Productivity Commission's Review of the National Access Regime

Submission on the Draft Inquiry Report

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1 Key Points

- The Commission's review is a timely opportunity to re-establish that Australia's access regimes enhance the long-term welfare of the community by promoting efficient investment in, and use of, Australia's infrastructure assets.

Declaration and greenfield investment

- Aurizon supports the Commission's draft finding that Part IIIA should be retained but believes a broader assessment of the Part IIIA framework could have been undertaken, including of the costs and benefits of retaining an economy-wide declaration mechanism.

- Aurizon considers that there is a case to reform the framework to promote an environment where the regulatory arrangements that are to apply to greenfield assets are determined prior to any capital being sunk. There seems to be little continuing basis to expose sunk, private capital to a substantial risk, when there is generally an opportunity to address the relevant policy objectives before an investment decision is made.

- Aurizon is generally supportive of the proposed amendments to the declaration criteria. However, Aurizon does not consider that the case for reverting to the natural monopoly test has been made. Given minimal evidence that the private profitability test is positively harmful, Aurizon considers that business is better served by stability and certainty than further change to this provision.

The application of the regulatory framework

- Aurizon considers that a broader assessment should be made by the Commission of the way in which the regulatory framework is applied by Australia's regulators. There is some indication that rail regulation is growing increasingly prescriptive, costly and complex, limiting the scope for negotiation and innovation, while imposing additional costs and risk of error without any clear offsetting benefit.

- An assessment should be made as to whether Australia's rail regulators are well-equipped to address the productivity challenges arising from managing the diverse requirements of multiple supply-chain users, the ever present need to maintain appropriate incentives for efficient and timely investment, and the very substantial issues involved in balancing the trade-offs between coordination and competition in the vertically separated, third party access environment.

- An important aspect of that assessment is whether the broad regulatory discretion bestowed by the National Access Regime is an appropriate framework for the long-term regulation of the rail sector. All of Australia's major open access export networks, together with the interstate railway, are regulated by undertakings approved and amended under statutes that provide only minimal guidance to regulatory decision-making.

Extensions and expansions

- Aurizon supports the retention of the existing power of a regulator to direct an expansion, which is an important safe harbour to support the primacy of commercial negotiation, subject to the continuation of the strict protections currently included in the legislation, particularly the prohibition on a regulator requiring an access provider to fund an expansion.

- Aurizon would support a review by a panel of experts to assess guidelines for the exercise of the ACCC's powers, noting the complex commercial, accounting and tax issues arising.

- There is need to distinguish between expansions of the existing system and geographical extensions, which are typically contestable. The power to direct geographical extensions should depend on the extension meeting the declaration criteria before it is included as part of the declared service.

2 Introduction

Aurizon welcomes the opportunity to comment on the Productivity Commission's (**Commission**) Draft Report on the National Access Regime.

Aurizon is the largest rail freight haulage operator in Australia by tonnes hauled, operating in key freight sectors and supply chains across the country. Aurizon is focused primarily on large, heavy haul rail tasks such as the transportation of coal, iron ore, other minerals, agricultural products and general freight, as well as containerised freight. It has business operations in Queensland, New South Wales, Victoria, South Australia and Western Australia. The operation in Queensland includes the management of approximately 2,670km of largely dedicated and purpose built, heavy haul rail infrastructure, known as the Central Queensland Coal Network (CQCN).

As Australia's leading freight and logistic business with the broadest national footprint, Aurizon is deeply interested in the development of access policy in the Australian railroad and bulk freight sectors. In this respect, the Group's activities include:

- the management of an independent network in Queensland (Aurizon Network Pty Ltd), regulated under the *Queensland Competition Authority Act* 1997 (Qld);
- the development of multi-user greenfield railroad and port projects in Queensland and Western Australia, which will support the growth of the resources sector; and
- a haulage business that acquires access from seven different networks, under the auspices of five different open access regimes.

Aurizon believes that the Commission's review is a timely opportunity to re-establish that Australia's access regimes enhance the long-term welfare of the community by promoting efficient investment in, and use of, Australia's infrastructure assets.

As both a regulated access provider and Australia's largest rail access seeker, Aurizon is well placed to provide insights to the Commission on the operation of access regulation in the railroad sector. In this respect, of particular interest to Aurizon is the scope for changes to the National Access Regime to lead to changes in the state and territory regimes that are the primary way in which Australian governments have elected to regulate the sector.

2.1 The freight rail task

The Australian rail freight task is dominated by intrastate traffic, servicing export markets, with iron ore in Western Australia accounting for approximately 60% of the total rail freight task on a net-tonne kilometre basis and bulk freight intrastate tasks in Queensland and New South Wales (primarily, coal) accounting for almost 30% of the total rail freight task.[1] Access for these services is predominantly priced at the ceiling with operators typically providing services to large, multi-national companies.

By way of contrast, the interstate market is dominated by intermodal traffic and accounts for approximately 10%[2] of the total rail freight task. Access to intrastate services are generally priced below the ceiling, reflecting a lower ability to pay, and the very substantial competitive constraint imposed by road freight. Regional services generally service the mineral ore industries with high value low volume product and agricultural industries. Passenger services are concentrated around urban centres and compete for capacity with rail freight services.

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1 Bureau of Infrastructure, Transport and Regional Economics (BITRE) (2012), TrainLine 1, Statistical Report, BITRE, Canberra ACT, p. 27

2 BITRE (2012), p. 30

2.2 Rail access regulation in Australia

Australia has over 33,000 kilometres of rail infrastructure;[3] of this, 95% is regulated as open access railroad either under the National Access Regime or under state-based rail access regimes.[4]

This extensive, interconnected map of open access regimes was introduced in the context of widespread reform of the Australian railways, and contributed to the substantial improvements in productivity and operational efficiency that have been realised since that time. These improvements have been underwritten not just by the increased competition stemming from access itself, but also by the liberalisation of railways freed from government ownership, better allocation of both private and public capital, and the rationalisation of services.

The modern Australian railroad bears little resemblance to that which the Industry Commission, and subsequently the Hilmer Committee, faced in the early 1990s, when recommending the introduction of open access regimes. Of particular note is that two-thirds of route kilometres, and the majority of Australia's major bulk mineral export networks, are now privately owned. Moreover, government is no longer directly involved in the operation and maintenance of freight rail services,[5] with above-rail freight markets now fully privatised, highly competitive and reliant on private investment for continued growth. More generally, as with many Australian industries, the railroads have also adapted to changes in the global economy, becoming more productive, interconnected, and reliant on global capital markets, particularly as regards investments made in critical export infrastructure.

Despite these developments in the structure and competitiveness of the industry, there has been little change in rail regulatory policy since the Hilmer Committee made its recommendations some two decades ago. As the following table shows, most of Australia's economically significant export networks continue to be regulated under negotiate-arbitrate regimes, like the National Access Regime, rather than industry-specific regimes. Rail also continues to be regulated by a mix of state and commonwealth laws, rather than under a single uniform set of nationally-consistent arrangements. Whilst this is reasonable given the significance of rail to the state economies, it makes the rail sector quite unlike other infrastructure sectors, such as electricity, gas, water and telecommunications, all of which have undergone very significant post-Hilmer regulatory reform aimed at adapting economic regulation to the bespoke requirements of the sector.

That major legislative reform has not occurred in the rail sector is, in many respects, a sign that the various state and national rail access regimes are generally meeting the expectations of users, local communities and government. While this stability and predictability is of significant value, both to the rail businesses that provide regulated access and those that use it, there is nonetheless a need for continual review to ensure that rail regulation continues to promote the development of the Australian economy.

Rail Access Regimes in Australia

	Economic Regulator	Regulatory Instruments	Rail Access Provider	Primary use
Cth	Australian Competition and Consumer Commission (ACCC)	Competition and Consumer Act 2011 (Cth) Part IIIA and ARTC Interstate Access Undertaking	ARTC (Interstate)	Intermodal, grain, ores, steel
		Competition and Consumer Act 2011 (Cth) Part IIIA and ARTC Hunter Valley Access Undertaking	ARTC (Hunter Valley)	Coal

[3] BITRE (2012), p.v

[4] The undeclared Pilbara rail lines account for approximately 1,500 km of track.

[5] Government involvement remains to the extent that community service obligations support specific industry policy, particularly where fully cost reflective pricing would compromise industry viability. The Commission's review of competitive neutrality arrangements should include a review of the effectiveness of government transport funding.

