



Characteristics of a Competition Policy

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1. Executive Summary

1 ‘Competition policy’ describes a collection of government policies that are intended to increase the competitiveness of an economy. From a microeconomic perspective, competition policy determines the terms and conditions upon which the state should intervene in markets. It emphasises the importance of government policy being efficient and effective, and the need for all government intervention to be justified on a cost-benefit basis. This paper summarises in a general way the major components of a competition policy. These are:

(a) The enactment and enforcement of an **antitrust law** that protects the competitive process by prohibiting market conduct that harms competition.

(b) The reform or repeal of laws that **restrict competition**. This encompasses at least two policies; (i) a review of enacted laws and regulations in order to ensure that they are compatible with competition; and, (ii) a mechanism that reviews all proposed new laws for their cost effectiveness and necessity.

(c) The **structural reform** of public utilities, including the separation of regulatory from commercial functions, the vertical separation of natural monopoly assets from competitive markets, and the horizontal separation of large businesses into smaller businesses.

(d) An **access regime** which gives firms access to natural monopoly infrastructure in order to allow them to compete in dependent markets.

(e) A **competitive neutrality** framework which ensures that (i) public and private enterprises face the same set of rules and (ii) that no contact with the state brings competitive advantage to any market participant.

(f) The introduction of **price controls** in monopoly markets, coupled with incentive mechanisms that encourage cost reductions, related reforms to improve competition in the regulated market, and regular regulatory reviews.

(g) A transparent **institutional and political structure** that supports the application of competition policy to markets.

2 The policies listed above demonstrate that competition policy is not averse to state-intervention in markets. It is a pragmatic policy that recognises the importance of government intervention to correct instances of market power, market failure, and monopoly. While competition policy is fundamentally premised on the power of free markets, it applies real-world standards and concepts, not blind ideology, in order to obtain realisable improvements in competition. These standards often depend on state intervention. In this respect, the question of how much or how little state intervention in markets is necessary to improve competition is different in every country and in every market. Ultimately, the question can be resolved by cost-benefit analysis, with intervention only being appropriate where the benefits of competition exceed the costs of regulation.

2. Introduction

3 The rivalry of firms engaged in competition lowers prices, reduces costs, improves efficiency and enhances social welfare. In recognition of the economic prosperity that is brought about by competition, many governments have undertaken microeconomic reform that is specifically designed to promote competition.

4 Very significant gains have been realised by comprehensive, national competition policies in those countries that have adopted them. For example, in 1995, all Australian governments agreed a National Competition Policy. When that policy was evaluated a decade later, it was found that the policy had boosted Australia's gross domestic product by between 2.5 and 5.5 per cent (between \$20bn and \$44bn) in its first five years¹. Over this time, microeconomic reforms, including competition policy, had increased the average household income of Australians by more than \$7,000².

5 This paper has been prepared for the School of Government, University of Melbourne on the characteristics of a competition policy. The parameters of competition policy determine, at least from a microeconomic perspective, the terms on which the state should intervene in markets.

2.1. WHAT IS COMPETITION POLICY?

6 'Competition policy' describes a collection of government policies that are intended to increase the competitiveness of an economy.

7 A comprehensive national competition policy includes:

- (a) Antitrust law;
- (b) The reform of anticompetitive laws, encompassing deregulation and the analysis of regulation for its impact on competition;
- (c) The restructure of public utilities;
- (d) A regime for access to essential facilities;
- (e) Policies on competitive neutrality; and,
- (f) The regulation of monopoly prices.

8 Each of these topics will be covered, in general terms, in this paper. A brief paper such as this one however, is not sufficient to describe, in detail, the substance of all these characteristics of competition policy. Further analysis, as appropriate to the particular circumstances of particular jurisdictions, is usually necessary.

9 It is important to note that, while the policies covered in this report are appropriate for most developed economies, it does not necessarily follow that they would be desirable in other economies. While there are lessons that can be learnt from such examples, their application to other countries is not straightforward. It is not difficult for regulations that are designed to promote competition to end up strangling it. Because of this, every policy response to a perceived shortfall in competition must be evaluated in terms of its costs and its benefits. There is no guarantee that an intervention that is appropriate in one country will be so in another. In this respect, there is evidence to suggest that countries at different stages of development, and with different levels of governance capacity, may require different policy responses.

10 Before turning to the particular policy areas, it is first appropriate to make some preliminary remarks on the conceptual basis of competition policy, and how competition policy delimits the role that the state plays in the economy. The relationship between the state and the markets is at the heart of any competition policy.

¹ Productivity Commission, "Review of National Competition Policy Reforms" (No. 33, February 2005), p.XVII. Available at: http://www.pc.gov.au/__data/assets/pdf_file/0016/46033/ncp.pdf

² *Ibid*, p. XVII

2.2. THE PARADOX OF COMPETITION POLICY

11 The central objective of competition policy is promoting vigorous competition in minimally regulated markets. It follows that, in large part, competition policy emphasises the importance of government being restrained from crowding out private sector competitors, preventing the free exchange of goods and services, increasing the costs of doing business, and pursuing inefficient or uncommercial activities. In many respects therefore, competition policy seeks to limit the amount of state participation in the economy by concentrating on the deregulation and liberalisation of markets.

12 However, it does not follow that competition policy is intended to bring about the absence of government. Rather, competition policy recognises that there is a place for government in taking the steps necessary to bringing about workable, effective competition. In this respect, competition policy is pragmatic, in the sense that it does not envisage ‘perfect competition’ in every (or indeed, any) market. The objective is workable and effective competition. This is a real-world standard, the meeting of which often requires strong public institutions and regulatory frameworks.

13 Most fundamentally, history demonstrates, and competition policy recognises, that durable market economies are rare, and that the absence of government does not bring about a vibrant, prosperous capitalist society. Market competition requires a number of institutional safeguards in order to flourish. Amongst other things, markets require the enforcement of private property rights, the consistent application of laws by independent judges, predictable and rational political decision-making, and the absence of corruption in public and private life.

14 More specifically, competition policy recognises that persistent and entrenched instances of market failure, monopoly, or market power, will not be cured by the application of competitive forces alone (at least, not in a timeframe and at a cost that society is prepared to accept). Government intervention is required to rectify these competitive deficits, even if that intervention itself comes at a cost.

15 In this sense, competition policy presents as a significant paradox. On the one hand, its principle objective is furthering the scope in which private sector firms compete for scarce resources in a largely unregulated environment. Yet, on the other hand, it requires governments to intervene in markets – often in a very significant and continued way – in order to bring about workable competition. This is a paradox that is not easily resolved, and reasonable minds often differ on how much, or how little, government intervention is appropriate under the guise of “improving competition”.

16 Ultimately, in practice, this issue must be resolved by weighing the costs and benefits of intervention. Where the cost of government intervention is outweighed by the benefits of competition, then such intervention is generally appropriate, even where it might be ideologically difficult to reconcile with the pro-market basis of competition policy. Under this rubric, competition policy envisages withdrawing the state from some areas (i.e. by repealing restrictions on competition), exposing the state to competition in others (i.e. by subjecting state-owned enterprises to competition), and, in some instances, actually strengthening and increasing the state (i.e. ensuring that the competition regulator is independent, well-resourced and effective).

2.3. PRIVATISATION AND COMPETITION POLICY

17 The process by which state-owned enterprises (SOEs) are transferred into the private sector is, of course, the most obvious way in which the state can reduce its participation in the economy. There is no question that the privatisation of SOEs has been viewed favourably in many countries over the last two decades. This is for a number of reasons, most not having anything to do with competition (e.g. income from the sale of assets, reduced government exposure to non-contingent and contingent liabilities, shifting investment cost to the private sector, sovereign credit rating).

18 Privatisation is not generally part of a comprehensive national competition policy. Provided that a SOE operates in a competitively neutral environment (see

Section 7 of this paper), competition policy is typically unconcerned with questions of ownership.

19 That said, many of the reforms that are part of competition policy occur in the context of privatisation. In many countries, a significant reason for the adoption of competition policy has been the concern that privatisation and corporatisation would increase the likelihood of SOEs abusing their market power. It is not, therefore, always straightforward to separate privatisation from competition policy.

20 Experience with privatisation and the promotion of competition has demonstrated that, in general, privatisation is consistent with competition policy where the SOE to be privatised operates in a competitive market. This is because, to the extent that privatisation improves the efficiency of the SOE, the competitive process will ensure that that improvement is passed on to consumers by way of lower prices or improved service levels. Thus, in competitive markets, competition policy is supportive of (or neutral towards) well-structured, orderly privatisations that preserve the competitive status quo.

21 Where, of course, a privatisation has the potential to eliminate competition in a market (as, for example, might occur where non-competitively neutral policies are proposed as an inducement to buyers), competition policy is opposed to privatisation. Further, in the context of public monopolies (i.e. electricity, telecommunications, oil and gas, water), which do not generally operate in competitive markets, competition policy is sceptical about the benefits of privatisation for two reasons.

(a) First, it is almost universally true that a SOE sold as an ongoing, protected monopoly will generate a much higher sale price than if it is structurally reformed or heavily regulated or both. Put simply, monopolies are valuable, and governments that seek to sell them are conflicted between their responsibility to promote competition and their desire to obtain the highest sale price possible. It is too often true that the latter consideration wins out, and monopolies are sold into private hands without having had their market power ameliorated.

Once monopolies are in private hands it can be much more difficult for governments to regulate to reduce their level of market power. Indeed, in some instances, it can be impossible, as constitutional and property laws present formidable obstacles for a government seeking to force the structural reform of a private business. Even where there is no specific legal obstacle, post-sale structural reform or the imposition of heavy regulation increases a country's sovereign risk, a consequence that many governments are unwilling to accept. In this respect, privatisation can entrench market power and make effective competition in the market much more difficult to achieve. It is for this reason that the Hilmer Report, which was a major review of competition policy in Australia in the early 1990s, warned of the dangers of governments trading "cash for competitiveness".³

(b) Second, a persistent problem in competition policy is the apparently intractable market power of legacy SOEs that own and operate natural monopoly infrastructure. For example, in the telecommunications context, despite decades of open access, incumbent fixed-line providers are still dominant in nearly all OECD countries. To those involved in competition policy, the primary problem in these markets is not the inefficiency of state ownership (which is what privatisation sets out to eliminate), but the ongoing challenge of encouraging new entry in markets dominated by a large business with market power. In this context, privatisation is, at best, a secondary concern, and at worst, likely to worsen the situation.

22 The two concerns outlined above should not be taken to mean that competition policy is opposed to privatisation. What they do mean however is that competition policy tends to prefer that structural problems are resolved and that, at the very least, the settings are in place for a competitive market to occur (if not competition itself), prior to privatisation. This means that SOEs with market power should be structurally reformed before they are sold, even if that means that the sale price is low.

³ *National Competition Policy Review, August 1993, p.227*

3. Antitrust Law

23 For many years, competition policy was considered to be synonymous with the laws dealing with anticompetitive behaviour. The scope of competition policy is now considerably wider, encompassing the much broader range of issues set out elsewhere in this paper. Nevertheless, antitrust remains a critically important part of competition policy. It is not the role of this paper to provide a detailed summary of the competition law in OECD countries. However, it suffices to make some general observations about the structure of antitrust law, and its role in promoting competition.

3.1. GENERAL CHARACTERISTICS OF ANTITRUST LAW

24 The primary objective of antitrust law is to protect the integrity of the competitive process, and thereby improving social welfare overall. It achieves this by either prohibiting market conduct on a per se (that is, a “without exceptions”) basis, or, alternatively, prohibiting market conduct has the effect of diminishing or harming the level of competition in the market. Antitrust law operates ex post, that is to say, after the prohibited conduct occurs, by imposing sanctions (including, in some instances, custodial sentences) on offenders. Like all punitive laws, it has a role in preventing prohibited conduct occurring at all by way of its effect as a deterrent.

