SUBMISSION

TO THE COMMITTEE OF INQUIRY

INTO THE COMPETITION PROVISIONS OF

THE TRADE PRACTICES ACT 1974, AND

THEIR ADMINISTRATION

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Prepared by: Trevor Lee, Group Manager Regulatory Affairs
ENERGEX Limited
150 Charlotte Street
BRISBANE Q 4000

Telephone: (07) 3404 1825

ABN 40 078 849 055

<u>**TABLE OF CONTENTS**</u>

EXECUTIVE SUMMARY

ENERGEX Limited (ENERGEX) appreciates the opportunity to make a submission to this review of an important and complex Act. This submission is at a high level and ENERGEX looks forward to participating further in the review process on the detail.

Section 45A and Section 76 – penalties for price fixing

Chapter 1 of this submission deals with penalties and associated administrative matters for dealing with price-fixing. In its intent, price-fixing is no different from many types of criminal behaviour and can involve sums of money which are many multiples of instances of simple fraud or theft. There is, however, one important difference in its effect. That is, victims of price fixes may be unaware that they are being robbed, even for decades. This is because a well-run price fix is almost impossible to detect, absent a whistleblower. Consequently, victims cannot protect themselves or limit the damage in the normal way and must depend on insiders to the fix breaking ranks or employees of the fixers informing the authorities.

What is clear is that, under current circumstances, the marginal benefits of price-fixing outweigh the marginal costs of being prosecuted and penalised, given the probability of detection. It is this trade-off which needs to be reversed. ENERGEX recommends that:

- **price fixing should be made a criminal offence;**
- **the possibility of additional pecuniary penalties should be examined;**
- **a party to a price-fix who "blows" to the authorities should be provided with immunity from criminal prosecution; and**
- **whistleblowers who are not party to the fix should be financially rewarded by the courts.**

The damage caused by price-fixing falls directly on buyers and consumers. It can also indirectly affect the competitiveness of firms operating in tradeable markets. Courts, however, do not attempt to determine the extent of either direct or indirect damage. Moreover, there is a disturbing trend for the ACCC and price-fixers to come to agreements on penalties and statements of facts to be submitted to a court.

ENERGEX considers that the public interest would be served if courts were to estimate the direct damage caused by a price-fix, perhaps by appointing an independent expert. This would promote transparency and aid in the assessment of penalties. Such an estimate could also be treated as a finding of fact for coat-tail actions by buyers and consumers:

- **the courts should formally assess the quantum of direct damages in price-fixing and this should be treated as a finding of fact.**

ENERGEX also considers that the present relationship between penalties and damages is not serving the public interest. This can occur when the actual victims of the price-fix cannot recover damages because of the penalties imposed. In some cases, such as the recent transformer case[1], price-fixers may go into liquidation after penalties are awarded against them, making restitution of damages to the actual victims near impossible – this abrogates the principle of natural justice:

[1] *Australian Competition and Consumer Commission v ABB*

- **the courts should have regard to S.82 of the TPA in fixing penalties to help ensure that funds are available for the actual victims; and**
- **a proportion of penalties should be "reserved" at the discretion of the court for damages claims.**

Attachment 1, 'The Causes and Consequences of Collusion' by Professor David Round is provided to assist this inquiry. One contribution of the paper is that it demonstrates that the classic defence of price fixers in claims for damages that only market shares and not prices were affected is groundless:

- **'market sharing' is simply a less direct means of 'price fixing' to the same end, but with greater difficulty of detection. Such a defence should be disregarded by the courts.**

Section 46 – a purpose or effects test?

Chapter 2 lays the foundation for ENERGEX's concerns that the effects test proposed by the ACCC is likely to prove to be the antithesis of the original intentions of the TPA in practice. It has yet to be demonstrated that S46 is deficient. If problems are discovered, ENERGEX considers that a "purpose plus" test to assess the whole context of the conduct of the firm should be sufficient.

- **there should be no effects test in S46, although consideration should be given to a "purpose plus" test if problems arise.**

Section 47(6) – a hindrance to efficient corporate restructuring

Corporations may split off functionally related entities for a variety of good and legal reasons (see Chapter 3). This, however, raises the risk of breaching S.47(6) or what is known as third line forcing. One solution could be to water down the per se restriction by introducing a substantially lessening competition test. An easier option would be:

- **there should be an exemption to S.47(6) for related party third line forcing.**

Section 50 – the need for simplicity and structural specificity

Chapter 4 outlines the broad views that have been put in over thirty years of debate on merger policy. This debate has generated much heat but little light. What is clear, however, it that a massive and highly costly merger 'industry' has evolved where vested interests abound, even as firms operating in real world markets face ever higher levels of uncertainty about the eventual success of their expansion plans. Inevitably, opportunities for greater efficiency have been lost.

It is about 60 years since Harberger first showed that the losses from market power in the United States were trivial (about equivalent to a good steak dinner per person a year). In Australia, the Bureau of Industry Economics and the Productivity Commission have reminded us that the costs of getting the regulation of market power wrong can far outweigh any benefits.

It is ENERGEX's view that much of the vast apparatus of the merger industry and the uncertainty for firms can be removed, for at least three reasons. First, it is no longer tenable that concentration is a major determinant of firm behaviour. Secondly, it is the potential for entry into a market which is important in controlling the behaviour of incumbents. Thirdly, the TPA is more than adequate to control both unilateral and joint instances of any anti-competitive conduct. To cut through the Gordian knot, ENERGEX proposes a simple test for merger proposals to the effect that:

- **two firms having a constraining degree of market power may exist in any market where there is ease of entry and expansion or potential import competition.**

No other criteria, tests and such like would apply. The test implies that four firms can be reduced to three under any structural conditions. However, three may not be reduced to two if one is likely to dominate the other, whether or not entry barriers are low or there is import competition. The possibility of authorisation or undertakings would still exist but may be little used.

ENERGEX views this test as a transition to a more lenient test down the track which relies solely on ease of sustainable entry and importation. This would accord with current theory about effective competition but may be a step too far at this juncture.

<u>Section 52 – misleading or deceptive to whom?</u>

Chapter 5 makes a case for raising the hurdles for breaches of this section. There is no requirement for intent and the section covers conduct such as 'inadvertence' and 'likely to mislead the susceptible'. This is explained in the ACCC's guidelines of August 1998. These requirements make compliance extremely difficult and costly. As the guidelines admit *"This makes preventing that conduct a real challenge."*

The ACCC is well aware of that challenge. On 12 September 2001, Justice Finn of the Federal Court made a number of highly critical comments about the ACCC and its conduct in the power surge case, including:

"as the agency responsible for policing S.52 of the TPA Act, it properly can be expected to set the example of care in its own representations to the public".

If the experts have substantial problems, how may ordinary businesses do better? This is particularly a problem for high profile companies that, given the publicity given by the ACCC to this section, seem to attract increasing numbers of vexatious allegations from pedants, activists, the obsessed and the like. Dealing with such allegations can take up a significant proportion of the time and energy of senior management.

ENERGEX proposes that:

- **a purpose test is included into S.52 and that a minimum benchmark is constructed that rests on ordinary or reasonable members of the public to whom the information is directed.**

<u>Section 71 – electricity is not a 'good'</u>

The genesis of the power surge case was in Victoria in 1996 when the ACCC put the view that electricity distribution companies were liable for damages as a result of power surges (and, later, brownouts) whether or not they were attributable to negligence. The ACCC later wrote to companies suggesting they may have breached the TPA provisions dealing with the merchantable quality of goods (and misleading and deceptive conduct).

Chapter 6 outlines the arguments involved. This matter has been extremely expensive to the companies. Unfortunately, for complex procedural reasons, Justice Finn of the Federal Court declined to make a formal declaration or ruling on the law in respect to S.71. Nonetheless, the companies can take comfort from both the commentary by the judge on the nature of electricity (eg "energy is not matter") and on the validity of the ACCC's arguments. At para 141 he states:

"There is a very real prospect that the view the ACCC has taken of Division 2 of Part V will be found to be incorrect."

ENERGEX proposes that this time consuming and highly costly matter is finally resolved:

- **amend S.71 of the TPA to exclude electricity.**

Section 83 – when are facts really facts?

Chapter 7 describes the circumstances where a legal curiosum appears to imply that agreed statements of fact presented to a court cannot be regarded as findings of fact by a court in subsequent private action for damages. If so, this would appear to defeat the whole policy intent of S.83 and the cost of seeking damages could be prohibitive. ENERGEX strongly recommends:

- **amend S.83 to overcome the apparent legal curiosum that would require the reproving of facts that have already been admitted or agreed in another court.**

Part IIIA: A change in administration is vital

The Terms of Reference note that it is not necessary to review the provisions of Part IIIA and ENERGEX accepts that and awaits the release of the long-completed (October 2001) Productivity Commission report on the matter with interest. However, this inquiry is to review the administration of the TPA and to deal with that issue it is necessary to say a few words about the provisions.

Chapter 8 makes the point that the ACCC is applying an incorrect model of regulation under Part IIIA which is the antithesis of the original intention of that Part. Moreover, the ACCC leads the Utility Regulators Forum which aims to provide consistency with this model in all jurisdictions. This compounds the problem and makes the radical changes needed near impossible.

ENERGEX suggest that this Inquiry considers the proposition that:

- **the administration of economic regulation under the TPA is removed from the ACCC.**

Where that responsibility should lie is being debated in the current CoAG Review into the Energy Market under the Hon. Warwick Parer, but the responsibility for deciding on the administration of the Act appears to be with this Committee.

Section 46 – a sister section for regulated industries

New Zealand has depended on S.36 of its Commerce Act (akin to S.46 in our TPA) in its version of very light handed regulation for many years. However, neither section was drafted for this purpose. Notwithstanding the views of the ACCC, it is inevitable that Australia will shift to second or third generation regulation in the near future as the less than optimal outcomes of the ACCC's approach become more apparent. The Productivity Commission appears to be leading the way in its recent recommendations on tugboats and airports.

There is no stock of monopoly rent (if there was any before) left in Australian regulated industries where cost of service reviews have been conducted. Therefore, there can be no abuse of market power. As ENERGEX understands it, such reviews have been conducted at least once and sometimes twice on regulated businesses. What is needed now is a sister section to S.46 which deals with the potential for abuse of market power in the way it is always interpreted by the courts – as a flow concept. If a firm is *"giving more and or charging less"* it cannot be abusing its power. Indeed, this is the antithesis of market power and the precise emulation of effective competition.

ENERGEX proposes that:

- **a new sister section to S.46 is drafted for regulating natural monopoly companies where abuse is defined as *"giving less and or charging more".***

1. SECTION 45A AND SECTION 76 – PENALTIES FOR PRICE FIXING

A pecuniary penalty of $10 million may be handed down by the Federal Court against each act of a corporation that breaches S.45(A) of the *Trade Practices Act 1974*. Since early 1993, when this amount became effective, no firm has had the maximum penalty awarded against it (although in total individual firms have faced penalties of up to $15 million), and price-fixing cases continue to come to court, frequently involving major Australian corporations. The much-hoped for deterrent effect of larger penalties clearly is not working. The expected gains to price-fixers, if we can assume that they are rational expected profit maximisers, appear to be greater than the expected costs of orchestrating and putting into effect a price agreement with rivals, where the cost calculation should include the expected cost of being detected, prosecuted, and found guilty (this will include, inter alia, legal fees, the opportunity cost of lost management time, public disgrace, any necessary restitution or compliance programs ordered, as well as monetary penalties).

Professor Fels, Chairman of the ACCC, has now on several occasions suggested that it is time to consider the introduction of criminal sanctions for price-fixing. We support him in this call, and urge the Review Committee to consider not only more stringent monetary and criminal penalties on individuals (it is, after all, an individual that makes the decision to collude on prices with a rival), but also to reflect on the desirability of introducing positive incentive mechanisms that will more readily and efficiently bring out into the open evidence on price-fixing - a reward, if you like, for what is known as whistleblowing. ENERGEX also believes that the quantum and disposition of pecuniary penalties needs re-examination at this time.

