GLENCORE

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National Access Regime
Productivity Commission
LB2 Collins Street East
Melbourne Vic 8003

Dear Patricia

Glencore is pleased to provide a submission in response to the Productivity Commission Draft Report on the National Access Regime (**"NAR Draft Report"**).

The original Glencore (previously Xstrata Coal) submission to the enquiry highlighted three key areas where Glencore believed the Regime would benefit from enhancement: clarification of the declaration criteria, economic efficiencies through improved coordination in multi user- multi owner systems, and ensuring an effective extension determination process.

The NAR Draft Report contains many recommendations that will improve the achievement of the Regime's objectives. In particular, we commend the Commission's recommendations; clarifying declaration criterion (b), and opening way to a more effective extension process.

However, Glencore believes applying a narrow theoretical approach to analysing the many practical difficulties in dealing with monopoly infrastructure providers represents a missed opportunity to assist in securing the global competitiveness of the east coast coal chains which ultimately benefit the Australian community. In particular, the commentary regarding economic rent seeking ignores; recognised economic principles regarding return and risk, the lack of credible alternatives when negotiating with natural monopolies, and provides no weight to the pricing principles in section 44ZZCA of Part IIIA of the Competition and Consumer Act 2010 (CCA).

Much of the east coast coal chain monopoly infrastructure has now been privatised (e.g. Dalrymple Bay Coal Terminal, Abbot Point Coal Terminal, Aurizon Network, Port Kembla) , and there are further planned sales of natural monopoly infrastructure providers in the near future (Newcastle Port Corporation and the R G Tanna Coal Terminal). In every instance of monopoly coal chain infrastructure being sold into private ownership in the last ten years there has been an associated significant increase in the cost of access to that infrastructure, through both the imposition of higher access charges and/or the reallocation of risk back onto the users of the infrastructure. While significant short-term funds have been raised by governments from

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the sale of the infrastructure, there is a long-term cost being imposed on the industries that depend on the efficient provision of the infrastructure capacity.

In an effort to improve returns and reduce risk, owners of monopoly infrastructure are increasingly pushing the boundaries of the regulatory regimes that are otherwise intended to protect the consumer. Nowhere is this behaviour more evident than with the draft Access Undertaking recently submitted by Aurizon Network to the Queensland Competition Authority under legislation that is modelled on the national competition arrangements.

Under drafting tabled by Aurizon Network they would be free to; impose access charges set by auction and well above historical regulated rates, would be able to preferentially price track-access for their own vertically integrated businesses such as their existing above–rail business and a potential future ports business, would control which new coal mines in the future can be developed, and would transfer all commercial risk associated with construction and operation of the rail network onto the users of the network. While this effort to reallocate risk and monopoly rent seek is normal commercial behaviour by a vertically integrated and privatised monopoly, it highlights the very real risk confronting the users of the infrastructure, and the broader economic detriment to the state if such monopolies are allowed to operate unconstrained and without an effective regulatory regime.

It is within this context that we urge the Commission to further develop its analysis and recommendations as regards the ability of natural monopoly infrastructure providers to extract monopoly rents and auction capacity rights. The regime must balance the legitimate requirements of monopoly infrastructure owners to generate a return commensurate with their risk, but also recognise the needs of the users who are dependent on the provision of the infrastructure and who generate a substantially greater economic benefit to the state in the longer term.

The review of the Regime represents a critical opportunity to address the erosion of regulatory protections which are adding to both the risk and cost of doing business in Australia for the coal export industry. State Governments and State regulators are also looking to the outcomes of the review of the Regime to inform what, if any, amendments are made to State based regulation. This is a unique opportunity to ensure that the effectiveness of the regulatory regime within Australia is evolved such that the greater economic benefit to the state from the industries that depend on the monopoly infrastructure is not placed at risk.

Yours sincerely

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Glencore

1. Declaration Criteria

The Commission's recommended changes to the declaration criteria are welcomed. However, Glencore is concerned that the natural monopoly test is too narrowly defined. Application of the net social benefit test would seem to better meet the objectives of the Regime notwithstanding there may be some difficulties in quantifying the costs and benefits to the community as a whole (it being noted that in this regard the Commission acknowledges that decision makers are already required to make judgements[1]).

The concern with ignoring the costs and benefits to the community as a whole and focussing narrowly on the actual cost of the facility (net of additional maintenance and reduced operational flexibility) ignores the broader environmental and community costs that could be incurred should an alternative facility be developed.

