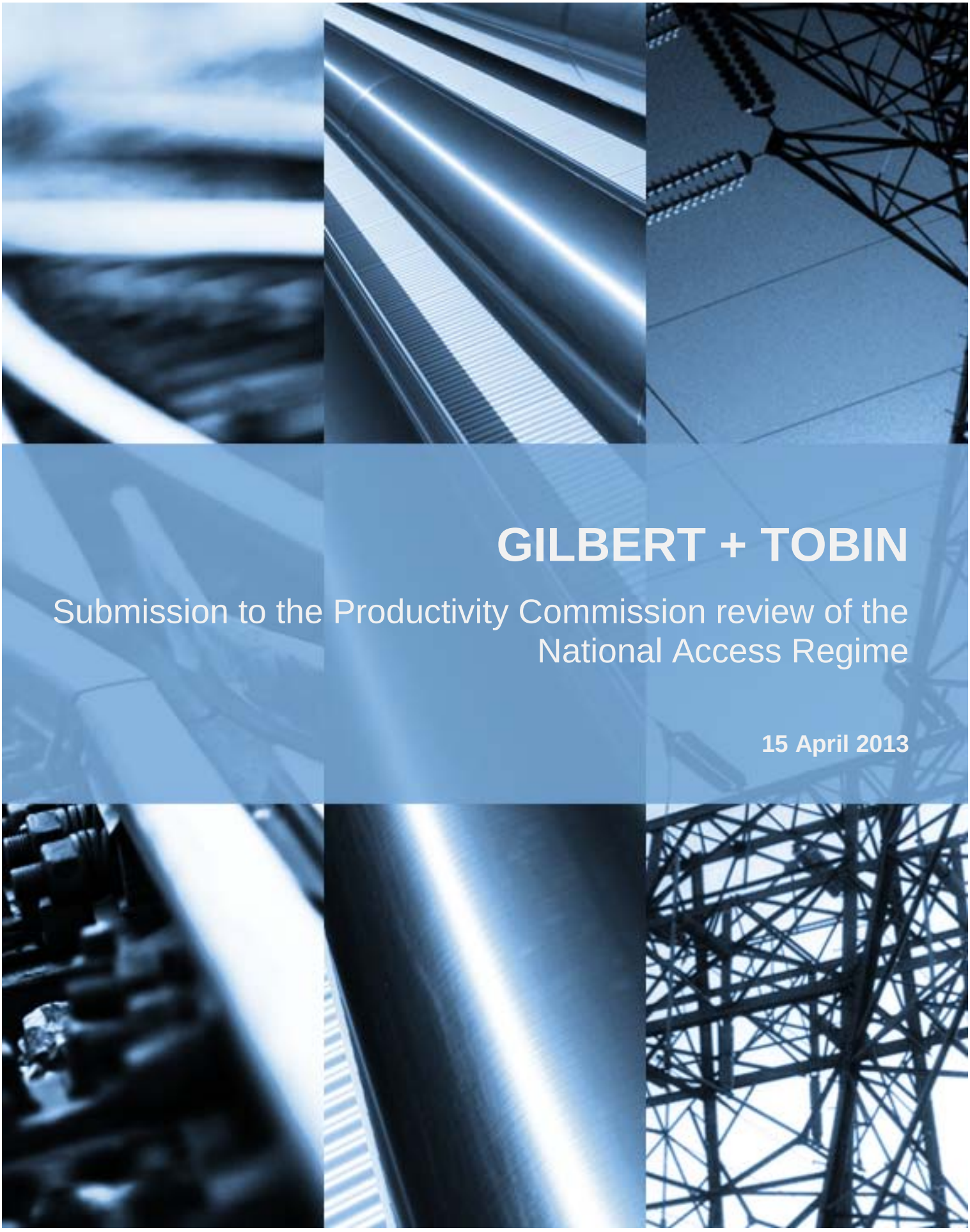

GILBERT + TOBIN

Submission to the Productivity Commission review of the National Access Regime

15 April 2013

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1 Summary

1.1 The National Access Regime retains an important role

- The COAG Competition Principles Agreement and the National Access Regime in Part IIIA of the Competition and Consumer Act 2010 have made a valuable contribution to the liberalisation of the Australian economy over the last two decades. This policy framework continues to have an important role to play in providing a framework for access to nationally significant infrastructure.

