the state of COMPETITION

Alexandra Merrett

Rachel Trindade

Issue 13 (Sept 2013)

Has competitive neutrality run its course?

Twenty-one years on from Hilmer and it's time to reflect on competition policy in Australia. While a review of the access regime is on foot and the new government is talking about a "Son of Hilmer" review of the competition laws more generally, competitive neutrality seems to have - once again - escaped attention. In this article, we remind you how competitive neutrality works and why we have it, before reflecting on its current "enforcement". Finally, we ask: do we need to fix competitive neutrality, or have we outgrown it altogether?

Over the next few months, there will be a lot happening in the land of competition policy. The new government is promising a review of our competition laws – principally focused on Part IV of the Act – while the Productivity Commission has been charged with assessing the effectiveness of our access regime. The government's review has been nicknamed "Son of Hilmer" but in fact appears substantially narrower in focus than the massive inquiry headed up by Fred Hilmer almost exactly 21 years ago.

Most aspects of Hilmer were implemented (in one form or another) within a few years and are now entrenched in the fabric of Australian competition policy. There is however a forgotten child: competitive neutrality. Initially adopted with relative enthusiasm, competitive neutrality has fallen off the radar. Few people know what it is; very few complaints are filed; and, when those complaints are upheld, even fewer responses from government are forthcoming. Indeed, the inadequacy of the enforcement process is a fundamental flaw of the current system.

Happy birthday, National Competition Policy!

What is competitive neutrality?

The essence of competitive neutrality is the principle that, for those areas in which government competes with the private sector, it should do so on an equal footing.

As stated in the Commonwealth's Competitive Neutrality Policy Statement (a link is provided in the Further reading section):

Competitive neutrality requires that government business activities should not enjoy net competitive advantage over their private sector competitors simply by virtue of public sector ownership.

Why do we care?

Competitive neutrality is a companion policy to the extension of the operation of competition law to the public sector, and it has the same rationale. Where government businesses compete on an unequal footing, the competitive process is distorted and consequently efficiency is reduced.

In economic terms, this harms "allocative efficiency" (meaning society's resources are not going where they should) and, over time, may affect dynamic efficiency (ie innovation). In layman's terms, it means good

The inadequacy of the enforcement process is a fundamental flaw of competitive neutrality

private sector businesses may be pushed out of the path of less efficient and responsive government businesses. Meanwhile (so the argument goes), consumers are left languishing – dealing with the infamous "customer service" of the likes of good ol' Telecom instead of the innovations of Optus, Virgin et al. We might complain about customer service now, but try to remember the process of getting a new phone line twenty years ago…

Indeed, it is important to bear in mind the context of the Australian economy at the time of Hilmer. Government bodies were a key provider (often the only provider) of many essential services: health, electricity, banking, insurance, transport (rail, sea *and* air). Without an effective competitive neutrality strategy, these sectors could not have been opened up to the discipline of private competition that we now take for granted.

Give me a concrete example

Although the trigger words "competitive neutrality" have not featured in the debate, this is precisely the principle underlying complaints from the commercial sector about the ABC's online news presence. Right now, Fairfax and News Limited are struggling to morph their business model from the age of the printing press into the digital era. A significant impediment to their ongoing profitability is that one of their key assets (and cost centres) – content – is increasingly available to the public at no charge.

While many free "news" services can't match the major newspapers for credibility, the taxpayer-funded not-for-profit ABC certainly can.

Fairfax and News are therefore left in the unenviable position of trying to persuade the Australian public to buy the cow when we already have a steady supply of free milk.

As illustrated by this example, competitive neutrality problems often involve a contest between public policy objectives (eg, citizens in a democracy require ready access to good information, especially in the form of Antony Green) and principles

One of these news stories is free to access; the other requires a subscription

of fairness and efficiency. In this light, it is no surprise that key battlegrounds are childcare, education and medical services.

