

Production process exemption, s44B(f)

Submission to the Productivity Commission review of the National Access Regime

Mike Smart, 8 Feb 2013

Introduction and disclaimer

My name is Michael Smart. I am a consulting director of the Sapere Research Group, an economic consulting firm. I have previously prepared expert evidence on several Part IIIA and Gas Law cases and testified before the Australian Competition Tribunal. I am not currently involved in any such matters.

The subject of this submission is the production process exemption that is contained in s44B(f) of Part IIIA of the Competition and Consumer Act 2010.

I make this submission as an individual. The views expressed here do not necessarily represent those of the Sapere Research Group.

Summary of submission

I submit the following points with respect to the production process exemption:

1. The current wording of the subsection is unclear, giving rise to multiple, conflicting judicial interpretations. As a result the subsection provides insufficient guidance or certainty to potentially affected parties.
2. The economic rationale for such an exemption is that, in some situations, declaration would introduce additional transaction costs that outweigh any likely benefit from enhanced competition in markets.
3. An assessment of the tradeoff between transaction costs and competition-driven allocative efficiency gains necessarily involves case-by-case examination of economic evidence.
4. Recognising that such an assessment may prove burdensome for the Courts, it is proposed to streamline the analysis in the following way:
 - a. If a comparable use of a comparable facility is sold as a stand-alone product in any market worldwide, then the exemption does not apply;
 - b. Otherwise, such a use of such a facility would be exempt unless it can be demonstrated that the allocative efficiency benefits of declaration would significantly exceed any net increase in transaction costs caused by declaration.
5. In the event that the evidentiary requirements of this test are considered to be too onerous, an alternative amendment to s44B is proposed: ss44B(f) would not apply when ss44B(a), (b), or (c) apply.

I submit that these changes would improve the certainty of application of s44B while faithfully addressing the economic issues that motivated the original exemption test.

s44B

Part IIIA of the Competition and Consumer Act 2010 provides for the declaration of certain types of service. A service is defined in s44B. It *means a service provided by means of a facility and includes:*

- (a) the use of an infrastructure facility such as a road or railway line;*
- (b) handling or transporting things such as goods or people;*
- (c) a communications service or similar service;*

but does not include:

- (d) the supply of goods; or*
- (e) the use of intellectual property; or*
- (f) the use of a production process;*

except to the extent that it is an integral but subsidiary part of the service.

Something that is not a service within this definition is incapable of being declared.

1. Problems with current provision

The meaning of the phrase “*the use of a production process*” has been the subject of four cases concerning declaration of railway infrastructure in the Pilbara region of Western Australia:

1. [1999] FCA 867, “Hamersley”;
2. [2006] FCA 1764, “BHP 1”;
3. [2007] FCAFC 157, “BHP 2”; and
4. [2008] HCA 45, “BHP 3.”

Unfortunately, the judgements in the first three of these cases arrived at meanings for this phrase that were inconsistent with each other. The third case gave rise to two separate interpretations, as Justice Finkelstein dissented from the majority. While the High Court reached a definitive conclusion on the application of that phrase to the particular iron ore railway at issue, it is difficult to generalise from that result.

In the first three cases, the Courts held that economic evidence was irrelevant to the understanding of words of ordinary meaning, such as “production process”, and that the application of the definition of the term to the facts is simply not a matter for economists. Recourse was instead had to dictionary definitions and applications of similar terms in unrelated case law, such as tax cases. Even these reference points proved controversial and inconclusive.

S44ZZRB provides a definition of “production” that is intended to be used to clarify the meaning of s44B(f). Production is there defined to include *manufacture, processing, treatment, assembly, disassembly, renovation, restoration, growing, raising, mining, extraction, harvesting, fishing, capturing and gathering*. I submit that this clarification does not overcome the problems noted above. For example, is accounting that is done in a mining company a production process because mining is production?

As a result, guidance for future matters is unsatisfactory. The question of applicability of the production process exemption can be considered settled only for iron ore railway lines.

2. Economic significance of declaration and production processes

Any proposed third party use of a facility falls into one of two categories. Either that type of facility use is already for sale in a market, or it is not. In the latter case, declaration would create a new type of market transaction—for the sale and purchase of that right to use the facility. Prior to declaration, that right was held exclusively by a vertically integrated organisation.

The introduction of a new transaction creates new transaction costs. Transaction costs include the time and effort involved in negotiating, monitoring and enforcing an agreement. Importantly these costs are incurred by the participants in a market transaction whether or not arbitration is invoked, although arbitration is likely to increase them.

Following the analysis of Nobel laureate Oliver Williamson, a facility proprietor's own-use (first-party access) carries certain transaction costs, but the move to a market-based transactional form (third-party access) will likely change them. Whether they increase or decrease with the move to a market mechanism depends on such characteristics of the transaction as: complexity, asset specificity, and the extent of disruptions. It is reasonable to suppose that for an existing vertically integrated operation, the transactional costs would increase with third party access. According to transaction cost economics, pioneered by Williamson, the attempt to minimise transaction costs is one of the primary determinants of the boundaries of a firm.

This field of economic analysis is relevant because declaration changes the boundaries of the access seeking and access providing firms. It places the relevant facility partly outside the control of its owner and partly within the control of the access seeker.

