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Submission into PC's Inquiry into the National Access Regime in Australia

RBB Economics, 18 February 2013

1. Introduction and summary

The Productivity Commission ('the Commission') has been asked to inquire into the National Access Regime (Part IIIA of the *Competition and Consumer Act 2010 (Cwlth)* and clause 6 of the Competition Principles Agreement), as well as the operation and terms of the Competition and Infrastructure Reform Agreement. The Commission has been asked to:

- examine the rationale, role and objectives of the National Access Regime (the NAR), and Australia's overall framework of access regulation;
- assess the performance of the NAR in meeting its rationale and objectives;
- report on whether the implementation of the NAR adequately ensures that its economic efficiency objectives are met;
- provide advice on ways to improve processes and decisions for facilitating third party access to essential infrastructure;

- review the effectiveness of the reforms outlined in the Competition and Infrastructure Reform Agreement (CIRA), and the actions and reforms undertaken by governments in giving effect to the CIRA; and

- comment on other relevant policy measures, including any non-legislative approaches, which would help ensure effective and responsive delivery of infrastructure services over both the short and long term.

The objective of the NAR in Australia is to promote the economically efficient operation of, use of, and investment in, the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets.[1] Although the origins of the NAR can be traced back to the findings of the Hilmer Committee in 1993[2], the access arrangements in Australia have evolved in a different way to that envisioned by the Committee.

The right of access recommended by the Hilmer Committee was intended to apply to those facilities "that exhibit natural monopoly characteristics, in the sense that they cannot be duplicated economically". The Hilmer Committee did not offer a precise operational definition of natural monopoly, but from the illustrations provided is seems reasonable to infer that it had in mind the cases where duplicate investment in competing infrastructure would plainly involve severe productive inefficiency. By trying to limit access to those facilities to those that exhibited the clearest possible natural monopoly characteristics, the Hilmer Committee was sensibly trying to confine the reach of an extremely interventionist policy instrument to a specific category of cases involving previously government-owned infrastructure facilities where competition has irretrievably broken down.

These limits in the scope of the access regime can also been seen in the words of caution contained in the Hilmer Committee's report. They acknowledge, for example, that access should only apply in "some circumstances" on public interest grounds and that the "notions of private property and freedom to contract [were] not to be disturbed lightly".[3] A series of tests were eventually incorporated into Part IIIA to try to identify when those circumstances arose.

This review by the Commission provides an opportunity to policy-makers to re-examine the rationale, role and objectives of the NAR and to identify the principles that should determine which facilities should fall under the NAR and which should be governed by industry-specific access regimes, particularly given the shift in the balance between the NAR and industry-specific and state-based regimes. Many of those extreme natural monopoly cases identified by the Hilmer Committee have now been addressed through the plethora of industry-specific and state-based access regimes that have sprung up since the Commission last considered the NAR in 2001.

These changes in the coverage of the national and the industry-specific access regime will need to be reflected in the way that the Commission undertakes its review. Given that industry-specific and state-based access regimes now address many of those extreme cases (such as electricity transmission grids, telecommunications networks, rail tracks and major pipelines), this

[1] Section 44AA, *Competition and Consumer Act*, (Cth) (2010)

[2] Hilmer Committee (Independent Committee of Inquiry into Competition Policy in Australia) 1993, *National Competition Policy,* Australian Government Publishing Service, Canberra.

[3] Hilmer Committee, p 242.

review, should consider whether there is still a residual role for a *national* access regime to apply to *other* infrastructure facilities in Australia. And if there remains a need for a residual access regime in Australia, whether the current tests contained in Part IIIA are the right tests to identify the limited circumstances when the notions of private property and freedom to contract should be disturbed.

The Issues Paper also seeks comments about whether the economic problem that the NAR was looking to address is as important now compared with when the NAR was introduced and what principles should determine which facilities should fall under the NAR or under the industry-specific access regimes. In our view, the review should recognise that the potential benefits from intervention are greatest in the extreme cases where there is no prospect (or even desirability) of establishing competing infrastructure facilities and that as these cases have increasingly been carved out into industry-specific and state-based access regimes, the potential benefits from intervention in marginal cases – whether through the NAR or through industry-specific regimes – is now unlikely to outweigh the costs of interfering with dynamic efficiency objectives.

