



Third Issues Paper: Industry Regulation and Price Oversight

March 2016

prepared for

The Department of Treasury, PNG Government

by

The Review Team, Consumer and Competition Framework Review

CONSUMER AND COMPETITION FRAMEWORK REVIEW

Issues Paper: Industry Regulation and Price Oversight

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EXECUTIVE SUMMARY

The Consumer & Competition Framework Review (“**Review**”) was initiated by the Department of Treasury in 2014, to examine the laws and institutions that protect consumers and promote competition in PNG.

Fourteen years have passed since the *Independent Consumer and Competition Commission Act 2002 (ICCC Act)* was passed by Parliament. PNG’s economy and business environment have grown and developed in that time. The Government now considers that it is desirable to conduct a comprehensive review of the consumer protection and competition framework, to ensure it meets the needs of the public and businesses.

The purpose of this Issues Paper is to seek comments relevant to industry regulation and price oversight, from organisations and individuals in PNG (or who do business in PNG), by 5:00pm on **Monday 16 May 2016**.

A number of questions are set out in **bold type**. Comments are also welcome on any other relevant matters.

In relation to the regulated industries (**Part II**), preliminary inquiries by the Review Team suggest a need to address issues relating to:

- The impact of cross-subsidies and need for implementation of the Government’s “CSO Policy” (on community service obligations).
- The need for regulation to create incentives for regulated entities to operate efficiently.
- The impact of Government intervention in the operations of regulated entities.
- The need for improved alignment of: regulatory contracts, expectations of shareholders (the Government), and incentives of executives.
- The costs and resource implications of regulation.

In relation to price oversight (**Part III**), it appears that price monitoring and price control are less extensive than in former years but still operate in relation to several crucial products, entailing costs for the ICCC and affected firms.

After considering all relevant comments received, the Review Team will publish for comment a draft of its report to Treasury, including recommendations for legislative and other reforms to the consumer and competition framework.

I. BACKGROUND

The Consumer & Competition Framework Review (“**Review**”) was initiated by the Department of Treasury in 2014.

The Review is examining the framework that protects consumers and promotes competition in PNG – including its legislation, institutions, regulatory settings and processes – and will provide the Department of Treasury with recommendations for improvement of this framework.¹

The Review will consider whether industry regulation and price oversight are carried out in an effective way, and whether there are changes that could be made to better serve the interests of consumers, businesses and regulated enterprises.

This Issues Paper is the last in a series of three:

- Consumer Protection is regulated under the ICCA Act and several other pieces of legislation, as discussed in the *Issues Paper: Consumer Protection and Economic Empowerment of Women*.²
- Competition in PNG is regulated primarily under the ICCA Act, as discussed in the *Second Issues Paper: Competitive Markets and Fair Trading*.³
- The present *Third Issues Paper: Industry Regulation and Price Oversight* discusses issues arising in relation to the regulation of key infrastructure industries in PNG (ports, power, postal services and motor vehicle insurance) and the pricing of selected goods (foods, fuels) and services (water, PMV and taxi transport).

Part I of this Issues Paper explains why Treasury has initiated the Consumer & Competition Framework Review, why industry regulation and prices oversight are important, and how the existing regulatory arrangements operate.

Part II and **Part III** of this Issues Paper raise questions for your consideration and comment by 5:00pm on **Monday 16 May 2016**. These questions are in ***bold italics***.

A. Aims of the Consumer & Competition Framework Review

Fourteen years have passed since the *Independent Consumer and Competition Commission Act 2002 (ICCA Act)* was passed by Parliament. PNG’s economy and business environment have undergone significant growth and development in that time. The Government now considers that it is desirable

¹ Department of Treasury, *Terms of Reference: Consumer and Competition Framework Review* (2014) paragraph 5. (Available online at: <<http://www.ccfreview.info/#!/background/galleryPage>>.)

² Available online at: <<http://www.ccfreview.info/#!/consultation/c24ib>>.

³ Available online at: <<http://www.ccfreview.info/#!/consultation/c24ib>>.

to conduct a comprehensive review of the framework for consumer protection and the promotion of competition, in order to ensure that the framework is appropriate to meet the current and emerging needs of the public and businesses.

The Review Team is required to:

- (i) review the effectiveness of the existing consumer protection and competition provisions and institutions;
- (ii) review the effectiveness of the current regime of economic regulation and regulatory administration;
- (iii) examine whether government business activities and services providers serve public interests and promote competition and productivity; and
- (iv) advise on appropriate changes to legislation, institutional arrangements and other measures.⁴

In order to understand the issues faced by PNG consumers and businesses, the Review Team:

- is holding a series of meetings with businesses and organisations;
- has published two previous issues papers – the first on *Consumer Protection and the Economic Empowerment of Women*, and the second on *Competitive Markets and Fair Trading*;
- will be conducting focus group meetings with consumers; and
- will schedule Public Workshops to discuss competition and industry regulation issues with businesses and members of the public.

The Review Team will later issue a Draft Report for public consultation, before delivering a Final Report to the Government, setting out the Review Team's recommendations on ways to improve the framework for consumer protection and promotion of competition in PNG.

The ability of the Review to make recommendations that bring positive results for PNG will depend to a significant degree on the information that is made available to the Review. The Review Team therefore welcomes comments, experiences, observations and ideas from organizations and individuals in PNG (or who do business in PNG), at all stages during the Review process.

Comments are now also sought in response to this *Third Issues Paper: Industry Regulation and Price Oversight*.

Please provide comments to the Review Team, by 5:00pm on **Monday 16 May 2016**, at:

telephone: (+675) 321 0400 (please ask for the "Competition Review")

⁴ Department of Treasury, *Terms of Reference: Consumer and Competition Framework Review* (2014), paragraphs 7 to 14.

email: comment@CCFReview.info

website: www.CCFReview.info

B. Current Framework for Industry Regulation

Many infrastructure-based industries in PNG are state-owned and several are regulated on the basis that they are monopolies or near-monopolies. These industries are subject to:

- Regulatory contracts in force under the ICCA Act;
- The generally applicable conduct rules under the ICCA Act;
- Industry-specific legislation (e.g. the *Electricity Industry Act 2002*, *National Capital District Water Supply and Sewerage Act 1996*);
- Accountability to shareholders, including oversight of SOEs by Kumul Consolidated Holdings Ltd;
- Public scrutiny, including by Parliament and the media.

An important issue for the performance and future competitiveness of these industries is whether the obligations to which they are subject are appropriate and coherent.

Regulated industries' obligations may be regarded as "appropriate" if they apply to the correct entities or activities and encourage enterprises to operate efficiently, meet the standards of safety and service expected of them, and provide returns that meet their investors' reasonable expectations. Regulated industries' obligations will be "coherent" if the incentives they create are aligned rather than contradictory.

It appears from preliminary investigation that the regulated SOEs may face issues both in relation to the appropriateness and the coherence of the incentives that current obligations place on them.

Regulation of enterprises that are state-owned

The Review is required to "examine whether government business activities and service providers serve the public interest and promote competition and productivity". In relation to the regulated industries (ports, power, postal services and CTP motor vehicle insurance), the Review considers the efficacy of the "regulatory contracts" to which each is subject. The Review also addresses fundamental questions regarding the role of SOEs in the PNG economy,⁵ and their governance.

Economic regulation aims to promote effective competition where this is possible, and to reproduce the incentives and discipline provided by competition where it is not feasible to introduce competition. Where there is

⁵ The ADB's recent assessment of the performance of PNG's SOEs in aggregate indicated returns on capital used of only 3.4% over 2007–2012 – well below market rates of return: Asian Development Bank *Building a dynamic pacific economy, Strengthening the private sector in Papua New Guinea* (2015) p 55.

monopoly or near monopoly, economic regulation seeks to ensure that regulated businesses do not earn monopoly profits or provide sub-standard services, but are able to cover the efficient costs of operating and maintaining their network assets.

