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CONFIDENTIAL

5 August 2013

ATTENTION: LYNDON ROWE

The Chairman
Economic Regulation Authority
PO Box 8469
PERTH WA 6849

Dear Mr Rowe

As you would be aware, in May 2013, the Productivity Commission released its Draft Report on the National Access Regime (**Draft Report**).

We **enclose** a copy of the submissions made to the Productivity Commission by BHP Billiton dated 12 July 2013 and Rio Tinto Iron Ore dated 5 July 2013 in relation to the Draft Report. These submissions highlight the significant costs and risks to railway owners associated with third party access, including:

- Loss of flexibility in, and efficiency of, operations and the consequential reduction in effective capacity;
- Additional maintenance, compliance, regulatory and administration costs;
- Cost of unplanned congestion and delays;
- Costs of delays to future expansion;
- High likelihood of disputes and the costs of litigation and adjudication; and
- Reduction in investors' ability to make productive use of their investment.

Further to the submissions made to the ERA by The Pilbara Infrastructure Pty Ltd (**TPI**) and Fortescue Metals Group Limited (**Fortescue**) on 4 July 2013 under section 10 of the *Railways (Access) Code 2000* (**Code**), the recent submissions by BHP Billiton and Rio Tinto to the Productivity Commission independently substantiate that there are real and significant costs of third party access that the ERA must take into account in exercising its powers under section 10 of the Code. A failure by the ERA to have regard to this material and the submissions of TPI and Fortescue of 4 July would of course be contrary to section 20(4) of the *Railways (Access) Act 1998*. Clearly these submissions are factual material relevant to the issues before the ERA, which the ERA must have regard to.

TPI expects the right to comment on preliminary views of the ERA in relation to Brockman Iron Pty Ltd's proposal for access to TPI's railway, particularly if such preliminary views of the ERA are contrary to either the submissions made by TPI or Fortescue, or are contrary to the material contained in the submissions of BHP Billiton and Rio Tinto to the Productivity Commission.

Yours sincerely

SPENCER DAVEY
Commercial Compliance Officer

National Access Regime Review –
Rio Tinto Iron Ore Submission in Reply to the
Productivity Commission Draft Report
5 July 2013

1. Introduction

1 Rio Tinto Iron Ore (***RTIO***) is the division of the Rio Tinto Group which has responsibility for Rio's global iron ore interests, including its iron ore mines and the rail and port infrastructure servicing these mines in the Pilbara, Western Australia.

2 RTIO previously made a submission addressing the Productivity Commission's Issues Paper of November 2012, focusing upon sections 44G(2)(b) and 44H(4)(b) of the *Competition and Consumer Act 2010* (***CCA***) (***criterion (b)***), and the role of the Australian Competition Tribunal (***the Tribunal***).

3 This submission responds to the Productivity Commission's Draft Report of May 2013 (***the Draft Report***). It addresses:

(i) the need to reinforce the production process exception, so that the exception can operate as an effective gate keeper against inappropriate applications;

(ii) the reasons why a private profitability test for criterion (b) is workable, conducive to productive efficiency gains, and most consistent with fostering competition;

(iii) the need to take all relevant costs into account under any natural monopoly interpretation of criterion (b);

(iv) the need to amend sections 44G(2)(a) and 44H(4)(a) of the CCA (***criterion (a)***) to clarify that access by declaration is focused upon the promotion of economic efficiency; and

(v) the reasons why existing safeguards in section s 44W of the CCA need to be maintained, particularly in light of any ACCC power to order expansions of infrastructure.

2. The production process exception

4 RTIO is well placed to comment upon the production process exception, as its Hamersley railway was the subject of a declaration application in August 1998 which was ultimately found to fall within the exception,[1] and RTIO intervened in proceedings concerning BHP Billiton Iron Ore (***BHPBIO***) rail facilities in 2008 which addressed the availability of the exception.[2]

5 Section 44B of the CCA defines the type of service that is capable of being declared open to third party access. It expressly carves out from the definition the use of a production process, except to the extent it is an integral but subsidiary part of the service in question.

6 'Production process' in this context has been interpreted to mean 'the creation or manufacture by a series of operations of some marketable commodity'.[3]

7 When the High Court considered the application of the production process exception to BHPBIO's Pilbara railways in 2008, it adopted a construction of section 44B which has effectively neutered the exception.

8 The High Court found that BHPBIO's use of its rail tracks and associated infrastructure was integral to the series of operations that constituted its production of iron ore stockpiles for sale.

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[1] See *Hamersley Iron Pty Ltd v National Competition Council* (1999) 164 ALR 203.

[2] These proceedings culminated in the High Court decision of *BHP Billiton Iron Ore Pty Ltd v National Competition Council* (2008) 236 CLR 145 (***BHPBIO v NCC***).

[3] *BHPBIO v NCC* at [37].

Accordingly, it accepted that BHPBIO's use of its railway amounted to use of a production process within the meaning of the CCA.

9 However, the High Court concluded that Fortescue was not seeking to use a service that amounted to a production process *vis-à-vis Fortescue*, stating 'What Fortescue seeks is the use of a facility that BHPBIO uses for the purposes of its production process.'[4] The Court was influenced in this regard by the fact that Fortescue was only seeking access to the service constituted by the use of below rail infrastructure, and was not seeking use of BHPBIO's rolling stock or to add its iron ore to BHPBIO's trains.[5]

10 BHPBIO had argued that, as Fortescue was seeking access to the same service (use of rails, train control systems, signalling systems and communications systems) which BHPBIO provided to itself as part of its production process, this meant that Fortescue was effectively seeking access to a service that amounted to use of a production process. It contended that the fact Fortescue would be using the rail lines for its own purposes rather than for the purpose of conducting BHPBIO's production process was 'not relevant to the characterisation of the service.'[6]

11 The High Court observed that the construction advanced by BHPBIO was not 'untenable', but it preferred the more restrictive construction identified above on the basis that it was 'more appropriate to advancing the overall objectives of Part IIIA…'[7]

12 However, the impact of the distinction adopted by the High Court – that services that are used by the facility owner as a production process will not attract the exception unless access to the 'process' is sought (as distinct from access to the infrastructure used by the incumbent in its production process) – means that the exception is unlikely ever to apply.

13 This means that facility owners using infrastructure as part of their own integrated business operations are at risk of having third party use interposed, even where the facility is acknowledged to be an integral part of the owner's production process.

14 This defeats the purpose of having a production process exception. Moreover, such a construction does not align with the 'efficiency' objective identified in section 44AA, which was introduced in 2006 (but which was not considered by the High Court in the context of Fortescue's 2004 declaration application).

15 The inefficiencies that the exception seeks to avoid arise from interference in a firm's production process through third party use of infrastructure that is integral to an incumbent's production process. The exception needs to operate as an effective gate keeper to ensure that regulation does not unduly interfere with an incumbent's own means of production, given the high inefficiency costs and investment disincentives such interference causes.

16 In the Draft Report, the Productivity Commission observes that the production process exception 'provides a useful initial filter for the obvious cases where coordination costs will exceed any competition benefits'.[8] However, the exception currently does not provide this filter.

17 The Productivity Commission also observes in the Draft Report that amendment to the exception is not necessary because coordination costs can be assessed under criterion (b), on the assumption that modifications suggested by the Commission to criterion (b) are adopted.

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[4] *BHPBIO v NCC* at [41].

[5] *BHPBIO v NCC* at [40].

[6] *BHPBIO v NCC* at [38].

[7] *BHPBIO v NCC* at [42].

[8] Draft Report, p.150.

This is not a compelling reason to avoid changes to the exception so that it achieves what was originally intended. Even if the Commission's suggested amendments to criterion (b) are accepted, it is still important that the production process exception works effectively to exclude inappropriate applications at the outset and to avoid wasted time and resources arising from unnecessary analysis of the declaration criteria. Further, if the Commission's suggested amendments to criterion (b) are not accepted (with the additional requirement that *all* costs be addressed under criterion (b), as discussed below), then consideration of all of the diseconomies and costs flowing from the use of a facility that is integral to the incumbent's production process may not be adequately provided for anywhere in the regime.

18 In light of the High Court's interpretation of the production process exception, it is necessary to amend the exception to make it clear that 'service' excludes the use of infrastructure, or a significant part of infrastructure, which is '*used as an integral part of a production process by the facility owner or access provider*.'