	Economic Regulator	Regulatory Instruments	Rail Access Provider	Primary use
		Competition and Consumer Act 2011 (Cth) Part IIIA	BHP (Goldsworthy Railway)	Iron ore
		Competition and Consumer Act 2011 (Cth) Part IIIA, and Rail Company Act 2009	TasRail (Tasmanian Rail Network)	Intermodal, coal, ores
QLD	Queensland Competition Authority (QCA)	Queensland Competition Authority Act 1997 (Qld) and Aurizon Network Access Undertaking.	Aurizon Network (Central Queensland Coal Network)	Coal
		Queensland Competition Authority Act 1997 (Qld) and Queensland Rail Access Undertaking and	Queensland Rail (Non-CQCN rail infrastructure in Queensland)	Passenger, coal, ores, intermodal, grain and cattle
NSW	Independent Pricing and Regulatory Tribunal (IPART);	Transport Administration Act 1998 (NSW) and NSW Rail Access Undertaking;	John Holland (Country Regional Network)	Grain, ores, cotton
			Sydney Trains (Metropolitan Rail Network);	Passenger and Intermodal
VIC	Essential Services Commission (ESC)	Rail Corporations Act 1996 (Vic);	V-line (regional Victoria) Vic Track (some yards and terminals in metropolitan Melbourne)	Passenger and Intermodal
		Rail Management Act 1996 (Vic)	Metro Trains Melbourne (Metro Rail Network)	Passenger and Intermodal
		Rail Corporations Act 1996 (Vic); South Dynon Access Arrangements	Asciano (South Dynon)	Intermodal
SA	Essential Services Commission of South Australia (ESCOSA)	Railways (Operations and Access) Act 1997 (SA);	Trans Adelaide, Genessee & Wyoming, Asciano, NRG Flinders, One Steel Ltd	Grain, gypsum, ores
		Australasia Railway (Third Party Access) Act 1999 (SA)	Genesee & Wyoming (Tarcoola to Darwin)	Intermodal, ores
NT	ESCOSA	Australasia Railway (Third Party Access) Act 1999 (NT)	Genesee & Wyoming (Tarcoola to Darwin)	Intermodal, ores
WA	Economic Regulation Authority (ERA)	Railways (Access) Act 1998 (WA) and Railways (Access) Code 2000 (WA) Brookfield Rail Part 5 instruments	Brookfield Rail (Brookfield Rail Network)	Grain, ores and intermodal
		Railways (Access) Act 1998 (WA) and Railways (Access) Code 2000 (WA) TPI Part 5 instruments	The Pilbara Infrastructure (TPI) (Cloudbreak to Port Hedland)	Iron ore

2.3 Access reform in the rail sector

Despite the productivity improvements in the railroad sector over the last two decades, there are a number of areas where open access has raised new challenges, particularly in the bulk mineral supply-chains. These include the increased complexity associated with managing the diverse incentives and requirements of multiple users, the ever present need to maintain appropriate incentives for efficient and timely investment, and the very substantial issues involved in balancing the trade-offs between coordination and competition in the vertically separated, third party access environment.

Resolving these and other issues in the various Australian rail access regimes will be fundamental to continued improvement in the operating efficiency of Australia's railroads. Faced with increased global competition, Australia's supply-chains are unable to be complacent in this regard, particularly given that any further benefit from National Competition Policy is likely to be difficult to extract. As noted by Professor Gary Banks:

> *"The economic landscape within which these [open access] regulatory arrangements now operate is very different from what it was when the NCP was conceived. As well as the implications of a marked shift from public to private provision of infrastructure services, the policy priority has tilted from the need to achieve efficient use of existing assets to the need for efficient investments in new infrastructure to accommodate burgeoning demand."*[6]

Moreover, these are unlikely to be issues that can be addressed solely through the application of Part IIIA, but will require substantial policy attention across a number of fronts. As acknowledged by Professor Banks:

> *".. [G]etting it right on infrastructure involves more extensive policy territory than the regulatory arrangements for monopoly providers. And while regulation has an important role to play, it is equally important that the rationale for regulating is cogent and that regulation can achieve its goal in cost-effective ways."*[7]

With these challenges for Australia's supply-chains in mind, there is a question as to whether the incremental findings and modest recommendations of the Draft Report represent a missed opportunity for broader productivity reform. While stability of the current arrangements is important, it is equally important to ensure that the National Access Regime will continue to support the efficient provision of infrastructure services in sectors that have radically changed since the inception of the regime, and in an environment of increased global competition for both physical resources and scarce capital. Moreover, there remains a continued need to ensure that regulation is being implemented in a timely, efficient and effective way.

In this latter regard, as dependent markets have matured, and open access become commercially and legally embedded, the parts of the regime that govern the entry of assets *into regulation* are now of considerably less practical importance than those aspects of the regime which govern assets *in regulation*. It is with regard to this latter aspect of the regulatory framework, Aurizon would echo the sentiments of Professor Banks, that:

> *"… some of the regulatory regimes that have emerged [from National Competition Policy] have proven to be complex and costly. And the clarity of focus of the regulatory endeavour has seemingly diminished".*[8]

These comments reflect awareness that Australia's regulatory regimes less frequently implement Hilmer's vision of light-handed, practical and commercial arrangements. Rather, it is increasingly the case that regulation, in a number of cases, has become prescriptive and complex; limiting the scope for commercial negotiation and innovation, while imposing additional costs and risk of error without any clear offsetting benefit. In this regard, while the extensive review in the Draft Report of the declaration criteria is notable, there would appear to be merit in further consideration of the practical, day-to-day operation of Australia's regulatory regimes.

In this context it is also valuable to highlight the following comments made by Professor Banks last year:

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6 Gary Banks (2012), Competition Policy's Regulatory Innovations: Quo Vadis?, Address to the ACCC Regulatory Conference, Brisbane, 26 July 2012 and the Economists Conference Business Symposium, Melbourne, 12 July 2012, p. 1

7 Gary Banks (2012), p. 11

8 Gary Banks (2012), p. 1

- Professor Banks approvingly quoted the Hilmer Committee's 1993 report which stated "*Regulated solutions can never be as dynamic as market competition and poorly designed or overly intrusive approaches can reduce incentives for investment and efforts to improve productivity…*"[9]

and

- "… *the very fact of exposure to price regulation and the uncertainties this creates – can in itself deter investment. This is the flipside of the 'hold up' rationale for regulation, with the regulator rather than the monopolist posing the threat to investment*."[10]

2.4 Scope of the terms of reference

Access determinations and undertakings are made under either Part IIIA or similar provisions in the relevant state and territory access regimes. The Commission has acknowledged that certification of state and territory access regimes provide the link between Part IIIA and these jurisdiction specific regimes.[11] Moreover, again as acknowledged by the Commission, state and territory governments frequently model their policy decisions on those taken in the design of Part IIIA.[12] For example the *Queensland Competition Authority Act 1997* closely mirrors Part IIIA in the way in which third party access regulation is applied in Queensland.

In this context, information on the way in which state and territory regulatory regimes are applied, provides an important insight into the workings of the National Access Regime. Moreover, the broad terms of reference for the inquiry require the Commission to report on a range of matters that would be difficult to consider in the absence of an assessment of the state and territory regimes, including:

> "*1. examine the rationale, role and objectives of the Regime, and Australia's overall framework of access regulation, and comment on:*
>
> (a) *the full range of economic costs and benefits of infrastructure regulation, including contributions to economic growth and productivity.*"
>
> *"2. to assess the performance of the Regime in meeting its rationale and objectives, including:*
>
> *(b) how the Regime has been variously applied by decision makers, but not so as to constitute a review of reconsideration of particular* decisions"
>
> *"4. provide advice on ways to improve processes and decisions for facilitating third party access to essential infrastructure, including in relation to:*
>
> *(a) promoting best-practice regulatory principles, such as those pertaining to regulatory certainty, transparency, accountability and effectiveness;*
>
> (b) *measures to improve flexibility and reduce complexity, costs and time for all parties;*
>
> (c) *options to ensure that, as far as possible, efficient investments in infrastructure are achieved; and*
>
> (d) *'greenfield' infrastructure projects and private sector infrastructure provision. "*

2.5 Structure of this submission

This submission is comprised of three main parts, reflecting those parts of the Draft Report most relevant to Aurizon:

- Chapter 3 discusses the relevance of the declaration criteria in relation to greenfield investments and the proposed amendments in the draft report to the declaration criteria.

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9 Gary Banks (2012), p. 16

10 Gary Banks (2012), p. 14

11 Productivity Commission (2013), National Access Regime, Draft Inquiry Report, Canberra, May 2013 p. 24

12 Productivity Commission (2013), p.16

- Chapter 4 examines the application of the regulatory framework in practice and the need for a review of regulatory decision making.
- Chapter 5 discusses the findings of the Commission in relation to the power of a regulator to order and extension or expansion of a declared facility.

This submission does not seek to address any specific issues or matters raised during the course of this inquiry concerning the current Aurizon Network Draft Access Undertaking (UT4) currently being considered by the Queensland Competition Authority.

3 Declaration and greenfield investment

A significant focus of the Draft Report is the declaration criteria in Section 44H, which sets out the tests for when an asset is declared. Similar provisions exist in some state and territory regimes. As the consequences of declaration can be severe, being an effective appropriation of private property rights, it is only to be expected that these tests have attracted significant attention.

Aurizon broadly supports the Commission's final conclusion, namely, that Part IIIA and declaration itself should be retained for the present time. That noted the Draft Report's discussion of declaration may nevertheless be framed too narrowly, in that the Commission has equated the scope of declaration with the broader question as to whether or not Part IIIA should be retained in its entirety. This means that less emphasis has been given in the Draft Report to a consideration of whether there are opportunities (other than incremental reform of the declaration criteria) to reconsider the ways in which Part IIIA applies to Australia's current and future infrastructure stock.

Aurizon believes that the Draft Report could have undertaken a broader assessment of the 'gate-keeper' aspects of the Part IIIA framework, with a view to ensuring that investors (particularly those in greenfield assets) continue to deliver Australia's infrastructure requirements.

In particular, there would seem to be three different sets of issues, whereas the focus of the Draft Report is focused primarily on the third:

- First, whether the *scope* of Part IIIA – namely, an economy-wide declaration mechanism that can be applied to all facilities (including unbuilt facilities) – remains the best way of achieving the objectives of National Competition Policy. Given the prevalence of industry-specific regimes, the maturing of regulation and dependent markets, and the importance of promoting greenfield investment in challenging financial market conditions, this is an increasingly pertinent issue.
- Second, whether or not Part IIIA provides an appropriate array of statutory mechanisms to give greenfield investors certainty about access arrangements *before capital is sunk.* In particular, it seems increasingly unreasonable to expose greenfield investors to uncertainty and potential sovereign risk, where the relevant policy issues are well understood and therefore capable of being dealt with prior to any investment occurring.
- Third, as the Commission rightly identifies, is the need to ensure that the declaration criteria are appropriately targeted at the economic problem. In this respect, Aurizon does not consider that the case for all the Commission's proposed amendments has been made. Aurizon supports the draft recommendations as to amending criterions (a) and (f), but not (b).