25 Antitrust law does not make monopoly itself unlawful. The law, with the exception of that part of antitrust that deals with mergers, is concerned with market behaviour not with market structure.⁴ Further, antitrust law does not prohibit “excessive” prices, and cannot impose price controls. As a consequence of these two limitations, antitrust is of limited effectiveness at promoting competition in near-monopoly or monopoly markets.

That is not to say it is useless; far from it, as it delimits the field of acceptable behaviour for firms with market power. However, it is not generally effective at leading to marked improvements in the level of competition in markets where competition is lacking and barriers to entry are high. This often requires structural or regulatory solutions, discussed in Section 4 and 5 of this paper.

26 The prohibitions in antitrust are twofold:

(a) It comprises a general prohibition on all arrangements between businesses that have the effect of lessening competition. This general prohibition applies to both horizontal and vertical business relationships. It also prohibits unilateral conduct that lessens competition by a firm with market power.

(b) It includes specific prohibitions on certain activities irrespective of the effect that they have on competition. The most common prohibition is with respect to price fixing, which is prohibited absolutely and without exception. The reason for the automatic prohibition is that some types of conduct are virtually always harmful to competition and are rarely (if ever) offset by any benefits to the wider economy. Accordingly, the conduct is prohibited without any need to inquire into the effect on competition of the particular arrangement.

⁴ It is worth noting that in some countries, including the United States, a court can order the break-up of a monopoly where it has engaged in anticompetitive behaviour in breach of the law.

3.2. SCOPE OF ANTITRUST LAW

27 It is now well accepted that antitrust law should apply to all economic actors, including those owned by the state. It should also apply to all legal forms through which business is conducted, including individual persons operating as sole traders (i.e. doctors, lawyers, and other professional persons). These principles reflect that fact that it is only by imposing antitrust economy-wide that a nation can avoid creating distortions or leaving pockets of anticompetitive behaviour unaffected.

28 Despite this, most countries exempt some industries from antitrust. Farmers, trade unions, the professions (lawyers and doctors), government businesses and banks have all, at one time, been exempt from antitrust. There is rarely a compelling economic reason for these exemptions. They are more commonly the result of rent seeking and politics than public good. A significant part of competition policy is concerned with eliminating all exemptions from antitrust, other than those that confer sufficient benefits on the community to justify the (substantial) social and economic cost of exempting a sector of the community from antitrust laws.

29 In some countries, blanket exemptions from antitrust have been replaced with an authorisation mechanism. Under such a system, a person seeking immunity from antitrust (either with respect to a particular activity, or transaction, or generally), approaches the competition regulator for permission. That permission can only be given following a public consultation process that determines whether or not it would be in the public interest. In practice, regulators all over the world have been extremely strict, and rarely grant such authorisations.

3.3. SANCTIONS

30 There are several types of sanctions for breaches of antitrust law:

(a) The most obvious sanction is the application of a fine. A fine is generally calculated without reference to how successful the contravention was – it is possible that an offender will be made subject to a fine without obtaining any commercial advantage from their offence.

These fines can be very substantial. In the United States for example, the penalty can be determined as up to \$100m or twice the injury or benefit resulting from the contravention. In Australia, the fine is the greater of \$10 million or 10% of a company's annual turnover. In the European Union, the fine cannot exceed 10% of a company's annual turnover.

(b) Many countries also permit awards of damages. This is a monetary sum calculated with reference to the damage or harm that others have suffered as a consequence of the unlawful behaviour. This is separate and in addition to fines that are calculated with reference to the damage that the behaviour has caused, even though both are calculated on a similar basis.

(c) Injunctions (i.e. preventing the behaviour from re-occurring), declarations (i.e. a formal finding by a court that an offence has occurred), and other continuing remedies that are designed to prevent a repeat of the offence (i.e. the European Union's continuing conduct remedy that requires Microsoft to 'unbundle' certain functions from its Windows operating system).

(d) In the case of serious cartel behaviour, custodial sentences of significant duration. It remains uncommon for individuals to be convicted of cartel offences in jurisdictions other than the United States. This is partly a consequence of the newness of such laws in most countries. Nevertheless, they are a very important deterrent that affects the behaviour of executives in a much more significant way than the imposition of corporate fines.

(e) In some countries, for some types of offences, such as mergers that lead to a lessening of competition, divestment of assets.

3.4. ENFORCEMENT AND INSTITUTIONAL ARRANGEMENTS

31 The severity of sanctions in the antitrust law is of no consequence if those contemplating the commission of offences cannot expect the law to be enforced and any transgressions punished. As Sir Samuel Romilly put it, albeit in another context, “the chief deterrent to crime is not barbarity of punishment but certainty of conviction.” The role of a competition regulator in detecting offences and effectively pursuing their prosecution is, therefore, of absolutely fundamental significance.

32 A variety of institutional models have been adopted around the world. In common law countries such as Australia, the United States and the United Kingdom, the practice is for the competition regulator to assume an investigative role akin to prosecutor: they collect evidence, develop a case, and then seek to prove it to a court. It is the court, not the regulator, which imposes sanctions. In other jurisdictions, including, most importantly, the European Union, the regulator itself has the power to make orders and impose fines in antitrust cases. Those orders are then reviewable by a court, but it is the regulator that makes them in the first instance. Lastly, in some jurisdictions, both regulators and courts impose penalties. For example, in the proposed competition law in Hong Kong, the Competition Commission will be able to impose small fines, but the Competition Tribunal (a judicial body) will be able to impose much larger fines.

33 As noted above, in Australia, the United States, and a number of other jurisdictions, some competition law offences are criminal and can be punished by way of custodial sentences. In this respect, in most jurisdictions, the apparatus of criminal justice is kept separate from the commercial courts that apply civil penalties and other sanctions. Where a competition offence is criminal in nature, the prosecuting authority, the experience and practice of the judge, and the procedures of the court itself, will all differ from a case where the offence is a civil one. In Australia, the Commonwealth Director of Public Prosecutions, not the competition regulator, prosecutes serious cartel offences. An experienced, criminal trial judge, not a commercial judge, hears such cases, with the issues ultimately determined by a jury. Similarly, in the United States, while the Federal Trade Commission and the Department of Justice pursue antitrust cases jointly, it is the Department of Justice that has the power to file criminal charges against defendants.

34 Building the institutional structures necessary for the detection and prosecution of antitrust offences can take decades to develop. In countries which do not have well-developed or resourced regulators, assistance from other countries – by way of cooperation and training – can be an effective way of developing a capacity locally. In this respect, the burgeoning field of international cooperation amongst antitrust regulators is a useful resource.⁵

⁵ Fels, A. “Transnational Networks and the Trade Practices Act” (2010) 18 *Trade Practices Law Journal* 50

4. Anti-competitive Laws and Regulations

35 The adoption of competition policies around the world has been accompanied by widespread public recognition that government interference in markets can impose significant costs, reduce the incentive for businesses to invest, lower a country's international competitiveness, and lead to reduced living standards. An essential principle of competition policy is that regulatory restrictions on competition should not be imposed unless it is demonstrated that the benefits of the restriction (to the community as a whole) outweigh the costs, and that those benefits can only be realised by regulation that restricts competition.

36 The Hilmer Report into Australia's national competition policy found, in the early 1990s, that "*the greatest impediment to enhanced competition in many key sectors of the economy are the restrictions imposed through government regulation.*"⁶ The repeal and/or reform of these laws have arguably been the most significant contributions made by competition policy to Australia's national competitiveness and productivity. Indeed, the almost unanimous recognition amongst OECD countries as to the importance of "better regulation" is testament to the economic importance of this development.

4.1. THE OECD GUIDING PRINCIPLES

37 The trend towards "better regulation," in the sense of more cost-effective and efficient regulation, has been driven in part by OECD-led reforms that commenced in the mid-1990s. For many years, the OECD has been promoting a whole of government effort to create a regulatory environment favourable to the creation and growth of businesses, productivity gains, competition, investment and international trade.⁷ This was, and remains, an iterative process, whereby the OECD would encourage cultural and practical changes at all levels of government.

38 In 1997, OECD Ministers finalised and agreed upon a set of seven principles for regulatory quality and performance. These principles have proved highly influential, and have been the benchmark against which the OECD has judged the performance of countries in the area of regulatory reform. These principles were reaffirmed by the OECD in 2005, and are as follows:⁸

- (a) Adopt at the political level broad programmes of regulatory reform that establish clear objectives and frameworks for implementation.
- (b) Assess impacts and review regulations systematically to ensure that they meet their intended objectives efficiently and effectively in a changing and complex economic and social environment.
- (c) Ensure that regulations, regulatory institutions charged with implementation, and regulatory processes are transparent and non-discriminatory.
- (d) Review and strengthen where necessary the scope, effectiveness and enforcement of competition policy.

⁶ *Independent Committee of Inquiry into Competition Policy in Australia in 1993, National Competition Policy: Report by Independent Committee of Inquiry into Competition Policy in Australia (Professor F Hilmer, Chairman), Australian Government Publishing Service Canberra, p xxix*

⁷ *OECD, Guiding Principles on Regulatory Quality and Performance, 2005, Paris. Available at: <http://www.oecd.org/dataoecd/19/51/37318586.pdf>*

⁸ *Ibid.*

(e) Design economic regulations in all sectors to stimulate competition and efficiency, and eliminate them except where clear evidence demonstrates that they are the best way to serve broad public interests.

(f) Eliminate unnecessary regulatory barriers to trade and investment through continued liberalisation and enhance the consideration and better integration of market openness throughout the regulatory process, thus strengthening economic efficiency and competitiveness.

(g) Identify important linkages with other policy objectives and development policies to achieve those objectives in ways that support reform.

39 These principles are the backdrop against which competition policy has developed, though competition policy is only one of a number of important issues contained therein. What is clear however, is the attention paid to ensuring that regulation is both effective, in the sense that it accomplishes its objectives, while also being efficient, in the sense that it does so at the lowest possible economic cost.

40 When it comes to regulatory reform, the particular focus of competition policy is on, first, identifying existing regulations that are anti-competitive and, if necessary reforming or repealing them. The second focus of competition policy is developing new regulations in light of their likely impact on competition. Each of these topics can be discussed in turn. In countries that have significantly advanced a regulatory reform agenda, the reform of existing laws has often already occurred, with the focus now on new regulatory proposals.

4.2. EXAMPLES OF ANTI-COMPETITIVE LAWS AND REGULATIONS

41 There are countless ways in which laws and regulations restrict competition.

4.2.1. REGULATORY BARRIER TO ENTRY

42 The laws and regulation that have the most direct and significant effects on competition are those that restrict entry by new businesses. These laws operate as a substantial, if not an absolute, barrier to entry. Regulatory barriers to entry confer a substantial benefit on firms already in the market, as they protect those firms from competition and allow them to charge higher prices (and therefore extract greater profits) than would be the case if entry by new businesses was permitted.

43 Removing regulatory barriers to entry is important even where new entry is unlikely. This is because even the threat of new entry imposes a competitive constraint on firms already in the market. As any attempt to increase prices to a supra-competitive level would be met by new entry, firms in a contestable market are subject to competitive forces even where entry does not actually occur.

44 Because of the benefit that regulatory restrictions on entry bestow on firms already in a market, support for these laws can be very entrenched. Often, large, powerful constituencies develop under the shelter of these laws. These groups have a vested interest in the continuation of the laws protecting them and any move to repeal them is almost certain to be opposed. The repeal of such laws has proven to be a very significant political challenge for competition policy, but has likewise generated some of the most significant economic benefits.

45 Regulatory barriers to entry can be categorised as follows:

(a) **Government supported monopolies.** These fall into four categories.

First, government owned utility companies are often protected by law from new entry. Historically, this was to enable government to provide basic services (water, electricity, gas, etc) to all persons in the community, regardless of the individual costs of serving each customer. Having a single provider allowed government to average the cost across the entire community, using the cross-subsidy from low-cost customers to meet the needs of high-cost customers. It was thought that if new entry were permitted, it would occur in low-cost, profitable areas, which would make it more costly for the government utility to fulfil its community service obligations. The reform of such monopolies is discussed in Sections 4 and 5 of this paper.