- Australia's contemporary infrastructure challenges have changed:

  – The policy priorities for access to infrastructure now often involve questions of investment in expansion and extension of capacity constrained facilities, compared to 20 years ago where the primary challenge was efficient use of spare capacity in existing infrastructure.

  – Obvious and perhaps more tractable candidates for access have largely been addressed through sectoral regimes, e.g. telecommunications, gas and electricity and other challenging areas of access have been addressed, e.g. payment systems.

  – More difficult challenges arise in relation to infrastructure such as rail, ports and water and sewerage infrastructure. In some cases, access regulation in these sectors appears to be poorly defined and not clearly meeting either reasonable private commercial needs or public policy objectives.

  – There are some other simple cases for access regulation which have largely been by-passed, e.g. airports, resulting in potentially adverse public policy outcomes.

- While private commercial agreement between the service provider and access seeker is the most desirable means to achieve access to significant infrastructure facilities, a legal framework for mandated access to key infrastructure remains appropriate.

1.2 There are problems with the design of the National Access Regime, that prevent it from operating effectively

- Leaving aside certification of existing State arrangements, Part IIIA was designed to provide a legal mechanism for access based around:

  – an ability for users to apply ex post for access to nationally significant infrastructure, particularly where access had been refused (the declaration process); and

  – a framework for access providers to offer ex ante access undertakings, which are approved and overseen by the ACCC.

- The mechanism allowing for the ACCC to approve and enforce access undertakings has generally been effective, and this has provided a flexible tool for State Governments in particular to deal with access issues – either permanently or as a transitional measure.

- However, the process for seeking access through the declaration process has proved cumbersome, costly and time consuming, with almost no successful track record of access under Part IIIA.

- In large part, this has been caused by a lack of clarity around the policy problem that declaration is designed to solve. There have always been two alternative justifications for regulating access on an ex post basis through declaration:

- To protect competition in related markets, controllers of bottleneck infrastructure must not be able to refuse access to essential inputs required to compete in those markets.

- To promote socially efficient use of monopoly infrastructure and avoid inefficient monopoly pricing and access terms.

- It has never been clear which of these objectives the declaration process was intended to address – and in truth it was probably both.

- This lack of clarity about what the policy objective of declaration has resulted in much of the debate about how the relevant declaration criteria are applied, and the role of the decision maker in the process – the two central issues dealt with by the High Court in *Pilbara Railways*.

- For example, if we are concerned only with the first objective above (entry conditions in related markets), then testing whether it is 'privately profitable' for a new entrant or user to duplicate or bypass the existing facility makes sense and can be done by a Court or Tribunal as a question of economic evidence.

- However, if the declaration process is primarily concerned with efficient use of monopoly infrastructure and the achievement of a wider set of social objectives, then a social cost or natural monopoly test may be preferable and, given the public interest issues at stake, the exercise of judgment at the political level seems appropriate.

- The policy tension is compounded because there is also insufficient recognition in the current regime that the context for the decision may affect the economic and policy tests that may be appropriate. Most significantly, whether access is being considered at an ex ante stage during project approvals or privatisation, whether regulation is being developed to ensure a form of status quo post-privatisation, or an application is being made to have regulation imposed ex post on existing infrastructure which has not previously been regulated.

- The following changes would help to give Part IIIA the greater policy clarity it needs.

1.3 In most cases, for new or newly privatised infrastructure, the policy decision about access arrangements should be settled up front and must include how future expansion and investment will occur

- Wherever possible, the question of access should be settled by policy makers during initial project approvals, privatisation or at the time of the grant of any State concession.

- While the amendments introduced to Part IIIA in 2010 to allow for 20-year ineligibility decisions go some of the way to providing up front certainty for investors, in our view this remains insufficient and has not yet been used. Most importantly, this mechanism does not provide certainty for the owner, investors or other stakeholders about the access framework that will apply where regulation (or continued regulation) *is* appropriate.