The remainder of this submission is structured as follows.

- Section 2 presents an overview of the economic problem that the NAR was designed to address. We find that the NAR was one just one part of a broader policy response aimed at overcoming market failures in public monopolies and other government businesses.

- Section 3 discusses the growth of the industry-specific and state-based access regimes and assesses whether these regimes are capable of being confined to those facilities that exhibited the clearest possible natural monopoly characteristics and whether there is still a need for a NAR for those (likely to be marginal) cases that are not covered by the industry-specific and state-based access regimes.

- Section 4 then considers whether the tests contained in Part IIIA strike the right balance between the benefits from intervention and the costs of interfering with dynamic efficiency objectives, particularly given the residual role that the NAR now plays in Australia and the potential for that regime (and for new industry-specific regimes) now to apply beyond the limited category of cases where access to the facility was considered to be essential to permit effective competition.

2. An overview of the economic problem

According to the Hilmer Committee, the economic problem that the NAR is trying to address was that in some markets, the introduction of effective competition required competitors to have access to facilities which exhibit natural monopoly characteristics, and which cannot be duplicated economically. Two terms that were central to the debate around access – natural monopoly and essential facilities – were defined by the Hilmer Committee as follows:

> *"Some economic activities exhibit natural monopoly characteristics, in the sense that they cannot be duplicated economically. While it is difficult to*

define precisely the term "natural monopoly",' electricity transmission grids, telecommunication networks, rail tracks, major pipelines, ports and airports are often given as examples. 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 in upstream or downstream markets. For example, competition in electricity generation and in the provision of rail services requires access to transmission grids and rail tracks respectively."[4]

In practice, the concern articulated by the Hilmer Committee gives rise to two separate economic problems – an "upstream" problem and a "downstream" problem. We explain each of these below and illustrate how a different policy response would be required to address each problem. This is useful because in the years following the release of the Hilmer Committee's report, the need for different solutions to each of these economic problems was not always well understood. The Commission, for example, in its 2001 Review of the *Prices Surveillance Act* 1983 released shortly before its 2001 review of the National Access Regime, suggested that the third party access regime introduced into Part IIIA (and which addresses downstream concerns) could address monopoly pricing concerns (which are upstream concerns) and that one effect of the NAR was to reduce substantially the areas of possible monopolistic pricing that might otherwise be covered by the prices surveillance regime in place at that time.

The following section identifies the upstream and downstream concerns when competitors require access to facilities which exhibit natural monopoly characteristics and which cannot be duplicated economically. For convenience, we describe as "upstream" the activity or assets that give rise to the natural monopoly, and as "downstream" the complementary activity that depends on access to the upstream facility, but that is capable of being contested by a number of competing providers with no inherent loss to productive efficiency. In some actual applications, there might not be a simple upstream/downstream relationship between these two activities, but that does not change the fundamental economic or policy issues.

2.1. Upstream concerns

In the case where the owner of an essentially facility was not competing in the potentially competitive ("downstream") activity, the Hilmer Committee argued that the owner of the facility would have little incentive to deny access to firms operating in those markets as competition in vertically related markets maximises its own profits. But the Committee noted that "like other monopolists, however, the owner of the facility is able to charge higher prices and derive monopoly profits at the expense of consumers and economic efficiency".[5]

Despite finding that the facility is able to charge higher prices and derive monopoly profits, the Hilmer Committee was reluctant to recommend detailed price regulation and preferred to rely on less intrusive measures such as creating competition *for* the market. The Hilmer Committee

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[4] Hilmer Committee, p 240.

[5] Ibid, p 241.

considered some form of limited price-based response (such as price oversight) may ultimately be needed but saw this as “a residual and second-best option”.