1.1 Price-fixing should be a criminal offence

Price-fixing is undertaken to subvert free market forces and to extract higher prices from buyers than would otherwise be the case. It is no different to fraud, where unsuspecting buyers are taken advantage of, or of robbery, where a thief steals the property of another person. Price-fixing doesn't just happen – it is the outcome of a deliberate strategy to interfere in, and suspend, the competitive process in order to extract value from buyers.

While price-fixing is about identical in intent and in outcome to many types of criminal behaviour, it differs in a very important way – with robbery or fraud, victims usually discover either instantly or relatively soon thereafter that their property has been misappropriated. It is generally far less obvious to the victims of a price-fix that market forces are no longer working in their favour. The "best" price-fixing agreements will be carefully orchestrated to present a picture of an apparently competitive market at work – firms taking turns, however worked out, to lead prices up or maintain them when they would otherwise fall, or elaborate schemes will be devised to turn tender processes to the private advantage of the colluding sellers. Buyers may never realise, or may take a considerable time to appreciate, that the market has been rigged. In a sense, it is close to the perfect crime, where no-one knows, other than the criminals, that it has been committed.

Hence buyers may not be prompted to put a defensive strategy into place, or to carefully review the pattern of, and trends in, prices they have been quoted. And without those triggers having alerted them to the possibility of illegal behaviour, they will not be able to signal to the ACCC the possibility that price-fixing is occurring. Until a suspicion is aroused, and that suspicion prompts a call to the ACCC, the damage to buyers mounts, to their detriment and ultimately to the detriment of final consumers. This damage is irretrievably sunk – the dollars withdrawn from buyers' pockets will never be returned to them, except if they pursue a successful action for damages.

Action by the ACCC might be successful, and large monetary penalties may be handed down against the price-fixers, but it has often been stated by judges in the Federal Court that the purpose of such penalties is deterrence, both to the current offenders and to any other firms that might contemplate similar action. No element of retribution or punishment should be included in the assessed penalties. Few serious attempts have ever been made by the courts in Australia to assess the damage inflicted on buyers by price-fixers, and the current disturbing trend for the ACCC and the colluders to agree to a statement of facts and a penalty which is submitted to the court for endorsement, means that a full public airing of what was done and what damage was done and to whom, is sadly lacking.

The fact that price fixing is still a common occurrence, even among large Australian firms and multinational firms operating in Australia, despite maximum corporate penalties of $10 million and $500,000 per offence for individuals, suggests that it is time to review the penalty regime – and its application - yet again. Judges are not setting penalties anywhere near the maximum amount. A further increase in the maximum corporate penalty might be necessary, to give judges the confidence that they can set higher penalties but not risk appeal by determining the maximum possible amount. Individuals, who ultimately make the decision on price-fixing, have still not experienced a penalty of more than $150,000 (except one case of separate offences). By making price-fixing a criminal offence, individuals would, ENERGEX submits, be far less predisposed to engage in this activity. Other penalties that would apply to the individual and that could not be transferred in some way could also be considered, such as community service.

There are other penalty possibilities that could be considered. One would be for the court to have the option of setting a penalty as some stipulated percentage of the firm's total profits over the period in which the price-fixing occurred. Another would permit the application of some multiplier to the additional profits assessed as having resulted from the price-fixing agreement. The prospect of such penalties would have the effect of raising the expected cost of collusion, thereby making it appear to be less profitable for the firm.

1.2 Incentive mechanisms to encourage the production of evidence on price-fixing

Price-fixing works best for the colluders when it is concealed. The better the concealment, so that it is hard for buyers to distinguish between price-fixed outcomes and normal commercial price rises due to supply and demand, the longer the price-fix is likely to last and the greater the social damage. If buyers are unaware that they are facing an anti-competitive agreement, the only hope of its being exposed is through an insider "coming clean" – the emergence of what is known as a "whistleblower". Many of the ACCC's successes against price-fixing have started with the information provided by such a person. Such informants may either have been in some way involved in the decision to fix prices, or may have come across the information in the process of implementing the decision, or simply may have become aware of it as an employee of the firm. To expose the collusive agreement, a great deal of courage is needed – the possibility of prosecution must be faced, and the enmity of colleagues (and friends) and the resulting damage to personal and work relationships, as well as future employment prospects, need to be taken into account. In addition, should such a person eventually appear as a witness, account will need to be taken of the enormous pressure that will be brought to bear both before, during and after the hearing.

ENERGEX believes that a society that values competition and that has made price-fixing illegal per se needs to ensure that there exists an appropriate incentive and protection mechanism for those who let the ACCC know about those activities. Currently, the detection and prosecution mechanism is one-sided – it provides the stick, in terms of ex-post penalties, but does not provide any tangible carrot to flush out revelations of price-fixing conduct. Whistleblowers provide a necessary antidote to the secret world of price-fixers. They need to be protected and rewarded for their efforts.

Currently, the ACCC can agree to an immunity from prosecution for an insider who in some way was involved in the agreement and who provides detailed information on the other parties involved. It can do little thereafter to protect the informant from the repercussions of the decision to co-operate. Perhaps no more is necessary. The individual, for whatever reason, has realised that the concerted action was socially wrong and has repented, in the process exposing himself or herself to considerable personal pressure and, from some quarters, opprobrium. This may be punishment enough, discounted from what could have been the case if the individual had been discovered through the ACCC's normal investigatory channels or by another whistleblower.

Now that the contribution of whistleblowers is increasingly being acknowledged (see, for example, the recent publicity as a result of the ACCC's "raids" on oil company offices), those who take part in price-fixing agreements now must be constantly wondering whether there is a potential whistleblower amongst them, and how soon this person might move. Each individual, if rational, should then consider the benefits and the costs of going first – getting in before anyone else and reaping the benefit that can only occur to the first informant. There exists a real first mover advantage here. ENERGEX raises the question as to whether a formal arrangement for immunity from prosecution should be considered, and also whether something more could be offered to encourage the production of such information.

Consideration also needs to be paid as to how to encourage and reward those on the inside who report their suspicions of the existence of a price-fixing agreement, but who were not involved in its establishment. At the moment, they earn the gratitude of the ACCC, the respect of judges and the approval of the community, but at a potentially great personal cost from which they may never recover. It takes a brave individual with the highest social motives to behave in this way.

ENERGEX believes that such important social behaviour should be positively rewarded. While it would of course be difficult to produce a socially-optimal incentive/reward mechanism that did not produce perverse incentives, and while care would be needed to discourage self-serving, malicious, vexatious or nuisance allegations, we suggest that consideration be given to some monetary reward be given to such informants by the court following successful prosecution by the ACCC. This amount would be left for the judge alone to determine, after having heard the evidence and assessed the role played in its production by the informant. A maximum amount could be proclaimed by law, just as maximum penalties are provided for in the *Act*, or provision could be made for an award of up to a certain percentage of either the final penalty assessed by the court (this amount to be paid ideally by the guilty parties in addition to any general penalty) or if not, to come out of the penalty amount before it is paid to general revenue), or of the amount of damage caused by the price-fix, if this amount could be estimated with any great accuracy.

1.3 The need for a formal assessment of the damage caused by price-fixing

Currently, even in fully argued cases, there is little attempt, if any, by the court to determine the additional profit accruing to firms as a result of their price-fixing. Judges appear to be content merely to characterise their conduct qualitatively as "serious" or in similar terms. It might, of course, be difficult for the ACCC, given its resources, to produce a full economic quantification of the direct gains of the price-fix, and hence of the direct social damage that has been caused (let alone the indirect costs), but ENERGEX believes that such an estimate should be provided in each hearing, for at least two reasons.

First, to place on the record a formal indication of the damage caused to buyers and ultimately to final consumers. This would serve to alert those hurt by price-fixing to the quantum of their suffering, to make them more careful observers of prices they pay, and to consider how they may wish to change their trading relationships with the guilty firms. A firm estimate of the damage would also assist the court either in setting its own penalties or in assessing whether to accept any agreed penalties put to it by the ACCC and the respondents. A determination of the quantum of damage caused in each case would also assist in ensuring that penalties in different cases had an appropriate degree of relativity, in keeping with the social impact of the price-fix.

Secondly, a formal, objective and impartial estimate of the damage caused, both in total and in relation to individual buyers, would be of great assistance to those buyers who might wish subsequently to take private action for damages against the colluders.

To be credible, the damage amount would need to be made by a recognised expert, who would have the power to collect whatever necessary data were available. While the ACCC could carry out this task, it no doubt would be better able to use its scarce resources in other directions. ENERGEX believes that the best way would be for the court to appoint an expert(s) in the field to carry out the investigation and to produce an estimate of the damage caused.[2] Both the ACCC and the respondents would need to have some rights to make submissions to the court about the assessment.

While this procedure would undeniably add to court proceedings, it would ensure a more accurate account of the impact of the price-fix, would enhance the public’s appreciation of the wrong-doing, would make the penalty more transparent, and would serve notice to would-be colluders that their conduct would be exposed to full public scrutiny. In addition, if the results of the research were to be treated by the court as a finding of fact, then subsequent coat-tail actions for damages by buyers would be more efficiently and speedily processed through the courts. ENERGEX believes that the prospect of damages being determined in this way would provide a most significant and socially-efficient deterrent effect.

1.4 The uneasy relationship between pecuniary penalties and restitution or damages for customers of price fixing corporations

Currently, when an entity is found guilty of price-fixing, the monetary penalty it is required to pay goes to general revenue. While we believe that this penalty has not been high enough to deter others, it can represent a significant percentage of the net profits expected in the near future. This may leave any aggrieved buyer who has been put at a

[2] It should be noted that there could be a difference between the damage caused to buyers and the gain to the colluding firms. Each of these amounts could be equal to, less than, or greater than the other. This difference between restitutionary or gain-stripping remedies, and compensatory damages, is well recognised in the common law.

commercial disadvantage by the price-fixing in a difficult situation, if it seeks subsequently to sue for damages under S.82 of the *Act*. A commercially significant penalty may be desirable for society in general, but there may be nothing left in the cupboard, as it were, for the buyer to extract to compensate it for the higher prices it was obliged to pay, or the inefficient substitution it was forced to undertake, as a direct result of the price-fix.

The clear intent of S.82 is private restitution or compensation, not retribution. ENERGEX believes there is little point in such a remedy being available if the Commonwealth has already emptied the safe. It believes that a denial of natural justice occurs in such a situation. There is a direct conflict between a public return in the form of deterrence effects and private restitution of profits illegally converted by price-fixers. The higher the former amount, the lower the probability that sufficient funds will be left to pay an injured buyer if a damages action is successful.

Accordingly, ENERGEX believes that consideration should be given by judges to this problem when assessing penalties. It is acknowledged that actions for damages under Part IV of the *Act* have not been common since 1974, the reasons for which are many. Thus a judge will not know at the time of handing down the penalty whether a private action for damages will ensue, although if the suggestion made above concerning the use of a court-appointed expert to estimate the quantum of damage caused to society in general were to be adopted, some idea of the possible amounts that could be claimed in a damages action would be available.

If this were the case, or even in the absence of such guidance for the court, ENERGEX believes that after having determined the appropriate level of penalty that is deemed to provide the justified level of deterrence to those contemplating price-fixing, a certain portion of this penalty should be held in abeyance by the court up to the period of limitation for private actions, to ensure that some funds might be available to meet any action for damages that is successful. If at the end of this period no such action has eventuated, then the balance of the penalty would become immediately payable to general revenue.

Of course, the amount thus reserved for private action would not necessarily provide a cap for the damages that could be proved. A buyer harmed by a price-fix may be able to prove, and be entitled to, damages in excess of this amount, if the court-appointed expert did not have access to highly disaggregated firm-specific information.

A more radical proposal would be that the whole penalty determined by a judge as socially appropriate would be reserved for damages claims. This would at least ensure that some minimum level of restitution would be available to buyers who had suffered from the price-fixing, although the allocation of a social penalty entirely to private interests would mean that the ultimate consumers (the public) would not necessarily receive any direct compensation for the higher prices that had been passed on to them. The argument here is that penalties passing into general revenue benefit all consumers (both those who bought the final products or services whose prices were increased due to the higher input prices, and other consumers who did not buy these good or services) indirectly, as funds from general revenue are used to provide education, health, social welfare and other government spending programs.

