

# RIO TINTO

## Submission

to

## Productivity's Commission's Annual Review of Regulatory Burdens on Business – Primary Sector

### Rio Tinto Group in Australia

Rio Tinto is a world leader in finding, mining and processing the earth's mineral resources. In 2006, Rio Tinto's Australian investments in iron ore, coal, aluminium, diamonds, uranium, gold and salt were valued at over A\$50 billion. These investments employ over 10,000 Australians. Rio Tinto is the largest iron ore producer in Australia, exporting over 120 million tonnes in 2006. Rio Tinto is a large investor in the coal industry – Australia's biggest export earner and an important source of international comparative advantage. Rio Tinto is also a large investor in bauxite production, alumina refining and aluminium smelting in Australia. Rio Tinto has a direct economic interest in a competitive Australian economy.

### Rio Tinto's Submission

Rio Tinto's submission is in response to the Productivity Commission's Annual Review of Regulatory Burdens on Business 2007 ('the PC Annual Review'), focusing on the primary sector. The law of relevance to this submission is Part IIIA of the *Trade Practices Act 1974* (Part IIIA), which establishes a legal right for third parties to seek mandated access to certain infrastructure-related services. In particular, this submission relates to the application and potential application of Part IIIA to the transport assets in the Pilbara region of Western Australia.

In assessing the relevance of Part IIIA to the PC Annual Review, this submission adapts the framework provided in the relevant *Productivity Commission Circular*, released in February 2007. In that context, Rio Tinto is of the view that Part IIIA:

- Creates unnecessary burdens, and
- Mainly impacts on the primary sector (i.e. on resource and agricultural export industries), although not exclusively (freight and airport services being notable exceptions).

## Recommendations

As outlined by the Prime Minister's Taskforce on Australia's Export Infrastructure,<sup>1</sup> the legislation should be amended to include an 'efficiency override' for applications under Part IIIA relating specifically to vertically-integrated export-dedicated facilities. This should be achieved by giving the relevant Minister the power to exempt from Part IIIA key export facilities on national interest grounds.

## Background

Following the Hilmer report in 1993 and the Council of Australian Governments Competition Principles Agreement (CPA), the Australian federal, state and territory governments agreed in 1995 to a program of competition policy reform under the National Competition Policy (NCP) framework.

In 1995 the Federal Government amended the *Trade Practices Act* (TPA) to include Part IIIA, which established a national third party access regime, now known as the National Access Regime ('the Regime'). The National Competition Council (NCC), which is tasked with providing recommendations under the Regime, has seen the rationale behind Part IIIA being to promote competition in markets where major 'bottleneck' infrastructure facilities confer substantial market power on their owners.<sup>2</sup>

Under the Regime, access to a service provided by a privately funded facility may be mandated by Government if:

- Access to the service would promote a material increase in competition in at least one market other than the market for the service;
- It would be uneconomical for anyone to develop another facility to provide the service;
- The facility is of national significance;
- Access can be provided without undue risk to human health or safety;
- Access would not be contrary to the public interest.

In the context of Pilbara iron ore operations, the Federal Court held in 1999 that Part IIIA has no application to Hamersley Iron rail line, to which access was sought, because it is a part of a production process used in the production of export quality iron ore. More recently, Fortescue Metals Group (FMG) has made an application for declaration of parts of the BHP Billiton Pilbara rail system. The Federal Court found, at first instance, that the BHP Billiton rail system was not protected by the "production process" exception, but this has been appealed to the Full Court and a decision is yet to be handed down.

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<sup>1</sup> Commonwealth of Australia, Australia's Export Infrastructure Report to the Prime Minister by the Exports and Infrastructure Taskforce, Exports and Infrastructure Taskforce, Canberra, 2005.

<sup>2</sup> National Competition Council, The National Access Regime: A Guide to Part IIIA of the Trade Practices Act 1974 An Overview, NCC, Canberra, 2002.

## Identifying the regulatory burden

From the Hilmer report onwards, it has been recognised that a delicate balance must be struck between the need to promote competition in infrastructure services and the risk of curtailing property rights that support investment.

Hilmer noted that “failure to provide appropriate protection to the owners of such [infrastructure] facilities has the potential to undermine incentives for investment.”<sup>3</sup> In 2001, a review by the Productivity Commission recognised the same tension, noting in particular that investment will be deterred if the regulatory impact is uncertain and insufficient return is allowed to cover risk.<sup>4</sup>

More recently, the Prime Minister’s Taskforce on Australia’s Export Infrastructure<sup>5</sup> and the Australian Bureau of Agricultural and Resource Economics<sup>6</sup> have analysed the enhanced regulatory risk under Part IIIA with a particular focus on export-dedicated assets.

They found that Australian export industries may lose market share through reduced competitiveness, as an unintended consequence of efforts to increase competition domestically. The PM’s Taskforce noted that third party access to a vertically integrated, tightly managed logistics chain may promote competition but undermine the efficiency with which that chain is operated and managed.