The rationale for economic regulation is commonly seen as valid even where the monopoly service provider is a state-owned utility. However, there are some differences: the profit motive that might drive private monopolies to charge customers high prices might not apply to state-owned utilities. The monopoly might face weak incentives to minimise its costs (which might lead it to 'gold-plate' its activities). SOEs also face political and public expectations and demands, which normally are muted for privately-owned enterprises. In some areas, concerns may arise from under-pricing rather than over-pricing.

Partial or total privatisation of SOEs could be pursued in order to improve SOE performance and the effectiveness of regulation. Whereas privatisation might be a longer-term objective, changes to SOE governance could assist by aligning managers' incentives more closely with the government's objectives.⁶ Fundamentally, each SOE requires a coherent set of obligations that are straightforward to monitor and do not require management to make complex trade-offs (which are more properly made by government).

Existing PNG policies address SOEs. The *Papua New Guinea Vision 2050* includes as a key milestone that "State-owned enterprises (SOEs) are effective and efficient in service delivery".⁷ In *Vision 2050* it was also recognised that:⁸

There is an urgent need to increase investment in SOE reforms, including in the areas of maintenance and capital expenditure. The implementation of the Public Private Partnerships (PPPs) and community services obligation policy in the medium-term and long-term will enable private sector participation and contribution to infrastructure development and other service delivery initiatives.

The *Medium Term Development Plan 2011-2015* observed that "[p]rivate sector competition will pose an ongoing obligation for SOEs to operate efficiently using cutting edge industry technology."⁹ Additionally, the *Papua New Guinea Development Strategic Plan 2010-2030* states the Government's "intent[ion] for state enterprises to operate on commercial principles, to be subject to competition and consumer protection policies, and to be accountable to the people—its ultimate shareholders."¹⁰ The role of

⁶ Ibid., p 55.

⁷ Papua New Guinea *Vision 2050* para 19.12.

⁸ Papua New Guinea *Vision 2050* para 20.4.1.

⁹ Papua New Guinea *Medium Term Development Plan 2011-2015*, p 16.

¹⁰ Papua New Guinea *Development Strategic Plan 2010-2030*, p 36.

competition is recognised in this context:¹¹

Competition will play an important role in motivating state owned enterprises to deliver good services. Community services obligations are ineffective without competition, as demonstrated by the poor delivery of community services obligations in the past by state owned monopoly service providers. The introduction of competition, where feasible, will place pressure on Government owned enterprises to upgrade their performances to that expected of them and required by the people of PNG.

The Review Team notes the White Paper prepared by the Government on State-Owned Enterprises.¹² This Paper raises important questions relating to the ownership and governance of SOEs, including the respective roles of the SOE boards and the State as shareholder (formerly through the IPBC and now Kumul Consolidated Holdings Ltd).¹³ The White Paper proposes some divestment of SOEs through public offerings and increased use of joint ventures or PPPs but also proposes diversification of state investment into new commercial sectors and a restriction on foreign control of SOEs or PPPs.¹⁴

The Review Team are aware of recent reforms to SOE shareholding structures and the creation of Kumul Consolidated Holdings Ltd. These new arrangements are in the process of being implemented. It will be important that these arrangements deliver desirable governance changes such as those discussed in this Issues Paper. Those changes might include, for example, more explicit requirements for financial returns, and rewards to management for achieving such returns.

Regulatory contracts

Regulatory contracts are the primary means of regulating the prices and service standards of monopolies and near monopolies in PNG. The ICCC issues regulatory contracts after consultation with the regulated entities and the public, and takes into account the particular characteristics of each industry in deciding on an appropriate form of price control.

Regulated entities can be declared subject to a regulatory contract, by Ministerial declaration or by the ICCC. The test applied by the ICCC for declaration is that the entity must supply the relevant goods or services in a market in which it has a substantial degree of market power.¹⁵

Currently, regulatory contracts govern service standards and pricing of

¹¹ Ibid, p 38.

¹² Ministry of Public Enterprises, *Principles of State Ownership and Participation in Commercial Activities* (October 2014).

¹³ Ibid. p. 35.

¹⁴ Ibid, pp xvii, 43.

¹⁵ A ministerial declaration does not require a market power finding: ICCC Act s 33.

services provided by four “regulated entities” (i.e. PNG Ports Corporation Ltd, PNG Power Ltd, Motor Vehicle Insurance Ltd and Post PNG).

Our preliminary analysis suggests that the regulatory contract approach has the following strengths:

- Regulatory contracts provide for a transparent process of decision-making, with requirements for consultation on draft regulatory contracts with regulated entities and the community, and with appeals provisions as a check on decisions of the ICCC.
- Regulatory contracts provide the regulated entities with certainty about the path of their prices over the regulatory period, as the contracts specify how prices will change (in absolute terms or using a formula). Certainty is necessary to encourage the regulatory entities to invest and to continue to supply services that meet the prescribed service standards.
- Regulatory contracts are flexible, as they do not require the ICCC to impose any particular form of price control.¹⁶ This is important because each industry has different requirements that can be reflected in how prices are set. For example, some industries like electricity are particularly exposed to changes in input costs (like diesel) which are out of the industry’s control. The regulatory contract can allow for these costs to be passed through. In other cases, it can be appropriate to put the onus on the regulated entity to manage its cost risks.

Although the regulatory contract approach has strengths, it may have some weaknesses. Three possible weaknesses of regulatory contracts include:

- The regulatory contract approach might not be effective at requiring or encouraging regulated entities to become more efficient by lowering their costs (and ultimately reducing prices) or improving their services.
- The implementation of regulatory contracts has tended to be resource-intensive.
- Certain regulatory contract provisions (e.g. s 36(6)) may have encouraged delays in implementing new contracts.

It is unclear whether the issues identified above stem from the regulatory contract design or the way in which the regulatory contracts have been implemented. The first two weaknesses are latent in the ICCC’s use of a ‘building block model’ in the regulatory contracts for port services, power services and postal services (but not CTP motor vehicle insurance). This model allows an entity to recover its average costs of operating, consisting of various blocks including operating expenses, depreciation and a return on the firm’s existing investments. Effective implementation requires a detailed analysis of the prudence and efficiency of a firm’s expected

¹⁶ ICCC Act s 35(4).

expenditures, which is inherently a complex and time consuming exercise. A building block model can provide incentives to become more efficient, but this depends on the specific details of each regulatory contract. We discuss this further in **Part II** (in relation to the particular industries subject to regulatory contracts).

It is also important to recognise that the legislative framework does not prevent the ICCC from adopting other methods of regulation in regulatory contracts, such as other 'direct' forms of price control, or 'indirect' forms of regulation such as prices monitoring. It is essential that any regulation pursuant to a regulatory contract should be appropriate to achieve the government's objectives and should align with other obligations. Additionally, SOE executives' incentives must align with the regulatory contract objectives, which must not be in conflict with other obligations placed on SOEs.

Community Service Obligations and CSO Policy

A 'community service obligation' (CSO) is an obligation to supply a service to a group of end-users, despite it being unprofitable to provide that service to some or all end-users. CSOs applied to an SOE are often in the form of a requirement to offer services to all users at the same price. Where the costs of serving different groups of users are very different, this creates cross-subsidies. Some users pay more than the costs of serving them, while other users pay less. Cross-subsidies effectively act as a tax on one group of users and a subsidy to another set of users.