The Commission was of the view[2] that Glencore's call for a "practicability to duplicate" test was not warranted because where such constraints presented a true barrier to developing an alternative facility, decision makers are able to take into account such considerations when determining whether a facility is a natural monopoly under criterion (b). However, where the natural monopoly test is applied without reference to the broader social and economic costs and benefits the practicability to duplicate may not be effectively taken into account.

In the alternative, a specific construction of the types of costs and benefits to the community should be included in the natural monopoly test cost and benefit analysis just as the Commission has acknowledged that the costs should include an estimate of costs associated with additional maintenance and reduced operational flexibility.

A further concern with the definition of the natural monopoly test being where "total market demand could be met at least cost by the facility", is that this could lead to circumstances where an already declared facility could fail this test when a significant expansion is required which results in increasing average costs. Saw tooth profiles in average costs are common when infrastructure requires significant expansion (but which is still less costly than a full duplication assuming such duplication was practically achievable).

While it could be argued that the other declaration criteria would continue to apply to prevent an application for revocation, failure of one test could provide grounds for a monopoly service provider to seek revocation of an existing declaration. The total market demand and cost test should therefore be a broad forward looking test taking into account likely foreseeable future demand not just the demand under application.

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[1] Productivity Commission Draft Report – National Access Regime, May 2013, p 21.
[2] ibid, p 169.

2. ***Economic Rent Seeking***

Having clearly acknowledged that the market failure the Regime should address is the lack of effective competition in markets for infrastructure services due to natural monopoly and that this is likely to cause an economic problem where *inter alia* service providers charge monopoly prices for access to their services, the Commission then appears to endorse economic rent seeking while acknowledging that some other form of intervention may be more appropriate.

The Commission's view that preventing economic rent seeking ought to only be prevented by the Regime if that rent seeking would result in an inefficient outcome in the dependent market[3], would seem at odds with the intent of regulation and the inclusion of pricing principles within the Regime. From commentary in the NAR Draft Report it would appear that the Commission does not regard economic rent seeking per se as counter to the objectives.

The Commission points to alternative mechanisms (such as facility based access arrangements, prices surveillance under Part VIIA of the CCA, or Part IV of the CCA) in order to address monopoly pricing albeit acknowledging that most other policy instruments have limited capacity to address a lack of effective competition for services. This leaves access seekers in a precarious position and represents a missed opportunity by the Commission to ensure the Regime remains relevant to the current operating and economic environment of a sector that makes a significant contribution to the Australian economy and which is struggling on a range of fronts to remain globally competitive.

Glencore's principal concerns with the Commission's analysis are that it:

1. *Ignores the pricing principles articulated in Part IIIA and in particular the practical ability to apply these where access to services requires extension of a facility.*

   If the Commission accepts that regulation is intended to address the market failure that arises from the lack of effective competition so as to avoid circumstances where transactions that would enhance community wellbeing may not otherwise proceed, it is difficult to understand how economic rent seeking can be supported or dismissed.

   It is also difficult to envisage that the pricing principles for access disputes and undertakings that exist within Part IIIA were only intended to apply where monopoly pricing would result in allocative inefficiency in the ultimate market for the export product. If this were the case there would seem to be little need for any other pricing principle other than (b) (ii) of Section 44ZZCA of the CCA.

   If a service is declared the presumption is that the pricing principles under Part IIIA would apply. These principles appear directed at preventing economic rent seeking by

[3] Ibid, page 19

ensuring that the infrastructure owner recovers the efficient cost of service provision and earns a return on their investment commensurate with the risks. How then can preventing economic rent seeking not be within scope of the Regime and further, where it is demonstrably failing, how can this review of the Regime not present the opportunity to address the failings?

Of more critical concern is that the apparent conflict in the application of these pricing principles in the case of extensions/expansions with the limitations imposed under the Regime in directing Extensions has been largely ignored in the review. This issue was highlighted in our original submission and was also addressed by the QCA in its submission.

Glencore contends that the application of such pricing principles should establish a ceiling on pricing able to be sought by infrastructure service providers in an Extension and that refusal to invest at that ceiling should present an automatic right for access seekers to fund the extension/expansion in a manner that is cost effective for the access seeker. This issue is addressed further below in discussion on directing extensions.