Nevertheless, ENERGEX believes that those parties whose commercial results are affected by a price-fixing arrangement should be able to sue for damages with some confidence that funds are available for compensation, especially in the situation where the collusive agreement was skilfully concealed and where no alternative sources of supply were easily available at a comparable pre-cartel price. It believes that firms which fix prices deserve to be confronted with two penalties – one which fully expresses society's outrage at their behaviour and its effects (the deterrent penalty), and another which provides compensation to the buyers who paid higher prices. Such a double-headed penalty should provide a much greater degree of deterrence. Anything less than this will provide the wrong signals to those who might be tempted to engage in collusion.

2. SECTION 46 – A PURPOSE OR EFFECTS TEST?

The current language of S.46 prohibits a firm with a substantial degree of market power from taking advantage of that power for one of three proscribed purposes. Proving purpose in the mind of a business is obviously not an easy matter, but S.46(7) does permit purpose to be inferred from the conduct of a firm or any other person. Nevertheless, there have recently been calls for the purpose test to be replaced by a simpler effects test – a firm would infringe S.46 if its actions merely had the effect of any one of the three proscribed outcomes.

ENERGEX is concerned that such a change would result in firms facing action for behaviour that was nothing other than the sort of pro-competitive conduct that the *Act* seeks to achieve and market economies require. All firms seek to do better than their rivals, and to make it harder for them to compete, and to make it hard for new entrants to gain a foothold in their markets. To do otherwise would be a breach of their fiduciary responsibilities to their shareholders. That this is not only socially acceptable but also highly desirable for the community in general was clearly acknowledged by the High Court in the *Queensland Wire Industries* case:

"Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to 'injure' each other in this way. This competition has never been a tort . . . and these injuries are the inevitable consequence of the competition S.46 is designed to foster."[3]

An effects-based test appears to ENERGEX to run counter to the very goal of the *Act*, and to the High Court's characterisation of competitive behaviour by successful enterprises. Firms that are competitively successful may possibly damage rivals, although perhaps only in the short term, or might deter rivals from engaging in competitive conduct, or might deter or prevent entry. Competition, as the High Court has noted, is a battle for survival; indeed it is all about the survival of the fittest, so long as the firm in question is socially fit to survive – that is, it has eliminated rivals and prospered simply because it has been better in proving what the market wants. In most markets which are highly competitive and dynamic, however, the number of participants (and jobs) actually increase as a virtuous circle of productivity growth and greater demand is created. Any change to S.46 must take account of all this.

An effects test would face the near impossible task of distinguishing between "good" and "bad" effects of specific types of conduct initiated by a firm with a substantial degree of market power. Action taken by a firm that has the effect of driving a less efficient rival out of the market, or preventing a less efficient rival from entering the market, is acceptable socially. The competitive process is nurtured by firms engaging in strategic behaviour that seeks to give them a distinct and sustained commercial advantage over their rivals and potential rivals. If firms face an effect test, they will be forced to rein in their "deliberate and ruthless" behaviour, much of which is not damaging but beneficial to society. Consumers will suffer. Less efficient rivals will prosper.

ENERGEX believes that if any effects test were to be introduced in to S.46, the section would need to be entirely rewritten so that it was clear that the only undesirable effect would be where an equally efficient rival were to be damaged by the action of a firm. An exception to this would have to be made to protect a firm that was currently not operating at maximum social efficiency but which was moving in that direction.

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[3] *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co Ltd & Anor* (1989) ATPR 40-925, at 50,010.

If such a test were to be introduced, the level and nature of the undesirable anti-competitive effect would need to be identified in practice, and it would need to be assessed in a *ceteris paribus* context. This task of identification and measurement would be near impossible even at a point in time. It could not hope to take dynamic change into account, which is unforecastable.

ENERGEX believes that it has not been demonstrated that S.46 is not working properly. While the decision of the High Court in the *Boral* appeal is awaited with great interest, it contends that a more detailed systematic study of the current operation of S.46 is needed before it is changed in the manner being urged by some parties.

While ENERGEX does not believe that the need for a change to S.46 has yet been demonstrated, it suggests that before an effects test is considered, with its likely damaging impact on competitive initiatives, consideration be given to what can be called a "purpose plus" test. Such a test could overcome the problems currently perceived to be caused by too literal a reading by judges and others of the proscribed purposes in the context of a firm's strategic behaviour.[4]

Under such a test, something extra is added to the purpose requirement, in recognition of the fact that the strategic behaviour considered in the context of S.46 is often ambiguous in terms of its apparent intent. A price cut could be genuinely competitive, or it could be a predatory tactic designed to drive a rival out of the market. An outcome of a genuinely competitive initiative could be to eliminate a less efficient rival from the market, or even an otherwise efficient one that was caught unawares and dealt a competitive blow from which it could not make a sustained recovery, competitively speaking.

To assist in identifying whether a firm has taken advantage of its market power, something extra should be added to the purpose test – a consideration of the firm's specific behaviour under investigation in the context of its entire package of conduct. In other words, an analysis needs to be conducted of <u>all</u> the conduct associated with the behaviour in question, in order to infer its true purpose. As Smith and Round say, "*the firm knows its purpose, while others must infer it.*"[5] A method is needed by which the ACCC or private parties can distinguish conduct that is part of a package that enhances social welfare, from that which distinctly has an anti-competitive purpose.

ENERGEX believes that such an approach is already catered for in S.46(7), whereby an inference as to purpose is permitted *"from the conduct of the corporation or of any other person or from other relevant circumstances."* It urges the Committee of Inquiry to consider the possibilities under S.46(7) carefully, and the practical relevance and insights of a *"purpose plus"* test, before plunging into the unknown waters of an effects test that could seriously hinder the introduction and continuation of genuinely competitive business initiatives that underpin the Australian economy.

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[4] Such a test has been proposed in R.L.Smith and D.K.Round, "Section 46: A Strategic Analysis of Boral", *Australian Business Law Review*, Vol.30, June 2002, pp 202-215.

[5] Supra n.4 at p.214.

3. SECTION 47(6) – A HINDRANCE TO EFFICIENT CORPORATE STRUCTURING

ENERGEX believes that the prohibition contained in S.47(6) of what is known as third line forcing works against the interests of a corporation that for whatever valid and legal reasons, chooses to structure its assets in several separate legal entities. In the genuine best interests of consumers, a business may wish to sell goods or services on the condition that accompanying or complementary goods or services are bought from a related entity. For example, to get the optimum performance out of an item that is linked into a network that it operates, a seller may have a good private and social reason to insist that the item be serviced by an associated entity. This would, however, be illegal per se under S.47(6), as no provision is made for any consideration of the effect of the conduct on competition, or on the public benefit.

3.1 Introduce a competition test

Section 47(1) states that a corporation shall not engage in the practice of exclusive dealing. Subsection 47(10) provides that there will only be a contravention of S.47(1) if there is the purpose, effect or likely effect of substantially lessening competition. However, this qualification does not extend to 47(6),(7)(9)(c) and (9)(d).

The reason behind this was that generally third line forcing has been considered anti-competitive. However, in recent times this perception has changed, and, in the Hilmer Report 1993, it was recommended that third line forcing provision should be consistent with other provisions associated with vertical arrangements, by replacing the per se prohibition with a competition test.

The need for this amendment has been associated with the growth in ‘shopper docket’ schemes such as those found between petrol and supermarket outlets. With the growth of such schemes it is also arguable that not all third line forcing is necessarily anti-competitive but can benefit consumers.

However, up until now, the only mechanisms for dealing with the per se offence has been to seek authorisation, which is costly and time consuming. Alternatively, notification of the proposed conduct is available.

Protection from being in breach of S.47(6) is not gained immediately by this notification. This immunisation occurs only after 14 days from lodgement, or on the date when the applicant is advised by the ACCC that it is satisfied that the likely benefit from the conduct outweighs the likely anti-competitive detriment. Authorisation is available, however, for third line forcing, but it can be a costly and time-consuming process.

3.2 Related Company Exemption

Should the corporation in question have in effect internalised such third line forcing by having its assets concentrated in one rather than in several distinct legal entities, it would not be at risk of breaching S.47. ENERGEX believes that to cover such situations there should exist in S.47(6) an exemption for related party third line forcing. It acknowledges that this conduct can be given a tick through the process of notification or authorisation, but believes that the need to apply and convince the ACCC that the public benefit outweighs any likely anti-competitive detriment creates delay and yet another unjust regulatory burden on a business that adds to its costs, and can stand in the way of efficient corporate restructuring. Until such notification is granted, the business cannot carry out its business in the manner it believes is both privately optimal and for the good of its customers, for fear of prosecution.

Of course, careful attention would need to be paid to the type of corporate interrelationships that were exempted, in order to eliminate the possible exploitation of loopholes by entities that were neither functionally related, or linked by valid legal ownership structures.

4. SECTION 50 – THE NEED FOR GREATER STRUCTURAL SPECIFICITY IN THE INTERESTS OF CORPORATE PLANNING EFFICIENCY

Most merger activity benefits the economy and the community at large. This arises from the possibility of economies of scale and of scope and dynamic efficiency. Takeovers (or the threat thereof) also play an important role in promoting the efficient use of resources by acting as a discipline on the management of companies. Regulations which inhibit such activity will reduce these effects.

Corporate organisations that seek to grow externally via acquisitions must spend considerable time in assessing the impact of such expansion on competition. Great uncertainty is faced in terms of whether the ACCC will investigate (in the course of which market enquiries must be made and bringing with it the risk of inadvertent disclosure of confidential information) and oppose the acquisition and uncertainty about the result of the ACCC's inquiries, either informal or through the much longer process of authorisation. All this can take some time to come to a conclusion. Meanwhile the organisation loses impetus in its expansion plans, and rivals can be alerted to its corporate intentions.

The debate on merger policy in Australia has been at the forefront of attention for at least thirty years, and for longer in the US and the UK. One broad line of argument in the Australian context is that structural measures such as S.50 are unnecessary if the behavioural provisions of the Act are appropriately applied. Another broad argument is that national champions are needed if Australia is to effectively compete in a ‘globalised’ world, which presumably refers to a world where barrier protections such as tariffs and subsidies are low and some competitors are reaping the benefits of economies of scale and of scope, ‘cheap’ labour and so on.

A different view, apparently supported by the ACCC, is that whatever increases competition (and that means numbers of competitors) must be good and that ‘national champions’ are best founded upon highly competitive markets at home. One retort to this so-called ‘Michael Porter’ thesis (an American economist) is that while this may be true for large economies like the United States, where minimum efficient scale comprises only a small proportion of the market, it will not work for relatively small economies like Australia where concentration is needed to capture the benefits of scale and scope.

Yet another view is that all of the above misses the essential point that it is economic efficiency which matters, not the level of industry concentration or competition. In many cases – as the argument goes – economic efficiency (especially its most important element – dynamic efficiency) may be best served by significantly ‘imperfect’ or concentrated markets.

The debate on mergers in Australia has not been resolved in three decades and, in the context in which it is conducted, is unlikely to be settled. One reason for this is simply that the different views mix together the theory of the firm and growth and trade theories in an inadmissible way. One consequence of the debate is that regulation of merger activity has become ever more complex and confusing. It induces a ‘Tar Baby’ effect, where new rules, guidelines or procedures are stuck on whenever a new problem emerges. Indeed, a whole ‘merger industry’ has developed, the cost of which is likely to far outweigh any deadweight loss which may otherwise have arisen from the exercise of additional market power from unconstrained merger activity.

This is emphasised because while the search for the undiscoverable continues, the danger is that more firms will react to the distortions in the regulatory framework rather than market signals.

Thus ENERGEX believes that the Committee of Inquiry should consider whether, at this stage of corporate and regulatory maturity in Australia, the time has come to provide greater legal and regulatory certainty to businesses that are contemplating an acquisition and a greatly simplified framework.

