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By email

National Access Regime
Productivity Commission
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Dear Mr Barker,

Submission in response to the Commission's Draft Report

Gilbert + Tobin filed a submission on 15 April 2013 in response to the Productivity Commission"s (**Commission**) Issues Paper. We welcome this opportunity to provide a further submission in response to the Commission"s draft Inquiry report (**Draft Report**).

We broadly endorse the assessments and conclusions in the Draft Report, subject to specific issues identified in this supplementary submission.

In this supplementary submission, we expand slightly upon aspects of our earlier submission, to the extent that such points touch upon issues raised in the Draft Report. Our four principal observations are:

(a) While the Draft Report"s focus is on Part IIIA of the *Competition and Consumer Act 2010* (Cth) (**CCA**), there is scope for a number of the conclusions in the Draft Report to be reflected through recommendations that COAG revisit principles in the Competition Principles Agreement (**CPA**), potentially as part of the National Regulatory and Competition Reform process. We consider this is important given the central role that the CPA plays as the overarching national framework for access regulation, which includes other Federal, State and Territory industry specific and generic access regimes, as well as Part IIIA itself.

(b) The history of, and context for, investment in and regulation of an industry (or in relation to a facility) is one of the most important policy considerations in the design of access frameworks and one which has important economic consequences relevant to the design of any access regime and for the residual application of Part IIIA. We consider this is important when considering specific issues such as the economic to duplicate test in criterion (b) and criterion (f) considerations.

(c) The focus placed by the Commission on the development of a workable approach to the extension and expansion of regulated facilities is timely and welcome, given capacity constraints in much essential infrastructure. We consider it desirable that the CPA acknowledge that expansions and extensions can be user funded and that the development of a general framework or principles for extensions and expansions, which is recommended to be undertaken by the ACCC also involve relevant regulators under State and Territory regimes.

(d) The assessment that the impact of monopoly power in integrated production / supply chains with downstream competitive markets (which would apply for example, to grain infrastructure, iron ore and coal) may simply be an issue of the transfer of economic rents is, in our view, likely to overlook important adverse efficiency and productivity implications of the exercise of such market power.

We also make a number of specific observations in response to the Commission‟s recommended changes to the declaration criteria and process.

Overarching role of the CPA and CIRA in guiding the National Access Regime

We see the National Access Regime as being founded in the Council of Australian Government (**COAG**) Agreements, namely the CPA and the CIRA, and in particular in clause 6 of the CPA. This provision is then given effect in a range of generic and industry specific access regimes at both the Federal and State and Territory levels. Part IIIA of the CCA is the Federal generic access regime.

We acknowledge that a review and consideration of industry specific regimes is beyond the scope of the Commission inquiry. Nonetheless, the role of the CPA is very important in setting the legal and policy framework for access regulation across all regimes. As well as directly shaping the framing of Part IIIA at a Federal level, certification of a State or Territory regime as an “effective access regime” is only available where the regime is found to comply with the principles in clause 6(2) to 6(5) of the CPA.

The general principle supported in Gilbert + Tobin‟s initial submission was that industry or project specific regimes are to be preferred in most circumstances and that Part IIIA should apply only in exceptional circumstances – as a residual or „backstop‟ measure (to use the term preferred by the Commission in the Draft Report). This principle seems to be generally aligned with the approach adopted by the Commission.

By contrast, wherever possible, industry or facility-specific access arrangements should be:

- settled „up front‟ as part of State concession, privatisation or other governmental processes; and
- incorporate provisions dealing with the future development and expansion of a facility, if expansion is to be regulated at all.

We welcome and endorse the acknowledgements in the Draft Report that certainty around access provisions is important for newly privatised infrastructure and that it is good practice for new infrastructure facilities (at page 322-323, Draft Finding 10.2).

In this context, we consider that a natural monopoly test is appropriate for a newly privatised industry or facility, prior to investment, or where there was clear guidance prior to investment that relevant infrastructure was to be subject to access regulation. However, in our view, the private profitability test is appropriate in the context of existing private infrastructure. These principles could ideally be reflected in clause 6 of the CPA. In the context of Part IIIA, which as a residual test is more likely to apply to existing infrastructure, these principles would support the retention of the private profitability test as applied by the High Court.