It is understandable why the Hilmer Committee resisted a recommendation of detailed price regulation for the natural monopoly part of the previously government-owned facility. Such regulation is often costly, intrusive and error-prone and typically comes at a cost to economic efficiency.

The industry-specific regimes that we discuss in the next section of this submission accepted that detailed price regulation was necessary both to prevent monopoly pricing by the natural monopoly element of the infrastructure facility and to give effect to a legislated right of access. Under full regulation of gas pipelines, for example, a pipeline provider must periodically submit an access arrangement to the AER for approval. The AER will then assess the revenues needed to cover efficient costs (including the cost of capital) and derive reference tariffs for the pipeline. The prices will usually reflect an incentive mechanism aimed at rewarding efficient operating practices.

Although detailed price regulation may have an important role to play in helping to set the price of the natural monopoly component of an essential facility in the extreme cases where there is no realistic prospect of competition (and indeed where competition would be so inherently wasteful that it should not even be encouraged), it is much less likely to be the appropriate response in the more marginal cases where competition can provide a constraint on the incumbent’s market power. As the Commission argued in its review of the prices surveillance regime in 2001:

> *“There are severe limitations to the role that price control can play in areas where competition is not strong. In such markets, regulators attempt to set prices at the levels they estimate would occur if there were more active competition. Yet this is a complex task requiring information that typically is not available. So, in practice, regulators are likely to end up setting prices above or below the efficient level. Yet if they are set too high, consumers are penalised, unless there is a market response which drives prices down. For firms that use the good or service, it could impede their performance and discourage investment. If prices are set too low, investment can be discouraged and firms may exit the industry, leading to more severe problems for consumers and the economy generally in the long term, including limited capacity, less innovation or inadequate maintenance or new investment.*

The Commission’s finding that price controls carried the risk of distorting markets was consistent with the instincts of the Hilmer Committee to avoid price controls where possible, but they conceded that the risk was worth bearing in markets where there was a natural monopoly:

> *These limitations suggest that governments and regulators should be wary of setting prices (either explicitly or indirectly). This is particularly the case in markets other than where there is natural monopoly, even if competition is not strong.”*

Although detailed price controls are usually a heavy-handed and intrusive way of preventing a facility owner from charging higher prices and deriving monopoly profits at the expense of consumers and economic efficiency, they can be a very effective means of addressing upstream concerns for natural monopolies. But the complexity involved, information required, and risks of getting the prices wrong, also means that we should limit their application to those extreme cases where there is no realistic prospect of competition.

2.2. Downstream concerns

The downstream concern arises when access to the upstream natural monopoly element is essential for effective competition in the downstream activity. In such circumstances, if the upstream monopolist chooses not to provide access, but instead reserves the downstream activity for its own (integrated) operations, it can prevent competition from taking place in the downstream activity even though that activity has the potential to be competitive.

The Hilmer Committee provided examples of effective competition in electricity generation requiring access to electricity transmission grids - the integration of the natural monopoly element (transmission grids) and a potentially competitive activity (electricity generation) raises concerns that control over access to the monopoly element may be used to stifle or prevent competition in the potentially competitive (downstream) sector. The Hilmer Committee argued that, even if access is not actually misused, the *potential* for such behaviour may deter new entry to, or limit vigorous competition in, markets dependent on access to the natural monopoly element.

In principle, it would be possible to solve the downstream problem – i.e. to allow competition in the downstream activity by appropriate access terms – without resolving the upstream market power problem. Consider the upstream activity as a monopoly in the manufacture of a product and the downstream activity as a potentially competitive retailing activity. The upstream monopolist might be able to exploit its market power in full by charging a monopoly wholesale price for its product to retailers, but that situation would still enable competing retailers to compete on the downstream retailing activity to ensure that retail margins were as low as possible. In this scenario, there could still be a public policy rationale for imposing price regulation on the monopoly activity (that is, on the level of the wholesale price) because even with effective competition in retailing consumers would nevertheless be faced with a downstream price that embodied the monopolised wholesale price level. But the choice on how – if at all – to intervene to solve the upstream market power problem is logically separable from the case for ensuring access terms (in this case a wholesale supply of the product to competing retailers) that ensures there is competition in the downstream activity.

