



Independent Consumer & Competition Commission

Tinned Fish & Tinned Meat Pricing Review



Issues Paper

6th June, 2006

Foreword

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

In its role of regulating prices of certain goods and services, the Commission has the responsibility to regulate prices of tinned fish and tinned meat products. In PNG, there are limited number of local producers of tinned fish and tinned meat products apart from suppliers who import these products from overseas and supply them to the consumers across the country. The main suppliers of locally produced tinned fish products are International Food Corporation who produces and distributes the “Besta and Supreme” branded tinned fish products and RD Tuna Canning who is involved in the production and distribution of the “Dianna” range of tinned tuna products. Hugo Canning is one of the major suppliers of tinned meat products, and it also imports and supplies tinned fish products under the “Ocean Blue” brand. The local producers of tinned meat products include Hugo Canning who produce and distribute the “Ox & Palm” brand corned beef whilst the Madang based company, James Barnes Limited, produces and distributes the “Globe” branded range of corned beef products. More recently, Frabelle (PNG) Ltd a subsidiary of the Frabelle Fishing Corporation has expanded its investment in PNG by the construction of a cannery plant in Lae to process and can tuna products for export and domestic sale. The introduction of Frabelle (PNG) Ltd has created additional competition in the domestic market by the distribution of its Frabelle brand.

Briefly, the current regulatory arrangements for tinned meat and tinned fish products under the Prices Regulation Act (Chapter 320) (Amended) involve the following procedures:

- Review of tinned fish and tinned meat prices, undertaken on an ad hoc basis and directed at consideration of exchange rate movements, imported price changes, and international freight and handling charges;
- Examination of changes in other non-commodity costs forming part of the total cost of these products such as storage, labour, overhead and manufacturing costs; and
- The setting of a fixed percentage retail and wholesale margin to be applied to the sale of tinned fish and meat products.

Under the provisions of Section 25A (6) of the Prices Regulation Act, the

Commission has decided to undertake a major Review of the pricing regulatory arrangements applying to tinned fish and tinned meat products. This Review will *inter-alia* consider whether the present price control arrangements for tinned fish and tinned meat products 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, the Commission is calling for submissions from all interested parties including the local tinned fish and tinned meat producers, wholesalers, retailers, consumers and other interested parties. The Issues Paper is intended to provide a brief overview of the issues that will be considered as part of the Review and the processes that the Commission will use in undertaking the Review.

The timetable for the current Review is as follows:

Release of Issues Paper.....	6 th June 2006
Receipt of Public Submissions.....	6 th July 2006
Release of Draft Report.....	7 th August 2006
Receipt of submissions on Draft Report.....	7 th September 2006
Release of Final Report.....	6 th October 2006

Submissions to the Commission will be available for public inspection unless the Commission agrees that all or part of the submission should remain confidential. However, in accordance with the provisions of the ICCC Act, it is intended to make the Review 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 be held in confidence.

Submissions to this inquiry should be received by **6th July 2006** and should be directed to:

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1.0 Introduction

1.1 Background to the Review

The methodology that is currently used to set prices for tinned fish and tinned meat products was originally devised back in the early 1990s and has basically remained unchanged since that time.

Much of the work under the former price control regime was administered through the Price Controller's Office and was less transparent than is envisaged under the ICCA Act. Notwithstanding agreed procedures for price evaluations, reviews were 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 Prices Regulation Act Chapter 320.

Hence, in light of the changed legislation relating to price regulation, there is the need for a review to decide whether to continue, amend or terminate the current regulatory arrangements for tinned meat and tinned fish. Upon concluding the review process, and should it be found that some form of price regulation is still required, the Commission as the regulator should have developed a transparent, accountable and consistent pricing methodology beneficial to both consumers and the participants in the tinned fish and tinned meat industries.

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, 20 (A & B), 21, 25 and 32A of the amended Prices Regulation Act;
- Confidentiality and public disclosure provisions of the Act on information received from submissions; and
- The current and prospective outlook for the tinned fish and tinned meat Industry in PNG.

Under Section 10 of the Prices Regulation Act (Chapter 320), the Government through the Minister for Treasury has declared the prices for both tinned fish and tinned meat products for price control purposes.

The *Independent Consumer & Competition Act 2002* made a number of changes to the Prices Regulation Act under which the prices for these 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 undertake a review of a Pricing Order under Section 21 of the Prices Regulation Act.
- Section 21 (2A) (see Attachment) was added which introduces specific requirements on the Commission 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 operate 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 more heavy-handed direct price control.

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 Prices Regulation Act (Chap.320) for full price control purposes.

These amendments to the Prices Regulation Act increase 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 Format of the Review process

This Review is initiated under the provisions of Section 25A (6) of the *Prices Regulation Act*. The process of the Review will be public and transparent and in addition to the tinned fish and tinned meat industry, other interested parties and the public are invited to make submissions to the Review.

The process will involve the following broad stages:

- ◆ Public announcement of inquiry & invitation for submissions to be made to the Commission;
- ◆ 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 Determination.

A timetable for the Review has been provided in the Foreword to this Issues Paper. Copies of submissions received by the Commission (unless treated as being 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 Draft Report and Final Report of the Commission are also public documents and can be obtained from the Commission's office once they are released.

2.0. Structure of the Tinned Fish and Tinned Meat Industry in PNG

This section details the existing structure of the tinned fish and tinned meat industries in PNG.

2.1 *Import, production and supply of tinned fish products*

Two key canneries and importers who between themselves occupy a significant portion of the tinned fish market in PNG through their extensive distribution network as well as brand loyalty dominate the current tinned fish industry. Their main activities include the importation of the various inputs (including aluminium cans and to certain extent raw fish when domestic supply is insufficient to meet production requirements), manufacture of the tinned fish products and the distribution of these products throughout PNG including some exports of the finished products (tinned fish) or excess raw fish to other markets throughout the region. The bulk of the domestic supply is undertaken onshore through production facilities located in Lae and Madang. The two major local operators are:

- International Food Corporation Limited (“IFC”); and
- RD Tuna Limited (“RDT”).

