



INDEPENDENT CONSUMER & COMPETITION COMMISSION

REVIEW OF FLOUR PRICES



DRAFT REPORT

28th February 2005

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The Independent Consumer and Competition Commission (Commission) is a statutory body, established under the provisions of the *Independent Consumer and Competition Act, 2002*. The Commission has been given responsibility for the promotion of competition and fair-trading, the regulation of prices for certain goods and services, the protection of consumers' interests, and other related purposes.

The Commission has three Commissioners:

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FOREWORD

The Commission is responsible for the regulation of the prices of “**Flour**” and flour products. In Papua New Guinea (PNG), flour grain is imported, milled and distributed by two companies, namely Associated Mills Limited (AML) and Tablebirds. AML is a subsidiary company of Goodman Fielder International (PNG) Limited (GFI) and manufactures the **Flame** and **Mothers Choice** flour brands while Tablebirds is a subsidiary of Mainland Holdings Limited (MLHL) and manufactures flour under the **3-Roses** brand.

Briefly, the current regulatory arrangements under the *Prices Regulation Act (Chapter 320) (“the Act”)* cover the following areas:

- Review of Flour prices, undertaken on a bi-monthly basis and directed at consideration of exchange rate, Australian Wheat Board (AWB) wheat prices and international freight cost changes;
- Annual reviews of the Annualised Non-commodity Costs such as mill run, labour, overhead manufacturing costs and international freight and handling charges; and
- The setting of a fixed retail and wholesale margin to be applied to the sale of flour and flour products.

Under the provisions of Section 25A (6) of the Act as amended, the Commission has decided to undertake a major review of the pricing regulatory arrangements applying to flour and flour in its various variant forms and packages. This review will *inter alia* consider whether the present price control arrangements for flour should continue to operate in their present form or be varied, or whether the price control arrangements should be terminated.

To assist the Commission in making informed decisions as part of the review, the Commission has sought submissions on the Flour industry pricing review from all interested parties including the local flour millers, biscuit companies, bakeries, hot-bake shops, household consumers and other interested parties.

As part of the public consultation process, the following stages of the flour review still need to be completed before a final review is released:

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|--|--------------------------------|
| ▪ Release of Draft Report | 28 th February 2005 |
| ▪ Receipt of Submissions on Draft Report | 11 th April 2005 |
| ▪ Release of Final Report | 31 st May 2005 |

This Draft Report is intended to indicate the Commission’s views on the submissions that have been received and to provide the Draft conclusions and determinations of the Commission on the future of price control for flour.

Submissions are invited on the Draft Report. These submissions will be available for public inspection unless the Commission agrees that all or part of an initial submission should remain confidential. However, in accordance with the provisions of the ICCC Act 2002, it is intended to make this process as transparent as possible, and to this end, submissions would normally be available for public inspection unless there are exceptional commercial-in-confidence reasons why submissions should be held confidential.

Submissions to the Draft Report should be received by **11th April 2005** and should be directed to:

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1.1 Background to the Review

The methodology that is currently being used by the Commission to set prices for “flour” and associated packaged products was originally devised in 1991, and has basically remained unchanged since that time. The current methodology has created some difficulties in administration. Furthermore, the process whereby decisions are taken on price adjustments has not been as transparent as is envisaged under the ICCA Act. Notwithstanding agreed procedures for price evaluations, reviews have been more focused on current costs and not other factors such as new investment requirements, service standards, and a balancing of the interests of the regulated business and consumers as is now required under Section 21(2A) of the amended *Prices Regulation Act (Ch. 320)*.

In addition, circumstances have changed in the flour industry prompting the need for a review to decide whether there is a need to continue, amend or terminate the current regulatory arrangements. The objective of this review should be a consideration of whether price regulation is required for flour, and if so, what is a transparent, accountable and consistent pricing system beneficial to both consumers and the Flour Industry, and contributing to the economic development of PNG.

The Draft report also considers the question of the Wholesale and Retail margins that have been set under the current price control regime. These margins were set at 11% and 10% for wholesale and retail trade respectively. However, whether these margins are still appropriate needs consideration.

1.2 Legislative Requirements

The Commission is undertaking this review in accordance with the amended provisions of the *Prices Regulation Act (Ch. 320)*. In undertaking this review, the Commission is to have regard to the following:

- Sections 10, 20A, 20B, 21, 25A, 25B, 25C and 32A of the Act;
- Confidentiality and public disclosure provisions of the Act on information received in submissions; and
- The current and prospective outlook for the Flour Industry in PNG.

Under Section 10 of the Act, the Government through the Minister for Finance and Treasury has declared flour and the following related flour product differential packaging for price control purposes:

- Bakers Flour
- Cracker Flour
- Biscuit Flour

- Soft Flour
- Wheat Flour
- Wholemeal Flour
- Self Raising Flour

The ICCC Act made a number of changes to the Prices Regulation Act (Ch 320) under which the prices for flour and its differential packages and products are controlled. In particular, the Prices Regulation Act was amended in the following ways:

- A new section, Section 20A was included which requires the ICCC to publicly notify its intention to determine a Pricing Order under Section 21 of the Act
- Section 21 (2A) (*see Attachment*) was added which introduces specific requirements on the ICCC in terms of the matters that it must consider when making a Pricing Order, including encouraging greater efficiency, ensuring an appropriate rate of return and appropriate safeguards for quality, reliability and safety for the supplying industry, and protecting consumers from the misuse of market power by suppliers of declared goods and services.
- Sections 25A, 25B and 25C were introduced which specify the process by which a review of a Pricing Order can be undertaken including the deadlines that must be met, the requirement for the Commission to publish details of its decisions, and the form of a decision that can be taken by the Commission as a consequence of such a review.
- Section 25A (6) allows the Commission of its own accord to initiate a review.
- Section 25C (3) specifies that in response to a review, the Commission may determine to:
 - continue to apply the existing price control arrangements in their present form,
 - vary the existing price control arrangements, or
 - terminate the present price control arrangements.
- Section 32(A) provides for the declaration of goods or services for price monitoring purposes as an alternative to price control. This is a less stringent form of regulation, which effectively allows the Commission to oversee the prices being charged for the declared goods or services, without requiring the industry to incur the cost of a more heavy-handed direct price control approach.

Under a *prices monitoring arrangement*, if it is evident that price movements are not reflective of appropriate competitive market benchmarks, the Commission can recommend to the Minister for

Treasury that the relevant goods or services be declared under Section 10 of the Act for full price control purposes.

These amendments to the Act increases the flexibility of the Commission in terms of its overall price control activities, and allow for appropriate mechanisms to be developed and implemented that meet the objectives of the Government in terms of price control while minimising the cost of undertaking the price control tasks, thereby ensuring that price control does not of itself create other unintended adverse economic consequences.

1.3 Review Process

This current review was initiated under the provisions of Section 25A (6) of the Act. The process to be followed by the Commission is to facilitate public comment and transparency at all stages of the review.

The process involves the following broad stages:

- Public announcement of inquiry & invitation for submissions to be made to the Commission (*see Attachment*);
- Release of an Issues Paper discussing aspects of the inquiry and the major issues that the Commission believes need to be considered;
- Release of a Draft Report and the inviting of submissions on that Draft Report;
- The possible holding of Public Hearings on the Draft Report; and
- Release of the Final Report and Determinations.

The remaining timetable for the review has been provided in the Forward of this Draft Report. Copies of submissions received by the Commission (unless treated as confidential) will be available for public viewing at the Commission's office on a 'Public File' or copies can be obtained from the Commission at a nominal cost for photocopying. The Final Report of the Commission is also a public document and can be obtained from the Commission's office once it is released.

The flour industry in PNG is comprised of local millers and importers of flour, premixes and bread components that supply flour and flour in its variant forms to the PNG market.

2.1 Major Players in the Flour Industry

In PNG there are two major players in the flour industry namely, Associated Mills Limited (AML) and Tablebirds.

