MINERALS COUNCIL OF AUSTRALIA

REVIEW OF NATIONAL ACCESS REGIME OF THE AUSTRALIAN COMPETITION AND CONSUMER ACT

Submission to the Productivity Commission

FEBRUARY 2013

Contents

Executive summary

The defining challenge for Australia's minerals industry is to transition from an era of "price-led" growth to one of "volume-led" growth. Investment in, and efficient operation of, key export infrastructure (ports, railways etc.) is critical in making this transition successfully.

Infrastructure bottlenecks – most notably in relation to multi-user coal facilities on Australia's eastern seaboard – were a key factor constraining the industry's ability to take maximum advantage of rapidly rising commodity prices in the period from 2003-04 to 2009-10. Such capacity constraints were much less apparent in the iron ore rail and port operations of the Pilbara where they are part of privately originated, owned and operated "vertically integrated" production systems – in other words, facilities that have never been in public hands.

Infrastructure constraints have eased in recent years as a result of increased investment and improvements in the operation of east coast infrastructure facilities. Official projections for key bulk commodities point to generic capacity for bulk commodity exports facilities through to the middle of the decade.[1] However, this is not universal. In specific areas there are critical market failures manifest in capacity constraints and bottlenecks.

This review by the Productivity Commission of Part IIIA of the Australian Competition and Consumer Act (the National Access regime) is an opportunity to assess the role and application of a system of statutory access rights which, inter alia, recommend the criteria under which one business should be required by law to make its private facilities available to another business and to identify legitimate distinctions in the interpretation and application of criteria between private integrated facilities and existing multi-user systems.

It is also an opportunity for the Productivity Commission to renew its focus on market efficient outcomes and the delivery of ongoing productivity improvements in regulated services.

The issues associated with Part IIIA came into sharp focus for the minerals industry during the prolonged disputes associated with applications for access to rail track for the transport of iron ore in the Pilbara. The resolution of those disputes also has implications for existing multi-user infrastructure (predominantly formerly or currently government-owned) currently subject to direct regulation, especially given the degree to which the 1993 Hilmer competition reforms[2] – the genesis of Part IIIA – were a response to the anti-competitive risks arising from the privatisation/corporatisation of government enterprises.

The Hilmer reforms were about opening the Australian economy to greater internal competition, in particular, creating markets in areas dominated by state-owned and operated utilities, infrastructure assets and, to a lesser extent, services.

The Hilmer Report, inter alia, identified criteria to be adopted in recommending the introduction of a system of statutory access rights in Australia – specifically designed to address the circumstances of the privatisation of government-owned enterprises which could manifestly reduce competition in upstream or downstream markets.

Hilmer's recommendations were heavily qualified in that the facilities and industries most likely to meet the statutory requirements for third party access would be those where there was "traditional involvement of government in these industries, either as an owner or regulator".[3]

Hilmer adopted and adapted the "*essential facilities*" doctrine (EFD) developed under United States jurisprudence. That doctrine requires the owner of a monopoly asset to provide third parties access, and on what terms, to the facility in order to ensure competition in a "related market", where the facilities are considered "*essential*" if:

- it constitutes a natural monopoly where it was physically impossible or prohibitively expensive to duplicate or otherwise construct substitute facilities – there must be no actual or possible sources of alternative supply;

[1] Bureau of Resources and Energy Economics, *Australian Bulk Commodity Exports and Infrastructure – Outlook to 2025*, July 2012.

[2] Independent Committee of Inquiry into Competition Policy in Australia, National Competition Policy, AGPS (1993) – henceforth described as the Hilmer Report,

[3] Hilmer, p. 251.

- it constitutes a real "*bottleneck*"—ie for which no physical or economic substitute exists;
- the owner of an essential facility need not expand its own capacity or reduce its own output in order to provide access to a competitor; and
- the facility must be truly essential to competition – it is not sufficient that the facility merely improves competition.

The EFD overrides the property rights of the access provider by imposing transactions on them that they would not voluntarily or necessarily have entered into. That is, it denies the owner the choice with whom, and on what terms, to enter into commercial enterprise. Hilmer clearly recognised the economic costs and risks associated with third party access. Hilmer also identified the considerable prospect of competitive benefits of third party access in the context of the transitioning of public utilities (generally characterised as having existing multiple users reliant to the services) to private monopolies.

Conscious of the dangers of over-riding property rights, Hilmer laid down a number of qualifications on any access regime to be created in Australia, specifically:

- the need to "*carefully limit the circumstances in which one business is required by law to make its facilities available to another*", because the "*failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment*".[4]
- the need for access should be "*essential*" to permit effective competition in a downstream or upstream market. [5]
- that if applied to privately-owned facilities "*it would be appropriate that an obligation to provide access does not unduly impede an owners right to use its own facilities, including any planned expansion of utilisation or capacity*".[6]

Hence, two fundamental questions arise in the context of this review:

- Under what circumstances (and terms and conditions) should one business be required by law to make its private facilities available to another business?; and
- What are the consequences, in terms of efficiency losses, regulatory costs and deterred investment in economic infrastructure and innovation, of getting the judgements wrong?

