withstanding the most intense scrutiny.

Much of our day-to-day work concerns the practical application of the provisions of the *Competition and Consumer Act 2010* (the Act), through the expert advice we provide to clients operating within or beyond the boundaries of the Act. We have also played substantial roles in shaping the regulatory regimes governing water and wastewater, communications, energy, land, and sea and air transport in Australia and the wider Asia Pacific region. In this submission we bring a practitioner's perspective, developed through a strong sense of what works in the day-to-day administration of competition law and policy.

Our submission is focused on three aspects of the Panel's report, and is structured as follows:

- section two offers our thoughts on the complex question of introducing competition to human services;
- section three sets out some proposals in relation to how the Panel's recommendations in the road transport sector might be put into practice; and
- section four comments on, and provides our recommendations, in relation to the misuse of market power prohibition.

The principal point of contact for queries relating to this submission is Luke Wainscoat, whose contact details are provided below. Please get in touch if you have any questions regarding this submission.

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[1] Competition Policy Review, *Draft Report*, September 2014 (hereafter referred to as the 'Draft Report').

2. Human Services

The introduction of competition and choice in the human services sector has the potential to generate substantial gains to the economy and the welfare of Australians because:

- human services are a large and growing part of the economy;[2]
- the large majority of these services is not subject to competition; and
- the benefits from the initial introduction of competition and choice to any market can be very substantial.

However, the introduction of competition to any sector is a complex and difficult task that can lead to poor outcomes if the correct form of competition is not adopted. The empirical evidence of the impact of competition in human services is mixed.[3] It follows that great care must be taken in how competition is introduced.

The rest of this section provides our:

- reasons for suggesting that an intergovernmental agreement establishing choice and competition principles in the field of human services should have different guiding principles to those proposed by the Panel;
- proposed approach to determining which form of competition will promote the most efficient outcome for human services; and
- proposed recommendations relating to the introduction of competition in the provision of human services.

2.1 Guiding principles

We welcome the Panel's recommendation that Australian governments should craft an intergovernmental agreement establishing choice and competition principles in the field of human services. However, we have some suggested amendments to the guiding principles for that agreement.

Making markets work better and improving productivity is the central reason for introducing competition in human services. This can be achieved by implementing the form of competition or regulation that will promote the **most efficient outcome** resulting in:

- services that more closely fit the needs of end-users;
- lower costs of providing services; and
- appropriate levels of innovation.

It follows that a one-size-fits-all approach to introducing competition and user choice in the field of human services is unlikely to be appropriate. Indeed, it risks potential negative outcomes, particularly if insufficient attention is given to managing service quality.

We therefore recommend that the proposed intergovernmental agreement include a guiding principle that focuses on efficiency, such as 'the form of competition and regulation implemented should be based on a market by market assessment of how best to promote the most efficient outcome in the given circumstances'. In our opinion, an emphasis on efficiency is consistent with the introduction of competition in

[2] Draft Report, p.140.

[3] See, for example, a summary of some of the evidence regarding the introduction of competition to health services in McKinsey, *When and How Provider Competition Can Improve Health Care Delivery*, 2010, p.3.

other sectors and it will provide a clear and practicable way forward to implementing competition and choice in human services.

This guiding principle is consistent with three of those identified by the Panel relating to the importance of user choice, diversity of providers and the stimulation of innovation. However, as recognised by the Panel, the enhancement of user choice and diversity in service provision will not necessarily be appropriate in all circumstances. For example:

- it will be difficult for consumers or their agents to make a proper choice about the best course of action given a lack information;[4] and
- there will not be an efficient outcome if there are a diversity of suppliers in a market which is a natural monopoly.[5]

We therefore recommend that an overriding objective of promoting efficient market outcomes should replace these two guiding principles.

The most efficient outcome will support an appropriate level of innovation. Therefore, in our opinion, the principle proposed by the Panel of stimulating innovation is not needed.

The scope for everyone to access the human services they need is an important part of a government's responsibility. However, efficient outcomes do not ensure equality of service provision. It follows that there is a need to consider a guiding principle regarding equality of service provision, such as 'vulnerable consumers should be afforded appropriate protection'.

We agree that the funding, regulation and delivery of services should be separate to allow the effective implementation of competition and choice. The aggregation of these functions has the potential to result in a conflict of interest that may hinder the effective implementation of competition and choice.