- AML is a subsidiary company of Goodman Fielder International (PNG) Limited (GFI), which owns 74% of AML's shares. The remaining shares are held by Melanesian Trustee Services Limited on behalf of the Pacific Balanced Fund. AML is the major participant in the flour industry, holding more than 60% of the domestic market share in PNG.

AML operates two flour mills, one in Port Moresby and the other in Lae, processing and distributing flour under the brand names "Flame" and "Mothers Choice" to all parts of the country. AML's products range from a 1kg pack to a 50kg bag and are sold for household consumption and for commercial use such as by biscuit companies, food processors and bakeries.

GFI employs 500 people who work in the flour mills in Lae and Port Moresby.

- Tablebirds is the other major player in the flour industry in PNG and is wholly owned by Mainland Holdings Limited. The company has a flour mill in Lae producing flour under the "3-Roses" brand for distribution and sale in PNG. Tablebirds also operates a chicken growing and processing facility, producing chicken products under the brand name "Tablebirds". The milling operation operated by Tablebirds also produces animal food products such as poultry food pellets.

AML held a monopoly of the PNG flour market for many years until Mainland Holdings Limited established a new flour mill in 2000 through its Tablebirds subsidiary. This operation has since provided competition to AML and currently holds about 30% of the market with an objective to increase its share to 35% of the total flour market in PNG.

Tablebirds mills and sells flour in packaging sizes ranging from 1kg to 50kg bags for various consumers including food processors, bakeries, biscuit factories, bake shops and households.

Other suppliers to the domestic market are essentially importers. As discussed further below, there has been a gradual growth in imported

flour products over recent years as import barriers have been lowered and various flour based bakery ingredients have been imported duty free as they fall outside the existing tariff definitions. While directly imported supplies represent a small component of the total market (around 10%), it has been a growing part of the market.

Under the provisions of Section 25C (3) of the Act, the Commission is required when undertaking a review of this nature to consider whether to:

- continue the existing price control arrangements in their present form,
- vary the existing price control arrangements, or
- terminate the present price control arrangements.

The first step in this review process therefore is to consider whether or not some form of price regulation should be retained. For the Commission to form a view on this matter it must address issues surrounding the extent to which competition exists in the relevant market, the degree of countervailing power consumers hold, and the opportunity for new entrants to enter the market or substitute products to compete against declared goods.

In the following sections the Commission addresses these issues.

3.1 Import Competition

PNG does not produce its own grain crops. Rather, it imports grain or flour products milled from grain. As a consequence, access to international markets for the supply of flour or grain for milling into flour products represents the primary source of these products for the domestic market. Barriers to entry for flour or grain will significantly influence the degree to which competition and contestable market behaviour can operate in PNG.

To protect the local flour milling industry in its infancy stages the Government placed a tariff on the importation of overseas flour products.

Initially a 40% tariff was imposed on imported flour to support the local industry. However, that tariff was reduced in 2003 from 40% to 20%. A further reduction in the tariff is expected as part of the Government's tariff reform program. As a consequence of the reduction in the tariff to date, there has been growing competition for the supply of flour products in the domestic market, particularly for the supply of product as input to other manufacturing activity (e.g. bakeries). This has been particularly evident in the area of imported premix flour used to make bread. The two domestic millers, AML and Tablebirds compete vigorously with each other and with flour premixes and bread ingredients imported free of duty from Fiji, Solomon Islands and Europe to protect their share of the market in PNG. This competition is primarily directed at the larger industrial users of flour products.

A further reduction in tariff protection is expected to occur by 2006 when tariffs will be reduced to 15%. This will further open up the domestic

market to competition and will facilitate more imported flour and premixes entering the PNG market.

While imported flour still carries a tariff of 20% (to be reduced to 15% in 2006), flour can be imported duty free from the Solomon Islands and Fiji, and premixes are free of duty from all locations. With the emergence in the domestic market of a number of smaller bakeries supplying the demand for bread across the country, there has been a fragmentation of one of the largest single consumer groups for flour in the country, namely the larger bakeries. The two domestic flour millers can no longer be assured of this part of the market, particularly as bakeries take to importing their flour or flour mix needs directly from overseas.

For this part of the market there has been a significant change in the competitive situation since price regulation was first introduced, with viable alternative sources of supply being available and acting as a constraint on the market power of the two domestic flour millers.

However, for the domestic household sector, there has not been as a significant change in the level of competition. The primary products consumed by this sector are the plain and self-raising styles of packaged flour which still attract a tariff of 20% (free from Fiji and Solomon Islands). While the reduction in this level of protection from 40% to 20% (and the further expected reduction in the tariff to 15% in 2006) increases the potential for competitive imports to act as a constraint on any use of the market power held by the two domestic millers, it does not represent as considerable a constraint as that evident within the market for flour products used by bakeries.

For other manufacturers and commercial consumers of flour, the opportunity to avoid the current 20% tariff is not as great as for consumers of bakery mixes. These larger commercial consumers do have some market (countervailing) power in terms of their ability to negotiate between the two domestic millers. However, it is only as the tariffs are further reduced that this consumer group will have further viable options in terms of overseas supply at non-tariff protected competitive prices.

3.2 Competition between the Two Local Millers

Prior to 2000, there was only one domestic miller and with the protection of a tariff of up to 40%, that miller held a dominant position in the domestic market. With the establishment of the second miller in 2000, that new miller has captured around 30% of the domestic market.

The industry has argued that there is competition in the PNG market for staple food including flour. They have argued that consumers have a variety of choices for staple foodstuff, and flour products compete with other staple foods such as rice, tinned fish, tinned meat, frozen food, noodles and biscuits. The industry believes therefore that it is constrained in its pricing behaviour by the availability of alternative foods that consumers can purchase.

It is argued that to be competitive, local producers have to deliver products of high quality and ensure that the price is fair and competitive. The industry argues that as tariff rates have fallen the flour industry has had to make changes to their activities to deliver a better quality product, while at the same time improving manufacturing efficiency and lowering costs to achieve prices that meet market demands and respond to consumer expectations.

The industry argues that this competition with other foodstuffs extends to alternative foods such as subsistence production.

The Commission has noted the change in the domestic industry since the commencement of the Tablebirds mill in Lae and the reduction in tariffs on flour. While there has been a gradual reduction in the share of the market held by AML as Tablebirds has captured about one-third of the total market and imports have taken around 10% of the market, the overall market is still held predominately by the two domestic millers which continue to have the benefit of a 20% tariff. The emergence of competition for flour supplies to bakeries and the like will ultimately benefit consumers in terms of the costs charged by the final product manufacturers. There is a danger however, that the two domestic millers will use their market position to recover any fixed or operating costs that are no longer recoverable from bakery customers, from other consumers and in particular the household sector. The present price control mechanism potentially allows this transference of costs from one customer group to another and although this may not be the intention of the millers themselves or of the price control mechanism, there is the opportunity at least for this form of cross subsidisation to occur.

The experience from the entry of a new miller into the domestic market suggests that there are potentially opportunities for further new entry and increased contestability in the domestic market if prices (and returns) generated by the domestic industry reach 'monopoly profit' levels. However, there remain constraints in terms of the extent to which the level of competition between the two millers (and any possible new entrant, be it another domestic mill operator or imports) will flow through to the household sector in particular. For example, while the two local millers handle some of their own distribution/wholesaling activities, they are still dependent on a fragmented retail sector for the supply of product to final consumers. Within the larger centres of Port Moresby and Lae and to a less extent in other larger towns such as Madang, Mt Hagen, Goroka and Rabaul/Kokopo, there is a degree of competition between retailers. This is limited in these centres only by the extent that household consumers are able to access transport to travel to the different retail shops that exist in these centres.

This competition between retail outlets (supported by advertising in daily newspapers, on radio or on TV) serves to place a cap on the margin that can be applied at the retail level on flour products. At the wholesale level also, there is evidence to support the view that in these larger centres there is competition between wholesalers in the supply of product to the various retail outlets.