Regulatory processes are inherently imperfect and the efficiency goal of regulation is itself multi-faceted. For example, it requires price levels and structures that will: (a) encourage efficient use and delivery of services, while (b) also encouraging efficiency in the nature and timing of investments. Moreover, issues surrounding declarations of third-party access to user-owned facilities as part of highly-integrated, complex supply chains (such as the iron ore railways of the Pilbara) raise very different regulatory questions from those relating to multi-user export infrastructure providing services to coal mining companies in NSW and Queensland.

The MCA considers the key principles of an efficient national access regulatory regime are:

- the primacy of the market – a presumption that the free an unhindered operation of the market will lead to efficient outcomes;
- minimum effective regulation – necessary regulation where it is demonstrably the most economically efficient way of addressing market failure and/or a specific social objective; and
- the need to prioritise private sector confidence in regulatory arrangements.

While regime efficiency in this context involves consideration of economic concepts (market power, market failure, competition, contestability etc.) it also hinges critically on ensuring that investors – whether they be infrastructure providers or users – have a high level of confidence that the essential terms upon which investments are made will remain in place during the life of the investment.

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[4] Ibid. p. 248.

[5] Ibid. p. 251.

[6] ibid. p. 256.

From this perspective, close attention to the specific circumstances and historical legacies that surround "*market failure*" and "*regulatory failure*" in industries is essential. A point reflected in the Hilmer Committee's original conclusion that the National Access Regime required flexibility to be adaptable to differences between industries and within an industry.

In the case of privately-owned vertically-integrated, single-user facilities, the most obvious "*regulatory failure*" has been the failure to provide the owners of facilities confidence that, *prima facie,* their infrastructure is not subject to "*declaration*" (under the Act) where it cannot be justified in a material consideration of market failure in accordance with the original Hilmer intent of Part IIIA.

In the case of multi-user facilities, while there has been considerable reform centred on market based solutions, the main "*regulatory failures*" have surrounded inadequate commercial alignment of market incentives between the interests of owners and users, and the interpretation of existing provisions[7] that require the provider to extend the facility and/or permit interconnection to the facility, resulting in inefficient use of existing capacity and which mitigates against bringing on new capacity, thus causing delayed and asynchronous expansion of port and rail capacity.

Further reform is required to better align the operational and commercial interests of owners and users. Owners and users need both the financial incentives and the regulatory capacity to extend the facility to both build and deliver expanded services with a portion of revenue at risk based on the fulfilment of key business performance indicators.

An emerging threat is the failure to properly and adequately determine the prospects of a competitive market for the provision of essential infrastructure services from a privatised multi user monopoly asset, where, *prima facie*, the circumstances which justified the original regulatory intervention, have not materially changed. That is, the regulatory arrangements under which the owner of the monopoly asset is required to provide third parties access, and on what terms, to the facility, in order to ensure a competitive market where those facilities are considered "*essential*" services.

Accordingly, the application of Part IIIA, and in the context of addressing capacity constraints to supply significantly greater demand for mineral commodities over the last decade, is markedly different for private originated and operated vertically-integrated production systems from former public monopoly utilities privatised to provide essential multi user infrastructure services. Accordingly, the imperatives of policy reform in each case are also different.

Recommendations

Multi-user infrastructure

The MCA considers that economic regulation has an important role to play in correcting market failure in multi-user infrastructure manifest in sub-optimal alignment between asset owners and users, where it is demonstrably evident that there is not, nor prospect of, a competitive related market for the provision of essential infrastructure services.

An emerging threat is the failure to properly and adequately determine the prospects of a competitive market for the provision of essential infrastructure services from a now privatised monopoly asset where, *prima facie*, the circumstances which justified the original regulatory intervention have not materially changed. The central issue concerns the interpretation and implementation of the regulatory arrangements under which the owner of the monopoly asset is required to provide third parties access (including extensions of capacity), and on what terms, to the facility, in order to ensure a competitive market where those facilities are considered "*essential*" services.

Regulation should provide for an efficient price for both service providers and users; operational issues managed by commercial contractual negotiation; recognition of the investment contribution of existing users; and scope to invest in additional capacity. Existing regulation of multi-user infrastructure services should not be revoked if a market failure was to result or other policy and practical considerations (particularly environmental, social or physical) would effectively create a natural monopoly following revocation.

- Private profitability cannot be seen in isolation - Investments have already been made in mines on the expectation that already regulated facilities will continue to be regulated. A significant change may render existing investments

[7] Australian Competition and Consumer Act, Part IIIA, sections 44V and 44W.

uneconomic or unable to compete internationally. Monopoly pricing would also lead to inefficient allocation of resources and reduction of national export income.