- To support this change, the COAG framework should be amended to require State or Federal Governments to consider the establishment of access arrangements at the time of any project approval or privatisation process with scope for investors and/or market stakeholders to be consulted in relation to any such decision.

- In most cases, this could be done by requiring proponents to lodge an access undertaking (e.g. Dalrymple Bay Coal Terminal or, more recently, the Queensland Government condition imposed on project approval for the Hancock Railway in the Galilee). For this to be effective, such directions need to specify timeframes, content and be effectively enforced.

- Dealing with the question of access up front at the initial stage of a project (or privatisation) then forms part of the wider public interest considerations associated with project. For that reason, a social cost test may be the appropriate economic threshold and the decision to require access should continue to be made, in the first instance, by a relevant Minister – informed by an economic regulator (e.g. the ACCC or a State competition authority).

- All access regimes should also be required to specify the framework, if any, governing further investment and expansion – either by the owner or third parties – and we would encourage the development of contestable funding models, in appropriate cases.

1.4 Where appropriate, access arrangements should provide for flexible and contestable funding models for expansion

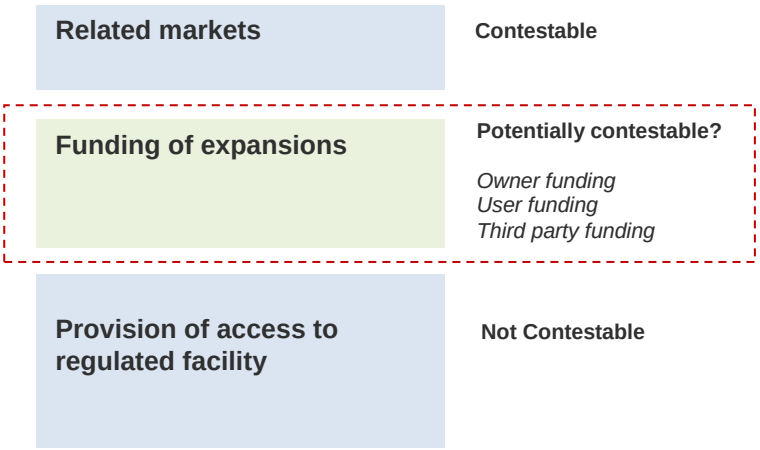
- A significant consideration in all access regulation is (and must remain) achieving the right balance in capital funding incentives – neither encouraging gold plating nor under-investment, where it is most efficient to expand.

- The high capital intensity of major infrastructure projects (especially in the resources sector) has led, over recent years, to the development of a number of flexible, multi-user project finance structures to fund investment in new or expanded unregulated infrastructure, particularly export coal terminals and railways. They have been able to be substantially debt funded, meaning a rate of return in some cases lower than that provided or required by a regulated entity.

- The current COAG and legislative principles underlying Part IIIA anticipate that investment in expansions will be primarily (if not entirely) funded by the existing owner. There is some evidence that this assumption, reflected in constraints on how ownership and cost arrangements are dealt with in relation to any expansion, may be preventing similar flexible funding models from being developed in a regulated environment.

- Specifically, where new investment is required in regulated infrastructure, it may be appropriate to facilitate 'user funding' of assets – particularly where the owner is not otherwise required to fund such investments or may do so at a commercially negotiated rate of return. This solution would permit users of a facility to bear the risks associated with any significant investment in expansions / extensions while at the same time ensuring the legitimate business interests of the access provider are protected.

Figure 1. Contestable funding



1.5 Where access has been settled 'up front', the ex post declaration process should be used only as a residual and exceptional mechanism, if at all, and a high economic threshold is appropriate

- After access questions have been considered and resolved (i.e. up front), the risk of any subsequent introduction of access regulation or re-regulation through the ex post declaration process under Part IIIA should be left for only very clear, "bright line" cases.

