"Recent developments in Competition Policy - the impact on the Water and Wastewater industries"

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Abstract

The Australian Competition and Consumer Commission's charter is to maximise the welfare of all Australians through the promotion of fair and informed markets. The Commission is significantly affected by the recent developments in Competition Policy. One development of importance to the water industry is the extension of the Trade Practices Act to all sectors of the economy, with the effect that government run and unincorporated businesses are now subject to the Act. The other major change is the review of State government arrangements and reforms . These reforms will affect many utilities and government businesses. Competition legislation has been designed to ensure that these restructured industries are subjected to adequate competitive pressures.

Introduction

I am pleased to have the opportunity to speak to you here today about areas of water reform that could be affected by the provisions of competition legislation.

As a result of the Council of Australian Government (COAG) initiatives agreed to in 1994, all Australian States and Territories are reforming their government run industries, including water, in an effort to make them more efficient in providing consumers with these most essential services.

I should not have to sell this audience on the importance of the efficient use of water. Many economists believe that the 21st century will be the age of water for much of the world. The increasing scarcity of clean, safe water is already placing real limits on the pace of development and the improvement of living standards in many Third World countries. In developed countries too, consumers will have to come to terms with the fact that the days of cheap subsidised water are coming to a close. Australia as a relatively arid agricultural and industrial country will not escape these pressures.

Water reform is a new area for the Commission, although many of the general principles we will apply have already been used in the electricity and gas industries.

Before I get onto specifics, I will quickly outline the major provisions of the current competition legislation, which includes the Trade Practices Act, with its new Access regime, and the Prices Surveillance Act. These three components of competition policy can be used separately or simultaneously to help ensure an adequate level of competition in an industry.

What is competition policy?

Competition policy is not about the pursuit of competition *per se*. Rather, it seeks to promote competition so that the gains in terms of greater efficiency and lower costs are passed on to consumers.

Competition policy questions arise at all levels of government. At the Commonwealth level - recent examples include issues concerning telecommunications and Pay-TV. At the State level, - there are issues concerning privatisation, deregulation of public utilities, agricultural marketing boards and the professions. At the local government level - the issue of contracting out is prominent. In some instances, policy is developed through consultations with all three levels of government, as is the case with water reform.

Competition policy is not simply a series of measures that positively promote competition, such as the application of the Trade Practices Act. An important element of competition policy is the removal of legislative impediments to competition.

Primary developments

A significant number of recent reforms had their genesis in the recommendations of the Hilmer Committee, established by the Council of Australian Governments (COAG) to develop a general approach to competition policy. These recommendations were the basis for restructuring competition policy, its administration and legislation. These changes included:

- Creation of the ACCC from a merger of the Prices Surveillance Authority and the Trade Practices Commission;
- Strengthening and extending Part IV restrictive trade practices provisions of the Act;
- Increasing penalties for breaches of the Act;
- Obliging Federal and State governments to implement micro-economic reform and to restructure the anti-competitive elements of their industries. It is this initiative that is stimulating the reform of the water industries.

Other primary areas of competition policy under Part IV of the TPA remain:

- Section 45 prohibits anti-competitive agreements which involve, for example, market sharing or restricting the supply of goods; agreements that contain an exclusionary provision or fix prices;
- Section 46 prohibits the misuse of market power. For instance, if a firm has a substantial degree of market power, it is prohibited from taking advantage of that power for the purposes of:

  - eliminating or substantially damaging a competitor;
  - preventing the entry of a competitor into the market; or
  - deterring or preventing a competitor from engaging in competitive conduct.

- Section 47 prohibits exclusive contracting that has the purpose or effect of substantially lessening competition. Broadly speaking, exclusive dealing

involves one person imposing restrictions on another's freedom to choose with whom, or in what, it deals;
- Section 50 prohibits mergers and acquisitions that would result in a substantial lessening of competition in a substantial market;
- The TPA also allows for authorisation or exemption of certain actions that would otherwise be in breach where the public benefit from the behaviour would outweigh the anti-competitive detriment.