It appears to ENERGEX that increased structural concentration of markets, at least up to a certain point, should not be of concern, for at least three reasons. First, the old-fashioned notion that firm numbers per se are the major determinant of market behaviour is no longer tenable. There is no simple, systematic, uni-directional relationship between firm numbers and their conduct. Each market needs to be assessed on its own merits. To be sure, collusion is easier if the number of sellers is low, but even then what matters is managerial attitudes, goals and incentives, but if an appropriate mechanism exists for its detection and control, as argued earlier in this submission, the fact of fewer firms in a market should not be regarded as necessarily leading to more collusion. Secondly, what matters most is potential entry to a market, either by new firms or imports. Where entry is possible, incumbents will always be constrained in their behaviour. Thirdly, the *Act* is able quite adequately to control both unilateral and joint instances of anti-competitive conduct that, when assessed in their proper context, they can be determined to have no socially-redeeming justification. The high success rate of the ACCC is its prosecutions under Part IV of the *Act* indicates that all firms need to ensure that their conduct does not result in any serious social detriment.

Consequently, it is suggested that consideration be given to amending S.50 so that it would apply only to those acquisitions that would lead to only two firms operating in the relevant market and where there is an imbalance of constraining powers. Getting the market definition correct would undeniably be more important under this scenario, but it would in fact merely codify what appears now to be an operating rule of thumb used by the ACCC, except for markets like banking where national "four pillars" policy currently operates. Such a simple structural rule would help to promote greater efficiency in operations, especially in markets where entry and expansion barriers are low and where there exist no impediments to imports, and would lead to greater administrative efficiency in the use of the ACCC's resources.

Some statutory riders might be needed if such a simple structural rule were to be put into place, governing a requirement for certain levels of sustained import competition and also for ease of entry and expansion. In the case of traded goods and services, if imports are significant in both quantity and trend pattern, and cannot easily by choked off, then any merger between two domestic firms is likely to be adequately constrained by the reality or threat of imports. In addition, if entry barriers into the relevant market are not high, then it is unlikely that the merged firm could raise prices or generally *"give less and charge more"*. Both these conditions are currently part of the ACCC's published framework for investigating mergers and acquisitions, as detailed in its *Merger Guidelines*.

5. SECTION 52 – MISLEADING OR DECEPTIVE TO WHOM?

Section 52 prosecutions, both public and private, are now a common occurrence. They serve to put the business community on notice that consumers should not be mislead into making purchases that do not fulfil the expectations engendered by sellers through their advertising or other forms of communication. ENERGEX fully supports the purpose of S.52.

However, the publicity given to successful S.52 actions has resulted in a heavy prophylactic compliance burden being borne by many large organisations that market their services heavily, as they seek to differentiate products and services to potential buyers. Such companies are facing an increasing stream of complaints to the ACCC. The unwanted effect of this is that the companies are experiencing the dead hand of regulation – the need to respond to the inquiries of the ACCC and satisfy it that under any reasonable interpretation, the conduct engaged in could not be seen to breach S.52. Valuable management time is consumed in convincing the ACCC that the consumer's complaint is without foundation.

ENERGEX considers that while such companies should present their material to the public after due consideration of all the types of people who could be expected to be exposed to this material, and of their ability to interpret this information, the benchmark should be one of ordinary or reasonable members of the public class(es) to which the information is directed and not, as at present, to ensure that even the susceptible are not misled. (Indeed, the present test is a nonsense as the susceptible, by definition, may believe anything.)

It is simply not economically efficient, privately or socially, to produce informative material that can be readily and fully comprehended by the least able member of each class, or to produce detailed material that will satisfy the eagle eye of the most technically competent consumer, while at the same time being comprehensible to the average consumer. The cost and volume of such information would be enormous. In addition, it is not possible to foresee the myriad ways in which different members of society might regard advertisements as being potentially misleading or deceptive.

With all the publicity nowadays given to the activities of the ACCC, an expectation has been raised in the minds of many consumers that the ACCC will fix for them any wrongdoings they perceive to have been carried out against them. Instead of directly approaching the business concerned, where the matter might be quickly and efficiently dealt with, they ask the ACCC to investigate. So long as the complaint is not trivial or unjustifiable, an activist ACCC will call upon the business to respond to the complaint. This diverts staff resources and costs money in investigations and explanations that subsequently are invariably accepted by the ACCC.

There is no requirement for intent under S.52 and the section covers conduct such as ‘inadvertence’. That is, a company is in breach even if it had no intention to mislead but, nonetheless, the susceptible part of a target audience were mislead through inadvertence. As the ACCC’s Guidelines (1998) acknowledge, *“This makes preventing that conduct a real challenge”.*

The ACCC has seen the truth of this statement in its own actions when it was criticised by Justice Finn in a number of respects on 12 September 2001 in the Federal Court. If the experts on S.52 have substantial problems, how may ordinary businesses do better?

As a company that is mindful of its social responsibilities, ENERGEX accepts that a balance is needed here – a trade-off needs to be made between looking after the interests of consumers and protecting the supplier from undue and unnecessary regulatory intervention. It believes that consideration should be given to the provision in the *Act* of a test that mandates the application of some minimum standard or hurdle that must be cleared before any conduct can be classified as misleading or deceptive. A purpose test should also be included. It is acknowledged that such tests would not be easy to formulate in legislation so that it was universally applicable to all classes of consumers, but meanwhile the cost burden on businesses in responding to essentially trivial and at times vexatious allegations is not inconsiderable.

6. SECTION 71 – ELECTRICITY IS NOT A "GOOD"

On 8 February 1999, the Electricity Supply Association of Australia (ESAA) instituted proceedings in the Federal court against the ACCC on power surge and brownout liability for alleged damage to consumer electrical goods.

Power surges are short term over voltages, where the fluctuation in voltage exceeds the standard tolerance. Companies like ENERGEX accept liability where this is caused by them (eg equipment failure) and is not a result of a deficiency in the customers' equipment, but not when it is the result of third parties (eg car into pole) or acts of God (eg lightning). The origins of the action can be traced back to events in Victoria in late 1996 when the ACCC put the view that distribution companies are liable for damages as a result of power surges whether or not such surges were attributable to negligence. This view was later extended to include brownouts. On 1 May 1997, the ACCC indicated its intentions to widely publicise the 'facts' that support compensation, to challenge any actions to the contrary, and to back a test case.

The matter soon spread to other States. For example, in December 1998, it is understood that a NSW company was obliged to invite claims on damages allegedly caused by surges and to inform all customers of their 'rights'.

A number of complex questions and issues arose in the trial in the ACT Division of the Full Court in Canberra. As ENERGEX understands it, there are about six legal opinions from senior QC's which largely disagree with the original arguments of the ACCC, including from the Chief General Counsel to the Commonwealth of Australia. It is also understood that there are strong precedents for the ESAA's position in New Zealand and the United Kingdom.

One of the key issues was whether electricity is a good for the purposes of Section 71 of the TPA, which provides that goods must be:

- *"of merchantable quality (fit for the purpose they were commonly bought);* and
- *"fit for any purpose that the consumer makes known to the supplier"*

Unfortunately, for complex procedural reasons, Justice Finn declined to make a formal declaration or ruling on the law in respect of the operation and effect of S.71 in his judgement of 12 September 2001. Nonetheless, the judge made supportive comments to the ESAA's arguments both on the nature of electricity and on the coverage of S.71. He was also critical of the ACCC's position and conduct.

It is very disappointing for distribution companies that the law in S.71 was not fully clarified. This has been a long and expensive matter for all parties and companies are exposed to estimated damages claims of around $80m a year. ENERGEX proposes that the law is clarified by simply amending the TPA to state that electricity is not a good for the purposes of the section.

7. SECTION 83 – WHEN ARE FACTS REALLY FACTS?

Following a series of court actions initiated by the ACCC, ENERGEX now believes that is has been a victim of a long-standing and highly effective price-fixing conspiracy. Firms involved have admitted certain facts and penalties have been handed down by the Federal Court. Section 82 of the *Act* allows a person who has suffered loss or damage as a result of a contravention of Part IV to recover that loss or damage from the person involved in the contravention. Importantly for the victim, S.83 provides that in a S.82 action for damages, a finding of any fact by a court in determining that a contravention of Part IV has occurred, becomes prima facie evidence of that fact.

Recent developments in the way in which the ACCC presents to the Federal Court agreements made with respondents as to both guilt (by way of agreed statements of facts) and mutually acceptable penalties, have led to some uncertainty now as to whether businesses that have suffered from this illegal conduct can rely on these admitted statements of fact presented to the court to press their claim under S.82.

In a recent application to the Federal Court for ENERGEX to be granted access to statements of agreed facts and outlines of submissions, in a case where its suppliers of transformers were found guilty of price-fixing on their own admissions,[6] Finkelstein J decided (at para 7) that he had *"no doubt that the proper approach is that access should be allowed unless the interests of justice require a different course."* Further, in para 8 he stated *"Surely a potential victim of anti-competitive conduct is entitled to see the evidence in which the court found that there had been contraventions to decide whether he will prosecute a civil case."* While granting ENERGEX access to the documents, however, the judge remarked that (at para 9)

> *"I note in passing that when deciding the case against the Alstom parties I made orders that statements of agreed facts in that case were relevant facts for the purpose of s83 of the Trade Practices Act. Although there is some doubt as to whether I should have made the order . . . it would have little practical utility if ENERGEX were to be denied access to the documents which founded the order. It is true that s83 only comes into operation when a new proceeding is commenced. But commonsense suggests that a party such as ENERGEX, who may obtain a forensic advantage by use of the section, should have access to the findings to decide whether those findings will usefully advance its position."*

In the previous hearing referred to by the judge,[7] at the end of a lengthy review of the reasons for penalties, the seriousness of antitrust contraventions, the optimum level of penalties, and of the principles to be applied in setting the quantum of penalty (in this case, while the facts were agreed upon, there was no agreement with the ACCC on penalty levels), as well as a brief recitation of the agreed facts, he had made the following observation (at para 51):

> *"The Commission also asks me to make findings that may be used in other proceedings in accordance with s83 which is what I have done in the earlier case. Now I am not so sure whether that was the proper course. I have disposed of this case on the formal admissions made by the respondents. The general rule is that formal admissions are only binding for the purpose of the particular case in which they are made . . . It is not clear whether a judge*

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[6] *Australian Competition and Consumer Commission v. ABB Transmission and Distribution Limited (No. 3)* [2002] FCA 609.

[7] *Australian Competition and Consumer Commission v. ABB Transmission and Distribution Limited (No. 2)* [2002] FCA 559.

> *who acts on formal admissions is making findings of fact. I rather think he is not, because the purpose of an admission, such as may be made in pleading, is to dispense with the need to prove the admitted fact. That is quite different from a case where the judge hears evidence and makes findings based on that evidence. At all events, I propose to do no more than record that I have resolved this case on the basis of the formal admissions. If that constitutes findings of fact for the purposes of s83, an issue upon which I make no comment, so be it."*

The earlier case to which Finkelstein J was here referring was an earlier penalty hearing in the series of transformer price-fixing cases.[8] Here, after having handed down a corporate penalty of $5.5 million and an individual one of $150,000, he found, at p.42,940, in relation to the relevant respondents, that *"the relevant facts in the proceeding . . . are those set out in the . . . Statement of Agreed Facts."*

If it be correct that agreed statements of fact that are presented to the court cannot be regarded as findings of fact by the court in a subsequent private action for damages, then ENERGEX believes that the policy intent of S.83 is being defeated. It strongly suggests that recommendations should be made for a revision to S.83 to overcome this legal curiosum that would require the reproving of facts that have already been admitted to another court.

While the approach of the ACCC may be socially efficient in terms of saving valuable court and enforcement time, a very large evidentiary burden may as a consequence be placed on those parties who have suffered damage from illegal anti-competitive acts, and who wish to proceed with a claim for damages in the Federal Court. Under such circumstances, the cost of seeking damages could be prohibitive and the policy intent of S.83 would be frustrated. A change to the *Act* is needed to give these parties the right to rely on the facts pleaded by agreement in such cases.

If such an amendment is not forthcoming, those entities charged by the ACCC have yet another reason to submit agreed statements of facts and penalties to the Federal Court – not only do they hope to limit their own exposure to a social penalty in this way, but they also create a shield for themselves from the prospect of the future payment of private damages.

[8] *Australian Competition and Consumer Commission v. ABB Transmission and Distribution Limited* (2001) ATPR 41-815.