Public interest exceptions

Unfortunately if you're a media mogul, the ABC's online news service falls outside the scope of competitive neutrality – it doesn't meet a threshold test of being a significant business (not really being a business at all). Even where this test is met, exceptions can be made in the public interest.

Where competitive neutrality would compromise public policy objectives, the government can use a "public interest" test as an out. This can be achieved in advance via ministerial decree or it may be justified after the fact (whereupon the onus rests with the government to prove its case).

A broad range of factors may be relevant to such exceptions, including:

- environmental issues;
- social welfare and equity;
- occupational health and safety concerns; and
- economic and regional development, including employment and investment growth.

Competitive neutrality requires a balance between efficiency & broader social objectives

For example, in the case of childcare, the Victorian Government states in its competitive neutrality FAQs:

> *Childcare is something of a special case in the application of [competitive neutrality]… The Government recognises that childcare is often provided by local councils in response to specific community needs and public policy objectives.*

Just last year, the Commonwealth signed the long-winded Education Services for Overseas Students (TPS Levies) (Levy exemptions) Determination 2012 (No. 1). Prompted by the spate of private college collapses, it requires private providers to undertake annual risk assessments and pay annual risk-based fees. The Australian Council for Private Education and Training is predictably unhappy with this development, observing that "These fees are likely to be onerous and the only exemptions from them (as the Determination makes clear) are public schools, TAFEs and public universities".

What happens to pricing where competitive neutrality *does* apply?

Where there is no carve out, assessing the implications of competitive neutrality can be quite a subtle exercise. Government entities can enjoy cost advantages – and suffer certain disadvantages – over multiple levels.

Tax exemptions are a key concern, but cross-subsidies can come in many other forms – eg a "business" that sits within a large government department is unlikely to be separately billed for rent or overheads. Even if costs are allocated on the basis of some equitable ratio (eg calculated by reference to the floor space used by the business), such allocation may fail to take into account the advantages inherent in the bulk buying power of government. This can affect everything from the price of toilet paper to rental costs. And, as any public servant will tell you, the government rarely pays a "commercial" rate for its staff.

Competitive neutrality policies can take into account some of these inequities, but not all. For an excellent discussion of the mathematical calculations that can be involved in the netting

Netting out the advantages and disadvantages of government ownership

Advantages can include:
- immunity from certain taxes and charges
- immunity from various regulatory requirements
- explicit or implicit governmental guarantees on debt
- concessional interest rates on loans
- not being required to account for depreciation expenses
- not being required to pay dividends to the owner of the business (ie the State)
- not being required to achieve a commercial rate of return on assets
- the ability to act consistently in a non-commercial manner
- captive or tied markets
- effective immunity from bankruptcy and
- where the government business operates in both monopoly and competitive markets, opportunities for cross-subsidisation

There can also be disadvantages, including:
- greater accountability obligations
- requirements to provide community service obligations
- reduced managerial autonomy
- requirements to comply with governmental wages, employment and industrial relations policies and
- higher superannuation costs

Source: Ian Hanrahan (see Further reading)

out of the various advantages and disadvantages, we recommend you have a look at the article by Ian Hanrahan (details in our Further reading section).

How is competitive neutrality entrenched?

When the Commonwealth and States signed up for National Competition Policy, one of the constituent documents – the Competition Principles Agreement – entrenched the objective of competitive neutrality. Pursuant to this agreement, the various governments committed to a range of obligations, including:

- the adoption of a corporatisation model for specific types of government bodies;
- the payment of full Commonwealth, State and Territory taxes or tax equivalent payments;
- the payment of debt guarantee fees to offset the competitive advantages provided by government guarantees;
- compliance with regulations to which private sector companies are normally subject; and
- the investigation and public reporting of allegations that significant government businesses are not implementing competitive neutrality principles appropriately.