It might seem intuitively obvious that an upstream monopoly problem becomes a "double monopoly problem" if the upstream firm chooses not to supply competing downstream operators and reserves both activities for itself. However, the basic "Chicago School" principle of one monopoly profit has long since established that this intuition is not robust. A company that is dominant in a particular activity (say manufacturing) has an incentive to enhance economic efficiency in a complementary area (say retailing). If the quality of the complementary good increases, or its price decreases, the demand for the original product would normally rise, thereby increasing the profits of the dominant firm. Hence, in the simple Chicago School models one can leave it to the upstream monopolist to make efficient choices about whether or not to promote competition in the downstream activity.[6]

There are of course potentially important exceptions to this simple principle. According to the so-called “commitment problem”, one theory suggests that an upstream monopolist might be unable to extract the full monopoly profit unless it can credibly commit not to supply to any downstream competitors. In such cases it is possible that the refusal to supply has an anticompetitive effect, as it enables the firm to extract the full monopoly profit, whereas its ability to do so unravels as soon as supply to third parties becomes an option There are also other “post-Chicago” theories – such as those concerning monopoly protection and monopoly leverage – that have been developed and applied in major monopoly investigations across the globe over the last 20 years, most notably in the various investigations into Microsoft in the US and Europe.

There can also be powerful practical regulatory considerations that tell in favour of the forced unbundling of integrated structures so as to limit the monopoly to the activities that cannot efficiently sustain competition. Chief amongst these is a proposition about effective economic regulation which is less complex and thus likely to be less prone to errors if it is confined to the smallest set of activities possible – for example to electricity transmission rather than to transmission plus generation.

The Issues Paper contains little or no discussion of these important contextual issues regarding the potential for market failure. The danger here is that unless there is a clear focus on the different market failures that can exist in industries with some natural monopoly characteristics, it is less likely that regulatory solutions will be properly targeted.

3. The implications of the growth of industry-specific regimes

A major change since the Hilmer Committee’s report and the 2001 Review by the Productivity Commission of the National Access Regime has been the development of a second track for access seekers to gain access to major infrastructure assets. The availability of this second track – which covers industry-specific and state based access regimes – now means that the facilities that were central to the concerns of the Hilmer Committee have been carved out of the scope of the NAR and are addressed elsewhere.

This section of our submission explores some of the characteristics of the industry-specific regimes that have evolved since the Commission’s 2001 review before examining the implications of those regimes for the scope of the NAR.

[6] Importantly, economic theory also shows that there can be positive efficiency benefits from allowing vertical integration or bundling of complementary activities, most notably as a way to avoid the double marginalisation effect which can cause prices to be higher and consumers to be worse off where previously integrated industry structures are broken into separate stages.

3.1. Characteristics of the industry-specific regimes

Some of the main features of the industry-specific access regimes that have developed since the Hilmer Committee's report and the 2001 Review by the Productivity Commission of the National Access Regime can be summarised as follows:

- They address the types of facilities that the Hilmer Committee had in mind. The Hilmer Committee conceded that it was difficult to define precisely the term "natural monopoly", but it suggested that electricity transmission grids, telecommunication networks, rail tracks, major pipelines, ports and airports were examples of the facilities that should be subjected to a legislated right of access.

- They acknowledge the need to engage in either detailed price regulation or to review or assess access charges proposed by the facility owners. In the case of gas pipelines, for example, the National Gas Law and Rules set out the regulatory framework for the gas pipeline sector and the Australian Energy Regulator (AER) is tasked with the role of regulating pipelines (in jurisdictions other than Western Australia). Different forms of economic regulation apply to different pipelines depending on competition criteria and the terms and conditions of access are determined followed well established price setting methodologies. Similarly, under the *Rail Management Act 1996*, the Essential Services Commission in Victoria is responsible for deciding whether or not to approve access arrangements submitted to it by access providers.