In the view of Rio Tinto, the unnecessary regulatory burden associated with the threat of declaration under Part IIIA partly stems from the pre-conditions for mandating access without the requirement for economic efficiency to be properly addressed and to govern the outcome.

*1. Part IIIA seems to render a recommendation of mandated access likely, because there is a focus on marginal increases in competition in imagined markets, rather than on overall economic efficiency and productivity.*

The first criterion for declaring a service – that declaration should promote a material increase in competition – represents a low hurdle. It is much less demanding than the equivalent tests envisioned by Hilmer or in clause 6 of the CPA. The Hilmer committee suggested the service should be mandated only where this was essential to bring about effective competition,<sup>7</sup> while the CPA noted that mandating the service should be necessary in order to permit effective competition.<sup>8</sup>

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<sup>3</sup> Commonwealth of Australia, National Competition Policy: report by the Independent Committee of Inquiry, AGPS, Canberra, 1993.

<sup>4</sup> Productivity Commission, Review of the National Access Regime, Report no 17, AusInfo, Canberra, 2001.

<sup>5</sup> Commonwealth of Australia, Australia’s Export Infrastructure Report to the Prime Minister by the Exports and Infrastructure Taskforce, Exports and Infrastructure Taskforce, Canberra, 2005.

<sup>6</sup> ABARE, *Australian Commodities*, 06.2 June Quarter, ABARE, Canberra, 2006.

<sup>7</sup> Parliamentary Research Service, *Research Paper Number 1 1994 National Competition Policy: Overview and Assessment*, Parliamentary Library, Canberra, 1994, appendix 4.

<sup>8</sup> National Competition Council, *National Competition Policy Agreements: Publications Compendium of National Competition Policy Agreements* (Second Edition 1998), Part I, Competition Policy Agreements, Competition Principles Agreement, clause 6, 1(b).

Using this relatively weak test of benefit, economies of scale may be thought to accommodate an access recommendation. For many infrastructure assets the assumption may be made that the cost of adding users is low once the asset has been established.

However, while most major infrastructure assets have high up-front costs and so benefit from economies of scale, many also suffer from diseconomies of scope. The requirement to guarantee access to a range of users with different incentives can dramatically reduce efficiency.

In this context, Rio Tinto points to the stark contrast between multi-user infrastructure used to export coal in New South Wales and Queensland (where major bottlenecks have developed) and the efficient export of iron ore in Western Australia.

Rio Tinto Iron Ore (RTIO) has made investments of nearly US\$5 billion since 2003 in expanding capacity in the Pilbara. An efficient and integrated system has enabled the business to respond well to the global growth in demand for iron ore, particularly from China.

Most industry analysts are predicting continued strong Chinese demand and forecasting that global seaborne iron ore shipments will need to grow by more than 860 million tonnes over the next 20 years in order to meet that demand. This represents an average increase in global production of 43 million tonnes per annum, in contrast to historical increases of around 4 million tonnes per annum.<sup>9</sup>

New expansion programmes will need to follow those currently underway, or Australia will lose market share to Brazil and India. This is a likely outcome if our single user facilities become multi-user facilities.

In the case of the Pilbara rail lines, the key inefficiencies of declaring private, integrated export-dedicated infrastructure relate to:

- Reduced throughput on existing lines, due to lost train slots, as a result of sub-optimal coordination (where optimal coordination relies on unilateral decision-making, whereas with a declared service all parties must engage in a negotiation);
- Delays in expansion of capacity, due to extended negotiations over what constitutes an optimal level of expansion to suit all users (where, for example, one user has a limited capacity to expand mine output in the near term and so has no interest in funding capacity expansion at that time);
- Opportunity cost of delaying introduction of improved technology, where technology must be adopted by all users but is economical only for users with larger scale volumes (one example of such a technology is faster locomotives);
- Permanent lost capacity, when expansion cannot be brought about at the right time to match upswings in demand, or with an acceptable risk profile.

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<sup>9</sup> Economic Evaluation of the Impact of Lost Iron Ore Production and Share, Port Jackson Partners report, April 2006.

These inefficiencies arise, in large part, because under mandated access, users have different and conflicting incentives.

The full integration of RTIO's Pilbara railway lines allows for sufficient volumes to be made available at port at all times. To achieve this, RTIO must run the system at above-average levels of throughput at certain times, to compensate for temporary changes in the level of demand.

A third party would have no incentive to seek throughput that was optimal for the owner of the rail assets, or to seek optimal investment in expansion, especially if that user was resource or capital constrained or had other factors affecting its decision making that differed from those driving the owner.

The fact that decisions over expansion will take the form of a quasi-commercial negotiation in itself implies increased delay, since parties will normally hold out for the best possible commercial outcome, given their own interests.

The potential for diseconomies of scope arising from the declaration of integrated rail assets in the Pilbara is, in fact, broad and varied. This submission has touched on a range of areas where diseconomies are likely to arise, but the issue has been treated at length in a range of contexts.