- Whatever the value of the private profitability test for new declarations – and this must be viewed with due regard to the circumstances of each case – it should not be the sole test for the revocation of regulation of regulated assets.
- Expansions to existing multi-user infrastructure should usually be subjected to regulated pricing and access regulations in line with the principles of efficient national access regulations (introduced above and in Box 2 later in this submission).

Privately-owned, vertically-integrated production processes

The application of Part IIIA to privately-owned, vertically-integrated facilities needs to be more clearly defined, including via a mechanism to exempt such facilities from the operation of the statute. This is in line with the recommendations made by the Prime Minister's 2005 Exports and Infrastructure Taskforce, and specifically:

- that there should be an "*efficiency override*" for applications for declaration of export related facilities under Part IIIA or its associated regimes; and
- that the "*production process exemption*" should be amended so as to make it "*clear that the purpose of the exemption is to prevent the imposing of third party access in vertically-integrated, tightly managed, logistics chains, especially those related to our export industries*".

Based on the above, the MCA considers that the criteria for access should be that:

- the barriers to entry, whether they be physical, commercial,[8] and/or regulatory, are so material as to create a natural monopoly with attendant anti-competitive risks
- competition be promoted in a market that is substantial and of national significance, other than the market in which the service is being provided, before the service is declared;
- the declared service be truly essential to competition in the market in which competition will be promoted, where essential means indispensable as a practical matter for participation in that market';
- the production process exemption prohibit or strictly limit access where doing so would disrupt a vertically-integrated production process; and
- the decision-maker be satisfied that granting access is in the public interest and in so doing, that the decision-maker takes account of the costs and risk of regulatory error.

February 2013

[8] Commercial barriers to entry as interpreted by Hilmer as 'prohibitively expensive' and recently by the High Court in terms of 'private profitability'.

The economic context

The fortunes of the Australian minerals industry and infrastructure development are inextricably linked. Mismatches in, or inadequate provision of, infrastructure mean that Australia misses out on maximising the export potential of its resources base either through product not being shipped or, ultimately, mines not developed.

In 2002-03, the year before the mining boom began, mineral and energy resources exports totalled $46 billion (in 2011-12 dollars) and accounted for just over 24 per cent of Australia's total exports. By 2011-12, the value of Australia's mineral and energy resources exports had more than tripled in real terms to be $158 billion, accounting for just over 50 per cent of the total value of Australia's exports. Notwithstanding this strong growth in export values, over the decade from 2000 to 2010 Australia's market share of production in major commodities fell, with the exception of a small increase in iron ore.

While growing global demand based on further urbanisation and industrialisation in emerging economies could underpin Australia's minerals sector for many years, it is generally acknowledged that the era of premium export prices is over. Those prices created the impetus for a significant supply response from both existing and new producers which is now underway. Hence, the defining challenge for Australia's minerals industry is to transition from an era of "price-led" growth to one of "volume-led" growth. Investment in, and efficient operation of, key export infrastructure (ports, railways etc.) is critical to making this transition successfully.

The ramp up of demand for minerals from 2003 onwards revealed some major shortfalls in Australia's infrastructure capacity that took time to repair. A range of policy challenges were revealed, including complex, lengthy and duplicative approvals regimes, poor supply chain planning which in turn hampered expansion prospects and skills shortages. In general, through the phase of industry growth characterised by rapid price rises there was a stark difference between the expansion record on the west coast (for iron ore) and the east coast supply chains (for coal, in particular).

The Minerals Council of Australia has maintained consistently that the interaction of ownership structures and regulation was a key factor contributing to infrastructure bottlenecks – most notably in relation to multi-user coal facilities on Australia's eastern seaboard. This in turn constrained the industry's ability to take maximum advantage of rapidly rising commodity prices in the period from 2003-04 to 2009-10. Such capacity constraints were much less apparent in the iron ore rail and port operations of the Pilbara where they are part of privately-owned and operated vertically-integrated production systems – in other words, facilities that never been in public hands nor supporting multiple users.

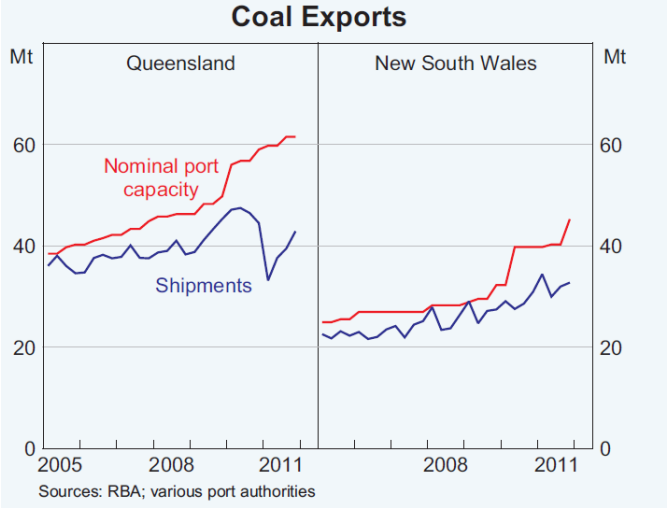
As the MCA has argued in submissions to the National Competition Council on access applications for the Pilbara railways under the existing Part IIIA provisions, the experience of the east coast coal infrastructure systems compared with the west coast iron producers during the 2002 to 2007 period was telling. The iron ore sector increased its throughput at the ports by much more than the coal sector. Over the period 1998 to 2006, world seaborne coal trade grew by 68.1 per cent, yet over the same period Australia's coal exports grew by 38.4 per cent. The seaborne trade for iron ore grew by 76.1 per cent over the relevant period, while Australia's exports of iron ore grew by 81.4 per cent.