SOEs in PNG have historically been tasked with providing various CSOs. In some cases these CSOs have been implicit rather than explicit. For example, the Government's Energy Industry Policy (EIP) suggests that PNG Power Ltd has historically been required by Government to set low tariffs for large industry users (as a matter of industry policy), and to subsidise higher-cost rural users.¹⁷

Because it is unprofitable to provide CSOs, SOEs have normally met their costs of providing them by using cross-subsidies. Sometimes SOEs have been granted a monopoly over particular services as a means of funding such cross-subsidies for unprofitable CSOs. For example, Post PNG has a statutory monopoly over letter delivery.¹⁸

Cross-subsidies create a number of problems. Perhaps the most significant is that cross-subsidies often require the government to protect a monopoly. If competition was allowed, new entrants might enter and serve the 'taxed' consumers because these users are charged a price that is above the costs of serving them. In turn, this new entry could drive prices down and reduce the capacity of the SOE to provide subsidies. The monopoly status granted to the SOE means that the CSO can be financed, but it has a substantial cost:

¹⁷ PNG Government, *Electricity Industry Policy* (2011), pp 1-2.

¹⁸ *Postal Services Act 1996* s.10.

it removes the disciplines imposed by competition and so leads to operational inefficiency and unclear goals. It also makes the subsidy non-transparent, so it is difficult to know the true costs of the CSO. This means that the Government and citizens cannot determine whether the benefits from any CSO justify its total cost.

If the CSO is dealt with transparently, many of these issues can be avoided. For example, a direct subsidy means that the SOE (or other party) which delivers the CSO does not need to recover losses and so can be exposed to competition in all areas. The SOE can also focus on its objective of delivering a commercial return.

The Government approved a new CSO Policy for SOEs in 2012.¹⁹ That CSO Policy is currently being piloted for broader implementation in 2016.

The CSO Policy provides for explicit and direct funding of CSOs that are provided by SOEs. This means that the entity providing the CSO can do so without needing to have a monopoly over other services in order to cross-subsidise that CSO. This is both more transparent (by revealing the true costs of the CSO) and enables the introduction of competition in the formerly monopolised good or service. To the extent that CSOs are funded explicitly and directly, SOEs' objectives are better aligned. By contrast, the present position appears to be that *SOEs may face contradictory expectations to deliver CSOs and to maximize profits*, with management struggling to reconcile these objectives.

If successfully introduced, the CSO Policy can be expected to promote better management of SOEs and increased competition. It therefore appears desirable that the CSO Policy should be implemented as soon as possible.

C. Current Framework for Price Oversight

The *Prices Regulation Act 1949 (PR Act)* provides that the Minister may declare any goods to be "declared goods" or "declared monitored goods" or any service to be a "declared service" or a "declared monitored service".²⁰ In respect of a declared good or declared service, the ICCC may fix the maximum price for sale or supply, either nationally or in any part of PNG or any "proclaimed area."²¹ It is an offence to sell goods or supply services (or to offer to do so) at a price that is greater than the maximum price fixed under the PR Act.²² In respect of a declared monitored good or a declared monitored service, the ICCC must monitor the prices of supply and report to the Minister periodically on whether or not it is desirable to declare those

¹⁹ PNG Government, *PNG Community Service Obligation Policy for State Owned Enterprises* (October 2012); PNG Government, *Community Service Obligation Guidelines* (October 2012).

²⁰ PR Act ss 10, 32A.

²¹ PR Act s 21.

²² PR Act s 33.

goods or services for the purpose of controlling their prices.²³

The prices that can be charged in PNG for certain goods (foods, fuels) and services (water, transport) are regulated by the ICCC under the PR Act. Both “price monitoring” and “price control” are administered by the ICCC.

The ICCC carries out “pricing reviews” (to be distinguished from “productivity inquiries”²⁴), on request by the Minister or a supplier, or on the Commission’s own initiative.²⁵ In recent years, price control has been removed from many products but a few remain controlled at present (i.e. fuels, PMV and taxi fares, water and sewerage services). Some formerly price controlled products are now subject only to price monitoring (i.e. staple foodstuffs).

Since price controls intervene directly in the market process, it is essential that they not be imposed except as a last resort. The enactment of criteria to which the ICCC must have regard in setting prices was an important step.

D. Relationship to competition policy and consumers’ interests

In addition to having obligations under their respective regulatory contracts, each of the regulated entities is bound by the competition and consumer protection provisions of the ICCC Act, to the extent they apply. The regulated entities have no immunity, for example, from the competitive conduct rules under ICCC Act Part 6. (In relation to those rules, readers are referred to the *Issues Paper: Competitive Markets and Fair Trading*.)

Consumers of the services that are provided by regulated entities and of the products that are subject to price control or price monitoring have a clear interest in the standards to which such services and products are provided and the prices at which they are offered. The regulated entities, declared goods and declared services are also affected by the general consumer protection provisions under ICCC Act Part 7. (In relation to those rules, readers are referred to the *Issues Paper: Consumer Protection and Economic Empowerment of Women*.)

II. ISSUES IN INDUSTRY REGULATION

This Part of the Issues Paper discusses a range of issues that the Review Team has identified from its preliminary work in relation to regulation of the principal utilities (electricity, port services, postal services and third party motor vehicle insurance). Additional issues may also be important.

An important issue for all regulated entities (or potentially regulated entities) is the threshold at which an entity, good or service may be declared by the Minister or the ICCC to be regulated.

²³ PR Act s 32A.

²⁴ ICCC Act s 122; please refer to *Second Issues Paper: Competitive Markets and Fair Trading*, Part III H.

²⁵ PR Act ss 25A-25C.

Question 1: Do the provisions in sections 32 and 33 of the ICCC Act set an appropriate threshold for declaration of a regulated entity, regulated good, or regulated service?

In relation to each of the regulated entities discussed below, the ICCC Act provides for review of certain decisions of the Commission by an Appeals Panel. The Appeals Panel must decide a review within six weeks of receiving an application for review.

Question 2: Is six weeks from the date of application sufficient for an Appeals Panel to decide a review of a ICCC decision? If not what period of time would be appropriate?

The Review Team welcomes your comments on the further issues discussed below, as well as on any other relevant issues.

A. PNG Ports Corporation Ltd

PNG Ports Corporation Ltd is a declared entity providing port and stevedoring access services in PNG, using the larger ports at Port Moresby and Lae, as well as fourteen smaller declared ports.²⁶ PNG Ports is licensed to provide port facilities for loading and unloading vessels at these ports and to provide berths and berth reservation services for vessels. It currently has sole authority over the sixteen declared ports.

Regulation of ports services is sometimes justified on the basis that it is uneconomic to have multiple suppliers of ports services in a particular geographic area. However, the potential monopoly power of a single port may be constrained by the availability of other ports in the nearby vicinity, particularly if good landside transport infrastructure is available.

Regulatory contract

PNG Ports' most recent regulatory contract expired in 2014. Renewal of the regulatory contract has been delayed by additional consultation and invocation of the appeals process in connection with changes in the ICCC's approach to regulation (in particular, subjecting additional ports services to regulation and introducing benchmarking).

PNG Ports' charges currently are governed by the draft regulatory contract it submitted in 2014.²⁷ This follows from provisions in the ICCC Act that provide for a draft regulatory contract to take effect if a new contract has not been finalised. It has been suggested to the Review Team that this might provide regulated entities with an undesirable incentive to delay a new regulatory contract.

PNG Ports' previous regulatory contract covered berth reservation services, berthing services, wharfing services and stevedoring access. In October 2014

²⁶ ICCC, *Review of the PNG Ports Regulatory Contract*, Final Report (December 2014), p. 27.

²⁷ ICCC Act s 36(6).

the ICCC notified PNG Ports that it would conduct a public review of the scope of the regulatory contract, including whether the contract should cover additional services including pilotage, storage, power charges, and utilities charges. The result of this review was the extension of regulation to a number of previously unregulated services which were related to the regulated services (that is, these services would only be acquired in conjunction with regulated services).