2.2 Appropriate form of competition or regulation

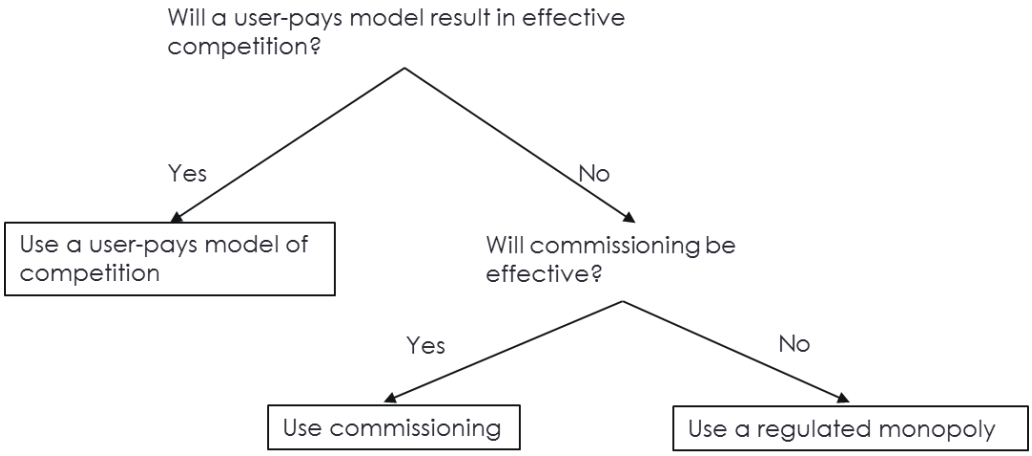
We recommend that the Panel sets out that the intergovernmental agreement should identify the form of competition and regulation that would promote efficient outcomes for those human services which account for the largest amount of turnover. This is a practical way of speeding up the important process of increasing productivity in the provision of human services. It would involve the following steps which are detailed below:

- separate human services into different markets to allow competition where possible without losing efficiencies from joint delivery, in the same way that electricity supply was broken into transmission, generation, distribution and retail; and
- determine the appropriate form of competition or regulation for each market. Competition or regulation should be adopted using the following framework, depicted in Figure 1:
  - user-pays competition should be introduced if it would be effective; otherwise
  - commissioning should be implemented if it can be done effectively; and
  - there should be a regulated monopoly if competition and commissioning would not be effective in a given market.

[4] Draft Report, p.150.

[5] Draft Report, p.150.

Figure 1: Choosing a form of competition/regulation



2.2.1 Cost structure

The first step in opening up services to competition is to separate those services for which there can be:

- effective competition with a user-pays approach;
- effective commissioning; or
- a regulated monopoly.

The supply of electricity was broken up into transmission (regulated monopoly), electricity generation (competition), distribution (regulated monopoly) and retail (competition). The supply of human services is more complex than the electricity supply chain so it will be more challenging to determine the most efficient structure.

The cost efficiencies that should be taken into account in this process include:

- efficiencies of vertical integration – for example, costs may be reduced by keeping the provision of pre-operating services, the undertaking of operations themselves and post-operating services together; and
- efficiencies of horizontal integration – for example, it may be cheaper to supply customers with two separate services together such as maternity and antenatal services.

The provision of some services will be characterised by a natural monopoly, ie the whole market can be supplied more cheaply by one supplier than two or more. For example, it is likely to be cheaper to have at most one cord blood bank in each capital city than to have two or more.[6]

Services that are associated with natural monopolies should be separated from them if:

- there could be competition for them; and
- the efficiencies of joint provision with the monopoly are not too great.

For example, a large hospital may have a natural monopoly on specialist operations whilst there could potentially be competition for outpatient work (perhaps through commissioning). However, the outpatient services should be kept as part of the hospital (and part of the monopoly) if the efficiencies are very strong between inpatient and outpatient services.

[6] There is one cord blood bank in Sydney, Melbourne and Brisbane. See http://www.sch.edu.au/departments/acbb, accessed 21 November 2014.

2.2.2 Models of competition and regulation

This section describes three possible forms of competition and regulation and the conditions under which they can be expected to lead to efficient outcomes.

User-pays model of competition

The user-pays model is the standard form of competition which applies to most of the economy where the user decides what to purchase from a range of suppliers. The difference between human services and, say, supermarkets, is that (some of) the funds may be provided by the government.

Competition between suppliers leads to efficient outcomes because they:

- strive to provide services that users want because this leads to greater sales and higher profits for the supplier;
- have an incentive to reduce their costs in order to increase their profits. Further, the more efficient suppliers grow at the expense of others. These effects tend to reduce the total cost of providing the service; and
- have an incentive to innovate in order to sell products at a higher price and/or to increase the level of their sales because this will increase their profits.

A number of conditions are required for competition to lead to an efficient outcome, namely:

- on the supply side:
  - the provision of the service must not be natural monopoly;
  - firms must be able to enter, expand and exit;
  - firms must not be restricted in the profit they can earn.[7] This is important in human services because there may be resistance to companies earning profits that could otherwise have been used to provide services;[8] and
  - firms must have a reasonable degree of flexibility in the services they provide and how they are provided. This allows suppliers to be innovative and reduce costs;
- on the demand side:
  - consumers need to have sufficient information and opportunity to make good decisions on which supplier to use. This is not the case when users are in the middle of a health crisis for example; and
  - users must be able and willing to search the market, compare prices and products, and switch without too great a cost. It is not necessary for all users to do this but there must be sufficient number to put pressure on the suppliers to provide better services. The Draft Report states that consumers should have access to relevant information.[9] However, the experience of introducing competition in other markets, and the evidence from behavioural economics suggest that simply providing information is not always sufficient to ensure that consumers make good decisions.[10]

[7] There are already some restrictions on the prices that suppliers can charge for human services in Australia. For example, aged care homes wanting to charge accommodation payments of more than $550,000 as a lump sum, or as rental-type payments based on a daily rate, must have their prices approved by the Aged Care Pricing Commissioner.