The result for market share was obvious: Australian coal slipped from 36.1 per cent of world market share to 30.7 per cent. Iron ore maintained its overall share against increased competition just below 40 per cent (39.6 per cent compared with 38.5 per cent).

Since then there have been significant improvements in supply chain management and the quality of regulation on the east coast – especially in the Hunter Valley coal chain, with accompanying expanded investment in infrastructure assets and capacity. These improvements have been due to improvements in the quality of implementation of regulations, in particular:

- whole of system coordinated planning; and
- commercial arrangements that deliver capacity and efficiency, and provide certainty of access to export infrastructure.

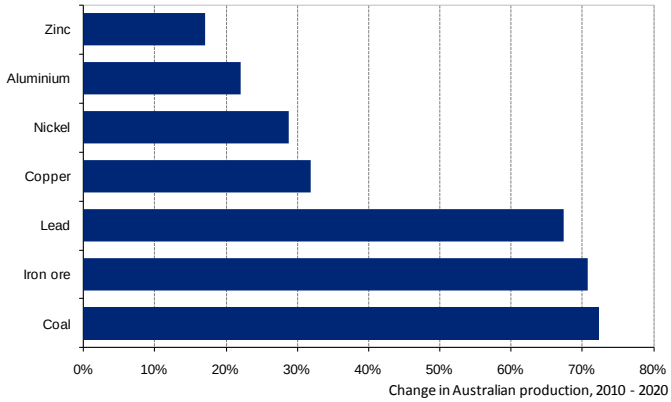
Chart 1: Changes in coal capacity and delivery – Reserve Bank of Australia



Looking ahead, however, there is still a large export infrastructure task if Australia's minerals industry is to seize export opportunities and capture market share in a highly competitive supply environment. Tracking known investment through to 2016 and then presuming Australia simply maintains market share from 2016 onwards, indicates the need for a large increase in the scale of supply.

Projections by Deloitte Access Economics show the potential change in mineral production to 2020 using a combination of global demand forecasts, official production forecasts to 2016 and on an assumption beyond 2016 that Australia maintains its global market share by mineral.

Chart 2 Potential change in Australian commodity production levels, 2010 – 2020



Source: Deloitte Access Economics

This shows the scale by which Australian production of key minerals needs to increase beyond 2010 levels. Over the next decade, annual coal and iron ore volumes would need to rise by 343 million tonnes and 300 million tonnes, respectively. That is more than double the lift in coal output achieved over the previous decade, and more than 20 per cent larger than the corresponding increase in iron ore production.

The associated infrastructure challenge for bulk commodities was examined by the Bureau of Resource and Energy Economics in 2012. BREE concluded that for iron ore, metallurgical coal and thermal coal, projects under construction will be sufficient through to the middle of the decade across of a range of growth scenarios. Beyond that, however, the outlook is more uncertain.

The decisions for these long lead-time investments need to be made over the next two to three years, highlighting the risk that, without the appropriate policy framework, infrastructure capacity constraints could undermine the industry's export volume growth.

BOX 1: EXCERPT FROM BUREAU OF RESOURCES AND ENERGY ECONOMICS

AUSTRALIAN BULK COMMODITY EXPORTS AND INFRASTRUCTURE OUTLOOK TO 2025

Figure 8.1: Long term outlook for thermal coal: nameplate capacity and export volumes

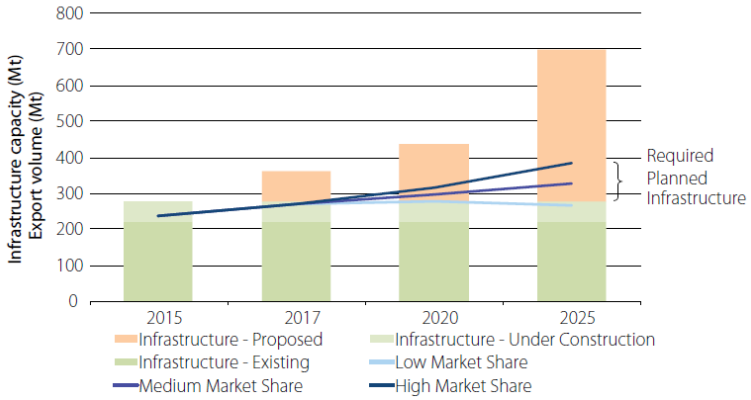


Figure 8.4: Long term outlook for metallurgical coal: nameplate capacity and export volumes