3. A private profitability test for criterion (b) is workable, conducive to productive efficiency gains, and most consistent with fostering competition

19 In the Draft Report, the Productivity Commission suggests that the private profitability test, recently endorsed by the High Court as the appropriate test for criterion (b), would be difficult to apply because it involves decision-makers having to estimate uncertain measures such as costs, prices, demand, capacity, and required rates of return.[9]

20 Such difficulties are overstated. These kinds of assessments, including assessments about future prices, are routinely made when a private sector entity makes an investment decision. As the High Court observed, the question of whether it would be economically feasible to develop an alternative facility, involving as it does the making of forecasts and the application of judgment, is '*a question that bankers and investors must ask and answer in relation to any investment in infrastructure. Indeed, it may properly be described as the question that lies at the heart of every decision to invest in infrastructure, whether that decision is to be made by the entrepreneur or a financier of the venture*'.[10]

21 Indeed, forecasts of many of these factors – costs, demand and capacity – are inevitably involved in the application of the proposed alternative natural monopoly test as well.

22 Furthermore, it is much less likely that there will be occasions where market evidence is readily available to demonstrate whether or not the natural monopoly test is made out, compared to the private profitability test where public announcements, internal company assessments, external reports, and actual construction, are routine and readily available to provide real world indicators of whether the private profitability test can be satisfied.

23 The Productivity Commission also expresses a view in the Draft Report that the private profitability test is less likely to result in productivity efficiency gains than a form of natural monopoly test.[11]

24 This concern appears to be based on the premise that, where a facility is privately profitable to duplicate, the market cannot be relied upon to ensure access is granted where that would be a lower cost option than having a duplicate facility built.

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[9] Draft Report, p.163.

[10] *The Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* (2012) 246 CLR 379 (***TPI v Australian Competition Tribunal***) at [106].

[11] Draft Report, p.158.

25 This premise is erroneous. As was pointed out during the Pilbara rail access proceedings by Professor Willig, Professor of Economics and Public Affairs at Princeton University, the purpose of the private profitability test is not to decide whether there should be one facility or two, it is to decide how the decision of sharing or duplication will be made – via private negotiation or regulatory intervention. Where duplication is feasible, the parties will have the incentive to reach the least cost arrangement, and the parties are far better placed to make this assessment than a regulator.[12]

26 Where privately feasible entry is possible, the facility owner and the access seeker will both have an incentive to find the solution that is least cost to them. The facility owner will assess whether it is less costly for it to provide access and offset some of its potential losses raised by new entry through access fees, or to face the threat of an alternative facility being constructed that may have technological and other efficiency and cost advantages over it. The access seeker will assess whether it is less costly for it to utilise the incumbent's facility at the access fees that can be agreed, or to construct (or have constructed) its own facility which it can control and may possibly be able to use to more effectively compete with the incumbent. These market participants have superior information to a regulator, they are far better placed to assess the costs to themselves of sharing versus duplication than a regulator would be in a declaration process.

27 Accordingly, the private profitability test is a more reliable indicator of whether duplication is feasible (and hence a deal will be done if it is lower cost than duplication, or a deal will not be done and duplication will result with ensuing facilities-based competition), or whether duplication is not feasible and so market forces cannot be relied upon to produce the most efficient outcome. It is only in circumstances where market forces cannot be relied upon to ensure the most efficient outcome that regulatory intervention is justified.

28 RTIO therefore believes that the private profitability test is in fact preferable from a productive efficiency point of view to the alternative constructions, because it relies upon the better informed market players rather than regulators to assess the true costs of access versus duplication.

29 Finally, RTIO endorses draft finding 3.1, in which the Productivity Commission articulates a key principle underpinning the design of access regulation:

> In markets where two or more infrastructure service providers are able to provide the same service (or an effective substitute service), allowing competition between providers will generally be preferable to access regulation because regulation in such markets could reduce welfare.
>
> Access regulation is most likely to provide net benefits to the community where there is monopoly provision of infrastructure services.[13]

30 Of the various alternative interpretations put forward for criterion (b), the private profitability test best reflects this principle.

31 The Productivity Commission has sought to formulate a version of the natural monopoly test that is also consistent with this principle, explaining: 'By taking into account total market demand, criterion (b) could preclude declaration of services that face meaningful competition from other facilities – effective duopolies or oligopolies. …allowing competition between two or more competing infrastructure service providers will generally be preferable to access regulation.'[14]

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[12] See oral testimony of Professor Robert Willig during the Pilbara rail access proceedings before the Tribunal, 3 November 2009.

[13] Draft Report, p.80.

[14] Draft Report, p.167.

32 However, even taking all market demand into account, a natural monopoly formulation still allows for the possibility that criterion (b) can be satisfied, potentially leading to regulatory intervention, where there is actual duplication of infrastructure and facilities-based competition is occurring. Only the private profitability test ensures that competition between providers will be given preference over regulation, by enabling - where it exists - real world evidence of actual competition between providers to be taken into account.

33 Further, in terms of potential duplication, the private profitability test ensures that where the development of an alternative is viable, the incentives set by Part IIIA will facilitate the development of facilities-based competition. By contrast, a natural monopoly type test sets disincentives to profitable duplication, encouraging potential new entrants to instead 'roll the regulatory dice' to see if a favourable deal will be mandated.

34 RTIO therefore urges the Productivity Commission to reconsider its proposed move away from the private profitability test.

4. All relevant costs need to be taken into account under any natural monopoly test for criterion (b)

35 In the Draft Report, the Productivity Commission has suggested an alternative construction of criterion (b) to the various interpretations adopted by the NCC, the Tribunal and the courts since Part IIIA's introduction. RTIO believes that the current private profitability test is the correct construction for criterion (b). However, if a natural monopoly test of the kind currently contemplated by the Productivity Commission is ultimately to be recommended, RTIO believes it should take into account *all* of the costs associated with meeting market demand using one facility.

36 An inclusive approach to costs is supported by economic principle, and is also far easier to apply as a matter of practice.

37 The Productivity Commission's proposed test relies upon categorising the costs that arise from mandated sharing of infrastructure said to include costs under the following headings:

- 'Additional maintenance costs';
- 'Costs arising from reduced operational flexibility': including scheduling costs from increased use of infrastructure, associated loss of flexibility in the management of the facility owing to the contractual rights held by a third party, and coordination problems between different users of the infrastructure – for example, in relation to the scheduling of train paths;
- 'Costs arising from problems with coordinating investments': covering investments aimed at improving the operation, or expanding the capacity, of infrastructure, including investments or innovations that are unexploited, delayed, mistimed or otherwise sub-optimal.[15]

38 In terms of economic principle, the proposal to exclude costs associated with coordinating investments from consideration under criterion (b) on the basis that these costs are 'dynamic in nature and while potentially significant, are unlikely to relate to a given level of foreseeable demand, which is what a natural monopoly test is focused on',[16] is misconceived.

[15] Draft Report, pp.108-109.

[16] Draft Report, p.168.

39 It is no answer to say that some of the costs that arise from sharing of infrastructure should be excluded because natural monopoly tests have not traditionally included such categories of cost. Natural monopoly tests do not traditionally focus upon the question of competitors sharing a facility *at all*. Natural monopoly tests arise in the context of an industry or market, focusing upon whether *one firm* can meet total market demand at a lower cost than two or more firms.[17] Assessing whether or not an industry is a natural monopoly is determined by assessing whether or not the cost function of supply across the industry is subadditive. As Professor Willig, Professor of Economics and Public Affairs at Princeton University, has observed, the classic natural monopoly test is 'not about a sharing arrangement.'[18]

40 If an adaptation of the classic economic test for natural monopoly is to be applied to address the distinct scenario of whether a facility owned by a firm can be shared with other firms to meet all demand at less cost than multiple firms using multiple facilities, the adapted test needs to reflect the circumstances of this different scenario – namely that multiple firms sharing a single facility will give rise to a range of costs.

41 The question of what categories costs should be taken into account under a natural monopoly type test adapted to criterion (b) was examined at length by the economic experts in the Pilbara rail access proceedings.