IFC is involved in the production, canning and distribution of the “Besta” and “Supreme” branded tinned fish products throughout PNG whilst RDT is involved in the production, canning and distribution of the “Diana” range of tinned fish products. IFC predominately uses mackerel and sardines as its supply of raw fish for its range of tinned fish products whilst RDT mainly uses the various species of tuna, with a particular focus on ocean blue and yellow fin species which are found throughout the waters of PNG.

The various brands of tinned fish products imported or produced locally are distributed according to their can size, ranging from between 95gm, and 425gm.

In terms of the supply of raw fish stock, both IFC and RDT source their supply from local fishermen and fishing companies such as the South Seas Tuna Loining Company. On certain occasion when domestic supplies are insufficient to meet production requirements or for certain special types of fish not caught locally, fish supplies are imported.

The introduction of a new competitor in the domestic market, Frabelle (PNG) Ltd, a subsidiary of Frabelle Fishing Corporation, was heralded by the commissioning in early April 2006 of a new cannery in Lae. It is designed to produce cooked tuna loins and canned tuna products of which the Frabelle brand has recently entered into the domestic market and also will be exported to the European market. Most of the raw tuna fish will be sourced from the local

waters while other inputs such as tins that will be imported.

In addition to these three domestic fish canneries, Hugo Canning Limited (“Hugo”), which is involved predominately in the production of tinned meat products, also imports and distributes tinned fish products under the “Ocean Blue” brand. Hugo does not engage directly in any domestic canning or production of tinned fish products but imports and distributes tinned fish throughout PNG.

Other imported brands of tinned fish are:

- FujiSan;
- King; and
- Solomon Taiyo.

With respect to import barriers, all canned Tuna Skip Jack and Bonito imported from Fiji, Solomon Island and Vanuatu are free from import duty under the provisions of the Multilateral Trade Agreement between the Melanesian Countries. Tariff duty on imported canned fish from other locations falling under Chapter 16.04 of the *HS Tariff* varies depending on the type of fish. Import duty on these products varies from 15% to 20%. Imports of sardines, sardinella, bristling or sprats, and canned pike are free from import duty. The high tariff acts as a form of protection to the local industries and provides some income generation for the government.

2.2 Imports, production and supply of tinned meat products

The two major local participants in the production and supply of tinned meat products in PNG are:

- Hugo Canning limited (“Hugo”); and
- James Barnes Limited (“JB”).

Hugo is engaged in the production, canning and distribution of the “Ox & Palm” branded tinned meat products whilst JB is involved in the production, canning and distribution of the “Globe” range of tinned meat products. Akin to the arrangement with tinned fish, both Hugo and JB utilise imported inputs (predominately raw beef meat and cans) in manufacturing their tinned meat products. The raw beef is primarily sourced from Australia and New Zealand whilst the cans are also sourced from Australia.

Apart from the two local manufacturers, other companies also import canned meat products into PNG market. The popular imported brand “Ailan Corned Beef” from Fiji is free from import duty under the Bilateral Trade Agreement between Fiji and PNG whilst other brands falling under Chapter 16.02 of *HS Tariff* are subject to a 25 % import duty. The high tariff is the commitment by the

government to protect and promote the local manufacturing industry as well as a source of income for the government.

Most of the canned meat brands are distributed in the domestic markets in can sizes ranging from between 200gm and 340gm.

2.3 Distribution and wholesaling of tinned fish tinned fish and tinned meat products

The distribution of tinned fish and tinned meat products is a function of the individual distribution arrangements operated by the major domestic manufacturers and the importing and wholesaling businesses who in turn supply product to retail outlets. The domestic manufacturing companies are responsible for distributing their products from their canneries located in Lae, Madang and Port Moresby through their branch networks and authorised outlets. Typically, each company is a wholesaler with the distribution of products undertaken by either themselves or through contractual arrangements with established wholesalers and retailers.

For the imported brands, the local importer undertakes most of the storage and distribution arrangements with established wholesalers and retailers throughout the country. The current regulated wholesale margin for all tinned fish and tinned meat products varies from 10% for transactions involving a related entity and 11% for transactions involving an unrelated entity.

2.4 Retailing of tinned fish and tinned meat products

The provision and sale of tinned fish and tinned meat products at the retail level is undertaken by the retailing sector. Retailing activity is independent from the operations of the manufacturers' activities. Retailers may also directly import tinned fish and tinned meat products.

Under existing price control arrangements, the retailers are entitled to a retail margin on the wholesale price of 8% for sales involving a related wholesale/retail business and 10% for sales involving an unrelated entity. The Review will also consider the appropriateness of these margins.

3. Retention of Price Control

3.1 Current pricing arrangement

Tinned fish and tinned meat are two forms of proteins in the diets of many Papua New Guineans. There are other forms of protein such as chicken, fresh fish and other forms of meat including pork, crocodile, cuscus, and kangaroo, which are substitutes for tinned fish and tinned meat products. Tinned fish and tinned meat products have the advantage over other forms of protein products of being relatively convenient and readily available for consumption purposes. The convenience of tinned fish and tinned meat is reflected in its wide consumption across the nation.

The supply of domestically produced tinned fish and tinned meat is predominantly met by RDT, IFC, JB and Hugo. The current pricing control arrangements were implemented in recognition of the limited domestic supply options and the existence of tariffs on imported supplies. The price controls were introduced to protect domestic consumers from perceived market power that was held by the domestic manufacturers. Initially the price control mechanism introduced made use of an “import parity” approach to price determination. That is, prices in PNG were determined on the basis of the cost of importing the same or similar products from overseas after allowing for freight, insurance and handling to deliver these products to PNG, any associated government levy or tariff, and other statutory imposts including domestic freight and cartage to main ports within PNG. Thus in effect, prices in PNG for tinned fish and tinned meat products were capped at a level that reflected the prices of competitive import products.