Government bodies were additionally required to earn sufficient revenue to cover their costs, as per their private sector counterparts. Finally, the Competition Principles Agreement required government bodies to ensure that prices for their goods and services "reflect **full cost attribution** for these activities". This might be achieved on the basis of fully distributed costs, marginal cost or avoidable cost, depending on the circumstances.

Notwithstanding the Competition Principles Agreement, though, competitive neutrality never translated into formal obligations that could form the basis of legal proceedings. Rather, the various jurisdictions adopted individual competitive neutrality mechanisms and established processes for the assessment and investigation of complaints.

Under the broad umbrella of each jurisdiction's policy statement for competitive neutrality, affected government bodies would generally create their own policy to reflect their specific issues. For example, UNSW publishes on its website a very rare beast indeed: a recently updated version of such a policy.

But what if UNSW breaches that policy? Again, speaking generally, the various jurisdictions established dedicated units – which usually sat within a government department or agency – to investigate such complaints. Those units can make recommendations to the powers that be, but the recommendations are not enforceable. If one stops to think about this approach, a key problem immediately becomes apparent: the gamekeeper is the very party who has been accused of poaching.

Tranche payments (aka: carrots)

"A-ha!", say those charged with implementing National Competition Policy, "we thought about that…". And indeed, they did. For the first several years of its existence, the National Competition Council was charged with handing out carrots to compliant jurisdictions in the form of compensatory payments. These were made via several tranches, and a key qualifier for payment was compliance with competitive neutrality obligations.

The payments specifically included a competition payment component, totalling $200 million (in 1994-95 dollars) for the first tranche, $400 million in the second tranche commencing in 1999-2000 and $600 million in the third tranche commencing in 2001-02. Competition payments were made to the States and Territories until 2005-06.

The National Competition Council made recommendations on the allocation of these payments in its tranche assessments, with the federal Treasurer the final arbiter.

Where the National Competition Council considered that a government had not complied with its reform commitments (or had not indicated a preparedness to address non-compliance), it recommended that the Treasurer impose a permanent payments deduction. Where a government promised to remedy non-compliance, the National Competition Council could recommend suspension, such that full payment would be received eventually if the short-coming was rectified. Queensland, New South Wales and Western Australia proved particularly recalcitrant, but most jurisdictions received their full entitlements eventually.

Compliance in the absence of carrots? Aye, there's the rub

Once the money ran out, enforcement was left entirely in the hands of the relevant governments. Here's an excerpt from FAQs posted on the Victorian Government's competitive neutrality website:

> ***Can I get compensation if the government business is in breach of Competitive Neutrality?***
>
> *The Victorian Government's Competitive Neutrality Policy provides no provision for compensation or termination of contractual arrangements where a breach of the Competitive Neutrality policy is found.*
>
> *However, **if the Government accepts the [Victorian Competition & Efficiency Commission's] recommendations**, the government business will need to change its practices to ensure it complies with [competitive neutrality] in the future (emphasis added).*

But if the government does not accept the recommendation, you're sorely out of luck. As mentioned earlier, there is no cause of action for a breach of competitive neutrality principles. One would have to re-formulate any complaint to fall within one of the anti-competitive prohibitions contained in Part IV of the *Competition and Consumer Act*, such as a misuse of market power or a substantial lessening of competition.

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Number of new complaints received	3	6	5	0	0	3*	2	4
Number of complaints not accepted	0	0	1	0	0	0	0	4
Number of complaints finalised through investigation	1	5	4	1	0	0	2	2
Duration of Investigation (average number of weeks)	43.6	26.9	28.3	55	_	_	49	46
Number of complaints withdrawn	0	1	1	0	0		0	0
Investigations carried over to next year	2	2	1	0	0	2	2	0

Note: * In 2009-10 one complaint was resolved through the VCEC taking a non-investigative approach. The complainant withdrew the complaint to enable the VCEC to take this approach as opposed to undertaking a formal investigation.