42 Professor Ordover provided the following opinion:

> “engineering” costs generally will underestimate the costs that will have to be incurred by the incumbent firm if it is required to provide access. That is, the costs of moving a particular quantity of iron ore (for example) produced in the incumbent’s mines to the incumbent’s storage and processing facilities will differ materially from the costs of moving the same aggregate tonnage that originates partly from the mines of the incumbent and partly from the mines of the access-seeker (or a third party). In particular, line sharing may result in loss of effective capacity on the line due to inefficiencies resulting from the need to coordinate shipments from different users. There may also be additional costs – such as unplanned congestion and delays – that cannot be fully accounted by each party but which nevertheless are “real” and which impose a burden on the incumbent firm (but also on the access-seeker). And there will be costs incurred by the managements of both firms in designing contracts, coordinating schedules, resolving disputes, and so on. …. **If a natural monopoly test is to be applied, it is essential that these costs are taken into account (as well as the direct engineering type costs)** when assessing whether it is cheaper to have one facility, rather than two facilities, service the foreseeable demand.[19] (emphasis added)

43 Professor Gans, Professor of Management (Information Economics) at the University of Melbourne, who appeared on behalf of the access seeker in the proceedings, also provided an expert opinion that a broad range of costs should be taken into account. Professor Gans opined that a facility will be uneconomic to duplicate if the revenue of access seekers from using the provider's facility less the full cost of access (*including coordination costs, opportunity costs and additional capital costs*), is greater than the revenue of access seekers from using the other facility less the costs of using and developing that facility.[20]

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[17] See, for example, Kahn, A, *The Economics of Regulation: Principles and Institutions*, Volume II (1988) 119; Sharkey, W, *The Theory of Natural Monopoly* (1982) 54; Posner, R, *Natural Monopoly and its Regulation*, (1999), p.1; Panzar, J, 'Technological Determinants of Firm Structure and Industry Structure' in Shmalensee, R and Willig, RD (ed), *Handbook of Industrial Organization*, Volume 1 (1989)3, 24. See also *Re Services Sydney Pty Limited* [2005] ACompT 7 at [102].

[18] Oral testimony of Professor Robert Willig during the Pilbara rail access proceedings before the Tribunal, 3 November 2009.

[19] Expert report of Professor Janusz Ordover, provided during the Pilbara rail access proceedings before the Tribunal, 3 July 2009 at p.7.

[20] Second expert report of Professor Joshua Gans, provided during the Pilbara rail access proceedings before the Tribunal, 21 August 2009 at [50].

44 When the Tribunal explicitly asked whether a natural monopoly test under criterion (b) should be confined to a limited range of costs and should exclude the diseconomy and inefficiency costs that arise from sharing, all of the economic experts to whom the question was put rejected such an approach. For example, Dr Williams, Executive Chairman of Frontier Economics Pty Ltd, observed:

> If you put things together you have extra costs, like coordination costs, then they are relevant to the test of natural monopoly, because natural monopoly is defined as when the function over its length is sub-additive, that is, when it's cheaper to do it all together than – than the sum of them when they're separate. So it seems to me quite improper not to take into account anything that makes it more expensive or less expensive when you do it all together than the sum of the costs when you do it separately.[21]

45 Similar discussions followed between the Tribunal and various of the other economic experts, such that when the Tribunal posited a version of the natural monopoly test that hived off the diseconomy costs of sharing to criterion (f), each of the economists to whom the proposal was put rejected it.[22]

46 In summary, there is no basis for recommending that all the types of additional costs that flow as a result of adapting the natural monopoly concept to a shared facility should not be taken into account. It would be artificial, and distort the purpose of the exercise, to include only some of the costs that arise from sharing in the cost comparison under criterion (b), but not others.

47 As a practical matter, drawing a distinction between broadly described categories of cost that arise from sharing of the facility that can be taken into account under criterion (b), and a broadly described category of costs that also arises from mandated sharing but is instead required to be assessed as part of the public interest under criterion (f), raises significant issues. Such an unnecessarily complex approach is likely to lead to confusion and give rise to protracted debate (and litigation) over categorisation of costs and the criteria under which they should be considered. This would distract from the important issues requiring analysis in declaration applications and result in unnecessary disputes and delay.

48 A large range of costs likely to arise from mandated sharing were identified in the Pilbara rail access proceedings, including:

- loss of flexibility in, and efficiency of, operations;
- coordination costs;
- loss of throughput;
- delays to technological developments;
- delays to changes to operational methodologies;
- delays to expansion which will necessarily arise as a result of consultation, negotiation and coordination with multiple users;
- disincentives to invest optimally;
- high likelihood of disputes;
- loss of facilities-based competition.

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[21] Oral testimony of Dr Philip Williams during the Pilbara rail access proceedings before the Tribunal, 5 November 2009.

[22] For example, the oral testimony of Professor Joshua Gans during the Pilbara rail access proceedings before the Tribunal, 3 November 2009; oral testimony of Dr Vincent Fitzgerald during the Pilbara rail access proceedings before the Tribunal, 3 November 2009; oral testimony of Dr Philip Williams during the Pilbara rail access proceedings before the Tribunal, 5 November 2009. In principle, Dr Aleksandr Sundakov's evidence was also that he would take all social costs into account, e.g. Expert report of Dr Aleksandr Sundakov, provided during the Pilbara rail access proceedings before the Tribunal, 7 August 2009 at [42.2].

49 Various economic experts gave evidence about the types of costs likely to arise from mandated sharing of the railway lines, including Professor Willig who identified the following costs:

- the costs of building the physical access or interface to the facility;
- conflicts and disagreements over priorities for expansions and changes in facilities operation;
- administration and regulatory costs of access sharing;
- litigation, regulatory compliance and adjudication costs associated with any conflicts that may arise from shared access;
- reduction in investment, maintenance and upkeep of a facility as a result of mandated facility sharing;
- costs of diminished output capacity and diminished optimization of facility operations;
- misallocation of resources attributable to mandated access as opposed to allocation based on market prices and supply/demand conditions;
- loss of potential competition between facilities if an access seeker built its own facility in the absence of mandated sharing;
- dynamic inefficiencies from reduced incentives to build new facilities or invest in new technologies.[23]

50 Professor Gans also identified the following broad range of costs as likely to be incurred:

- technical costs;
- costs caused by access to a shared facility that will not arise in duplication such as augmentation costs and coordination costs where there is insufficient capacity;
- economic costs such as lost profits to the incumbent where their demand is displaced by the access seeker;
- investment costs;
- loss of efficiency costs; and
- operational costs.[24]

51 Within this range, it is evident that there is ample scope for dispute about which category any particular cost will fall into.

52 For example, interpretation issues will almost certainly arise in trying to categorise costs of the additional infrastructure needed to redress diminished output capacity. In the Pilbara rail access proceedings, there was evidence of very significant infrastructure costs that would need to be incurred to accommodate multiple users on the railway lines for any given level of tonnage. For example, for additional third party tonnage of ≤10 million tonnes per annum (***mtpa***) on RTIO's railway lines, an additional 1 to 2 third party train sets (known as 'consists') would be required, and an additional RTIO consist might also be required compared with the position if there were two independent rail lines (which would naturally be less congested). For additional third party tonnage of 20 mtpa, an additional 2 to 3 third party

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[23] Expert report of Professor Robert Willig, provided during the Pilbara rail access proceedings before the Tribunal, 30 June 2009 at [42].

[24] Oral testimony of Professor Joshua Gans during the Pilbara rail access proceedings before the Tribunal, 3 November 2009 and second expert report of Professor Joshua Gans, provided during the Pilbara rail access proceedings before the Tribunal, 21 August 2009 at [50].

consists would be required and for the Hamersley line (though not the Robe line), an additional 1 to 2 RTIO consists would be required. As consists cost in the region of $56 million to $105 million each,[25] the costs of additional consists alone (i.e. over and above the consists required if there were separate facilities) would be in the hundreds of millions of dollars.

53 However, this above rail solution of running extra trains is only one way to address the issue of displaced tonnages; below rail expansions or modifications could also be made to reduce the impact on throughput. For example the interconnection mode could be by way of fly overs, which could cost in the hundreds of millions of dollars, but result in much less disruption than would flow from a classic junction system. The Tribunal found that adding extra consists would increase congestion, and accordingly there would be diminishing marginal returns from adopting the 'extra consist' approach as the sole means of reducing the effect on throughput. When a rail line reaches economic capacity, the marginal return of adding a consist would be less than the marginal cost, and so the Tribunal found that at this point it would then be necessary to undertake below rail expansions to increase throughput in addition to adding consists.[26]

54 Clearly it would be unworkable in this scenario to try to distinguish between costs that might be characterised as 'problems with coordinating investments' (on the basis that they involve a below rail solution of improvements to operations or expansions), which the Commission suggests be considered under criterion (f), from costs which might be regarded as 'additional maintenance costs' or 'reduced operational flexibility' (if above rail solutions are implemented by way of additional consists and scheduling). Absurdly, where a combined above rail and below rail solution is assessed, if the Commission's approach were adopted, part of the costs would be considered under criterion (b), whilst part of the costs would be carved off to criterion (f), whereas if a purely above rail solution was considered, all costs could be brought within criterion (b). That is, whether or not criterion (b) is satisfied could be arbitrarily dependent upon the view the NCC, designated Minister, or Tribunal takes as to how an infrastructure owner should elect to address displaced throughput in any given scenario.