- They can often resolve access issues (relatively) quickly. Since access was sought in the rail access case in the Pilbara through the NAR, the Pilbara Rail Access Interdepartmental Committee has been given the task to develop a rail haulage regime for iron ore products that could be applied to the Pilbara railways. The process has been driven by a desire to develop a workable regime more expeditiously than the current track access declaration applications being sought under Part IIIA of the Trade Practices Act 1974. The Department of Treasury and Finance in WA noted that "the Part IIIA processes have led to significant costs and are unlikely to deliver certainty to stakeholders in the short to medium term".

The complexity of these regimes – particularly with regard to detailed price regulation – also illustrates that this is heavy intervention that should be reserved only for tough cases in which it is clearly recognised that the idea of competition in the facility in question cannot work, or would not even be desirable on public policy grounds.

So while these industry-specific regimes have dealt with sectors where the public benefits of access regulation (and detailed price regulation) probably exceeded its costs, it is not clear how their application will be confined to those facilities that exhibited the clearest possible natural monopoly characteristics. A review by the Commission that ignores the potential for the creeping over-use of access regulation by governments and which risks creating a wider disincentive to risk-taking and investment from firms in more marginal sectors is unlikely to provide a robust and comprehensive policy solution in an important area of economic regulation and competition policy.

3.2. Implications of the industry-specific regimes on the scope of the NAR

An important implication of the growth of industry-specific regimes is that the NAR now effectively only applies to services other than those clear cases where there was such a strong public interest in ensuring effective competition can take place.

A useful outcome from this review would be for the Commission to clarify what the scope of the NAR now is in light of the development of the industry-specific regimes and whether the limits that the Hilmer Committee had in mind for the application of a legislated right of access are still relevant. Clarification by the Commission would be particularly welcome given that there have been calls by some parties to either relax the declaration criteria to ensure that certain facilities are captured by the NAR without the need to pass the tests contained in Part IIIA or to tighten or remove the criteria to ensure that facilities that were not previously government-owned infrastructure facilities are not captured by the NAR.

In its 2011/12 Annual Report, the National Competition Council (NCC) noted that it believes that the existing scope of the NAR is appropriate and that calls to expand that scope or to narrow that scope should be rejected. It argues that:

> *Calls for services to be deemed to be declared, or for parties to be forced to lodge access undertakings with the ACCC, in many cases now appear to be calls for an expansion of the declaration process beyond the "limited category of cases" envisaged by the Hilmer Committee in order to satisfy private commercial interests. Similarly calls for services to be excluded from the application of the National Access Regime are often an effort to advance private interests ahead of the public interest inherent in the application of the declaration criteria.*[7]

The NCC's comments appear to acknowledge that the scope of the NAR should not stray too far from the "limited category of cases" envisaged by the Hilmer Committee. But given that almost all of those cases are now addressed by industry-specific and state-based access regimes, what precisely is the remaining scope of the NAR?

If the NAR is to be retained as a residual access regime to deal with issues that are not dealt with under the industry-specific regimes, then it will inevitably deal with facilities that are likely to be privately owned, have relatively high fixed costs, and provide a significant infrastructure service. The NCC has publically indicated that it has undertaken studies of sectors where it anticipates that third party access issues of the kind addressed under Part IIIA may emerge such as access to services provided by petroleum import terminals, water and wastewater networks, financial and equity market clearing and settlement systems, and carbon geo-sequestration and associated facilities.[8]

In some of these areas, the NCC has flagged that there is a risk that governments may turn to industry-specific regimes to side-step the safeguards contained in the NAR and is (rightly)

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[7] National Competition Council 2012, *Annual Report 2011-12*, Melbourne, p 3.

[8] National Competition Council 2012, *Annual Report 2011-12*, Melbourne, p 24.

concerned about the risks of undermining incentives for investment and dynamic efficiency in those sectors.

We share those concerns but our primary concern is with the potential for the creeping over-use of an access regime in the more marginal sectors where the costs in terms of dynamic efficiency outweigh and static and short-term improvements in productive efficiency regardless of whether that review is undertaken under the auspices of a national, state, or industry body.