[8] For example, there has been criticisms in the UK that profits earned by hospitals are not being used to improve patient care or pay off hospital debts, see http://www.theguardian.com/society/2012/may/03/hinchingbrooke-hospital-eyewatering-cuts, accessed 14 November 2014.

[9] Draft Report, p.27.

[10] See, for example, Waddams Price, C. *Shedding Light on Consumer Behaviour in Energy Markets*, in Behavioural Economics in Competition and Consumer Policy, 2013, Mehta, J. eds.

Competition with an ineffective supply side may leave the impression of competition, ie users able to choose between suppliers, without firms facing strong incentives to provide better products at lower costs – leading to an inefficient outcome.

Competition with an ineffective demand side may lead to inefficient outcomes where suppliers are focused on winning business but not on what customers want. For example, firms may compete to provide a cheap but low quality service if the level of quality is not easily observable. Alternatively, it may lead to a large number of customers using a default or incumbent supplier, with few customers switching to alternative suppliers that offer better service or value for money.

Commissioning

Commissioning is a form of 'competition for the market'. Government's commission services by:

- making decisions about human services program objectives and priorities (and sometimes the model of service provision); and
- eliciting bids from potential service providers, one or more of whom will ultimately enter into a contract for the provision of the relevant service.[11]

Alternately, a government may delegate the responsibility of commissioning and provide the funds required to another body. Users typically have no choice of supplier. The contract between the government and the supplier may include a range of targets and incentive payments.

An effective commissioning strategy will lead to firms putting in bids based on the cost to them of providing the service, and the government will be able to choose the supplier that can provide the service most efficiently. Commissioning can lead to innovation if the contract focuses on the outcome users want (rather than the process of providing the outcome) and suppliers have flexibility in the way they provide services.

Commissioning can lead to efficient outcomes when there is a natural monopoly, ie the cost of supply will be lowest with one supplier. A number of conditions are required for commissioning to lead to an efficient outcome, including:

- on the supply side:
  - a range of firms are needed who can bid on an equal footing. Firms that have better information often have an advantage at the bidding stage. Therefore, it is important to ensure that all relevant information is public;
  - the administration cost of contracting is not too significant. This includes designing and monitoring the contract;
  - suppliers must have some freedom in how a service is provided in order for them to have an incentive and ability to be efficient and innovate; and
  - commissioning will not promote efficient outcomes if the service provider is able to cherry pick the users it services or otherwise shift costs to other suppliers;
- on the demand side:
  - commissioning operates best when outcomes can be measured that users care about. This requires that the government knows what users care about. Otherwise the supplier will focus on its price, resulting in low price and low quality services; and
  - the government needs to be able to measure whether the supplier is delivering its contract, and to be able to terminate the contract of the firm if it does not meet the required standards.

Commissioning will lead to high costs if the supply side does not work effectively because firms will not compete hard against each other and/or they will be restricted in their ability to lower costs. It will lead to

[11] Draft Report, p.159.

cheap and low quality services if the quality of outcomes cannot be measured and/or governments do not know what users value.

Regulated monopoly

A regulated monopoly service provider is not subject to competition from rival providers. Rather, the government regulates prices and sets targets for the supply of services. Regulation is likely to be appropriate where user-pays competition and commissioning would not be effective, for example when there is:

- a natural monopoly such that competition between suppliers would lead to higher costs; and
- long lasting assets or very few potential suppliers, such that it is difficult to arrange effective competition for the market on a regular basis using commissioning.

There must be effective regulation of the service to provide appropriate incentives to improve the quality of the service offered and to maintain costs at an efficient level.

2.3 Proposed recommendation

We recommend that the Panel include the following recommendation in its final report:

> Australian governments should prepare an intergovernmental agreement establishing choice and competition principles in the field of human services by March 2016.
>
> The guiding principles should be:
>
> - funding, regulation and service delivery should be separate;
> - the form of competition and regulation should be chosen based on a market by market assessment of which will promote the most efficient outcome; and
> - vulnerable consumers should be afforded appropriate protection.
>
> The agreement should identify the most efficient form of competition and/or regulation for those human services which have the largest revenues.
>
> Each jurisdiction should:
>
> - continue to implement competition and choice whilst the intergovernmental agreement is being reached, focussing on the areas where the potential efficiency gains are largest; and
> - develop an implementation plan founded on these principles that reflects the unique characteristics of providing human services in its jurisdiction.

3. Road Transport

Australia has reaped significant benefits from microeconomic reform in the electricity, gas and water infrastructure sectors. Over the last two decades, we have harnessed both markets and regulatory tools to deliver an enduring increase in productivity.

The impressive record of economic reform in these sectors stands in stark contrast to that of the road transport sector. The road transport infrastructure sector remains firmly in the control of government, and there has been an inability to obtain other sources of funding for this vital infrastructure. At the same time, road managers have been unable, or unwilling, to recognise the inherent trade-off between road network performance and cost. As a result, Australia is faced with worsening road congestion in urban centres, and is missing opportunities to improve the productivity of our heavy vehicle fleet.

The avoidable cost of road congestion in capital cities is forecast to be $20.4bn in 2020.[12] Indeed, it has been estimated that a one per cent improvement in the productivity of the Australian logistics industry would increase GDP by $2 billion each year.[13] To put this into more concrete terms, changing from a standard articulated 6-axle truck to a B-double vehicle, improves the productivity of the freight task by around 30 per cent.