Source: Victorian Competition & Efficiency Commission (www.vcec.vic.gov.au/)

The first – claiming a breach of section of 46 – would be difficult to make out. Assuming one can demonstrate market power (never an easy task), one would then need to show use (again, quite tricky) *but also purpose*.

It is something of a myth that purpose is the stumbling block in section 46 cases (a myth that we will address in our next edition). That said, it is exactly where public policy objectives are significant that a party may struggle to prove the existence of one of the three proscribed purposes such as damaging a competitor or impeding entry.

Much like in *RP Data v The State of Queensland*, a court may well find instead that the conduct was motivated by matters of broad public policy (in that case, observance of the national privacy principles). In stark contrast to your average High Street business, a government "business" may not spend much time thinking about its competitors.

Nonetheless there will be cases – like *NT Power* – where a government business can be shown to be acting for the same reasons as any other commercial enterprise. Where this occurs – for example, a government business underprices its services in order to win a tender – there may well be evidence of a proscribed purpose. But if the underpricing is due to a failure to apply full cost attribution, then it may be very hard to show there is any taking advantage of *market* power. All in all, basing a section 46 case on a competitive neutrality complaint is likely to be harder – not easier – than your average commercial case.

Nonetheless, there may be scope to allege the conduct substantially lessens competition (**SLC**). Whether the conduct falls within the terms of section 45 or 47 will depend on specifics, but *Baxter* provides a model at least for a tender scenario. While this discussion is happily devoid of facts, as a general principle, an SLC case based on an underpriced bid would appear easier to make out than a section 46 case.

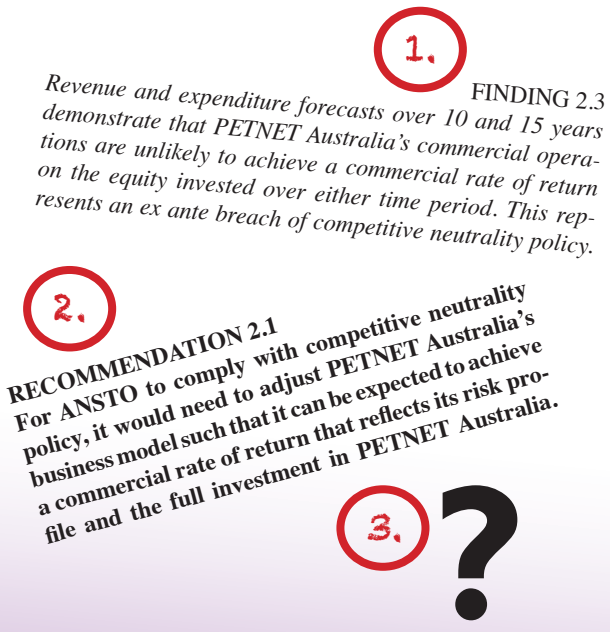
Regardless of the preferred cause of action, the court books are hardly overflowing with examples of successful cases. Proving something is anti-competitive is difficult, time consuming and extremely expensive. Even if successful, the question of remedies would be difficult to resolve. A party wronged by a government business in a tender process is unlikely to find that an action under competition law delivers an effective solution.

Is the appetite for competitive neutrality waning?

In these circumstances, it's reasonable to ask how competitive neutrality has fared in the decade or so since the competition payments were exhausted. The answer is, not well.

Looking at the Victorian data above, one can see that very few complaints have been made (noting that all 4 lodged in 2011-12 were rejected prior to any assessment). Any complaint that is actually assessed takes an extremely long time to review. And then, assuming one can lodge a complaint in an acceptable form and wait a year for its assessment, the best outcome is a recommendation… that the relevant government business may or may not follow.

Data for the various jurisdictions are available only in piecemeal form, but the Victorian complaints numbers are pretty representative. If one looks at the Commonwealth, there have been a total of 15 investigations undertaken by the Australian



A "successful" competitive neutrality complaint in 3 easy steps: 1: the finding; 2: the recommendation; 3: who knows... (Adapted from the PETNET report on the Productivity Commission's website)

Government Competitive Neutrality Complaints Office (an autonomous unit within the Productivity Commission). Of these, only 3 have occurred since 2005. Queensland has had just one investigation proceed to a final report since 2003.