The facilities explored by the NCC, and which it indicated may be addressed through industry-specific regimes, represent a significant departure from the concern of the Hilmer Committee that the regime apply only to a "limited category of cases where access to the facility was essential to permit effective competition and declaration was in the public interest having regard to the significance of the industry to the national economy and the expected impact of effective competition in that industry on national competitiveness". In many sectors, those facilities are likely to have been created through private sector investment which may have involved innovation, investment and risk-taking. The monopoly position that has evolved is likely to reflect a reward for the risks that the private sector operator undertook. And importantly, unlike the facilities that that were previously government-owned infrastructure facilities, these facilities would not have had their monopoly business subjected to detailed price regulation.

Finally, for these "private monopolies", the trade-off between static benefits generated by providing access to a competitor to a facility and the dynamic benefits that arise from providing an incentive to a competitor to develop competing facilities is likely to take a different complexion from the case where the facilities were previously government-owned infrastructure facilities.

4. Are the criteria capable of striking the right balance?

Another key question that the Commission will need to address is whether the criteria currently contained in the NAR – and which have been replicated in a number of the industry-specific regimes – can help regulators strike the right balance between the benefits from intervention and the costs of interfering with dynamic efficiency objectives.

The two criteria that are likely to attract the most attention are criterion (a), which explores whether declaration would promote a material increase in competition in at least one market (whether or not in Australia), other than the market in question and criterion (b) which asks whether it would be uneconomical for anyone to develop another facility to provide the service.

At first glance, it is difficult to find fault with criterion (a). As the Commission notes in its Issues Paper, this criterion uses the promotion of competition in another market as a benchmark to determine whether declaration will accord with the efficiency objectives of Part IIIA. The Commission argues that competition is seen as a means to improve living standards and improved competition is considered to be a proxy for more efficient outcomes (reflected in lower prices/higher output) in the dependent market.[9]

9 Productivity Commission 2012, *National Access Regime*, Issues Paper, Canberra, p 11.

While identifying how access could benefit competition ought to be a core issue in any application for access, this criterion has a number of weaknesses that limit its ability to help regulators determine whether access should be granted. These include:

- It can be hard to delineate when one market ends and another starts. When dealing with vertical integration, and where a firm carries out successive processes, it may be difficult to determine whether the output of one such process is a product or service for which there is a market.

- Access seekers are able to put forward multiple markets, some of which may be completely unrelated to the economic problem that the NAR is trying to address, in order to find “another” market in where access to an upstream facility may increase competition.[10]

- Too much attention on promoting downstream competition could dissuade firms from competing across both upstream and downstream activities, which would provide more real competition and benefits for consumers.

More fundamentally, policy makers can easily improve competition in a dependent market by granting access at low prices to an upstream monopoly facility. That would quite quickly lead to lower prices or more output downstream and improve living standards. The real question is what that would do to the incentives for the upstream operator, and for other firms contemplating risky investments in new facilities in analogous or related industries.

In its parallel inquiry into the Compulsory Licensing of Patents, the Commission recognised that patents are required to allow innovators to capture a sufficient amount of the benefits to the community from their activity without the risk of imitators exploiting the effort of innovators without compensation. Such exploitation would – in the absence of an effective system of patents – result in under-investment in innovation as imitators engaged in “free-riding” on the efforts of inventors. Patents therefore provide private producers with an incentive to engage in innovative activity which in turn promotes dynamic efficiency and provide incentives to invest in creative effort.

A more liberal approach to compulsory licensing would push the price of the innovative activity closer to the cost of reproduction of that innovation, which would be close to zero. As a result, the consumption of the existing output of investment in creative effort would increase and, in the short term, increase consumer welfare. But this simply ignores the trade-offs that policy makers are required to make when setting the legal and economic framework to protect and encourage innovation in an economy.