PNG Ports sought a review of this decision by the Appeals Panel. The Appeals Panel found that some of the services were already likely to be regulated, as they were supplied 'in connection with' the supply of the three declared services. For other services, the Appeals Panel found there were some deficiencies in the ICCC's process and reasoning, and ordered the decision be reconsidered. The ICCC has proposed to include many of these services as regulated services (or captured as part of current regulated services) in the revised regulatory contract. The basis for their inclusion is the ICCC's finding that PNG Ports has market power in the provision of these services. This raises the issue of whether the process by which services are declared allows appropriate scope for the ICCC to target service regulation to areas of significant market power, while also providing PNG Ports with regulatory certainty and sufficient opportunity to make submissions and challenge the decisions of the ICCC.

Some commentators have highlighted that the current regulatory contract process requires that each contract contain pricing principles to be followed in the succeeding regulatory period.²⁸ In relation to the Ports regulatory contract, the ICCC's 2010 contract contained provisions setting out principles that would have to be used in the 2014 regulatory contract.²⁹ This included provisions relating to how assets would be valued, the specific form of cost modelling (a building block model) and that consideration must be given to subsidies between existing ports. The ICCC is consequently bound to use a building-block model in the current regulatory period. However, the ICCC has proposed to change the regulatory contract so that it shall not be bound to use this approach in the next regulatory period but will instead rely on more general regulatory principles and make clear that it will not simply 'roll forward what is in the previous regulatory contract'.³⁰ This raises an issue about the appropriate role for pricing principles which outlast the regulatory contract. On the one hand, they provide increased certainty to stakeholders about future regulation. On the other, they may prevent regulation from effectively responding to changes in market circumstances. The Review Team seeks comments on the value of these provisions to regulated entities and to consumers.

²⁸ ICCC Act s 35(3)(e) requires that the Regulatory Contract must "Specify pricing policies and principles that are to be adopted in any Regulatory Contract that is issued in replacement of that Regulatory Contract on the expiry of its term".

²⁹ These principles are listed in ICCC, *Review of the PNG Ports Regulatory Contract, Final Report* (December 2014), Annexure A.

³⁰ Ibid.

A further issue raised by the regulatory contract is the treatment of CSOs relating to ports that are uneconomic or loss making. The pricing of port services has in the past included cross-subsidies by which profits from the larger ports have subsidised operation of the smaller ports. Cross subsidies create poor efficiency incentives because financial losses at a port have little direct consequence, and to ensure ongoing funding of the subsidy they require competition to be restricted.

A formal CSO Policy is presently being piloted by Government which could apply in future to ports. As that policy is not currently fully operative, the ICCC has incorporated a transparent cross-subsidy element into the pricing of port services, via a levy applied to 'Tier 1' ports including Port Moresby and Lae. In part, the ICCC's approval of pricing cross-subsidies reflects that PNG Ports is not able to shut down unprofitable ports but does not presently receive any CSO funding.³¹ The Review Team seeks comments regarding the likely effects of the ICCC's approach and how this may change with the implementation of the Government's CSO policy.

A final issue is how well the regulatory contract promotes economic efficiency. Some concerns have been expressed as to whether the regulatory contract approach has encouraged efficiency improvements. The ICCC's recent change to 'post approve' major capital expenditure by PNG Ports, rather than 'pre-approve' such expenditure, also might not provide efficiency incentives. For example, such a change reduces PNG Ports incentives to reduce capital expenditure during the regulatory period and creates uncertainty about future cost recovery. On the other hand, this may be appropriate if new capital expenditure is highly uncertain – such as expenditures on the new port at Motukea, which was recently acquired by PNG Ports. The Review Team seeks comments on whether the regulatory contract approach provides sufficient efficiency incentives.³²

Question 3: Should competition be introduced between ports in PNG by placing each port under separate ownership?

Question 4: Does the PNG Ports regulatory contract provide sufficient incentives for efficient operation of ports? Why or why not?

Question 5: Are the provisions in section 33 of the ICCC Act relating to the declaration of regulated services appropriate, or could they be improved?

Question 6: Have the Appeals Panel's findings on service declarations applying to PNG Ports clarified how these provisions should operate?

Question 7: Do the appeal provisions in Part 5 of the ICCC Act

³¹ Ibid. p. 155.

³² Note also issues regarding efficiencies in the context of SOE ownership, raised in Part I B of this Issues Paper.

promote good regulatory outcomes while avoiding undue delays in the implementation of regulatory contracts?

B. PNG Power Ltd

A single monopoly entity, PNG Power Ltd (**PPL**) performs all four functions of electricity supply in PNG:

- Generation of power, which in PNG is produced through a combination of hydro, gas and diesel sources.
- Transmission of power, through high voltage conductors between generators and major supply points (e.g. cities and towns).
- Distribution of power, through low voltage wires to homes and businesses.
- Retailing of power, including billing and payment functions.

The transmission and distribution functions are widely considered to be natural monopolies, in the sense that it is less costly to have a single transmission and distribution network. The generation and retailing functions are potentially competitive, however. Multiple sources of generation capacity are required to service peak and off-peak demand and to deliver reliable supply.

The Government's 2011 *Electricity Industry Policy (EIP)* set a new course for the electricity industry to meet growing demand and improve upon the management and performance of PPL. The EIP identified limited external discipline on PPL to manage its costs and seek efficiencies as a key problem.³³ The EIP also identified the multiple objectives the Government sought to achieve through PPL as imposing constraints on PPL that it cannot easily manage and which undermine PPL's efforts to exercise commercial discipline.³⁴ Further problems were noted with the ability of PPL to finance investments in needed generation investments.

The EIP reforms have sought to introduce competition in different market segments:

- In PPL's exclusive licence areas (small loads),³⁵ competition for new generation is to be facilitated via a compulsory competitive tendering process from which PPL is excluded (creating new independent power producers (**IPPs**)).
- For larger loads (customers with 10MW loads or greater) within the exclusive supply areas, competitors can enter the generation market and retail electricity directly. This requires the development of an access code to govern competitors' use of PPL's transmission and

³³ PNG Government, *Electricity Industry Policy* (2011), p. 1.

³⁴ Ibid.

³⁵ PNG Power has the exclusive right to supply small customers (<10 MW load) within 10km of its network throughout Papua New Guinea.

distribution networks.

- In areas outside of the PPL licence areas, competition is to be facilitated using competitive tender processes.

The EIP did not introduce retail competition for small loads. The ICCC is responsible for implementing elements of these reforms, including licensing entrants, developing a third party access code and developing a grid code. Draft codes have been issued by the ICCC for comment.

The reforms to promote competition in the electricity sector appear to have been progressing slowly. There has been little competitive generation by IPPs since the EIP was developed.³⁶ However, there have been recent announcements about forthcoming investments in generation through biomass and gas fired plants.³⁷ These investments will be in IPPs developed to service PPL's small load retail customers in PPL's exclusive licence areas. Other measures to promote competition, such as the accounting separation of PPL's operations into the potentially competitive and non-competitive elements, are foreshadowed in the 2013 regulatory contract. These measures may also be important to facilitating entry of the kind envisaged by the EIP. The Review Team seeks comments about any existing regulatory or other barriers to implementing the EIP.

Regulatory contract

The most recent regulatory contract between the ICCC and PPL has the following key characteristics:³⁸

- A standard building block model is used to determine an annual revenue requirement, based on the ICCC's review of PNG Power's cost and demand forecasts.
- Prices are set using a price cap, of the form CPI-X, based on a weighted average of the different prices applying to different kinds of customers.
- PPL is given the discretion to differentiate in prices between service areas, on the basis of the different costs of providing services in different areas, but must maintain the same relativity of charges between different customer groups.
- The contract forecasts substantial increases in capital expenditure and prices. This primarily results from forecasts of new investments in infrastructure to address reliability concerns, with the price cap being set at CPI+6.57 per cent (meaning that prices were to rise by this amount in each year of the 5-year regulatory period).³⁹

³⁶ Two IPPs supply power to PNG Power in Port Moresby (diesel generation by Hanjung at Kanudi and gas generation by ExxonMobil from its LNG processing site) and one in Lae (diesel generation by Daewoo, under construction).