The Draft Report notes that there is a requirement in clause 4(3) of the CPA for Australian governments to consider whether to adopt access regulation prior to privatisation. On our reading of clause 4(3) of the CPA, this is not explicit, even if it is regarded as implicit. The provision provides only that the States in the course of privatisation should review *“the price and service regulations to be applied to the industry”.* We consider that clause 4(3) would benefit from being made clearer about the need to consider whether access regulation is required prior to privatisation.

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In our view, at the time of privatisation, Australian Governments should review and address whether third party access arrangements (and not only price and service regulation) ought to be imposed, taking into account the principles in clause 6 of the CPA, together with any historical regulation of the relevant facility. These principles should also explicitly identify the need to deal with principles for funding expansions of capacity, if any are to be imposed, as discussed further below.

History and context matter and should influence any approach to access regulation

In our original submission (at page 7-8), we observed that – particularly in the case of privatisation – the history of ownership is an important factor which should be taken into account in addition to traditional market power and bottleneck issues and considerations, when considering whether and/or how to regulate for third party access.

A consideration of the circumstances in which investment was undertaken or may be undertaken is specifically considered in the Draft Report in the context of the settings in the National Access Regime and Part IIIA. We would see the history of ownership and market expectations (including any sunk investment) as being very important, in this context.

For example, there are likely to be significant practical differences when applying access regulation in respect of:

- an existing or greenfield facility which has not previously been regulated and which has been funded by private capital investment;
- a new or greenfield investment being undertaken by a formerly regulated entity (e.g. through the extension or expansion of an existing and regulated asset); and
- the privatisation of a publicly-funded, multi-user facility with a history of regulation, and which has supported substantial sunk investment by users in their own long-lived assets.

The guiding principle in each case ought to be the need for regulatory certainty and predictability – both for access providers and existing users of infrastructure. This is consistent with the oft-repeated conclusion of the High Court in *East Australian Pipeline*:[1]

> *The greater the degree of uncertainty and unpredictability in the regulatory process, the greater will be the perceived risk of investment. The greater the perceived risk of investment, the higher will be the returns sought. Various methodologies referred to in the Code must at least not be inconsistent with the principles stated by the legislature, which are directed to economic efficiency.*

Where there is a history of regulation in respect of a facility, which has supported investment by users in long-lived assets, this is a valid and important consideration that ought to be taken into account when developing any ongoing regulatory framework.

Equally, where no regulation has applied historically to an asset (including because it is a greenfield development), the State should seek to provide maximum up front certainty and predictability for the owner and investors around access issues.

[1] *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* (2007) 233 CLR 229 at [243]

One practical implication of this is, as set out above, that in our view while a natural monopoly test may be more appropriate as the test to be applied to a newly privatised industry, prior to investment or where there was clear guidance prior to investment that the relevant infrastructure was to be subject to access regulation, it is not appropriate where there has been prior investment with no expectation of access regulation. For the same reason, the private profitability test is appropriate in the context of existing private infrastructure and should therefore also be retained in Part IIIA, which operates as an ex post mechanism.

We also see the role of past regulatory experience as particularly relevant and important when dealing with the complex issue of expansions and extensions, discussed below.

Implications for the approach to regulating expansions

Section 44W

The Commission has extensively canvassed the issue of expansions (and extensions) in its Draft Report. We consider this is welcome and timely, for the reasons set out in our primary submission. We would agree with the recommendation to make clear in Part IIIA that extensions includes expansions.

Further, we consider it desirable that clause 6 of the CPA be amended to acknowledge that expansions and extensions can be user funded.

The Commission has asked whether the current constraints in sections 44W and 44X of the CCA strike the right balance between the interests of infrastructure service providers and access seekers (Information Request 4.1).

Section 44W is specific to Part IIIA (i.e. it is not reflected in the CPA) and appears to have been drawn from the original *Moomba Sydney Pipeline System Sale Act 1994* (Cth). These specific provisions appear to have been crafted in that very specific context. It is an open question as to whether they are generally appropriate. We have no specific position in respect of section 44W within the context of Part IIIA, other than that perhaps, consistent with our views that clause 6 of the CPA acknowledge that expansions and extensions can be user funded, this could be acknowledged in section 44W (noting, it is implicit if not explicit in section 44X).