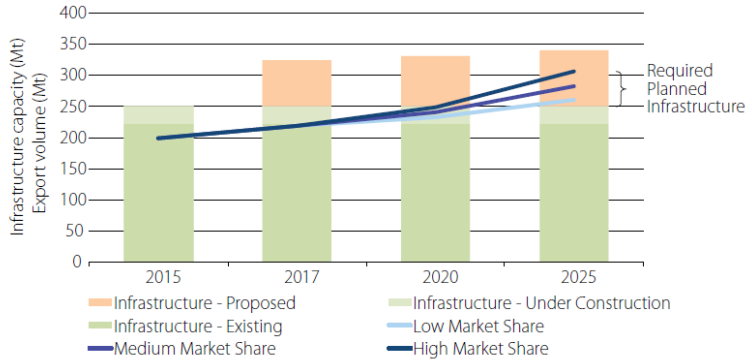
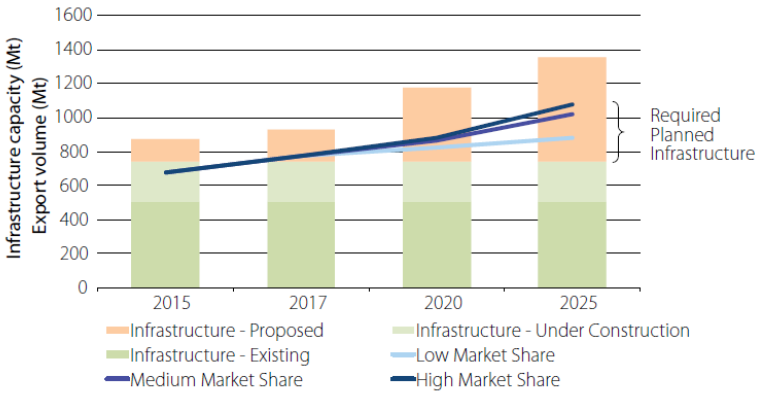


Figure 8.7: Long term iron ore outlook: nameplate capacity and export volumes



An efficient national access regulatory regime

The minerals sector requires stable, transparent and efficient regulations to ensure it can invest in the infrastructure required to produce minerals for export. Essential to that stable environment are rules on access regimes that reduce rather than increase sovereign risk.

Regulation impacts all stages of minerals industry activities from exploration, mining, processing and closure to relinquishment of tenure. Regulation can help overcome market failure and ensure efficient operation of markets. Yet regulation can also create more problems than it solves when it is inappropriately targeted, created for the wrong reasons or left too long unchecked. Where there is this outcome, the economy is unable to achieve its full potential as businesses incur unnecessary direct and indirect costs. Regulation therefore requires careful consideration at the drafting, implementation and review stages.

Regulation should provide for an efficient price for both service providers and users and operational issues managed by commercial contractual negotiation recognition of the investment contribution of existing users.

In the case of multi-user facilities, while there has been considerable reform centred on market based solutions, the main "*regulatory failures*" have surrounded inadequate commercial alignment of market incentives between the interests of owners and users, and the interpretation of existing provisions[9] that require the provider to extend the facility and/or permit interconnection to the facility, resulting in inefficient use of existing capacity and which mitigates against bringing on new capacity, thus causing delayed and asynchronous expansion of port and rail capacity.

Further reform is required to better align the operational and commercial interests of owners and users. Owners and users need both the financial incentives and the regulatory capacity to extend the facility to both build and deliver expanded services with a portion of revenue at risk based on the fulfilment of key business performance indicators.

Significant infrastructure often involves substantial externalities – that is, the effects on third parties are not entirely reflected through the pricing system. Building new ports or materially expanding existing ports, for example, often raises environmental issues with additional obligations on the users of the services.[10]

The MCA considers the key principles of an efficient national access regulatory regime are:

- the primacy of the market – a presumption that the free an unhindered operation of the market will lead to efficient outcomes;
- minimum effective regulation – necessary regulation where it is demonstrably the most economically efficient way of addressing market failure and/or a specific social objective; and
- the need to prioritise private sector confidence in regulatory arrangements.

While regime efficiency in this context involves consideration of economic concepts (market power, market failure, competition, contestability etc.) it also hinges critically on ensuring that investors – whether they be infrastructure providers or users – have a high level of confidence that the essential terms upon which investments are made will remain in place during the life of the investment. From this perspective, close attention to the specific circumstances and historical legacies that surround "*market failure*" and "*regulatory failure*" in industries is essential.

In the case of privately-owned vertically-integrated, single-user facilities, the most obvious "*regulatory failure*" has been the failure to provide the owners of facilities confidence that, *prima facie,* their infrastructure is not subject to "*declaration*" (under the Act) where it cannot be justified in a material consideration of market failure in accordance with the original Hilmer intent of Part IIIA.