Currently prices are set on the basis of a ‘cost plus’ approach that combines the cost of the imported and domestic inputs to derive a domestic manufacturing costs. Under the current price control arrangements, the regulated businesses advise the Commission of movements in their major cost inputs including the costs of the imported beef meat, mackerel and tuna, aluminium cans and other components of tinned fish and meat products and, subject to a materiality test of the overall price change against the last price change, prices are adjusted to reflect increases (or decreases) in costs. The costs that are included in the ‘cost plus’ approach are:

- The international cost and freight of imported inputs such as raw fish, beef meat, and aluminium cans (including import levy);
- Insurance;
- Manufacturing and overhead costs;
- Domestic freight, cartage, wharfage, storage and handling costs; and
- A mark up of between 3% and 11% on the total of the above.

A main port price per tonne for the individual tinned fish and tinned meat products is determined using this formula, and prices for individual can sizes and product type are determined from the movement in main port prices.

3.2 Continuation of price regulation

Under the provisions of Section 25C(3) of the Prices Regulation Act, the Commission must determine whether to:

- Continue to operate price control in its present form, or
- Vary the form of price control, or
- Terminate price control.

Any decision to terminate price control needs to be based upon the current projected state of competition in the industry. Price control was originally introduced to protect consumer welfare from potential price exploitation. At the time of the inception of the price control arrangements, there were limited supply options for the provision of tinned fish and tinned meat. Since then, there are now three (3) local producers for tinned fish as well as two local producers of tinned meat products in PNG. Furthermore, there are also other companies or major wholesalers who are involved in importing other brands of tinned fish and tinned meat products and are supplying them to the domestic market. This would indicate that there is at least some form of contestability in the markets for these products.

The major source for demand for tinned fish and tinned meat consumption in PNG are domestic households who individually may appear to hold little countervailing power in terms of the prices charged for tinned fish and tinned meat products. Suppliers may therefore be able to take advantage of their market position in the prices that are charged. However, as a group, consumers may exercise greater countervailing power, particularly when there are a number of competing retail outlets for these products. These circumstances are more likely to exist in the larger urban areas where there are a number of competing retail outlets and visible forms of price competition (for example, newspaper advertising of prices for tinned meat and fish products). Furthermore, there are potentially other alternatives available for consumers in terms of protein products, although these might not be as attractive and convenient as tinned products, and therefore poor substitutes from a consumer perspective.

There is currently a strong consumer allegiance to the existing “Ox & Palm” and “Globe” corned meat brands and the tinned fish brands of “Besta and Dianna” reflecting the taste and other non price attributes of these products. Hugo Canning & James Barnes have an existing market share of about 80-85% and 30-40% respectively of the tinned meat market while IFC and RD Canning have

about 55-60% and 75 % in the domestic tinned fish market respectively. In addition, Hugo's distribution of imported tinned fish has a market share of 10-15% (note all these market shares are estimates provided by the respective companies). Thus these companies retain a strong influence over the local supply of tinned fish and tinned meat products in PNG notwithstanding the availability of imported products and the opening of a new fish cannery in April this year. The retention of some form of price regulation may therefore still be appropriate should it be considered that competition is limited and two or three suppliers hold strong market power.

The Commission is seeking information and submissions on the current and projected state of competition and contestability in the tinned fish and tinned meat market in PNG and the need to continue some form of price regulation

3.3 Form of price control

If some form of price control or price regulation should be continued for tinned fish and tinned meat products in PNG, the Commission is required to consider whether the existing form of regulation should apply and if not, what alternative form of regulation should be used.

The options that are available to the Commissions are identified in the Prices Regulation Act, namely:

- Price control as Declared Goods under section 10 of the Prices Regulation Act; or
- Price monitoring as Declared Monitored Goods under section 32A of the Prices Regulation Act.

Price control as a Declared Good would require the Commission to have regard to the provisions of Sections 20A, 20B, and 21 of the Prices Regulation Act. Specifically that would require the Commission to:

- Undertake a lengthy public review process each time it was proposed to alter the maximum prices approved under the Price Declaration;
- Prepare and publish draft reports and other material relating to the proposed price change; and
- Have regard to the requirements of Section 21 (2A) of the Prices Regulation Act that *inter alia* requires the Commission to ensure that an appropriate balance is kept between the interest of consumers and the

suppliers/manufacturers of tinned fish and tinned meat products.

To meet these requirements, the Commission could establish a price direction/price path which would provide for some degree of automatic adjustment of prices albeit against an approved price adjustment methodology (see Section 5 of this paper).

Price Monitoring under section 32A provides a less intrusive method for price regulation. Under the price monitoring approach manufacturers/suppliers can adjust their prices without the need for prior Commission approval. Under this arrangement, prices of products ex-terminal/warehouse in Port Moresby, Madang and Lae would be monitored by the Commission against a selected benchmark. This would allow the Commission to monitor the prices being charged by the local manufacturers or suppliers against accepted international benchmarks for tinned fish and tinned meat products.

The Commission invites submissions on the forms of regulation (i.e., price control or price monitoring) that could be applied to tinned fish and tinned meat products in PNG if some form of regulation was considered necessary.

4. Price Control Methodology

4.1 *Cost plus approach vs building block*

Under the provisions of Section 21 (2A) of the Prices Regulation Act, if some form of price control is retained, 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 the declared good;
- The desirability of encouraging greater efficiency in the production and supply of declared good;
- The need to ensure an appropriate rate of return on any investment in the production or supply of the declared good;
- 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 the best mechanism is to achieve these particular objectives.

The Commission has elsewhere sought to achieve these objectives by linking the determination of regulated prices with the efficient costs of producing or supplying the regulated goods or services. This allows 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 that good or service. The prices that consumers are required to pay therefore do not include inefficiencies or inappropriate cost pass through that might otherwise occur in a market where there is no regulation and the supplier has a degree of market power.