Section 44X is more general and appears to be broadly in line with the CPA provisions.

Section 44W, which is not reflected in the CPA, has not been uniformly adopted by State legislation or access regimes which apply to privatised, multi-user infrastructure with a history of regulation and government investment. However, as noted below, it has been translated into the generic access regime in the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**).

Section 44W is more narrowly cast then the expansion principles in clause 6(4)(j) of the CPA and, in its current form, is likely to limit the scope of the ACCC to regulate flexible and contestable funding arrangements for expanded capacity.

Whilst we accept the principle that any capital cost (and risk) ought be borne by the party obtaining the benefit of the investment, we share the concern, also expressed by the Queensland Competition Authority and Xstrata, that the principles in section 44W governing extension and expansion go beyond those required by the CPA and, in some cases, operate too narrowly to form a base line for State-based industry or facility-specific regimes.

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Contestable (i.e. user) funding

We note the comments made in our earlier submission in relation to contestable funding models (at page 4) and welcome the focus of the Commission in the Draft Report on the complex issue of principles governing expansion of regulated infrastructure. This is likely to remain one of the most significant challenges for access policy, given that private capital is likely to be more disciplined than public funding and will seldom invest in „spare" capacity. Without workable principles in the CPA that support flexible and contestable funding of expansions, therefore, access regimes will increasingly fail to respond as market power shifts from being reflected in the pricing of *existing* capacity to the pricing governing investment in *future* capacity (and associated hold up risk).

The operation of section 44W is not likely to provide sufficient flexibility for dealing with longstanding regulated assets, post-privatisation. For these regulated assets, we question whether in some cases the ability to be required to expand or to allow others to do so (and to then take ownership of that expanded capacity e.g. as security for funding for example) may form part of the more limited "bundle of rights" that were acquired by investors at the time of privatisation.[2]

For example, as noted by the Queensland Competition Authority, sections 44W and 44X are reflected in subsections 119(2)(b) and (c) of the QCA Act and have influenced negotiations between Aurizon Network and the coal industry over the detailed arrangements governing user funding of expansions to the below rail Central Queensland Coal Network governed by Aurizon Network"s access undertaking. While the Commission is correct that other access arrangements (such as the Australian Rail Track Corporation undertaking in the Hunter Valley) include high level user funding mechanisms, these have not yet had to deal with regulated expansion issues to the degree of detail as the Queensland Competition Authority and industry have done under Aurizon Network"s UT3.

In our view, in the case of these kinds of long-regulated assets, State legislation and access frameworks should reflect the more flexible language in the CPA. Clause 6(4)(j) relevantly provides:

> *The owner may be required to extend, or to permit extension of, the facility that is used to provide a service if necessary but this would be subject to:*
>
> *(i) such extension being technically and economically feasible and consistent with the safe and reliable operation of the facility;*
>
> *(ii) the owner"s legitimate business interests in the facility being protected; and*
>
> *(iii) the terms of access for the third party taking into account the costs borne by the parties for the extension and the economic benefits to the parties resulting from the extension.*

The protection of the owner"s legitimate business interests ensures that it receives a commercial return on any investment, without preventing or restricting alternative ownership or funding arrangements from being used.[3]

For these reasons, we submit that where the principles in section 44W of the CCA are retained, in respect of the regime in Part IIIA, there should be more flexibility allowed for expansion principles which apply to historically regulated assets under State, industry and facility based access regimes. For State-based industry and facility-specific regimes (applying to historically regulated assets), the

[2] *Telstra Corporation Limited v The Commonwealth* [2008] HCA 7.

[3] *Telstra Corporation Limited* [2006] ACompT 4 (2 June 2006).

original „expansion principles" in clause 6(4)(j) are generally preferred and could be supplemented, by expressly acknowledging user funding for expansions and extensions.