³⁷ See: www.Oilsearch.com

³⁸ ICCC, *Final Report on PNG Power Limited's Electricity Regulatory Contract Review* (November 2013).

³⁹ This relates to the non-fuel components of costs. Prices are adjusted to reflect changes in fuel costs as a pass-through.

- PPL faces incentives to lower costs because its price path is fixed. If PPL is able to be more efficient in its operating costs while still meeting the minimum service standards, then it will be able to retain the financial benefit achieved, over the remainder of the regulatory period.
- Service quality measures are imposed, including on the reliability of supply, with penalties for poor performance.

Our review of the regulatory contract for electricity has raised the following issues:

- How should the price structure under which PPL sells electricity be determined? For example, should tariffs have fixed and variable charges? Should the practice of charging lower prices for the first 30kWh of usage continue? The main issue is whether it is appropriate for the ICCC to determine price structure, or whether it is more appropriate for PPL to retain this discretion. The argument for more discretion is that it can provide PPL with incentives to set more efficient price structures that increase consumption.
- How should poor previous performance be addressed in a future regulatory contract, as where real prices for electricity have increased without significant improvements in reliability?? Penalising PPL financially may result in even worse future performance, because it reduces PPL's ability to finance new investment. The ICCC's recommendations for Government (as shareholder) were to reduce remuneration for PPL's senior management if financial and service targets are not achieved.⁴⁰
- Whether and at what time subsidies should be unwound which currently favour parts of PNG where electricity is generated using higher cost diesel fuel? This would result in cheaper electricity in lower cost areas and better incentives for investment in generation in high-cost areas. Currently, the cross-subsidies make investments in generation in high-cost areas uneconomic.
- Whether and how the efficiency of PPL can be determined without recourse to a lengthy and intensive assessment of PPL's costs? Benchmarking of PPL's costs against those of an efficient firm, which is often pursued in other jurisdictions, appears problematic as there is no good domestic comparator for PPL and few (if any) good international comparators.
- What process should be adopted for setting service standards (e.g. reliability) and what the implications should be if those are not met? In monopoly industries, the level of service is not subject to competitive pressure. Rather, service standards are set through various regulatory and policy processes with which businesses have to comply. These may be based on historical standards, or the government's or regulator's assessment of consumers' willingness to

⁴⁰ ICCC, *Final Report on PNG Power Limited's Electricity Regulatory Contract Review* (November 2013) p 40.

pay for service improvement. The ICCC proposed significant improvements in service performance in the regulatory contract, with penalties for non-compliance which were to be directed into a “reliability improvement fund”.

The issues raised above point to a number of areas where the limitations of applying standard regulatory techniques to SOEs are apparent. For example, the ineffectiveness of regulation in delivering lower costs and greater efficiency may indicate that PPL’s management are pursuing objectives that are not aligned with its financial viability and the interests of consumers in the long term. Further, giving PPL the flexibility to set its own specific tariffs within a broader control might only be appropriate if PPL behaved commercially.

The Review Team is advised that the Government has directed PPL not to increase its tariffs, though tariff increases are permitted under the regulatory contract. This has left tariffs below the levels needed to recover average costs, and required the IPBC to provide PPL with additional funding to cover the shortfall.⁴¹

PPL maintains a uniform tariff structure nation-wide, although it has been permitted by the ICCC to geographically de-average this tariff structure. This might reflect the fact that the Government’s CSO Policy, which could directly fund more expensive service areas, is still in its pilot stage.

Our preliminary assessment is that improving the governance of PPL so that the objectives of PPL are commercially focused and trade-offs between different government objectives are avoided, will be important to improve the operation of the regulatory framework. The Review Team seeks comments on how recent governance changes (including the new Kumul structure) may assist in securing improved performance from PPL, and what further changes might be beneficial.

Question 8: Has the electricity reform process been effective in implementing the 2011 Electricity Industry Policy? Why or why not?

Question 9: Where and how can the regulatory framework enable greater investment in generation capacity?

Question 10: Where and how can the regulatory framework enable greater competition in the electricity industry?

Question 11: Is there a need to clarify the objectives of PPL? How can this be achieved?

Question 12: How should PPL’s objectives and incentives be identified within the newly-established Kumul structure?

⁴¹ See, PNG Power Ltd 2014 media release: <<http://www.pngpower.com.pg/index.php/news/126-2014-news/262-electricity-tariff-remains-the-same>>.

Question 13: Would a different approach to regulating PPL encourage greater efficiencies from PPL?

Question 14: Who should be responsible for setting PPL's service standards and tariffs?

Question 15: Should PPL have more flexibility in regard to tariff-setting? Why or why not?

C. Motor Vehicle Insurance Limited

Third party insurance is mandatory in PNG for all motor vehicle owners.⁴² Motor Vehicle Insurance Ltd (**MVIL**) was established by the *Motor Vehicles (Third Party Insurance) Act* to provide Compulsory Third Party (**CTP**) motor vehicle insurance. At present, MVIL is the sole CTP insurer in PNG.

CTP insurance differs from services provided by the other regulated SOEs. CTP insurance is not likely to be a 'natural monopoly', as cost conditions do not make it cheaper to have one insurer rather than many. In many other jurisdictions, having CTP insurance is compulsory but motorists may choose among a number of insurers when purchasing it.

Regulatory contract

The current MVIL regulatory contract commenced in January 2013. The contract has a five year term. The pricing of CTP insurance is not subject to the 'building block' price regulation that applies to other SOEs under regulatory contracts. Rather, the ICCC applies a price cap because the pricing of CTP requires estimation of the cost of claims which have been incurred (including claims on accidents that have happened but are yet to be paid). The necessity for estimation of future claims introduces an element of uncertainty into the determination of appropriate premiums.

It is not obvious that MVIL requires protection as a monopoly and the legislation appears to permit additional insurers to enter the market.⁴³ One explanation of MVIL's monopoly may be an expectation that MVIL will cross-subsidize nationally uniform rates:

As part of its regulatory obligations, MVIL has to maintain a presence in all provincial centres throughout PNG. The premiums are uniform across all centres to ensure that the compulsory service can be provided at an affordable level.⁴⁴

The ICCC further explains that other cross-subsidies are embedded in premiums:

Furthermore, a degree of cross subsidies between policyholders

⁴² *Motor Vehicles (Third Party Insurance) Act 1974* s 48.

⁴³ *Motor Vehicles (Third Party Insurance) Act 1974* s 72.

⁴⁴ ICCC, *Review Of The Compulsory Third Party Motor Vehicles Insurance Regulatory Contract* (2013), p. 55.

with high claims experience and other policy holders exists to ensure that cover can be provided at an affordable level to all vehicle owners in PNG. In the absence of a CSO Policy, the uniform premiums and cross-subsidies between different policy holders helps to ensure that MVIL continues to provide sustainable CTP motor vehicle insurance coverage scheme throughout PNG.⁴⁵

For this policy to be sustainable it is likely to be necessary to restrict competition, as otherwise competitors could enter to supply services in lower cost areas.