However, in the smaller towns and remoter locations, there is not the same degree of competition between retail outlets or possibly between wholesalers. This is not an issue that is exclusive to flour, but is common to other products that are retailed outside of the major centres where there is some degree of competition between retail outlets.

The anecdotal evidence is that retail outlets in remoter areas, particularly small roadside stores and bush stores will charge what the market will bear. To the extent that alternative sources of supply are available (for example, villages arranging their own bulk supply and transport from a larger centre or town) there is a limit to which the smaller trade stores can charge. They will normally seek to maximize their price to ensure cost recovery (including possibly the high cost of transport) while at the same time keeping prices within limits that the local household consumers can afford to pay.

The industry has argued that flour competes with other foodstuffs and that as such, the price of these competing goods places a 'market' cap on the price that can be charged for flour. To the extent that consumers must make a choice between whether to spend their limited cash on say tinned meat or on flour, or whether they can afford to buy flour or alternatively rely on traditional starch type products such as taro and yams, there is a limit to what price manufacturers, wholesalers or retailers can charge for flour. However, to argue that these alternative foodstuffs represent competitive alternatives that will ensure the price for flour is kept at a level commensurate with the efficient economic cost of production would be to misinterpret the evidence. Consumers will always have to make choices between alternatives, and these alternatives range from, for example, clothing to housing to foodstuffs to entertainment to education to medicines. Within these various choices that have to be made given the limited financial resources available to most consumers, there may be some close substitutes, and therefore the price of one might influence the price of the other. In the PNG context both rice and flour are currently subject to price regulation. Other potential substitutes such as taro, kaukau, yams or English potatoes are not subject to price regulation but are heavily influenced by seasonal patterns.

The Commission accepts that there has been greater contestability in the flour market with the advent of the second miller. It does not accept however, that the price of flour particularly for household consumers, is kept at economically efficient cost reflective levels by the existence of alternative foodstuffs (with the possible exception of rice or similar high starch products). Indeed, the Commission notes with concern that notwithstanding the emergence of greater contestability at the manufacturing level, the retail (and possibly wholesale) activity beyond the larger centres exhibits very little competitive tension.

3.3 Countervailing Powers of Consumers

The countervailing powers of consumers are an important aspect to consider in reviewing the need for price regulation.

The largest individual consumers of flour in PNG are local businesses including bakeries and processed food manufacturers who use flour based products in their production processes. Potentially these consumers hold significant countervailing power that could counter any market power that might be held by the local flour millers or flour suppliers. Thus, prices for flour products for these consumers could be kept in check by the respective powers of the suppliers and consumers. With the further anticipated reduction in tariffs and continuing zero tariffs on bakery premixes, this countervailing power can be expected to remain strong.

However, the Commission is also conscious of the large group of consumers, mainly domestic households who hold very little countervailing power in terms of the prices charged for flour products. These consumers have little countervailing power in terms of prices charged for flour beyond the power not to purchase flour if some form of substitute is available. However, for many domestic uses, including the making of scones, there is no ready substitute for flour.

Thus, with little or no countervailing power, the smaller consumers, namely domestic households, find themselves in a position where they cannot individually act to limit any market power held by the two domestic millers.

3.4 Commission Draft Findings

The Commission is required to come to a view as to whether some form of price regulation is still required for flour. From its examination of the market and the developments over recent years, the Commission has found that:

- the market for the supply of flour and flour products has undergone some reform in recent years in terms of the level of competition, but is still heavily influenced by the two domestic millers;
- although the tariff barrier to imports of flour is expected to fall to 15% by 2006, it is not expected to be removed completely over the next five years;
- large commercial consumers of flour and flour products have access to a range of alternative suppliers of flour including the importation of flour premix products at zero tariff rates. They are also able to exercise a degree of countervailing power in their negotiations on price and supply, effectively negating some of the market power of the two millers;
- smaller consumers, primarily households, have little countervailing power and are effectively price takers;
- the market for household consumers is further complicated by the limited retail competition in areas outside of the main towns,

thereby further reducing contestability for this sector of the market.

The regulation of prices at the mill door stage and the regulation of the wholesale and retail margin have less importance for that sector of the market comprised of larger commercial customers. Essentially these customers are able to negotiate on similar terms with the domestic flour millers and have access in many instances to offshore imported supplies.

Thus, notwithstanding that for these customers the cost of flour is an input cost to their final output (be it bakery products or other processed foodstuffs), there is less need for direct price regulation for these consumers as a single group.

However, for smaller consumers, and in particular domestic households, there is little opportunity for alternative imported supplies to meet their needs. Furthermore, they hold little if any countervailing power in the domestic market. There is also a danger that given the different market conditions in this part of the market, there might be a temptation for the domestic industry to transfer costs that it cannot recover from the more competitive end of the market servicing larger consumers to the household sector.

Smaller consumers also face a market with limited wholesale and retail competition. While this may not be unique to flour, or as great a problem in the larger urban areas of Port Moresby and Lae, it remains an issue for a large proportion of the population.

The Commission considers therefore that there is justification on competitive market and equity grounds to continue some form of price regulation for flour at the mill door, wholesale and retail sales levels. The Commission believes that this regulation will need to encompass both parts of the domestic market for flour, that is, the larger commercial consumer end and the household consumer end. However, to minimise the cost of regulation, particularly in instances where the evidence points to strong, active competition and contestable activity between suppliers and the existence of countervailing power, the Commission considers that less intrusive options need to be considered to the extent possible.

Draft Determination 1

The Commission proposes to continue price regulation of flour and associated products with this regulation to apply at least at the mill door stage, as well as on the wholesale and retail margin.

This chapter discusses the options available to the Commission in terms of the form of regulation that could be used for flour pricing and the relative merits of either price control or price monitoring

Having concluded that price regulation of flour should continue, the Commission must decide the most appropriate way of applying that regulation. If price monitoring is adopted whereby suppliers, wholesalers and retailers set their own prices, the Commission would simply compare these prices with an appropriate benchmark with the threat of full price control should prices be set above levels indicated by the benchmark. This is a less intrusive form of regulation, although it requires access to some form of benchmark that can be readily obtained and used for price monitoring purposes. Also, with a large number of small retail outlets and limited competition between these retail outlets in most instances, there may be little incentive for an individual retailer to keep the retail margin within the bounds set by the benchmark. This could also create monitoring and compliance checking problems for the Commission.

If a price control mechanism were to be used, the Commission would need to determine the appropriate level of prices and the mark-up margins, and the approved process whereby changes in the margins could be made. The process of reviewing the prices and the margins in response to an industry request would necessitate a lengthy and detailed process whereby the Commission would effectively need to model the efficient costs of supply. This could be a costly and intrusive approach especially for small individual retailers.

The Commission could adopt a 'price path' approach whereby the Commission would calculate and specify an appropriate formula linked to some appropriate indicator of cost changes (and incorporating some form of efficiency adjustment). This formula could then be applied over a number of years without the need for a full price review.

This form of regulation would give incentive and stability for future planning purposes while at the same time ensuring that consumers are not required to pay any more than efficient costs. It also has the advantage that while the initial price path process is data intensive, the price adjustment mechanism over the price path period is relatively simple, cost effective and non intrusive.

4.1 Existing Form of Regulation

Under the existing price control regulatory arrangements, there is essentially a five-step process:

- Review of the cost of imported grain with adjustments to take account of the change in the FOB price for grain, shipping and handling costs, and exchange rate variations.

- This review process is undertaken on a monthly basis with changes in the price of flour only being passed through to consumers when there is an overall change in the landed cost of grain of 5% since the last adjustment.
- The ‘pass through’ of milling, packaging and shipping costs for the local flour mill operations with the adjustment to the components of these costs being made on an annual basis using the previous year’s cost components to set the current year’s production and packaging costs, and the most recent freight costs from Lae and Port Moresby to the Main Ports of Rabaul, Madang and Wewak being used to set the current year’s freight charges for main port delivery.
- Conversion of the overall net adjustment in milled flour costs (including main port delivery costs) into prices for individual types and package sizes for flour.
- The inclusion of an 8% increase to base prices for sales of less than 10 tonnes.
- Addition of an 11% wholesale margin and 10% retail margin to the into-store price to determine the final retail price.