In the case of multi-user facilities, while there has been considerable reform centred on market based solutions, the main "*regulatory failures*" have surrounded inadequate commercial alignment of market incentives between the interests of

[9] Australian Competition and Consumer Act, Part IIIA, sections 44V and 44W.

[10] This point was made by the 2005 Prime Minister's Export and Infrastructure Taskforce.

owners and users, and failures in the execution of existing provisions[11] that require the provider to extend the facility and/or permit interconnection to the facility, resulting in inefficient use of existing capacity and mitigating against bringing on new capacity and thus delayed and asynchronous expansion of port and rail capacity. An emerging threat is the failure to properly and adequately determine the prospects of a competitive market for the provision of essential infrastructure services from a privatised monopoly asset where, *prima facie*, the circumstances which justified the original regulatory intervention have not materially changed. The central issue concerns the interpretation and implementation of the regulatory arrangements under which the owner of the monopoly asset is required to provide third parties access (including extensions of capacity), and on what terms, to the facility, in order to ensure a competitive market where those facilities are considered "*essentia*l" services.

Accordingly, the application of Part IIIA, and in the context of addressing capacity constraints to supply significantly greater demand for mineral commodities over the last decade, is markedly different for private originated and operated vertically-integrated production systems, in contrast with former public monopoly utilities privatised to provide essential multi user infrastructure services. Accordingly, the imperatives of policy reform in each case are also different.

The importance of Hilmer

The Hilmer report, as an investigation into the competitiveness of the entire Australian economy, was wide in scope. The origins of Part IIIA lie in that part of the Hilmer Report which recommended the introduction of a system of statutory access rights in Australia – akin to the "*essential facilities*" doctrine established in US jurisprudence. The essential facilities doctrine (EFD) requires the owner of a monopoly asset to allow third parties access to the facility in order to improve competition in a "related" market, for instance, a downstream market.

Any analysis of Hilmer must take note of the context of the reforms. Predominantly, competition policy discussions were in the context of the transformation of government-owned and managed monopolies into competitive entities – either through corporatisation or privatisation. Hence the Report concluded that:

> *In designing the regime the Committee was conscious that almost all the cases of essential facilities identified for the Committee were in the public sector because of the history of government ownership of infrastructure. While the public interest rationale for provide an access right is the same irrespective of ownership, the proposed regime takes account of the special conditions that can arise when the facility is owned by a State or Territory Government.* [12]

The EFD overrides the property rights of the access provider imposing on the access provider transactions that it would not voluntarily have entered into, that is, it denies the owner/investor the fundamental premise that they may choose with whom to enter into commercial enterprise. Under the EFD, facilities are considered "*essential*" if:

- it constitutes a natural monopoly where it was physically impossible or prohibitively expensive to duplicate or otherwise construct substitute facilities – there must be no actual or possible sources of alternative supply;
- it constitutes a real "*bottleneck*";
- the owner of an essential facility need not expand its own capacity or reduce its own output in order to provide access to a competitor; and
- the facility must be truly essential to competition – it is not sufficient that the facility merely improves competition.

The Hilmer Report invoked the concepts behind the essential facilities doctrine in making the case for a national access regime, arguing that:

> *Some economic activities exhibit natural monopoly characteristics in the sense that they cannot be duplicated economically … Some facilities that exhibit these characteristics occupy strategic positions in an industry, and are thus 'essential facilities' in the sense that access to the facility is required if a business is to be able to compete effectively …*

[11] Australian Competition and Consumer Act, Part IIIA, sections 44V and 44W.

[12] Hilmer Report p. 239.

While Hilmer clearly recognised the economic costs and risks associated with third party access, the report also identified the considerable prospect of competitive benefits of third party access in the context of the transitioning of public utilities to private monopolies. Conscious of the dangers of over-riding property rights, Hilmer laid down a number of qualifications on any access regime to be created in Australia, specifically:

- the need to "*carefully limit the circumstances in which one business is required by law to make its facilities available to another*", because the "*failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment*".[13]
- the need for access should be "*essential*" to permit effective competition in a downstream or upstream market. [14]
- that if applied to privately-owned facilities "*it would be appropriate that an obligation to provide access does not unduly impede an owners right to use its own facilities, including any planned expansion of utilisation or capacity*".[15]

Further, in his Second Reading speech implementing the changes to the TPA in 1995, then Assistant Treasurer George Gear, emphasised that access provisions were geared towards essential facilities in general, and former government-owned assets, in particular. Ultimately, he said, the ability of the economy to grow and provide jobs and an improved standard of living depends on how well the productive potential of the economy is employed and enhanced. Importantly, the focus of proposed reforms was on:

> *access to services provided by means of essential facilities and elimination of net competitive advantages enjoyed by government businesses where they compete with the private sector*.[16]

In the subsequent debate, Mr Gear went on to stress that:

> *… we are not introducing competition for competition's sake; we are introducing competition where it is for the public benefit*.[17]

The issues associated with Part IIIA came into sharp focus for the minerals industry during the prolonged disputes associated with applications for access to rail track for the transport of iron ore in the Pilbara. The resolution of those disputes also has implications for existing multi-user infrastructure (predominantly formerly government-owned) currently subject to direct regulation, especially given the degree to which the Hilmer reforms – the genesis of Part IIIA – were a response to the anti-competitive risks arising from the privatisation/corporatisation of government enterprises.