- The declaration process should be an exceptional and residual right and only made available where there is a very clear economic case to do so. Questions of public policy are unlikely to feature prominently at this stage, given that they were addressed as part of the initial approval process. This has the following implications:

  – the higher, 'private profitability' test for duplication or bypass of the facility is likely to be the more appropriate economic standard;

  – the decision to declare should be made by an economic regulator and not the Minister (given similarities to other similar decisions associated with merger clearances and authorisations, the ACCC may be most appropriate); and

  – as primarily an economic decision, the declaration decision should be subject to a merits review process by the Tribunal.

1.6 Residual issues associated with existing infrastructure for which access has not been determined up front

- We recognise that the approach in this paper does not resolve residual questions surrounding the application of Part IIIA (and the declaration criteria) to existing infrastructure, which is currently unregulated and for which the question of access was not addressed at the time of privatisation or construction/investment.

- For these facilities, we suggest that the final outcome of the High Court in *Pilbara Railways* is likely to strike an appropriate balance, being the application of a private profitability test for the economic test of duplication or bypass. However, we have a number of concerns about the implications of the decision for the breadth and operation of the 'public interest' test – which we address in some detail in section 9.1. Amongst other things, we question whether the declaration decision in these cases should continue to be made by the Minister, or whether it would be more appropriately managed by the ACCC (rather than the NCC).

- Finally, there may be cases involving existing infrastructure which would be better served through enhanced remedies to section 46 (misuse of market power) – than the application of the declaration process. This is likely to be particularly the case where there are pricing disputes involving suppliers with substantial market power. In these cases, it may be that enhanced remedies offer a more targeted way forward (such as a power for the Court to direct that pricing be arbitrated by the ACCC).

2 Role and function of the National Access Regime

The National Access Regime and the Competition Principles Agreement have played an important role in the liberalisation and opening up of the modern Australian economy.

In the period since the introduction of Part IIIA in 1995, the regime has provided a policy framework within which market principles have been introduced into the operation of former public infrastructure and have been accepted by State Governments and industry as an important consideration when dealing with significant infrastructure facilities in the context of privatisation.

However, as the Commission's Issues Paper identifies, the Australian economy has evolved significantly since the early 1990s.

Amongst other things, these changes include:

- Most industries characterised by natural monopoly characteristics have been made subject to sectoral access arrangements, including telecommunications, electricity transmission/ distribution networks, gas pipelines and rail networks.

- The liberalisation process of the mid 1990s is substantially complete and policy priorities are focussed on *encouraging* private sector investment in new or expanded infrastructure (rather than more efficient use of largely existing, publicly-funded capacity).

- Due to the high scale economies required for private investment in export infrastructure, a number of coal rail and terminal projects in Queensland and New South Wales over recent years have been delivered using contractual multi-user finance arrangements, at a rate of return less than what has been required for expansions to regulated infrastructure.

- There is increasing emphasis on the role and impact of access policy – and investment incentives in particular – on consumers, which has led to greater regulatory intervention in pricing and investment decisions in energy markets where consumer price impacts have been felt acutely over recent years.

As the Commission's Issues Paper also identifies, the possibility of further privatisation of government-owned infrastructure facilities in the future creates a need for greater certainty about what the National Access Regime will deliver. There is also an increasing demand for access rules to deal with and facilitate investment in new capacity.

The broader policy framework has also become more sophisticated, with COAG in the *Competition and Infrastructure Reform Agreement 2006* (**CIRA**) recognising the need for more targeted competition policy objectives across individual sectors (i.e. specific policy reviews for port and rail freight infrastructure).

3 The 'economic problem' which access is intended to solve

We agree with the Commission that it is critically important, at the outset, to resolve the question of what policy objective Part IIIA is intended to resolve. In this regard, there have always been two policy justifications given for the National Access Regime – which have often become blurred:

- To promote socially efficient use of monopoly infrastructure and avoid inefficient monopoly pricing and access terms (the efficiency argument).

- To protect competition in related markets, controllers of bottleneck infrastructure must not be able to refuse access to essential inputs required to compete in those markets (the 'denial of access' argument).

While these objectives are similar and often complementary, they can give rise to different policy choices and tensions. We would argue that much of the debate over the years around the appropriate economic test to apply as part of the declaration process to the question of economic duplication is because the policy objective of declaration has never been properly and clearly resolved between these two alternatives.