Second, government can create an unofficial monopoly by allocating public works and services to a single firm without a competitive tender process. For example, it continues to be the case, in many countries, that the construction and maintenance of public assets, such as roads, is an effective monopoly, as governments provide the contracts to undertake such works to a single firm (often a SOE) without a tender process.

Third, some governments have conferred monopolies on the marketing and sale of agricultural products. This has been justified by stakeholders in a number of ways, including the need to guarantee farmers a certain price, the desirability of increasing the market power of farmers, and the desire to make a country more competitive in international agricultural export markets. None of these justifications typically withstands economic scrutiny.

Fourth, governments sanction monopolies by application of intellectual property law. This is beyond the scope of this paper.

(b) **Quantitative restrictions.** Some government regulations limit either (a) the number of competitors in a market; or (b) the volume of production; or (c) both. The former is usually accomplished by restrictive licensing regimes, and the latter

accomplished by production quotas.

In a market governed by quantitative restrictions, competition is not prohibited as such, but the tightly controlled industry structure means that it is very weak (and often increases the scope for anticompetitive agreements and other antitrust offences).

Many examples of such regimes exist. An elaborate milk quota system continues to exist in the European Union, whereby a ceiling is set for the milk production of each nation state. In Australia, regimes of this sort existed for many years in the egg, milk and potato industries but have now been abolished. Many countries continue to apply quantitative restrictions to their taxi industry, i.e. the government limits where the number of taxicabs authorised to be on the road at any one time.

(c) **Qualitative restrictions.** In many markets, entry is restricted to those businesses able to demonstrate to a regulator that they meet, and continue to meet, certain quality-standards. There are often very good reasons for these rules (i.e. it would not be desirable to impose no quality controls on nuclear power stations for example), but competition problems manifest in at least two respects.

First, it is often the case that quality standards are imposed on industries that arguably do not require mandated quality control (i.e. the supervision of hairdressers for example). Such rules can safely be removed without any appreciable decline in quality, at least, not to such an extent as to warrant state intervention. Second, regulatory regimes can be far more restrictive than necessary – often getting more restrictive over time as they encourage and protect powerful constituencies. Thus, a quality restriction can, over the fullness of time, morph from being entirely justifiable to very anticompetitive.

(d) **Trade barriers.** Trade barriers, both to international and inter-regional commerce, are self-evidently a significant barrier to entry. The removal of such barriers is occasionally discussed under the label of competition policy, but it is more commonly considered as a question of trade policy.

4.2.2. REGULATORY RESTRICTIONS ON CONDUCT

46 There are a very diverse number of laws that prevent businesses from engaging in conduct that they would otherwise have an incentive to undertake. Where that conduct would have resulted in a firm operating at a lower cost, or otherwise in a more efficient way, these restrictions negatively impact on competition. Often however, these restrictions have a compelling public interest basis that justifies restricting competition. For example, it is not in the community's interest that companies are permitted to pollute the environment, manufacture unsafe products, or prepare food in an unhygienic way. Because of this, each regulatory restriction on conduct must be considered individually to see whether the cost of the regulation is justified by a public interest. It is not possible to otherwise generalise on conduct restrictions. That said, two conduct restrictions that have often raised concerns for competition policy are price controls and advertising restrictions.

4.3. THE REVIEW OF EXISTING LEGISLATION

47 As indicated above, a focus of competition policy is on identifying existing laws that have a negative impact on competition. To this end, a number of countries have pursued legislative review programs that aim to identify anticompetitive laws and examine whether they cannot be repealed, reformed or replaced. One of the largest and most formal reviews of this sort occurred in Australia in the 1990s, and ran for almost a decade.

4.3.1. THE AUSTRALIAN LEGISLATIVE REVIEW PROGRAM

48 In Australia, the Hilmer Report into Australia's competition policy found that the most significant impediment to competition in Australia was the existence of laws and regulations that affected competition. In response to this finding, Australian governments agreed in 1996 to a legislative review program. The idea was that all existing laws should be reviewed in light of the principle that restrictions on competition should not be permitted unless it was demonstrated (ideally by quantitative analysis) that the benefits of the restriction to the community as a whole outweighed the costs, and that those benefits could only be realised by regulation that restricted competition.

49 One of the first tasks for policy-makers following the Hilmer Report was the identification of such laws – 1,800 laws were identified in 1996 as having a deleterious effect on competition. The number of sectors affected were diverse, as set out in Table 1 below.

50 The national competition policy required all Australian governments to undertake comprehensive, bona fide examinations of the effects of restrictions on competition and on the economy generally. The reviews were required to be conducted openly and transparently, with maximum scope for public participation and consultation. It was judged appropriate that independent panels at arms-length from government would review each piece of legislation individually. It was also agreed between Australian governments that if a jurisdiction retained an anticompetitive law, it would be systematically re-evaluated at *least* every ten years.

Table 1: The scope and variety of anti-competitive laws in Australia in the 1990s

| | | |
|--|--|--|
| Regulation of the dairy industry | Domestic marketing arrangements for rice | Shop trading regulations |
| Liquor licensing | Third-party motor vehicle insurance | Worker's compensation arrangements |
| Professional indemnity insurance for legal practitioners | Regulation of Australia Post | Agricultural marketing arrangements |
| The regulation of pharmacies | The regulation of professional occupations | Employee choice and public sector superannuation schemes |
| The gaming industry | Taxi licensing and regulation | Animal welfare regulation |
| Food quality regulation | The regulation of digital television | |

51 Each review was, in general terms, and for each piece of legislation, required to:

- (a) clarify the objectives of the legislation;
- (b) identify the nature of the restriction on competition;
- (c) analyse the likely effect of the restriction on competition and on the economy generally;
- (d) assess and balance the costs and benefits of the restriction; and
- (e) consider alternative means for achieving the same result including non-legislative approaches.

52 While the process of review was underway, governments published annual reports documenting their progress. The National Competition Council, an independent national body charged with supervising the competition policy, produced annual reports documenting the progress of each Australian government. The final such report was produced in October 2005, and provides a snapshot of outcomes from the National Competition Policy program over the period 1995-2005.⁹

53 The process of reviewing all these laws and, where judged appropriate, amending them, took more than a decade. That process is now largely completed. As a consequence of this program, a number of very significant microeconomic reforms were undertaken and a great deal of anticompetitive legislation was repealed. That said, a number of issues emerged:

- (a) First, governments tended to “pluck the low hanging fruit.” Those laws that restricted competition, but did not have the support of powerful constituencies were repealed quickly. Those laws that were politically controversial were not reformed within appropriate timeframes, or at all. Particularly contentious issues were, and remain, government support for the agriculture sector, worker’s compensation insurance, and environmental and planning laws.

⁹ National Competition Council, “Assessment of governments’ progress in implementing the National Competition Policy and related reforms,” October 2005. Available at: <http://ncc.ncc.gov.au/docs/2005%20assessment.pdf>

(b) Second, many laws had an inter-jurisdictional dimension, in that effective reform of the affected industry would require cooperation amongst different Australian governments. This cooperation has historically been difficult to achieve, and the legislative reform program was no exception. While this is unlikely to have a direct parallel in countries that lack Australia’s federal system of government, it does point to the issues associated with reforming sectors that include multiple stakeholders.

54 Despite the issues above, the legislative reform program was one of the most significant microeconomic reform programs in the last decade. It led to the withdrawal of the state from a substantial number of industries. Entire industries were completely deregulated as a consequence of this program.

4.3.2. RETROSPECTIVE REVIEW OF REGULATIONS IN OTHER COUNTRIES

55 Outside Australia, many other countries have conducted and will continue to conduct reviews of regulations that are already on the books. For example, in 2011, there have been major developments in this area in the United States and the United Kingdom.

56 In the United States, a significant recent development was the promulgation of Executive Order 13563 by President Obama on 18 January 2011, requiring all American regulatory agencies to prepare plans to periodically review their existing regulation. In the accompanying explanatory memorandum, the rule change was explained as follows:¹⁰

... *Executive Order 13563 emphasizes the importance of retrospective analysis of rules and contains a “look back” requirement: “Within 120 days of the date of this order, each agency shall develop and submit to the Office of Information and Regulatory Affairs a preliminary plan, consistent with law and its resources and regulatory priorities, under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, expanded, streamlined, or repealed*

¹⁰ M-11-10, Executive Order 13563, “Improving Regulation and Regulatory Review” (February 2, 2011)

so as to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives."

... The aim is ... to create a defined method and schedule for identifying certain significant rules that are obsolete, unnecessary, unjustified, excessively burdensome, or counterproductive. Agencies should explore how best to evaluate regulations in order to expand on those that work (and thus to fill possible gaps) and to modify, improve, or repeal those that do not. Candidates for reconsideration include rules that new technologies or unanticipated circumstances have overtaken. Agency review processes should facilitate the identification of rules that warrant repeal or modification.

While systematic review should focus on the elimination of rules that are no longer justified or necessary, such review should also consider strengthening, complementing, or modernizing rules where necessary or appropriate—including, if relevant, undertaking new rulemaking. Retrospective review may reveal that an existing rule is needed but has not operated as well as expected, and that a stronger, expanded, or somewhat different approach is justified. In formulating its preliminary plan for retrospective review, each agency should exercise its discretion to develop a plan tailored to its specific mission, resources, organizational structure, and rulemaking history and volume.

57 The new American system requires agencies to submit to oversight by the Office of Management and Budget. It remains to be seen whether it produces an effective system of legislative review. By way of caution, the experience in Australia would suggest that allowing each agency to set its own parameters for review can make meaningful change more difficult to achieve.

58 In the United Kingdom, the Government began a "red tape challenge" in April 2011. Every month, the government plans to publish the regulations that relate to a particular sector on a public website for comment. The submissions will then be assessed, and the regulations will be sent to the Minister responsible. Ministers will then have three months to determine which regulations can be repealed, with

the presumption that all regulations will be repealed unless accompanied by a justification. An independent reviewer will assess ministerial decisions under the program. It is an open question as to whether the UK Government's new program will be effective. The detail of the proposal is currently scant, particularly with respect to independent oversight of ministerial decisions.

4.4. GATE-KEEPING ARRANGEMENTS: REGULATORY IMPACT ANALYSIS

59 In most other OECD countries, nearly two decades of competition policy, deregulation and trade liberalisation has shifted the focus of reform from repealing existing laws to the review of new laws. This is a more complex and iterative process than the systematic review of existing laws under a legislative review program. It requires a durable "competition culture" in government and a robust system of assessment in order to ensure that new laws promote, rather than impede, competition.

60 The process of ensuring that government's continue to enact regulations that promote competition is referred to as gate-keeping. The Australian National Competition Council has described gate-keeping in the following terms:¹¹

Effective gate-keeping is necessary to guard against the introduction of legislation that is not in the public interest. Australia is subject to a rapid regulatory accretion, and governments face a variety of pressures to enact new laws. Where new laws are in the public interest, community welfare is enhanced. But the costs as well as the anticipated benefits of regulation need to be assessed rationally. This is the role of gate-keeping systems...

¹¹ National Competition Council, "Assessment of governments' progress in implementing the National Competition Policy and related reforms," October 2005, p.xiv.

61 The purpose of gate-keeping is to prevent governments, having reviewed and removed anticompetitive laws, from, over time, enacting new ones and easing the benefits of reform. Gate-keeping mechanisms are necessary because the number of rules being produced by regulatory agencies is so enormous that it cannot be reviewed by parliamentary means. Such mechanisms are also necessary because the political process can be influenced by sectional lobbying, and, when this occurs, laws can be enacted that discriminate in favour of political constituencies. Of course, gate-keeping mechanisms cannot prevent a country's legislature or regulators from enacting bad laws – gate-keeping would raise democratic concerns if they did. They can however, make the costs of bad law clear to both the public and decision-maker. This, it is hoped, reduces the likelihood of their occurrence.