Multi-user infrastructure

In 2008, the MCA developed its Strategic Framework for Sustainable Operation of Minerals Industry Multi-User, Multi-Owner Export Infrastructure. This framework is centred on market-based solutions but with the recognition of the particular needs to ensure efficiency in (primarily) east coast export coal supply chains through:

- the primacy of the market in the provision and operation of export infrastructure;
- where government intervention is only justified in cases of market failure and the demonstrable capacity to remedy;
- minimum effective, nationally consistent regulation implemented in a timely fashion;
- whole of system coordinated planning; and
- commercial arrangements that deliver capacity and efficiency, and provide certainty of access to export infrastructure.

The key is that the regulatory system should allow for robust commercial frameworks underpinned by contracts that align performance accountability with system capacity. The Principles are outlined in more detail in Box 2.

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[13] ibid. p. 248.

[14] ibid. p. 251.

[15] ibid. p 256.

[16] Commonwealth Parliament of Australia, Hansard, 30 June 2005, p 2793.

[17] Hansard, ibid, p 2819.

BOX 2: STRATEGIC FRAMEWORK – PRINCIPLES

Primacy of the Market and minimum effective regulation

- Industry ownership and commercial arrangements in preference to public sector ownership and government regulation of operations.
- Industry sector provision and operation of export infrastructure – with explicit industry involvement allowed where there is the opportunity for privatisation or private investment.
- Operational issues relating to export infrastructure access and pricing are best left to the market through commercial negotiation between infrastructure providers and users and given effect through commercial contractual arrangements.
- Regulation in the context of export infrastructure provision be confined to investment facilitation and other non-supply chain functions such as project and environmental approvals.
- Market intervention should be based on a proper cost/benefit analysis with all the costs of regulation fully accounted for.
- If regulation is required, access protocols provide certainty of access rights for existing users and provide the environment that gives appropriate incentives for infrastructure expansions necessary to create access for new projects in a timely manner.

Whole of System Master Planning (in supply chains where appropriate)

- Coordinated system planning for facilitation of alignment of capacity and performance with economic interests, identifying responsibilities and interests of all parties in multi-user, multi-access public–private infrastructure. This planning to be given effect through contractual arrangements between infrastructure providers and users.
- Evaluation and identification of the most efficient investment options (from loadpoints to port to system rules, contingent upon anti-competitive considerations) for increasing chain capacity from a cost and risk perspective and guide/inform capital investments in new infrastructure.

Commercial Arrangements (including commercial drivers in Regulation)

Commercial arrangements are a matter best dealt with by individual companies in order to reflect their own commercial requirements.

A framework for commercial contracts may include:

- Clear and binding obligations on both parties;
- Performance based arrangements;
- Flexibility to respond to market and operational conditions; and
- Resolution of disputes to be resolved in the marketplace and/or through common law (ultimately to the determination of the courts), in preference to a regulator.

Public Sector involvement in Infrastructure

- Government business enterprises (GBE's) as owners/operators of public infrastructure be parties to master planning and adopt Commercial Arrangements above in the planning and operation of infrastructure.
- Government-owned entities provide adequate and timely investment in expanding and improving efficiency of system capacity (including technological innovation), in coordination with the rest of the export chain.
- Government to provide alternative rail corridors and port sites to promote facilities-based competition.
- Ensure competitive neutrality between transport modes – transparent and equitable arrangements for access.

For multi-user infrastructure the policy priority should be to align owner and users interests to optimise infrastructure investment.

There are clear advantages in single user infrastructure where the unified control of investment and operational decisions maximises productivity and cost competitiveness, such as in the Pilbara iron ore export chains. In other regions, such as the long running coal export chains of the Hunter Valley or Queensland, where historically individual users lacked the scale to support dedicated rail and port facilities, infrastructure will inevitably be shared between multiple users.

It is true that in the past the regulatory framework led to delayed and asynchronous expansion of port and rail capacity, inefficient use of existing capacity and patchy regulation of infrastructure owners creating poor capacity utilization and missed opportunities. This goes to the quality of the regulatory framework. As Port Jackson Partners (PJP) argue in the report *Opportunity at risk: regaining our competitive edge in minerals resources* argue, optimising infrastructure requires deliberate action to improve the alignment between asset owners and users.

> *This will not be achieved without policy intervention: unlike users, asset owners are not fully incentivised to optimise infrastructure. Comparisons of the value of a lost tonne to different parties make this clear.*

To this end, regulators must take into account the relative costs of lost throughput to the respective parties. As PJP note below rail operators and infrastructure funds earn a regulated rate of return on their investment, meaning a lost tonne may cost them very little or even nothing, depending upon the regulatory arrangements. By comparison, producers lose the marginal contribution (sale price less marginal production cost) on every missed tonne.