3.1 The scope of the declaration mechanism

Perhaps the most important policy decision taken in the design of Part IIIA is the breadth of its prospective coverage. Where the declaration criteria are met, the regime is not otherwise constrained in its potential application to a particular function, product or service, to a particular geography, or even to a particular point in time (being applicable to unbuilt, future facilities). In this sense, while the declaration criteria are generally considered to be the gate-keeper to regulation, it is the preceding legislative decision to expose all infrastructure assets to the risk of declaration which is the first step.

This aspect of the regime was a calculated decision of the Hilmer Committee, which had considered whether microeconomic reform of individual industries would better promote its objectives versus universal coverage. The Committee rightly decided the best way to reform a uniform landscape of government-owned infrastructure businesses was via a consistent, economy-wide approach, particularly given the impracticality of predicting how open access would play out in each industry (including whether a viable dependent market would ever be able to develop).

Some twenty years later, there is now a question as to whether a declaration mechanism that was intended to deal with a landscape of unregulated, government-owned infrastructure, is the best way of effectively regulating key infrastructure assets in the post-NCP economy. This is particularly so having regard to the embedding of access regulation in key infrastructure sectors, the maturing of competition in dependent markets, and the predominance of private rather than public capital in many markets.

Of course, the principal constraint on Part IIIA's application is the test for declaration, and significant attention has been, and will continue to be, directed at 'getting the declaration criteria right'. However, this understandable focus on how the tests should be applied can have the effect of diverting attention from the equally important question as to whether those tests should, in fact, ever apply. In other words, are there classes of assets, services or indeed, whole industries, where continued exposure to the risk of declaration under Part IIIA imposes more costs than it does benefits. This question has particular relevance in relation to the risk that the resultant uncertainty could result in investors not proceeding with greenfield "enabling infrastructure" that could have otherwise delivered an increase in economic activity and, as a result, substantial community benefits.

3.1.1 The Commission's view in the Draft Report

The benefits of third party access, together with the corporatisation and privatisation of government businesses, should not be understated, including by the way of improved efficiency and increased capacity utilisation which has driven economies of scale. These benefits have largely been realised through better use of existing infrastructure to the point where, in some areas, there is now an increased need for investment in new greenfield infrastructure.

As open access has matured and become embedded in many Australian infrastructure sectors, the practical relevance of the declaration process has diminished. In large part, this reflects the fact that Australia's infrastructure is now typically covered by industry-specific regimes, with declaration being imposed by legislation or government policy rather than by the process envisaged in Part IIIA.[13] The popularity of industry-specific regimes reflects a view that bespoke industry arrangements often promote the commercial priorities of industry more effectively than the vanilla arrangements in Part IIIA. In each case, however, the maturing of the regulated service together with associated dependent markets, has left the declaration mechanism with little continuing prospect of being broadly applied.

Nevertheless, it is clear from the way in which the Commission frames its discussion of the 'value' of Part IIIA, that it does not consider the primary purpose of declaration is imposing actual working access regimes. Rather, the Draft Report primarily ascribes value to the 'backstop' function of Part IIIA, together with its role as an example of sound access regulation.[14] That is, the value of declaration is not in its *actual* application, but in the *prospect* of its application to services that are not otherwise caught by other open access laws. This could reasonably be interpreted as a finding that the latent benefits of Part IIIA outweigh any negative impact on investment incentives.

However, when the issue is framed in such a way, the need to continually assess whether the broad scope of declaration remains of benefit is even more important. In particular, if it is not intended that declaration ever really be used (or at least, very rarely used), then it is reasonable to ask whether retaining the universality of declaration is a proportional way of obtaining the benefits identified by the Commission? In particular, it does not seem necessary for the entire economy to be potentially subject to a heightened level of regulatory risk in order to address the remote possibility that a natural monopoly has evaded detection some twenty years after the implementation of National Competition Policy. Nor does it seem appropriate for private infrastructure investors to be put at risk for potential, but by no means certain benefits in order to promote consistency in state and territory regimes.[15]

3.1.2 Greenfield investment and the scope of declaration

It is of course recognised that, given the incremental approach taken in the Draft Report, there is little appetite to consider this issue at the present time. Nevertheless, to the extent that a future government might contemplate broader reform, particularly aimed at promoting economic growth, there would appear to be a question as to whether consideration should be given to a winding back of the sectors or assets to which declaration might apply. The case for doing so seems to be strongest in relation to greenfield investment.

This prospect reflects a view that the continued exposure of greenfield investment to the risk of declaration is the feature of the regime that delivers the most marginal of benefits. It also reflects the

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[13] The services provided by Queensland rail infrastructure were declared by regulation, however since the introduction of amendments to the Queensland Rail Access Regime in 2010, the application of the QCA Act is only via s 250 of the Queensland Competition Authority Act 1997 (Qld)

[14] Productivity Commission (2013), pp.242-243

[15] Productivity Commission (2013), p.243

recurrent concern that the risk of declaration is a disincentive to greenfield investment. The potential for regulation to truncate investors' returns once capital is sunk, or to otherwise impact on the operation or management of an infrastructure asset such as to reduce the attractiveness of the investment, is broadly recognised, and well discussed in the Draft Report.

As the Commission rightly notes, it is difficult to establish just how significant the risk of declaration is to an investor in greenfield assets. This is partly because the risk does not generally result in otherwise economic projects being entirely deterred, but is instead apparent in the risk management strategies used by infrastructure investors to mitigate regulatory risk. This more subtle economic effect is, of course, more difficult to observe than the complete (and unlikely) abandonment of worthwhile infrastructure projects due to the risk of declaration. While the hedging of regulatory risk by investors makes it easier for projects to proceed, its widespread practice in Australian infrastructure projects is not costless, and has a number of undesirable economic consequences. This includes the imposition of costs associated with mitigating the risk commercially (i.e. through indemnities, etc), the incurrence of higher project overheads (i.e. legal costs), the potential inefficient scoping of infrastructure to minimise spare capacity, and the added complexity of project development in the face of sovereign risk.

In any case, while agreeing with the Commission that the magnitude of this risk is difficult to empirically establish, and therefore act upon, it is submitted that it is incumbent on policymakers to consider whether there are ways in which the risk of declaration to infrastructure projects can be mitigated while still retaining the benefits of Part IIIA. It is accepted that the declaration criteria play some role in gate-keeping the risk, but it seems unlikely that periodic fine tuning of s 44G will eliminate the recurring concern that Part IIIA is adversely affecting investment. This concern has been heightened by the significant adverse (and continuation) of the global financial crisis on availability of capital, as well as the more recent weakness in prices for Australia's major resource exports. As a result, Aurizon believes that this aspect of the regime will remain the subject of debate for some time to come.

3.2 Options for light-handed regulation of greenfield assets

3.2.1 The importance of solving regulatory issues up front

Underlying the view that it is not necessarily essential for declaration to apply to greenfield infrastructure, is an increased recognition that an effective, modern access policy facilitates an environment where those promoting infrastructure developments – investors, service providers and government – establish the regulatory arrangements to apply to an asset *before* capital is sunk.

There seems to be little continuing basis to expose sunk, private capital to a substantial risk, when there is generally ample opportunity to address the relevant policy objectives before an investment decision is made. Indeed, in the context of privately funded, multi-user infrastructure investment, it seems increasingly unreasonable to expose capital to uncertainty and sovereign risk, where the relevant policy issues are well understood, and therefore capable of being dealt with prior to any investment occurring (including through the lodgement of a voluntary undertaking).

The attractiveness of this approach is reflected in the way in which open access is increasingly implemented in the rail sector. To that end, as the Commission notes,[16] it is the frequent practice of Australian governments to negotiate open access requirements (if any) as part of a project approvals process. These negotiations often recognise that open access can and should be implemented in the context of a genuine commercial framework for multi-user infrastructure, rather than through a prescriptive regulatory regime. That is to say, there is an increased awareness that open access can form an integral part of the commercial model for infrastructure investment, and greenfield proponents have a strong incentive to increase utilisation of sunk assets through negotiating commercial access arrangements and maximising throughput.

To that end, Aurizon is currently working with state and territory governments on the development of commercial, multi-user frameworks for port and rail development. As the Commission has noted, this includes the negotiation and implementation of multi-user, open access arrangements in relation to:

- the proposed Central Queensland Integrated Rail Project from the Galilee Basin;

[16] Productivity Commission (2013), p. 207

- the proposed development of the Abbott Point Coal Terminal by the North Hub Consortium (a joint-venture with Lend Lease);
- the proposed Surat Basin Railroad (a joint-venture with Glencore and AETC); and
- the ongoing consideration of new, independent railroads in the Pilbara, including the East Pilbara Independent Railway project.

3.2.2 The current options

Aurizon believes that an approach where open access arrangements are determined up front during project development should be better supported by legislation. To that end, Aurizon considers that government and infrastructure providers should have available a broad, cost-effective and flexible range of statutory mechanisms that give certainty about access requirements prior to committing capital.