The review of imported grain prices into PNG is supported by information provided by the Australian Wheat Board (the AWB Card Price), and shipping and associated handling cost quotes for the transport of grain from Brisbane to Port Moresby. These charges are converted from US dollars and Australian dollars to Kina based on the monthly average exchange rate for the period concerned. The Commission receives this information on a monthly basis as provided by AML, the largest supplier into the PNG market. An average price of milled flour in PNG (including main port coastal freight charges) is calculated using the annually adjusted mill overhead and labour charges plus a profit mark-up. If this average cost per tonne increases or decreases by 5% or more over the cost at which the last price adjustment was made, a new price will be set. This process avoids frequent fluctuations in price that can be influenced by seasonal conditions in the supply and availability of grain and in exchange rates.

The annual review of the various milling costs, including the waste costs (and waste recovery), overhead costs, and labour and energy costs are based on information supplied to the Commission by AML of its actual costs in the previous year. This information is supported by a ‘procedures’ audit undertaken by Deloitte Touche Tohmatsu. The information provided by AML incorporates manufacturing costs, including fixed and variable costs, and depreciation, but excludes raw material costs including grain and packaging costs. These milling and overhead costs are applied to the total volume of throughput of flour to determine a cost per tonne of flour milled. The various milling and overhead costs (that is, costs excluding grain, additives and packaging costs) account for approximately one-third of the total per tonne costs that are incorporated into the price setting mechanism. The Commission has assessed these costs on an annual

basis, although no attempt has been made to benchmark the costs in some way. The packaging and additional additive costs (or savings for wholemeal, or self raising flour by comparison to standard flour) are not provided in separate detail to the Commission.

The wholesale margin of 11% and the retail margin of 10% have not been subject to any form of periodic review and essentially have been adopted as a 'rule of thumb' without any form of detailed cost investigation.

4.2 Issues with the Current Price Control Mechanism

There are a number of issues that are raised by the current price control mechanism, particularly in the context of the requirements of Section 21(2A) of the Prices Regulation Act.

Under the provisions of this section of the Act, the Commission is required to have regard *inter alia* to the following:

- The need to protect consumers of declared goods from the misuse of market power;
- The cost of producing declared goods;
- The desirability of encouraging greater efficiency in the production and supply of declared goods;
- The need to ensure an appropriate rate of return on any investment in the production or supply of the declared goods;
- Quality standards;
- The impact on inflation of a price control order; and
- The economic and social impact of a price control order.

The need to achieve a balance between the interest of the suppliers/manufacturers and consumers is embodied in these legislative requirements.

The Commission must therefore consider what is the best mechanism to achieve these particular objectives.

The Commission has in other recent pricing decisions sought to achieve these objectives by linking the determination of regulated prices with a determination of the efficient costs of producing or supplying the regulated goods or services. This has allowed the Commission to differentiate between the actual costs that a manufacturer/supplier may incur, and the 'efficient/best practice' costs that apply to the provision of the regulated goods or services. The prices that consumers are required to pay therefore should not include inefficiencies or inappropriate cost pass-throughs that might otherwise occur in a market where there is no regulation and the supplier has a degree of monopoly market power.

The Commission has noted in submissions from the milling industry, that the industry has acknowledged that it has had to improve its efficiency in recent years as the tariff rate has fallen from 40% to 20% and as commercial users, particularly bakeries have taken advantage of the opportunity to import flour mixes free of duty. The industry has effectively acknowledged that increasing competition has forced efficiency improvements that the existing price setting mechanism has failed to deliver.

Notwithstanding these efficiency improvements, the Commission has still received submissions to the effect that flour prices in PNG are still too high by international standards. As noted in one submission:

*'There is significant evidence that flour prices are a little too high compared to international prevailing competitive prices. This has major implications on biscuits and noodles which must compete with products on an international basis. Both industries are feeling severe competition and are handicapped by higher input cost on flour compared to overseas competition.'*¹

The cost impost that this submission in part refers to is a reflection of the continuation of the existing tariff on imported flour. This is a Government decision and the Commission is not able to alter this decision. However, it also raises questions for the Commission in terms of its legislative obligations to encourage greater efficiency in the production and supply of declared goods. To the extent that the industry has been able to achieve efficiencies in response to greater competitive pressure, so the Commission has to consider to what extent further efficiencies can be achieved and passed through to consumers of all types and sizes.

The Commission makes the following observations in relation to the existing price control mechanism:

- by far the largest component of flour costs is the cost of imported grain, and the present mechanism allows for a pass-through of the costs based on a verifiable arms-length international price for grain;
- the milling cost recoveries while supported by a 'procedures' audit, are not subject to any assessment of best practice efficiency, and there is evidence in the submissions received from the industry that costs have been misallocated in previous years;
- the allocation of fixed costs for milling have been made on a 'per tonne milled' basis, but as volumes have declined (particularly with the introduction of a second miller and increased competition from overseas) these fixed costs have been allocated over a smaller volume of output and accordingly have been

¹ Lae Biscuit Company Ltd, Submission to Inquiry, 18 June 2004

increased on a per tonne basis notwithstanding the increase in domestic competition;

- the 'profit mark-up' is calculated on a percentage of operating costs (that is, grain costs, plus transport plus milling costs) basis and thus increases in absolute kina value terms with increases in costs, thereby providing no incentive for the millers to improve their efficiency or seek to reduce costs;
- the percentage profit mark-up is not fully substantiated;
- the packaging cost are neither benchmarked nor verified from independent sources;
- the 8% additional charge on base prices for sales of less than 10 tonnes appears to have no justification as the costing process used to arrive at the base price effectively covers all the costs incurred by the milling companies as derived from their financial accounts.

The approach that has been adopted to price control under the current arrangements has effectively been an acceptance of the costs as reported by the milling companies (and in terms of the surcharge for sales of less than 10 tonnes, an additional allowance which is above and beyond the cost of the businesses). These are costs that have been incurred by the companies with little or no incentive from the regulatory process to address or achieve overall costs efficiencies. On the basis of the submissions from the industry itself, the one factor that has driven the industry to seek to achieve efficiencies in recent years has been the emergence of another domestic miller, and the growth in import competition. The price control mechanism does not appear to have had any effect in this area.

In terms of the requirements of Section 21(2A) of the Act, the Commission does not believe that the present mechanism meets the legislative requirements on the Commission. The Commission believes that it is appropriate therefore that in any regulatory arrangements that are adopted as a consequence of this current review, it should seek to have more details provided by the milling companies on their costs, and further supportive argument as to the justification of these costs from an overall operating efficiency perspective (while recognising the operating circumstances in the PNG context). As noted above, the largest part of the cost base reflects prices set by an internationally operating market, and thus provides a benchmark of the type that the Commission favours. However, the Commission is concerned that the same degree of benchmarking rigor has not been applied to the other costs that are ultimately included in the price charged for flour and flour products of the type subject to price regulation.

4.3 Regulatory Options

Under the provisions of Section 25C (3), the Commission, having decided to continue with some form of regulation, must decide whether to continue with the present form or vary the form of regulation. As discussed above, the Commission has a number of concerns with the present form of regulation, and thus needs to consider its options in terms of how this form of regulation should be varied. The Commission essentially has two options that it must consider. These are:

- some form of monitoring of prices, (Section 32A), or
- some form of direct price control (Section 21).

These options will be discussed in more detail below.

4.4 Price Monitoring

Price monitoring is a less intrusive form of price regulation. Essentially, it relies upon the ability of the Commission to assess movements in the price of the declared good or service against the movement in some independent price (or cost) indicator. If the Commission determines over a period of time that the prices of the declared good or service are increasing at a faster rate than the indicator used (or declining at a slower rate than the indicator if prices are declining), then the Commission can request an explanation from the regulated entity or industry, and if not satisfied with the explanation given, can recommend to the relevant Minister that prices be declared for the more information intensive and intrusive direct price control form of regulation.