62 Various gate-keeping mechanisms have been tried over the years. Currently, for example, the United Kingdom operates under a "one-in, one-out rule", which requires Ministers to identify an existing piece of regulation to be repealed for every new one proposed. It has also imposed a three-year moratorium on domestic regulation for small businesses and start-ups. While there is a place for rules such as these in some circumstances, the most mainstream policy designed to improve the quality of new regulation is regulatory impact analysis, and it is on this mechanism that this paper will focus.

4.4.1. REGULATION IMPACT ANALYSIS

63 Regulatory impact analysis (RIA) is a study of the costs and benefits of all feasible, alternative regulatory solutions to a given problem. Most OECD countries now require new regulations to be prepared in conjunction with some form of RIA. The widespread consensus on the appropriateness of RIA is in large part due to its effectiveness at improving the efficiency and effectiveness of new regulations.

The OECD describes it in the following terms:¹²

"RIA represents an essential core tool for ensuring the quality of new regulations through a rigorous, evidence-based process for decision making. A well functioning RIA system can assist in promoting policy coherence by making transparent the tradeoffs inherent in regulatory proposals, identifying who is likely to benefit from the distribution of impacts from regulation, and how risk reduction in one area may create risks for another area of government policy. RIA improves the use of evidence in policy making and reduces the incidence of regulatory failure arising from regulating when there is no case for doing so, or failing to regulate when there is a clear need."

64 The primary objective of RIA is simple. By requiring government agencies to identify a number of different policy options, and then analyse their costs and benefits, RIA is intended to identify the most efficient regulatory solution to any given public policy problem – that is, the one that produces the greatest benefit at the least cost.

65 Of course, part of this process involves identifying those government regulations that, regardless of their form, would impose more costs on society than they would benefits. Obviously, such regulations ought not to be enacted. Similarly, the process allows policymakers to determine whether a regulatory response to a problem is better than doing nothing; i.e. whether the cost of the problem exceeds the cost of the regulation. Further, by encouraging government agencies to consider proposed laws in a cost/benefit framework, the quality of government decision-making itself be improved. If properly integrated into the decision-making process, RIA can improve the quality of the process itself, resulting in more efficient and effective regulation.

¹² OECD, *Indicators of Regulatory Management Systems*, 2009, p.61.

66 Additional objectives of RIA also include:¹³

(a) In some contexts, RIA can assist government to coordinate multiple policy objectives. For example, both economic growth and preservation of the environment are legitimate objectives for government but can often be difficult to reconcile with one another. A trade-off will often, if not always, be required. RIA can be of assistance in identifying those policies that weigh competing interests in the most efficient way.

(b) Lastly, in many countries, RIA is integrated into the public consultation process. In this way, it is an essential part of improving government accountability and transparency. It exposes the way in which a government decision is made to public scrutiny, which not only improves the quality of decision-making, but adds legitimacy to the decision itself.

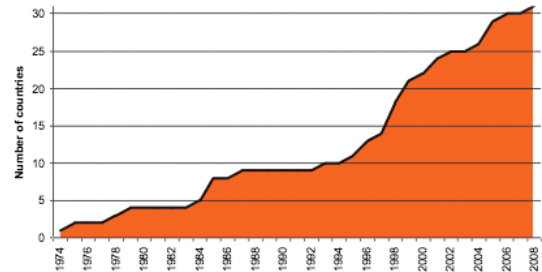
4.4.2. RIA REQUIREMENTS IN OECD COUNTRIES

67 The experience of RIA in OECD countries is long and varied. A number of countries, including the United States, began using RIA in the 1970s,¹⁴ but most date their adoption of the process to the 1980s. In 1997, OECD Ministers adopted the OECD Report on Regulatory Reform, which included a recommendation that OECD governments systematically use RIA in the development of new regulation.

The inclusion of RIA in the OECD regulatory reform process greatly facilitated the widespread adoption of formal RIA requirements in OECD countries.

This is illustrated in Figure 1 below.

FIGURE 1: ADOPTION OF RIA REQUIREMENTS IN OECD COUNTRIES



Source: OECD (2009), *Indicators of Regulatory Management Systems*, p. 64, Paris.

68 While the practices between countries vary significantly, there is increasing convergence in the way RIA requirements are structured. This is in large measure due to the regulatory reform process run by the OECD and the European Union, both of which have had a standardising effect on countries within their ambits. In particular, across the following questions, countries are increasingly adopting a standard approach.

(a) *The requirement to conduct RIA.*

It is now almost universally true that government agencies are required by law or by binding administrative rule to undertake RIA for all new regulations. It is no longer the case that such analysis is done on a voluntary basis. Compliance with these requirements, in Australia at least, is high. In 2009-2010, only 16% of regulatory proposals reached the decision-maker without RIA being conducted to an acceptable standard.¹⁵ This was higher than in 2007-08 and 2008-09, where non-compliance figure was 10% and 15% respectively.

(b) *When RIA is undertaken.*

In nearly all countries, RIA is conducted prior to a regulatory proposal being finalised. Because a core purpose of RIA is to assist a decision-maker to choose between alternatives, undertaking RIA after a proposal has been finalised is of considerably less

¹³ OECD, *Regulatory Impact Analysis: Best Practices in OECD Countries*, 1997.

¹⁴ Indeed, Denmark adopted a mechanism for assessing the economic and social effect of regulation as early as 1966.

¹⁵ Office of Best Practice Regulation, "Best Practice Regulation Report", 2009-2010, at p. 16. Available at: http://www.finance.gov.au/obpr/reporting-publications/report-09-10/docs/practice-regulation-report_2010.pdf, p. 16

usefulness, though still occurs in some countries.

There is greater variation in the types of laws that require RIA to be undertaken. Some countries require RIA for all new laws and regulations. Others require it for major proposals only. In Australia, a RIA must accompany all primary laws and major subordinate regulation. It is usual for countries to qualify the requirement in this way: i.e. to 'major' or 'significant' regulation. It is unusual however, for a jurisdiction to not require RIA for subordinate regulation at all. The OECD indicates that, as of 2008, only Portugal and the Slovak Republic required RIA for primary laws and not for subordinate regulation.¹⁶ With one exception, all countries require RIA for primary laws, although this again is occasionally qualified to apply only to 'major' or 'significant' laws. The United States does not require RIA for laws enacted by the US Congress, and in this respect, is unique amongst OECD countries for not requiring RIA for the passage of primary legislation.

It is worth noting that many countries, including Australia, Canada and the United States, allow agencies to undertake short form RIA for minor proposals. This recognises that it is better to make all laws and regulations subject to RIA requirements, and then permit agencies to undertake short-form analysis for minor proposals, than it is to exclude some (potentially costly) regulations from the regime altogether.

(c) *The enforcement of RIA requirements.*

Nearly all OECD countries have an independent agency that is responsible for assessing the adequacy of RIA undertaken by other government departments. It is also usually the case that the external agency has the power to block and revise the proposal, at least to some extent.

All OECD countries adopt similar mechanisms. For illustrative purposes, in Australia, at the Commonwealth level, the Office of Best Practice Regulation (OBPR) currently performs that role. The process that that agency has imposed is set out in Figure 2 below. In short, it is an Australian

government requirement that a Regulatory Impact Statement (RIS) accompany all new regulatory proposals. That RIS must be certified as adequate by the OBPR before a decision is taken on the enactment of the law/regulation. By involving the OBPR at an early stage of decision-making, agencies can significantly reduce the prospect of a regulatory proposal being found unacceptable by the OBPR. The RIS is attached to the relevant legislation or regulation, and a summary is provided to the decision-maker. All RISs are made public on the Internet. If a proposal goes to a decision-maker and is approved without a RIS being done, it is a requirement that the analysis is undertaken within one to two years of the regulation being implemented.

(d) *Transparency and accountability*

Most OECD countries require agencies conducting RIA to undertake public consultation. This is the case in Australia, Canada, the United States, the United Kingdom and New Zealand. This is, in one sense, an obvious requirement, as it is unlikely that any agency is sufficiently farsighted to identify all feasible regulatory options and/or the costs and benefits of every option without input from stakeholders. It is also the case that RIA undertaken by agencies are made publicly available, usually via the Internet.

69 Despite the increased uniformity in RIA processes, there is a great deal of variation, even within countries, as to the quality of the analysis that is undertaken in a RIA. This is, in part, due to the different levels of expertise as between countries, or between agencies in the same country. That said, at a minimum, all RIA should meet the following minimum requirements:

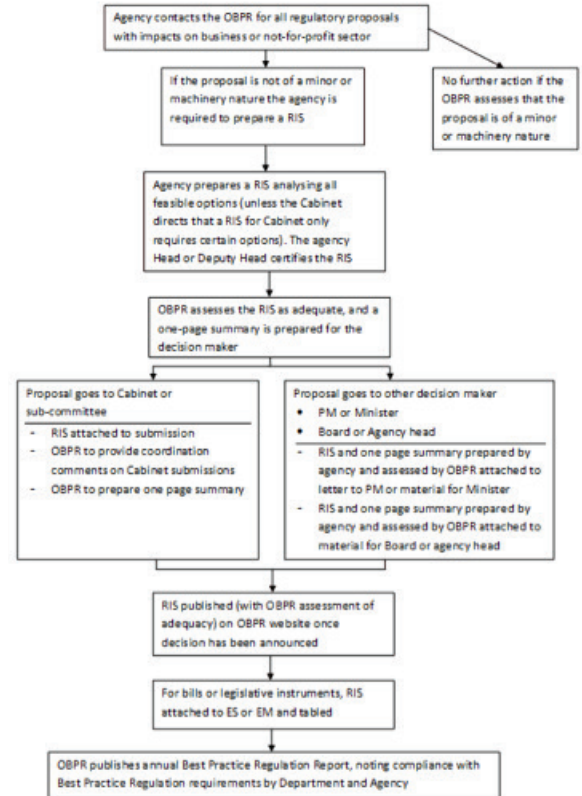
(a) More than one regulatory proposal is identified that resolves the particular problem. In Australia, "all feasible options" must be identified in the RIS, though different countries adopt different forms of words. The option of "doing nothing" must also be considered.

¹⁶ OECD, *Indicators of Regulatory Management Systems, 2009*, p. 113.

(b) The costs and benefits of each option are identified, evaluated and assessed. It is now increasingly the case that agencies must identify costs and benefits quantitatively, and then conduct quantitative cost-benefit analysis. In Australia, the United Kingdom and Canada, agencies are required to quantify costs and benefits in every instance. In most OECD countries however, quantification is only required for major proposals.

(c) The costs and benefits of each option are weighed against one another in a substantive and transparent way.

FIGURE 2: RIA PROCESS FOR NEW COMMONWEALTH LAWS AND REGULATIONS IN AUSTRALIA



Source: Australian Government, *Best Practice Regulation Handbook (2010)*, Canberra.

5. Structural Reform Of Public Monopolies

70 In those sectors where the state has owned and operated monopolies, the removal of regulatory barriers to entry is not enough to bring about competition. Where a firm has been given the benefit of a state-supported monopoly for a long period of time, its market power will be so entrenched that structural reform is required. This is especially true in markets where an essential input to competition is provided by natural monopoly infrastructure and the incumbent has developed a vertically integrated monopoly over that infrastructure.

71 Structural reform of public monopolies is focused on dismantling legacy market structures, and in so doing, eliminating the market power of the state-owned incumbent firm. As the name implies, it involves permanent change to the structure of the firm and the market.

72 There are essentially three dimensions on which structural reform occurs:

- (a) First, is the separation of regulatory functions from commercial functions.
- (b) Second, is the separation of natural monopoly assets from potentially competitive assets.
- (c) Third, is the horizontal separation of large government businesses into smaller, competitive (often privately owned) firms.

5.1. SEPARATION OF REGULATORY FUNCTIONS FROM COMMERCIAL FUNCTIONS

73 Historically, many governments gave control of an entire sector to a SOE. That SOE would determine what services needed to be provided, provide those services, and regulate the provision of those services (including determining the price charged to consumers). In every sense of the word, the sector was run as a monopoly – with all aspects of the market, including its regulation, determined by the one SOE.