To that end, Part IIIA currently provides for only two real options for infrastructure providers seeking regulatory certainty ahead of a greenfield project:[17]

- first, ineligibility rulings (in effect an access holiday); and,
- second, the lodgement of a voluntary undertaking.

For a variety of reasons, neither option is particularly well suited to the task of promoting infrastructure development. In relation to ineligibility rulings, Aurizon does not support the Commission's reasoning that the ineligibility mechanism is fit for purpose. Having considered the suitability of ineligibility applications on prior occasions, Aurizon has found that the current mechanism:

- introduces additional uncertainty into the timeline for the development of a project;
- heightens, rather than mitigates risk, by exposing confidential information about a project prior to financial close to an uncertain and lengthy public consultation (at least 6 months), thereby compromising other commercial objectives;
- fails to deliver an appreciable benefit to the investor, as it does not provide certainty from declaration under state and territory regimes;
- substantially *increases* the risk of the asset being regulated as failure to obtain a ruling would, in effect, be a decision that a service met the declaration criteria, and thus should be regulated.

In addition, from the perspective of government, ineligibility rulings are an 'all or nothing' proposition, and therefore provide limited flexibility for policymakers to approve light-handed regulation or commercial open access models.

The lodgement of a voluntary undertaking is also rarely a preferred option. Most significantly, it requires an investor to 'roll the dice' with a regulator in circumstances where the statute provides limited guidance on the prescriptiveness that might be imposed, either initially, or as the undertaking is renewed. In this respect, while Australia's regulators have some appreciation of the challenges associated with greenfield investment, this is not universal and there remains a risk that a regulator could apply regulatory models that have little bearing on the operational or commercial circumstances of a greenfield asset.

3.2.3 Options for reform

Given the limited options currently available, Aurizon believes that there is significant merit in giving consideration to the adoption in Part IIIA mechanisms enacted in the National Gas Law. It considers that these mechanisms are sufficiently adaptable for use in the Act, and provide an adequate range of options for infrastructure investors seeking upfront certainty on access arrangements.

In particular, Aurizon believes there is considerable merit to consider:

- Retaining the current ineligibility mechanism, but introducing procedural protections (including confidentiality arrangements) to allow infrastructure proponents to formally gauge the view of the Council or the Minister prior to a public consultation commencing;

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[17] Of note, under the Queensland legislation that applies to Aurizon's Central Queensland Coal Network, only the second is available.

- Providing options for some form of limited open access regulation, including:
    - In the case of a greenfield project, introducing arrangements for the exemption of a project from price regulation, whereby the ACCC is empowered to consider and accept a limited form open access undertaking that prescribes the mechanics of open access (including dispute resolution) but does not authorise the ACCC to impose a price or capital return outcome for the duration of the undertaking; and
    - More generally, introducing arrangements for the Minister, when considering a declaration recommendation from the NCC, or on the application of the owner of a declared facility, to make light regulation determinations. The effect of a light access regulation is proposed to be equivalent to a price regulation exemption.

3.3 Reforming the declaration criteria

A considerable portion of the Draft Report is dedicated to assessing the interpretation of the declaration criteria. As regards the Draft Findings, Aurizon supports the proposed amendments to criterions (a) and (f), but does not consider that the case for reverting to the natural monopoly test has been made.

3.3.1 Criterion (a)

The continued weakening of criterion (a) by successive court and tribunal decisions has resulted in an easily-met test that gives little protection to infrastructure providers. Aurizon therefore supports the Productivity Commission's finding that criterion (a) requires amendment.

Criterion (a) has always been interpreted in such a way to make it a considerably weaker test than that which is applied in jurisdictions that apply antitrust concepts. Under the essential facilities doctrine, for example, the equivalent test is directed at whether the refusal to supply access results in a monopolisation of an upstream or downstream market. In other words, the test is directed at whether or not access is *essential* to competition, not merely desirable. By contrast, criterion (a) has always been interpreted as being met merely by evidence that there would be an "enhanced environment" for competition following declaration.[18] The relevant inquiry has been merely whether declaration will create "better" opportunities for competition, than would be the case absent declaration.[19] This lower bar is consistent with the role of Part IIIA as "an instrument for the more efficient working of essential facilities",[20] rather than as a remedy to anticompetitive behaviour.

However, as acknowledged in the Draft Report, this already weak test was hollowed by the Federal Court's decision in the *Virgin Blue* case.[21] That case held that, in assessing the state of competition with or without access, the fact that an access seeker may already obtain access on commercial terms was not relevant. All that is necessary to satisfy criterion (a) is evidence that access generally, rather than access by way of declaration under Part IIIA, will materially promote competition.

The practical effect is to encourage declaration applications in circumstances where access is already commercially provided, and the downstream market already competitive, but where an access seeker believes it can invoke Part IIIA for greater negotiating leverage.[22] It has also detracted from the purpose of criterion (a), which is to identify as suitable for regulation those markets where intervention is truly necessary in order to sustain competition in dependent markets, not to provide an opportunity for regulators to intervene in commercial markets for access.

Aurizon would therefore support amending the legislation to clarify that the appropriate test is whether or not *regulated access on reasonable terms and conditions through declaration*, rather than access in general, would materially promote competition.

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18 *Re Virgin Blue Airlines Pty Ltd* [2005] ACompT 5 at [162]

19 *Re Sydney International Airport* [2000] ACompT 1 at [20]

20 *Sydney Airport Corporation Limited v Australian Competition Tribunal* [2006] FCAFC 146 at [78]

21 *Sydney Airport Corporation Limited v Australian Competition Tribunal* [2006] FCAFC 146 at [79]-[81]

22 There has been at least one declaration application since the Full Court's decision in relation to a facility where access was already commercially provided (*Application for Declaration of the Caltex Jet Fuel Pipeline at Sydney Airport*).

3.3.2 Criterion (f)

Aurizon supports the Commission's draft finding that criterion (f) should be a rigorous test with better defined parameters. That this test takes the form of a broad cost-benefit assessment, consistent with the Tribunal's approach in the Pilbara Infrastructure case, is appropriate.

While cognisant of the practical difficulties of cost-benefit assessment, in the case of rail, the danger of treating the potential impact of declaration on an integrated facility too lightly cannot be overstated. The nature of an integrated rail transport facility necessarily includes coordinated interfaces between multiple services such as customer loadouts, below-rail capacity, above-rail train operations and port and stockpile unloading services. The potential for declaration risks distorting the decisions on investment, capacity planning and the choice of technology are therefore significant.

To the extent that amendments provide greater clarity and certainty about the application of the "public interest" test, the costs of uncertainty will be reduced. Firming up the test through a positively framed requirement that declaration should 'promote the public interest' and providing for a more rules-based approach in the form of a 'having regard to' provision would improve application of the criterion. In that respect, in addition to those matters highlighted in the Draft Report Aurizon considers the test should include consideration of the potential impact of declaration on the coordination costs imposed on services which form part of an integrated service or supply chain.

3.3.3 Criterion (b)

Aurizon does not consider that the case has been made for amending criterion (b) to introduce a 'natural monopoly test'.

Much has already been written on criterion (b), and Aurizon considers that the Draft Report sets out in a reasonable way the arguments that have been made both for and against the natural monopoly test and the private profitability test.

However, Aurizon does not consider that the Draft Report has made a persuasive case for legislative reform. In particular, there does not appear to be sufficient evidence that the public interest would be promoted by yet further change in the meaning of criterion (b). The relative merits of different interpretations have now been actively debated for a decade in the context of lengthy litigation, ultimately being resolved by the High Court. While this debate has been of considerable academic interest, there does not appear to be any evidence that there is a prevalence of unregulated facilities "avoiding" regulation only by reason of being profitable to duplicate and consequently harming social welfare. Until such time as it can be demonstrated that the private profitability test is an actual problem for the Australian community – i.e. that there would be material benefits from a change to the natural monopoly test, or there are significant costs associated with not changing from the privately profitable test, or that it is actually thwarting the role of Part IIIA in regulating away monopoly rents – Aurizon would consider that business is better served by stability in the law.

Moreover, while recognising the economic basis for the natural monopoly test, Aurizon does not consider that a case has been made for reversing the commercial, common-sense approach to criterion (b) that was set out by the High Court. In Aurizon's view, the natural monopoly test, which in effect requires the decision-maker to speculate as to whether the community is better off with or without a new facility being built, encourages impractical, resource intensive exercises, which require a regulator to make commercial judgments for which they are often ill-equipped. By way of contrast, the private-profitability test accords with a normal, commercial understanding of a bottleneck facility, gives appropriate weight to the desirability of facilities-based competition and development more generally, and best minimises the risk of 'false positives'.

Aurizon would therefore agree with the report provided to the Commission by Professor Allan Fels, that:

> *"… the Tribunal's interpretation [of the natural monopoly tests] has involved prolonged, information intensive, and potentially error-prone inquiries in contexts where a private profitability assessment would have been easier to assess … and less likely to lead to error. Moreover, the private profitability approach accords with the common sense notion of a 'bottleneck' … and is consistent with the test applied under the 'essential facilities' doctrine, and in the assessment of competition processed more generally … There is therefore considerable precedent in its*

> *application, reducing the risk of error and increasing its effectiveness as a filter against unmeritorious applications".*[23]

As noted above, Aurizon considers that perhaps the most desirable aspects of the private-profitability test is that it gives primacy to a commercial decision to replicate a facility. That is to say, where a private business elects to sink private capital in the construction of a new infrastructure asset, the private-profitability test will give priority to genuine, facilities-based competition for access without any need for the imposition of regulation.