2. *Ignores the risk to the community (economy) should the infrastructure provider get it wrong and drive mining investment offshore.*

Where users of infrastructure are price takers in their ultimate product markets they will be acutely interested in price and price stability of infrastructure services. Investors in new mine projects will direct scarce investment capital to the jurisdictions that offer an adequate return for risk. Where economic rent seeking reduces mine investment returns this risks global demand for resources being met from other countries. If Australia is not cost competitive due in part to economic rent seeking by infrastructure providers, the community will lose the benefits of employment generation, royalties and tax revenues.

Left to "commercial" negotiation there is a risk that the infrastructure provider gets its assessment of the access seeker's ability and willingness to pay wrong. The regulator may operate with less information than the commercial parties but there is substantial evidence in Australia and overseas that regulated infrastructure is attractive to investors and accordingly pricing decisions by regulators with less than perfect information have not deterred investment.

What is untested is the extent to which investment capital in mine projects has been or will be redirected offshore due to infrastructure owners miscalculating an access seeker's ability to pay or willingness to accept poor commercial terms. While the Commission states that it has received no conclusive empirical evidence on the Regime's

effect on incentives to invest in infrastructure services and in dependent markets[4], does this justify the risk to the Australian economy of accepting an Access Regime that facilitates rather than hinders economic rent seeking by natural monopolies?

If the Commission is wrong in asserting that economic rent seeking is unlikely to affect commodity exports, or the infrastructure provider pushes monopoly pricing to the point where royalties and tax revenues are affected, the Regime will have failed to achieve its objective. Surely there is a need to invoke a precautionary principle such that where a natural monopoly exists (ie the declaration criteria are met) the ability to extract economic rents must be curtailed.

3. *Provides no weight to the time honoured economic principle that returns on investment should be commensurate with the risks involved.*

As recognised in the pricing principles in Section 44ZZCA of the CCA access prices should include a return on investment commensurate with the regulatory and commercial risks involved.

The transfer of economic rents violates this principle as it simply allows the service provider to extract profits from the user that bear no resemblance to the risks borne by the service provider, and could result in the user being left with returns that do not reward it adequately for the risks borne on its investment.

As a regulated monopoly service provider Aurizon Network is exposed to very little commercial and regulatory risk. With each Undertaking renewal their risk profile has diminished to the point that it is difficult to point to any real level of risk borne by Aurizon. Yet, in this environment Aurizon is able to refuse to invest in expansions of their monopoly network unless they can obtain returns in excess of the regulated rate.

While Aurizon points to the (currently theoretical) ability of an access seeker to "user fund" an expansion as a natural hedge against their demands being excessive, the practical effect is to enable Aurizon to charge access rights at the opportunity cost of capital of the miner rather than at a level that reflects the risks inherent in the service provision. The miner's opportunity cost reflects the risks it bears in competing in global commodity markets and accordingly is not an appropriate benchmark return for a monopoly infrastructure provider.

[4] Ibid, page 15

> An access regime that permits this appropriation of profit by a natural monopoly without acceptance of the commensurate risk to occur cannot be regarded as effective or in Australia's long term interests.

Glencore, contests that if curtailing economic rent seeking is not the purpose of regulating access to monopoly infrastructure, then either the objectives of the Regime need to be reviewed or a less narrow and theoretical construct needs to be applied.

3. Extensions

The Commission's recommendation to require a monopoly service provider to both geographically extend and expand the capacity of a facility is welcomed. Further the recommendation that the ACCC should publish guidelines on how its power to direct expansions and extensions would be exercised is welcomed as there is currently significant ambiguity in the application and interpretation of the matters under Sections 44V, 44W and 44X of the CCA (and as similar provisions are applied in State equivalent Acts).

Glencore agrees that intrusive approaches to regulation should only be used where light handed approaches and non regulatory options have demonstrably failed. However, where a regulated infrastructure owner has signalled its intent to maximise the benefit of its monopoly position (including by way of extracting monopoly rents) it is inefficient to rely on negotiated outcomes without a robust fallback position via more prescriptive regulatory provisions.

Glencore contests that the positions adopted by Aurizon Network in Queensland as regards expansions provide manifest evidence that light handed regulation has demonstrably failed. Furthermore, there exists a significant risk that other regulated infrastructure providers, upon which Australia's export coal industry relies to remain competitive, will adopt Aurizon's approach.

The Commission has sought further input on the adequacy and workability of the safeguards in the CCA related to the Australian Competition and Consumer Commission's power to direct an infrastructure service provider to extend its facility. To illustrate the deficiencies in the current approach we present an analysis of the expansion process recently proposed by Aurizon Network in Queensland.