Further, given the importance of this issue across a range of generic and industry specific access regimes, we support the Commission"s recommendation for the development of a general framework or principles for extensions and expansions to be undertaken by the ACCC – but note that this should involve other relevant regulators (given the more detailed experience of State regulators, to date, with these issues).

Implications of monopoly power in integrated production / supply chain with downstream competitive markets

The Draft Report considers the exercise of market power by an infrastructure owner within a commodity supply chain where for price takers, that is in downstream markets where prices are set, for example, by world commodity markets (at pages 10-11 and 91-92). This could apply in grain markets or mineral commodity markets, including in a number of contexts where there is existing or anticipated access regulation. In these circumstances, the Draft Report concludes that access regulation is unlikely to increase efficiency.

We would make a number of observations in relation to this scenario.

The stylised example assumes that monopoly pricing has no impact on the overall level of services that are taken and the overall level of production. This is an extreme conceptual case unlikely to apply in such strict terms, even in relation to downstream global commodity markets.

Monopoly pricing, or rent shifting, is likely to have a material effect on the returns of the downstream users of the infrastructure. Reducing the returns of users in the supply chain will lead to less investment, less entry and less expansion over time. It would be more difficult to fund investment in businesses with low returns and which are exposed to the threat of those returns being taken by a monopoly infrastructure provider. Lower returns expose businesses to higher prospects of failure, through the economic cycle.

Further, where there are potential rents in a supply chain, if they are taken at the monopoly level, there is no prospect for them to be competed away over time. Rents provide the incentives and signal for new entry, including new business models.

The community will not be indifferent to where rents in the supply chain are taken, in this case. Where access regulation translates to more efficient costs of access, the result will be higher volumes exported on international commodity markets – with the important potential benefit of increased employment and State revenues.

Recent experience in coal and other commodity markets demonstrate that this is not a theoretical proposition. To the extent that access regulation can help to deliver more efficient infrastructure pricing, and provided that imposing such obligations does not give rise to other substantial inefficiencies and costs, such lower costs support increased export competitiveness and associated economic and community benefits.

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Response to the Commission findings in relation to the declaration criterion and decision framework

Criterion (a)

Gilbert + Tobin supports the Commission‟s draft finding in relation to criterion (a) that an economic test for „promotion of competition‟ that requires net benefits to be identified in a final consumer market test is unworkable.

We agree that economic linkages between upstream and downstream consumer markets are often indirect. This kind of test, if applied, would be likely to add considerable complexity and disputation to declaration processes and seems likely to distract, rather than enhance, the role of the criterion as an economic "bottleneck" test (that is, whether intervention is required to enable and promote competition in related markets).

We have no particular objection to the proposal that the reference to "access" in criterion (a) be limited to access on reasonable terms and conditions, provided it is clear that the question of access not turn on anticipating the determination of a subsequent access dispute. As legal representatives in the Virgin Blue case, and also the Sydney Water case, we know from experience that there is a tendency to seek to bring forward and conflate into the question of whether there should be access to the services of a facility, the secondary question of whether the particular determination of an access dispute would promote competition. The two issues are, under the current institutional decision making framework, separate and should be kept separate.

We would not agree with the observation that the Full Federal Court‟s interpretation of criterion (a) in that matter was other than a plain reading of the provision. Further, this interpretation is preferable to the alternative, for a number of reasons, as set out in the Full Federal Court‟s decision. If there was a process in which the question of access and the determination of a dispute could be resolved in one proceeding, then it may be appropriate to combine the issues.

Criterion (b)

For the reasons set out above, we would support the retention of the private profitability test under Part IIIA.

However, if a natural monopoly test were to be reinstated (as recommended by the Commission), we consider that the impact of declaration on investment in alternative infrastructure (as well as the direct truncation risk which the Commission has noted) are both matters that ought to be included as a potential cost of declaration within the wider public interest considerations under criterion (f).

Criterion (f)

Gilbert + Tobin generally supports the draft recommendation of the Productivity Commission that criterion (f) should be amended to include a „having regard to‟ clause to direct the decision maker when applying the public interest test (page184) and that the test be framed as a positive one (page186).