Giving priority to the potential for facilities-based competition is consistent with the principles of national competition policy and the intent that third party access should apply where access to a bottleneck facility is essential to competition in a dependant market. That regulators have adopted the contrary view is a departure from the view that regulation is last resort, not a first port of call. For example, that Part IIIA could be used, as argued by the NCC, to avoid "unnecessary and wasteful duplication of infrastructure investments",[24] suggests a level of oversight that goes beyond what is necessary to overcome bottlenecks and promote competition.

The possibility that the natural monopoly test will exclude the possibility of facilities based competition, thereby entrenching a facility as a monopoly and depriving the market of the benefits competition could have offered is acknowledged in the Draft Report:[25]

> *"Access regulation could distort the incentives of third parties to invest in infrastructure facilities of their own. There could be negative consequences for dynamic efficiency if access regulation discourages third parties from investing in alternative infrastructure that would have used new technologies and innovations. There can also be forgone benefits from rival infrastructure facilities directly competing with one another, reducing the likelihood of creative destruction. Innovation and creative destruction are regarded as important determinants of a nation's productivity."*

Indeed, even where a facility is a natural monopoly in the sense that duplication would initially raise total costs, duplication could be socially beneficial.[26] That is, a second facility would incorporate technological and process improvements, avoid the coordination costs of multiple users of a single facility, promote competition in the supply of the service and to encourage further innovation and efficiency.[27] This can be seen in the case of Pilbara iron ore supply chains, which compete with each other, driving efficiency through technological innovation and cost cutting, realising benefits that are not necessarily able to be predicted by a regulator.

It is questionable that a regulator will ever have sufficient information to identify what investment is 'wasteful' and what is not. Equally it does not appear appropriate for a non-expert regulator to make what is, in effect, a commercial assessment as regards the expenditure of private capital. Implementing a test for least total costs is no easy task, given the difficulty of quantifying opportunity costs associated with foregone facilities-based competition, together with the significant (but difficult to quantify) costs that access might impose on an incumbent. Such costs can include coordination inefficiencies, loss of control and intellectual property, financial losses associated with regulated pricing and the negative impact on future investment and are almost impossible to assess in advance. In fact, the costs on the incumbent are likely to be unquantifiable given they will be specific to the particular business in question depending on the opportunity costs associated with the impact of third party access on its particular business plan, particularly when applied retrospectively.

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[23] Professor Allan Fels AO (2013), Submission to the Productivity Commission Inquiry into the National Access Regime, March 2013, Submission 40] p. 54

[24] Feil, J. 2008, Third Party Access to infrastructure – Why, when and how?, NCC, paper prepared for 11th Annual Global Iron Ore and Steel Conference, Perth, 11-14 March, p. 3

[25] Productivity Commission (2013), p, 107

[26] Fels, A (2013) p. 52

[27] Note that in contrast to the Draft Report (p. 161) that acknowledges that duplication 'could' generate better allocative and dynamic efficiency benefits than would be the case under declaration, where facilities based competition is possible, the efficiency object of Part IIIA is more likely to be met directly through competition in than indirectly through third party access.

3.3.4 Other comments on declaration

(a) Requirements for applications

Applications for declaration are made pursuant to s 44F. In some circumstances, an application for declaration might be made without any notice to the owner of a facility. This can arise because there are currently no conditions precedent to the making of an application, other than the prospect that the NCC can recommend that a service not be declared where an application is not made in good faith.

The practical effect is that a person can make an application without ever having made an attempt to negotiate access to the facility or evaluated whether it is in fact uneconomic to duplicate all or part of the facility. To the extent that an applicant does demonstrate that it has undertaken these steps, the burden and costs of responding to the application may still disproportionately be borne by the owner of the facility and not the applicant. This is particularly so as an incomplete or inadequate application is not a clear basis for the NCC to conclude that an application has not been made in good faith. This can put the owner or operator of the facility in the invidious position of having to respond to an unclear, incomplete or inadequate application, of which they may have had little or no notice, with the risk that the NCC (or some other stakeholder) will seek to 'fix it up' rather than summarily dismiss it.

The consequence of the current approach is that the practical burden of proof falls on the owner of the facility to, without notice, demonstrate that the criteria are not satisfied rather than the applicant being required to demonstrate the criteria is satisfied. This is particularly concerning giving the very short consultation periods that are required in order for the NCC to meet its statutory timeframes.

Aurizon suggests that cost and resource burden in the consideration of an application for declaration for a service could be more adequately balanced through amendments which allow the NCC to dismiss an application, as opposed to making a recommendation not to approve, if:

- the application has not been made in good faith;
- the applicant cannot demonstrate that it has made genuine attempts to commercially negotiate access to the facility; and
- the application is not accompanied by evidence that it would not be profitable for the applicant to duplicate the facility.

(b) Ongoing review of declaration and revocation

Part IIIA does not provide sufficient clarity as to the rights of the owner of a facility when there is a material change in circumstances following declaration.

Critical inputs into whether it is economic to duplicate the service are the foreseeable demand and the current technology. Both of these assumptions may deviate substantially over time from those assumed in the original decision making, calling into question whether the declaration should continue. Further, s 44F(4) requires that the Council, in deciding to make a recommendation, to determine whether it would be economical for anyone to develop another facility that could provide part of the service. There may be difficulties for the Council in foreseeing all of the circumstances which might arise as to whether it would be economical for anyone to develop a facility that could provide part of the service where:

- additional infrastructure might be built in the future which would allow part of the service to be duplicated;
- technological progress which might make alternate means of providing the part or all of the service; and
- demand for the service increases substantially beyond the range assumed in the original decision where the costs of expanding exceed the costs full or partial duplication.

Similarly, it is feasible that while it may be uneconomic to duplicate the entire facility for the declared services, it might not be uneconomic to duplicate a section or subset of the declared facility.

The CCA does not provide a clear pathway or process for the declaration to be reviewed to take these issues into account. For example, if during the term of the declaration another facility is developed that was not considered in the original decision, and which could otherwise support facilities based competition or render it economic to duplicate part of the declared service, the owner of the service

should be able to seek revocation of the relevant part of the service. However, there is no requirement within the CCA for the Council to consider an application by the owner of the facility for revocation of part or all of the declared service.

Aurizon suggests that the CCA could be improved in this respect by including a specific mechanism for the provider of a declared service to seek revocation of part or all of the declared service where it can demonstrate that the s 44H declaration criteria are no longer met. This would clarify a process and mechanism around the operation of the revocation of declaration set out in s 44J.

4 The application of the regulatory framework

Once the decision has been made to 'declare' a service, the implementation of the legislation and ongoing administration of a regulatory regime will ultimately determine whether the decision to declare was in the public interest. That is from the perspective of enhancing social welfare, what is important is not the decision to declare itself, but exactly what follows that decision – and whether the resulting regulation (if any) is applied in a timely, effective and efficient way.

With that in mind, Aurizon considers that the most important question for the Commission is whether the practical, day-to-day application of the statutory framework is promoting a real increase in social welfare. In at least some of the markets in which Aurizon operates, this would seem a real issue, as steadily escalating regulatory cost and complexity, longer and more complex decision making processes, increased regulatory creep and the associated risk of regulatory error, raise questions about whether reform is needed in the administration of Australia's access regimes.

Aurizon's experience in both its regulated below rail network business and as an above rail train operator, suggests the main issue is whether there has been a loss of focus in the regulatory endeavour. In particular, many regulated rail corridors now seem to be at the limit of the incremental benefit that can be achieved by additional regulation, given the competitiveness of above-rail markets and the elimination of monopoly rents through price controls. It is likely that much of the significant efficiency gains from competition reforms have been achieved and incremental reform of the regulation in its current form could result in diminishing marginal returns.

In this respect, Aurizon would raise three issues for further consideration:

- First, many of Australia's most economically significant railroads are regulated by complex undertakings, which are approved by regulators acting with very substantial levels of discretion. Does it remain appropriate for such a level of control to be vested in regulators, applying what are now mature access regimes, in the absence of more specific guidance on the objective of regulation?

- Second, is there an ongoing issue with regulatory creep, resulting in increasing levels of prescription, complexity and cost? It would appear that rail regulation in particular is characterised by a desire to anticipate and resolve every foreseeable commercial problem, either in an undertaking or in standard agreements, rather than seeking to address issues in the first instance through commercial negotiation. As a result, where the negotiate-arbitrate framework is retained, as recommended in the Draft Report, should consideration be given to how commercial negotiation can be promoted?

- Last, is an aging statutory framework directed at competition in dependent markets, ill-equipped to provide guidance to regulators struggling with the difficult issue of coordinating Australia's export supply-chains in a multi-user, vertically separated access environment? Is this contributing to an unguided expansion of regulation beyond network assets to unregulated elements of the supply-chain?

Aurizon considers a review of regulatory decision making has merit prior to the publication of the Productivity Commission's final report. In this respect, Aurizon acknowledges that the Commission has requested further information that may inform its consideration of how regulation is working in practice. Information Request 4.1 in the Draft Report seeks information on the appropriateness of safeguards for the service provider and other users of the facility in ss 44W and 44X of the CCA. Aurizon provides comment on regulation in practice, particularly as it is implemented through access determinations by regulators in the remainder of this section in response to this information request.