We welcome the Panel's recommendations about the importance of prioritising reform of road pricing. Our submission focuses on three practical reforms that provide a starting point to the introduction of road pricing, and which will also enhance the efficiency of the road infrastructure sector.

Specifically, in our opinion:

- Australian governments should undertake a review of historic road performance, and put in place the systems and processes to provide next day information on road infrastructure performance;
- toll road pricing flexibility and city-specific toll road pricing strategies should be introduced to promote improved road network performance; and
- an entity should be established with responsibility for promoting heavy vehicle productivity through efficient investment in and use of the road network used by B-Doubles and B-Triples, initially as a trial within a single jurisdiction, prior to a wider roll out.

We set out each of these in greater detail in the rest of this section.

3.1 Understanding road network performance is the key to road reform

We do not systematically collect and report information on road use in a manner that allows for performance of the road network to be assessed.[14] Without this information, we are unable to understand the performance of the road network – we are flying blind. For example:

- What was the busiest day for the Sydney or Melbourne urban road networks in 2013?
- How is daily road use changing?
- Was the most recent improvement in road speed performance during the school holidays better or worse than the last school holiday period?

[12] Bureau of Transport and Regional Economics, 2007, *Estimating Urban Traffic and Congestion Cost Trends for Australian Cities*, Working paper 71, p.xv.

[13] Acil Allen, *The Economic Significance of the Australian Logistics Industry*, 2014, p.i.

[14] Here we are using the term 'road use' to mean the number of vehicles traversing the road network within a certain geographic location, and over a particular time, say a 10 minute period.

These questions are fundamental to investment and operational decision making. This information would:

- identify locations of worsening performance within the road network, and so help to identify investment priorities;
- make road agencies accountable to the public for performance outcomes;
- inform trends in performance and so facilitate medium to long term planning of the road network (or alternative transport modes), to address areas of concern;
- help to understand the drivers of road use performance, and so might lead to other investments (eg, deployment of emergency vehicles in strategic locations), to achieve road performance benefits; and
- over time, we expect it would be possible to provide users with probabilistic forecasts of road conditions, given expected rainfall and other factors.

This type of historic actual information is taken as a given in many other infrastructure sectors. Indeed, its absence would be a cause for considerable concern.

Measuring historic road use at a sufficiently fine level of detail to make the information useful to road planning and investment decision making has been challenging. However, technology changes means that this is no longer the case. Specifically, the wide adoption of GPS mapping technology in vehicles has led to data on road use becoming available for short road segment across the country.[15] While this information is used principally for real-time traffic congestion monitoring, historical information can be used to develop a picture of road network performance.

Regardless of these technology developments, there is scope to make better use of data that is already collected on road use. Many of the data collected by road agencies is read on a relatively low frequency, given its use to calibrate traditional traffic models. We could increase the frequency with which we collect this data to make it more useful for an assessment of road performance.

We therefore recommend that Australian governments undertake a review of historic road performance, and put in place the systems and processes to provide next day information on road infrastructure performance. This will provide the information base to support further reforms, and assist with identifying road investment priorities while making road agencies accountable for performance outcomes to road users.

3.2 Implementing road pricing by rethinking our approach to toll roads

Toll roads have been used to fund investment in the road network from private sources. The focus on funding of the specific infrastructure has meant that the associated toll (or road use price) is set with reference to what is needed to fund the road, rather than considering how users might respond to the toll. Maximising the benefits to the road network (including non-toll roads) is not taken into account when setting the toll rate.

This lack of pricing flexibility hinders the potential for our toll road networks to facilitate road performance improvements while providing pricing choices to road users and allowing them to manage toll road use bills more proactively.

There is a need to rethink the objective of our toll road pricing strategy (indeed simply having a toll road pricing strategy would be helpful), to refocus the objective of toll pricing on maximising efficient use of our road network while providing an opportunity to recover the total cost of satisfying toll road provider obligations. In practice this would involve:

- decoupling the toll rate paid by a user for a particular road segment from the rate paid to a toll road provider for each vehicle movement along the toll road;

[15] See, for example, the traffic flow data provided by www.here.com.

- developing a toll road pricing strategy that allowed flexibility so as to maximise the use and revenue from the entire toll road network within a city, subject to the constraint that total revenue should be equal to the amount paid to all of the toll road providers; and
- examining opportunities to extend the toll road network within the city by evaluating the scope to recover the costs of the investment through the additional use that might be created throughout the entire toll road network.

In our opinion, this approach would provide strong incentives to develop prices that reflect demand at different times of day, taking into account the willingness-to-pay of road users in different locations. Importantly, pricing flexibility creates the opportunity for road users to lower the amount they spend on toll roads through their travel choices. That said, we acknowledge that some more vulnerable customers might be adversely affected by toll road pricing flexibility, and so any reform should also consider what targeted concession arrangements might be provided to road users that might otherwise have difficulty in paying toll road bills.

In addition, consideration would need to be given to ensure that the commercial arrangements in place with existing private toll road providers would not adversely affected. In practice, a pricing strategy might be applied initially to those toll roads directly controlled by the government, and then extended as part of new toll roads, or once initial toll road contracts end.