Part IV of the TPA is applied to demonstrations of market power. The provisions of the Prices Surveillance Act allow the ACCC to apply ongoing oversight of the pricing and performance of a firm operating in a market with minimal competitive pressures. After a firm is declared by the Treasurer, the ACCC can use the provisions of the Prices Surveillance Act as a substitute for competitive pressures and to restrain the rate and level of further price increases. The measures most often used to restrain price increases include price caps, with provision for productivity increases, the need to seek approval for price increases and the monitoring of costs, prices and profitability, with public reports.

Access to "Essential" Services

The *Competition Policy Reform Act* 1995 provided for the insertion of a new Part (IIIA) into the Trade Practices Act, to establish a regime to facilitate third party access to nationally significant services provided by facilities with natural monopoly characteristics. The Hilmer report emphasised that in some markets the introduction of effective competition requires competitors to have access to facilities which exhibit natural monopoly characteristics, and hence cannot be duplicated economically. The term 'access' means the ability of market participants to purchase the use of facilities on fair and reasonable terms.

The Hilmer committee used the term 'essential facility' to refer to a facility that occupies a strategic position in an industry such that access to it (or its services) is necessary for a business to compete in a market which is upstream or downstream from the facility. Examples include electricity transmission lines, telecommunications networks, railway lines, airports and, importantly for the water industry, - points of access such as pipelines for gas and water.

When an owner of a facility also competes in upstream or downstream markets, there could be an incentive to inhibit access to competitors in those markets. Thus, the owner of pipelines that also competed in the purification process could restrict access to water and limit competition in distribution to consumers.

Access regimes will only apply to significant infrastructure facilities with natural monopoly characteristics and with wide economic influence. Although it has not yet been considered, pipelines, filtration plants and associated equipment may fall under this definition.

The Commonwealth may establish an access regime for facilities that have an interstate influence, or which have national significance and are not covered by an effective state regime. States may choose to set up their own access regime to apply to facilities within their borders.

Under the national regime, a firm seeking access to an infrastructure facility will, no doubt, first try to reach private agreement with the facility owner. If the owner refuses access, or demands what seems to be unreasonable prices or conditions, the firm may approach the National Competition Council seeking to have the facility "declared". The Council will prepare a recommendation for the Minister and, if the facility is declared, the applicant will have a legally enforceable right to negotiate access with the owner.

If the parties are still unable to agree on the terms and conditions of access, the ACCC will arbitrate. Appeal mechanisms are available for both parties in relation to the declaration and arbitration processes.

As an alternative to this process, the owner of a facility can offer an undertaking to the ACCC stating the terms and conditions it will apply when providing access to third parties. If the ACCC accepts the undertaking, these services cannot be declared by the NCC. This approach may give the owner greater certainty on third party access arrangements.

Although there has not yet been an access declaration or undertaking under the new Part IIIA of the Trade Practices Act, legislation with similar effect has been created by State governments to cover particular facilities.

I'll just make a few observations on the characteristics of the water industry and the reforms so far, before looking at how these new approaches are likely to be treated by the competition legislation.

Reforms so far

The management of water must respond to the conflicting demands of both current and future commercial and environmental users. Unlike other products, one consumer's use can damage another's, both over time and across locations. Balancing these interests cuts across generational and geographic boundaries and requires a long term national perspective - hence the Commonwealth Government's involvement. However, as most water systems were developed by state and local governments, water assets and interests are largely regionally focussed and any reforms will need the support of all governments and communities.

Water reform, as outlined in COAG's Strategic Framework for Water Reform, reflects this comprehensive support. This agreement targets 1998 for completion of the first group of reforms, including structural separation of water supply functions, adoption of two part tariffs for urban water and the implementation of comprehensive systems of water allocations or entitlements. The next stage requires completion of rural water supply reforms by 2001.

In addition, the Competition Principles Agreement requires States and Territories to apply competitive neutrality principles, consider reform of the structure of public monopolies, review anti-competitive legislation and apply the competition principles to local government.

While the first target date is still quite distant, all States and Territories are progressing, albeit at differing rates, in terms of organisational and pricing restructuring. The Hilmer Report made a strong case, on both efficiency and public policy grounds, for separation of service delivery functions from regulatory and public policy functions, to allow government businesses to focus on their commercial objectives and performance. Hilmer also made a case for the separation of vertical service functions, to reduce the monopoly power of incumbents and to more readily allow new firms to compete.