4.1 The broad discretion of rail regulators

Aurizon believes that the threshold issue to note is that the access regimes which apply to Australia's most economically significant open access railroads (particularly, the eastern coal supply-chains and the interstate mainline network); contain only minimal legislative guidance on decision-making:

- For example, the ACCC's power to make access determinations that apply to declared services is extremely broad. Section 44V(2) provides for the ACCC to make a determination dealing with 'any matter' relating to access by the third party to the service, with guidance only in the form of limitations set out in s 44W(1) which seek to protect existing rights and interests of parties. Further, s 44X(1) lists the matters which the ACCC must take into account in making a determination. Having provided guidelines in these sections, regulatory discretion over the scope of regulation is maintained by s 44X(2) which provides for the ACCC to take into account any other matter that is thought relevant by the regulator.

- Likewise, the provisions that apply to the approval of access undertakings often provide only very limited guidance to the regulator in the exercise of its discretion. For example, under the *Queensland Competition Authority Act* 1997, the QCA can compel the production of an access undertaking, and modify without constraint that undertaking once given, whilst being constrained in its decision-making by a single, non-exhaustive list of matters that it may take into account (s 138).

The complexity of issues facing regulators can mean that a broad discretion is appropriate. Nevertheless, the costs and risk of regulatory error are such as to raise a question as to whether this level of discretion is suitable for the regulation of assets of national importance. As put by the Commission in a prior review:

> *"Regulatory discretion cannot be eliminated and, indeed, some discretion is desirable. However, to reduce the risk of regulatory error, statutes should be clear about the objectives of regulation, the behaviour at which intervention should be targeted and the principles governing the type of intervention".*[28]

As acknowledged in the Draft Report,[29] regulation imposes a range of costs, including the direct compliance costs associated with developing and amending access undertakings, responding to draft and final regulatory decisions, additional reporting obligations, the costs of any levies that fund the regulator,[30] and costs associated with maintaining separate business structures in some instances.[31] That there are costs to regulation is uncontroversial. However the issue is whether the benefits of regulation outweigh the costs, not just in making the initial decision about whether or not a service should be declared, but also in making the subsequent regulatory decisions about whether or not a particular proposal should be accepted. It is in this respect that additional guidance from statute would appear appropriate.

The issues that have been encountered in rail access regimes in the approval of 'standard agreements', highlight the shortcomings of sparse statutory guidance. In Queensland, the Hunter Valley coal, and the interstate networks, the approval of standard contracts by the regulator has evolved as part of the regulatory arrangements. The purpose of these standard contracts is to reduce transaction costs and mitigate the risk that the network provider may exercise monopoly power. However, over time, these contracts have developed into elaborate commercial contracts covering a broad range of commercial interactions between an access provider and third parties. For example, Aurizon Network now maintains well over a 1,000 pages of standard contracts, encompassing three different standard access contracts, a standard interconnection agreement, two standard studies funding agreements, and the suite of contracts that comprise the Standard User Funding Agreement – all of which are revised and approved by the QCA every four years.

In assessing and approving these standard contracts, it is difficult to see how the statute provides any practical direction to the regulator. These contracts are in substance commercial agreements between third parties and the network provider on matters such as infrastructure standards, risk sharing,

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[28] Productivity Commission (2002), Annual Report 2000-01 'Better regulation of infrastructure', Annual Report Series, 14 February 2002, p. 14

[29] Productivity Commission (2013), p.105

[30] Productivity Commission (2013), pp. 234-239

[31] For example, the case of Aurizon, the regulated subsidiary Aurizon Network is ringfenced and operated separately from the parent company.

operational issues like scheduling process and timeframes, and the management of and liability in relation to incidents. When the regulator is required to consider the terms of these contracts, statutory references to promoting competition or efficiency are not particularly instructive. This suggests that the approval and revision of standard contracts is largely undertaken without any meaningful statutory guidance at all.

4.2 The problem of regulatory creep

Third party access regulation based on the negotiate-arbitrate model is underpinned by an acknowledgment that commercial negotiation achieves more efficient outcomes than regulation, but that regulation may be necessary where negotiation breaks down. However, there is a question as to whether this structure is being supported in practise, with many regimes now characterised by progressively more time-consuming and complex decision making processes frequently supplanting commercial negotiation, together with transaction costs "*inflated by inappropriate or overly intrusive regulatory approaches*." [32]

In the rail sector, access undertakings are continuing to grow in size and complexity, driven in part by the expansion of standard access agreements beyond their initial role of providing a safety net for negotiation, to providing a full suite of options to suit different commercial preferences. Further, whilst the lack of arbitrations during a regulatory period is often used as a demonstration of the effectiveness of the regulatory regimes, it could also be argued that where regulatory periods are relatively short, regulatory resets can effectively become a de facto dispute resolution mechanism. With each successive access undertaking, regulators are being required to make determinations to pre-empt commercial disputes, making arbitrations during the term less likely.

Against this background, it is submitted that consideration should be given to encouraging regulators to give a more genuine appraisal of the potential for issues to be resolved via commercial negotiation, having regard to the materiality of the issue and the likelihood of a breakdown of negotiations leading to a dispute. It is further submitted that this assessment would provide a level of objectivity in relation to the need for regulatory intervention and ensure that decisions are targeted to significant problems that are unable to be resolved by commercial agreement.

4.3 Regulation and the coordination of Australia's supply-chains

The current model for the economic regulation of rail does not contemplate an 'end point'. In the access regimes relevant to rail, the regulator is required to promote 'effective competition in related markets', without any particular dimensions around what is 'effective competition' or when 'effective competition' has been achieved. The statute instead contemplates additional competition, or additional efficiency, thereby encouraging a search for regulatory precision, with proposals being assessed against the 'perfect' industry structure and theoretical efficiency benchmarks that are taken to be the proxy for effective competition.

In effectively competitive markets, firms constantly adapt to changing demand and supply conditions with varying incentives for investment and innovation in the form of some level of (albeit ephemeral) market power. In this context, regulation will always be able to identify 'imperfections' as against a notional standard of perfect competition, and there will always be a temptation for regulators to 'fix' those imperfections. The risk is that, in seeking to fix the imperfections, regulation can introduce its own inefficiencies and costs, perpetuating the need for additional intervention. In the context of rail, this issue has arisen in the numerous efforts of regulators to 'fix' what are perceived to be coordination failures in export supply chains, but are often simply signs of competition itself.

The introduction of open access to supply-chains was, in effect, a trade-off between the efficiency gains from competition against coordination losses. This issue has been discussed at length in the economic literature in the coordination versus competition debate.[33] This trade-off arises because, essential to the

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[32] Banks, G (2012), p. 14

[33] For example, see:

- José A. Gomez-Ibañez (2010), Competition vs. Coordination: The Analytics of Open Access with Illustrations from Railroads, prepared for Annual Regulatory Conference of the Australian Competition and Consumer Commission, Surfers' Paradise, Queensland, July 29.
- Fels, A (2013), Submission to the Productivity Commission Inquiry into the National Access Regime, p. 18.

task of promoting competition, is the ability of multiple entities with different interests in the supply-chain to select what is of value, and to do so in conjunction with whatever other services they require. The regulatory arrangements ought to anticipate and account for the needs of individual firms, and, where efficient to do so, provide sufficient flexibility to allow operators and other suppliers to create value for end users.[34] It is submitted that promoting service differentiation in dependent markets is fundamental to maximising the scope for market forces to provide end users with an optimal outcome.

The differentiation is, however, counter to the centralised decision-making that is a feature of vertically-integrated supply-chains. Under those conditions, costs and benefits are optimised across the entire chain, leading to reduced operational differentiation and throughput maximisation – but no competition, other than that between supply-chains themselves. That is to say, the supply-chain as a whole might function more efficiently, and therefore be more competitive vis-à-vis other supply-chains, but there will be minimal non-price competition within the constituent functions.

Recognising this issue, Australia's rail access regimes are now increasingly – without any clear statutory guidance, other than the requirement to promote efficiency – moving to try and regulate entire supply-chains to obtain the benefits for centralised coordination while trying to maintain competition. This has manifested itself in two key areas, both of some concern:

- the assumption that other components of the supply chain are inefficient, leading to decisions affecting the contractual arrangements and operational activities of unregulated services; and
- assumptions regarding the appropriate distribution of income across the supply chain.

These issues can be most effectively illustrated through two case studies, each discussed in the following sections.

(a) Regulation of competitive elements of the supply-chain

In the Hunter Valley Coal Chain in New South Wales, the below rail access provider, ARTC, is regulated under the Hunter Valley Access Undertaking (HVAU). The approved undertaking includes requirements for ARTC to determine an 'efficient train configuration'. The intention is to reform the below-rail regulation to promote what the regulator regards as the "most efficient" rollingstock configuration. It is submitted that this is an example of regulatory creep, with the regulatory action going beyond the declared service itself in the guise of coordination.

The approach taken so far by the ACCC is to find that the 'efficient train configuration' is the longest train which can be accommodated by the current network configuration. The reason this is the maximum length is historical. The network configuration matches the train that was in use at the time of construction by the then government-owned vertically integrated rail service provider. There is no evidence to support this particular length as being inherently more 'efficient' than a longer length train. Rather, it is likely that longer trains could be more efficient given the technological changes (improved tractive power, better braking performance etc) over time.

In attempting to move above rail train operators to a standard train length, the regulation is seeking to replicate the efficiencies that an integrated supply chain would achieve. In doing so, the effect is to neutralise any product differentiation in the above rail market, in effect reducing competition to price only in the above-rail service and simplifying the coordination task between the different functional layers of the supply chain. While a level of homogeneity emphasises competition based on price, and therefore promotes costs reducing productive efficiency, it comes at the expense of dynamic efficiency. As rolling stock is a long term investment, regulatory intervention into the competitive above-rail market effectively 'sets in concrete' the rolling stock configuration.