The benefits of introducing pricing flexibility to promote efficient investment in, and use of, infrastructure is currently an important debate within the electricity network sector. Many of those arguments for network tariff reform apply equally to toll roads. However, the benefits of toll road pricing reform might be orders of magnitude in excess of those anticipated from electricity network tariff reform because the potential performance improvement outcomes of toll road pricing to the logistical operations of our cities is very significant.

We therefore recommend the introduction of toll road pricing flexibility and city specific toll road pricing strategies to promote improved road network performance.

3.3 Refocusing heavy vehicle road reform

Improving the productivity of our heavy vehicle fleet involves:

- extending the locations across our road network where larger and so more productive vehicles can travel; and
- allowing for the adoption of new technology in heavy vehicles that improve the safety and performance of our heavy vehicle fleet.

Much of the focus of road reform has been on how to charge heavy vehicles in a manner that promotes efficient use of the road network and provides funds directly to road providers, including state and local governments. Providing a stronger link between road use, prices and funds is important to encourage appropriate decisions for efficient investment in the road network so as to improve the performance of the freight task.

The complexities of shifting from our current institutional and price setting arrangements to an alternative structure that improves incentives has meant that little progress has been made.

Consistent with the Panel's recommendation to introduce road pricing reform, there is merit in establishing an entity solely responsible for purchasing access to the currently defined restricted access vehicle network (which includes the B-Double[16] road network, and the performance based standard road network), on behalf of those heavy vehicle users. The entity would have the objective of promoting efficient use of, and

[16] A B-double is a type of heavy vehicle including two semi-trailers where the second semi is a mounted B-double.

investment in, the defined road network used by say B-Doubles and B-Triples,[17] and improving productivity of the freight task. It would achieve this objective by:

- charging B-Doubles and B-Triples for access to, and use of, the defined network, in lieu of current road user charges and/or the state-based registration fee;
- paying road providers (ie, state/territory and local governments) for the use of the defined road network by B-Doubles and B-Triples. This would be based on an access fee to be negotiated with each state-based road provider, including local government road providers reflecting the allocated B-Doubles and B-Triples share of the costs for the defined road network; and
- negotiating with road providers to extend the road network for B-Doubles and B-Triples, taking into account anticipated demand for the network extension and the costs/charges that the road provider might impose for the provision of the network extension.

Consideration will need to be given to the regulatory pricing arrangements to ensure that charges for B-Doubles and B-Triples reflect the efficient cost of investing in and maintaining the defined B-Double and B-Triple road network. This approach would have the effect of replacing the current heavy vehicle charging determination process undertaken by the National Transport Commission.

Such an approach to reforming heavy vehicle road provision:

- focuses on creating incentives for efficient expansion in the road network;
- ensures that road providers continue to receive the funds that they currently receive via the heavy vehicle charging framework; and
- provides the scope to introduce pricing flexibility for a segment of the heavy vehicle fleet where the benefits from charging reform are likely to be the greatest.

This approach to reforming heavy vehicle charging and road funding is analogous to that proposed above for the toll road network. The important feature of this is to draw a distinction between how charges might be set for road use, versus the payment to the provider of the road service, to create strong incentives for efficient investment in, and use of, the defined road network.

This approach is relatively simple and could be readily implemented within the current institutional arrangements for the provision of road infrastructure. In addition, it could be trialled on a single road segment (say the Hume Highway between Melbourne and Brisbane), or within a single jurisdiction.

Finally, we suggest that the entity has responsibility for the road network used by B-Doubles and B-Triples because this network is readily defined. That said, the model could be adopted to other vehicle types or definitions of the road network so as to scale the reform as the effectiveness of the model and its benefits becomes better understood. Once the proof of concept has been developed, consideration the reform could be extended.

We therefore recommend that an entity is established with responsibility for promoting heavy vehicle productivity through efficient investment in and use of the road network used by B-Doubles and B-Triples, initially as a trial within a single jurisdiction, prior to a wider roll out.

3.4 Proposed recommendation

We propose that the Panel include the following recommendation in its final report:

- Australian governments should undertake a review of historic road performance, and put in place the systems and processes to provide next day information on road infrastructure performance;

[17] A B-triple is a B-double with an additional semi-trailer.

- toll road pricing flexibility and city specific toll road pricing strategies should be introduced to promote improved road network performance; and
- an entity is established with responsibility for promoting heavy vehicle productivity through efficient investment in and use of the road network used by B-Doubles and B-Triples, initially as a trial within a single jurisdiction, prior to a wider roll out.

4. Misuse of Market Power

This section sets out the reasons why, in our opinion:

- there is no strong rationale for removing the current 'take advantage' and 'purpose' elements of s.46;
- the Panel's proposed amendments to s.46 will not make the provision a more clear, predictable and reliable means of identifying and prohibiting anti-competitive conduct; and
- any benefits to be derived from the Panel's proposed amendments are likely to be outweighed by the considerable cost of a long period of uncertainty regarding how the provision will be interpreted.

4.1 Rationale for the removal of 'take advantage' and 'purpose'

The Panel recommends the repeal of two of the three current limbs of s.46, ie:[18]

- the 'take advantage' element, which requires a causal connection between market power and the relevant conduct; and
- the 'purpose' element, which requires the firm engaging in the conduct to have done so with the purpose of eliminating or substantially damaging a competitor, preventing entry or deterring or preventing a firm from engaging in competitive conduct.