As set out below, the objects of Part IIIA need to recognise that the economic and policy role played by the regime will be depend on context. In particular:

- Where a decision about access is being made 'up front' as part of project approvals or privatisation processes, it may be appropriate for a wider set of social or efficiency considerations to be taken into account (e.g. community concerns with multiple infrastructure corridors etc) as well as issues such as any history of regulation (and sunk investments of the owner and other market participants based on the existing regulatory environment).

- In those cases where access is being proposed ex post through declaration, then it may be more appropriate to focus on the 'bottleneck' problem and require any party seeking access to establish duplication or bypass of the facility is not privately profitable.

The process for managing expansion of regulated assets also raises particular difficulties and the current Part IIIA framework does not deal effectively with this issue. This would be helped by requiring all access regimes and undertakings to specify the basis on which investment and expansion is to be undertaken, including any provision for contestable or 'user funding' arrangements.

We do not consider that anything has occurred over the decade since the Commission last reviewed the National Access Regime which suggests that general competition law, and section 46 in particular, is any better suited to providing the necessary detailed structure, flexibility and ongoing governance required to facilitate access to facilities.

4 Part IIIA must be able to deal with increasingly complex ownership and investment arrangements

We submit that the most important priority for Australian access policy must be to provide both *certainty* and *flexibility* to achieve access in a way that facilitates, and does not inhibit, investment in new and expanded assets.

The question of infrastructure ownership and use has become more complex than was the case in 1995:

- **Increasingly, multi-user/owner project structures reflect 'best practice' for access arrangements.** Contractual user-owned structures are being used to project finance major infrastructure projects where the scale or capital intensity required in order to support this investment is beyond the capacity of any individual investor. This model also enables projects to access international and third party debt and equity funding.

- **Governments are leaving funding of infrastructure to the private sector which typically is more disciplined about capital investment and does not fund 'spare' capacity.** While historically, public funding could allow for long term investment in capacity, this is generally not possible when infrastructure is privately funded and capital expenditure requires an immediate return. As such, projects are occurring on a 'staged' basis, with little if any 'spare' capacity and new users must be able to underwrite their participation through long term capacity commitments.

- **Access regimes, particularly involving supply chains, must be able to be developed in an integrated manner across different facilities and, at times, owners.** Experience with East Coast coal supply chains (and more recently, grain supply chains) has demonstrated that export-facing facilities often operate as part of integrated supply chains. Accordingly, regulatory mechanisms applied to one facility need to recognise the importance of coordination with other parts of the supply chain in order to be effective.

  By way of example, the establishment through commercial agreement of the Hunter Valley Coal Chain Coordinator (**HVCCC**) to provide "whole of system" planning to the Hunter Valley coal chain has proven perhaps the most successful multi-user framework to date. While aspects of this arrangement required authorisation by the ACCC, it did not involve a voluntary access

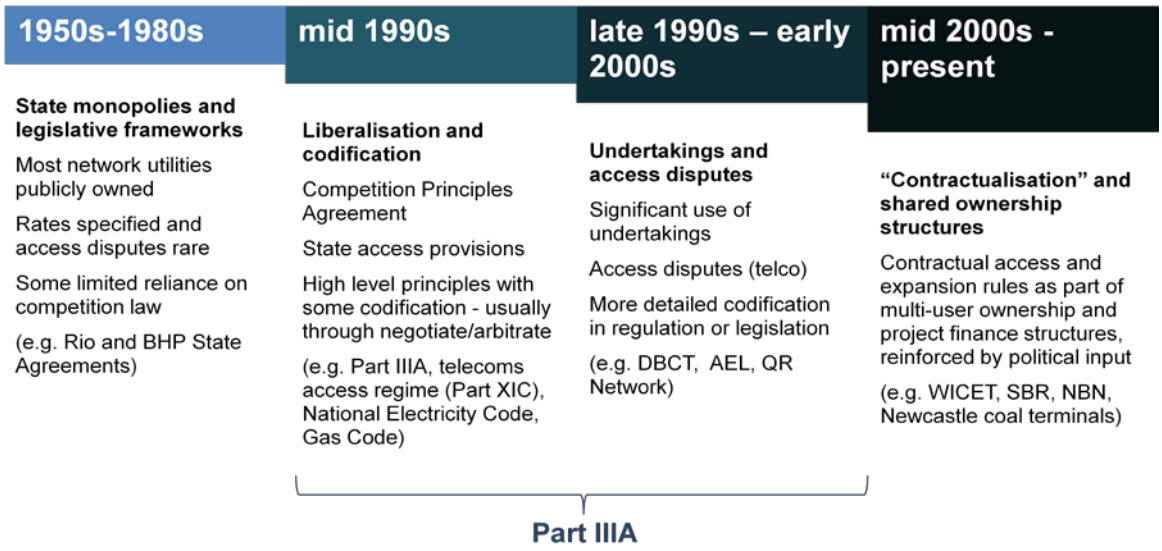
undertaking or declaration – and could not have done so given that it involved a collaborative approach involving a number of separate facilities and several owners, including coal producers, two port terminals (NCIG and PWCS) and above and below rail operators.