55 It is also evident that a number of the costs identified in the Pilbara rail context (for example, loss of facilities-based competition) do not fit neatly into the categories posited by the Productivity Commission, leaving scope for protracted debate over where such costs should be taken into account.

56 Moreover, the wide range of costs identified in the context of the Pilbara's rail infrastructure will not be the same costs that arise from mandated sharing of other types of infrastructure with different forms of ownership and use. It is impossible to envisage every type of cost that may arise from mandated sharing across the universe of infrastructure that may be brought within Part IIIA, let alone to ensure specific categories of costs are sufficiently described to enable a clear view to be taken of which category each cost falls into and under which criterion they should be considered.

57 An additional issue that arises from the proposed natural monopoly test's narrow approach is that costs that clearly arise from mandated sharing could be subject to very different levels of assessment, depending upon whether they are to be considered under criterion (b) or criterion (f).

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[25] In the Pilbara rail access proceedings, Fortescue estimated that a consist would cost $56 million. RTIO estimated that the cost of an additional consist would be $105 million, comprising $65 million for the consist, $20 million for additional operating costs and $20 million for extra maintenance.

[26] *In the matter of Fortescue Metals Group Limited* [2010] ACompT 2 (30 June 2010) (***Fortescue***) at [971]-[972].

58 In light of the High Court's finding that the Tribunal cannot 'lightly depart' from a designated Minister's assessment of the public interest under criterion (f),[27] the consequences of the suggested division of costs is that the relatively technical assessment of coordination costs of investment will be largely placed in the hands of the designated Minister. There will be the potential opportunity for some costs of sharing to be assessed in a detailed manner by technical experts in the Tribunal, whereas other costs that arise from sharing would only be subject to a detailed assessment by the Minister, who lacks the expertise and experience of the Tribunal, and has limited time to consider the matter and limited ability to call for clarifying material. There is no justification for introducing different treatment and a different level of scrutiny in respect of the various categories of cost that arise from sharing a facility.

59 It makes far more sense, both in terms of principle and practical application, to have technical matters like the true economic costs of providing access (including costs of coordination of investment) assessed together under criterion (b).

60 This division would still leave significant work for criterion (f), as consideration of broader public interest factors – such as environmental issues, security concerns etc. – not just the costs imposed by sharing a facility, would appropriately be considered here.

5. Criterion (a) should include an explicit efficiency test

61 As noted in the Draft Report, and as the Productivity Commission previously flagged in its 2001 review of the national access regime, the current formulation and interpretation of criterion (a) has the potential to set an inappropriate threshold for the grant of declaration.

62 RTIO agrees with the Productivity Commission's view that 'competition' in the context of criterion (a) is intended to be a proxy for more efficient outcomes. It also endorses the Commission's observation that 'competition can be an imprecise proxy for efficiency in some circumstances'.[28]

63 RTIO supports the Productivity Commission's proposed amendment to criterion (a), so that an assessment of whether this criterion is met is undertaken by comparing the status quo and declaration (rather than access). This comparison ensures that the test for whether regulatory intervention is needed is based on reality, and removes the artificial abstraction introduced by the Full Federal Court in 2006[29]. However, RTIO believes that this amendment alone is insufficient.

64 To ensure criterion (a) is focused upon improvements in economic efficiency, RTIO believes it should be amended to read: *'(a) declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service, and thereby result in an overall material improvement in economic efficiency.'*

65 There is little down side to being more explicit about the efficiency aims of criterion (a), and, rather than leading to 'interpretation issues' as the Productivity Commission suggests, this clarification would guard against possible misinterpretation by future decision-makers who are generally unwilling to read into a statute concepts that are not explicitly stated in the text (e.g. 'access' as meaning regulated access or declaration, the confusion over the meaning of 'uneconomical', the contrary interpretations of 'reconsideration'). A clear efficiency focus in

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[27] *TPI v Australian Competition Tribunal* at [112].

[28] Draft Report, pp.169 and 177.

[29] See *Sydney Airport Corporation Limited v Australian Competition Tribunal* [2006] FCAFC 146.

criterion (a) would contribute to greater certainty around how the criterion will be interpreted by various decision-makers.

66 Moreover, linking the promotion of competition in a dependent market to an overall material improvement in economic efficiency would enable decision-makers to disregard improvements in a purported market which has been identified by an applicant but which is minor or theoretical, where this impact would be outweighed by the inefficiencies generated by declaration in terms of higher prices and/or lower output in the dependent markets that are the actual focus of the declaration application. This resolves the problem that can arise where narrow, technical markets are artificially construed for the purposes of showing an improvement in competition in a purported field of rivalry, which thereby satisfies criterion (a), even though overall economic efficiency will not be materially enhanced by access through declaration in the field of actual competitive behaviour, which is the real focus of the application.

67 RTIO agrees with the views expressed by the Productivity Commission in Box 2 of the Draft Report, noting the following key observation in particular:

> Access regulation is unlikely to increase efficiency where the incumbent owner of infrastructure has no ability to affect prices — for example in downstream markets where prices are set by world commodity markets. In these circumstances, the incumbent owner would have a strong incentive (through the sharing of its fixed costs) to provide access to any capacity that will be unused for the foreseeable future, provided the access charges recover the full costs of use by the third party.
>
> ….
>
> In this example of a vertically integrated price taker, intervention to require access risks lowering efficiency and, in the long term, reducing investment in infrastructure.[30]

68 However, RTIO considers that the current regime risks allowing regulatory intervention in precisely these circumstances where access will in fact lower efficiency, because of the possibility of an applicant being able to construct a market where rivalrous behaviour will be promoted, regardless of how insignificant that market is overall and without any evidence that it will lead to lower prices or higher output.

69 By way of example, in the Pilbara rail access proceedings, the applicant put forward a market for haulage services for iron ore on each of RTIO's railway lines in the vicinity of the railway line as a relevant dependent market. The Tribunal found that, notwithstanding that declaration would have no impact on the market which was at the heart of the application – the global market for iron ore – criterion (a) was satisfied because potential consumers would benefit from being able to use RTIO's railway lines, and hence there was a promotion of a material increase in competition in those rail haulage markets. No consideration was given under criterion (a) to how access would impact upon the conduct of the potential consumers, or how access would affect overall industry performance or efficiency.[31]

70 The Productivity Commission asserts that a criterion (a) test focusing upon 'declaration' rather than 'access' would obviate the need for an efficiency override, as a 'declaration test' would not be satisfied where there is already effective competition in dependent markets. However, in the Pilbara rail access proceedings, while the Tribunal interpreted criterion (a) as incapable of satisfaction where effective competition already existed in a market, it nevertheless found criterion (a) was satisfied in respect of RTIO's railway lines because it would provide a benefit to potential consumers by way of more transportation choice in respect of a purported market for rail haulage.

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[30] Draft Report, pp.12-13.

[31] *Fortescue*, [1155]-[1159].

71 The history of criterion (a)'s interpretation by decision-makers demonstrates there can often be conflicting understandings of how the criteria should be applied and what thresholds they are intended to set, particularly where there is no express statutory language to make the aims of the criterion clear. If the Productivity Commission supports the view that the promotion of economic efficiency is the intended aim of criterion (a), it should recommend that the aim be made explicit to avoid further costly debate and misinterpretation.

6. Safeguards need to be maintained in respect of mandated expansions

72 Allowing the ACCC to order expansions of privately-owned infrastructure creates significant risks for facility owners, and will involve the ACCC making decisions for which it is ill equipped. The safeguards set out in section 44W to protect infrastructure owners' interests when their facilities are declared have always been recognised as an important and necessary aspect of the declaration regime, and take on a heightened significance where the regulator can mandate expansions.

73 There are two safeguards in particular that RTIO wishes to comment upon.

74 First, RTIO believes it is vital that the requirement that the ACCC not make access determinations that would result in a third party becoming an owner of part of a facility or an extension of a facility, without consent, is retained.