I understand that most states have now made significant institutional changes to their urban water authorities. The Sydney Water Board was corporatised and its wholesale retail and trading businesses separated; Melbourne Water was corporatised and divided into, a headworks corporation, three retail businesses (to encourage competition by comparison) and an environmental function. The ACT combined its electricity and water functions into one corporatised entity to gain economies of scale primarily in administration, maintenance and some capital expenditures. While South Australia corporatised a body with statewide responsibility for its water resources, it outsourced the management of its supply function for Adelaide.

This restructuring process is likely to proceed from the major centres through to the regions. Current water supply markets usually coincide with city boundaries or local council jurisdictions. However, given variations in these market sizes and population densities some suppliers may need to look closely at the probable competitive gains from separating functions relative to the costs of losing scale economies. Some markets may find efficiencies from further part or full amalgamations. However, the Commission will examine closely any proposed merger or acquisition it feels would be likely to lead to a substantial lessening in competition. The Commission will oppose any proposed merger it feels is likely to contravene section 50 of the *Trade Practices Act 1974.*

Progress has also been made in restructuring water prices to better reflect the value of the assets used to provide the services and the operating costs of supply. Water pricing has traditionally involved under recovery of capital and operational costs and cross subsidies between users. Water authorities are increasingly seeking to improve the efficiency of water usage by linking their charges to the actual costs of supply. Fewer tariff structures are now based on property values. Community service obligations, such as rebates for pensioners, are being identified and transparently funded. Many tariffs now comprise a component covering the costs of accessing the system as well as a component linked to the volumes used. Linking price to usage should reduce demand for water and the need for large investments.

ACCC areas of interest in the water industry

While the COAG reforms aim to introduce greater competitive pressures into the water industry, its natural monopoly characteristics, together with its current fragmentation, means that the market structures generally envisaged by these reforms may not quickly emerge.

The Commission may need to review these evolving structures in terms of the anti-competitive provisions of the TPA. The provisions of the Prices Surveillance Act and the TPA Part IIIA Access regime may also prove useful in restraining prices.

I will talk a little on the areas of primary interest to the Commission.

Privatisation

The States are taking differing paths to reform of their water industries. Some may privatise significant segments of the industry.

One possible concern for competition policy would be that privatised segments could retain many natural monopoly features and, in the absence of appropriate regulation, would be able to meet their commercial objectives by raising prices above costs or cutting back on service quality.

Mergers

The COAG reforms should restructure industries in a way that promotes competition. However, industries do not remain static and through time further restructuring may occur through mergers and new entry. There is also the UK experience where mergers have been proposed between suppliers of different utilities - say water and electricity. In Australia, the ACTEW combines both supply functions.

In the future, the Commission may need to assess proposed mergers under s.50 of the TPA. As I said earlier, this section prohibits mergers that substantially lessen competition in a substantial market. In order to assess the change the proposed merger would have on competition, the ACCC must first draw boundaries around the market in question and assess the level of competition within that market.

When defining a market, the Commission uses a framework that sets market boundaries in terms of the product's characteristics, the levels of vertical production that constitute the product and the market's geographical reach. If these boundaries are set too narrowly then market power could be over-estimated. On the other hand, if boundaries are set too broadly, they may encourage under-estimates of market power.

Current water markets are relatively small and fragmented. These markets have been defined in accordance with the infrastructure in place, local government boundaries and licensing controls. In some instances, it may be that just more liberal licensing laws, or perhaps a pipeline between two supply areas, would substantially redraw these boundaries. The Commission's recently released merger guidelines indicate that the potential for such dynamic changes should be recognised when market boundaries are considered.

Horizontal mergers occur between suppliers of like goods and services. The Commission is most concerned when horizontal mergers increase concentration in industries with high barriers to entry and little import competition. Vertical mergers occur between successive activities within one production process. For water, that would mean between the activities of storage and distribution of fresh water and removal of waste water. Vertical integration is of concern if concentration at one level

of production can be utilised as market power in a successive level of production. When assessing any proposed merger in the water industry the Commission will be mindful of the potential for the subsequent emergence of anti-competitive structures.