The Panel's principal rationale for the removal of these two elements and their replacement with a 'substantial lessening of competition' test is that:[19]

- the 'take advantage' element is difficult to interpret and apply in practice; and
- the focus on damage to a competitor of the purpose element is inconsistent with the objective of the Act, being to protect competition.

In our opinion, the Panel has overstated the extent to which the 'take advantage' element of s.46 is difficult to interpret – its meaning is now relatively well settled in case law. Although we agree that the 'take advantage' element is difficult to apply in practice, there is no basis on which to expect that the Panel's proposed amendment would be any less difficult to apply. Further, although the focus of the existing provisions on damage to a competitor might appear at odds with the overall objective of the act, there are good reasons as to why the existing purpose element is consistent with the objective of the Act.

4.1.1 Take advantage

The 'take advantage' element is currently the primary filter for distinguishing between pro- and anti-competitive unilateral conduct. In *Queensland Wire*, the High Court established that the term 'take advantage' meant nothing more than 'use'.[20] It considered that the appropriate test for determining whether BHP had taken advantage of its market power was to ask whether:[21]

- it is only by virtue of its market power that BHP was able to engage in the conduct; and/or
- it was likely that BHP would engage in the same conduct if it were operating in a competitive market.

Since that time the courts have attempted to apply this same test by asking whether a firm without market power could, or would, engage in the same conduct. Although in *Rural Press* the High Court determined that

[18] Draft Report, p.44.

[19] Draft Report, pp.42 – 43.

[20] That is, the term did not require one to show a hostile intent on the part of the defendant. *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* [1989] HCA 6; (1989) 167 CLR 177, para. 22.

[21] See *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* [1989] HCA 6; (1989) 167 CLR 177, para. 28.

the test was one of mere ability,[22] the 2008 clarifying provisions ensure that, when assessing whether a firm has taken advantage of its market power, the court may consider whether it would have had an incentive to engage in the conduct if it did not have market power.[23] This is consistent with the most recent and, in our opinion, clear and comprehensive interpretation of the provision in *Cement Australia*.[24]

Although the meaning and test for 'taking advantage' is relatively well settled in case law[25], there is no question that it is difficult to apply in practice. The test requires an assessment of what a hypothetical firm without market power would do if it were in similar circumstances to the defendant. In other words, the test seeks to determine whether there is a 'business rationale' for the conduct that does not rely on the existence of substantial market power. In order to address this question, the courts have been willing to consider a number of factors such as evidence of similar conduct engaged in by firms without market power, conduct engaged in by the defendant at a time when it did not have market power, and objective assessments of the profitability of the conduct.

Although the judiciary has at times taken different views as to the relevance of such information,[26] this does not imply that the test should be altered. Rather, these challenges simply reflect the fact that any test that seeks to distinguish pro- and anti-competitive unilateral conduct is inherently difficult to apply. Irrespective of the intrinsic difficulty of applying such test, including that of the 'taking advantage' form, there is no reason to expect that the Panel's proposed amendment will alleviate the court of these challenges. Indeed, in many respects the Panel's proposal simply codifies the current test for 'take advantage', as it has been applied by the courts. Put another way, under the Panel's proposal, in order to defend an alleged breach of s.46 a firm must put forward evidence as to why a firm without a substantial degree market power would engage in the same conduct.[27]

4.1.2 Objective of a prohibition on unilateral conduct

The Panel notes that the focus of the prohibition on showing a purpose of damaging a competitor is inconsistent with the overriding policy objective of the Act being to protect competition, not competitors.[28] In its view, all prohibitions should focus on protecting competition and not individual competitors. On that basis, the Panel observes that business and trading conduct should be prohibited if it has the purpose, or would have or be likely to have the effect, of substantially lessening competition.

There is little debate that the objective of the Act is to protect competition, not competitors. However, the current formulation of s.46 is not inconsistent with this objective. Although the prohibited purposes focus on conduct that is directed to one or more competitors or potential competitors, such purposes are consistent with conduct that is exclusionary in nature. In other words, the role of the purpose provisions is to limit the

[22] In applying the 'hypothetical competitive market test', the Justices of the Full Federal Court considered the motivation for the conduct to be irrelevant for establishing the necessary causal connection between that conduct and the market power of Rural Press. On appeal, the High Court upheld the decision of the Full Federal Court, noting that "to reason that Rural Press and Bridge took advantage of market power because they would have been unlikely to have engaged in the conduct without the "commercial rationale" - the purpose - of protecting their market power is to confound purpose and taking advantage." See Rural Press Ltd v Australian Competition & Consumer Commission [2002] FCAFC 213 and Rural Press Ltd v ACCC [2003] HCA 75; 216 CLR 53; 203 ALR 217; 78 ALJR 274 (11 December 2003), para. 51.

[23] Competition and Consumer Act, s.46(6A)(c) and Trade Practices Legislation Amendment Bill 2008, Explanatory Memorandum, para. 1.41.

[24] *ACCC v Cement Australia* [2013] FCA909, para.1899.