The Commission has previously used price monitoring for its regulation of ice cream prices and petroleum products prices ex the Napa Napa refinery, and the transportation charge for petroleum products ex the main port and outport fuel terminals. To date this has proved to be a satisfactory form of regulation for these industries.

In response to the Issues Paper, the flour milling industry has proposed that some form of price monitoring arrangement be used to regulate the industry.

*'AML believes that the best method of ensuring ongoing growth of competition in the flour market, ongoing improvements in quality and efficiency while ensuring that PNG consumers are protected from unjustified price movements is to adopt a 'price monitoring' regulatory model.'*²

In its submission, AML outlines how it proposes a price monitoring arrangement would work.

² Submission from Associated Mills Limited, June 2004

*'It is proposed that a formula be adopted that reflects movements in commodity prices and exchange rates and that this formula would be checked and updated by the manufacturer monthly. This component of the formula would follow a 'building block' approach based on published Australia Wheat prices. Furthermore, to reflect increases or decreases in other costs, it is proposed a cost plus approach be adopted. This formula would form the basis of calculating ex-factory prices, and would be available for audit by the ICCC upon request.'*³

The proposal by AML is along similar lines to the current regulatory mechanism, including a provision that prices would only be adjusted if the mechanism resulted in a price change of greater than 5%, and the cost plus components relating to the domestic milling activity would only be revised annually.

The 'price monitoring' proposal by AML goes beyond a monitoring process that is linked to a comparison of price movements against other cost indicators. It requires the Commission to agree to the cost pass-through of domestic milling activities. As noted above, it is precisely at this point where the Commission has some difficulty with the existing price regulation arrangements. These domestic costs represent about one-third of the ex-factory/main port price and are the area of cost more likely to be reflective of domestic production efficiencies or inefficiencies.

However, the proposal does incorporate a price/cost monitoring process for the imported component of domestic flour prices, that is, landed grain costs. This represents two-thirds of the main port ex-factory price of flour and the proposal to use a price monitoring mechanism for this component is similar to the approach adopted by the Commission for petroleum products pricing.

Tablebirds has supported the adoption of a price monitoring approach. Similarly to AML, Tablebirds has proposed that the Australian Wheat Board data (adjusted for exchange rate changes) be used to monitor the movement in imported grain costs. For the domestic cost component (that is, domestic production labour, packaging and other local costs), Tablebirds has proposed a CPI based adjustment to reflect movement in underlying costs.

While there is merit in the use of Australian Wheat Board prices as an independent indication of movement in the grain prices, the Commission has more difficulty with the monitoring arrangement for the domestic cost component. The proposed industry approach embodies all the problems of the existing price control arrangements, namely:

- inability to benchmark the domestic cost component against any independent cost indicator;

³ AML Ibid

- inability to determine whether the current domestic cost component in value terms is the appropriate starting point for monitoring future price changes;
- reliance upon a 'cost pass-through' arrangement for the domestic component which allows for price increases when demand falls and fixed costs are spread over a smaller volume output;
- failure to provide any incentive for investment in cost cutting efficiency improvements in the domestic activities as these cost savings will be immediately passed on to consumers as part of the annual 'cost base' resetting arrangement for the domestic cost component.

The implied use of CPI to adjust the domestic cost component as suggested in the Tablebirds submission provides a possible solution assuming that there is no other adjustment to the domestic cost component other than a prior agreed cost indicator (be it CPI or possibly some form of $CPI \pm X$ formula to take into account *inter alia* efficiency savings over time). This is the approach that the Commission has used for the petroleum industry, where the domestic distribution and retail margins will be adjusted annually using a $CPI-X$ formula. In both cases the Commission has set the initial kina value of the margin, and this will be adjusted using the $CPI-X$ formula developed using a five year financial model of the relevant sector.

An alternative price monitoring arrangement would be to link the movement in the price of flour products with the movement of similar products in some other indicator country. As most of PNG's grain imports come from Australia, movements in prices of indicator flour products in Australia could be used to monitor movements in the price of flour products in PNG. An adjustment mechanism would be required to account for changes in the exchange rate between the two countries to reflect the impact of exchange rate movements on the cost of grain imported into PNG.

The advantages of this method would be:

- its relative simplicity – there is no need to analyse the underlying cost of milling activities in PNG;
- its ability to reflect efficiency savings in Australia in terms of price movements in PNG; and
- the independence of the indicator that would be used.

Whatever monitoring approach used, the Commission would need to determine an initial starting point for prices for flour products in PNG. If the monitoring arrangements are limited to the imported price of grain, then it is possible to calculate an average grain price based on the Australian Wheat Board price. However, the Commission would need to determine a kina value for the domestic production activity.

If a monitoring approach is used for the total price for flour, the Commission would need to determine a total price for flour products which would then be monitored against an agreed cost indicator.

4.5 Price Control

A price control mechanism will necessitate the Commission setting the price for individual flour products. Essentially this is the process that is currently operating. However, as noted in Section 4.2 above, there are a number of drawbacks with the current price control arrangements.

A price control mechanism is not favoured by the milling industry itself. However, in submissions from consumers, there appears to be support for a continuation of direct price control.

‘Maximum prices on flour remain an important tool against abuse of market power.’⁴

The adoption of direct price control would involve a three step process, namely:

- Determination of the cost pass-through for imported grain.
 - a mechanism already exists for determining this component of total cost, and this mechanism could be retained with monthly updating of cost movements based on Australian Wheat Board data.
- Determination of an initial cost and then mechanism for annual adjustment of local milling and packaging costs.
 - the Commission does not favour a simple ‘cost pass-through’ approach based upon actual costs (although the allowable costs would need to include not only efficient costs but costs peculiar to PNG)
 - packaging costs are included in this step as these also need to be linked to some form of verifiable efficient cost
- Allocation of costs across product and packaging types.
 - a verifiable cost allocation process needs to be determined
 - at both this stage and the previous stage, the determination of demand volumes is an important input

The Commission is satisfied that a cost determining mechanism of the type currently in place can be used to determine movements in the grain input costs. Consideration could be given to the ‘5%’ rule in terms of when

⁴ Submission from Lae Biscuit Company

changes in price could occur. These are essentially matters that can be assessed once the remainder of the mechanism is understood and seen to be functional.

In terms of the second and third steps as outlined above, the data requirements become more extensive. Desirably to achieve an 'incentive' form of regulation which rewards the industry for improvements in its efficiency but penalises it for being inefficient (in much the same way as the competitive market operates), a price control mechanism that operates over several years would be desirable. The Commission has adopted five year price paths for some industries (eg. petroleum, post, water) and ten year price paths for other industries (eg. electricity, telecommunications). Whatever period is adopted, the Commission has to form a view as to what might be the level of efficient production costs over the length of the regulatory period.

Any form of incentive regulation also has to make allowances for projected new investment during the regulatory period and changes in demand. Projections of these items would also be required for incorporation in the financial modelling of the price paths. In submissions made to the Commission, the milling industry has not foreshadowed any significant new investment over the next five years. However, in evidence submitted by AML, it is evident that there has been a reduction of production throughput by that miller as a result of the commencement of the operations of the Tablebirds mill and the gradual decline in the tariff and emergence of other import competition. Changes in the volume of production by individual mills complicates the allocation of fixed costs on an individual factory basis creating anomalies in terms of the calculation of average costs of the type discussed previously.

It has been suggested in submissions to the Commission that the price path covered be set on the basis of an annual adjustment for CPI changes. The Commission supports the concept of underlying legitimate cost increases being built into the price path. However, it should not be assumed that the full effect of inflation should be allowed to pass through in this way. Although the milling industry has not foreshadowed any new efficiency improvement initiatives over the next five years, it should be expected that there will be at least some efficiencies achieved. This would therefore suggest that any CPI based adjustment should include a factor for efficiency gains:- a CPI-X adjustment rather than the full CPI adjustment.