In a similar way, a legislated right of access to petroleum import terminals, water and wastewater networks, financial and equity market clearing and settlement systems, and carbon geo-sequestration and associated facilities, could increase output or lower prices in a dependent market, thus providing short term consumer gains. But the true cost of such interventions could be much greater, if less easy to quantify.

[10] An example can be found in the rail access case where the Australian Competition Tribunal found that competition would not be improved in either the upstream or downstream markets, but would be improved in an intermediate “rail haulage” market.

First, the nature of any increased competition that is created by granting third party access is inherently more limited in scope than the competition that could be created by competing investments and rivalry across both the upstream and downstream activities. There is a risk of under-investment and less variety and rivalry in the affected upstream services as access seekers engaged in free-riding on investments made by the incumbent firm. There is an analogy here with competition in research-based pharmaceuticals: there is no doubt that price competition and short term consumer gains can be achieved when multiple generic manufacturers are freed to manufacture and market me-too rivals of the original patented medicine. But the long term consumer benefit from such competition is likely to be much smaller than the gains that are achievable by encouraging competing research-based firms to compete with successful patent owners by creating new, more efficacious, active ingredients.

Second, intervention in more marginal cases runs a clear danger that it will create a wider disincentive to risk-taking and investment from other firms that fear their property would be subject to potentially costly and intrusive regulation if their investment plans were successful in creating an asset that would come to be envied by others. As the net for compulsory access cases is cast wider and wider, the uncertainty as to where such intervention might strike next also increases exponentially, and so the scope for unintended adverse consequences on incentives to invest and to create valuable assets multiplies.

The limitations of criterion (a), particularly with regard to its inability to weigh up the costs of allowing access on the investments made by the facility owner to its upstream, monopoly operations places considerable pressure on criterion (b) to help policy makers determine whether the facility in question exhibits natural monopoly characteristics, and cannot be duplicated economically.

Criterion (b) has been subjected to much debate since the introduction of the Regime and three competing approaches of the "uneconomical to develop" test have evolved over time.

The first of these is the natural monopoly approach, which looks at whether the facility in question can provide society's reasonably foreseeable demand for the relevant service at a lower total cost than if it were to be met by providing two or more facilities.[11] The problem with this narrow technical definition of natural monopoly is that it is a purely static test that focuses on productive efficiency to the exclusion of all other factors and consequently sets a very low bar for intervention. Almost any competitive rivalry involves the duplication of some fixed costs between the participants, whether that comprises rival R&D programmes in commercial aerospace or two competing grocery retailers' distribution vehicles passing one another on their ways to competing stores. The simple fact that a lower total cost for the industry might be achieved with a single supplier does not generally justify the conclusion that society is best served by having a single "natural monopoly" operator. Instead, most competition policy regimes assume that, except in extreme cases, some element of duplication is a cost worth incurring in order to secure the dynamic benefits of rivalry and to avoid the need for hands-on regulatory interference to control monopoly provider discretion.

The second approach looks at net social benefits and asks whether, for a likely range of reasonably foreseeable demand for the services provided by means of the facility, it would be

[11] *The Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* [2012] HCA 35, [79].

more efficient, in terms of costs and benefits to the community as a whole, for one facility to provide those services rather than more than one. One of the reasons given by the Australian Competition Tribunal in the rail access case for abandoning the net social benefit test for the monopoly test was the difficulty of concluding, at least in quantifiable terms, that there is or is not a "net social benefit". Such a test also requires an evaluation by a regulator that economic efficiency from the point of view of society as a whole would be served by a declaration of access, which increases the risks of regulatory error – and the potential for rent seeking – in the process.

The third approach is the private profitability approach which asks whether any person (including the incumbent operator of the facility) would find it profitable to establish a second or competing facility. Although the High Court has now held that this is the preferred interpretation of criterion (b), there is very little guidance on how the test will work in practice, particularly in those (presumably common) cases where unlike in the rail access case, other facilities have not actually been developed.