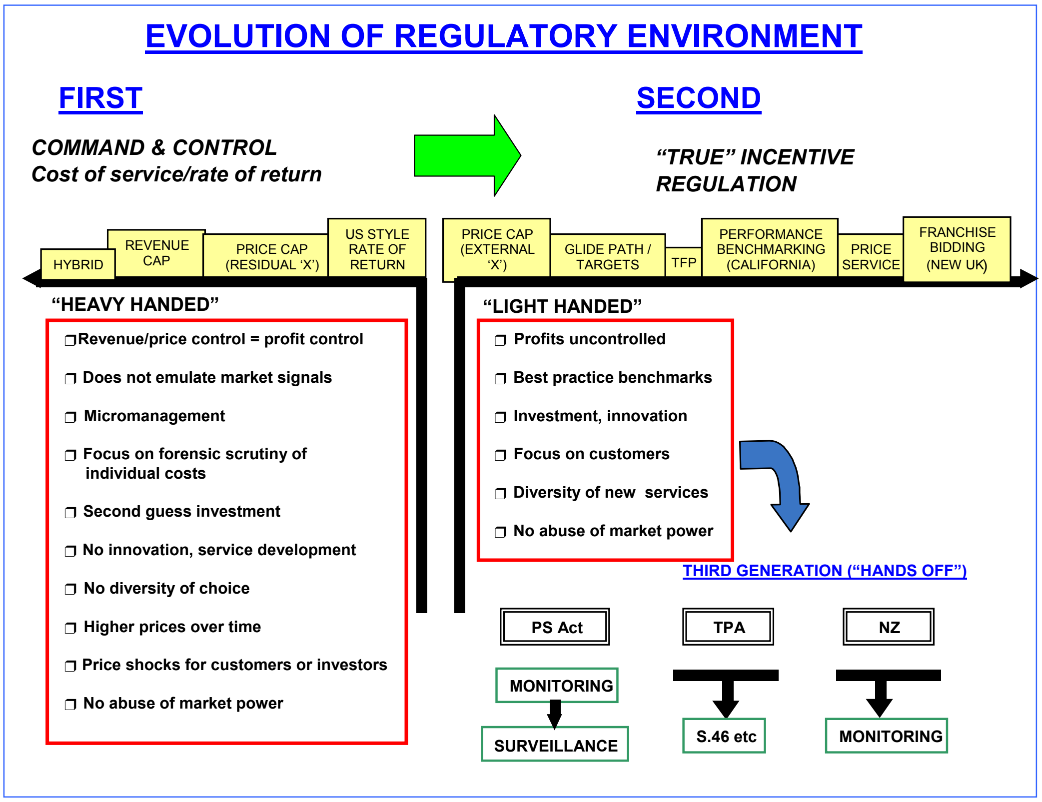
8. ADMINISTRATION OF TPA – CHANGE IS VITAL FOR ECONOMIC REGULATION

Perhaps the most important issue facing the Review Committee from the point of view of regulated companies, consumers, user industries and the economy is the administration of economic regulation by the ACCC and, indirectly, its influences from its leadership role on regulation applied in the States and Territories.

ENERGEX appreciates that the committee does not wish to examine the provisions of Part IIIA as these were the subject of the very long awaited Productivity Commission final report on this matter (it was completed in October 2001 and is yet to be released). But it is necessary to say a few words about those provisions to make sense of the arguments for changing the administrative arrangements, which is the province of the Committee, as we understand it.

Chart 1 shows three generations of forms of regulation. The ACCC applies (and supports other jurisdictions) forms to the left of the 'US Style Rate of Return' box under the 'First Generation' heading. These are the most heavy handed forms of regulatory intervention which exist anywhere.

Chart 1



Source: ENERGEX Limited

The key message here is that such models, where revenues/prices are forced to equal or track costs, are derived from the neoclassical notion of perfect competition where, by definition, the objectives of the Hilmer reforms, National Competition Policy and Part IIIA cannot be achieved. Revenues/prices do not equal or track costs in effectively competitive (but imperfect) markets which regulation should be seeking to emulate. It is only when prices and costs are de-linked will incentives be created for the achievement of dynamic efficiency, innovation, investment, diversity of consumer choice and the other objectives of which Hilmer and the rest speak.

No economist is able to find examples of perfect competition in real world markets, except perhaps under temporary conditions in local fruit and vegetable markets. Yet those are the conditions which are imposed. One consequence is that customers enjoy short-term price cuts. However, this is not in the long term interests of consumers as prices will eventually be higher than otherwise, with no innovation, product or service development or quality improvements. It is akin to condemning an industry to a single technological fix – like the black bakelite phone or the black model 'T' Ford.

Regulators can bask in the glory of short-term price cuts as the consequences of their actions will not become apparent until after they have left office. The ACCC has used the Mandy Rice-Davies defence in responding to such criticism – *"They would say that wouldn't they!"* Of course, they would, because it's true. That is not just the view of "vested interests" but of the most eminent economists in Australia, the United States and the United Kingdom. Attachment 2 lists some of those comments for the Committee.

If industries such as energy are to develop the sorts of high reliability and other services required by their customers, there must be a shift to the second or third generation regulatory forms shown in Chart 1. It is ENERGEX's view that the administration of economic regulation should be removed from the ACCC as a matter of priority. Where that responsibility should lie is a matter currently being examined by the CoAG Review into the Energy Market. However, as ENERGEX understands it, this Committee has responsibility for advising on this matter.

9. SECTION 46 – A SUGGESTED ADDITION / ALTERNATIVE FOR REGULATED FIRMS

ENERGEX believes that it is time to offer regulated companies and their customers the opportunity to move to a "third generation" oversight of regulated utility firms (see Chart 1). The need for heavy-handed intervention has passed. The "stock" of market power with respect to pricing that was allegedly enjoyed by these firms has now been fully eliminated. Prices are now tightly tied by pricing regulators to low cost of service levels, with the addition of an approved profit margin. What is needed now is light-handed regulation to control the "flow" of instances where there might be an undesirable use of market power (to back up the formal monitoring approach). This could be achieved by the creation of certain simple thresholds which would provide the trigger points for further regulatory action.

It is submitted that S.46 in its current form is not the most appropriate vehicle to provide this light-handed regulation. A new section is needed to cover only the on-going activities of regulated utilities. It is now well-characterised in Australia that abuse of market power results in a firm "giving less and charging more". Clearly, then, if a firm is giving more and charging less (for example, by lowering its prices and/or by increasing its quality, range of product, or service levels) there is no need for regulators to intervene in its operations.

Thus a new section could be created that applies light-handed "flow" regulation only to regulated natural monopolies or utility providers, and that covers behaviour not easily policed under S.46. The thrust of this section would be to hold that there is no use of market power by a regulated firm if it gave more and/or charged less. For example, price increases would be acceptable if in real terms they constituted a lower charge, or if they were associated with a demonstrably higher quality product or service.

The effect of such a provision would be akin to a charter of conduct being imposed on certain nominated firms. If they agreed to be bound by it, this would effectively result in an undertaking to the Federal Court, a breach of which would suffer the usual consequences of such a breach. At the very least, any breach would result in the firm being bound yet again to price and profit control or to formal surveillance and monitoring activities.

ENERGEX believes that regulated utilities have reached a state of competitive maturity in which the costs of complying with formal regulation are so great that the prospect of light-handed self-policing regulation would offer such large savings in management time as to be enough to encourage these firms to avert at all costs the procedures of formal pricing surveillance and control. In other words, the threat of re-regulation would provide the incentive to effectively self-regulate and to keep prices below the rate of inflation, and in line with productivity improvements.

Attachment 1:

THE CAUSES AND CONSEQUENCES OF COLLUSION

David K Round
Professor of Economics
and
Director, Centre for Applied Economics
University of South Australia

1. Introduction

The British economist Sir John Hicks once said, *"The best of all monopoly profits is the quiet life".* All firms in markets for capital goods enjoy a degree of market or monopoly power, by which they are free to some extent from the constraints imposed by the operation of the competitive process; and they seek constantly to enhance their market power by a variety of types of strategic behaviour.

Firms act strategically in order to shape their own commercial environment to their advantage, in order to protect their market shares from incursions by rival businesses, and to protect themselves generally from what are known as the five forces of competition, which are:

- the countervailing power of buyers
- the bargaining power of suppliers
- the threat of substitutes
- the entry of new rivals
- rivalry amongst existing competitors.

Strategic behaviour may be thought of as conduct by a firm that is not economically inevitable, carried out only because market forces demand it, but which in contrast is the outcome of a conscious attempt to secure a sustainable commercial advantage over its rivals, in the process securing or increasing the firm's long run profits. Strategic conduct is part and parcel of a truly rivalrous market, as recognised by the High Court of Australia in *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co Ltd & Anor* (1989) ATPR 40-925, at p. 50,011, where it was stated that:

"Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to 'injure' each other in this way. This competition has never been a tort . . . and these injuries are the inevitable consequence of the competition S..46 is designed to foster."

The greater the degree of market power held by a firm, the greater the degree of freedom it has to act strategically, and the greater this freedom, the more likely it becomes that market power will be used to implement socially undesirable kinds of behaviour. However, it is only when unilateral or non-cooperative strategic behaviour strays beyond the boundaries of *"good hard play"* that it becomes of concern. But this type of strategic behaviour is hard to assess, especially in a competition law context, as it can range from being highly competitive to grossly anti-competitive in nature.[9]

[9] The conduct of firms and their operating environments have become increasingly complex as firms expand to operate in multiple markets (both in terms of product and of geography) that are linked in ways that provide synergies for the business as a whole. Therefore, to understand conduct in any one market it will

In contrast, the sort of strategic behaviour that is undertaken jointly, or co-operatively with rivals, resulting in a collusive contract, arrangement or understanding, in order to deny the benefits of competition to the other stakeholders in a market, is difficult to justify on either economic or social grounds. Collusion is highly likely to have few, or indeed any, socially redeeming features.

It is primarily under conditions of oligopoly that firms have an incentive to enhance their market power jointly with their rivals through cooperative strategic behaviour. The hallmark of oligopolistic markets is uncertainty and interdependence. Because each firm has relatively few rivals, each one recognises its interdependence with its rivals, but also knows it is free to make decisions aimed at securing its own commercial environment in order to achieve a sustainable commercial advantage. Uncertainty exits as to what rivals are doing at the same time, what the best counter-strategies might be, and how rivals will react to the firm's new initiatives. Thus, collusion becomes attractive, as it will reduce this oligopolistic uncertainty, so long as rivals can be trusted not to cheat on any agreements made.

2. What is Collusion?

A collusive agreement occurs when firms agree to act, or not act, in a certain way. The aim will be to suppress the inherent competitive forces in the market, so that surplus may be appropriated from consumers to producers. Collusion between sellers means that buyers face fewer choices, if any, in the price/product/service packages offered to them by rival sellers. Market forces are hobbled, and are directed to enhancing the welfare of producers at the expense of buyers (and ultimately of society in general).

Collusion may be explicit (a concerted plan of action with an anti-competitive purpose or intent) or implicit, whereby firms operating under oligopolistic market conditions engage in parallel behaviour, as they know that this will be both jointly and privately optimal. It can be coercive (imposed on rivals who feel compelled to comply with the firm that proposes the action, which is usually a firm regarded as the market leader) or fully consensual.

It can be especially difficult to assess the strategic behaviour of large firms that are leaders in their market. They need continually to balance their own competitive position against the commercial health of all of their rivals. As Michael Porter has pointed out, such leaders are often better off (both politically within the market and in terms of long run private profit) by implementing strategies that improve or protect the industry as a whole, rather than seeking a greater competitive advantage specifically for themselves (the benevolent dominant firm model of microeconomic theory).[10]

Firms engage in collusion in an attempt to overcome the uncertainty they would otherwise face in the market. If the co-colluders can be trusted (few collusive agreements are ever stable in the long run), then market spoils can be shared according to some predetermined formula and the quiet life can be enjoyed. <u>Prices are likely to increase, or at least will be prevented from falling, as a result of the agreement, regardless of whether the agreement specifically relates to prices</u>.

Price-fixing is generally regarded as the worst kind of collusion. If prices are not the result of freely fluctuating forces of market demand and supply, then the judgment of a group of firms replaces the judgment of the market. Market failure occurs and social welfare falls. It is for this reason that naked price-fixing is usually deemed to be illegal per se in most countries; its mere occurrence is deemed to substantially lessen competition. This is the case in Australia, where S.45A of the

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not be enough to consider simply that market in isolation. The five forces of competition - and more - need to be fully considered, as a firm will engage in a co-ordinated set of strategies jointly to advance its multiple goals over its whole commercial environment.