By contrast, attempts to improve integration across the various parts and participants within the similar coal supply chain at Dalrymple Bay Coal Terminal (**DBCT**) in Queensland have proved largely ineffective to date. This is despite the fact that at DBCT both the rail network and port are separately regulated under the Queensland Competition Authority Act.

- **The history of ownership (and regulation), particularly in the case of privatisation, is now an important factor which should be taken into account in addition to traditional market power and bottleneck issues.** This is particularly the case where participants in related markets have substantial sunk investments based on existing regulatory arrangements.

To some extent, the complexity of these ownership and other issues has left the National Access Regime struggling to respond to the complexity of new ownership and investment structures, which has in turn meant that there has been limited scope for Part IIIA to provide or support residual or transitional access frameworks.

Figure 2. Evolution of Australian access policy



5 For greenfield or privatised infrastructure, access issues should be settled up front

While it may be possible to conceive of circumstances where ex post declaration should be available in relation to greenfield infrastructure, we consider that it is far better to have access arrangements, if required, settled up front.

In the absence of an access obligation which applies automatically to new infrastructure (e.g. telecommunications or electricity transmission), access obligations may be imposed by state governments as part of other related processes, including during privatisation or as a condition of state leases, concessions or development approvals. To the extent that this ensures up front certainty for investors, owners and participants in related markets, we support this approach.

However, we do not consider that the same economic or policy standard applied as part of the ex post declaration process should apply when deciding whether to impose access rules to new infrastructure

and are concerned by a trend by some State Governments to view the declaration criteria in sections 44G and 44H as the 'threshold' that must be satisfied before *any* access arrangements may be justified through these governmental processes.

The difficulties with applying the same economic standard in all cases is also relevant given that the declaration criteria have been interpreted by the High Court in the *Pilbara Railways* case in the context of existing, privately-owned and highly integrated rail infrastructure. It is not clear that the relevant economic test and policy approach in this context should necessarily also apply to dealing with access decisions being made in all sectors and across all contexts. For example:

- Where privatised infrastructure has a long history of regulation and multi-user access, and in which existing users have substantial sunk investments in assets reliant upon that regulation, it may be appropriate for such regulation to continue.

- In many cases, State Governments may view third party access obligation as a quid pro quo for preferential rights granted as part of the development process (e.g. a monopoly right to use a rail corridor or the use of compulsory acquisition of land in order to support construction of infrastructure).

We endorse the relatively new mechanism for declaring facilities ineligible for declaration under section 44LG.[1] This provision provides that a person with a material interest in a proposed facility can request the service provided by the facility be ineligible for declaration for a period of at least 20 years. To date, we are not aware of any applications being made under section 44LG.[2]

6 What level and type of intervention?

Access policy in Australia has evolved into something of a patchwork of regimes within and across industries, with different features and points of failure. In our view, while nationally consistent regulation is preferable, we recognise that a number of State regimes have provided longstanding and effective regulation in a range of sectors – including railways, ports and water infrastructure.[3]

In many cases this diversity highlights that access rules must fit the industry and infrastructure to which they are applied. In others, overlapping and inconsistent regulatory arrangements (usually between state regimes) would have been better avoided. In particular, we consider that more could be done to achieve consistency across rail access regimes, for which very different approaches have been taken despite a common set of customers and market structures.