It has often been noted that declaration itself does not provide or guarantee access. It merely creates the possibility of access on negotiated and possibly arbitrated terms. As such, many inconveniences suffered by a facility owner thanks to declared access can be compensated through access pricing. However, the market transaction costs are new costs to society that did not previously exist. The welfare problem posed by these new costs cannot be removed through any access pricing scheme.

Seen in this light, declaration involves the following tradeoff. An improvement in allocative efficiency is sought by using declaration to blunt certain uses of monopoly power that are not otherwise illegal. However, the cost of seeking this improvement is a reduction in productive efficiency through the increase in transaction costs that it causes.

For example, a principal reason why a piece of machinery within a factory should not be declared is that the contractual arrangements needed to facilitate an outside party's use of an embedded machine would be exceedingly complex and probably incomplete. That is, there is likely to be some important situation in which the contract fails to set out the rights and responsibilities of the parties, inviting costly haggling and disputation. Agreements would be hard to conclude and even harder to monitor or enforce. The invasiveness and disruption would likely be intolerable. It would, in any case, seriously threaten the economics of the factory from the owner's standpoint.

Moving beyond the factory walls, it becomes more difficult to draw a sharp distinction between the type of intervention that would be unacceptably disruptive and the type that would represent only a small change in routine. An obvious point of low-cost intervention would be just after the creation of a marketable product, meaning a good or a service that can be sold on a market.

The economic history of industrial production shows that intermediate products that are now routinely sold on markets were once the midpoints in complex, vertically integrated production processes. Car parts, computer chips, and industrial chemicals¹ provide examples of this phenomenon. The separability of components of a production chain depends on the current state of technology, and cannot be evaluated without that context.

3. Importance of economic evidence

The Hilmer Report discusses exempting production processes from declaration on page 251:

“Unless the owner of a facility consents to access being declared, the Minister could only make such a declaration where:

“I Access to the facility in question is essential to permit effective competition in a downstream or upstream activity; Clearly, access to the facility should be essential, rather than merely convenient.

“II The making of the declaration is in the public interest, having regard to: (a) the significance of the industry to the national economy; and (b) the expected impact of effective competition in that industry on national competitiveness.

“These criteria may be satisfied in relation to major infrastructure facilities such as electricity transmission grids, major gas pipelines, major rail-beds and ports, but not in relation to products, production processes or most other commercial facilities.”

This brief mention is expanded somewhat in footnote 42 which cites an unsuccessful attempt by a new firm to access the intellectual property of an established rival. The connection between these observations and the definition of service within s44B is clear.

While little light is shed on the specific rationale for exempting production processes, it seems clear that the Hilmer Committee sought to prevent declaration of production processes because of the economic consequences of permitting it.

Despite the Courts’ refusal to consider economic evidence on this issue, parts of several of the judgements indicate that the Courts relied on economic concepts to help refine the definition of a production process. For example:

- In *Hamersley*, Justice Kenny identified the creation of a marketable commodity as an endpoint of a production process. [para. 32]
- In *BHP 2*, Justice Greenwood noted that the invasiveness and disruptiveness of third party use of a facility was relevant to the production process exemption. [para. 178]

¹ Wood pulp, crude oil, bauxite, pelletised iron ore, etc. provide further examples.

- In BHP 3, the High Court preferred Fortescue’s construction of the production process exemption because, *“Only this construction of par (f) is consistent with a reading of the definition of ‘service’ in s44B of the TPA in a way that would advance the attainment of the large national and economic objectives of Pt IIIA, ...”* [para. 42]

I submit that these concepts are useful in deciding whether declaration would be economically efficient (hence consistent with the Act’s objectives), but that the current production process exemption rule prevents recourse to economic evidence, which is crucial to an efficient decision.

4. Proposed new test

Given transaction cost economics and the continuing articulation and specialisation of industrial production, I submit that focus on the plain English term “production process” is unhelpful as a guide to the relevant concepts. Rather, any attempt to exempt a particular service should be evaluated on the basis of the likely transaction costs created by declaration of that service, given the current state of technology.

For services of a type that is already sold separately on an existing market, the transaction costs are demonstrably manageable, and declaration should not be opposed on that ground. However, for services that are so deeply embedded in the process of creating a marketable product that similar services are not unbundled in any comparable industry worldwide, declaration should only proceed if it can be shown that the competitive benefit will outweigh the new transaction costs. The burden of proof should be on the advocate of declaration.

I therefore propose the following text for a revised s44B (f):

A “service” includes a type of use of a type of facility that is sold as a stand-alone product on any market worldwide. If it is not, then it may only be a “service” if it can be shown that the allocative efficiency benefits of declaration would significantly exceed any new transaction costs that declaration might cause.

5. Alternative formulation

While it is my view that an economic rule of reason is required to properly deal with the issue to which the current production process exemption is addressed, it is recognised that the practical implementation of such a test may pose difficulties in practice for Courts.

In the event that such an empirical economic test proves unworkable, I would support a clarification of the current s44B that was indirectly suggested by Justice Finkelstein in his judgement in BHP 2 [para.6]. This suggestion is that ss44B (f) apply only to services other than those mentioned in ss44B (a), (b), and (c).

The practical import of such a change would be to remove the possibility of s44B (f) exemption for the use of roads, railway lines, for handling or transporting things such as goods or people, or for a communications service or similar service. Such a change would, I believe, be more consistent with the evident intent of the Hilmer Committee, and would better advance the attainment of the large national and economic objectives of Pt IIIA.