A 'cost plus' approach of the type that has been used for price setting in the past relies upon historical actual costs of the businesses concerned. No attempt is made under this approach to consider the appropriate efficient costs, and to make allowances for the pass through of efficiency savings to consumers while at the same time as providing an incentive to the producer to recover the cost of these efficiency enhancing investments and share in the benefit over time. Thus, there is no incentive in a 'cost plus' approach to encourage improvements in overall operating efficiency to the betterment of the business, consumers, and to the economy as a whole.

In order to implement a more appropriate form of regulation that recognises and rewards efficiency in production and operation, the Commission needs to examine the overall operating efficiency of the domestic manufacturing facilities used to produce tinned fish and tinned meat. The Commission notes that there has recently been the establishment of a new facility for the production of tinned fish, and that the existing producers are also involved to a greater or lesser extent in the export of product from PNG. This would imply that the production costs of the domestic facilities meet international benchmarks in order for these products to be competitive in international markets, although there may be a degree of cross subsidisation within individual companies in support of their export activities. Also, the newly established canning facility could be expected to be designed on 'best practice' principles, although this has yet to be demonstrated. The Commission will be interested in exploring the extent to which best practice production techniques are used in PNG. These practices could be expected to flow through to appropriate efficient cost reflective prices to consumers and this would be recognised in the method used to set price paths should some form of regulation be required.

Further efficiency improvements in the domestic industry may require new investments by manufacturers/suppliers. Before investing in any new equipment or technology, the manufacturer/supplier would normally want some assurance that the price of goods sold would allow for the cost of the investment to be recovered together with a return on the investment. A 'cost plus' approach to pricing regulation of the type currently used for tinned fish and tinned meat products in PNG does not allow for a recovery of this investment over time. An alternative form of price regulation that both allows a recovery of these costs while at the same time a sharing of the benefits with consumers needs consideration.

The Commission, when adopting a 'building block' approach for other regulated goods and services, has included in the building block costs, an allowance for the recovery of new prudent investment expenditure over time and a rate of return on that investment. This is achieved by using forward projections of efficient operating and capital costs rather than a static cost plus approach that relies upon actual costs incurred in the most recent period (usually the last 12 months).

A 'building block' approach is therefore linked to the forward projection of costs over a period of time (often five years). These cost projections are based on efficient costs of production (taking into account the particular operating environment in which the business operates) and prudent capital expenditure projections. These projections are also developed in the context of forward projections of demand.

The main components of the 'building block' approach are:

- Operating costs
- Return of capital (depreciation)
- Return on capital

Under this methodology, prices would be based upon a recovery of all these costs over time.

The Commission is inviting comments and submissions from industry stakeholders and the public on the use of a 'cost plus' versus a 'building block' methodology in the setting of prices, or the use of some other methodology for setting prices. The Commission also wants to explore the relative efficiency of the domestic cannery operations and to what extent further efficiency improvements can be expected or require further investment to achieve.

4.2 Components of building block approach

In order to use a building block approach (or even a 'cost plus' approach), the Commission will need to obtain information from the industry on the various costs components that are involved in importing, manufacturing and supplying tinned fish and tinned meat products in PNG. The Commission needs to 'test' or benchmark these cost estimates in order to come to a view as to whether they reasonably reflect 'efficient' costs.

A building block approach would normally need to project costs over a period of up to five years. As discussed below, this provides an environment where not only efficiency gains can be passed through to consumers, but the businesses themselves have an incentive to outperform the efficiency costs included in the pricing model and therefore achieve a higher rate of return than that built into the regulated price path. Use of forward projections also allows a more automatic price adjustment process, thereby reducing the overall costs of regulation over time.

The current pricing model allows a 'mark-up' of between 3% and 11% on costs. The Commission has no evidence to support whether this mark-up is an appropriate return on the investments in the industry. Furthermore, as the mark-up is applied as a percentage of costs, there is no incentive for the regulated entity to achieve efficient costs as this would reduce the kina value of its mark-up.

The Commission is seeking input into what are the efficient operating costs for tinned fish and tinned meat canning and distribution in PNG

A rate of return appropriate for the industry needs to be determined for inclusion in the building block model. The rate of return should reflect an appropriate return on the investment by the business in the manufacture/supply of regulated goods. The Commission would normally use a Weighted Average Cost of Capital (WACC) as the basis for the appropriate rate of return. The WACC will take into account issues such as the appropriate return that the business should generate on both the equity and the debt capital in the business.

A Capital Asset Pricing Model (CAPM) is the type of financial model normally used by the Commission to determine the WACC. To populate the CAPM model, the Commission will need to have regard to the risk free rate of return that presently applies in PNG, the additional costs that should be included to reflect appropriate commercial debt margins on the risk free rate, the level of the additional risk that tinned fish and tinned meat production and distribution might attract above and beyond the standard risk allowances that would apply to other businesses in PNG, the treatment of tax (a pre tax or a post tax rate of return) and the normal debt equity ratio that should be applied to this industry.

The components of the WACC are discussed in more detail in the Commission's final reports on the Water industry and Post PNG. Copies of these reports can be obtained from the Commission.

The Commission is seeking submissions on the appropriate rate of return to use for the tinned fish and tinned meat industry in PNG and the components of a CAPM calculation of WACC.

The rate of return must be applied to some valuation of the business to provide a value of the return on investment generated on an annual basis.

There are various methods used to derive a value of the investment. Ultimately the Commission is seeking to determine the financial value of the business. Thus, while some estimation of value may be built around the asset values of the business (the Regulated Asset Values Base or RAB), effectively the Commission is attempting to derive an 'economic value' of the business reflecting not simply the investment that has been made in the business over a period of time, but the value of the business to its owners (and therefore the value on which they would expect to generate a financial return).