In spite of this, the NCC seems ready to recommend declaration under Part IIIA, but less ready to examine the potential for increases in cost. On one occasion, the NCC found that "the nature of diseconomies of scope makes qualitative analysis [of these diseconomies] speculative and controversial."<sup>10</sup>

This disinclination appears to stem from the legislation itself. There is only a weak requirement in the legislation to consider any unintended consequences that might come from mandating access. The last criterion is broad and somewhat vague. It requires only that access must not be contrary to the public interest.

The fact an existing investment can 'cope with' providing access to third parties does not mean mandating access will lead to efficiency gains. If the NCC is not required to consider the costs of mandating access (including indirect costs and diseconomies of scope), there is a real risk the Regime could lead to a net economic loss, even if it succeeds in promoting greater competition in some imagined markets (as, for example, has occurred in the NCC consideration of applications for access to the Pilbara railways, where markets such as the "rail haulage market" and the "iron ore tenements market" have been conceived because it is agreed by all that the real market – the iron ore market – is a fully competitive global market and will be unaffected by an access declaration).

*2. The application of Part IIIA focuses on the economic viability of sharing assets given an established asset base, but increased regulatory risk has an impact on the pre-investment stage.*

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<sup>10</sup> National Competition Council, Final Recommendation: Fortescue Metals Group Ltd application for declaration of a service provided by the Mt Newman railway line under section 44F(1) of the Trade Practices Act 1974, Melbourne, 2006.

Extending discretionary government control over private investments has consequences other than the impact on efficiency at the micro-level.

Looked at in retrospect, some successful mining projects may have withstood some degree of increased cost. But when investors contemplate a new project they lack the benefit of hindsight. Instead, they earn extra profits on some investments and make significant losses on others. They rely on the security of returns from successful investments as the basis for future projects.

As the Productivity Commission has highlighted, while some level of regulatory risk attends all investments, “the scale of investments in essential infrastructure, as well as the fact that, once in place, the assets are ‘sunk’, mean that regulatory risk can be a more critical factor in investment decisions and may sometimes deter projects.”<sup>11</sup>

Since changes under Part IIIA are limited to assets of national significance, declarations are likely to have a broad economic impact.

Over time, a significant increase in regulatory risk is likely to lead to a reduction in infrastructure investment. This may come precisely when the economy needs this type of investment most.

*3. While iron ore mining majors may seem to be doing well enough to withstand reductions in efficiency and/or increased levels of regulatory risk, this ignores the highly competitive nature of global iron ore markets, as well the large swings in cyclical demand that attend world commodity markets.*

Australia has maintained market share in world iron ore markets through sustained effort and constant innovation.

Key challenges to the Australian industry have included the opening of the Carajas mine in Brazil in the 1980s, as well as the need to improve reliability of supply significantly to meet expectations of our East Asian customer base through the 1980s and 1990s. Global competition for improved reliability of supply, particularly from Brazil, remains intense.

For these reasons, there is a significant risk to Australia’s export competitiveness that arises from government intervention to set prices and terms of access to private infrastructure assets.

As outlined above, new expansion programmes will need to follow those currently underway, or Australia will lose market share to Brazil and India.

While seeking to promote domestic competition and encourage entrepreneurial behaviour, the regulation risks reduce the capacity of Australian producers to export. This may have the effect of reducing demand for Australian product and Australia’s market share globally.

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<sup>11</sup> See Productivity Commission, Review of the National Access Regime, Report no 17, AusInfo, Canberra, 2001, p. xix.

## **Analysing the cost of the regulatory burden**

The cost of ineffective applications under Part IIIA can be broken into the general and the specific.

On a general level, the cost is likely to flow from increased risk attending investments, as outlined above. If the NCC is more likely than not to recommend an asset once a third party seeks access this will increase risk and reduce investment. While the ‘chilling effect’<sup>12</sup> on investment and innovation may seem more marked in times of cyclical downturn, step-wise expansion in mining capacity relies critically on higher prices in good times.

In terms of specific cost, it has been estimated by consultants Port Jackson Partners<sup>13</sup> that Australia could lose up to A\$43 billion in export revenues and A\$13 billion in capital investments over the next 20 years through delayed or abandoned capacity expansions, if third party access was imposed on mine to port rail infrastructure in the WA iron ore industry.

Economic modelling by the Centre for International Economics suggests an annual loss of \$1.5 billion, of the order of \$20 billion over twenty years in net present value terms.<sup>14</sup>

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<sup>12</sup> See Productivity Commission, *Review of the National Access Regime*, Report no 17, AusInfo, Canberra, 2001, p. xix.

<sup>13</sup> Economic Evaluation of the Impact of Lost Iron Ore Production and Share, Port Jackson Partners report, April 2006.

<sup>14</sup> Centre for International Economics, National Competition Policy Access Regimes and the National Interest The case study of Pilbara iron ore, prepared for Rio Tinto, March 2006.