Competition for CTP motor vehicle insurance could be readily introduced in PNG, assuming that other domestic and international insurers would be willing to offer these services. Other changes to the regulatory framework may be required, however, to ensure that insurers have sufficient funds and to maintain the quality of service.⁴⁶

The regulatory contract also determines service standards for MVIL. This has included very specific instructions about the opening of particular branches, and requirements for upgrading branches. This raises the question of whether this is an appropriate role for the ICCC, including whether the ICCC has the expertise to trade off the costs and benefits of higher service standards. An alternative approach, adopted in many other jurisdictions, is to leave the setting of standards as a task for Government policy and for the regulator to monitor whether these standards are met efficiently.

Question 16: Is regulatory reform required to enable the development of a competitive market for compulsory third party insurance?

Question 17: Could the regulatory contract for MVIL be simplified or removed? If so, would other arrangements be necessary to protect consumers from high prices?

Question 18: What would be the likely impact if MVIL de-averaged its rates for CTP across PNG? Would services in higher-cost areas become unaffordable for many users?

Question 19: If the market for CTP motor vehicle insurance was competitive, would it be necessary to regulate service standards for that product?

Question 20: If the market for CTP motor vehicle insurance was competitive, would other protections for consumers be necessary (such as an insurer licensing scheme)?

⁴⁵ Ibid.

⁴⁶ For example, schemes commonly used in Australia license suppliers of CTP, and the regulator may have some oversight of fees charged. See for example the scheme in NSW run by the Motor Accidents Authority: <<http://www.maa.nsw.gov.au/>>.

D. Post PNG

Post PNG is an SOE created under the *Postal Services Act 1996*, with the functions of providing a letter delivery service and postage stamps. Post PNG has a monopoly over “reserved services,” including the delivery of smaller letters (under 250gm).⁴⁷ Post PNG also supplies private mailbox, parcel delivery and logistics services.

Regulatory contract

The regulatory contract under which Post PNG operates (renewed in 2014) covers the following services:

- a standard letter service for delivery in PNG;
- a standard letter service for delivery from PNG; and
- rental of private letter boxes and bags.

Other services, such as parcel delivery, are not regulated because these services are higher value (per piece) and subject to competition from freight and logistics companies.

The financial performance of Post PNG (like many postal operations around the world) has been poor over the past few years.⁴⁸ The traditional business model for postal operators is affected by digitalisation and globalisation. Letter volumes in particular are in decline due to the use of alternative communications such as email, mobile telephony, internet telephony and fax machines. The current regulatory contract indicates that annual revenues for the regulated services are forecast to decline by 25 per cent in the period to 2016, driven by a 40 per cent decline in letter demand.

The Government has previously provided financial support, through the IPBC, for Post PNG. In June 2014, IPBC injected PGK 40 million into Post PNG for the purpose of “securing its future as the state owned entity restructures its operations”.⁴⁹ This has included a focus on expanding its logistics business.

Our review of Post PNG’s previous regulatory contract raises the following issues:

- The increasing use of alternative forms of communication in substitution for letters raises questions about the monopoly status of letter delivery and hence the necessity for a regulatory contract for Post PNG. The risk of monopoly pricing of letter delivery services and private boxes reduces as competition from alternative modes of communication intensifies. Consequently, while the ICCC notes in the regulatory contract review that Post PNG is a statutory monopoly, this

⁴⁷ *Postal Services Act 1996* ss 10, 11.

⁴⁸ Kumul Consolidated Holdings Limited, portfolio notes: <<http://www.ipbc.com.pg/portfolio/post-png-limited/>>.

⁴⁹ Ibid.

might not be sufficient to support ongoing price control.⁵⁰

- The ICCC appears to be extensively involved in setting service standards for Post PNG, including the hours of operation for postal offices with varying staffing levels and obligations relating to expansion of the network or closure or reductions in the hours of operation of postal offices.
- The forecast financial performance of Post PNG raises questions about the ongoing viability of its service delivery standards. While the costs of maintaining the existing letter delivery network are rising, Post PNG's volumes and revenue are in decline.⁵¹ How Post PNG ought to respond is unclear. A firm operating in a competitive market would need to focus on cost reductions. Achieving cost reductions might require reduced service quality, such as slower delivery times or a smaller post office branch network. This does not appear to be contemplated by the regulatory contract. Section 5 of the regulatory contract contains clauses that allow the ICCC to penalise Post PNG for non-compliance with the service standards, and provide for the ICCC to recommend to Post PNG's board that senior management of Post PNG be penalised for such non-compliance.⁵²

Question 21: Should the services of Post PNG continue to be subject to a regulatory contract? Why or why not?

Question 22: Should particular services offered by Post PNG be subject to price monitoring rather than direct control of prices under a regulatory contract?

Question 23: Would significant harm to consumers result from changes in postal service delivery such as reductions in opening hours, closure of branches or slower letter delivery times?

III ISSUES IN PRICE OVERSIGHT

The ICCC currently is required to control the prices of water and sewerage, fuels, and PMV and taxi fares. The ICCC currently is responsible for monitoring the prices of wheat flour, rice and sugar.

A. Price monitoring: staple foods

In the past, many staple foods were produced (or imported) by only one or two key suppliers. Tariffs were applied to many imported products. Price controls were applied in response to the small numbers of domestic suppliers and high barriers to entry.

Reforms in the PNG economy to remove tariffs and other barriers to entry

⁵⁰ ICCC, *Review Of The Postal Services Regulatory Contract Final Report* (October 2014) p. 7.

⁵¹ *Ibid.*, p. 21.

⁵² ICCC, *Final Postal Services Regulatory Contract For The Regulatory Period From 1 January 2012 to 31 December 2016*.

have led the ICCC to progressively replace price controls with price monitoring.⁵³ Currently, the ICCC has responsibility for monitoring the prices of three staple foods: flour, rice and sugar.

Price monitoring involves the collection and analysis of data and prices and benchmark changes in costs, so that the ICCC can assess whether the firms selling monitored products are responding competitively to changes in costs. If competitive behaviour is not observed, the ICCC may recommend to the Minister that price controls be imposed.

The ICCC's approach is to recommend regulation if competition is inadequate. However, it is also necessary to consider the costs of regulation (e.g. the cost of complying with regulation, failures of service if prices are set too low, or increased risks of bribery and corruption). Regulation should only be recommended if the benefits of regulation exceed the costs, even if competition is not considered effective in the relevant market.

In some circumstances, the ICCC appears to be proposing price monitoring, despite the relevant market being competitive:

The Commission's draft position is that the rice market is competitive at all levels of the value chain. That is, competition appears to be effective among growers, importers and retailers. However the Commission does have some concerns about retail competition in particular. The Commission is therefore of the view that continued monitoring in some form is appropriate.⁵⁴

Price monitoring does impose costs on the ICCC and on firms subject to requirements to supply information.⁵⁵ It is important that the costs associated with monitoring are taken into account in the decision about whether to monitor prices or not. This is important because the ICCC has only limited resources and should seek to put these resources to their best uses.

The indirect benefits of price monitoring must also be recognised. The ICCC's price monitoring activities have enabled it to comment on the effects of other policies which are relevant to consumers and to act as an advocate for competition. For example, the ICCC has analysed the impacts of tariff levels on domestic rice production policies.⁵⁶ To the extent these bear on the case for regulation of prices, these can be important functions for an independent regulator.

⁵³ For example, with respect to sugar, the tariff was reduced from 70 per cent to 40 per cent in 2010 and later to 35 per cent. See ICCC, 2012-13 *Sugar Industry Pricing Review Final Report* (October 31, 2013). The tariff on Wheat Flour was reduced from 40 to 15 per cent in 2010. This was then reduced to 12.5 per cent on 1 January 2012, and then to 10 per cent from 1 January 2015. Imports of rice are not subject to tariffs or quotas.

⁵⁴ ICCC *Draft Report Rice Industry Pricing Review* September 2015, p. 68.

⁵⁵ "The Commission is also proposing to continue to monitor the retail price of one kilogram packages of Roots rice in stores around PNG. The Commission uses its own staff for this purpose, but can also require retailers to provide this information directly to the Commission." Ibid.