74 For example, in Australia in 1901, control of the entire telecommunications sector was vested in the Postmaster-

General's Department, which was disaggregated in the 1970s into the Australian Telecommunications Commission (trading as Telecom Australia). Until the late 1980s, the Australian Telecommunications Commission (and its predecessors) was the sole provider of telecommunications services in Australia as well as being the regulator of technical standards on the network. In effect, the entire sector was considered an arm of government, and was "self regulating" in the manner of government departments. That is to say, there was a modicum of restraint that came from not being required (or even expected) to turn a profit, and being largely focused on delivery of a community service.

75 It is now well recognised that giving a government monopoly a role in regulating the market in which it competes is inappropriate. It necessitates that the firm be the judge of its own market conduct and is therefore a conflict of interest. It is also anticompetitive, as it makes it possible for the SOE to use its regulatory powers to frustrate its competitors in the market, or to advantage itself, or both. Put simply, a regulator cannot also be a competitor.

76 There are few SOEs in the OECD that continue to have regulatory powers. The regulation of SOEs, and industry more generally, has been replaced with:

(a) In some instances, regulation by a government department directly. When it comes to SOEs, this is generally disfavoured, as it does not eliminate the conflict of interest entirely. The government still has an interest in the commercial performance of its SOEs, and may regulate to advantage the SOE or disadvantage competitors.

(b) Independent regulators at arm's length from the government. This is the preferred option in the case of SOEs in the utility sector. All utility companies in Australia are regulated by one or more specialist technical regulators, as well as by the competition regulator. This true of most countries in the OECD.

(c) Industry codes of conduct, either adopted voluntarily by regulated sectors or prescribed by the government. Compliance with codes of conduct can be either voluntary or mandatory, with breaches being investigated and prosecuted by the competition regulator or another technical regulator.

5.2. VERTICAL SEPARATION OF PUBLIC MONOPOLIES

77 Many industries in which government has historically played a role exhibit some natural monopoly characteristics. This is at least partly why government was involved in such markets in the first place, it being recognised that it would be too socially costly to allow a private-firm to use its control of a natural monopoly to charge monopoly prices. Markets that are generally thought to be natural monopolies include fixed telecommunications networks, most rail tracks, electricity transmission and distribution, and natural gas pipelines.

78 There are at least two competition problems in these markets, apart from the problem of monopoly itself:

(a) First, there is a potential that the public monopoly is able to cross-subsidise its competitive business with revenue from its monopoly business. This puts rivals in the competitive market at a disadvantage that can be so significant as to deter all entry.

(b) Second, where competition in a prospectively competitive market relies on the purchase of an input in (or the sale of an output to) a monopoly market, the monopolist is able to exploit its market power in the monopoly market to obtain a competitive advantage (or impose a competitive disadvantage) in the prospectively competitive market.

79 Promoting competition in sectors of the economy that exhibit natural monopoly characteristics has been an enduring and sometime intractable problem of competition policy for decades. It is fair to say that no single model has been universally successful, and the correct public policy response continues to be controversial. The regulatory remedies fall into one of two categories:

(a) **Behaviour remedies.** Behavioural remedies are those mandating that the monopolist perform certain actions and refrain from doing others. In this context, this nearly always refers to access regimes. These are discussed in Section 6 of this paper.

(b) **Structural remedies.** Structural remedies are those where the government requires the structure of the industry to change, usually by requiring the monopolist to divest certain assets. In this context, structural separation has been used to separate the 'upstream' monopoly assets from the 'downstream' potentially competitive assets.

80 Structural reform is generally preferred to behavioural regulation for a number of reasons. The most important of these is the fact that structural reform is a permanent solution that does not require ongoing regulatory supervision of the incumbent firm. Behavioural regulation, on the other hand, requires regulatory supervision to ensure compliance and punish breaches. It is therefore costly with plenty of scope for regulatory failure. Structural separation is generally not appropriate however, where the upstream and downstream services are closely integrated (as in bulk freight railroads) and structural separation would impose very significant inefficiencies as a result.

81 Structural separation of vertical industries has been widely used in most OECD countries to restructure public monopolies. Generally speaking, vertical separation has involved separating monopoly assets from potentially competitive markets. Control of the monopoly asset has been transferred to a firm that is required by law to provide access to the asset. The price at which access is granted is, in all cases, regulated. Sometimes, but not always, this separation has occurred in the context of privatisation, but privatisation of the upstream monopoly asset is less common than the privatisation of the downstream, competitive business.

5.2.1. STRUCTURAL SEPARATION IN AUSTRALIAN COMPETITION POLICY

82 Vertical separation has been widely used in Australia, as indeed in most OECD countries, to restructure industries that were formally controlled by public monopolies. For example, vertical separation is the predominant regulatory remedy in the Australian rail industry. With the exception of Queensland and Tasmania, all states have vertically separated their rail networks to varying extents:

(a) In NSW, the regional and Hunter Valley coal networks are owned by the Rail Infrastructure Corporation, and are leased to the Australian Rail Track Corporation ('ARTC'). The freight rail operator, previously known as FreightCorp, was privatised and now trades as Pacific National (part of Asciano).

(b) In Western Australia, the freight track is leased to WestNet Rail, which is owned by Babcock & Brown Infrastructure. The freight operator is the Australian Railroad Group ('ARG'), now owned by Queensland Rail.

(c) In Victoria, an integrated long-distance passenger railroad named V-Line owns the regional rail network (which the Government reacquired from Pacific National) and the interstate network is operated by the ARTC. Above rail freight services are run by Pacific National.

(d) In South Australia, the interstate network is controlled by the ARTC (though the line to Darwin is owned by FreightLink, and some other parts of the network are controlled by Genesee & Wyoming).

83 In the telecommunications industry, the Commonwealth government has passed legislation that has allowed it to structurally separate the now-privatised incumbent Telstra. It is now considered by many that failing to separate Telstra prior to privatisation was erroneous. The Government is in the process of building a fibre network to largely replace the copper network owned by Telstra.

84 Australia is one of the few OECD countries where it has been implemented in the telecommunications sector (the other being New Zealand). Most countries have taken the view that separation of PSTN networks (i.e. traditional copper wire

networks) is too costly, and have instead imposed various accounting and functional separation regimes. There is a widespread belief however, that as networks transition to IP-based technologies, many of these costs will be ameliorated.

85 With respect to the electricity industry, until the mid-1990s, in some Australian states (Victoria, South Australia and Tasmania) generation, transmission, distribution and retailing were carried out by a single monopoly business. In other states (New South Wales and Queensland) generation and transmission were operated by a single monopoly, while distribution and retailing were carried out by businesses with geographic monopolies. A major feature of electricity market reform has been to separate each of these four functions:

(a) It has always been assumed, correctly, that the transmission and distribution businesses (i.e. the 'wires') were natural monopolies. Each state now has a monopoly transmission business (i.e. high-voltage wires), and a number of geographic distribution businesses (i.e. the lower voltage wires connected to premises). Both transmission and distribution are heavily regulated.

(b) Several competing generation businesses were created in each state, usually by making each power station a separate business. There has been some consolidation amongst generators over time.

(c) Lastly, electricity retailing has been separated and any company is, generally, free to sell electricity to any consumer in any geographic region.

86 The electricity sector has been vertically separated for many years, starting with the separation imposed by the Victorian government in the early 1990s. Some parts of the electricity industry have been privatised, although only in some states, and only sometimes in conjunction with structural reform.

5.3. HORIZONTAL SEPARATION OF PUBLIC MONOPOLIES

87 Horizontal separation is where a single large firm is broken up into smaller units, which are then free to compete with one another. For example, if an SOE has a market share of 80%, horizontal separation might envisage creating two firms with 40% share, or four firms with 20% share. Because horizontal separation does not, in principle, involve an element of natural monopoly, it is generally more likely to produce a workably competitive market than structural separation.

88 There are at least two errors however, that are commonly made by government in imposing horizontal separation:

(a) In order to successfully separate an SOE horizontally, the government must have a realistic appreciation of the minimum efficient scale of a firm engaged in producing the relevant goods or services. If this is not known, and the individual firms are too small, then they will either operate inefficiently or need to reconsolidate in order to obtain an efficient scale.

For example, in the 1980s, the American telecommunications incumbent AT&T was required to divest its local exchange service operating companies into seven, small regional companies. Operating at the regional level proved to be inefficient, and these companies have all since consolidated into national carriers.

On the other hand, if the size is too large, then it may be the case that less competition is promoted than would otherwise be the case.

(b) The structure of the horizontal separation must actually allow competition to occur. In many cases, the separation proceeds by geographic region, with little scope for substitution between regions. Thus, the government ends up creating a smaller number of geographically separate monopolies rather than one large, national monopoly.

For example, when British Rail was privatised and restructured, the train operating companies (the above-rail rolling stock operators) were given franchises over specific areas of the network. It was thought that

this would allow the companies to 'adjust' to competition while still providing a modicum of competition. In the event, unsurprisingly, there was (and remains) little competition between British train operating companies, most of which continue to operate in geographically discrete regions.

89 Horizontal separation very commonly occurs in the context of privatisation. The history of such privatisations suggests that governments may be too willing to offer generous concessions to the newly separated firm in order to achieve the sale. These concessions are usually described as "compensation" for the adjustment separation requires. In practice, once these concessions are in place it can be very difficult, politically and legally, to remove them. It is therefore incumbent on governments to design compensation, if indeed it is truly necessary, in such a way as to ensure that it does not create lasting problems for competition.

One concession that is proven to create problems is giving a firm a "grace" period in which to adjust to competition. This is what occurred in Australia in the 1990s, when the incumbent was given a period of "limited competition" in order to adjust. Likewise, this was the justification given for the franchise structure that was implemented after the privatisation of British Rail. These grace periods simply allow incumbent firms to entrench their market power, and make the subsequent development of competition much more difficult.

6. Access To Essential Facilities

90 As discussed in Section 5, in some markets, effective competition depends on firms having access to services provided by means of natural monopoly infrastructure. These markets are often referred to as being 'dependent' on the infrastructure. For example, firms cannot compete in providing train services if they do not have access to track, and electricity generators cannot compete with one another if they cannot distribute their output on electrical wires. The facilities that provide these indispensable services are known as 'essential facilities'.

91 Where the firm that owns the essential facility is not in the business of providing the dependent service, it generally has little interest in denying access. The incentive of such a firm is to maximise the profit that they can derive from the asset and, given that the asset is a monopoly, this means charging monopoly prices. This will result in the amount of access being suboptimal, as high prices will discourage it. In these circumstances, the appropriate regulatory approach is price regulation. It may also be necessary to impose a 'duty to deal' obligation on the firm, namely, an obligation that it grant access to any objectively qualified access seeker. While this latter obligation is not, strictly, necessary from an economic point of view, it is an essential requirement in giving entrants sufficient certainty as to encourage investment in dependent markets.

92 Where however, the firm that owns the facility is vertically integrated and also provides a dependent service, it usually has a clear interest in denying access to its downstream competitors. In most cases, its incentive is to favour its own business and disfavour its competitors. This is done in any number of ways, from denying access outright, charging competitors higher prices for access, providing access products of inferior quality to competitors, or by sabotage.

93 As discussed in Section 5, the regulatory response that is most appropriate where a vertically integrated firm controls a natural monopoly is structural separation. In some circumstances however, vertical

separation is either impractical (i.e. because the vertically-integrated firm is privately owned, and separation would be equivalent to a costly nationalisation program), or because it would be too inefficient (i.e. because vertical efficiencies between the upstream and downstream services are significant). In such circumstances, government around the world have imposed access regimes that, in essence, oblige the facility owner to sell access on a non-discriminatory basis at a regulated price and, usually, at a regulated quality. These access regimes are complex, and are discussed later in this section.

94 The intended outcome of access regulation is that competition in markets that depend on access to the infrastructure is promoted without inefficient duplication of the infrastructure itself. The difficulty with such regimes however, is that they must also preserve the rights of the owner of the infrastructure, i.e. incentives for the owner to invest in and improve the asset must be maintained. In this, access regulation requires a very difficult balancing exercise between the desirability of encouraging entry, often by way of a low price, and the absolute necessity of preserving investment incentives by allowing the infrastructure owner to earn a commercial rate of return.