[10] M Porter, *Competitive Advantage* (1985), at p.8.

Trade Practices Act deems price-fixing contracts, arrangements or understandings between firms (the wording actually prohibits the fixing, controlling or maintaining of prices, discounts, allowances, rebates or credit) to substantially lessen competition and therefore to contravene S.45 of the Act, its general purpose section that prohibits collusive agreements between firms.

Price-fixing can occur in a multitude of ways and have a wide variety of outcomes. It can be overt or tacit; direct or indirect; based on a formula or on some ad hoc calculation; can involve a ringleader or a widespread “meeting of minds”; can involve coercion to comply or can be warmly embraced by all participants; can be irregular or systematic; can last for a short time or for a prolonged period; can involve cheating or be tightly adhered to; may be directed at some or all of the buyers of the product; may or may not involve other forms of collusion like geographic market sharing or agreed levels of output at the same time; may be heavily concealed or haphazard in its cloaking; may involve a strong punishment mechanism for those who cheat on the agreement or may tolerate lapses from the patterns of agreed behaviour; may or may not treat each firm equally; and can be profitable or simply loss-stemming. The possibilities are endless. Hence it is very difficult in the absence of admissions, when the conduct is subtle rather than blatantly collusive, to determine whether an agreement or understanding on price exists. Much detective work will be necessary.

Under oligopoly, any sort of market conduct is theoretically possible, ranging from intensively competitive to fully collusive, monopoly-like behaviour. Generally, the least favoured type of competition is price competition, as price cuts can be quickly and easily matched, leading to no real sustained competitive advantage. Thus, especially important under conditions of oligopolistic interdependence is a wish for pricing tranquillity. If the prices being charged by a rival firm are known to another firm, and if there exists an agreement or even just an (implicit) understanding that the rival will behave in an accommodating way in its pricing policies, and if the rival can be trusted, then the firm in question has a degree of certainty about a key market parameter. It is important to note that pricing tranquillity can come about not just through an explicit or implicit agreement not to compete on prices,[11] but through a variety of types of cooperative behaviour such as market-sharing agreements via fixing acceptable overall market shares for each firm, by exclusive allocation of customers or by exclusive territorial rights; agreement on sale terms and conditions; technology and new product suppression; information exchanges; collective boycotts, and so on.

<u>Each of these types of collusive behaviour, while not explicitly related to prices, has an outcome that suppresses competition between firms and therefore results in no downward pressure on prices, the same effect that would be achieved if the firms in question had agreed not to engage specifically in price competition</u>.

3. Market Sharing Agreements as a Form of Collusion

More generally, S.45 of the Trade Practices Act prohibits contracts, arrangements or understandings that restrict dealings or affect competition. In S.45(2)(a) a firm is prohibited from making a contract or arrangement, or coming to an understanding, if it contains an exclusionary provision (one that, when made between parties in competition with other, has the purpose of preventing, restricting or limiting the supply of goods to particular persons); or if a provision of the contract, arrangement or understanding has the purpose, effect or likely effect of substantially

[11] Apart from agreeing on a specific price to be charged, a variety of formulae can be used that will give the same outcome, such as most-favoured-nation clauses (any buyer is guaranteed by the seller that it will be charged the current lowest price charged to any buyer by the firm); meeting-competition clauses (the buyer is guaranteed that if another seller offers it a lower price, its current contract price will be immediately lowered to that level); and trigger prices (if market prices fall below this level, then each firm will expand its output to the pre-agreement level, thus lowering prices and destroying the agreement, and so providing a predetermined punishment mechanism).

lessening competition in a market. Giving effect to any such contract, arrangement or understanding is prohibited by S.45(2)(b).

There can be no doubt that any type of arrangement between two or more firms (I shall henceforth use the general term "agreement") that has the requisite anti-competitive purpose or effect will be covered by S.45(2). While price-fixing is deemed by S.45A to substantially lessen competition as it is thought to be inexcusably detrimental to society, other types of agreement must be demonstrated to have the necessary anti-competitive purpose or effect. From this it can be observed that the policy thrust of the Trade Practices Act is that if competition is damaged either by price or by non-price collusion, social damage will occur – the free play of the competitive process is damaged – and penalties are accordingly called for.

An agreement by rival firms to share or divide up the market in some way may not appear on the face of it to have any direct or immediate impact on prices, and therefore might arguably be said not to constitute price-fixing, but in reality by giving some assurance, if not certainty, to rivals that their own turf will not be subject to a contest for customers, it removes the need for keen quotes to be given and a "take it or leave it" attitude to pricing will develop. Buyers have no other alternative supplier to turn to, if rivals have agreed not to compete for them, and if no substitute products are available or suitable.[12] Prices therefore do not have to respond to market forces, and so remain higher than would have been the case if there had been fierce price and non-price rivalry between sellers wishing to secure orders from the buyer. Competition is as undeniably lessened as if an agreement had occurred to raise prices. The judgment of the firms involved, designed to secure their own environment and profit at the expense of buyers, has replaced the competitive interplay of market forces.

Price-fixing undeniably lessens competition in a market. Market sharing is simply a less direct means to the same end, with the same purpose and the same ultimate effects. If it substantially lessens competition, it is illegal.

Of course, whether market sharing has the same quantum of effect on competition in a market as a specific agreement on prices, is very difficult to establish, as there is no direct counterfactual to observe. Unless strategy documents of the colluders are discovered, in which alternative scenarios, including specific agreements on particular prices, are discussed, it is not possible to say that a market sharing agreement will have had precisely the same anti-competitive effect as any one agreement on a particular price. But the direction of the effect (a transfer of surplus from buyers to colluders) and its qualitative impact on the market will coincide. Competition will be choked off, and buyers will be denied the benefits of rival sellers seeking to outdo each other in terms of the price/product/service packages they offer.

Numerous cases of market sharing and tender rigging have been found by the Court to be in breach of S.45(2), (recently, for example, see *ACCC v Rural Press* (2001) ATPR 41-804; *ACCC v Ithaca Ice Works* (2000) ATPR 41-777; *ACCC v Simsmetal* (2000) ATPR 41-764; *ACCC v Tubemakers of Australia Ltd* (2000) ATPR 41-745; *ACCC v Tyco Australia Pty Ltd & Ors* (2000) ATPR 41-740; *ACCC v SIP Australia Pty Ltd* (1999) ATPR 41-702; *ACCC v J McPhee & Son (Aust) Pty Ltd* (2000) ATPR 41-758; *ACCC v Foamlite (Aust) Pty Ltd* (1998) ATPR 41-615; and *TPC v TNT Australia Pty Ltd* (1995) ATPR 41-375). A very brief outline of the facts of each of these cases follows, to provide an indication of the broad range of types of market sharing that have been found to result in a substantial lessening of competition in many different Australian markets.

[12] Some economists believe that if any agreement between firms proceeds beyond price to cover non-price areas, the probability that it will be detected increases, as a result of either intentional or inadvertent exposure.

In *Rural* Press, two rural newspapers in South Australia agreed to keep their circulation within separate geographic areas, leading to a finding that this conduct had substantially lessened competition in the geographic market from which the new entrant had withdrawn as a result of the agreement. In *Ithaca Ice Works*, rival suppliers made agreements on a number of issues, including not only prices but also a moratorium on approaching the customers of rival suppliers, and reporting to rivals if one of their customers sought out a new supplier, and to refrain from tendering for a reopened site unless it involved a change of management. In *Simsmetal* a large scrap steel merchant sought to bully a smaller rival into making a market-sharing arrangement whereby it would not approach Simsmetal's customers for high-grade steel scrap. Noteworthy in this judgment were the statements of Heerey J that *"Market sharing agreements, like price-fixing, contravene fundamental principles of competition law and are very damaging to the community"*, and *"Because such arrangements are inherently difficult to detect, when they are revealed a substantial deterrent is called for*".[13] The *Tubemakers* case also involved market sharing and tender rigging in the market for fittings and valves used in a variety of water and sewerage supply systems.

In *Tyco*, highly complex rules for the purpose of allocating contracts (with accompanying cover pricing to disguise the collusive tendering arrangements) were developed by several fire sprinkler and alarm supply companies. In *SIP*, an agreement was made between firms as to which buyers of compressors each firm would alone deal with, as well as on the prices that were to be charged, in a market where there were numerous other competitors selling substitute products. In *McPhee*, each company was found to have a policy of not quoting for business to a customer of the others. In *Foamlite*, the firms involved agreed not only not to compete on price for the customers of rivals who were parties to the agreements, but also that they would not seek business from each other's customers. In *TNT* the companies agreed not to poach each other's customers by either failing to respond to a request for a quote or by knowingly quoting a higher price than that charged by the current supplier, and implemented an elaborate strategy for compensation if by chance business was obtained from the customer of a rival.

From these cases, in all of which the respondents were found guilty and had heavy monetary penalties awarded against them, there can be no doubt whatsoever that market sharing, whether on a customer, product, geographic or revenue basis, can be unlawful in Australia, as it amounts to agreeing not to bid competitively for each other's customers, thereby substantially lessening competition.

The actual extent to which prices will rise, or will be kept from falling, as a result of any kind of collusive behaviour cannot be easily predicted in advance. It will depend on a host of institutional factors relating to the market and the regulatory environment, as well as the nature of the agreement, the reasons for it and the commitment of each of the participants to making the agreement work. A listing is provided in Appendices 1 and 2 on a wide range of variables found by economists to be important determinants of the presence, longevity and success of collusion.

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[13] In *ACCC v CC (NSW) Pty Ltd & Ors* (1999) ATPR 41-732 it was found that a successful tenderer had agreed to pay a fee to losing bidders for a construction project. Lindgren J held that such an arrangement has the effect of "controlling price" if it restrained a freedom that would otherwise exist as to a price to be charged. A similar argument could be mounted for market sharing agreements, which most likely have the purpose and the effect of maintaining prices even though a specific price is not agreed upon. An indirect means to fix a price is still price-fixing, as Fisher J noted in *TPC v Nicholas Enterprises Pty Ltd & Ors* (1979) ATPR 40-126.

4. Proving Collusion

The economic approach

Because Australian courts have not so far had to consider in detail a large number of cases involving collusion, they have not yet developed a structured analysis of collusive situations as is increasingly being used in the US, where firm and market characteristics are evaluated in terms of how they assist in overcoming the problems inherent in forming and maintaining a collusive arrangement. What is needed in Australia is the development of a *structured*, but not structural, analysis of the situation in which the collusive strategic behaviour under consideration occurs.

The following questions should be asked in sequence:

- Is there any proof that the rivals had an opportunity for direct communication, or that they in fact communicated directly?
- Is there any evidence of anticompetitive intent behind the parallel conduct? Why was the behaviour initiated? Was it part of broader pro-competitive packages of initiatives across the firms' whole operations, and what were the goals of these packages?
- Was the behaviour difficult to imagine as arising in the absence of detailed communication, because it appears arbitrary or unusually complex?
- Was the behaviour difficult to understand as rational in the absence of an agreement, including the absence of a legitimate justification for the practice (in other words, could the price increase be explained by independent profit-maximising conduct?) That is, would this collusive strategic behaviour have damaged the firms in question, if their economic environment was not suited to this action?[14]

The key issue to which an answer is sought is effectively this: did the firm(s) in question have the ability to act, with a real expectation of ensuing profits, without taking account of the likely and possible reactions of rivals – in other words, was the conduct difficult to understand as being commercially rational and leading to sustained long run profits in the presence of competitive constraints from rivals, or did the firm expect no effective reaction from them?

As a broad guiding principle, or major screening test, the key question to ask is this: were the actions of the group of colluders essentially profitable in their own right (i.e., independent of the five forces of competition), across the totality of their operations, or did profitability depend on their expectations about the constraining actions and reactions of the five forces (that is, the firms would only have done it if they knew that they could get away with it – at least in terms of threats from within the group)?