The High Court observed that the question of whether a facility was privately profitable to build or not was one that bankers and investors – rather than theoretical economists – would commonly ask. That may be true, but it does not necessarily make the answer to the question any easier to determine, and there is a danger that this approach to criterion (b) has so many moving parts that it leads to inherent confusion between measures aimed at addressing upstream and downstream problems. We do not think that such uncertainty provides any guarantee that this is the approach whose application gives the best (or consistent) results from a public policy perspective.

A robust and reliable test for criterion (b) is a key safeguard in the NAR as it helps prevent the scope of the access regime from creeping too far from the limits conceived by the Hilmer Committee. The important question for the Commission as part of this inquiry will be to consider whether legislative changes may be needed to either confirm the interpretation of criterion (b) or to move it back to a (more stringent version of the) natural monopoly interpretation that is capable of limiting declaration only to those extreme cases where the prospect of upstream competition has broken down irretrievably, where we would want to discourage inefficient duplication of assets, and where the public benefits of intervention (in a heavy-handed manner) were extremely strong.

In our view, a private profitability interpretation of criterion (b) is not capable of providing the safeguards required in the access regime. One reason for this is that in industries where the upstream facility owner can influence the downstream price (which also implies that criterion (a) would be met), that facility owner can influence the results of the private profitability test. By setting the downstream price high, for example, the facility owner would be signalling to the bankers and investors that the High Court would rely upon that a reasonable margin could be made in the downstream market and that entry would be profitable. The facility could not, therefore, be declared.

Conversely, if the upstream facility owner did not exploit any market power that they had in the downstream market and set a low price for the final good, they would be signalling to the bankers and investors that it may not be privately profitable to develop their own facility. In that situation, the decision by the upstream facility owner not to charge high prices downstream, which regulators might applaud from a public policy perspective, could lead to their upstream facilities being declared. (In this example, criterion (a) would not be met because it was already competitive, but the existing test allows an access seeker to simply look for another market that may be less competitive – whether it is material or not).

To the extent that the facility owner can influence prices in the downstream market, the private profitability test effectively transfers control over when their facility would be declared to the facility owner. By influencing the price in the downstream market, they could determine how much profit a rival infrastructure investor might make, and thus effectively influence whether their facility would be declared or not. In some cases, facility owners may not want to encourage entry upstream and may prefer to provide access to access seekers on agreed terms, even though dynamic efficiency might be better served by rival upstream entry.

5. Conclusion

In some ways, the NAR has been a remarkably successful policy tool. By motivating industry-specific and state-based access regimes it has either directly, or indirectly, regulated those sectors of the economy that have strong natural monopoly characteristics, where competition has irretrievably failed, and where the public benefit from access intervention was strong. In many of those areas, the benefit of boosting productive efficiency by discouraging wasteful duplication of certain facilities clearly outweighed the potential for discouraging dynamic efficiency incentives.

The problem is that there does not appear to be an effective mechanism in place to contain the growth of these industry-specific regimes. The temptation for governments increasingly to side-step the declaration process in the NAR and potentially apply intrusive and heavy-handed policy solutions in sectors where the case for an access regime has not been made, suggests that the Commission may be focusing its inquiry in the wrong place and that a review of these industry-specific regimes is also warranted to ensure that a legislated right of access is considered to be a rarely needed safeguard. Focusing solely on the NAR is unlikely to lead to policy prescriptions that can help protect the dynamic efficiency incentives that are generally of greater importance to economic efficiency and consumer welfare than static considerations.

The question now is whether the NAR is still needed to perform a residual role in Australia and to consider whether there is a need for a legislated right of access (including through industry-specific regimes) to sectors beyond those cases that have been picked off by the creation of specific access regimes. One can never discount the possibility that such further interventions could be warranted, but we would favour a regime that required demonstrably tough conditions should be met before doing so. The case for intervening in more marginal sectors whether under a national or industry-specific access regime, and where dynamic efficiency incentives are likely to matter more than in those sectors with strong natural monopoly characteristics, is far from clear. Unless the Commission is able to arrest the potential for the creeping over-use of a legislated right of access - including through industry-specific regimes - the policy prescriptions from this review will be unsatisfactory and incomplete.