(i) Deficiencies in the Aurizon Expansion Process

Access to the Central Queensland Coal Network owned by Aurizon Network is declared. Aurizon Network operates under an Access Undertaking approved by the Queensland Competition Authority (QCA). Accordingly the presumption should be that access seekers that have a legitimate interest in the use of the network and can meet minimum operational and safety requirements ought to be able to negotiate for access without other filters being applied.

Aurizon Network in its Undertaking submitted to the QCA in April 2013 (2013 DAAU) [5] has proposed a framework that:

- Effectively enables Aurizon Network to decide when mine developments occur, which mines are viable and hence can be developed, and to ignore and override other coal chain capacity allocation processes;
- Enables Aurizon to auction capacity to the highest bidder or to preference access seekers that agree to an integrated service offering by Aurizon (eg haulage and/or port services (noting Aurizon does not own ports but has signalled its intent to do so);
- Removes any obligation on Aurizon Network to undertake an Expansion even if Access Seekers are willing to fund the Expansion. An Expansion is contingent it protecting Aurizon's "legitimate business interests" (legitimate business interests are very broadly defined to include: allocation of capacity being made to its highest marginal value (to Aurizon Network), having regard to the quality and saleability of the product, and the expected duration for demand for access, while ignoring the various protections from these implied risks under the Undertaking);
- Limits commencement of Expansion studies unless and until Aurizon Network determines (in its discretion) that there is likely to be sufficient demand for the service.
- Reserves for it the sole right to design, procure and construct Expansions without any commitment to deliver value for money, nor provide any guarantee or accept any risk where the Expansion fails to deliver the promised capacity; and

Taken individually or collectively these factors will substantially undermine the objectives of the Regime and yet are argued (by Aurizon Network) as consistent with the requirements of the Queensland Competition Authority Act (1997), which is generally consistent with the CCA.

(ii) User Funding Limitations

Addressing the Extension Process must include resolving the limitations on developing a viable user funding model that opens the way for contestable third party funding.

As highlighted in our original submission and as noted by the QCA in its submission to the enquiry, the current legislation does not permit effective user funding of expansions. The emphasis is too heavily weighted towards protecting the legitimate business interests of the infrastructure service provider and this terminology is very broadly interpreted by the service provider.

[5] 2013 Aurizon Draft Access Undertaking, Part 8 via http:/www.qca.org.au/rail/Qrnetwork2013DAU/

Recommended changes:

Consideration of the following principles should be included in any amendments to the CCA or included in the recommended guidelines governing Extensions (assumed to include expansions):

1. *Information Asymmetry*
   - Where the access seeker and infrastructure service provider are unable to reach agreement on whether and under what terms to extend a facility within a reasonable defined period, there should be an automatic failsafe being the right for the regulator to direct the infrastructure service provider to provide all reasonably required information and to permit and cooperate with implementing the extension (subject to the access seeker or their nominee providing funding).
   - Where the infrastructure service provider fails to comply with the direction of the regulator as regards provision of information the regulator should have broad discovery powers and the ability to appoint an expert to advise on resolution of the scope, schedule, cost and procurement approach for delivery of the infrastructure extension.

2. *Cost and Quality and Timely Delivery of Extensions*
   - The presumption should not be that the infrastructure service provider is the only party able to design and manage the construction of the extension.
   - The infrastructure service provider should be required to tender the design of the extension but should have the right to require minimum standards consistent with their existing infrastructure and in meeting their other regulatory obligations (such as under rail safety legislation).
   - The infrastructure service provider should be required to tender the construction and construction delivery management functions (but should be able to retain for itself the right to step into the delivery management where the appointed party is demonstrably risking their legitimate business interests).
   - Where the infrastructure service provider seeks to undertake the design, construction and/or construction management on the grounds that this is the only way to protect their legitimate business interests, they should not be able to do so on a no liability basis rather they should be obliged to do so on market terms.
   - Where the infrastructure service provider undertakes the design, construction and/or construction management, the party funding the extension ought to have a step in right where the infrastructure service provider is failing to meet time, cost, quality metrics (which should be able to be applied on a look forward basis).