[25] We accept that there is a degree of uncertainty as to how the clarifying provisions may alter the court's interpretation of the test for showing a 'take advantage'.

[26] In particular, in *Melway* the judiciary took opposite views to whether the relevant conduct should be appropriately considered a refusal to supply or the continuation of an exclusive distribution system. As a result judges differed in terms of the meaning they attributed to Melway's adoption of such a system at a time when it did not have market power. See Robert Hicks Pty Ltd (trading as Auto Fashions Australia) v Melway Publishing Pty Ltd [1998] FCA 1379 (30 October 1998); Melway Publishing Pty Ltd v Robert Hicks Pty Ltd [1999] FCA 664 (20 May 1999); Melway Publishing Pty Ltd v Robert Hicks Pty Ltd [2001] HCA 13; 205 CLR 1; 178 ALR 253; 75 ALJR 600 (15 March 2001).

[27] The only circumstance in which the court would not be required to consider this analysis is if it were to consider the second limb of the Panel's proposed defence first, and conclude that the conduct could not be considered to benefit the long-term interests of consumers.

[28] Draft Report, p.43.

prohibition on unilateral conduct to that which has the purpose of excluding rivals, to the detriment of the process of competition.

Once the exclusionary focus of the section is recognised, the merits of its focus on competitors (rather than competition) becomes clear. Further, if the provision was to be widened so as to prohibit any conduct that has the purpose, effect or likely effect of substantially lessening competition, it would have the potential to capture conduct that is not exclusionary in nature but, rather, is pro-competitive.

In contrast to the other provisions where a substantial lessening of competition test applies (namely sections 45, 47 and 50), the Panel's proposed amendment to s.46 would not be targeted at a particular type of conduct – by design, it would apply to *any* conduct engaged in by a firm in its day-to-day operations.[29] As proposed, the provision would capture any conduct engaged in by a firm with substantial market power that:

- is considered to have the purpose, effect or likely effect of substantially lessening competition; and
- is not considered to benefit the long-term interests of consumers.

The consequence would be that any form of unilateral conduct that results or could be expected to result in an increase in prices or restriction of output may be at risk of breaching the provision. This is because the term 'substantially lessen competition' may be assessed by the courts in terms of a change or likely change in market outcomes without due regard to the extent to which the conduct has hindered the incentive or ability of rivals to enter or expand.

Actual or likely market outcomes have been considered relevant for the assessment of whether or not a substantial lessening of competition has taken place in other contexts. For example:

- in the context of s.45, certain agreements have been assessed by the court by reference to their effect or likely effect on price or quantity outcomes;[30]
- in the context of s.47, at least one case of exclusive dealing has been found to have the likely effect of substantially lessening competition on the basis that, prior to the conduct, there was evidence of discounts being offered, resulting in a reduction in wholesale prices;[31] and
- in the context of mergers, one of the criteria that the court must consider in determining whether the merger would be likely to substantially lessen competition is the likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins.[32]

These examples raise the prospect that the Panel's proposed re-design of s.46 may capture any conduct that allows or involves a firm with market power raising prices. In a dynamic, market economy, raising prices amounts to conduct that is more likely to attract entry by rivals, rather than to exclude them – yet, it is far from clear that this would not be caught by the Panel's proposed redraft of the section.

[29] By contrast, s.45 relates to contracts, arrangements or understandings that restrict dealings or affect competition, s.47 relates to exclusive dealing and s.50 relates to mergers and acquisitions.

[30] For example, in *Dowling v Dalgety*, a case involving an agreement to refuse access, the court was not satisfied that the exclusion of the applicant was likely to have the effect of substantially lessening competition on the basis that the provision of access would not have a downward influence on price. In *Gallagher v Pioneer Concrete*, a case involving an agreement to restrict supply, the court found that there was likely to be a lessening of competition in both an upstream and downstream market caused by an artificial limit being imposed on the supply of an input. See Re Desmond Walter Dowling v Dalgety Australia Limited; Elders IXL Ltd; Australian Mercantile Land and Finance Company Ltd; Austest Company Ltd and Primac Association Ltd [1992] FCA 35; (1992) 14 Atpr 41-165 (1992) 106 Al (10 February 1992), paras 120 – 121 and Re Graham Vincent Gallagher and Ors v Pioneer Concrete (NSW) Pty Limited [1993] FCA 59; (1993) 14 ATPR 41-216 (1993) 113 ALR 159 (26 February 1993), paras 181-182 and 189.

[31] See *Australian Competition & Consumer Commission v Universal Music Australia Pty Limited* (includes corrigenda dated 7 March 2002 &amp [2001] FCA 1925; 1 October 2002) [2001] FCA 1800 (14 December 2001)

[32] See section 50(3) of the Act.

The term 'long-term interest of consumers' is not well understood in the context of competition prohibitions. It is currently applied in the context of Part XIC of the Act - Telecommunications Access Regimes – and is interpreted as conduct which has, as its objective, the efficient investment in infrastructure.[33]

Although efficiencies in investment and service provision is the central objective of regulation as applied to network industries, it is not a concept that is easily transferrable to the assessment of firm-specific conduct. Further, as a matter of principle, it is not at all clear that unilateral conduct by a firm with a substantial degree of market power should be prohibited on the basis that it does not benefit the long-term interest of consumers. It is fundamental to a market economy that businesses operate in their own self-interest, with the objective of maximising profits, not consumer welfare.