The setting of the initial absolute prices for flour products as part of any price control mechanism creates its own set of problems. The Commission has noted above its concern about some components of costs that have been reported in the past as part of the current price control mechanism. In particular, the Commission has yet to be convinced that the current indirect costs and packaging costs in the present pricing mechanism are appropriate.

In submissions received, it has been suggested that the operating costs of the most recently established mill, namely that operated by Tablebirds, should be used as the benchmark as this mill is current state of

technology and milling practice. The Commission notes however, that the Tablebirds mill is part of a larger food production business and the Commission would therefore need to be convinced that joint and common costs such as overheads and certain fixed costs, had been properly allocated before accepting the Tablebirds mill costs as the legitimate starting point for setting the initial prices.

There is one important advantage of a price control mechanism over a price monitoring approach. Under the price control arrangements, the milling industry will have absolute certainty of its future price path as under any determined price adjustment mechanism the Commission would establish a clear set of rules and processes for future price adjustments. This is one of the strengths of a price control mechanism of the 'incentive regulation' type that the Commission has adopted elsewhere.

Under a price monitoring mechanism, depending on what part of the flour price was subject to monitoring (that is, the final price, the imported grain costs, or the domestic milling costs), the milling industry would not have the same degree of price setting security. Under price monitoring, if the Commission observed movement in domestic prices outside that occurring in the comparator used, the industry would need to satisfy the Commission that the price charges were legitimate. The Commission would retain the right to recommend that the industry be placed under direct price control if it was not happy with the reasons given. There is thus a degree of lack of regulatory certainty that can be created for the industry.

4.6 Commission's Draft Decision

4.6.1 Price Regulation of Ex-Mill Prices

The Commission has given extensive consideration to the regulatory options available to it. On balance, the Commission favours a price monitoring approach, preferably based on a monitoring of movement in the final ex factory price of flour products from the two millers. A single price movement indicator should be used and prices compared on a quarterly basis using information provided on individual product prices by the industry.

The Commission favours this approach for the following reasons:

- Ease of application.
 - under the arrangements proposed (and discussed below), the regulatory burden on the industry would be kept to a minimum while still achieving the desired effect of regulating flour prices
- A monitoring arrangement on individual product prices will effectively regulate the maximum price while encouraging the industry to compete with the emerging competition for particular

parts of the market (e.g. supply of the bakeries and other food processor markets)

- by setting the initial prices, the Commission will ensure that the industry will not be able to cross subsidise prices of those products facing increasing competition with prices charged for products which face less competition
 - this method will force the industry to maximize its operating efficiencies while still benefiting from the (albeit declining) tariff protection afforded the industry
- A monitoring approach recognizes the increasing level of competition emerging in this industry and avoids many of the financial modelling complexities of cost allocation and accounting for businesses with declining market shares that are still seeking to recover past investments
- the additional cost involved in the financial modelling required to determine an incentive based price path would potentially outweigh benefits of a price control approach
- The largest component of domestic flour costs is the price of grain and provided this is reflected in the monitoring arrangement, the domestic prices should be capable of remaining within any external price movement indicator used as part of a monitoring arrangement.

4.6.2 Price Regulation of Freight Charges

The Commission has had to consider the merits of including domestic freight costs in the price monitoring arrangement. Under the present price control arrangements, prices are determined on the basis of delivering product into the main ports (namely Port Moresby, Lae, Madang, Rabaul and Wewak). The domestic mill operators have little control over the freight charges, although they have demonstrated a capacity in the past to seek out economies in shipping arrangements presumably to counter some of the effects of the emerging import competition as tariffs decline or are circumvented.

The Commission is concerned to ensure that consumers are not disadvantaged by any market power held by the transport companies. To the extent that the flour milling companies can exercise countervailing power as consumers of this transport facility, this is to be encouraged. Thus, the Commission will adopt a monitoring approach to freight charges from the mills to the main ports. The approach to be adopted will be similar to that adopted for the petroleum industry. The Commission will monitor movements in the reported freight costs provided by the milling industry against its own internally created Freight Cost Index (FCI).

4.6.3 Price Regulation of the Wholesale and Retail Margin

The current regulation of the wholesale and retail margin is based on a 'rule of thumb' approach adopted by the Price Controller around the time of the establishment of the Price Controller's Office. The Commission is not aware of any underlying merits in the 11% and 10% mark-ups applied to wholesaling and retailing respectively. The Commission has also not received any submissions seeking to substantiate the continuation of this level of mark-up. The only submission received on this issue suggested that sufficient competition existed to avoid the need for a continuation of a regulated mark-up.

As previously discussed, the Commission is not convinced that sufficient competition exists across the wholesale and retail sectors at a national level. Further investigation is required into the level of competition within the wholesale and retail sectors overall (and not just for flour and other price controlled products). Thus, the Commission proposes recommending to the Minister for Finance and Treasury that an enquiry be commenced later in 2005 into the level of competition and extent of contestability within the PNG wholesale and retail sectors as a whole.

In terms of this present inquiry, the Commission's draft determination is that the wholesale and retail margins for flour products be subject to price control for the period of this determination.

The Commission has received submissions to the effect that the wholesale and retail margins that are actually charged are less than the percentage mark-ups that are currently allowed under the price control rules. The Commission therefore proposes to set an absolute kina value for the wholesale and retail margin. This kina value (for different products and sizes) will be based on the declared value of flour in its various forms and packet sizes as at 1st January 2005. This absolute kina valued margin will remain unchanged for the period of the price determination or until the completion of the proposed review of the wholesale and retail sectors, whichever occurs first.

4.6.4 Duration of the Determination

The Commission has considered the options for the duration of the determination. Under the revisions to the Act, the Commission is required to undertake an extensive public review each time there is a request for a price change. This is to ensure that there is the opportunity for full public debate and transparency in decisions that are taken by the Commission.

The Commission has the opportunity to make a determination that extends over a period of time. This is consistent with 'incentive regulation' that is based upon a price path being determined using projections of efficient costs and creating the opportunity over time for the regulated business to achieve efficiencies above and beyond those projected.

Thus, the opportunity exists to set a price path extending beyond a single price setting event.

The Commission has used price paths extending up to 10 years for certain regulated utilities. The more usual regulatory period is 5 years. This period allows time for the regulated entity to seek to improve its efficiency beyond that set under the price path, and usually represents a period of time for which financial and business projections can be confidently made.

Over the next five years, a number of further developments can be expected in the flour milling industry. Tariffs will be reduced from 20% to 15% in 2006, further development of the bakery and food processing sector can be expected within PNG, and opportunities for new competitors to enter the market (possibly by way of imported product) will exist throughout this period. The Commission considers that a five year price determination provides a good balance between the interests of consumers and those of the supplying businesses.

In setting a five year price path, the Commission's determination will set the price adjustment rules that will apply over the next five years from 1st June 2005. A further review of the flour industry will be undertaken by the Commission prior to the end of the five year period, that is, prior to 31st May 2010.

Draft Determination 2

The Commission will adopt the following forms of price regulation for flour products over the next five years:

- **a price monitoring approach for the ex factory price of flour products**
- **a price monitoring approach for the freight charges ex factory to main port in PNG**
- **a price control approach for the wholesale and retail margin, with the absolute kina value of the wholesale and retail margin being held constant for the five year price determination period or until the Commission completes a more detailed review of the wholesale and retail sector, whichever comes first.**

The Commission's determination will apply from 1st June 2005 for a five year period.

In accordance with the Draft Determination outlined in Chapter 4, the Commission has developed the procedures and mechanisms that will apply to the price regulatory arrangements for flour over the next five years.

5.1 Price Monitoring of Ex Factory Price

The price monitoring arrangements for milled flour products will apply to the ex factory price. Freight charges will be monitored separately.