In the transitional process, by requiring ARTC to price access to the network in order to encourage a particular length train, the regulatory requirements also impose higher above-rail costs on the system. For

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- Mulder, M. Lijesen, M. and Driessen, G (2005), Vertical separation and competition in the Dutch rail industry: A cost-benefit analysis: Paper submitted to the Third Conference on Railroad Industry Structure, Competition, and Investments, Stockholm, 21 and 22 October 2005.
- Jeremy Drew (2006),Rail Freight: The Benefits And Costs Of Vertical Separation And Open Access, Drew Management Consultants ©Association for European Transport and contributors 2006

[34] QRN, *Submission on QR Network's Electric Traction DAU*, 25 September 2012, p.37

example, based on current rollingstock investments in the system, Aurizon will be required to add one locomotive to its standard train, but is prevented by the length of the track passing loops from adding the additional 41 wagons that Aurizon's locomotives can efficiently haul (as only around a further 22 wagons will fit). That is, Aurizon could be forced to operate inefficiently over-powered trains in order to attract the lower access charges associated with the 'efficient train configuration'.

Regulation that forces Aurizon to add one locomotive, but prevents it from adding more wagons to maintain the ratio of payload to locomotive power is inefficient from an above rail perspective. The decision by the regulator is *intended* to affect the operating and investment behaviour of the non-regulated and highly competitive above-rail market. However, no provision is made in the regulation for the point at which it is appropriate for the regulator to allow for competition to address efficiency versus seeking to regulate the coordination tradeoffs in relation to the timing and investment in below-rail and above-rail capital. As such, this regulatory decision risks extending one of the key regulatory risks for regulated businesses, incentives to invest, to the unregulated and competitive businesses potentially resulting in long term inefficiencies across the supply chain.

(b) Redistribution of income and risk in the supply-chain

A key issue associated with the expansion of efficiency regulation beyond the regulated service itself, and to the entire supply-chain, is the difficulty associated with determining when a reform genuinely promotes efficiency as against a reform that simply redistributes income from one element of the supply-chain to another (whether from operator to mine, vice versa, or from mine to mine). This is of particular concern to business when the prospect of this occurring is raised after investments have been made.

For example, in both the Queensland and the Hunter Valley coal chain, regulators have promoted changes to the contracting structure whereby a mine (rather than an operator) enters into a long-term access agreement with the network provider. In the Hunter Valley, this has been mandated by the regulator, such that with the commencement of the 2011 Hunter Valley Access Undertaking, train operators no longer have any direct contractual relationship with the below-rail service provider as all operator access agreements were transitioned to agreements held by producers.[35] The introduction of these split agreements separated the contractual entitlement for below-rail capacity rights from that of the right to operate trains on the network.

Aurizon supports this contract structure, as benefits have undoubtedly been created through the alignment of below-rail capacity with upstream and downstream fixed investment in mines and port. Of note however, is the one element of these reforms that was directed at permitting end users to more flexibly deal with operators to incentivise above-rail performance. This took the form of requiring the below-rail provider to take steps necessary to enable a producer to 'switch' operators within a certain time window. There was significant debate, at least in Queensland, in determining whether this time window should be as short as 48 hours, or as long as 30 days – yet it remains doubtful that it could be proven that 48 hours is invariably *more efficient* than, say, 5 days, or that 30 days must always be *less efficient* than 7 days.

That is, a short time period that encourages frequent switching will require operators to maintain excess capacity and rollingstock, put in place flexible crewing arrangements, and potentially expose them to a greater degree of capital risk. This may result in a higher cost, and thus price, associated with that level of flexibility. By way of contrast, these costs would be avoidable with a longer period, but at the expense of less flexibility for producers to manage multiple operators. In deciding between the two, the regulator is not in a position to assess the change in increments of competition, or increments of efficiency, but rather is left merely judging what is of commercial or operational value to the supply-chain and making changes that result in the redistribution of costs and income between mine and operator.

[35] Access Holder Agreements are tripartite agreements with the primary contractual relationship between the access holder, producers, and ARTC. The agreements contain an attachment that is the sub operator agreement executed by operators which cover operational matters in relation to the use of the access rights.

5 Directed Extensions and Expansions

When third party access was first introduced to railroads, there was a degree of under-utilised capacity available for new users and increased capacity utilisation promised improving economies to scale. Since then, for some of Australia's major supply-chains the existing spare capacity has been consumed and this has resulted in the need for new investment to increase capacity.

Investment under negotiated terms, rather than as a result of a direction from a regulator, is generally the optimal way for networks to develop. This recognition of the primacy of commercial negotiation is inherent in the negotiate-arbitrate model, and consistent with the objective that commercial outcomes are preferable to those imposed by a regulator. It is also particularly relevant for the rail sector where the negotiation of access involves corporate entities with sufficient expertise, or the capacity to procure the necessary expertise, to negotiate up-front terms and conditions of access for expansions or extensions to a facility to support commercial investment in dependent markets.

However, there are circumstances where a service provider may be unwilling or unable to expand or extend their facility, including where it lacks the capital to do so, where it has alternate uses for that capital, or where it does not consider that the regulatory framework provides the compensation necessary to meet the return expectations of its shareholders. The importance of such considerations for investment decisions has been strengthened following the global financial crisis.

On balance, it is reasonable that the regulatory regime includes powers for the regulator, in certain circumstances, to direct the service provider to expand the facility to meet the requirements of the access seeker. This achieves the regime's efficiency objectives. But, equally, it must remain subject to the strict protections currently included in the CCA at s 44W (particularly the prohibition on a regulator requiring an access provider to fund an expansion), and the expansion not altering the service provider's return expectations for the existing facility. As noted in the Draft Report, the powers in the CCA in relation to extensions or expansions have not needed to be exercised. Similar powers are included in Part 5 of the QCA Act and the QCA has also not been required to rely on these provisions in the making of an access determination.

The Draft Report canvases a range of matters associated with the powers to direct expansions and extensions in the CCA and requests further information on the adequacy and workability of the existing safeguards. In this respect Aurizon is well placed to respond given the level of consideration it has been required to give to these matters.[36]

In particular Aurizon submits that:

- The power for a regulator to direct an expansion of a declared service facility is reasonable, provided the legitimate interests of the access provider are protected, including that the restrictions on access determinations at s 44W are retained;
- The power to direct geographical extensions should depend on the extension satisfying the declaration criteria. That is, unless an extension meets the declaration criteria, it should not automatically form part of a declared service;
- Despite the lack of precedent in relation to the existing extension powers in the CCA, the provision provides a 'safe harbour' to support the primacy of commercial negotiation;
- The effectiveness of the extension power is presently affected by tax legislation which does not facilitate capital contributions towards expansions in the event that the service provider is directed to extend the facility; and
- Draft recommendation 8.8 is not necessary at the present time, but were it to occur, it should be undertaken by a panel of experts, rather than the ACCC, given the complex commercial, tax and accounting issues raised.

[36] Aurizon Network has developed a suite of 9 agreements to facilitate an effective user funding model which is currently under consideration by the QCA

5.1 Extensions versus Expansions

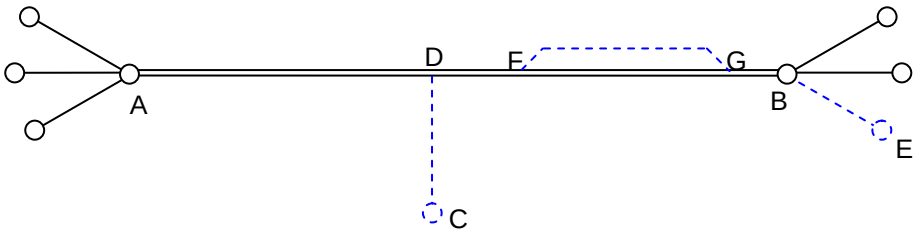
Draft recommendation 8.7 targets the uncertainty as to whether subsection 44V(2) of the CCA provides the ACCC the power to require a service provider to expand its facility, in addition to being able to require a geographical extension. Aurizon supports the recommendation to clarify the interpretation in relation to 'expansions', in particular that the regulator should have the unambiguous power to direct the expansion of a facility, provided the restrictions on access determinations at s 44W are retained.

Aurizon also believes that the obligation for the owner of a declared service to allow connection to the facility should be maintained. However, Aurizon considers geographical extensions should be excluded from the definition of the declared service unless the declaration criteria are met.

Unlike expansions, geographical extensions to a railway typically involve a single point of connection to a common mainline (for example a spur or branchline). In contrast, an expansion to the facility will generally involve two points of connection to the existing infrastructure (i.e. passing loop, duplication or deviation).

As an example, assume an access seeker wishes to operate train services from a new mining development/precinct at point C in the figure below, to a new export terminal at point E. The proposed service is effectively comprised of three services:

- the operation of train service from node C to D requiring a new geographical *extension*;
- the operation of a train service on the existing facility from node D to B which requires an *expansion* between nodes F and G; and
- the operation of a train service from node B to E which requires a new geographical *extension*.



Assuming it is uneconomical (not privately profitable) for anyone to develop a new facility to provide the point to point service from node C to E, then an access seeker would require access from node D to B on the existing facility. However, services between nodes C-D and B-E requires the geographical extension of the facility and, therefore, investment in new rail infrastructure.