Of course, consumers benefit from the enhancement of competition between suppliers, each operating in their own self-interest. However, the suggestion that firms with market power should be prevented from reaping the rewards of that power requires a substantial degree of caution. In our opinion, no unilateral conduct provision should have the objective of restricting firms with market power from engaging in conduct that enhances that power – potentially to the detriment of consumers – in circumstances where such conduct does not deter new entry or prevent existing rivals from competing.

4.2 Interpretation and application of the provision

The Draft Report states that a competition policy is fit for purpose if, amongst other things, competition laws are clear, predictable and reliable.[34] In our opinion, the Panel's proposed amendment to s.46 does not meet these criteria. The Panel's proposed test is more complex than the current formulation of s.46, because a case heard before the court will necessarily involve an assessment of whether:

- the firm that engaged in the conduct has a substantial degree of market power;
- the conduct has the purpose, effect or likely effect of substantially lessening competition by reference to a counterfactual state of affairs (in place of the current need to assess the purpose of the firm's conduct);
- it would be rational for a firm without market power to engage in the same conduct, ie, the effective operation of the current 'take advantage' test; and
- the conduct is in the long-term interest of consumers.

In other words, relative to the current provision, the Panel's proposed amendment:

- introduces an additional 'hypothetical counterfactual analysis' of the effect or likely effect of the conduct on competition; and
- introduces a potentially complex analysis of whether the conduct in question benefits the long-term interest of consumers.

There is currently no clarity as to how either of these tests would be applied by the court in the context of unilateral conduct.

4.3 The cost of change is not justified

In our opinion, the Panel should give very careful consideration to the threshold question of whether a potentially new law in relation to unilateral conduct is capable of bringing about sufficient improvement to

[33] As per s.152AB, the object of that Part is to promote the long-term interests of end-users of carriage services or of services provided by means of carriage services. For the purposes of that Part, in determining whether a particular thing promotes the long-term interests of end-users, regard must be had to the extent to which the thing is likely to result in the achievement of the objective of encouraging the economically efficient use of, and the economically efficient investment in the infrastructure by which listed services are supplied

[34] Draft Report, p.16.

warrant such a change. Irrespective of the Panel's preferred, revised structure or wording of the misuse of market power provision, any proposal for reform should be tested against this principle.

The two elements of s.46 that the Panel recommends be removed – 'take advantage' and 'purpose' – have been central to the prohibition on unilateral conduct for over 30 years. Since 1978, around 20 misuse of market power cases have come before the Federal and High Courts combined. These have each contributed to what is now the reasonably settled interpretation of the provision's key elements, such as 'taking advantage'.

The significant value of this, existing case law will no longer have any utility if the Panel's draft recommendations are given effect. Further, the introduction of a new misuse of market power provision would lead to a significant period of time during which businesses will not know how the new law will be interpreted by the courts. The timeline over which new case law can be developed is substantial; it would require:

- a business to engage in conduct that may be considered to breach the provision;
- the detection and investigation of that conduct;
- the initiation and completion of legal proceedings in relation to that conduct; and
- the resolution of any such proceedings, including appeals to a higher court.

By way of illustration, in the case of *Cement Australia*, more than ten years passed from the date of the first alleged contravention in 2002, to the handing down of the Federal Court judgement in 2013. This case is still potentially subject to appeal.

Taking this example, and without allowance for the additional delay that a new law may engender, it cannot reasonably be expected the first judgment in relation to the Panel's recommended amendments would occur within ten years of any new law being enacted. Early judgements are also more likely to be subject to appeal, in order to test the meaning of the terms 'substantial lessening of competition' and 'long-term interest of consumers' as they relate to unilateral conduct. In reality, the period of uncertainty before a sufficiently dense body of precedent can be established is likely to be 20 or more years.

Such uncertainty will impose direct costs in the form of additional legal advice, and will inevitably affect the strategies of businesses. During this period, businesses are more likely to shy away from pro-competitive conduct if there is a risk that courts will interpret the new law in a manner that prohibits such conduct.

In our opinion, the changes proposed by the Panel involve a necessarily long term investment with significant costs and little, if any, apparent benefit. Perhaps more importantly, we are yet to see compelling evidence that anticompetitive conduct is occurring that is not capable of being caught under the current s.46, but would be prohibited under the proposed new law. Ultimately, in our opinion the Panel's proposed amendments are highly unlikely to simplify the assessment of conduct under the provision, and so the likely substantial costs of its potential amendment are unlikely to be justified.

4.4 Proposed recommendation

We recommend that the Panel leave the primary prohibition (section 46(1)) as it is.

Alternatively, if the Panel was to confirm its draft recommendation that the primary prohibition in s.46 should be re-framed to prohibit a corporation that has a substantial degree of power in a market from engaging in conduct if the proposed conduct has the purpose, or would have or be likely to have the effect, of substantially lessening competition in that or any other market, then we recommend:

- excluding reference to the long-term interests of consumers as a mandatory element of any 'defence'; and

- providing an explanation as to the meaning of ‘substantial lessening of competition’ as it relates to this unilateral conduct prohibition.

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