Mergers often provide gains in efficiency. Horizontal mergers will often achieve greater economies of scale in production. Vertical mergers commonly reduce the transaction costs involved with negotiating between input levels. The Commission is often placed in the position of assessing a proposed merger in terms of its net benefit after countering the loss of competitiveness with the predicted gains in efficiency. When an acquirer believes it has a strong case for a merger on efficiency grounds, in spite of the apparent anti-competitive effects, it can apply to the Commission for an authorisation to exempt it from further action under s.50.

The Hilmer strategy to increase competitive pressures on government utilities was to separate out those components of vertical production without natural monopoly characteristics and encourage new entry, if necessary, with the assistance of a regime that facilitates access to the natural monopoly activities. Implicit in this approach is the assumption that in all instances the competitive gains from keeping sequential activities separate outweigh the efficiency gains of vertical integration. While this approach may prove appropriate for most utility markets, for some water markets the efficiency losses of keeping activities separate may outweigh the gains from increased competition. Some have questioned the potential for competition in many water activities.

An interesting question is whether there are efficiencies in merging water and related industries,. For example, can gas pipeline operators also maintain water pipelines? If there are economies in distribution, gas, electricity and water providers may decide to join forces.

As you can see the Commission will need to deal with some complex issues when it assesses proposed mergers in this industry and I believe it should remain flexible and take a case-by-case approach.

Exclusive arrangements -Contracting out and franchise bidding

There may also be scope for promoting competitive pressures by engaging private companies in bidding for the supply of the many inputs and services required to supply water (such as design, electrical engineering, construction, maintenance, metering and accounting services). A number of water suppliers are increasing private sector involvement through engaging private firms to both develop and operate facilities that feed services into the water supply function. SA Water is contracting out much of its metropolitan based operations, maintenance and construction work. Melbourne Water has also outsourced much of its maintenance work.

Water authorities are also franchising out management functions while retaining ownership of the supply assets. However, water authorities need to consider their objectives when developing the criteria used to chose successful bidders. If the contract goes to the highest bidder, providing the authority with the highest return on the assets it is leasing, bidders will be encouraged to recoup these inflated returns to assets from consumers where possible.

Some French water authorities have specified the price at the time of calling bids and awarded the franchise to the bidder offering the lowest water supply price for a specified quality of service. Reportedly, while there was vigorous competition when franchises were issued, franchises rarely changed hands at renewal, suggesting either weak competition at renewal (perhaps because of the advantages provided to incumbent firms) or that the threat of losing the franchise had forced the incumbent franchisee to restrain prices, allowing little commercial gain for a new entrant.

Most of these contracts grant the right of one supplier to provide a service to the exclusion of others, for a set period of time. Where such contracts are negotiated under competitive conditions, for a relatively short time period, the Commission may see few competitive problems. However, where the services are contracted out to a single supplier for a substantial period of time, such contracts may risk contravening the anti-competitive conduct provisions of the Trade Practices Act.

Pricing restraint - use of PSA provisions

While substantial efficiencies can be achieved from market based approaches, by themselves they may be insufficient to overcome all the problems caused by the natural monopoly characteristics of these markets. This market characteristic may continue to provide water suppliers with the discretion to achieve their commercial objectives by exploiting their pricing power.

Policies for the reform of the industry will therefore need to recognise this reality and adopt a pragmatic combination of pro competitive and regulatory measures. These regulatory measures may need to include some form of price restraint to ensure that water prices are close to those expected under competitive conditions.

The options for pricing oversight would include those provided by the Prices Surveillance Act:

- surveillance restraint on price increases;
- periodic inquiries and/or ongoing monitoring of pricing structures and behaviour. This could include the yardstick approach which I will mention separately later; and
- price cap regulation such as a CPI-X approach.

Some States have established their own price regulator. However, the National Competition Policy arrangements note that States can request the ACCC to apply this kind of price regulation to the water prices in their State.

Under the Prices Surveillance Act, surveillance can restrain price rises but has no power to reduce prices as they stand. Therefore monopoly pricing can still occur if prices are not reduced as costs fall, say, as productivity increases.