There are various options available to the Commission in terms of the valuation that should be used. These include:

- Historical Value: this represents the written down book value of the business. The advantage of this approach is that the value can be readily obtained from the financial account of the business. However, this value will be in Kina of different years (and therefore of different underlying value) and the assets may no longer be fully utilized (that is, sub-optimal) and therefore would not normally be expected to generate a return to the business
- Optimised depreciated replacement costs (ODRC): this form of valuation reflects the current costs of the assets that are in use after allowance for assets that are not fully used (optimised out of the valuation) and deduction for the value of assets that have already been 'consumed' in an economic and financial sense (depreciation). The advantage of this approach is that it effectively represents the value of the business if a new entrant was to buy the assets at their replacement costs today. The disadvantage is that it represents an upper end of the valuation scale and its determination is open to a high level of subjectivity in terms of the equipment and technology that might be used to undertake tinned fish and tinned meat canning and distribution in PNG
- Optimised deprival value (ODV): essentially this valuation reflects a compromise in terms of the two extremes of historical value and ODRC in that it is measured as the lesser of ODRC and the value that the asset owner would have to be paid to compensate them fully if they were deprived of the asset. The value that the owner would be paid if they were deprived of the asset is the greater of the scrap value of the asset and the economic value.

The economic value is usually determined by the use of some form of Return on Asset Test (RAT) or may be determined based on a market value of the business if it is sold as a going concern, The advantage of the ODV valuation is that it reflects the market value of the business and as the Commission is seeking to determine a financial value upon which to apply the WACC to generate the return on investment, it more closely reflects this objective than say the historical or ODRC valuation methodology.

The Commission seeks comments on the methodology used to derive a Regulated Asset Base for purposes of applying the WACC to generate the return on investment.

Using a building block methodology that seeks to establish a price path over a number of years, it is normal practice to roll into the RAB new investment that occurs over the regulatory period of up to five years. New investment would only be rolled into the RAB on which a return on investment is calculated if the investment is considered to be prudent.

The Commission will require information on the projected prudent capital expenditure likely to be incurred by the tinned fish and tinned meat businesses over the period of the regulatory price path.

Adjustment to the RAB is also required for the consumption of capital (that is depreciation) and asset sales and disposal that occur over the period of the price path. The Commission will need to obtain information on the rates of depreciation applied to various asset categories by the industry and projected asset disposals or sales over the period.

The Commission is seeking information on:

- *The prudent capital expenditure over the regulatory period of up to five years;**
- *The rates of depreciation used on the remaining asset lives of existing assets;**
- and**
- *Anticipated scrapping or disposal of assets over the period of the price path**

4.3 Price path determination

The Building Blocks model is designed to provide an efficient cost based estimate of the revenue requirements of the tinned fish and tinned meat canning and distribution businesses over the price path period. This estimated revenue requirement will be expressed in current or real terms, depending on the form of modelling undertaken. The projections of anticipated costs are based on the best available advice at the time the price path is set. However, the revenue projection will need to take into account actual changes in underlying costs over time. The rate of actual costs changes across the economy (the level of inflation) may in practice be different to the estimates included in the building block cost modelling.

Thus, it is normal to link the revenue requirement to some form of inflation based formula, such as of the CPI +/- X type. In effect, this formula, which is based on the revenue requirement derived from the cost building block modelling, allows for changes in the general level of inflation (the Consumer

Price index or CPI component) and makes an adjustment through the X factor for changes in efficiency levels, demand projections, capital investment requirements, and other factors that have been built into the modelled required revenue projections.

While it is normal to use CPI in this type of price/revenue adjustment formula¹, it is also possible to use other indicators of underlying cost changes (such as movements in relative exchange rates). The Commission would favour the use of CPI rather than exchange rate adjustments. However the Commission has used exchange rate adjustments in conjunction with CPI movements in certain circumstances.

For an industry such as tinned fish and tinned meat where a significant proportion of the final value is a reflection of the value of the imported inputs used in the production of the tinned fish and tinned meat products, there may be merit in deriving a pricing formula which separates the cost of these imported inputs from the domestic incurred canning/production, and packaging costs. In these circumstances the Commission would need to satisfy itself that the cost of the imported components being included in the final revenue requirement and price path formula reflected an arms length, commercial price at world parity rates. This is an option that the Commission will need to consider.

The Commission invites submissions on the appropriate form of the required revenue/price path formula that should be used for tinned fish and tinned meat canning and distribution. The Commission also seeks comments on the possible treatment of the costs of imported inputs used in the production of tinned fish and tinned meat products in the pricing formula.

4.4 Volumes of demand and production

For the Commission to consider appropriate costs for production, distribution and final sale of tinned fish and tinned meat products, it would be desirable to have estimates of total domestic demand and the supply of this demand from domestic production and imported supply. The Commission will also need to relate operating costs with throughput volumes for the relevant tinned fish and tinned meat canneries/packaging plants/distribution centres.

In order to derive appropriate estimates of costs, the Commission must allocate

¹ The Commission uses an 'adjusted' CPI prepared by the National Statistician which excludes betel nut and alcoholic beverages

fixed costs over the throughput of production, and allocate variable costs with the volume of product being produced and/or handled. The Commission therefore needs from the industry:

- The total demand anticipated for tinned fish and tinned meat products over the next five years;
- A breakdown of total demand by local manufactured/canned verses wholly imported product; and
- The volumes of production assumed in the cost estimates produced by the industry.

The Commission invites submissions on the projected demand and domestic manufacture/production and imported supply of tinned fish and tinned meat products over the next five years.

4.5 Price path period

Incentive regulation of the type the Commission favours requires that the price path be set over several years (rather than a year on year process as inherent in a 'cost plus' approach). The Commission would normally favour a five year price path. This allows sufficient time for the pricing formula to maximize its desirable attributes of encouraging greater efficiency while providing price certainty for both consumers and suppliers. It also reduces the dead weight cost of repeated intensive price reviews.

