Working Party No. 2 on Competition and Regulation

VERTICAL SEPARATION IN REGULATED INDUSTRIES

-- Australia --

This note is submitted by the Delegation of Australia to the Working Party No. 2 FOR INFORMATION at its next meeting on 27 October 2000.
EXPERIENCE WITH VERTICAL SEPARATION IN REGULATED INDUSTRIES

Australia

Introduction

1. Under the 1995 National Competition Policy, structural reform of public monopolies through separation of natural monopoly elements and potentially competitive elements is one of the key elements in a regulatory strategy aimed at addressing concerns about anti-competitive conduct that could arise in the case of vertically-integrated industries.\(^1\) Other regulatory controls used to guard against the potential misuse of control over access to the natural monopoly elements in the industry include a legislative regime for access to ‘essential facilities’, price regulation, ‘ring fencing’ arrangements (accounting separation) or some combination of these regulatory tools. The fact that reforms usually form part of a package can make it difficult to separate out the impact of individual elements such as structural separation.

2. Structural separation has been an important element of competition reforms in the electricity and rail industries where separating out the contestable elements of former public monopolies has been an important pre-condition to promoting competition in markets. In the gas industry, vertical integration has historically occurred at the retail/distribution level, and this has been addressed in most States through ring-fencing arrangements rather than full separation. The incumbent telecommunications carrier remains vertically integrated but residual market power concerns are addressed through a mixture of special misuse of market power rules, record keeping rules and access arrangements. Vertical integration is less of an issue for airports and postal infrastructure. Access arrangements applicable to services provided by the non-competitive elements of the industries have been important in promoting competition in the competitive elements of most infrastructure industries both as a substitute for, and a complement to, structural separation policies.

Electricity

3. In 1991, all Australian governments agreed to implement reforms to boost competition in the electricity industry. Since then, most States have structurally separated their electricity industries. This has involved clearly separating the generation and retail segments (which are contestable in nature) from the transmission and distribution segments (which have natural monopoly characteristics). Structural separation is supported by an access regime that ensures that all contestable businesses are able to access transmission and distribution networks in a non-discriminatory manner.

4. As part of a national code for the electricity industry, electricity transmission and distribution companies must also comply with ring fencing guidelines, which aim to ensure the accounting and functional separation of non-contestable services from other services offered by the companies.

5. Structural separation has facilitated competition in the electricity generation sector through enabling the establishment of a National Electricity Market. Interstate trade in electricity began in May

\(^1\) Under the Trade Practices Act 1974 (the primary competition statute), neither the government, nor the Australian Competition and Consumer Commission (the primary independent competition regulator) has power to force structural separation.
1997 between New South Wales and Victoria, and the National Electricity Market commenced operations between the southern and eastern States in December 1998. Competition in the Australian retail electricity sector has also been introduced with the progressive lowering of thresholds enabling electricity customers to choose their electricity supplier. As a result, there has been an increase in the number of retailers in the electricity sector.

Results

6. The reforms in the electricity market have led to lower prices and more efficient investment in the sector by reducing excess generator capacity. A 1998 survey found that large customers in Victoria and New South Wales had achieved savings averaging twenty-six per cent on their electricity bills.

7. The reforms also appear to have had a positive impact on complaints about anti-competitive conduct although they have created new concerns with the operation of the new regulatory arrangements. These concerns would be expected to subside as the regulatory arrangements become more established.

Rail

8. Australia’s rail industry involves activities that are both regulated by government legislation and activities that are subject to competitive forces. The monopoly infrastructure (the track) is subject to regulation by the access regime established under the Trade Practices Act. However, the downstream above-rail activities of freight and passenger operations are not subject to regulation, and are open to competition. Government policy is to promote competition by allowing third party access to essential facilities such as railway tracks. General access provisions in the Trade Practices Act implement this policy objective, and promote competition between above rail freight and passenger operators.

9. The Federal government has vertically separated the ownership, accounting and operation activities of Australia’s interstate rail industry by establishing a separate track infrastructure provider, the Australian Rail Track Corporation, to own and manage key elements of the interstate network. A separate entity, the National Rail Corporation, provides interstate and intrastate freight services. Both corporations have separate legal identities, and operate each business independently of one another. Furthermore, each entity has separate accounting arrangements.

10. However, the majority of Australia’s rail industry is regulated by State governments, not the Federal government, and the separation of the ownership, accounting and operation activities of the regulated monopoly and the non-regulated competitive activity differ among jurisdictions. For example, in New South Wales, the ownership, accounting and operating activities of the track, maintenance, freight and passenger operations have been separated from one another. However, Western Australia, Queensland and Tasmania, there has not been separation of the ownership, accounting and operation activities of their above and below track operations.

Results

11. In New South Wales, where rail operations have been structurally separated, the Commission has not received significant complaints of anti-competitive behaviour against the behaviour of the rail services operator. On the other hand, in Queensland, which still maintains an integrated operation (albeit with accounting separation), there have been some complaints about the conduct of the operator. The Commission is investigating one of these complaints under those provisions of Australia’s competition laws dealing with misuse of market power. The allegation is that the operator provides track access to its own downstream operator at lower prices than to third party operators. There have been no substantial
complaints against the operator that operates rail services in Western Australia in a totally integrated fashion within a non-corporatised entity.