75 Interference in the ownership of nationally significant infrastructure is likely to have a major impact upon Australia's productivity. Accordingly, incursion into the ownership structure of a facility should only be undertaken where it is absolutely necessary. RTIO does not consider that any arguments have been made to demonstrate that access seekers require ownership of part/s of an access provider's facility in order for Part IIIA to function effectively.

76 Interposing multi-party ownership into a privately-held facility will create complex management issues, investment disputes and delays, and operational, maintenance and financing risks. Rather than facilitating the efficiency aims of Part IIIA, access determinations which could impose multi-party ownership would create significant inefficiencies.

77 By way of example, even simple matters such as the scheduling of maintenance works on different parts of the infrastructure owned by different parties would necessarily involve consultation, negotiation and coordination, with the potential for delays and increased costs (and possibly safety concerns). Causation disputes may arise where damage or delay occurs and the various owners dispute who is liable for repair, leading to delays in remedying the issue and resultant loss in productivity. Or more significantly, the terms on which the infrastructure owner is able to acquire finance could be detrimentally impacted by the imposition of a third party access seeker with a lower credit rating.

78 Such a power may also involve an expropriation of property by the ACCC, where part of a facility that was originally owned by a private firm, including the right to use the land on which the facility is situated, becomes the property of a third party. This raises legal as well as practical issues.

79 Secondly, RTIO believes it is vital to retain the requirement that the ACCC not make access determinations that would require the provider to bear some or all of the costs of interconnections to the facility (or of extensions or expansions to the facility).

80 Company boards are the most appropriate body, and are best equipped, to determine whether a company undertakes potentially significant capital expenditure, not the ACCC. In making a decision about whether to invest capital, a board will need to consider, amongst other things:

- whether the company can afford to make a particular capital investment. Would such expenditure result in the company being unable to pay its debts as and when due?;
- whether a particular investment will generate an acceptable return for shareholders given the likely rate of return and risk; and/or
- whether there are better alternatives available for investment (which could include return of capital to shareholders).

81 Capital expenditure decisions generally involve consideration of a wide body of information, analysis of multiple factors, and the weighing up of risks governed by the company's particular investment risk profile. The ACCC does not have the time, experience or expertise to undertake this task. More fundamentally, allowing the ACCC to require a company to invest in an expansion for the benefit of third parties would require the ACCC to usurp the board's proper functions, and interpose the ACCC into the management of the infrastructure owner's business. Part IIIA was never intended to involve such statutory intrusion into Australian businesses.

82 If the service provider could be required to fund any part of works mandated by the ACCC, the ACCC could potentially require a company to make an investment even where the board's view is that there are better options available for investment of shareholder money. It could also require an investment to be made at a rate of return the board believes is inadequate given the risks involved (which may be high, given revenues will depend upon an access seeker remaining financially viable and paying future access charges). It could even require an investment where the board thinks it cannot afford the investment, or that it would be financially imprudent and/or raise insolvency risks to make the investment.

83 Providing for the ACCC to become so involved in a company's decisions not only exposes the infrastructure owner to potential risks, but also raises issues for the ACCC.

84 It is not appropriate for the ACCC to make decisions for shareholders of companies about how and where their money is invested.

85 The way costs are dealt with under the current regime is appropriate, particularly given that section 44X enables the ACCC to take into account the value to the provider of extensions (and expansions) or interconnections whose cost is borne by someone else. This provides a sufficient avenue to set off any windfall the service provider might otherwise obtain through access fees and other terms and conditions.

86 The safeguards included in the access determination provisions to protect the interests of infrastructure owners whose facilities are declared have always been recognised as important and necessary. The Hilmer Committee recognised the importance of having provisions to ensure access did not unduly impede an owner's right to use its own facility, including any planned expansion of utilisation or capacity.[32] Most recently, the High Court in the Pilbara rail access proceedings observed that concerns that the exercise of private proprietary rights not be 'lightly' overridden by the national access regime were addressed by the safeguards set out in sections 44W and 44X for service providers against whom access is granted.[33] RTIO believes that these safeguards, and particularly the ownership and payment protections discussed above, are even more important in light of an ACCC power to mandate expansions and must be retained.

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[32] *Report by the Independent Committee of Inquiry into Competition Policy* (August 1993) (***Hilmer Report***), p.256.

[33] *TPI v Australian Competition Tribunal* at [173]-[174].

BHP Billiton
Submission to the Productivity Commission's Inquiry into the National Access Regime
12 July 2013

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1. EXECUTIVE SUMMARY

BHP Billiton welcomes the opportunity to respond to the Productivity Commission's Draft Report on the National Access Regime (**Regime**)[1].

The Commission's Draft Report makes an important contribution by clearly identifying those exceptional cases where access regulation may increase welfare, and other cases where access is unlikely to increase efficiency, and could reduce welfare.

However, the Commission has failed to conduct the first and most critical task referred for its inquiry: an analysis of the costs and benefits of infrastructure regulation. A rigorous, real world cost benefit analysis is vital to evaluating the Regime's impact on the national interest. Without it, the Commission cannot meaningfully address the overwhelming majority of its Terms of Reference (see Box 1), or propose reforms which would promote the national interest.

The Commission's failure to undertake this practical, evidence based evaluation is reflected in its theoretical analysis, and the inadequacy and impracticality of its key recommendations.

BHP Billiton urges the Commission to conduct a rigorous cost benefit analysis having regard to the actual, practical experience and evidence of the Regime's impact, before preparing its final report.

Failure to do so will be a missed opportunity to identify reforms that promote the national interest, and complete the critical review mandated by the Council of Australian Governments, and entrusted to the Commission.

2. OUTLINE OF SUBMISSION

This submission addresses the following matters.

- The Draft Report's valuable contribution to identifying when access may result in public benefits, and when it is unlikely to achieve any benefits.
- The critical importance of a full cost benefit analysis of access regulation.
- The information the Commission should have analysed more closely in conducting a cost benefit analysis, including information relevant to the Regime's impact on investment incentives.
- The Commission's failure to understand the practical reality and real world complexity of the impacts associated with infrastructure access, as shown in:
    - the Commission's proposal that declaration criterion (b) should be assessed using an entirely impractical and unsound "natural monopoly" test;
    - the Commission's inadequate analysis of whether the Regime should be amended to ensure that access declaration does not occur where access would impose extensive costs on tightly integrated and intensively utilised infrastructure;
    - the Commission's view that there is no need for overarching reform of the Part IIIA declaration process, even though Part IIIA decision makers currently lack the time, skills and resources to make well-founded decisions; and
    - the Commission's draft recommendation that the ACCC should have the intrusive and likely ineffective power to direct a provider to expand the capacity of its facility against its will.
- The Commission's specific questions about Part IIIA negotiation/arbitration.

[1] Productivity Commission, National Access Regime: Draft report, May 2013 (**Draft Report**).

Box 1 – Fulfilling many of the Terms of Reference requires a cost benefit analysis

Terms of Reference[2]	Cost benefit analysis
"In reporting on the Regime and the CIRA, the Commission is to: 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;	**REQUIRED**
b) the operation of the Regime relative to other access regimes, including its consistency with those regimes and the effectiveness of the certification process; and	Not essential
c) the roles of the National Competition Council, the Australian Competition and Consumer Commission and the Australian Competition Tribunal in the administration of the Regime, and the Minister as decision maker, and the relationship between the institutions;	**REQUIRED**
2. assess the performance of the Regime in meeting its rationale and objectives, including: a) the effectiveness of enhancements made to the Regime and the regulatory reforms agreed under COAG's National Reform Agenda; and	**REQUIRED**
b) how the Regime has been variously applied by decision makers, but not so as to constitute a review or reconsideration of particular decisions;	**REQUIRED**
3. report on whether the implementation of the Regime adequately ensures that its economic efficiency objectives are met, including: a) whether the criteria for declaration strike an appropriate balance between promoting efficient investment in infrastructure and ensuring its efficient operation and use; and	**REQUIRED**
b) whether the criteria for declaration are sufficiently well drafted in the legislation to ensure that its objectives will be met;	**REQUIRED**
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;	**REQUIRED**
b) measures to improve flexibility and reduce complexity, costs and time for all parties;	**REQUIRED**
c) options to ensure that, as far as possible, efficient investments in infrastructure are achieved; and	**REQUIRED**
d) 'greenfield' infrastructure projects and private sector infrastructure provision;	**REQUIRED**
5. review the effectiveness of the reforms outlined in the CIRA, and the actions and reforms undertaken by governments in giving effect to the CIRA; and	**REQUIRED**
6. comment on other relevant policy measures, including any non-legislative approaches, which would help ensure effective and responsive delivery of infrastructure services over both the short and long term."	**REQUIRED**

[2] Extracted from Draft Report, vi-vii.