Under a CPI +/-X price path, the regulated business effectively faces a price or revenue cap on its sale of regulated goods and services. Provided the regulated business can retain its costs within the cost projection used in the building block model used to derive the CPI +/-X price path, the regulated business will earn a commercially acceptable rate of return and recover all efficient costs. If the business can reduce costs below those included in the building block model, the business can retain the financial benefit of these additional cost savings for the period of the price path. There is no claw back or requirement to force these additional cost savings to be passed through to consumers during the period of the price path. To achieve cost savings, the regulated business will in all probability want more than one or two years to put into place various cost saving technologies. The CPI +/- X form of regulation provides the incentive for the business to make these types of cost saving investments. A five year price path allows sufficient time for the industry to implement cost saving technologies.

The Commission invites comments on the length of the regulatory period.

4.6 Price for individual products

The price path if expressed in total revenue requirement terms needs to be converted into prices for individual tinned fish and tinned meat products. The industry produces a range of products and different product sizes. A price control mechanism needs to define how prices for individual products should be changed consistent with the overall total revenue requirements.

A number of options are available to the Commission. These include:

- Setting prices for individual products based upon some form of direct cost allocation methodology for each product and adjusting these prices in accordance with movement in the price path formula;
- Setting an average price for a basket of similar products, allowing individual prices within this basket to be set by the manufacturer/supplier and adjusting the average price using the price path formula;
- Setting a total revenue cap and allowing prices to be set such that, together with demand projections, they result in total revenue outcomes consistent with the required revenue cap.

The Commission is seeking comments on the way in which prices for individual types and sizes of products should be set consistent with the overall objective of recovery of the efficient building block costs

4.7 Cartage and sea freight

Coastal and land freight costs under the current pricing arrangements are included in the cost recovery for tinned fish and tinned meat products ex-terminal/warehouse. These costs reflect the average cost of delivering products to outlying areas in the country, depending upon the contractual arrangement between the fish and meat canning industries and the local shipping or cartage operator.

The Commission must determine whether prices should be set ex-terminal/warehouse at the place of manufacture, or ex warehouse in Lae, Madang and Port Moresby, or delivered to the customer/retailer. The Commission must also determine what an appropriate efficient cost is for that

freight service. The Commission also needs to consider how and whether to regulate this cost.

The Commission notes that for some other products, coastal freight charges are regulated using either a price monitoring or price control formula, but for others coastal freight charges are not regulated. Also the Commission notes that it is regulating coastal freight charges for tinned fish and tinned meat but not road transport charges. The Commission must consider whether this differential treatment of coastal freight from other freight should continue.

The Commission is seeking submissions on the inclusion of coastal or cartage freight as part of the cost build-up for ex-terminal/warehouse prices. The Commission is also seeking input as to what value should be applied to such freight services and how this cost should be adjusted over the regulatory period.

4.8 Timing of price adjustments

If the outcome of this Review is that some form of price control should continue, the Commission will seek to put into place a price determination which will provide a degree of pre-determined adjustment to prices within an overall incentive based price path model. This approach may provide for price adjustments to be made annually and that during each year the business would manage its overall costs such that it keeps its total costs within the modelled revenue requirement derived from the forward projection of the efficient cost building block model for the industry.

However another option would involve more regular price adjustments, reflecting movements in the costs of imported inputs into tinned fish and tinned meat products that make up a larger part of the final price charged to consumers.

One alternative may be to allow regular (for example, monthly) flow through adjustments in price for changes in the cost of imported components. The Commission would need to be satisfied that these costs were determined on an arms length basis and reflect movements in an import parity price for these components.

Under this arrangement the Commission would effectively set the revenue requirements for the production, canning, and distribution functions undertaken by the tinned fish and tinned meat companies domestically and allow a pass through of the movement in the import price of the imported components,

possibly based on some independent indicator. The production/packaging costs could be set on an annual basis (or even a five year basis to preserve some of the advantages of incentive regulation), thereby encouraging the tinned fish and tinned meat companies to manage their domestic operating costs within the cost based revenue requirements of the production, packaging and distribution activities of the companies. The cost of the imported components landed in PNG would be allowed to flow through to the final price for tinned fish and tinned meat products, and then using an appropriate formula, converted to a price for particular tinned fish and tinned meat products and can sizes.

However, it should be noted that more regular price adjustment of this type effectively reduces the effect of incentive price regulation and reduces it to a cost plus form of regulation with all its associated disadvantages to the industry as well as the community as a whole.

The Commission is seeking views and submissions on the timing for price adjustments under the regulatory price path, and what options might be available to retain the benefit of an incentive form of regulation while at the same time allowing for a pass through of what would be an arms length international prices for the imported inputs used in the production and canning of tinned fish and tinned meat.

4.9 Monitoring of Price Changes

The Commission has the option to use a price monitoring approach. As previously noted, this has a number of advantages, principally in terms of the cost of regulation and the greater freedom that it gives the regulated entity to manage its pricing arrangements while at the same time ensuring that the Commission maintains appropriate oversight powers in terms of the potential for suppliers to extract monopoly rents in terms of the prices that they charge for their goods and services.

For a monitoring approach to be successful the Commission needs to have access to some price or cost 'indicator' which can be used as a guide to possible efficient price movements of the regulated goods or services. In the context of rice and flour prices in PNG, the Commission has used international prices as derived from the pricing series provided by the Australian Bureau of Statistics to provide this indicator. The emphasis in selecting an indicator is to find a series that will reflect movements in the efficient prices over time, and to find a series that is independent of the actions of the suppliers in PNG. Thus the Commission can not readily use as an indicator the price for tinned fish or tinned meat that is imported into PNG by the existing domestic manufacturers or suppliers as they have an interest in the behaviour of the price series and theoretically could

influence its movement over time to reflect their own interests.