12. In the interstate rail industry, the access regime under the Trade Practices Act and separation has had a significant effect on the level and quality of competition. Before the introduction of the access provisions in the Trade Practices Act, there was a single operator, National Rail, on the interstate track network. However, there are now five above rail operators providing freight services and one above rail operator providing passenger services. This indicates that separation, corporatisation and access provisions have stimulated competition to new levels in the interstate rail freight industry. It is estimated by the rail industry that freight rates on the Melbourne-Perth interstate corridor have dropped by twenty-five per cent since separation and the introduction of the access provisions in the Trade Practices Act. Similarly, since vertically separating the New South Wales network, freight rates are estimated to have fallen by twenty per cent. The Australian Rail Track Corporation claims the quality of service provided by the interstate freight operators has increased in terms of efficiency and reliability.

13. The transitional costs for the rail industry have been substantive. Vertically separating the interstate rail operations required the Federal government to create the Australian Rail Track Corporation to own and manage access to the interstate track. Therefore, separation imposed the costs of establishing the infrastructure company as well as the costs involved of establishing a separate above rail operator. The costs associated with the introduction of access regulation were also relevant in the transitional period.

14. The rail industry may have economies of scope associated with vertical integration. The vertically integrated rail operators argue that integration allows them to save money and improve efficiency through the smooth co-ordination of infrastructure investment, access arrangements, maintenance and rollingstock operations. It has been suggested that one advantage of vertical integration is that it allows rail organisations to develop integrated systems, where responsibility for the entire rail operation is vested in the one organisation. Therefore, there are no ‘gaps’ of responsibility in the running of the railway and greater efficiency can be obtained through better co-ordination of the maintenance, track and rollingstock aspects of a rail business. Whether such economies outweigh the benefits of vertical separation will depend upon the particular circumstances of each rail business (urban / regional / interstate / freight / passenger).

Gas

15. The Australian gas industry comprises four sectors – production, transmission, distribution and retailing. Production and retail are competitive activities, while pipeline transmission and distribution are generally monopolies. Production services have traditionally been provided separately, but retail and distribution services have usually been integrated. It was common in some States and Territories to have one company undertaking both the distribution and retailing of natural gas. This created the potential for a vertically integrated company to shift costs between its businesses in order to gain a competitive advantage in one market. For example, the distribution business could cross-subsidise the retail business, giving the retail business a competitive advantage over any competing retailers.

16. In the mid-1990s, Federal and State governments agreed to introduce significant reforms to increase competition in the natural gas industry. In 1997, all governments introduced the National Third Party Access Code for Natural Gas Pipeline Systems (the ‘Gas Code’), which requires contestable gas businesses (retailing and production) to be separately owned or ring fenced from the monopoly pipeline transmission and distribution businesses.
17. The minimum ring fencing requirements of the Gas Code now prohibit cross-subsidisation, for example, by requiring businesses to allocate costs shared between different services in a fair and reasonable manner. The ring fencing requirements in the Gas Code are designed to ensure that related businesses cannot gain preferential treatment at the expense of other market participants. In addition, contracts between related businesses are subject to regulatory approval. Australia’s competition regulators may vary these arrangements on a case-by-case basis, either by imposing additional obligations or by waiving certain obligations.

Results

18. It is difficult to measure the impact of structural separation or ring fencing on competition and prices in Australia’s gas industry. This is because ring fencing is just one element of a package of reforms to the industry, which have until now focused on prohibiting the monopoly pricing of transmission and distribution services, and providing third party access to these services. With this access regime in place, attention is now being directed at increasing competition amongst natural gas retailers. Furthermore, there are concerns that the benefits of reform will not be felt if greater competition is not introduced in the production sector.

19. Greater competition in Australia’s retail gas sector is now being introduced with the progressive lowering of thresholds that enable gas customers to choose their gas supplier. In recent years, the number of gas retailers has also increased due to government initiatives. For example, prior to the privatisation of Victorian gas businesses, the incumbent retail/distribution company was separated into three separate businesses, each comprising a separate retailer and distributor. Each distributor is also required to service another retailer.

20. Although complaints against anti-competitive behaviour in Australia’s gas industry have fallen in recent years, this cannot be attributed solely to the structural separation of entities under the Gas Code. The Gas Code does require vertically integrated businesses to ring fence their accounts, but it also requires a range of other access terms and conditions to be established, with the aim of providing for third party access to the pipeline and therefore, increased competition amongst gas retailers. Access arrangements are probably most important in promoting competition, rather than structural separation, and has been the main regulatory tool used to address natural monopoly problems.