The question to be asked, then, is whether there existed a rational motive for the respondents to behave collectively, given that the market in question is characterised by behavioural interdependence. In particular, it is necessary to focus on behaviour that, <u>unless undertaken jointly</u>, would have damaged the individual position of each defendant. If the industry's economic environment is not suitable for joint action, then firms would be irrational to collude. Thus an agreement is unlikely to occur and it would not make economic sense to infer otherwise.

If observed behaviour is consistent with what firms could do by acting independently, it would be irrational for them to collude and risk prosecution (assuming, of course, that rational action and knowledge of Australia's trade practices laws is a feature of <u>all</u> the decision makers in a firm, no matter what their position in the managerial hierarchy). The key thing to note about the success of

[14] See J. B. Baker. "Two Sherman Act Section I Dilemmas: Parallel Pricing, the Oligopoly Problem, and Contemporary Economic Theory", *The Antitrust Bulletin*, Vol XXXVIII, pp. 143-219, at pp. 176-77.

coordinated interaction in an otherwise competitive market environment is that it is profitable for each firm if and only if all the other firms in the market (or almost all of them) participate.[15]

Conclusions about Australian price-fixing and collusion principles must be tempered by the fact that most of the cases heard in recent times have involved admissions, and so a wide range of possible scenarios has not yet been fully considered. The problem of finding a suitable methodology for proving the existence of an arrangement between firms in the presence of only circumstantial evidence remains unsolved. But one thing has stood out - even if the evidence might have been circumstantial, any failure by respondents to explain their conduct on oath as a reasonable business practice has hurt them in court.

<u>The judicial approach</u>

In the absence of admissions, it is now well established that it must be shown that the respondents had both the incentive and the opportunity for a meeting of minds on the need to collude or raise prices. The necessary conditions for an arrangement can be traced back to the *Coal Vend* case in 1911, where Isaacs J stated that

"Community of purpose may be proved by independent facts, but it need not be. If the other defendant is shown to be committing other acts, tending to the same end, then though primarily each set of acts is attributable to the person whose acts they are, and to him alone, there may be <u>such a concurrence of time, character, direction and result as naturally to lead to the inference that these separate acts were the outcome of pre-concert, or some mutual contemporaneous engagement</u> . . ."[16] (emphasis added)

A necessary element for a breach of S.45 is communication and an expectation being aroused therefrom by each party about the future actions of the others. In the words of Fisher J in *TPC v Nicholas Enterprises Pty Ltd & Ors* (1979) ATPR 40-126, at p. 18,342, the essential elements of an understanding are:

". . . the necessity for each of the parties to have communicated with the other, for each to have raised an expectation in the mind of the other, and for each to have accepted an obligation qua the other."

He saw mutual obligations as the essential feature of an understanding, although whether this was necessary was questioned on appeal. He thought it possible to infer an understanding from circumstantial evidence, but cautioned against automatically drawing the inference, as "*it is frequently possible for another explanation of the facts to be given in evidence, for example that the [conduct in question] was dictated not by commitment to an understanding but by ordinary commercial considerations*".[17] Justice Fisher also found that commitment could be communicated by means other than a verbal response. But there could not be an understanding between two parties unless each aroused in the other an expectation.

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15 If the market is conducive to concerted action, firms may establish what are called focal (self-evident) rules to fix prices without engaging in any formal arrangement. If under such circumstances no agreement is necessary for firms to achieve the observed outcome, then it would be irrational for them to agree, when the focal rule results in effective joint action without taking the risks associated with formal communication.

16 *The King and the Attorney-General of the Commonwealth v. The Associated Northern Collieries and Others* (1911) 14 C.L.R. 387 at p. 400.

17 The US position is that circumstantial evidence can support a finding that the alleged conspiracy is more probable than innocent alternatives. But if the challenged behaviour has a plausible alternative explanation congruent with self-interest, or if an inference of conspiracy might result in deterring otherwise pro-competitive conduct, circumstantial evidence is insufficient to infer conspiracy. As already noted, US courts tend to infer conspiracy from behaviour that, unless implemented jointly, would have damaged the defendants' commercial interests, such as increasing prices when demand has been falling.

Judgments in Australian price-fixing cases have tended to be long on broad, general market facts and judicial reasoning, but short on hard economic evidence such as price series over time and firms' methods of price determination. This in part has been due to the fact that many cases, especially those heard in recent years, have been pleaded as guilty and the Court had only to set down reasons for the quantum of penalty.

5. Penalties for collusion

Price-fixing is regarded by judges as abhorrent and inimical to public welfare. For example, in *ACCC v J McPhee & Son (Australia) Pty Ltd* (1998) ATPR 41-628, Heerey J labelled it “a form of cheating” against “fair, honest and ethical business behaviour”, noting that it “commonly occurs in secret and between parties who seek a mutual benefit. The risk of detection is often low and the potential gain to the contraveners, and damage to the community, large. Therefore the penalty needs to be correspondingly high.” In *TPC v TNT Australia Pty Limited & Ors* (1995) ATPR 41-375, at p. 40,166, Burchett J was of the opinion that, given the purposes of the Act, “an arrangement to maintain a cartel by deliberately providing poor service in order to compel customers to turn to or return to a supplier with whom they might be dissatisfied, must be particularly pernicious.”

How, then, do judges proceed to determine the appropriate level of monetary penalty when a respondent is found guilty of price-fixing? Because the fines for price-fixing convictions have been relatively low, especially in view of the fact that the respondents confessed in so many cases, it is instructive to consider the Act's guidance regarding monetary penalties.

Guidelines for setting penalties are provided in S.76 of the Trade Practices Act, and other indicia have been developed in the case law. S.76 provides that the penalty should be

“. . . appropriate having regard to all relevant matters including the nature and extent of the act or omission and of any loss or damage suffered as a result of the act or omission, the circumstances in which the act or omission took place and whether the person has previously been found by the Court in proceedings under this Part or Part XIB to have engaged in any similar conduct.”

French J elaborated upon this guide in *TPC v CSR Ltd* (1991) ATPR 41-076 at pp. 52,152-53, where he indicated that additional indicia should include:

“(a) the size of the contravening company;
(b) the degree of power it has, as evidenced by its market share and ease of entry into the market;
(c) the deliberateness of the contravention and the period over which it extended;
(d) whether the contravention arose out of the conduct of senior management or at a lower level;
(e) whether the company has a corporate culture conducive to compliance with the Act, as evidenced by educational programs and disciplinary or other corrective measures in response to an acknowledged contravention;
(f) whether the company has shown a disposition to co-operate with the authorities responsible for the enforcement of the Act in relation to the contraventions.”

Heerey J adopted this list in *ACCC v NW Frozen Foods Pty Ltd & Ors* (1996) ATPR 41-515 at pp.42,442-45, and three further considerations were added:

- similar conduct in the past;
- the financial position of the respondents; and
- the deterrent effect of the penalty.

Other judges have added their own levels of gloss to all these factors.

While there has been no disagreement among judges that a penalty should constitute a *"real punishment"* on defendants (a term first used by Smithers J in *Trade Practices Commission v Stihl Chain Saws (Aust) Pty Ltd* (1978) ATPR 40-091 at p. 17,896) and that it should reflect the seriousness with which Parliament regards price-fixing, there has been some divergence, especially of late, in the interpretation of the object of the penalty. While traditionally it was held that the sole purpose of a penalty was to create deterrence (see, for example, French J in *TPC v CSR* at p. 52,152, where he stated " *The principal, and I think probably the only, object of the penalties imposed by S.76 is to attempt to put a price on contravention that is sufficiently high to deter repetition . . ."),* there have recently been suggestions that a separate punitive element might be appropriate in fixing the quantum of penalty.

In *NW Frozen Foods v Australian Competition and Consumer Commission* (1997) ATPR 41-546 at p. 43582, Burchett and Kiefel JJ stated that a penalty fixed so as to create deterrence "*should not be greater than is necessary to achieve this object; severity beyond that would be oppression"*, and, further, at p. 43,585, that *". . . the penalties imposed by S.76 are . . . not criminal sanctions, and their purpose, established now by a long line of cases, is not punishment."* However, Carr J, at p. 43,587, preferred an alternative position, namely that in his view *"the cases decided to date on the question of the assessment of pecuniary penalties have not ruled out or excluded punishment as one of the purposes of S.76".* Similar comments have been made by Goldberg J, who queried not only whether penalties were having the desired deterrent effect, but also wondered whether some retributive penalty was called for.[18]

6. Conclusions

Collusion is still prevalent in Australia, despite having been the focus of considerable legislative, enforcement and judicial attention since the early 1970s. Yet it is a practice widely condemned by economists because collusion, either price or non-price collusion interferes with the interplay of supply and demand, and denies buyers the benefits of flexible, independently determined competitive prices. An agreement by rival firms to share or divide up the market in some way may not appear on the face of it to have any direct or immediate impact on prices, and therefore might arguably be said not to constitute price-fixing. However, buyers have no other alternative supplier to turn to, if rivals have agreed not to compete for them, and as such prices are not responding to market forces and will remain higher than would have been the case if there had been fierce price and non-price rivalry between sellers. In other words, market sharing is simply a less direct means to the same end, with the same purpose and the same ultimate effects.

[18] See *ACCC v Australian Safeway Stores Pty Ltd* (1997) ATPR 41-562.

Attachment 2: COMMENTS ON FIRST GENERATION REGULATION

This appendix provides selected comments from experts, consumers and businesses in submissions to various regulatory reviews on the form of regulation being applied by the ACCC and jurisdictions. Various phrases are used to describe this form such as 'command and control', 'cost of service', 'cost-plus', 'building blocks', 'WACC' etc. A number of comments make the point that this form is identical to US rate of return regulation, a long discredited regulatory approach.

Views of Independent Experts

Australian access/price reviews have attracted many submissions from independent parties, including eminent economists, former regulators and advisers to governments on regulation, both here and overseas and international banks and credit rating agencies. These have expressed concerns about the form of regulation being applied at several levels:

- the regulatory approaches being implemented appear to abrogate the objectives of National Competition Policy and the individual regimes;
- first generation regulation will have adverse consequences for economic efficiency, investment, innovation and state development; and
- the weighted average cost of capital (WACC) methodology used in the models contains some fundamental flaws, and there is contention over the values of key parameters. In any event, the WACC is not being developed and interpreted in a manner likely to satisfy regulatory policy.

KPMG

KPMG has advised several jurisdictions in establishing regulatory regimes. However, it is now criticising how regimes are now being implemented, noting the approaches of regulators as:

> *"Examples of regulators who are clearly more comfortable with American style rate of return concepts than with incentive regulation which is explicitly required by the statutory instruments they are supposed to be following."* [gholdaway@kpmg.com.au]

And concluding that the approach undermines the reforms of National Competition Policy to the National Electricity Market:

> *"The approaches that regulators are currently promoting involve a bias towards rate of return concepts that will stifle innovation and productivity growth."*

KPMG has produced a "report card" on performance of all regulators since the regimes were established against the objectives of policy and the legislative frameworks (KPMG, 2000). Paraphrasing the objectives, the report card includes the following comments.

Objective: Regulators to apply incentive based regimes:

> *"Regulators are undermining incentive and promoting rate of return type regulatory approaches". "No one benefits from rate of return regulation".*
>
> *"Regulators appear to be determined that successful firms will earn little more than a modest rate of return and that unsuccessful firms will be directed in how to mend their ways. This is rate of return regulation".*

"The focus is on controlling inputs – with the implication that a regulator knows best what inputs lead to the best outcomes. This is the antithesis of incentive regulation – which should be about defining outcomes and then allowing regulated businesses to determine the best and most efficient ways to deliver."

Objective: Prevention of monopoly rent

"What we are getting: determination to prevent the extraction of monopoly rents, - regression to rate of return concepts."

"Characterising returns to efficiency gains as monopoly rents so quickly that incentive is compromised".

Objective: Foster efficient level of investment (and innovation)

"The forms (of regulation) favoured by the regulators to date seem to the author at least, designed to anchor the industry in its existing paradigm. Cost tracking revenue controls and lack of the possibility of earning or retaining profits in excess of the assessed rate of return are the most damaging feature of Australian regulators preferred approaches".

"Regulators have maintained a consistent downward pressure on allowed rates of return. A determination of 'strip out' returns to innovation too quickly blunts the incentive to become more efficient. The pressure on rates of return continues with the current proposals for post tax WACCS."