In examining this option, the Commission will need to look at a range of possible indicators of price movements, desirably series that reflect the price movements in competitive markets. The series need not be of one product alone, although should more than one price series be used the Commission would have to decide how to weight the various price series together to derive a final indicator series. The Commission has used this approach in its Freight Cost Index which it uses to monitor the movement in domestic freight charges within PNG. However, the Commission recognises that the weighting together of multiple price series adds to the complexity of the price monitoring arrangements, and it is in part to lessen this complexity that the Commission has been attracted to the use of the monitoring arrangements for other goods and services.

The Commission is seeking views and submissions on the possible indicator series that could be used for tinned fish and tinned meat products should a monitoring approach to price regulation be adopted.

5. Wholesale Margin on Tinned Fish and Tinned Meat Products.

5.1 *Activities covered*

At present, the wholesale activity for tinned fish and tinned meat is undertaken by various independent wholesalers and to some extent by the tinned fish and tinned meat manufacturers themselves in cases where a major retail operator purchases direct from the suppliers' terminal/warehouse. To discourage smaller retailers from purchasing direct from the terminals/warehouse, the tinned fish and tinned meat companies set minimum purchase requirements. The current wholesale margin on tinned fish and tinned meat products is set at 10% for related entities and 11% for unrelated entities on the into store price. This margin does not cover the cost of freight from the manufacturer's facilities or wharf to the wholesaler. These costs are separate and are not subject to price control under the current arrangements.

The current allowable retail margin for tinned fish and tinned meat products is 8% and 10% for related and unrelated entities respectively on the into store price. However, where a retailer purchases direct from the tinned fish and tinned meat manufacturers at ex-terminal/warehouse price, the retailer is allowed a margin of 18% which is less than the combined (and cumulative) 11% wholesale and 10% retail margin that applies to two independent transactions covering the wholesaling and retailing functions. To what extent this creates competitive disadvantages for certain types of suppliers, or acts in some way as a constraint upon competition will need to be considered by the Commission.

The wholesaling function is undertaken by a limited number of businesses in PNG. While some degree of competition exists between wholesalers/retailers in the larger centres where consumers can access more than one retail outlet, the opportunity for competition is not as high in other centres and remoter locations. In these circumstances there is the potential for market power to be exercised in a manner that could disadvantage consumers.

The Commission must consider whether some form of regulation of wholesalers' margins should continue and if so what form of regulation (i.e. price control or price monitoring) should be used. Submissions are invited on this issue.

5.2 *Form of regulation*

Assuming price regulation continues in some form, the Commission must decide on the most appropriate way of applying that regulation and the level of the

margin allowed. If price monitoring is adopted whereby wholesalers could adjust their own wholesale margins without the need to seek prior approval from the Commission, the Commission would compare movements in this margin with an appropriate benchmark with the threat of full price control should margins be increased at rates above an appropriate 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 and the initial setting of the wholesale margin. The Commission will also need to put in place appropriate data collection arrangements whereby it can obtain information on the margin charged by the wholesaler.

If a price control mechanism is used, the Commission would need to determine the appropriate level of the wholesale margin and the process whereby an approved change in the margin could be made. The process of reviewing changes in the margin in response to an industry request would necessitate a lengthy and detailed process whereby the Commission would effectively need to examine the underlying cost changes within the wholesaling sector.

Rather than undertake a detailed review of these margins each time a change is requested, the Commission could adopt a 'price path' approach similar to that discussed above whereby the Commission would evaluate an appropriate formula linked to some appropriate indicator of cost changes (and incorporating some form of efficiency adjustment) and this formula could be applied over a number of years without the need for a full price review.

The current pricing arrangement of setting the wholesale margin at 11% has been in existence for some time, and may not be reflecting adequately the efficient cost of the wholesaling activity.

The Commission has foreshadowed a major review into the wholesale and retail sector to examine the issue of competition and pricing behaviour in this sector. It is envisaged that this review will commence later in 2006 and will incorporate the issues surrounding the setting of wholesale and retail margins for foodstuffs amongst other goods. At this time the Commission is inclined to a view that the margin should be set consistent with the current level assuming that the Commission forms a view that regulation of prices for tinned fish and tinned meat needs to continue. This will be a matter that the Commission will consider as part of the present Review.

The Commission is seeking views on the wholesale margin that should apply to tinned fish and tinned meat in advance of the completion of the foreshadowed review of the wholesale and retail sectors, assuming that some form of regulation is required for these products.

6. Retail Margin on Tinned Fish and Tinned Meat Products

6.1 Activities covered

The retailing activities for the sale of tinned fish and tinned meat are provided by businesses such as trade stores, supermarkets and other convenience stores. The larger supermarkets usually have their own wholesaling division and supply many of the small retail outlets and trade stores. There appears to be a high concentration of market power in the hands of a relatively few retail/wholesale businesses in PNG. While there is evidence of competition between these businesses in the larger centres such as Port Moresby and Lae, in the smaller centres and remote rural locations there is little if any competition between retail outlets for the sale of tinned fish and tinned meat products.

Currently the retail margin of 8 % and 10% for the said entities on the into store cost is declared under the Prices Regulation Act (amended) and is factored into the final tinned fish and tinned meat product price. The 8% and 10% margin on the into-store price for the retailer has been fixed at this level for a number of years.

The retailing activities of retail stores cover regulated tinned fish and tinned meat products plus a wide range of other regulated and non-regulated products. Thus, in any consideration of the appropriate costs to be recovered from the regulated products, allowance must be made for costs that more appropriately relate to unregulated activity.

The Commission must consider whether some form of regulation of retailers' margins should continue and if so what form of regulation (i.e. prices control or prices monitoring) should be used. Submissions are invited on this issue.