⁵⁶ ICCC *Draft Report Rice Industry Pricing Review* September 2015, s 9.

Question 24: Is there scope for greater competition to be introduced in any market for staple foods?

Question 25: Do you consider that the benefits of price monitoring outweigh the costs? Why or why not?

Question 26: What lessons can be learned from price monitoring of staple foods for operation of the price monitoring regime generally?

B. Price control: water and sewerage

Water and sewerage supply in PNG is delivered by two utilities: Eda Ranu (which supplies Port Moresby) and Water PNG (which supplies areas outside Port Moresby).

Eda Ranu and Water PNG are currently regulated under the price control provisions of the PR Act. The recent review of water and sewerage prices by the ICCC proposes that each of Eda Ranu and Water PNG should be declared a “regulated entity”⁵⁷ and therefore become subject to a regulatory contract.⁵⁸ As these are both network utilities with long-lived assets, the potential for greater certainty under the regulatory contract regime seems desirable in principle. While this would provide for greater consistency across the network businesses, it is important that this should not increase the costs associated with regulating.

The nature of the inquiry and the regulatory approach undertaken by the ICCC is similar for both price controls and regulatory contracts. There are some differences which might favour the use of regulatory contracts where market power is substantial and expected to be long-lasting. These include the appeal provisions relating to regulatory contracts, and the opportunity to have regulatory commitments of up to 10 years. The Review Team seeks comments on the advantages or disadvantages of regulatory contracts in this setting.

Economic regulation of water utilities is common in other jurisdictions, primarily due to the existence of natural monopoly infrastructure. The trunk and reticulation networks of water utilities are not economical to duplicate and, in many cases, neither is bulk water supply or sewerage treatment. In some countries, such as Australia and the United Kingdom, there have been attempts to introduce competition in certain stages of water and sewerage supply but competition has not flourished.

In recent years, the performance of PNG’s water utilities does not appear to have been satisfactory. ADB indicators on return on equity show average returns of less than 5 per cent between 2002-2012,⁵⁹ and the ICCC has

⁵⁷ ICCC Act s 32.

⁵⁸ ICCC, *Water and Sewerage Pricing Review: Final Report* (July 2015).

⁵⁹ Asian Development Bank, *Finding Balance 2014: Benchmarking the performance of state-owned enterprises in island countries* (2014), appendix 2, p. 46.

observed that operating costs for both Eda Ranu and Water PNG have continued to rise at rates well in excess of the rate of inflation.⁶⁰ Overall volumes of water and the number of customers have not increased materially nor have service levels improved over the same period.

The particular price control method used by the ICCC for both of these utilities is based on the costs-of-service. This allows the utilities to recover their forecast costs over the regulatory period. Although this approach has only relatively weak incentives to increase efficiency, the ICCC considers an approach that holds costs at current levels while focusing on service level indicators and a price cap will best promote consumer interests.⁶¹ This is because the ICCC has found no evidence that Eda Ranu or Water PNG were responding to incentives to reduce costs. Further, using a price cap rather than a revenue cap may provide some incentive for Eda Ranu and Water PNG to expand service volumes, as this will improve their financial importance.

The ICCC's focus on improving service performance, and linking revenues to that performance, raises the question of appropriate regulatory objectives in the water sector. Should regulation be focused on improving service levels, or lower prices? This is a difficult trade off that might be better undertaken by policy makers rather than by regulators. The Review Team invites comments on whether the ICCC's approach appropriately balances service and price, and whether this is an issue for the regulatory framework more broadly.

As in other sectors, the water and sewerage sectors appear to involve competing objectives of service affordability (because water and sewerage are essential services) and operator profitability (so that network investments can be made). This is reflected in the debate over whether there should be any fixed charges (invariant to use of water or sewerage), and whether charges for usage should increase as usage increases. The ICCC has decided against fixed fees and has proposed the use of cross-subsidies from high-use customers to low-use customers. This raises the issue of who is best placed to set prices. In an environment of regulated returns, it may be preferable to allow the regulated entities to make these price structure decisions. This could be done within a framework of pricing principles under direction from Government or the ICCC.

Cross-subsidies are also apparent between areas within Water PNG's network. The the CSO Policy is not yet in full operation also appears to create problems for Water PNG, as it expands service into small communities with very small numbers of customers and high unit costs. This raises concerns similar to those already raised with respect to electricity, ports, post and MVIL.

⁶⁰ ICCC, *Water and Sewerage Pricing Review: Final Report* (July 2015) p. 112.

⁶¹ *Ibid.* p. 115.

A further issue is whether there is scope to merge the operations of Eda Ranu and Water PNG. While there might be some benefits from merging their operations (such as reduced duplication of costs), the costs of such a merger are not clear.

Question 27: Is there scope for greater competition to be introduced in any segment of the water or sewerage industries?

Question 28: Would it be efficient for Eda Ranu and Water PNG to be consolidated?

Question 29: Is the ICCC's approach of linking service performance to the prices consumers' pay likely to promote better performance?

Question 30: Is it desirable for water and sewerage charges from some areas to cross-subsidize services to other areas? Why or why not?

Question 31: What practical implications would regulation under a regulatory contract rather than price control have for the water and sewerage operators?

Question 32: What lessons can be learned from price control of water and sewerage services for operation of the price control regime generally?

C. Price control: refined fuels

The ICCC currently is responsible for the regulation of prices for oil based refined petroleum products: Petrol, Diesel, Kerosene and Jet A1.

The regulatory and price setting arrangements for petroleum products expired in December 2014. After consultations during 2014 and 2015, the ICCC has recently released a revised draft report on future fuel price controls.⁶² The key recommendation is that the Minister declare that the Commission will continue to regulate the monthly retail prices for Petrol, Diesel and Kerosene under s 21(2)(g) of the PR Act.

The ICCC indicates that direct price control would involve setting maximum retail fuel prices in the various geographic areas.⁶³ This would include regulated margins for wholesale, retail and drum filling (which is a common method of purchasing retail fuel in areas outside of Port Moresby).

In addition to retail fuel supply, the ICCC will monitor the price of jet fuel (known as Jet A1). This reflects concern about market power in the supply of Jet A1 by Puma Energy outside of Port Moresby. The ICCC has proposed to "carry out a further review with the intention to regulate the price of Jet

⁶² ICCC, *Petroleum Industry Pricing Review Revised Draft Report* (August 2015), p. 12.

⁶³ *Ibid.* p. 15

A1”⁶⁴ under Part 8 of the ICCA Act.

The ICCA’s economic case for regulating retail fuel prices is that the wholesale and retail markets are not effectively competitive and so are not operating efficiently.⁶⁵ The proposed regulatory approach is to calculate the efficient costs of wholesaling and retailing fuel (differentiated by geographic region) and apply these as maximum prices.

The supply of fuel to retail customers relies on a series of functions or activities, including:

- Refining fuel from crude oil, or importing refined fuel from overseas. There is a single refinery in PNG at Napa Napa, operated by Puma, and a number of importers of fuel including Mobil and Niugini Oil.
- Wholesale activities (e.g. purchase, storage and bulk transport of fuel to retail sites), which are capital intensive but markets are capable of sustaining more than one operator. Data collected by the ICCA indicates that no less than two wholesalers are present in nearly all areas across PNG.⁶⁶
- Fuel freighting, where the fuel is freighted by land or sea to fuel retailers. The ICCA suggests that there is limited competition in the market for sea or road freighting of wholesale fuel, although the barriers to entry in this market are not obviously high.
- Retail activities, which include operating service stations and drum filling. These functions tend to be less capital intensive and more competitive. This market seems to have low barriers to entry although there may be few retailers in less populated areas due to lower demand.