Objective: Promotion of competition

"Pro competitive rhetoric is getting lost in a rate of return like concern to closely track the costs incurred to prevent 'inefficient' bypass."

Objective: Regulatory certainty and discretion

"Certainty has been largely sacrificed to the countervailing objective of regulatory discretion."

<u>Independent Pricing and Regulatory Tribunal of NSW (IPART)</u>

IPART, the NSW regulator, has recognised the problems of command and control regulation:

"The history of intrusive cost-plus regulation is replete with examples of heavily regulated utilities that exhibit low levels of efficiency, poor investment practices and below average service performance. Both theory and experience indicate that repeated frequent confiscation of the benefits of efficiency improvements combined with uncertainty over future regulatory actions will lead to poor performance and welfare loss." [IPART, 1999, p.13]

As IPART makes clear, incentive regulations should seek to emulate competitive processes and outcomes:

"The competitive process is dynamic and its specific outcomes are unforecastable. No regulator can accurately assess the levels of efficiency or service an industry is capable of over time. Hence, the regulatory framework should aim to create conditions which encourage the industry itself responding to the incentives it faces to move towards its continually shifting performance frontier." [IPART, 1999]

IPART selects total factor productivity, or glide pathing and external benchmarking as superior forms of regulation and is undertaking their development. In another paper IPART supports is approach in the following terms:

> *"A glide path provides strong incentives for NSPs to pursue efficiency gains by allowing them to retain a proportion of any gains in the subsequent regulatory period without distinguishing between management-induced and windfall gains', and "The glide path approach exemplifies the Tribunal's current views in respect of the most appropriate regulatory approach to 'benefit sharing'." [IPART, 1999, p. 3]*

<u>Californian Public Utilities Commission</u>

The former President of the Commission, Dr Dan Fessler, has urged Australian regulators not to adopt the 'building block' model which is said to be:

> *"…conceptually analogous to a traditional American style cost of service/rate of return proceeding".* [Fessler, 1999].

The dismal performance of traditional US regulation is well known and was applied in California at the time of Dr Fessler's presidency. He has submitted that such regulation has performed poorly in California and was not in the long-term interests of consumers, citing weak and perverse incentives, rising costs, increasing intrusion, unpredictability and systemic failure. He has urged regulators to adopt the new forms of true incentive regulation.

The Commission has since switched to such regulation. In a recent decision it states:

> *"We have long considered incentive-based ratemaking superior to command-and-control regulation. PBR mechanisms (benchmarks) send the important message that minimising costs without sacrificing service quality and reliability can result in greater rewards with 'less' regulation than traditional cost-of-service regulation. In order to provide these incentives, we must necessarily break the link between rates and costs."*

Slightly further down, the report states:

> *"First, prices for electric services in California are simply too high. The shift to performance-based regulation can provide considerably stronger incentives for efficient utility operations and investment, lower rates and result in more reasonable, competitive prices for California's consumers".*

It can be seen that the Commission recognises that the linking or tracking of costs and prices under traditional cost of service/rate of return regulation has not achieved the objectives of regulation. It is only when this link is broken under true incentive regulation which replicates what happens in real world markets that the benefits of dynamic markets will eventuate.

Another notable feature of the Commission's report is that all types of stakeholders signed up to the determination even though their self-interests differed widely. In short, while no doubt some groups required some time to be convinced of the benefits of reform, the prospect of better services at lower prices over the longer term from increased efficiency was recognised as being in their interests. That is a lesson we have yet to learn in Australia.

<u>Emeritus Professor Brian Johns</u>

Professor Johns is a former head of the Commonwealth's BIE, Deputy Chairman of the TPC and Associate Commissioner of the ACCC. He has made a submission to the 2001 EDPR in Victoria criticising the Office of the Regulator-General's (ORG) approach to regulation and arguing for a model that mimics the characteristics *"… to be found in the real-world competitive markets"* and points to the need to induce superior innovation through "Schumpeterian" effects. He quotes IPART (1999):

> *"Generally, incentives to pursue efficiency gains will be strongest where the Network Service Providers (NSP) retain the largest amount of revenue over the longest period of time". [Johns, 1999, p.2]*

Professor Johns concludes that the cost of service 'building block' model has serious disadvantages, including effects on investment, efficiency and for consumers. For example:

> *"There is in fact a danger that the regulatory approach proposed by the ORG will lead to less capital expenditure in the Victorian electricity supply industry than would be efficient from the community viewpoint". [Johns, 1999, p.9]*

Johns also deals with the dangers of micro-management by the regulator under cost of service, a risk he sees as the *"Achilles heel of the cost-based form of regulation".* He also refers to the principal-agent problem in such regulation, where the objectives of the government or the community at large (the principal) in setting up the regulatory framework are ignored and superseded by the objectives of the regulatory authority (the agent).

Other Australian Economists

Professor Stephen King (University of Melbourne) is an adviser to the ACCC and has published several commentaries on Australian regulation. In discussing the building block model, he speaks of "*intrusive hands-on regulation"* and agues that this approach *"disguised under a more acceptable name"* has involved *"reinventing the worst aspects of United States rate of return regulation"*. He concludes that this approach *"… has brought together the worst aspects of overseas experience to create a sterile framework that threatens to undermine the benefits of micro economic reform".* [King, 2000]

Professors Joshua Gans and King (October 2000) investigated the precise differences between rate of return regulation and a CPI-X approach to incentive regulation in the context of the Victorian 2001 review of electricity distribution prices. It is concluded that the building block approach is rate of return and therefore in breach of the Victorian regulatory arrangements.

UK Regulators/Economists

Professors Stephen Littlechild, Michael Beesley and Martin Cave are respected economists or former regulators who have made submissions or presentations to utility reviews in Australia. Each of their contributions echoes the points made above. For example, Professor Cave (Brunel

University), on behalf of the Victorian Department of Treasury and Finance, has found that the building block model could have a major adverse effect on incentives for efficiency. The Department itself has also submitted that it does not believe that the building block model is consistent with light handed regulation and pointing out the merits of switching to external *"output orientated (sic)"* benchmarks.

US Economists

Professors Sandford Berg (Florida) and Jerry Houseman (MIT) are also respected United States commentators on regulation who have made presentations or statements on Australian regulation during visits here. Again, their comments are much the same. For example, Professor Houseman in a presentation to the ACCC on the cost based regulation being applied here refers to the loss of dynamic efficiency (ACCC 15 July 1997):

> *"A cost based access fee would discourage dynamic efficiency for two reasons. First, a new entrant would not invest at efficient levels because cost based regulation does not reward risk taking for new services. Services which do not succeed never earn back their investment. However, services which do succeed only earn back their costs.*
>
> *The second reason why cost based regulation decreases dynamic efficiency is that firms do not have the economic incentive to increase productivity and lower costs through time. If firms lower their costs it leads to a reduction in their permitted access charges. To the extent that if the regulator does its job correctly it will remove all incentive for productivity gain".*

In the same way, Professor Berg quoted at an ACCC conference (Melbourne, November 1997):

> *"…command and control mechanisms comprising cost of service regulation tools are at best blunt and crude, preventing the worst abuses, but not sharp enough to encourage anything better. An incentive approach promises more".*

Financial Sector

A number of finance academics, finance houses, investment groups and credit-rating agencies have also made submissions to price and access reviews or have published commentaries elsewhere. These have expressed concern about the interpretation of regulators of their objectives and the form of regulation being implemented, pointing to adverse consequences for investment and economic development in the jurisdiction concerned and for Australia. For example, Standard and Poor's (see Credit Focus, Feb 1999) notes the building block approach will increase regulating risk and the cost of capital and could result in the downgrading of credit ratings and inefficient hedging practices. As another example, SG Hambros, part of the world's fourth largest bank, predicted that there would be:

> *"- increased cost of equity capital;*
> *- increased cost of debt capital by potential credit agency changes to credit ratings and by more restrictive debt covenants; and*
> *- sovereign risk implications, which may diminish future investment by the private sector in regulated assets, in Victoria and Australia."* [SG Hambros, Submission to 2001 EDPR, p4.]

Academics such as Associate Professor Stephen Gray (Queensland) and financial market players, including several of the major Australian and international banks, have made submissions or written directly to governments pointing to fundamental flaws in the CAPM approach and the WACC methodology and have disputed the parameters of the WACC model being adopted by regulators. Professor Gray shows how the approach particularly discriminates against investment by utilities.

This is an involved technical debate, which is not reproduced here, but a flavour of those views can be taken from Hastings Funds Management's submission to the 2001 EDPR.

> *"We believe that there is a fundamental flaw in a regulatory rate of return which is based on the Capital Asset Pricing Model (CAPM). One of the key assumptions of the CAPM is that there are no transaction costs and the market has perfect liquidity. In the case of the regulated utilities in Australia, this is not true."*
>
> *"The Office (ORG) does not appear to have reviewed the considerable body of academic work relating to ill-liquidity. It has ignored this premium in its calculation of the CAPM".*

Hastings then go on to calculate a pre-tax real WACC using what they consider to be real-world parameters and find a WACC of 10.8 percent, substantially higher than regulators.

Other contributions point to a range of similar 'flaws' including in the areas of: multi-period not single period CAPM; non-diversifiable risk; ex ante/ex post inflation problem; cost of debt and index linked bonds; higher total factor productivity in CPI problem; misinterpretation of gamma.

Views of Regulated Businesses

The access and price reviews contain a considerable body of submissions from regulated businesses, both privately and publicly owned. The key deficiencies in the regulatory regimes being implemented – as argued in the submissions – appear to be as follows:

- The regimes represent heavy handed rate of return regulation of the most intrusive form, but without the checks and balances that such regulation requires, and are a major shift from the approaches foreshadowed by governments in their reform policies or promised where utilities were sold:
    - statutory requirements for light handed regulation are ignored;
    - the micro-management involved, by non-experts, raises risk and the issue of who is responsible when things go wrong;
    - one result is bloated bureaucratic costs that are ultimately borne by taxpayers/consumers.
- Efficiency and its twin–investment – are compromised by the lack of incentives, low returns and higher risks, as well as a lack of confidence in regulatory stability:
    - negative signals are sent to global capital markets;
    - the criteria by which prudent Boards judge investment projects are ignored;
    - there is not even certainty about any payment for investments in the networks necessary to meet customers' expectations or statutory objectives.
- The regimes are, however, creating perverse incentives, including with no provision for promoting innovation and the dynamic efficiency required by Government as being in the long term interests of consumers:
    - they are unsustainable, with unsatisfied community and customer needs that are growing, but inducing a narrowing of the skill and technological resource bases that will be unable to respond in future;
    - there will be no take up of new technologies which have the potential to create virtuous circles, as there is only risk and no reward. This will stifle industrial development and limit the size of the 'cake' that can be shared with customers;
    - the industries will be condemned to 'poles and wires' or pipelines, with no enhanced services such as best practice supply reliability;
    - the change in culture that companies have strived to introduce into their businesses will be eroded by the regulation.
- The regimes contradict the statutory objectives by impeding rather than promoting new entry.

What the businesses in general appear to want from regulation may be summarised as follows:

- Strong incentives and rewards for delivering improved services to customers and greater efficiency and lower long term prices by mimicking real world markets (price not cost and profit control).

- Smooth adjustments to prices to reflect public policy principles on gradualism, recognising the adaptive capabilities of business and the social harm of price shocks.

Views of Consumers

Relatively few of the submissions to reviews from user or customer groups have focussed on the form of regulation to be preferred. However, a number have complained about the way in which regulation is being implemented through review processes. They complain about the credibility of procedures, arguing that they are being led through a process which is neither transparent nor understood, where options are not evaluated and where it is not explained which arguments find favour or not, and why, nor how decisions are reached. The good practices applied in other countries are suggested as models.

The views of residential consumers in what they want from regulation is evident from several surveys conducted by independent consultants as part of the reviews. For example, a survey conducted in the 2001 EDPR on behalf of one of the businesses showed that 3 out of 4 consumers preferred the enhanced services (undergrounding, higher reliability, hardship policies, environmental measures, etc) to the regulator's approach of focussing on short-term price cuts. Another showed that about 3 out of 4 preferred slowing transitioning prices to price shocks even if the shock worked in their favour the first time.