The independent indicator to be used for purposes of monitoring movements in the prices of flour products ex factory will be the Average Retail Price of 2kg Self Raising Flour (average all capital cities) as reported by the Australian Bureau of Statistics in ABS 6403.0.55.001, Average Retail Prices of Selected Items, Eight capital Cities. The average eight capital price will be converted to a kina value using the average Australian dollar/kina exchange rate as reported by the Bank of Papua New Guinea for the last day of the quarter for which the ABS retail price applies. Table 5.1 provides details of the kina equivalent of the average retail price for the period December 1997 to September 2004.

**Table 5.1 Average Retail Price (kina per packet)
2kg Self Raising Flour (eight capitals)**

Period (Quarter)	Kina per packet	Period (Quarter)	Kina per packet
Sep 2004	7.82	Mar 2001	4.98
Jun 2004	7.91	Dec 2000	5.10
Mar 2004	8.29	Sep 2000	4.48
Dec 2003	8.63	Jun 2000	4.36
Sep 2003	8.30	Mar 2000	4.75
Jun 2003	8.81	Dec 1999	5.29
Mar 2003	7.55	Sep 1999	5.62
Dec 2002	7.25	Jun 1999	4.95
Sep 2002	6.90	Mar 1999	4.32
Jun 2002	7.25	Dec 1998	3.74
Mar 2002	6.28	Sep 1998	3.92
Dec 2001	6.06	Jun 1998	3.76
Sep 2001	5.50	Mar 1998	3.82
Jun 2001	5.24	Dec 1997	3.33

Source: Australian Bureau of Statistics Pub No. 6403.0.55.001

The price monitoring arrangements will not apply to the actual kina equivalent of the Australian price. Rather, the monitoring arrangements will be based on the movement in the kina equivalent of the Australian price over time. Movement in the kina equivalent of the Australian price will be compared to movement in the PNG price of the relevant flour products.

To test the correlation between movement in the Australian price for flour and the price in PNG, the Commission examined the movement in PNG prices to movement in the Australian prices for a six-year period from 1999. The Commission obtained information on average flour prices in PNG from the National Statistical Office, and compared the movements in the Australian price for 2 kg self-raising flour adjusted for the Kina/AUD as presented in Table 5.1.

In recognition of the monitoring nature of the price control system that the Commission proposes to use, the Commission compared the movement of prices on a quarter by quarter basis, and then using a moving 12-month average to take into account of the slight variations in price movements from one period to another. Table 5.2 provides a summary of the movement in the PNG prices and the Australian prices for the period from 1999 using the base of December 1999=100.

**Table 5.2 Index of Movement in PNG and Australian Flour Prices
December 1999=100**

Year – Qtr	PNG Flour Prices		Australian Flour Prices	
	Month on Month Index	Moving 12 Month Index	Month on Month Index	Moving 12 Month Index
1999Dec	100.00	100.00	100.00	100.00
2000March	97.48	92.39	89.79	97.40
June	94.85	96.24	82.42	94.61
Sept	91.80	96.03	84.69	89.22
Dec	91.33	93.86	96.41	88.33
2001March	95.91	93.47	94.14	89.41
June	108.83	96.97	99.05	93.57
Sept	114.12	102.55	103.97	98.39
Dec	112.44	107.83	114.56	102.93
2002March	122.04	114.36	118.71	109.07
June	130.12	119.68	137.05	118.57
Sept	138.31	125.73	130.43	125.19
Dec	139.09	132.39	137.05	130.81
2003March	176.60	146.03	142.72	136.81
June	163.70	154.42	166.54	144.19
Sept	162.45	160.46	156.90	150.80
Dec	159.70	165.61	163.14	157.33
2004March	159.24	161.27	156.71	160.82
June	158.97	160.09	149.53	156.57
Sept	158.46	159.09	147.83	154.30

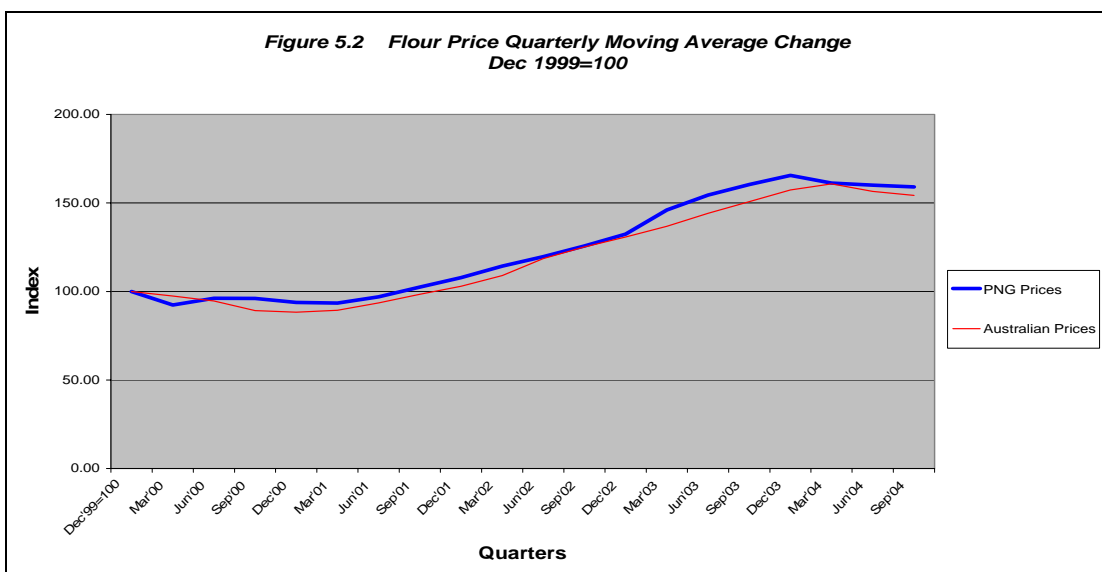
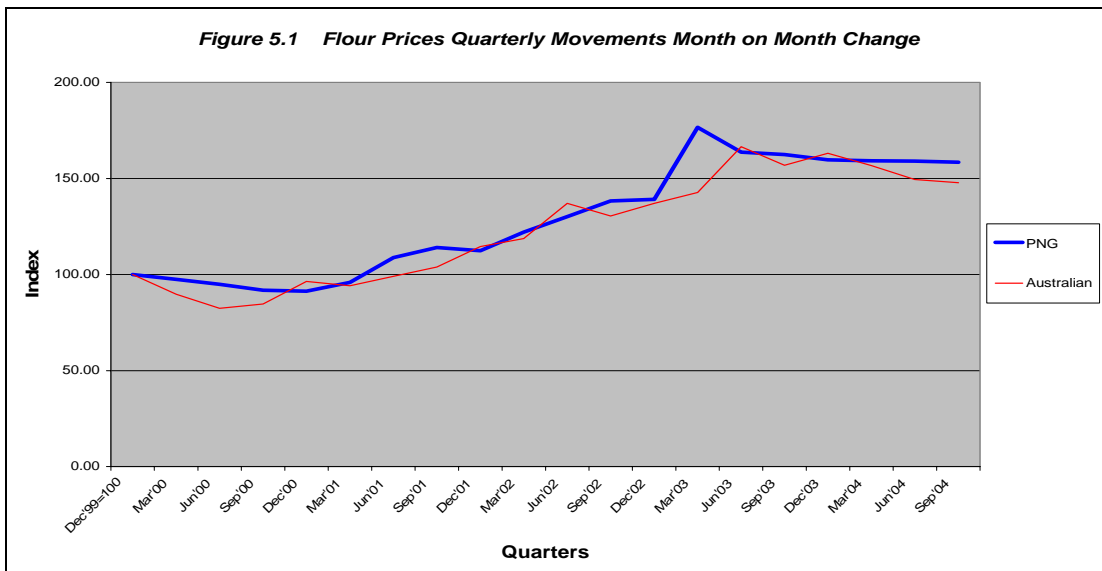
Source: ABS Retail Prices Self Raising Flour, NSO Average Retail Prices Flour

Figures 5.1 and 5.2 demonstrate diagrammatically the movement in the two price series using the month on month and 12 month moving average approaches. It can be seen from these diagrams, that although there can be some differences in the movement in the Australian and PNG series at different times over the period examined, broadly the two series follow a similar path⁵.