Price capping (CPI-X) can address this issue. It imposes an upper limit on permissible price increases, linked to increases in an appropriate price index. The "X" value should in effect be negative (allow price increases that are less than the index) and reflect anticipated productivity gains.

Early UK application of price caps to water supply prices included a substantial positive "X" value, thereby allowing suppliers to increase prices substantially above CPI. This positive "X" value was applied to give suppliers the incentive to invest in the capital equipment deemed necessary to achieve the newly imposed water quality standards. However, the following years' profit outcomes indicated either the anticipated levels of investment were not achieved or that attainable productivity was underestimated.

I will just talk a little on quality of service monitoring. It is often forgotten but it really is a necessary element of price regulation.

Regulation of service quality

Price regulation will not be sufficient to identify when and if prices rise. Prices are effectively increased if the price level is maintained while the service quality is reduced. If the quality reduction reflects a cost reduction, the supplier will appropriate the gain in increased profits. Quality of service monitoring is therefore necessary to determine if prices have been indirectly increased.

The UK regulator (OFWAT - Office of Water Services) monitors the quality of water services against a set of benchmarks. This performance information is published regularly to introduce one element of the broader concept of "yardstick" competition between water companies.

Victoria has made the licenses of its three retail water businesses conditional on them achieving specified quality performance criteria (technical standards, customer service, information) as well as adhering to specified pricing policies.

The Victorian regulator, Office of the Regulator-General, publishes quality of service performance data as a start to their approach to "competition by comparison". This is also known as yardstick competition.

Yardstick competition

This approach to regulation was outlined in the mid-80s by Andrei Shleifer, who suggested that by comparing the performances of similar firms, a regulator could estimate benchmarks which would generally infer attainable cost and price levels for firms in that industry. The UK legislation covering the water industry included this concept by specifying that proposed mergers must take into account the number of water suppliers remaining under independent control. This number should not be reduced to a level that inhibited the regulator's ability to develop such benchmarks.

Since the establishment of this legislation, there has been much discussion on what constitutes a sufficient number of water suppliers to allow the regulator to do his job. Is there a number which once reached would necessarily preclude further mergers? Andrei Shleifer believed that as few as two firms could be sufficient to allow yardstick competition, but pointed to the possibility of collusion at this number. It is also our experience that collusive behaviour becomes less likely as numbers increase.

The UK experiment with yardstick competition is drawing considerable criticism. Some have argued that if suppliers are dissimilar in too many aspects, the resulting benchmarks could not be used to represent "best practice". Others believe these benchmarks by themselves would provide insufficient incentive to improve performance - the penalty for non performance might not be severe. Yet despite the criticisms, some merger decisions in the UK have been significantly influenced by their impact on comparator numbers.

I would agree with those that argue that while yardstick competition is of assistance to regulators in assessing the performance of natural monopoly suppliers, it would not fully replicate market pressures. In other words it does not equate to a market. Therefore, to give it market attributes, such as minimum threshold numbers of participants, and make maintenance of such thresholds a pivotal reason for rejecting mergers, seems somewhat off target. As I said before, the Australian water industry is currently quite fragmented and industry participants may seek to amalgamate in the early stages of the reforms. However, the Commission will examine closely any proposed merger we feel is likely to have anti-competitive effects.

I do not mean to dismiss yardstick competition, but merely point out that it is a tool that undoubtedly would help a regulator in its task of ensuring natural monopolies provide services at lowest prices but would remind you of its resemblance to a full monitoring regime under the PSA - a regime we could use to determine the extent of market power in an industry.

Conclusion

I would just conclude by saying that the water industry may present us with the most complex restructuring issues of any of the utility services. The structures that evolve are not likely to be uniform and I think a case-by-case approach may be necessary when applying the anti-competitive provisions such as mergers and exclusive dealings. Of course, access matters will also be complex and the will depend particularly on the extent of structural separation undertaken and the degree of competition this effects.

Given the natural monopoly characteristics of the industry, a regulatory regime that covers pricing and service quality would probably always be necessary. This regime could easily be adapted to perform the task of yardstick comparison.