6.1. ACCESS REGIMES AND PRIVATE PROPERTY RIGHTS

95 There is no question that access regimes are a significant intrusion by the state on the private property rights of the facility owner. The very essence of private property is the right to exclude others, and the right to set the terms on which the property can be used. Both are abrogated by an access regime. In countries like Australia and the United States, which have constitutions that protect property rights, court cases have been fought over the constitutional permissibility of access regimes.

96 In some respects, this particular controversy is misplaced. Property rights are not, not have ever been, a collection of

unqualified and absolute rights to do with ones property as one likes. It has always been the case that private property rights are restricted, abrogated or dispensed with in the face of a compelling public interest. There are few, for example, that question the legitimacy of laws limiting the use that can be made of land in a residential area, or laws mandating that public transport operators provide their services in a non-discriminatory way.

97 The controversy comes because what is often not recognised is that competition is itself a legitimate public interest that justifies intrusions on private property rights. To permit a vertically integrated monopolist to leverage upstream market power in order to extract monopoly rents significantly retards economic development and prosperity. This is a cost that is born by the community, and one that the government has a legitimate interest in reducing.

98 Consider for example that, in 2005, a decade since the adoption of a national competition policy in Australia which included imposing access regimes in most infrastructure markets:¹⁷

- (a) Average real electricity prices Australia-wide had fallen by 19 per cent since the mid-1990s;
- (b) There were substantial reductions in rail freight rates - ranging from 8 per cent for wheat, to as much as 42 per cent for some coal traffic;
- (c) Real port charges fell by up to 50 per cent; and
- (d) Average telecommunications charges fell by more than 20 per cent in real terms.

99 These are the benefits to which mandatory access is directed. To the extent that the curtailment of an access provider's private property rights is necessary to achieve these benefits, then there is no compelling theoretical difference between access regulation and any of the other myriad of laws that restrict such rights for a public purpose.

¹⁷ Productivity Commission, "Review of National Competition Policy Reforms" (No. 33, February 2005), p.XIX

6.2. TYPES OF ACCESS REGIMES

100 In general terms, there are three broad categories of access regimes:

- (a) Access that is ordered following a court case under the antitrust law;
- (b) Access under specialised laws that apply to only one sector, or indeed, to only one company; and,
- (c) Access under a general, statutory scheme that allows for access to a facility in any sector following a process of inquiry.

101 It is impossible for the purposes of this paper to discuss in great detail the significant variation in access regimes between countries, between sectors, and indeed, even between companies in the same sector. All OECD countries have been perfecting their access arrangements for decades. They are all extremely complex, and yet it is fair to say that no access regime works without regular and systematic intervention by a regulator. It suffices to say that such a regime may never be conceived. What follows are some general comments on the three types of access regimes set out above.

6.3. COURT-ORDERED ACCESS TO FACILITIES

102 It occasionally transpires that a court, following proceedings taken under the antitrust law, requires a defendant to provide access to its facilities. This would ordinarily follow from a case brought by an aggrieved access seeker, rather than by the regulator. It has not happened to any significant extent in most OECD countries.

103 Indeed, the only significant jurisdiction where this occurs is the United States, where it remains possible (although controversial and difficult) for a plaintiff to obtain an order for access from an antitrust court. Such orders are often referred to as coming under the 'essential facilities doctrine'. The practice originated with the Supreme Court's judgment in *United States v Terminal Railroad Association* 224 U.S. 383 (1912) and has been invoked on a number of occasions throughout the twentieth century.

104 As this paper is concerned with competition policy, it is beyond its scope to deal extensively with the legal and

economic characteristics of court-ordered access. However, it is important to note that court-ordered access is not a substitute for a working access regime; indeed, it is positively undesirable. Court-order access is no more than an ad hoc and temporary fix to a problem that requires systematic and continuous regulatory intervention. Courts, which are fundamentally devised to dispose of matters with finality and certainty, are simply not equipped to impose, enforce, supervise and revise a working access regime.

105 As the Supreme Court of the United States said in *Verizon v Trinko* 540 U.S. 398 (2004):

... [Anticompetitive violations [of an access regime imposed by a court] may be ... "beyond the practical ability of a judicial tribunal to control." ... Effective remediation of violations of regulatory sharing requirements will ordinarily require continuing supervision of a highly detailed decree. We think that Professor Areeda got it exactly right: "No court should impose a duty to deal that it cannot explain or adequately and reasonably supervise. The problem should be deemed irremediable by antitrust law when compulsory access requires the court to assume the day-to-day controls characteristic of a regulatory agency." ... An antitrust court is unlikely to be an effective day-to-day enforcer of ... detailed sharing obligations

106 Given the many problems with court-ordered access, and the rarity with which it occurs, the power of an antitrust court to order access is of peripheral significance.

6.4. SECTOR-SPECIFIC REGULATION

107 In a contemporary competition policy, all major utility sectors should be covered by a sector-specific access regulation. In most sectors, it is appropriate that a specialised, technical regulator administer the regime. Virtually all major OECD economies now have working access regimes in their telecommunication and energy sectors. There is increased convergence in the way these regimes are structured, and the assets to which access is granted. There is more divergence with respect to those sectors

where the benefits of access are less clear and the costs more substantial. This includes the rail sector, water services, and postal networks.

108 It is beyond the scope of this paper to examine the workings of every access regime in every sector. By way though of general comment, it is instructive to consider the increased convergence in the way in which the telecommunications sector is regulated. This consensus on the way in which the telecommunications sector should be regulated, i.e. by way of cost-orientated access to the local loop, is instructive. As the design of access regimes in that sector is, at least at a very high level of generality, similar across countries, it can be used to make some general comments on access regimes.

109 In the 1990s, all major OECD jurisdictions enacted legislation that provided for the local loop unbundling (LLU). In Europe, the process began in the early 1990s, but it took much of that decade for the telecommunications framework regulations to be negotiated and agreed between the member states. That regulation has since been applied in order to achieve LLU across the member states. In the United States, the Telecommunications Act 1996 required dominant carriers to provide unbundled access. In Australia the same reform occurred in 1997, although it took the competition regulator a number of years to impose terms on access. It was not until the late 2000s, that LLU became commercially available in Australia. New Zealand was one of the last OECD countries to require LLU, with the Government not supporting the move until 2006.

110 From the experience in these countries, a number of lessons have been learnt on the design of an effective access regime:

(a) The access price must be genuinely cost-orientated. In many countries, including Australia, the United Kingdom, and much of Europe, access prices were too high for too long. This discouraged entry. Once the regulator lowered the price to a level that more accurately reflected the cost of providing access services, the demand for access (and the competition that resulted) increased substantially.

(b) The regulatory regime must be predictable and certain. Most jurisdictions undertake reviews of the regulated market periodically. In many countries, these reviews were a source of regulatory risk that hampered investment and introduced uncertainty into the market. In those countries where regulators have been prepared to indicate to the market a “longer term” view, the market tends to respond favourably, at least to the extent that the prospect of serious changes in the regime over the course of the regulatory cycle is diminished. This, arguably, is what occurred in the United Kingdom following Ofcom’s Strategic Review of the fixed telecommunications sector in 2003-2004.

(c) While unbundling has proven to be an effective way to encourage facilities-based competition, the longer term outlook for investment is less certain. The increased unlikelihood of private-sector investment in fixed-broadband networks has led to many governments, including those in Australia, New Zealand and Germany, proposing taxpayer funded network investments.

6.5. A GENERAL STATUTORY SCHEME FOR ACCESS

111 It is possible to devise a general, statutory scheme that allows for access to a facility in any sector following a process of inquiry. The scheme applies economy-wide, rather than being designed specifically for a sector in which a natural monopoly problem has been identified. This option has not, insofar as I am aware, been adopted in any jurisdiction other than Australia, where a national access regime has been in place for over fifteen years.

112 When Australia adopted its competition policy in the early 1990s, there was little, if any, access regulation imposed on utility companies. It was broadly recognised however, that any access regime needed to be uniform as between the different Australian jurisdictions. It would not be acceptable, for example, to have different regimes imposed on the electricity sector in different regions of the country, as this would create distortions to investment patterns.

113 With this in mind, a national access regime was conceived in the early 1990s. The scheme was designed to apply to facilities that were (a) uneconomic to duplicate; (b) of national significance; and (c) where access to those facilities was necessary to promote competition in another (usually downstream) market. The regime was not to be limited by sector,¹⁸ as it was felt that the problem was widespread in the economy and that a general solution was appropriate.

6.5.1. STRUCTURE OF AUSTRALIA’S NATIONAL ACCESS REGIME

114 The regime, which is contained in Part IIIA of the *Competition and Consumer Act* 2010, continues to apply in Australia. When an application is made for access to a facility, the regime mandates a complex inquiry process, at the successful conclusion of which the infrastructure facilities are “declared”. This means, in effect, that third parties are given an enforceable right of access to those services provided by way of the declared facility.

115 The process is as follows:

(a) *A party wanting access to a facility applies to a regulator called the National Competition Council (NCC). That application is judged against a list of mandatory criteria. The NCC cannot recommend that a service be declared unless it is satisfied that:*

(a) that access (or increased access) to the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service;

(b) that it would be uneconomical for anyone to develop another facility to provide the service;

(c) that the facility is of national significance, having regard to:

(i) the size of the facility; or

(ii) the importance of the facility to constitutional trade or commerce; or

(iii) the importance of the facility to the national economy;

¹⁸ Some sectors were however, excluded. The most notable is the telecommunications sector, where a specialist access regime had already been enacted.

(d) that access to the service can be provided without undue risk to human health or safety;

(e) that access to the service is not already the subject of an effective access regime; and

(f) that access (or increased access) to the service would not be contrary to the public interest.

(b) If the NCC is satisfied that all these tests are satisfied, then it makes a recommendation to a government minister that the service is declared. The minister then makes the decision as to whether or not the asset is declared. It is common for the minister to not declare a service, even where the NCC recommends that it should be declared.

(c) The decision of the minister, whether positive or negative, is subject to full merits review by the Australian Competition Tribunal – a body made up of three members, one a senior judge and the other two experts in competition law. The Tribunal has the final say on whether or not the service is declared.

116 In the event the service is declared, the party seeking access obtains an enforceable right of access. The legislation envisages that, where a service is declared, the access seeker and access provider will negotiate commercially acceptable access terms. Where this does not occur however, the access seeker can apply to the competition regulator for arbitration. The result of that arbitration is, again, subject to full merits review in the Australian Competition Tribunal.

6.5.2. EVALUATION OF AUSTRALIA'S NATIONAL ACCESS REGIME

117 It is widely acknowledged that Australia's national access regime has not been a practical success. It has been law in Australia for more than fifteen years and, in that time, the declaration process set out above has failed to produce one working access regime of note in any sector. There are two main reasons for this.

(a) First, most of the sectors in which access was likely to be required are exempt from the declaration process because the specialised access regimes discussed earlier

apply to them. This is true of electricity, gas, telecommunications and rail. In all these sectors, it was clear that the generalist regime was never going to deliver the detailed, tailored regimes that would be required to promote competition. As a result, governments enacted specialist regimes that apply instead of Part IIIA.

For example, in telecommunications, it was felt that an entrenched monopoly like the copper wire did not need to be protected, at least to the extent envisaged by Part IIIA, from unmeritorious access claims. Indeed, it would have been overly costly for an inquiry process to occur in a sector when it was clear that access was required – and, in fact, had already been imposed to a limited extent prior to the introduction of the national access regime. Thus, in 1997, a number of telecommunications services were declared by legislation (without an inquiry or regulatory intervention). It remains much easier for additional telecommunications services to be declared and regulated under the specialist laws than would be the case under the national access regimes.

In electricity and gas, it was acknowledged that access regulation not only needed to promote competition but also needed to facilitate the government's objective of imposing a national market for energy. Specialised regulation, and indeed, a specialist regulator, was required in order for this to occur.