3. THE DRAFT REPORT'S VALUABLE CONTRIBUTION

The Draft Report makes an important and insightful contribution by recognising that "only in exceptional cases should access to an infrastructure service be regulated"[3], and by identifying particular conditions under which access is not likely to promote welfare.

In particular, Draft Finding 3.1 states:

> In markets where two or more infrastructure service providers are able to provide the same service (or an effective substitute service), allowing competition between providers will generally be preferable to access regulation because regulation in such markets could reduce welfare.
>
> Access regulation is most likely to provide net benefits to the community where there is monopoly provision of infrastructure services.[4]

The Commission has also noted that "the potential benefits" from access regulation "come from addressing allocative inefficiencies for monopoly pricing or denial of access, and hence from facilitating lower prices for consumers."[5] Further, it has explained that "access regulation is unlikely to increase efficiency where the incumbent owner of infrastructure has no ability to affect prices – for example in downstream markets where prices are set by world commodity markets".[6]

This is vitally important, as it confirms sound economic principles:

- Where competition is possible, allowing competition is likely to deliver better welfare outcomes than access regulation (put another way: access regulation can reduce welfare when applied in situations where competition is possible). This is consistent with the policy underlying critical provisions of the national competition law framework established under the *Competition and Consumer Act 2010* (Cth) (**CCA**) (see Box 2).

- The purpose of access regulation is to facilitate allocative efficiency, not short term productive efficiency (ie access regulation should not be applied simply because granting access would avoid or discourage the duplication of existing facilities, in circumstances where access would not achieve any improvement in allocative efficiency).

- Where a business operates infrastructure to produce export commodities or other products which are sold into a competitive market, and cannot affect prices in that market, access to that infrastructure is unlikely to achieve the "potential benefit" of increasing allocative efficiency. This is precisely the situation presented by the applications for access declaration of BHP Billiton's and Rio Tinto's Pilbara iron ore railways. The Commission's analysis suggests that access would not deliver efficiency benefits and should not be imposed in those contexts.

The Commission has also proposed some beneficial reforms to declaration criteria (a), (e) and (f) (see Box 8 in section 7.4). Further, its draft recommendation that the Tribunal's merits review function be retained is an important endorsement of the importance of merits review under Part IIIA.[7] However the Commission's draft recommendations concerning the declaration criteria and process do not go far enough (see 7.4 and 8 below).

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[3] Draft Report, 2.

[4] Draft Report, 34.

[5] Draft Report, Box 2, 12.

[6] Draft Report, Box 2, 12.

[7] Draft Finding 9.1, Draft Report, 38. See also BHPB Submission, 8-12.

Box 2 - The preference for competition is well established in Australian law

The Commission's Draft Finding 3.1 reflects a well-established principle of Australian competition law and policy: that competition is to be preferred over monopoly, even when monopoly may be expected to achieve costs savings or other benefits.

This preference is highlighted by the prohibition of anticompetitive mergers and acquisitions under s 50 of the CCA.

In particular, a merger of two viable competitors[8] to create a monopoly is unlikely to be permitted under s 50, even if the merger would create a "natural monopoly", or would otherwise achieve cost reductions or other efficiencies that neither firm could achieve alone. Similarly, s 50 would be unlikely to permit creation of a monopoly even if the merged firm would be bound by court-enforceable undertakings to regulate the monopoly's ongoing conduct (ie, in a manner similar to regulated access terms).[9]

In reflecting this preference for competition over monopoly, the Commission's Draft Finding 3.1 interprets Part IIIA consistently with other critical elements of Australia's competition law framework.[10]

4. THE COMMISSION'S MOST IMPORTANT TASK: A FULL COST BENEFIT ANALYSIS

4.1 The Terms of Reference require a rigorous, fact based cost benefit analysis

The very first matter referred to the Commission requires the Commission to "examine the rationale, role and objectives of the Regime, and Australia's overall framework of access regulation", and comment on:

> 1(a) the full range of economic costs and benefits of infrastructure regulation, including contributions to economic growth and productivity.

Cost benefit analyses are critical to policy analysis, as recognised in the Commonwealth Government's Best Practice Regulation Handbook 2010,[11] and in Professor Allan Fels' submission to the Commission, which quotes the Commission's own statement that:

> In assessing the case for any regulation, the costs of intervention are an important consideration. Even if a regulation will have benefits, intervention will only be warranted if those benefits exceed the regulatory costs.[12]

The Commission appears to acknowledge as much: Box 1.2 in the Draft Report, which outlines general principles for assessing policy reforms, states: "the benefits of policy should outweigh the costs to the community as a whole", and "all effects of policy should be considered".[13] The Commission has also previously advocated cost benefit analyses: "appeals to nation building

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[8] In contrast, a merger to create a monopoly may potentially be permitted in the very special context of a "failing firm" – ACCC, Merger Guidelines, November 2008, [3.23].

[9] ACCC, Merger Guidelines, November 2008, Appendix 3, [20].

[10] The High Court has stated that "the primary object of statutory construction is to construe the relevant provision so that it is consistent with the language and purpose of all the provisions of the statute." (*Project Blue Sky Inc And Others v Australian Broadcasting Authority* (1998) 153 ALR 490, 509 [69]-[70] per McHugh, Gummow, Kirby and Hayne JJ). The object of the CCA is stated in s 2; that is, "to enhance the welfare of Australians through the promotion of competition and fair trading and consumer protection". Section 15AA of the *Acts Interpretation Act 1901* (Cth) states that in interpreting a provision of an Act "the interpretation that would best achieve the purpose or object of the Act (whether or not that purpose or object is expressly stated in the Act) is to be preferred to each other interpretation." It is entirely correct as a matter of law that Part IIIA should be interpreted consistently with s 50 of the CCA, as reflected in Draft Finding 3.1.

[11] Commonwealth Government, *Best practice regulation handbook*, June 2010, 26.

[12] Professor Allan Fels AO, *Submission to the Productivity Commission Inquiry into the National Access Regime*, March 2013, 38; Productivity Commission, *Review of the National Access Regime*, Inquiry Report No. 17, 28 September 2001, 59.

[13] Draft Report, 44 - 45. Also see the guidelines imposed on the Commission under the s 8(1)(c) of the *Productivity Commission Act* 1998: "In the performance of its functions, the Commission must have regard to the need… to encourage the development and growth of Australian industries that are efficient in their use of resources, enterprising, innovative and internationally competitive".

are no substitute for hard-headed analysis of benefits and costs".[14] The former Chairman of the Commission echoed this sentiment:

> Where private entities are considering investing large sums of money in infrastructure, their decisions will generally be based on a hard-headed assessment of the costs and revenue streams, and of the attendant risks. Yet … governments continue to base decisions on 'vision' or to achieve goals that are not subjected to rigorous, publicly tested analysis. [15]

A thorough, "hard-headed" cost benefit analysis should therefore properly underpin decision making about the future of the Regime.

4.2 The Commission has failed to conduct a cost benefit analysis

The Commission has acknowledged that "ideally, a rigorous cost-benefit analysis would be undertaken", and expressly quoted quantifiable evidence on the extensive costs of access (see Items 1-3 in Box 3). However the Commission described the task of undertaking a cost benefit analysis as "difficult", and did not attempt it.[16] Difficulty is no justification for omitting a cost benefit analysis.[17]

Box 3 – Quantifiable evidence on the costs of regulated access

1) A three month delay to Rio Tinto's iron ore expansions would result in costs in the order of $10 billion in lost export revenues and $4 – 6 billion in lost GDP. These delays could not be avoided by contractual or regulated terms, and average delays may be longer.[18] This conclusion by the Tribunal was based on extensive evidence from the three major Australian iron ore producers; it has not been questioned in the related legal appeals.
2) The rated capacity of the regulated Dalrymple Bay coal chain is 85 mtpa, but it has not delivered an annual outcome of above 64 mtpa.[19]
3) The ARTC's Hunter Valley rail network, which is regulated by a Part IIIA access undertaking, operates at 13 – 15% below contracted capacity.[20]
4) BHP Billiton has now also provided the Commission with evidence from the Pilbara rail access proceedings, given under affirmation by Mr Marcus Randolph, then Chief Executive, Ferrous and Coal for BHP Billiton. Mr Randolph testified that:
   a) the risk to BHP Billiton from third party access was the highest value item on BHP Billiton's internal risk register, and was valued at $7.9 billion.[21]
   b) BHP Billiton could "rebuild a completely independent railroad" for less than that amount, and had discussed spending $2 billion to do this, rather than incur the costs associated with access.[22]

[14] Productivity Commission, *Submission to Infrastructure Australia's National Infrastructure Audit*, September 2008, 9.