3. *Right of access seeker to participate in Extension processes*

The infrastructure service provider should be obliged to undertake an Extension process in accordance with the following principles:

- Where an access seeker requests capacity and is willing to fund the cost of the feasibility studies and can demonstrate a reasonably foreseeable potential requirement for the capacity in the time frame nominated, the infrastructure service provider must undertake the studies at the cost of the access seeker.
- In demonstrating a reasonable requirement for the capacity, the infrastructure service provider cannot apply criteria that; is discriminatory, preferences its own business interests or requires disclosure of unnecessary and commercially sensitive information. The information able to be required should centre around: likelihood of obtaining access rights to other parts of the supply chain, having a credible schedule for development of the project that generates demand for the service, and demonstrating an ability to fund, or provide security for the cost of, the study.
- The access seeker should have the right to dispute (to be resolved by the regulator) a determination by the infrastructure service provider that they are not a legitimate applicant for the service.
- Studies must be undertaken promptly and in accordance with good industry practice, failing which the access seeker must have a facilitated step in right
- There should be no general grounds or application of legitimate business interest type tests at this stage of the process that can be used to deny an ability to participate in the study phase.

4. *Rights of infrastructure service provider where they refuse to invest at regulated rates*

The pricing principles under Part IIIA of the CCA should apply to pricing of extensions. That is, the application of such principles should establish a ceiling on pricing able to be sought by infrastructure service providers. If the infrastructure service provider refuses to invest at that ceiling there must be an automatic right for access seekers to fund the extension.

5. *Facilitation of Financing of Extensions*

- The access seeker should not be prevented from procuring third party funding for the extension (ie the funder need not be the access seeker).
- The third party funder should have access to dispute resolution processes under the regulatory process even though they are not an access seeker.
- In circumstances where the infrastructure service provider becomes insolvent the part of the facility funded by the access seeker (or their nominee) or the income stream derived

from it should be able to be protected (eg by way of becoming an owner or secured lender).

- The requirement that the facility owner not bear any of the costs of extending the facility should not apply where the costs are attributable to the acts or omissions of the service provider during the study, construction and operation of the extension.
- The infrastructure service provider should not be able to discriminate as between parts of the facility funded by it and parts funded by others as regards, maintenance of the facility, revenue derived from the facility or optimisation risk.

6. *Durability & Transferability of Rights*
    - Where the access seeker's requirement for access ceases, but the extension they funded has enduring value, they (or any nominee third party funder) should not be prevented from continuing to receive any income stream earned by the infrastructure service provider from the user funded extension.
    - There should not be a presumption that the extension funded by the access seeker (or their nominee) ought to be optimised or written off where overall demand for the services diminishes. The optimisation risk should be borne with reference to the relative ongoing demand for the service that triggered the relevant capacity of the facility versus the demand that existed pre expansion.

While not within the scope of the Regime, the Productivity Commission could comment on the economic benefits of amendments to the Income Tax Assessment Act (1997) to avoid highly complex structures which further complicate user funding of monopoly infrastructure. These may include:

- specific amendments that ensure upfront capital costs provided by legitimate user funders are not immediately assessable to the infrastructure service provider
- that the party funding the extension can access the depreciation deductions attributable to the extension and other typical deductions on capital borrowed or contributed for depreciable assets.

Such changes can be justified on the basis of the significant cost and complexity existing rules drive and should be subject to safeguards to ensure they apply only in circumstances of legitimate user funding due to refusal of a regulated monopoly infrastructure service provider to extend a facility at regulated rates.

4. Negotiate Arbitrate Model

While market based solutions, and in particular commercial negotiation, should remain the preference for business dealings, the fact remains that where there is only one supplier of

services and users have no real or practical bypass, there cannot by definition ever be a commercial negotiation.

Accordingly, asserting the primacy of a negotiate arbitrate model in circumstances where a natural monopoly exists risks damaging Australia's international competitiveness and hence the community that is meant to be served by the Regime.

The challenges of relying on a negotiate-arbitrate model where there is no practical alternative to the monopoly service provider include:

- Information asymmetry as between the service provider and user;
- The ability for the service provider to use the time taken to resolve arbitration against the user;
- The fact that there is no real countervailing power (regardless of the level of sophistication of the applicant) in a natural monopoly situation which means that the monopoly service provider can extract unreasonable terms and pricing (bearing no reflection to the risk) up to the point that the applicant is prepared to walk away. This by definition is not a commercial negotiation.

Accordingly, while there should always be scope for parties to negotiate as a first right, there must be a credible, robust and timely alternative available to access seekers. Glencore, therefore contends that pre-determined minimum terms and pricing must be developed by regulators where a facility is the subject of declaration.