We see any question of whether Commonwealth or State arrangements are preferable as not the most important one. The more important distinctions to be drawn are between:

- sector-wide specific access regulation (e.g. electricity, gas, telecommunications);

[1] Introduced into the CCA by *Trade Practices Amendment (Infrastructure Access) Act 2010.*

[2] NCC's Annual Report for 2011/12 (page 7)

[3] We accept that coordinated State legislation has also been used to establish national access arrangements in energy markets, however these are nonetheless best viewed as national frameworks, rather than State-based.

- facility-specific access regimes implemented through access undertakings (e.g. ARTC rail network, DBCT coal terminal); and

- a general ex post right to access to any economically significant facility, such as through the declaration process.

On this question, we consider that sectoral and facility specific regulation (through undertakings) have been shown over the last two decades to be preferable to any general right of access.

The fact that access arrangements across telecommunications, energy, railways, airports and other network industries have evolved so differently reflects the value of protecting and encouraging industry specific access policy wherever possible.

7 Access undertakings offer a flexible and useful mechanism to settle the question and terms of access up front

The process for the ACCC to approve and oversee access undertakings lodged under section 44ZZA has proven one of the most useful elements of the Part IIIA framework to date – providing a flexible mechanism for establishing access arrangements, sometimes as a transitional measure.

In some regards, the original policy intent of undertakings has not been realised, in that facility owners have not typically lodged undertakings in order to achieve certainty and to avoid declaration.

However, it has provided the legal machinery for the establishment and oversight of arrangements that have been required as part of other governmental processes, such as following privatisation or as a condition of leases or project approvals. We see this as an important role which Part IIIA should continue to play. Examples include:

- The use of a voluntary access undertaking under the *Queensland Competition Authority Act* to maintain regulatory arrangements at Dalrymple Bay Coal Terminal following privatisation of the terminal.

- Section 24 of the *Wheat Export Marketing Act 2008* required grain port terminal owners to submit voluntary access undertakings to facilitate non-discriminatory access to grain-handling ports. This is due to be replaced by a voluntary code of conduct by 30 September 2014.

- A requirement under the Intergovernmental Agreement for the Australian Rail Track Corporation (**ARTC**) to lodge an access undertaking covering access to its below rail infrastructure.

- The Queensland Government required a railway infrastructure proponent to lodge an access undertaking under Part IIIA as a condition of granting State approval for the project, although to date no undertaking has been submitted.[4] This is an example a case where greater clarity as to the timing and process would benefit all stakeholders.

[4] This is a condition of the Declaration of the Railway by the State Government as an Infrastructure Facility of Significance pursuant to section 125(1)(f) of the State Development and Public Works Organisation Act 1971.

- While not under Part IIIA, it is also noteworthy that the introduction of the NBN regulatory framework involved substantial undertakings being lodged by both Telstra and NBN Co.

In acknowledging the value of undertakings, we nonetheless consider that changes could be made to further assist their use:

- Part IIIA should be amended to require access undertakings to specify the approach, if any, to be adopted to investment in new or additional capacity. We anticipate that these provisions might deal with issues such as:
  - Whether expansion must be undertaken by the existing owner in the event of any shortfall in capacity and, if so, at or above the standard rate of return applying to existing or replacement capital expenditure.
  - If the owner is unconstrained in pricing of expansions, whether existing or new proponents (or third parties) could fund expansions, e.g. whether funding will be made 'contestable' such as through user funding arrangements.
  - What arrangements are put in place to ensure that the legitimate interests of the owner are protected, particularly where third party funding is being used to expand an asset.
- Further consideration should be given to allowing scope for multiple facility owners/operators to jointly lodge an undertaking, where the service being provided involves the use of more than one facility. This would enable a single access framework to be implemented across a rail-port system, where this was appropriate.