Regulation of retail fuel prices of the kind implemented (and proposed to be implemented) by the ICCA requires it to estimate the efficient costs of all of these activities. There is variation in the costs of supplying fuel across PNG. This creates a considerable burden on the ICCA to gather information on the costs of supply and how those differ across regions. It also increases the probability of regulatory error: if regulated prices are too high it can facilitate excess profits or too much entry. If regulated prices are too low, it can cause undersupply of wholesale or retail fuel.

For price control to deliver maximum benefits, it should allow regulated firms to recover their efficient costs. However, determining the ‘efficient costs’ of supplying wholesale or retail fuel is complex and prone to error. In markets like those for fuel in PNG, there are a number of existing wholesalers, transport companies and retailers. Estimating the efficient

⁶⁴ Ibid. p. 175.

⁶⁵ Ibid. pp. 31-32.

⁶⁶ Ibid. p. 42.

costs is complex, because each business tends to be organised differently (for example, some will sell fuel as well as other products), and prone to error because the costs of gathering information are high.⁶⁷ Further, selecting the lowest cost firm as the benchmark efficient cost or using an efficient cost model creates issues of viability for other firms.

More generally, the complexity of the industry has meant that the ICCC has had to devote considerable resources to regulation and enforcing compliance with the regulations.⁶⁸

The challenges of regulating the fuel industry raise two key issues for the regulatory framework:

- Whether there are net benefits arising from price control of the retail fuel industry, and whether regulation should be better targeted or different forms of regulation pursued.
- Whether there are other barriers to competition that, if removed, could reduce the need for ongoing regulatory intervention.

Because regulation is only an imperfect substitute for competition, it is important to apply regulation only where material problems have been identified and can be addressed in an effective way and at a reasonable cost. The ICCC's analysis suggests that there are limits on the effectiveness of retail competition in some cases. However, regulation should not be applied unless it brings benefits that outweigh its costs.

It is necessary to consider: (a) whether the costs of regulation outweigh its benefits, which includes both direct costs to the ICCC and costs of regulatory error; and (b) whether non-regulatory or less-intrusive regulatory solutions would be preferable, in the sense of delivering greater net benefits to the community.

The Review Team invites comments on whether price control under the PR Act could be better targeted. This might include, for example, requirements to target only enduring monopoly (rather than ineffective competition) for price control. Alternatively, it might require a finding of persistent excessive profits, or require a separate initial declaration inquiry into whether the industry is suitable for price regulation. These decisions could be subject to review by a third party, perhaps using appeal provisions similar to those in place for regulatory contracts.

The Review Team also invites comments from market participants regarding areas in which greater reliance could be placed on the forces of competition in the fuel industry in PNG. This might involve reducing barriers to entry, such as contractual barriers or access to land.⁶⁹ Expanded competition might

⁶⁷ For example, the ICCC received only 6 responses to a survey on retail fuel margins.

⁶⁸ The ICCC's current review commenced in March 2014 and has taken over 18 months.

⁶⁹ Both are identified as barriers, in the ICCC's reports on price control.

reduce the need for regulation.

Question 33: Is there scope for greater competition to be introduced in any segment of the market for refined petroleum products?

Question 34: Are significant costs imposed by regulation? If so, please give examples. If so, what alternative price control arrangements would reduce the costs of regulation incurred by the industry and the ICCC?

Question 35: What lessons can be learned from price control of fuels for operation of the price control regime generally?

Question 36: Would there be benefits in limiting the scope of price control to areas of enduring monopoly rather than to areas where competition might be considered ineffective? What would be the costs of this approach?

Question 37: Should more light handed regulatory arrangements apply to retail fuel supply? What arrangements would be appropriate?

Question 38: Should the appeal provisions applicable to regulatory contracts be extended to price control and price monitoring?

D. Price control: PMV and Taxi Fares

The ICCC is responsible for the regulation of PMV and taxi fares, both of which are declared services under the PR Act. The ICCC undertook its first major review of the PMV and taxi industry in 2007, and imposed price controls which expired in 2012. The ICCC completed a review in 2014 and has proposed a five-year price path for PMV and taxi fares.

The economic case for regulating PMV and taxi fares is different from the case for regulating the SOE monopolies using regulatory contracts. In contrast to the monopoly network industries, there are many suppliers of PMV and taxi services⁷⁰ and low barriers to entry into the industry. Necessary inputs such as vehicles can be acquired at relatively low cost and these costs can be recovered if an operator wishes to leave the market. Restrictions on the numbers of licensed vehicles can be barriers to entry but it appears that there are large numbers of PMVs and taxis. This should mean that the market is workably competitive. The ICCC has suggested, however, that price controls may be needed in order to keep prices below the competitive equilibrium level during periods of high demand:

[T]he Commission is of the view that while commuters may have some form of countervailing power for taxi services, they are limited to exercise such powers when services are offered during night

⁷⁰ ICCC, *PMV & Taxi Fare Review: Final Report* (December 2014), pp 39-40.

hours or when there is a high demand. As for PMVs, it appears that commuters have limited countervailing power.⁷¹

The OECD has noted that monopolistic pricing for taxis is possible even in the presence of substantial numbers of providers because of uncertainty about the price of taxis that are available now and that might be available if the first taxi is not taken.⁷²

The ICCC concluded that fare regulation is justified, and that prices monitoring would not be an effective alternative given the large numbers of operators. The form of fare regulation imposed is a CPI-X price path. This approach provides for fares to vary each 12 months with the general price level in the economy (CPI) less a specific 'X' factor which represents some degree of efficiency gain over the forthcoming period. The particular control also reflects the significant impact of the price of diesel fuel (on PMVs) and petrol (on taxis) by directly including this in the CPI-X formula. The X factor has been set at zero in the current 5 year period; that is, price increases occur in line with cost increases estimated by CPI, with no efficiency gains assumed.

The ICCC's approach avoids the need for a detailed assessment of the current costs of taxi and PMV operators. However, it does presume that existing input costs are fairly reflected in existing fares – if existing fares are too high or too low this can cause distortions. This may particularly be an issue in relation to setting different fares in Port Moresby and the regions, as costs and revenues might be quite different.

Consequently, while there may be some benefits from fare controls in certain circumstances, it is likely to impose costs on operators and could affect service.

The ICCC has commented extensively about conduct and standards in the PMV and taxi industry outside of its fare-setting role.⁷³ Many of these issues could be addressed through the new regulatory authority proposed to have responsibility for road transport.

Question 39: Is there scope for greater competition to be introduced in the market for PMV and taxi services?

Question 40: Do you consider that the benefits of price control of fares outweigh the costs? Why or why not?

Question 41: What lessons can be learned from price control of

⁷¹ Ibid.

⁷² OECD Transport Research Centre, *(De)Regulation of the Taxi Industry: Round Table No 133* (2007).

⁷³ The ICCC's concerns relate to operators not meeting service standards; taxis and PMVs operating illegally (unlicensed); taxis operating without taxi meters installed; new taxi licences not being issued; overcharging contrary to regulated fares; and anti-competitive price-fixing among operators. There is a connection here with service levels, as fares are set to recover the costs of delivering a defined service level.

PMV and taxi fares for operation of the price monitoring regime generally?

IV. CALL FOR SUBMISSIONS

The Consumer and Competition Framework Review seeks to understand the needs of PNG consumers and businesses, and how the current laws and institutions could be improved to ensure that the needs of consumers and businesses are met.

Your comments on matters raised in this Issues Paper and other related matters are welcomed. Your comments on earlier Issues Papers are also welcomed.

Please provide comments to the Review Team, by 5:00pm on **Monday 16 May 2016**, at:

telephone: (+675) 321 0400 (please ask for the "Competition Review")

email: comment@CCFReview.info

website: www.CCFReview.info