However, in our view, the Draft Report does not adequately address:

- the need for criterion (f) to be applied and framed as an economic net cost-benefit test; and

- the implications of the High Court decision in *re Pilbara Infrastructure*[4] referred to in our earlier submission in relation to criterion (f), regarding the uncertainty now created about the matters to be taken into account by the Minister when applying the test.

In our previous submission, we endorsed the views of the Law Council that criterion (f) would benefit from being framed clearly as a cost-benefit test. This reflects our view that declaration under Part IIIA operates as a „backstop" or residual regime only, and therefore it should be applied sparingly and in clear and unambiguous cases.

We do not share the view of the Commission (at page184):

> *Such order-of-magnitude approaches [i.e. a clear cost-benefit outcome] may be regarded as reasonable in cases where the net impacts of access are unambiguous. However, at least some decisions would invariably require contentious judgment calls. These decisions would require reliable estimates of costs and benefits, which may be difficult to compile within the timelines set down for declaration decisions. Regardless of whether a high-level or precise approach is taken, any identifiable gaps in the analysis would provide fresh opportunities for the validity of decisions to be disputed, prolonging resolution of declaration applications. The difficulty of assessing „marginal" declaration claims could be addressed in other ways, such as through an affirmative public interest test*

We submit that short declaration timeframes, unreliable evidence and the prospect of contentious and „marginal" declaration claims are not reasons for rejecting the introduction of an explicit cost-benefit test. To the contrary, we submit that this is precisely why such an orthodox approach (together with changing the criterion to a positive test) is important.

The introduction of a cost-benefit test may also help to mitigate the effect of the High Court"s characterisation of the public interest test under criterion (f) as being one of a "generally political kind".

With respect, we consider that this imports a degree of uncertainty and politicisation into declaration under Part IIIA which is unfortunate and unnecessary. We therefore support amendments to the criterion aimed at reinstating the approach originally articulated by the Tribunal in *Fortescue*[5], being principally an economic cost-benefit test, capable of being applied (by the National Competition Commission, Minister and Tribunal).

We invite the Commission to reconsider its conclusion on the introduction of an explicit cost-benefit test for criterion (f), along the lines of that proposed by the Law Council.

Institutional decision making framework – including deemed Ministerial decision

Gilbert + Tobin make the following brief observations about Part IIIA institutional arrangements (and the associated recommendations in the Draft Report):

- As noted above (in relation to criterion (f)), we view the declaration decision under Part IIIA as one of a distinctly economic and/or technical nature, and which should only be made on the clearest economic evidence. We do not share the Commission"s view in the Draft Report (or for that matter the High Court in *Pilbara Infrastructure*) that broader "public policy judgment" should be relevant or appropriate, in this context (at p288). We see the declaration decision as one

[4] *Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* (2012) 290 ALR 750; [2012] HCA 36.

[5] *In the matter of Fortescue Metals Group Limited* (2010) 242 FLR 136; [2010] ACompT 2 (30 June 2010) (at [1160] – [1174]).

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more appropriately made by a technical regulator (either the ACCC or, perhaps preferably, the Tribunal) then the Minister.

- We share the reservations of other respondents in relation to the continuing role of the National Competition Council in the declaration and certification process, given the limited number of declaration and certification applications. The NCC has itself acknowledged this may limit its longer term viability (page 28 of the second NCC submission).

- We support the Commission"s recommendation that where the Minister does not publish a decision, it should be deemed to follow the NCC recommendation and be taken to have adopted the NCC"s reasons. We agree with the Law Council that, on balance, this amendment is likely to enhance transparency and accountability in the declaration process.

Merits Review

Consistent with our view of declaration as a decision best made by a technical regulator, Gilbert + Tobin endorses the important role of limited merits review under Part IIIA.

We also consider that it is too early to form a concluded view of the effectiveness of the modifications made to the merits review processes and role of the Tribunal under Part IIIA by the amendments introduced in 2010 and, more recently, through the decision of the High Court in *Pilbara Infrastructure*.

We welcome the opportunity to participate at the Commission"s public hearings in respect of the Draft Report, and to further discuss the issues set out above.

Yours sincerely

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Partner	Partner