(b) Second, the process by which a service is declared is very time-consuming and costly. In one sense, this is unavoidable, as declaration is a significant intrusion on private property rights and it is appropriate that it be carried out in a prudent way – especially given the very substantial sums of investment that are often at stake. This requirement for comprehensive reviews has rendered Part IIIA largely unviable from a commercial perspective.

118 Given these drawbacks, the focus of contemporary Australian access policy is on sector-specific access regimes.

7. Competitive Neutrality

119 Competition policy does not force firms to compete as equals. It is not a policy of forced equality, indeed, quite the opposite. Differences between firms – in their costs, experience, assets and culture – are the source of the relative advantages (and disadvantages) on which competition depends. Attempting to eliminate such differences would be inimical to competition.

120 However, in some markets, differences between firms can be a consequence of governmental interference, rather than the consequences of a sustained period of competitive differentiation. This creates an equity issue, in the sense that a firm disadvantaged by government regulation is unable to offer its goods and services as competitively as it otherwise would be able. Over time, this creates distortions in the market, discourages new entry, and harms competition.

121 A key plank of competition policy is eliminating these ‘artificial’ sources of difference through a collection of policies labelled “competitive neutrality”. Competitive neutrality aims to eliminate any factors that advantage or disadvantage, relative to private sector counterparts, those firms that have a relationship with the state. It is directed at advantages and disadvantages caused by the asymmetrical application of government policy, regulation or contracting or those that accrue to SOEs by reason of state ownership. A workable definition used on occasion by the OECD is:

Competitive neutrality can be understood as a regulatory framework (i) within which public and private enterprises face the same set of rules and (ii) where no contact with the state brings competitive advantage to any market participant.¹⁹

¹⁹ OECD, “State-owned enterprises and the principle of competitive neutrality,” September 2009. Available at: <http://www.oecd.org/dataoecd/43/52/46734249.pdf>

122 Competitive neutrality is not concerned with the competitive advantage that many SOEs enjoy by reason of their historically dominant position in many markets. The policies that deal with the market power of SOEs were discussed in Sections 4 and 5.

7.1. TYPES OF STATE OWNED ENTERPRISES

123 Government participates in private markets in many different ways. Competitive neutrality is not limited, in this respect, to government participation in markets by way of their trading enterprises. Competitive neutrality also applies to eliminate the relative advantages and disadvantages that flow from grants of exclusive rights and licenses to private enterprises, minority government ownerships, and government contracting. Further, the legal form of SOEs does not limit competitive neutrality; it is immaterial whether SOEs are in a corporate firm identical to that available by the private sector, a special legal form reserved for SOEs, or whether it is a government department.

124 For the purpose of this paper, the term SOE is used, though it may not be applicable in every example.

7.2. EXAMPLES OF COMPETITIVE NEUTRALITY PROBLEMS

125 Some typical advantages that accrue to SOEs and which are dealt with by competitive neutrality include:

- (a) A reduction in the amount of tax that SOEs are required to pay, or a complete immunity from taxation;
- (b) Exemptions from antitrust law;
- (c) Ability to cross-subsidise commercial operations from non-commercial, government operations;
- (d) Being permitted to earn a return below a commercial rate of return for a sustained period of time;

- (e) Non-commercial dividend payments, noting that this can be a source of competitive disadvantage as well;
- (f) Immunity from various regulatory requirements (i.e. various requirements of corporate governance, record-keeping, licensing and prudential requirements, etc);
- (g) Being granted a role in regulating the market (discussed in Section 4);
- (h) Implied protection from takeover and bankruptcy;
- (i) The availability of state-aid, and an advantage in government procurement; and,
- (j) Explicit or implicit government-guarantees on SOE debt, together with the availability of concessional interest rates on loans from the government and/or private lenders.

126 There are a number of disadvantages that stem from state-ownership, including reduced wage and price flexibility, community service obligations, exposure to freedom-of-information laws and other accountability laws, and reduced managerial authority. It is possible that these disadvantages might outweigh any competitive advantages in some circumstances; however, this is generally considered to be unlikely, given the significant benefits that also flow from state-ownership.

127 In any case, where an SOE enjoys a competitive advantage, it may be able to price below its rivals even where it does not have a market-based cost advantage. In this way, an SOE is able to offer lower prices than its more efficient competitors. This misallocates society's resources from an efficient firm to an inefficient one. Over time, this may very well drive private-sector competitors from the market, thwarting the emergence of effective competition.

7.3. COMPREHENSIVE COMPETITIVE NEUTRALITY POLICIES

128 A number of jurisdictions have developed general policy frameworks to deal with questions of competitive neutrality. It is worth noting that, regardless of whether a country has a specific policy on competitive neutrality, most OECD countries have implemented similar reforms under other labels. For example, there is almost universal consensus that competition law should apply to all actors in the market, this being the case in virtually all OECD countries with some narrow exceptions.

129 There are a number of dimensions to comprehensive competitive neutrality policies. In particular:

- (a) The scope of the policy must be clearly defined, particularly, what types of governmental activity fall within the policy. It is usually the case that the policy is limited to 'commercial' activity, thus excluding government social programs.
- (b) A rigorous framework wherein the sorts of advantages summarised in the previous section can be identified and removed is required. Some of these advantages can be difficult to identify. For example, it can be difficult to obtain an appreciation of the costs of providing non-commercial services, quantify the advantage the firm has in debt markets, or determine what the SOEs existing rate of return is. There are now however, well developed analytical tools to assist with many of these issues.
- (c) A system for ongoing monitoring and enforcement.

130 The OECD has reported that “corporate governance reform can go a long way to reducing competitive neutrality problems.”²⁰ Corporate governance reform is intended to ensure that all government agencies involved in commercial activities function like independent businesses, operate efficiently, focus on costs, and trade in the same way as private-sector counterparts. In virtually all cases, corporate governance reform refers to corporatisation. This refers to a process by which all the commercial activities of the agency are separated from the government by putting them in an independent corporation, managed by an independent board of directors that is subject to the duties imposed by corporate law.

7.3.1. COMPETITIVE NEUTRALITY IN AUSTRALIA

131 With respect to Australia, in the mid-1990s, Australian governments agreed to implement competitive neutrality policies as part of the National Competition Policy reform package. The reform package had a number of major requirements. Importantly, it required Australian governments to corporatise SOEs where it was appropriate that they do so.

132 It also mandated the adoption of policies that, generally, require SOEs to:

- (a) charge prices that fully reflect their costs;
- (b) pay, or include an allowance for, government taxes and charges;
- (c) pay commercial rates of interest on borrowings;
- (d) generate commercial profits; and
- (e) comply with the same regulations that apply to private businesses, including antitrust laws.

²⁰ OECD, “State-owned enterprises and the principle of competitive neutrality,” September 2009, p.330.

133 All Australian governments have now adopted such policies.²¹ The National Competition Policy also required governments to adopt mechanisms to investigate breaches of competitive neutrality principles and to otherwise report on compliance. At the national level, a body called the Australian Government Competitive Neutrality Complaints Office (AGCNCO), which is administered by the Productivity Commission, receives and investigates complaints about competitive neutrality.

Where a complaint is upheld, the AGCNCO is limited to making recommendations to the government with respect to restoring competitive neutrality in the relevant market. This has occurred on a small number of occasions.²² Various state and territory agencies have also been given the role of investigating alleged breaches of competitive neutrality policies.

7.3.2. COMPETITIVE NEUTRALITY IN THE EUROPEAN UNION

134 The Treaties of the European Communities prohibit a Member State from making grants of “state aid.” State aid is broadly defined to encompass measures that distort or threaten to distort competition by favouring certain undertakings or the production of certain goods. This is a competitive neutrality policy, though that terminology is used less frequently in the European Union than it is in other countries.

²¹ The Commonwealth policy is available at: <http://www.treasury.gov.au/documents/275/PDF/cnps.pdf> (accessed 18 April 2011). It is representative of equivalent policies that have been adopted by the states and territories.

²² For example, recommendations were made in complaints against the Australian Valuation Office (05/2004) and ARRB Transport Research Limited (09/2001), and in respect of the customs treatment of Australian Post (07/2000) and the meteorological services provided by government to the aviation industry (12/2001).

135 An undertaking has received state aid under EU law when:

- (a) there has been an intervention by the State;
- (b) the intervention confers an advantage to the undertaking on a selective basis, that is to say, the advantage is not conferred on all market participants;²³
- (c) competition has been or may be distorted;
- (d) the intervention is likely to affect trade between Member States.

136 Where these criteria are met, and an exemption is not applicable, the state intervention is *prima facie* unlawful. A state wishing to proceed with such a measure must notify the European Commission and apply to it for prior authorisation. Over time, the Commission has developed a complex set of criteria that it applies to such

²³ *An intervention does not constitute state aid if it is a "general measure," that is, one which applies to all participants in a market equally (e.g. taxation, labour market regulation).*

applications. If the state fails to obtain that authorisation, and grants state aid anyway, the European Commission and the national courts, are obliged to recover the grant from the beneficiaries.

137 There are many exemptions available, some of which are uncontroversial, such as measures adopted to recover from natural disasters or emergencies. However, there are two exemptions which have generated significant controversy:

- (a) First, is the permissibility of "aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment";
- (b) Second, is the permissibility of "aid to facilitate the development of certain economic activities or certain economic areas, where such aid does not adversely affect trading conditions contrary to the common interest".

138 Further, the European Commission has also developed a General Block Exemption Regulation that declares certain types of commonly granted aid as being compatible with EU law.

8. Monopoly Price Controls

139 Price controls are typically seen as absolutely inimical to competition. The free movement of prices is the very essence of the competitive process. In this respect, a very significant focus of competition policy has been on the repeal of price controls, and the delimitation of prices surveillance and oversight mechanisms.

140 However, as indicated in the introductory remarks, competition policy is pragmatic. It recognises that where a firm has a monopoly or market power, or where a market is only weakly contestable, there can be scope for prices to be charged above the efficient level for a sustained period of time. While economic theory suggests that high prices would, eventually, encourage entry and lead to price reductions, the view is often taken that the social cost of high prices exceeds the cost of regulatory intervention. In such circumstances, price regulation is judged necessary.

141 Economic efficiency has not however, been the principal reason for price regulation in the past. There is no doubt that “high” prices are politically unpopular, as indeed are “low” prices, at least for the producers selling their products below a price they consider “fair”. The politics of prices are such that governments have often been inclined to impose price regulation to protect certain favoured constituencies from the effects of “high” or “low” prices. This intervention can come at the cost of economic efficiency:

(a) Where a price is genuinely “high”, in the sense that it is above the long run actual cost of production, it encourages additional entry, stimulates investment, and fosters innovation. It is often the case that politicians mistake a short period of “high” prices as a problem, where in reality it is setting the groundwork for a sustained period of entry and vigorous competition. If the price is regulated, then that entry is foreclosed and competition is weakened. In the long run, prices end up being higher than would be otherwise be the case.

(b) Often however, a price is not genuinely “high”, merely perceived to be so as judged against some subjective measure like “fairness”. In such cases, the price charged actually reflects a competitive return on capital, given the risk of the investment. Where a

price such as this is regulated it can be very damaging to competition, particularly over the long run as new investment and entry is discouraged.

(c) Lastly, where a price is too “low”, attempts to set a price floor will encourage inefficient levels of production for the level of demand at that price. This most commonly occurs in agricultural markets either directly through price regulation or indirectly through subsidies.

142 In all OECD countries, competition policy has greatly enhanced the clarity of price control policies. It is fair to say that it is now unusual, in most countries and in most markets, for price controls to be considered a legitimate public policy response. Some markets continue to be of concern, particularly agricultural markets, but it is now increasingly unusual for prices to be regulated in OECD jurisdictions. The circumstances where price controls are appropriate are now well-known, and are as follows:

(a) Price regulation is only appropriate in monopoly markets or where monopoly pricing is an identified risk of the industry structure (very high barriers to entry, one firm with market power). Price controls are never appropriate, from an economic perspective, in competitive markets.