[15] Gary Banks, *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, 10.

[16] Draft Report, 11.

[17] See, in another context, the Commonwealth Government *Best Practice Regulation Handbook*, 2010, 11:

> "If the benefits are difficult to value does the [Regulatory Impact Statement] still need to have a cost-benefit analysis?
>
> Yes – even though it can be very difficult to place a monetary value on some factors, including environmental and social impacts. The cost-benefit analysis should recognise this and include a qualitative discussion of these impacts so that they can be compared with other impacts that can be more easily quantified."

[18] *In the matter of Fortescue Metals Group Limited* [2010] ACompT 2, [1265-1267,1296,1298]. Noted in Draft Report, 238.

[19] See BHP Billiton, *Submission to the Productivity Commission Inquiry into the National Access Regime*, 15 February 2013 (**BHPB Submission**), 4; Draft Report, 238.

[20] BHPB Submission, 21; Draft Report, 326.

[21] Transcript of oral evidence before the Australian Competition Tribunal, 17 November 2009, Mr Marcus Randolph, 2285.

[22] Transcript of oral evidence before the Australian Competition Tribunal, 17 November 2009, Mr Marcus Randolph, 2305.

4.3 **The Commission cannot usefully address its other Terms of Reference without understanding the full costs and benefits of the Regime**

Without a practical, real world evaluation of the evidence on the impact of access regulation, it is impossible for the Commission to respond meaningfully to other critical Terms of Reference, including Terms of Reference 2, 3, 4 and 6 (see Box 1).

4.4 **The Commission proposes that other Part IIIA decision makers should do this type of analysis, but provides no guidance on how to conduct this analysis**

Some of the Commission's key draft recommendations about the declaration criteria propose that Part IIIA decision makers should carefully estimate and evaluate the costs associated with access. This would require the NCC and Minister to consider additional maintenance costs and reduced operational flexibility caused by access, compliance and administrative costs associated with access, and "the effect of declaration on investment in markets for infrastructure services and dependent markets" (see Box 8).

The Commission has missed a vital opportunity to provide guidance to these decision makers about assessing the costs of access as required by the Commission's own draft recommendations, even though the Commission has had more time to do this analysis than Part IIIA decision makers would have when considering a declaration application in practice.

5. **THE COMMISSION HAS NOT EVALUATED ONE OF THE MOST CRITICAL COSTS OF ACCESS: INVESTMENT DISINCENTIVES**

5.1 **The Commission's basis for not evaluating investment disincentives**

Investment disincentives are a critical and well-recognised cost of access regulation. The Terms of Reference require the Commission to advise on how to "ensure that, as far as possible, efficient investments in infrastructure are achieved."[23] The Commission cannot address this requirement unless it understands how the Regime affects investment in practice. However, the Commission has not meaningfully evaluated this issue. It did acknowledge that access can affect investment incentives positively and negatively,[24] but then declined further evaluation on the ground that it lacked "conclusive empirical evidence".[25] In taking this approach, the Commission set the bar unrealistically high (ie "conclusive empirical evidence"), and declined to do the analysis because the evidence failed this artificial standard. In doing so, the Commission has given too little attention to the significance of the evidence before it (see Box 3), and relied too uncritically on untested and unproven assertions that regulation can "minimise" economic distortions and "promote" efficient investment (see Box 4).

The Commission is the pre-eminent body charged with assessing such matters. Its role is *precisely* to evaluate these issues, as reflected by the Terms of Reference and the former Chairman:

> … the very fact of exposure to price regulation — and the uncertainties this creates — can in itself deter investment. … The Commission has previously argued that the efficiency losses from setting regulated prices too low could generally be expected to be higher than from setting them too high. … That said, the proposition that there is an asymmetry in investment cost impacts has been contested **and the Commission will need to revisit this in its forthcoming review of Part IIIA**.[26] [emphasis added]

The Commission's choice not to address these issues rigorously, on the basis of the available evidence and its considerable expertise, seriously undermines the Draft Report.

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[23] Term of Reference 4(c), Draft Report, vii.

[24] Draft Report, 254. See also Table 3.1, Draft Report, 107.

[25] Draft Report, 15, 241-242 and 260.

[26] Gary Banks, *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, 14 – 15.

Box 4 - The evidence suggests that regulation cannot "minimise" the costs of access

The Australian experience suggests that access regulation does not minimise or avoid the costs associated with access. Professor Allan Fels, who has spent his career dealing firsthand with the benefits and shortcomings of regulation, made this point in a submission to the Commission.[27]

The Commission has acknowledged the existence of access costs and regulatory error …

The Draft Report acknowledges the evidence in points 1-3 of Box 3.[28] It also describes an experience concerning ARTC in the Hunter Valley,[29] where:

- ARTC considered that regulated prices determined by the ACCC provided an insufficient return to justify expenditure for a planned expansion;
- users voluntarily agreed to arrangements with ARTC which provided a higher return; and
- as a result, the investment proceeded because the parties abandoned regulated prices.

… but also appears to assume these costs and errors away.

However the Commission also makes statements which dismiss the experience with access – for example, it states that economic distortions from access "can be minimised" by regulation[30] and that "well designed and implemented access regulation can promote efficient investment".[31]

These statements are, at best, aspirational. They are not supported by the experience to date.

The Commission ought to address the clear quantitative evidence about the shortcomings of regulation, rather than relying on untested and unsubstantiated qualitative assertions

5.2 What does the evidence suggest about investment disincentives?

The fundamental question for a prospective investor is: "What do I get for my money?" For an investor in infrastructure, this means "How much can I *use* (or sell the use of) the facility?" For an investor in infrastructure associated with a mining project, this means "How much can I *produce* using the facility?" The value of an infrastructure investment is critically determined by the investor's ability to make productive use of the investment over its lifetime.

The prospect of access prevents an investor from answering this fundamental question with any certainty. The evidence before the Commission suggests that access delays expansions and results in capacity shortfalls (see Box 3) – ie, that access *reduces* investors' ability to make productive use of their investment. As explained in BHP Billiton's previous submission:

> An infrastructure owner facing the prospect of third party access does not know:
>
> - how much capacity will be allocated to third parties;
> - the size of the reduction in system capacity caused by regulated multi-user operations; or
> - what the access terms will be, or how they will impact on the infrastructure owner's business (For example: Will protection of the third party's confidential information require the owner to separate its rail operations from the rest of its business? What impact will access have on the owner's ability to undertake technological and operational improvements?).
>
> This uncertainty over the capacity which will be available to the infrastructure provider discourages and defers infrastructure investment; if access is granted, it may cause investments to be cancelled rather than simply deferred.[32]

[27] Professor Allan Fels AO, *Submission to the Productivity Commission Inquiry into the National Access Regime*, March 2013, Part 3 generally; see also BHP Billiton Submission, Annexure B, Part 3.5; and *In the matter of Fortescue Metals Group Limited* [2010] ACompT 2, [1242, 1265-1267].

[28] Draft Report, 238 and 326.

[29] Draft Report, 232.

[30] Draft Report, 234.

[31] Draft Report, 242.

[32] BHPB Submission, 29.

This uncertainty introduces an additional risk to the project, making the investment "more expensive". This will inevitably weigh on an investor's decision about whether and how much to invest in infrastructure. The Commission does not cite any evidence to suggest that access regulation can occur without giving rise to such uncertainty.

Box 5 – The impact of access on incentives to invest in infrastructure which may be declared

An investor is considering whether to invest $2 billion to build a single user railway which would initially transport 50 mtpa of iron ore. The $2 billion investment is designed so that it could be expanded to transport 60 mtpa in 5 years' time for minimal additional expenditure.

The investment is profitable, and the best use of the investor's funds, if the railway remains a single user facility.