21. The Commission has received several allegations of anti-competitive behaviour involving the company that owns the New South Wales gas distribution network as well as retailing gas in New South Wales markets. Although the distribution and retail businesses in this State are ring-fenced, it has been alleged that this company’s distribution network has favoured its owner-retailer over a potential entrant. These allegations, however, were found to be inconclusive, and were not pursued by the Commission. The majority of complaints received by the Commission about anti-competitive behaviour in the gas industry concern the extent to which existing haulage agreements prevent third parties from obtaining access to capacity on transmission pipelines, and the lack of competition between gas producers in the upstream sector.

Telecommunications

22. Since 1997, it has been government policy to permit, allow and promote competition in all areas of the Australian telecommunications industry. The number of carriers has grown significantly since 1997, and there are currently forty-four carrier licences on issue. While the partially-privatised Telstra (until 1991 the monopoly provider of telecommunications carrier services) remains the primary provider of the
‘local loop’, other carriers such as Cable & Wireless Optus, AAPT and MCI WorldCom, have rolled out limited local networks of their own.

23. Telstra has not been structurally separated. Government policy has been to apply special misuse of market power rules and to enforce special record-keeping rules applicable to the telecommunications industry under the Trade Practices Act. Recent amendments to the Trade Practices Act have also established an industry-specific regime for regulated access to carriage services. These regulatory tools are all designed to address problems that may be associated with vertical integration and the market power of incumbent operators.

24. The Commission has undertaken industry consultative processes in relation to accounting separation and intends to issue a formal instrument mandating accounting separation in the near future. In the meantime, competition in local call telephony has been a principal area of concern to the Commission. It conducted a public inquiry into local call services during 1998 and 1999 and, in July 1999, mandated access to an unbundled local loop service and a wholesale end-to-end carriage service. This was designed in part to stimulate competition for the provision of local calls, which was not developing as a consequence of the control by Telstra of the only ubiquitous fixed access network in Australia. The decision is still being implemented and concerns continue to be raised about the non-competitive activity.

Air services

25. Australia has regulatory arrangements to promote competition in all contestable parts of the air services industry. Formerly, the Federal government owned and operated all Australia’s major civil aviation airports. Since 1997, it has leased all but the Sydney International Airport to private operators. The airports were leased as vertically integrated entities, comprising both competitive and non-competitive elements. Non-aeronautical competitive services (including aircraft operations, cargo terminal services, ramp handling services, maintenance and catering services) are not usually regulated.

26. Non-competitive activities in Australia’s privatised airports include aeronautical services, which are subject to price cap regulation. A price-monitoring regime also applies to certain air services (‘aeronautically related services’) that are likely to have significant complementarity with aeronautical services. The services and facilities subject to monitoring in Australia include aircraft refuelling services, aircraft maintenance sites, check-in counters and car parks.

27. Airport operators in Australia are also required to provide regulators with separate sets of financial accounts for aeronautical and aeronautically related services, and for the enterprise as a whole. This enables the regulator to assess the financial performance of the regulated part of the business separately from the non-regulated activities of the airport operator company. A quality-monitoring program has also been implemented at the privatised airports to assist the regulator in its consideration of pricing proposals and to improve transparency of airport performance. The program involves collection of information on a number of performance indicators.

28. The regulatory framework for aeronautical services in Australia also includes a number of mechanisms to enable users to obtain access to certain airport services. The services involved are those necessary for the purposes of operating civil aviation services at an airport, and which are provided by the means of airport facilities which cannot be duplicated economically (natural monopoly facilities). The framework is designed to encourage users and facility owners to negotiate the terms and conditions of access with recourse to arbitration procedures when negotiation fails. A recent decision by the Australian Competition Tribunal (the body established to review decisions of the Commission and others) regarding certain airport services at the Sydney International Airport held that third party access to the airport should
be granted in order to promote competition in downstream markets such as ramp handling and cargo terminal services.

29. Australia’s regulatory arrangements governing the air services industry also include limits on ownership of airports by airlines. Australia’s airlines are prohibited by legislation from holding more than five percent of an airport operator company. The Courts have power to impose penalties or divestiture orders if an airline breaches this rule. To date no airline has invested in an airport operating company to any extent.

Post

30. Australia’s postal market contains a range of players. The largest company, the government owned and operated Australia Post, operates as a legislated monopoly for much of the traditional domestic letter market, but operates in competition with other postal providers for parcels, international mail services and specialist courier services. Australia Post has not been structurally separated. The monopoly over the traditional letter market has been granted to enable Australia Post to fund its ‘community service obligations’, such as providing postal services to unprofitable rural areas. The monopoly takes the form of ‘reserved services’ based on the weight of letters. Australia Post is not considered to be a natural monopoly and, as a result, the key issue is not structural separation, but the problems for competition that may arise in horizontal markets from a legislated monopoly. The existence of legislative protection has led to concerns that Australia Post could cross-subsidise its activities in competitive markets.

31. Legislation currently before the Federal Parliament will require Australia Post to maintain separate records for its monopoly services, and these records will be subject to regulatory scrutiny. The intention of the record keeping rules is to ensure that Australia Post is not cross-subsidising from its monopoly services to competitive services.