6.2 Form of regulation

Assuming price regulation continues in some form, the Commission must decide the most appropriate way of applying that regulation and the level of this retail margin. If price monitoring is adopted whereby the retail outlets could adjust their own margins once the Commission approved an appropriate margin, the Commission would simply compare the movement in the margin charged with an appropriate benchmark with the threat of full price control should the industry lift their margins above that 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 would also create monitoring and compliance checking problems for the Commission.

If a price control mechanism is used, the Commission would need to determine the appropriate level of the controlled margin and the approved process for changes in that margin overtime. The process of reviewing the margin 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 supplying the retail service. This could be costly and intrusive approach for individual small retailers.

As referenced in discussion on the wholesale sector, the Commission has foreshadowed a major review of the wholesale and retailing sectors to commence later in 2006. It is envisaged that as part of that review, the Commission would consider the need for the continuation of some form of regulation of wholesale and retail margins.

Thus, if the Commission was to conclude that some form of regulation of the prices of tinned fish and tinned meat was required following this current review, the Commission could give more detailed consideration to the matter of margins as part of this larger inquiry. This would also allow the Commission to consider issues such as the allocation of costs for individual types of products sold within the retail sector and the level of competition at different locations within PNG. If the Commission was to adopt this approach, then it would likely adopt a similar arrangement as currently applies to rice and flour, that is, fixing the monetary value of the retail (and wholesale) margin until such time as the foreshadowed industry review is undertaken.

The Commission is seeking views on the retail margin that should apply to tinned fish and tinned meat in advance of the completion of the foreshadowed review of the wholesale and retail sectors, assuming that some form of regulation is required for these products.

Attachments

Attachment 1

Section 21 (2A) of the Prices Regulation Act Chapter 320

When making an order under Subsection (1), the Commission shall have regard to:

- A. the need to protect consumers and users of the declared goods or services from misuse of market power in terms of prices, pricing policies (including policies relating to the level or structure of prices) and the standard of the declared goods or services;
- B. the cost of making, producing or supplying the declared goods or services;
- C. the desirability of encouraging greater efficiency in relation to making, producing or supplying the declared goods or services;
- D. the need to ensure an appropriate rate of return on any investment in relation to the declared goods or services;
- E. the borrowing, capital and cash flow requirements of persons making, producing or supplying the declared goods or services;
- F. considerations of demand management and least-cost planning;
- G. existing standards of quality, reliability and safety of the declared goods or services, and the desirability of encouraging improvements in those standards;
- H. the effect any proposed order on general price inflation over the medium term;
- I. the economic and social impact of any proposed order; and
- J. any other matters the Commission considers relevant.

Attachment 2

Public Notice on Release of Issues Paper



Independent Consumer & Competition Commission
Office of the Commissioner

6th June 2006

PUBLIC NOTICE

To: General public, importers, wholesale and retail operators, manufacturers and distributors of tinned fish and tinned meat products, Government agencies and other interested stakeholders.

ICCC COMMENCES REVIEW OF TINNED FISH AND TINNED MEAT PRICES

The Independent Consumer and Competition Commission (ICCC) today announced that the Commission will embark on a public enquiry into the setting of the regulated prices for tinned fish and tinned meat in PNG with the release of an Issues Paper.

In announcing the public enquiry, The Commissioner, Mr Thomas Abe said, "Tinned fish and Tinned Meat is a declared good under Section 10 of the Prices Regulation Act and this legislation allows the Commission ("ICCC") to undertake a review and to determine appropriate pricing levels for the various range of tinned fish and tinned meat products.

The Commission could alternatively as a result of the review decide that tinned fish and tinned meat prices no longer need to be regulated. " If there is sufficient competition in the market there may not be a need for the ICCC to set the price of these products", Mr. Abe said.

Mr. Abe said that because tinned fish and tinned meat forms significant part of the daily protein of the diet of most Papua New Guinean, if the Commission decides to continue to regulate tinned fish and tinned meat prices "it is imperative that the prices for these products reflect the efficient cost of

producing and providing it”.

He added that a review of the pricing regulation of other declared goods such as Batteries, Butter, Coffee, Margarine, Milk, Poultry, Soap, Sugar and Tea will follow at a latter stage after the completion of this current review.

“As part of this review, the Commission has the opportunity to consider a range of possible regulatory techniques, including the monitoring of tinned fish and tinned meat prices against some international benchmark, or some other more direct form of prices setting arrangement”, Mr. Abe said.

The inquiry is being conducted under Section 25A (6) of the Amended provisions of the Prices Regulation Act, and will be a public inquiry in which all members of the community are invited to make submissions.

To assist in the process of public consultation, the Commission has released an Issues Paper which identifies a number of the matters and issues that will have to be considered as part of the inquiry. The timetable for the review period is as follows:

Release of Issues Paper.....-	6 th June 2006
Receipt of Public Submissions..... -	6 th July 2006
Release of Draft Report.....-	7 th August 2006
Receipt of submissions on Draft Report.....-	7 th September 2006
Release of Final Report.....-	6 th October 2006

Mr. Abe stressed that the review timetable gives the opportunity for the general public, consumers, key Government agencies and major players in the industry and private sector to actively participate and contribute in this public process. The participation and contribution of both individuals and corporate bodies is vital in assisting the Commission to make an informed decision on whether or not to regulate tinned fish and tinned meat prices and how this regulation should occur.

All written submissions should be received by the Commission no later than 6th July 2006 and be forwarded to the address below:

MR. THOMAS ABE
COMMISSIONER & CEO
INDEPENDENT CONSUMER AND COMPETITION COMMISSION
P O BOX 6394
BOROKO, NCD

PHONE: 325 2144
FAX: 325 3980

Copies of the Issues Paper can be obtained from the Head Office at 1st Floor Garden City Complex, Boroko or through the Commission's websites: www@iccc.gov.pg while other enquiries to any aspects of this review should be addressed to Mr. Taunao Vai from ICCC or through this email: tvai@iccc.gov.pg

Authorised by:

Thomas Abe
Commissioner & CEO