In relation to the first of these proposals, considerable work has been undertaken by Aurizon Network and the coal industry in Queensland over recent years to seek to develop a set of 'Standard User Funding Agreements', to introduce contestable funding into the regulated coal rail regime – under the 2010 Aurizon Network Access Undertaking.[5] A similar mechanism (although far less well developed) was also included in the ARTC Access Undertaking governing expansion of the Hunter Valley coal rail network.

Similar schemes that contemplate third party funding being introduced into new expansions are also a feature of a number of recent and unregulated project financing and access structures used for East Coast coal terminals, including at Port Waratah and Wiggins Island.

8 If the question of access is resolved ex ante, then declaration should remain a narrow residual mechanism

Where our proposed approach has been adopted and questions of access are resolved by policy makers at the time of investment, the remaining role of any 'general' ex post access framework such as declaration under Part IIIA should be narrow at most and subject to well defined and clear economic tests (with any wide ranging political discretion to be avoided).

[5] Most recently, this led to the submission of a set of SUFA agreements by Aurizon Network on 21 December 2012.

For these facilities, and for existing unregulated private facilities, we suggest that the final outcome of the High Court in *Pilbara Railways* in relation to criterion (b) is likely to strike the appropriate balance, being the application of a private profitability test for the economic test of duplication or bypass.

However, there is a case for re-visiting whether the Minister is the appropriate person to make declaration decisions in these cases. Consistent with similar decisions (such as merger clearance and authorisation decisions), we submit that declaration decisions should be made by an experienced economic regulator such as the ACCC in order to ensure that they are free from political and policy ambiguity and uncertainty. The decision maker should also be subject to standards of transparency, procedural fairness, and appropriate merits review.

Finally, there may be cases involving existing infrastructure which would be better served through enhanced remedies to section 46 (misuse of market power) than the application of the declaration process. This is likely to be particularly the case where there are pricing disputes involving suppliers with substantial market power. In these cases, it may be that enhanced remedies offer a more targeted way forward (such as a power for the Court to direct that pricing be arbitrated by the ACCC).

9 The operation of the declaration criteria

9.1 Criterion (f)

We are concerned with the implications of the High Court's decision in *Pilbara Railways* for criterion (f) (the 'public interest' test).

As noted above, access regulation, if justified on economic and wider policy grounds, should be agreed by governments with investors, owners and other market participants as part of an 'up front' regulatory compact either through schemes of general application across a sector (e.g. electricity transmission/distribution and telecommunications) or, if on an individual basis, as part of governmental processes associated with the particular project of facility – and reflected in access undertakings.

The risk and uncertainty associated with subsequent regulation through declaration should be minimised by ensuring the criteria are applied sparingly and only in clear cases. They should be based only on well understood economic principles and subject to merits review.

With respect, we therefore view the High Court's characterisation of the public interest test within the declaration criteria as a very wide discretion of a 'generally political kind' as concerning. The High Court (including Heydon J) appeared to also endorse a distinction between the public interest criterion (and possibly also the nationally significant infrastructure requirement (criterion (c)) with other criteria such as the promotion of competition test (criterion (a)) and duplication test in criterion (b), which were said to be 'technical' criteria, of a kind more appropriately addressed by the NCC and reviewed by the Tribunal.

We submit that the approach adopted by the High Court to the operation of criterion (f) will leave the declaration process open to considerable uncertainty and severely limit the ability of stakeholders to seek review of declaration decisions based on this criterion.

We endorse the role of a public interest test in the declaration criterion provided that it operates as an economic test allowing the costs and benefits of access (including benefits associated with any promotion of competition identified under criterion (a)) to be brought to account. In that sense, we consider that the approach previously adopted by the Tribunal better reflects the way that the test ought to operate in order to provide sufficient certainty.

We have had the benefit of reviewing and contributing to the submission made to the Commission by the Law Council of Australia and support the amendments proposed in those submissions, including:

- redefining the public interest test as a net public benefit test, similar to that applied by the ACCC under section 90 for the purpose of granting authorisations; and

- clarifying the interaction of criterion (f) with costs and benefits also considered for other purposes under earlier criteria.