Competition regulations should ensure that this misalignment is not perpetuated.

Recommendations

As noted above, regulation should provide for an efficient price for both service providers and users; operational issues managed by commercial contractual negotiation and recognition of the investment contribution of existing users. In the case of multi-user facilities, while there has been considerable reform centred on market based solutions, the main "*regulatory failures*" have surrounded inadequate commercial alignment of market incentives between the interests of owners and users, and the interpretation of existing provisions[18] that require the provider to extend the facility and/or permit interconnection to the facility, resulting in inefficient use of existing capacity and which mitigates against bringing on new capacity, thus causing delayed and asynchronous expansion of port and rail capacity.

Further reform is required to better align the operational and commercial interests of owners and users. Owners and users need both the financial incentives and the regulatory capacity to extend the facility to both build and deliver expanded services with a portion of revenue at risk based on the fulfilment of key business performance indicators. This means:

- Existing regulation of multi-user infrastructure services should not be revoked if a market failure was to result or other policy considerations (particularly environmental or social) would effectively create a natural monopoly following revocation due to the practical inability and financially infeasible to develop an alternative facility.
- Private profitability should not be seen in isolation. Where there is only one supplier of services to multiple users there is no market hence market forces cannot be relied upon to facilitate competition in mineral export supply markets.
    - Investments have already been made in mines on the expectation that already regulated facilities will continue to be regulated. A significant change may render existing investments uneconomic or unable to compete internationally. Monopoly pricing would also lead to inefficient allocation of resources and reduction of national export income.
- Whatever the value of the private profitability test for new declarations – and this must be viewed with due regard to the circumstances of each case – it should not be the sole test for the revocation of regulation of regulated assets.
    - factors such as where social, environmental and geographical limitations may create a natural monopoly for a service provider need to be considered.

More generally, the MCA argues expansions to existing multi-user infrastructure should usually be subjected to regulated pricing and access regulations in line with the general *Strategic Principles* outlined above.

[18] Australian Competition and Consumer Act, Part IIIA, sections 44V and 44W.

Finally the terms of access regimes for multi-user infrastructure should be spelt out clearly from the outset of the approvals processes.

Privately-owned, vertically-integrated export infrastructure

Part IIIA has undergone numerous examinations by the courts to explore the meanings of various statutes. Among the most important have been:

- the examination of the definitions used in the section 44G(2) providing the grounds for an access declaration – in particular the test of whether "*it would be uneconomical for anyone to develop another facility to provide the service*"; and
- the scope of the "production process" exemption, section 44B and related.

It is not necessary to revisit the full history of these cases over the past decade. Of particular recent significance are the deliberations of the High Court in its September 2012 which reasoned that the test of whether any competitive alternative infrastructure was "uneconomic" was private profitability rather than a "natural monopoly" or a net social benefit test.

The MCA is not providing an analysis of the High Court's reasoning of the law as it stands written , rather we suggest to this review by the Productivity Commission that the decisions have exposed policy deficiencies.

As argued above, the Hilmer reforms were developed in a context of the privatisation and corporatisation of publicly-owned monopolies. There is a case, then, that privately-owned, vertically-integrated infrastructure should not be captured.

A marginal improvement in competition in some related market should not outweigh the loss to the nation in export efficiency. Efficiency is a prime economic factor to be considered in assessing any intervention by the State into privately held, vertically-integrated export infrastructure.

Recommendations

The Prime Minister's 2005 Exports and Infrastructure Taskforce recommended that there should be a means to exempt integrated facilities from the operation of Part IIIA of the Act (then the Trade Practices Act, now the Competition and Consumer Act) and specifically:

- that there should be an *"efficiency override"* for applications for declaration of export related facilities under Part IIIA or its associated regimes; and
- that the *"production process exemption"* should be amended so as to make it *"clear that the purpose of the exemption is to prevent the imposing of third party access in vertically integrated, tightly managed, logistics chains, especially those related to our export industries".*

Accordingly, based on the above, the MCA holds that the criteria for access should be that:

- the barriers to entry, whether they be physical, commercial[19], and/or regulatory, are so material as to create a natural monopoly with attendant anti-competitive risks;
- competition be promoted in a market that is substantial and of national significance, other than the market in which the service is being provided, before the service is declared;
- the declared service be truly essential to competition in the market in which competition will be promoted, where essential means indispensable as a practical matter for participation in that market;
- the production process exemption prohibit or strictly limit access where doing so would disrupt a vertically-integrated production process; and
- the decision-maker be satisfied that granting access is in the public interest and in so doing, that the decision-maker takes account of the costs and risk of regulatory error.

FEBRUARY 2013

[19] Commercial barriers to entry as interpreted by Hilmer as 'prohibitively expensive' and recently by the High Court in terms of 'private profitability'.