The very low level of complaints could be because government businesses across the country are so compliant that there's not even a suspicion that they could be failing to fulfil their obligations. On the other hand, it just might be that private businesses have no clue that such obligations exist or they (or their advisors) have no faith in the competitive neutrality process and cannot be bothered wasting time and money in pursuit of a complaint.

The coming of age of National Competition Policy

It's worth remembering that competitive neutrality was just one of several planks underpinning the extensive programme of reform set out in National Competition Policy. Other recommendations for deregulation – such as corporatisation, privatisation and extending the application of the competition laws – have largely been achieved. Competitive neutrality was really the only mechanism that was ongoing in nature, and which could not be readily checked off. Kind of like a behavioural undertaking from government...

One way to look at competitive neutrality following the exhaustion of the competition payments is to consider the efficacy of bribing your child to eat her vegetables. Such a strategy may be useful when the child is young. By the time that child is 21, however, you really expect her to eat vegies of her own accord.

Accordingly, as governments reduce their presence in and eventually exit certain activities (such as electricity generation), the economy may be considered sufficiently "mature" to no longer require competitive neutrality and its attendant carrots.

On the other hand, there seems to be a residual unease in the community at the complete absence of government involvement in certain activities (particularly essential services). Further, it is clearly the case that the government *does* continue to play a significant role in particular fields. Accordingly, reflecting on the original rationale for competitive neutrality, maybe we need not just to keep it but in fact to ensure effective enforcement.

To this end, it's notable that competitive neutrality is not only an Australian issue. Just this month, new measures were announced in Finland to extend the operation of competitive neutrality and the issue of State Aid (effectively another name for competitive neutrality) is a hot topic in Europe generally.

So as National Competition Policy celebrates its 21st birthday, it's worth asking whither competitive neutrality. Perhaps like a valued steward who guides us through to adulthood, its role was always limited. Is it time to say thanks and goodbye? Alternatively, maybe competitive neutrality *is* a true son of Hilmer and worthy of review. The bottom line is: what we have now isn't working. Let's fix it or ditch it.

About the authors

Dr Alexandra Merrett is an experienced lawyer specialising in competition and consumer law. She has a particular interest in market power and the use of economic evidence. Alexandra may be contacted on 0432 942 098 or mail to: alexandramerrett@bigpond.com

Rachel Trindade also specialises in competition and consumer law. She has advised on a wide range of business structures and commercial arrangements, particularly in the fields of energy, transport and logistics. Rachel may be contacted on 0402 038 301 or mail to: trindade@bigpond.net.au

Alexandra and Rachel are Australian Legal Practitioners within the meaning of the Legal Profession Act 2004 (Vic), with liability limited by a scheme approved under Professional Standards Legislation.

Further reading

• Ian Hanrahan's article is a real gem, explaining the nuts and bolts of competitive neutrality. It's a little old, but as you've seen this is not exactly a fast moving area of the law: see "Becoming competitively neutral – removing the gilded edge of government business" (2004) 12 *Competition and Consumer Law Journal* 19

• It's always worth bookmarking the key agreements underpinning National Competition Policy. Go to: http://ncp.ncc.gov.au/docs/PIAg-002.pdf

• Here's the Commonwealth's Competitive Neutrality Policy Statement: http://archive.treasury.gov.au/contentitem.asp?ContentID=275

• Finally, don't forget the Productivity Commission's comprehensive review of National Competition Policy, available at: http://www.pc.gov.au/projects/inquiry/national-competition-policy

In our next issue, we consider section 46, one of the likely discussion points for Son of Hilmer (perhaps more aptly known as Dawson's Little Brother?).

Make sure to get it by subscribing via the "Newsletter Sign-up" button on our website.