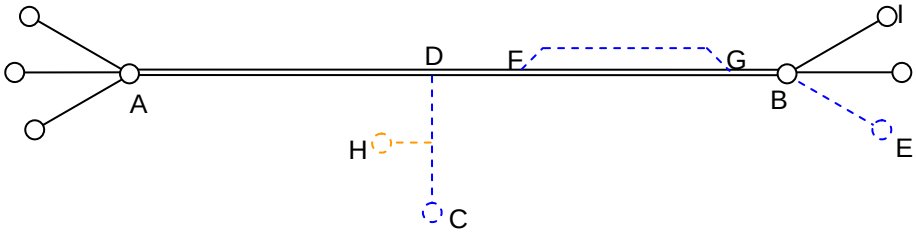
As the rail infrastructure between nodes C-D and B-E does not presently exist, then it is reasonable to assume that the extensions to the facility could be provided by anyone willing or able to develop and provide those services.

The extensions are therefore contestable in the sense that the access seeker has the discretion to either develop the facility, negotiate with the existing service provider to extend the facility, or to seek an access determination which directs the service provider to geographically extend its facility. Options for an alternative supply provide an effective constraint on market power through competition for the provision of the service. That is, the service provider's ability to price the extension above a competitive level is limited by the ability for the access seeker to construct its own extension, as long as the service provider is required to allow connection to the existing infrastructure (as is the case under the CCA).

In cases such as this, where a geographical extension of the facility is required to provide the access seeker's proposed services, there is no basis for the geographical extension of the facility to be subject to regulatory controls through the existing declaration. Aurizon notes that, these concepts are reflected in the National Electricity Rules where the major customer connections are not regulated (prescribed or negotiated) transmission services in most jurisdictions.

There may be circumstances where such a geographical extension of the facility could be used by other access seekers in the future. For example, in the figure below, if an new access seeker later wants to

operate a service from H to I, where the extension C to D is owned by a party other than the owner of the facility from nodes D to I, then the access seeker would be required to negotiated access with two service providers to operate the proposed service.



There would be transaction costs associated with the access seeker being required to negotiate access with multiple service providers (that is, the owner of C to D and the owner of D to I). The owner of the facility C to D may refuse to negotiate access on the grounds that it is not declared. In that case, the second access seeker at H may develop an alternate facility, seek declaration of the extension C to D, or consider a different point of interconnection.

It is submitted that these examples, which follow the usual way in which mines commercially develop, demonstrate why the power to direct the owner of a facility to undertake a geographical extension of the facility should only be exercisable where it can be demonstrated that the extension satisfies the declaration criteria. To the extent that there are demonstrated material efficiency and public interest grounds for the owner or operator of the existing declared facility to also be the owner of the geographical extension, the ACCC should have the power to direct the extension following public consultation. However, it is difficult to imagine a circumstance where this would be the case and the owner would not already have an incentive to extend. Consequently, the preferred approach would be for the parties to negotiate an agreement independently of ACCC intervention.

Aurizon acknowledges that the potential for an additional process to review whether coverage of the existing declaration should extend to a geographical extension might add time and uncertainty to the negotiation of access, but it is unlikely to be necessary very often. In such a circumstance, the owner of the facility should be protected in the coverage decision by having the decision assessed by a body which is independent from the regulator that is arbitrating an access dispute. Consequently, the ACCC when presiding over an access determination could refer the matter of coverage of a geographical extension to the NCC.

Aurizon recommends the Commission consider amending draft recommendation 8.7 to exclude geographical extensions from the definition of the declared service unless they meet the declaration criteria. In addition a process could be developed to allow for assessment, for example by the NCC, of proposed geographical extensions in the event that they are to be included in as part of the declared service. This would reverse the initial premise that the geographical extension is declared and the owner of the facility could be directed to undertake that extension.

5.2 Expansion power in the CCA is a ‘safe harbour’ for negotiation

Although the existing expansion powers in the CCA have not yet been invoked, they are nonetheless effective because of the ‘safe harbour’ they provide to support commercial negotiation. In many respects, that these provisions have not been used is a better outcome than would be the case if they were frequently invoked, noting the preference for negotiated terms over regulatory intervention.

The Draft Report correctly notes the information asymmetry associated with the costs and risks of an expansion to the facility and, particularly, that the service provider and access seeker are better placed than the regulator to understand these matters in the prevailing market conditions. The Commission acknowledges the significant costs and risks of regulatory error arising from information asymmetry and observes:

> *‘Private negotiation is generally preferable to regulated extensions (or expansions), particularly because of the practical difficulties of directing investments (including those arising from information asymmetry)’ p.139*

Given the requirements of Clause 2.2 of the CIRA that wherever possible terms and conditions for third party access should be commercially agreed between the access seeker and the operator of the infrastructure in the first instance, it is submitted that the relevant regulatory objective should be to facilitate effective commercial negotiation.

Notwithstanding these practical difficulties, the ability to direct a service provider to expand its facility provides a strong incentive for the parties to negotiate commercially acceptable terms and conditions. For example, Aurizon Network has negotiated terms and conditions for the expansion and, as applicable, extension of the central Queensland coal network directly with coal producers for the Wiggins Island Rail project and the Goonyella to Abbot Point project. The direct customer negotiations have allowed for the timely and efficient investment in rail infrastructure and have promoted competition in the rail haulage market with Pacific National and Aurizon securing rail haulage contracts with coal producers utilising capacity created from both projects.

Were the power to direct an expansion to be used prior to commercial negotiations occurring, there is a considerable risk that economic regulators would attempt to achieve unrealistic levels of precision in the terms and conditions with which an access seeker makes a capital contribution to support an extension, where this is required to provide the access rights being sought. The desire to obtain a precise outcome or strong preferences to ensure the negotiated outcome replicates the cash flows that the access provider would have been entitled to earn had the regulator prescribed the terms and conditions of access, would appear contrary to the stated objectives of simulating a commercial outcome in the first instance. A further risk is that such an approach may stimulate a prolonged debate regarding the regulatory parameters, which itself contributes to disincentives to invest.

It is therefore highly desirable that the primary focus of the powers to direct expansions is to provide an effective constraint on the exercise of market power in order to facilitate effective commercial negotiation.

The provisions are also effective in the sense that they provide an appropriate limit on the regulator's power in order to protect the investment incentives and business interests of the access provider. The relevant provisions in the QCA Act [37] broadly mirror those in the CCA, including the ability for the QCA to make an access determination that requires the extension of the facility subject to:

- a third party not becoming the owner of the facility without the consent of the owner; and
- the provider of the service not bearing some or all of the costs of extending the facility.

These provisions are intended to protect the interests of the owner of the service, particularly where the expansion would form an integral part of the total service and is not severable from its existing property rights (as is usually the case with rail expansions). This ensures the expansion does not interfere with the access providers legitimate businesses interests and provides a safeguard to ensure that the service provider is not able to hinder access to a significant facility. To date, neither the ACCC nor state based rail regulators have been required to exercise the powers to direct an expansion, and without further evidence to the contrary, there would seem no compelling or substantive basis to remove these protections to the service provider.

5.3 The effectiveness of the power to direct an extension

The Draft Report comments that a decision by the ACCC to direct an extension (or expansion) may require complex operational, commercial and legal considerations. In making this observation the Commission has referred to the 700 pages comprised in nine agreements which form the Standard User Funding Agreement (SUFA) proposed by Aurizon Network to the QCA.

It is important for the Commission to appreciate that Aurizon Network has considered and proposed to Queensland's coal producers a range of potential funding models, not just SUFA, including a contractor model of only 140 pages, under which Aurizon Network would be contracted by access seekers to construct user funded assets. These simpler models have not been as attractive as SUFA to stakeholders, as they did not provide sufficient certainty regarding the coal industry's objective of tax neutrality. Nevertheless, they may still be invoked by an access seeker for an individual project, noting that SUFA is simply the standard – and that alternatives are able to be negotiated where Aurizon Network and a funder agree.

[37] See: s 118, s 119

That noted, the SUFA model proposed by Aurizon Network achieves a tax neutral arrangement for both the access seeker and the service provider, whilst also ensuring the service provider retains operational control over expansions that are not severable from the existing network and which are integral to the ongoing viability of its own investments. To the extent to which additional funding models could be made available through amendments to the tax legislation (particularly, as regards capital contributions) Aurizon considers that a broader range of user funding options may become available to support the relevant power to direct an expansion.

It is submitted, that the practical issues observed with developing tax effective funding arrangements which would permit a regulator to effectively make a direction to extend a facility while preserving the safeguards for the owner of the facility, must be overcome through a broad range of accounting, finance, tax and legal reforms; rather than through amendments to, or removal of, those safeguards. This broad range of reform required to achieve the benefits of workable user funding models may be beneficial to the development of alternate models for the funding of improvements to public infrastructure and, therefore, may have broader public interest outcomes.

5.4 Guidelines on the ACCC's powers

Draft recommendation 8.8 suggests that guidance should be prepared on how the expansion provisions would be exercised by the ACCC. Aurizon does not necessarily believe this recommendation is necessary as, in the absence of a clear need to rely on this power, the development of guidelines without any precedent or actual requirement may be a risk to business.

If guidelines are required, and it is not clear that they are, Aurizon does not consider that the ACCC is the best entity to undertake such a review. First, as a matter of good practise, it would seem inappropriate for a regulator to review the scope of its own powers, particularly where those powers have yet to be applied at all and are therefore amendable to expansive interpretation. Second, as the prospect of a directed expansion involves considering a number of different policy areas (including commercial and tax issues), the ACCC is unlikely to possess the necessary internal expertise to run an effective, independent review.

Accordingly, Aurizon suggests that, if draft recommendation 8.8 is retained, it be redrafted to ensure that any review of the ACCC's exercise of the expansion power be undertaken by an independent panel of experts rather than the ACCC, and that this review involves a detailed public consultation process.