(b) While competition policy will countenance the imposition of price controls, it is a last resort. Price controls do not fix the underlying problem, which is a lack of competition. They simply ameliorate its effects for a period to, hopefully, allow the competitive deficit to be dealt with by another policy. In this respect, price regulation should only be contemplated in tandem with other measures that are designed to improve the state of competition in the market.

(c) The price regulation should contain measures to provide an incentive to improve efficiency (e.g. CPI-X).

(d) Lastly, price regulation should be reviewed after a certain interval with a bias towards its repeal. That is to say, a government body should be required to prove that price regulation is still necessary and desirable before the measure is renewed.

9. Institutional Framework for Competition Policy

143 This paper has largely taken as a given the existence of an institutional and political framework that advances the objectives of competition policy. However, the experience of implementing competition policies in many countries has shown that this is very far from the reality. Although it is beyond the scope of the paper to provide detailed observations on the mechanics of competition policy, it is useful to make some brief remarks in this respect.

9.1. THE POLITICAL CONTEXT OF COMPETITION POLICY

144 Applying the principles of competition policy to a national economy is not a painless reform. As with most economic reforms, it creates both winners and losers. It can therefore be expected that competition policy will generate the same political controversies as most economic reforms. Indeed, a particular political difficulty of competition policy is that, generally speaking, it creates a large, diffuse group of 'winners' whose individual gain is quite small, and a small group of 'losers' who suffer quite significant losses. This creates substantial political challenges.

145 Consider for example, the political implications of the reform of a regulated industry like the milk industry – which continues to be protected by a quota system in many major markets (i.e. the European Union). The repeal of these protections leads to very substantial declines in the price of milk (as has occurred in countries that have deregulated their milk industries like Australia). This has an asymmetric political impact - as there are far fewer producers of milk than there are consumers of milk, the price reductions are disproportionately 'felt' by producers. This creates a very vocal group of 'losers', namely farmers and milk processors, that opposes competition policy, and a largely passive group of winners, namely the population that consumes dairy products, that has no strong view on competition policy.

146 This political feature of competition policy necessitates the need for:

(a) support of competition policy by those at the top level of government, rather than just the agencies involved in developing the policy;

(b) a principled defence of competition policy from those in positions of political leadership;

(c) considered, non-distorting and effective adjustment policies that support (and sometimes compensate) those most negatively affected by competition policy; and,

(d) an institutional structure that is demonstratively fair, principled and transparent in the way in which it implements the competition policy.

147 It is the last of these four points that is worth developing further.

9.2. INSTITUTIONAL SUPPORT FOR COMPETITION POLICY

148 As indicated throughout this report, various aspects of competition policy are vitally reliant on the activities of expert, independent and transparent regulators. The way in which this is achieved, particularly, how regulatory powers are distributed between the various arms of government, is incredibly varied as between the OECD. There are however, some broad generalisations that can be made, both on matters of principle and institutional design.

149 With respect to the former, the 'qualities' that a regulator involved in competition policy ought to possess are well known. It ought to be independent from government and the sectors it regulates, accountable for its decisions, subject to appeal and review procedures from courts and/or tribunals, act in accordance with procedural fairness principles, and be predictable, transparent and timely in its decision-making.

These are elementary observations. More specifically:

(a) Competition regulators, particularly those with responsibility for economic regulation, have a vital role to play in ensuring that the rest of government acts consistently with competition principles. It is often the case that the economic and industrial expertise that is essential to competition policy is largely contained within competition regulators, and it makes little sense to prevent the rest of government from benefiting from it. It is for this reason, for example, that many countries have cabinet-level ministers with responsibilities for competition; i.e. the Competition Commissioner in the European Union. As desirable as this involvement can be, it does raise real questions of independence from government. These concerns can require careful internal safeguards.

(b) The regulatory responsibilities of competition regulators, particularly those responsible for regulating individual sectors, require specialised expertise. Most generally, a degree of economic sophistication is required. Further, it is usually necessary to understand, in some technical detail, the nature of the sector being regulated. It is for this latter reason that many jurisdictions have individual regulators for each sector (i.e. an energy regulator, a telecommunications regulator, etc). This expertise, which can require experience working in the sector itself, increases the prospect of regulatory capture.

150 In regards to institutional design, every OECD country has taken a slightly different approach. In general, and stressing that there are a great many exceptions, many OECD countries have structured economic regulation as follows:

(a) A competition regulator that enforces the antitrust law by bringing proceedings before courts;

(b) Separate economic regulators for each sector of the economy that requires the ongoing supervision of a dominant operator, usually, the utility sectors;

(c) An institutionally separate apparatus for the administration of criminal justice, where relevant;

(d) A specialist appellate body, whether a separate administrative tribunal or some degree of specialisation within the court structure, that reviews competition decisions; and,

(e) A separate regulator with responsibility for consumer protection.

10. Research

151 There are numerous research possibilities in the field of competition law and policy.

152 There is a vast amount of specialised research in the fields of law and economics. Regarding the economics questions, the dominant framework is that of industrial organisation economics. Even though there is much research and debate about the details, the broad method of analysis is the subject of general agreement.²⁴ Likewise, on the legal side, there is general agreement about what the principles of the law should be and what are the main process and procedural approaches and issues.²⁵ Most of this research does not venture into the fields of politics or public administration nor even into general issues about regulation and law enforcement.²⁶

153 As noted in this paper, there is a distinction between competition law and competition policy.²⁷ In the broader field of competition policy with its central focus being on government activities that restrict competition, there is seemingly endless scope for research into the economics, law and politics of the many government

restrictions and hindrances to competition at every level of government and that are applicable to virtually every sector of the economy that occur at in all countries. Essentially the core approach, however, is the technical application of standard microeconomic theory to analyse the competitive issues that arise when there are restrictions on economic activity imposed by the government.

154 Australia is a particularly interesting field of study because it seems to have gone further than anyone in the world in adopting a systematic approach to the challenge and in fact making some progress in cutting back such government restrictions. This is reflected above all in the National Competition Review (the Hilmer Report) of 1993 which set out a framework later largely adopted by governments for analysing and dealing with government restrictions on competition.

155 There is an interesting body of research and major potential research opportunities regarding the political economy of competition law. Competition law has major effects on property rights and gives rise to immense pressures from interest groups for that law either not to apply at all or at least not to apply to those particular interests. The politics of the establishment and continuation of competition law offers a rich field of study.²⁸

156 Similarly, the institutional arrangements are an important area for study. First, there are issues concerning the independence of competition agencies and courts, especially in developing countries. Second, there are issues concerning the relationship of

²⁴ Two advanced textbooks which cover the field are: Dennis W Carlton, Jeffrey M. Perloff, *Modern Industrial Organisation*, 4th Edition, Pearson Addison Wesley 2005 and Motta Massimo, *Competition Policy: Theory and Practice*, Cambridge University Press 2004.

²⁵ A sample of many treaties and textbooks covering the field are: SG Corones, *Competition Law in Australia*, 5th Edition, Thomson Reuters 2010; Russell V Miller, *Millers Australian Competition and Consumer Law Annotated*, 36th Edition, 2014; Richard Wish, *Competition Law*, 6th Edition, Oxford University Press 2009; Phillip E. Areeda and Herbert Hovenkamp, *Antitrust Law*, 3rd Edition, volumes 1 to 14 and Andrew I Gavil, William E Kovacic, Johnathon V Baker, *Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy*, American Case book series, Thompson West, 2nd Edition 2008.

²⁶ See, however, Karen Yeung, *Securing Compliance: A principled approach*, Hart Publishing 2004, Oxford.

²⁷ For guides to the making of competition policy see: Independent Committee of Inquiry into Competition Policy in Australia (op cit fn 6); and Organisation for Economic Cooperation and Development, *Competition Assessment Toolkit 1.0 (and subsequent editions)* OECD 2007.

²⁸ Seminal studies include: George J Stigler, *The Economic Theory of Regulation*, *Bell Journal of Economics and Science* (Spring of 1971) reprinted in George J Stigler, *The Citizen and the State, essays on regulation*, Chicago University Press 1975; and James Q Wilson, Editor, *The Politics of Regulation Basic Books* 1980. These reflect a public choice approach. See also: OECD, *Making Reform Happen: Lessons from OECD Countries*, OECD Paris 2010; and Eric M Patashnik, *Reforms at Risk: What happens after major policy changes are enacted*, Princeton University Press 2008.

competition law to other areas of government regulation— what is, for example, the relationship to regulation of public utilities by specialised regulators? How should this be optimised? What happens in practice? What is the best arrangement? Similar questions arise in regard to the relationship of competition law and consumer law institutions

157 Competition law is a form of regulation. There is again immense potential for the treatment of competition law as a particular case where regulatory theory and empirics might apply. What are the strategies, behaviour and outcomes of what the regulators do? How do they go about their business? Where do they fit in politically? How does one view them from a political or interest group perspective?²⁹

158 There is also scope for study of the international dimension of competition law. There is no global competition law. There is a vast amount of cooperation and convergence. The networking between regulators, practitioners, the judiciary and all others involved in this area is strong and important and has a powerful influence. The political economy of this subject is especially complicated.³⁰

159 How does competition law apply to developing countries? Here there may be challenges to the whole idea of a competition law, where the culture is not conducive to supporting competition, where resources are limited and so are skills, and where business behaviour may be somewhat different from in the advanced countries?³¹

160 How does competition law and policy fit into the spectrum of economic policy? How does it relate to industry policy, monetary policy and in developing countries to development policy?

161 Since 1989 when virtually every country of the world has decided to rely upon the market to be the predominant supplier of goods and services, governments have come to realise that the market only works well if there is competition and, as a result, have adopted competition laws and policies as a key component of economic policy. As this paper indicates, there is considerable scope for technical research on legal and economic issues but beyond that there is a wide field of potential research possibilities in the fields of politics, public administration, regulation, law enforcement and international relations.

²⁹ Some basic references include: Ari Freiberg, *The Tools of Regulation*, Federation Press 2010; Malcolm K Sparrow, *The Regulatory Craft: Controlling Risks, Solving Problems and Managing Compliance 2000*, the Brookings Institution, Washington, DC, USA; Ian Ayres, John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, 1992, Oxford University Press; John Braithwaite, *Regulatory Capitalism: How it Works, Ideas for making it work better*, 2008, Edward Elgar, UK; Cass R. Sunstein, *Risk and Reason: Safety, Law and the Environment*, Cambridge University Press 2002; and John Braithwaite, Peter Drahos, *Global Business Regulation*, Cambridge University Press 2000.

³⁰ A seminal analysis, which includes competition law, is Anne-Marie Slaughter, *A New World Order*, Princeton University Press, 2005.

³¹ An overview is provided in D. Daniel Sokol, Thomas K. Cheng and Ioannis Lianos, *Competition Law and Development*, Stanford Law Books, 2013. For case studies of China, see: Mark Williams, *Competition Policy and Law in China, Hong Kong and Taiwan*, Cambridge University Press, 2005; and Adrian Emch, David Stallibrass (eds), *China's Antimonopoly Law: the First 5 Years*, Walters Kluwer 2013.

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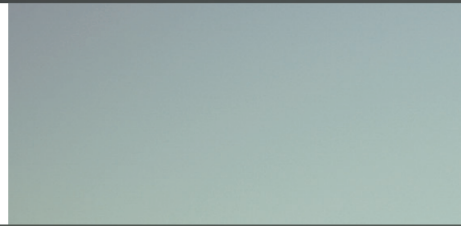
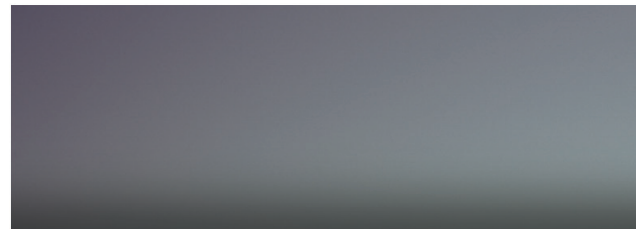
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