⁵ The Commission has repeated this analysis using the gazetted main port into store prices for flour as set by the current price control mechanism. Again, the movement in the prices as gazetted in PNG follows closely the movement in the prices from the ABS flour series adjusted for the Kina/AUD exchange effect.

The broad concurrence in movement in the price indices is not surprising given the high cost component represented by Australian wheat in both the prices in Australia and in PNG. In applying this indicator, the Commission will need to have regard to changes in Australian retail taxes (although these are not anticipated to change) and PNG import taxes that may affect the cost of grain imported into PNG. However, these issues would be considered should the Commission issue a 'please explain' request in response to the movement in prices in PNG being above that identified by the indicator index.

On inspection the Commission is inclined to use the 12-month moving average as the monitoring series as this will tend to smooth out some of the quarter by quarter differences caused by timing effects. As a monitoring device, it provides a clear guide to the flour milling industry of the benchmark that the Commission will use and will require the industry to keep price movements within the bounds set by the more competitive Australian market from where the grain imports used in domestic flour milling are sourced.



For purposes of monitoring, the Commission will update the Australian series quarterly using information from the Australian Bureau of Statistics with adjustments for exchange rate changes. Movement in the 12-month moving average series will be used to monitor movements in the 12-month moving average ex factory prices of flour products in PNG. Where over time, the Commission identifies movements in domestic ex factory prices greater than movements in the indicator index (or less than the indicator index if this is falling), the Commission will seek an explanation from the relevant mill operator. If the Commission is not satisfied with the explanation provided, the Commission will reserve the right to have the ex factory price declared for price control purposes.

The monitoring mechanism requires the determination of an initial ex factory price for each of the products to be monitored. The Commission has the choice of adopting the current ex factory prices as currently reported to the Commission or request additional data from the industry to allow revised ex factory prices to be set.

As discussed above, the Commission has some concerns with the present costing estimates for domestic milling as provided by the industry. The Commission is prepared to use a calculation of the grain price component of the total ex factory price using the formula as currently used to set prices. However, in response to this Draft Report, the Commission is seeking from the industry more detail on their actual domestic milling and packaging costs before the Commission will set an initial starting price for the monitoring process. Information will be sought from both milling companies and the Commission will review this data prior to the release of its final decision.

Specific information to be sought from the industry will include:

- audited cost break-up of milling and packaging costs for the latest year
- volume of production for the latest year
- supporting justification for the profit margin claimed
- supporting justification for the cost allocation used (particularly where non-regulated products are produced and where costs are shared across different products)
- proposed ex factory prices for the following products:

<u>Product</u>	<u>Pack Size (kg)</u>	<u>Pack</u>
Bakers flour	50	Polypropylene
Cracker flour	50	Polypropylene
Biscuit flour	50	Polypropylene
Soft flour	50	Polypropylene
Wheat flour	25	Polypropylene
Wheat flour	10	Polypropylene
Wheat flour	5	Polypropylene
Wheat flour	2.5	Polypropylene
Wheat flour	2	Paper

Product	Pack Size (kg)	Pack
Wheat flour	1	Paper
Wholemeal flour	50	Polypropylene
Wholemeal flour	25	Polypropylene
Wholemeal flour	10	Polypropylene
Wholemeal flour	5	Polypropylene
Wholemeal flour	2.5	Polypropylene
Wholemeal flour	1	Paper
Self raising flour	50	Polypropylene
Self raising flour	5	Polypropylene
Self raising flour	2	Paper
Self raising flour	1	Paper

Under the price monitoring arrangements, the two millers will provide to the Commission by the 8th day of January, April, July and October each year, the ex factory price as at 1 January, 1 April, 1 July, and 1 October respectively, for each of the products, package sizes and package types as listed above. The millers will be entitled to adjust their prices without obtaining prior Commission approval. The Commission will monitor the movement in the ex factory prices using the indicator index as discussed above. This monitoring will be conducted using the 12-month moving average approach in recognition that prices can and will move independently of the indicator rate. However, the continuous monitoring by the Commission will form part of any formal notification to the industry that the Commission requires an explanation of the reason for recent movements in prices which appear to lie outside movements in the indicator index.

5.2 Price Monitoring of Domestic Freight Costs

The Commission will use its internally calculated Freight Cost Index (FCI) to monitor movement in the freight charge. The freight charge is based on the cost per tonne for the coastal freight of flour from Port Moresby/Lae to the main ports of Rabaul, Madang or Wewak. The freight costs should be forwarded to the Commission at the same time as the quarterly reports on ex factory prices.

The FCI prepared by the Commission is based on a weighted average of costs impacting on the freight sector. The Commission will monitor movements in the freight costs advised by the milling companies and will issue 'please explain' notices to the milling industry should movements in the freight costs appear to fall outside the indicator rate provided by the FCI. The Commission will examine the movement in freight costs over time recognizing that adjustments may occur at infrequent intervals and thus may need to be considered over more than one quarterly period.

5.3 Price Control of Wholesale and Retail Mark-Ups

The Commission will maintain the present declared status for the wholesale and retail margin for flour products under the provisions of Section 10 of the Act. Under the provisions of Section 21 of the Act, the

Commission is proposing that the following wholesale and retail mark-ups be applied as the maximum mark-up that can be used (see Table 5.3). These absolute mark-ups will remain unchanged for a period of five years or until such time as altered by the Commission as the result of a proposed review of the wholesale and retail sector.

Table 5.3 Proposed Declared Wholesale and Retail Mark-Up for Flour Products

Product	Pack Size (kg)	Mark-up per kg	
		Wholesale (kina/kg)	Retail (kina/kg)
Bakers flour	50	17.30	17.50
Crackers flour	50	17.30	17.50
Biscuit flour	50	17.30	17.50
Soft flour	50	17.30	17.50
Wheat flour	25	18.10	18.20
Wheat flour	10	18.30	18.50
Wheat flour	5	18.70	18.80
Wheat flour	2.5	18.90	19.10
Wheat flour	2	18.90	19.10
Wheat flour	1	18.90	19.10
Wholemeal flour	50	17.20	17.40
Wholemeal flour	25	17.90	18.10
Wholemeal flour	10	18.20	18.30
Wholemeal flour	5	18.50	18.70
Wholemeal flour	2.5	18.80	18.90
Wholemeal flour	1	18.80	18.90
Self raising flour	50	17.90	18.00
Self raising flour	5	18.60	18.70
Self raising flour	2	19.20	19.40
Self raising flour	1	19.40	19.60

The Commission will conduct periodic inspections of retail and wholesale businesses to confirm that these absolute kina value margins are not exceeded in the prices charged. Freight charges from the main ports (including Port Moresby and Lae) to locations other than the other main ports of Madang, Wewak and Rabaul are not specifically monitored or price controlled.

The Commission has undertaken a review of the regulatory arrangements applying to flour products under the provisions of Section 25A (6) of the Act. Flour products are currently declared under the provisions of Section 10 of the Act.

Under the provisions of Section 25C (3) of the Act the Commission has made the following Draft Determinations:

1. Price regulation of the prices of flour products should continue.
2. With the exception of the wholesale and retail margins, the form of price regulation to be applied is to be varied from the price control currently operating.
3. Unless varied by its Final Determination, the Commission will Gazette an order that specifies the form of price regulation to be adopted.
4. The form of price regulation to be applied, subject to the Minister making an appropriate declaration under Section 32A of the Act, will be:
 - price monitoring of the ex factory price of flour products under the provisions of Section 32A of the Act
 - price monitoring of the coastal freight charges for main port delivery of flour products under the provisions of Section 32A of the Act
 - price control of the wholesale and retail margin of flour products under the provisions of Section 10 of the Act, with the declared price per kilogram margin for various flour products and package sizes to be as specified in Table 5.3 and to be fixed under the provisions of Section 21 of the Act
5. The declaration of prices and price regulatory arrangements will apply for a five year period from 1st June 2005 until 31st May 2010.

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