Competition and Monopoly in Public Utilities

*Megan Richardson (ed.), **Deregulation of Public Utilities: Current Issues and Perspectives**, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1996*

*Reviewed by **Alan Moran***

THIS excellent collection of papers provides both a guide to the new competition regime in Australia and insights into the practicalities of its operation in the energy and telecommunications fields.

Pride of place is given to Michael Trebilcock and Michal Gal's contribution on the theory, which they discuss in the context of a study of deregulation of electricity and gas in Ontario. Electricity developments of Ontario Hydro (quaintly named in view of the fact that 60 per cent of its output is nuclear) lag behind those of Victoria, Australia. However, Ontario confronts the same problem of how to create a competitive system where some parts are natural monopolies and some vertical integration could lead to lower-cost production.

Trebilcock and Gal offer references to suggest that, in static terms, the savings from integrating electricity could approach 12 per cent of total costs. This finding will not impress contemporary policy-makers in North America, the United Kingdom or the Antipodes, where disaggregation is the favoured approach on the basis that vertical integration could thwart the creation of savings stemming from the dynamics of competition. Around the edges of that basic stance, many issues remain to be resolved, such as the degree of disaggregation and the need for disaggregation at the local level in distribution and retailing of electricity, where there are economies of customer interaction but the advantages held by incumbents pose obstacles to new players. (Curiously, Philip Williams, in one of his two contributions to this collection, dismisses out of hand the possibility that such economies are possible and enthusiastically advocates enforced structural separation at the retail/distribution level.) There are also issues of reintegration, convergence of carriers and marketers of gas, telecommunications and electricity, mergers between rival suppliers, and the price of access to main distribution facilities, a matter which is highly contentious in New South Wales at present.

Greater insights for Australian readers emerge from the paper's treatment of gas, in which Australia has no experience of trading. It is difficult to see how competitive rivalry such as exists in North America, with its swaps and posted prices, can emerge in the Australian industry with its monopoly suppliers. Moreover, there is the issue of long-term contracts signed at a time when monopoly provision was assured and potentially undermined by new supplies.

Frances Hanks's Spartan introduction manages succinctly to review the book's contributions and provides insights into the reasons for, and shortcomings of, recent amendments to the Trade Practices Act (TPA). These had their origins in the *Queensland Wire* case, in which BHP was compelled to offer product as raw ma-

terial to a competing firm. Hanks, like Warren Pengilley and others, adverts to the immense difficulties faced by the court in deciding the price at which the monopolist would be compelled to sell. She points out that the Hilmer Committee was naïve in its treatment of Section 46 of the TPA; but the legislation of Part IIIA shows even less inhibition and arrogates to the Australian Competition and Consumer Commission (ACCC) wide powers to determine the policy on access and to grant immunity from the court for access regimes it considers to be acceptable. Efficiency is the goal, but there are many dimensions to this: improved economies of scale, better resource utilisation, or rivalry that generates Schumpeterian gains. The guidelines give very broad scope to the ACCC and its sister agency, the National Competition Council, to decide which of these to apply.

This matter is taken up in the commentary by Jim Holmes, who notes that regulators tend to seek and amass whatever power they can and need to be constrained if light-handed regulation is not to disappear.

Part IIIA of the TPA was carefully limited to service industries, in recognition of the fact (notwithstanding the *Queensland Wire* case) that it would be inappropriate for a car manufacturer or a newsprint mill to be compelled to supply competitors. But (though Hanks does not address it) the exclusion of 'production processes' from the Act's ambit is qualified by the phrase 'except to the extent that it is integral but subsidiary to the service'. This opens a yawning gap that many would like to use to compel owners of gas-processing plants to open them to competing supplies of raw gas on terms ultimately determined by the regulator. Beneficial though this might be in the short term, the outcome could create a new dimension of sovereign risk that would inhibit future investment.

Stephen King's article on asset valuation carefully disassembles the different bases on which asset prices can be established as the foundation for a regulated access price. King has published his analysis in a number of places. His conclusion that historical costs should be the fall-back position where agreement is not voluntarily reached pleases many users but begs many questions. If historical costs are the basis for charging, should output from fully depreciated assets be free? If so, on what basis should access be determined where there are many suitors for it? If the allocation is to the users in place and the capacity is tradable, as it surely should be, the beneficial ownership has migrated from the original owner to the customer. It is unlikely that this directs the incentives for building new links to the appropriate party. Moreover, by analogy with other industries, if historical costs are the correct basis for charging, it would seem that ICI should give away its ethylene from its older plants!

Henry Ergas's essay contrasts the very light-handed approach to telecommunications regulation in New Zealand with that practised in Australia. He concludes that New Zealand has achieved the better outcome, at a quarter of the cost to the public purse. According to Ergas, NZ Telecom has achieved much faster productivity gains than Telstra (some of which, he acknowledges, are a matter of catching up). He concludes that New Zealand prices are now lower than those in Australia, and that NZ Telecom has lost market share no more slowly than Telstra.

Naturally enough, this view of the world is hotly contested by AUSTEL (though unfortunately not in this collection). One important consideration is that the bulk of NZ Telecom's gains were established under the reformed monopoly prior to the establishment of the light-handed regulation. In other fora, Neil Tuckwell of AUSTEL has argued that New Zealand is better placed to achieve lower prices because of the structure of its market in both local and international calls; but, even so, Australian prices are no higher. However, the benchmark that Tuckwell uses — calls between New Zealand and Australia — shows New Zealand's rates to be lower. It is also true that Telstra has been inhibited in achieving management downsizing by political constraints.

A sour note is injected into the collection by Philip Williams, who is a much better economic historian than an economist. Williams takes issue with the Industry Commission's (IC) pioneering 1989 paper on electricity, *Energy Generation and Distribution*, which was arguably the crucible in which the present approach was forged, at least in Australia. He suggests that the IC view that there should be a 'law of one price' reflects poorly on the training of economists in Australia. As a longstanding teacher in the profession, Williams would be aware of how poorly the subject is taught. While, as he says, there is nothing wrong with price discrimination — it allows cost-effective theatre matinees to be shown and cheap tickets to the ballet for the indigent — it does not promote efficiency where it stems from regulatory fiat. The 'law of one price' does not mean a single price; time considerations, quality differences and other matters are likely to mean several prices for different products.

Ramsey pricing, which Williams advocates, is based on prices (on taxes, in its original formulation) that defray costs in proportion to the strength of demand for each of the total product's joint outputs. Market-based variations of this are found in products as diverse as motor cars, alcohol and hotel rooms, where suppliers are able to obtain a higher contribution to their profits from the more luxurious goods in the range. Their ability to do so is, however, constrained by competition. A perverted form of Ramsey pricing was applied to monopoly electricity supplies so that commercial businesses (which were tied to their location) were milked, consumers who are able to exercise political power received relatively advantageous prices, and footloose major users could negotiate highly favourable prices. None of this is possible with homogenous products like electricity once arbitrage is permitted. Those benefiting from low prices would sell their contracts until an equilibrium law of one price prevailed. Ramsey prices are therefore consigned to the dustbin of economic history once a free market is created.

The papers in general add up to a first-class review of the issues arising from deregulation of services with monopoly elements and provide a good fusion of the theory and its practical applications.

Alan Moran is Director of the Deregulation Unit of the Institute of Public Affairs and Convenor of the Energy Forum of private sector energy supply businesses.