The investor attempts to consider the impact of access on its investment, assuming:

- *that track access is declared 4 years after the railway is completed; and*
- *(optimistically) that access will result in a 15% capacity shortfall and delay the 10 mtpa expansion by 3 months.*

What production would the $2 billion investment deliver?		
	Never declared	**Declared from year 4**
Year 1	50 mt	50 mt
Year 2	50 mt	50 mt
Year 3	50 mt	50 mt
Year 4	50 mt	42.5 mt[33]
Year 5	60 mt	48.9 mt[34]
Years 6 - 20	60 mtpa	51 mtpa
Total	1160 mt	1006mt
Investment cost per tonne delivered	$1.72	$1.99

Box 5 presents a highly simplified example of how risks associated with access can impact on an investment decision. In this example, the investor makes assumptions about the impact of access, in an attempt to answer the question "What do I get for my money?" The results show that the investor can invest $2 billion to achieve 1160mt production (at a cost of $1.72 per delivered tonne) if the facility is not declared, or 1006 mt (at a cost of $1.99 per delivered tonne) if it is declared. In other words, if declaration occurs, the investor will have "paid more to get less" than if the facility remained a single user facility.

In practice, this could affect the investor's decision in the following ways:

- If the access-adjusted investment case (ie lower production, higher costs per delivered tonne) shows the investment is profitable and is the investor's best use of funds: **investment proceeds, but at higher cost and lower return**.
- If the access-adjusted investment case shows the investment is profitable but is no longer the investor's best use of funds: **no investment** (the investor may pursue another option, which may not involve infrastructure, or be based in Australia).
- If the access-adjusted investment case shows the investment is not profitable: **no investment**.

[33] Figures reflect a 15% capacity shortfall each year from year 4 (when declaration occurs).

[34] We have not included the minimal additional cost of the expansion in year 5 in the costings in this table; this is appropriate given the assumption that the expansion costs are significantly borne in the initial $2 billion investment, with small incremental cost in year 5. These figures reflect the assumption that the expansion to 60 mtpa is delayed by 3 months, so that expanded production scheduled for Q1 of year 5 is not achieved until Q2 of year 5; it also reflects the assumed 15% capacity shortfall, resulting in production of 10.625 mt in Q1 (ie (85% x 50 mtpa)/4) and of 12.75 mt in Q2, 3, and 4 (ie (85% x 60 mtpa)/4), producing a total of 38.25 + 10.625 = 48.875 mt.

- Even if the investment proceeds, the investor may seek to:
  - limit the declaration risk – eg, by reducing the size of the investment or cancelling the expansion, to avoid having "spare" capacity for access; or
  - postpone investing until the access risk is better understood – eg, by deferring the expansion until the declaration application is determined.

The best outcome is that the access risk increases the cost and lowers the return on investment, but the investment proceeds nonetheless; the other alternatives are that the investment is cancelled, deferred or reduced.

In practice, the investment decision in Box 5 would be further complicated, and the investor would be further deterred from investing, if the ACCC exercised a power to order the investor to expand their infrastructure to accommodate an access seeker. To take a simplified example, suppose the ACCC ordered the investor to expand capacity by 10 mtpa in year 4. In this situation:

- The provider would find itself in the midst of construction works to accommodate its competitor at precisely the time it intended to be expanding for its own business.

- The need to undertake expansion works in accordance with the ACCC's direction would delay the provider's own expansion, thereby further reducing the return (ie delivering fewer tonnes) on the provider's investment. This delay would be an inevitable consequence of the provider needing to negotiate/arbitrate with the access seeker about the complex issues raised by a mandated expansion (see Box 10 below), and address issues concerning the interaction of the mandated expansion with the investor's own expansion and operations.

- The provider may be required to construct the investment it had intended to use for its own purposes in order to accommodate its competitor. If this occurred, the competitor could effectively free ride on the investor's upfront investment, and make use of a "cheap" expansion option, forcing the investor to consider a more expensive expansion option instead. This could fundamentally change the economics of the investor's investment, and may deter or delay the investor's own expansion.

The practical issues associated with mandated extensions and expansions are addressed in Box 10 below.

6. THE "NATURAL MONOPOLY" TEST FOR CRITERION (B) IS UNWORKABLE IN PRACTICE AND UNSOUND IN PRINCIPLE

6.1 The Commission's Draft Recommendation 8.1

Declaration criterion (b) provides that a service can only be declared if "it would be uneconomical for anyone to develop another facility to provide the service". The High Court held that this test requires assessment of whether it is "privately profitable" to develop another facility.[35] However the Commission has made a draft recommendation that this criterion should be amended:[36]

> … such that criterion (b) is met where total market demand could be met at least cost by the facility. Total market demand should include the demand for the service under application as well as the demand for any substitute services provided by facilities serving that market. The assessment of costs under criterion (b) should include an estimate of the costs associated with additional maintenance and reduced operational flexibility imposed on the infrastructure service provider from coordinating multiple users of its facility.

6.2 The natural monopoly test is impractical

The Commission's proposed natural monopoly test would be highly impractical to apply and would create significant uncertainty about declaration outcomes.

The proposed test is not practical. A practical approach would be clear and straightforward to apply, and would rely on information and analysis which is used and understood by access seekers and infrastructure owners alike. The natural monopoly test does not meet that standard. The Draft Report does not even begin to answer the challenging questions that would need to be addressed in order to apply the natural monopoly test in practice (see Box 6). In contrast, the private test applies a "hard-headed", well-understood:

> question that bankers and investors must ask and answer in relation to any investment in infrastructure … *the* question that lies at the heart of every decision to invest in infrastructure, whether that decision is to be made by the entrepreneur or a financier of the venture.[37]

The proposed test does not provide certainty about declaration outcomes. The unanswered questions about how the natural monopoly test could be applied in practice (see Box 6), and the absence of any established industry analytical techniques to apply it, mean that the test confers a substantial discretion on regulatory decision makers. No access seeker could reliably predict whether this test will be satisfied (and hence whether the facility could be declared), since it requires a detailed understanding of the cost structure of the provider's facility, which will not be known to access seekers. An unpredictable test, based on a regulator's discretion and techniques and information which are unavailable to critical stakeholders, hardly provides certainty to those most affected by its application.

In contrast, the private test can be applied using information and techniques familiar to market participants. Predicting the outcome of the private test does not require hypothetical, abstract or unfamiliar analysis, or regulatory fact-finding. The private test asks precisely the question access seekers will typically consider when deciding whether to build infrastructure or seek access, and industry participants can readily predict the answer to that question.

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[35] *Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* [2012] HCA 36 (14 September 2012) at [159].

[36] Draft Recommendation 8.1, Draft Report, 36.

[37] Decision of the High Court of Australia in *Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* [2012] HCA 36 (14 September 2012) at [106].

Box 6: The natural monopoly test is unworkable in practice

There are critical questions about how the natural monopoly test could be applied in practice.

Essential issues	Questions unanswered by the Draft Report
What options are relevant to determine whether "total market demand" could "be met"?	The Draft Report **does not** provide any guidance on this point. • Does the test assess the capacity of the existing facility, or the capacity of the facility following potential expansions? • If the test assesses expansions, what options are assessed? ○ Capital investment in the facility (eg duplicating a section of rail)? ○ Operational changes to expand the facility (eg longer operating hours)? ○ Capital investment in infrastructure other than the facility, which expands the facility's capacity (eg faster train loading or unloading equipment)? ○ Only the "cheapest" expansion options (eg double tracking a flat section of track), or also more expensive options (eg building a new bridge)?
Does "cost" mean "actual cost"?	The Draft Report **does not** explain whether "cost" refers to the *actual* cost to the provider of accommodating demand in accordance with its standard practice. For example: • Does the test measure actual cost, or an alternative regulatory concept such as "efficient" costs? • In either case, does the test measure the cost of accommodating demand in accordance with the provider's design standards, or with the access seeker's standards? What if the provider's standards are necessary and efficient for the provider's operations, but more expensive than the access seeker requires?
What categories of "costs" are assessed?	The test requires an assessment of "least cost", including "the costs associated with additional maintenance and reduced operational flexibility." The Draft Report **does not** identify what time period is used to assess costs, or what other types costs must be assessed. For example, does the test consider: • A return on historical capital costs? A return on capital costs associated with expansions? If so, how will capital cost be converted to an "operating cost" to allow the natural monopoly test to be applied? • Opportunity costs? (If a "cheap" expansion option is used to accommodate demand, does the test assume the provider is compensated for having to use a more expensive option for its own needs in future, and assess that cost?) • Consequential loss? (If expansion works temporarily close part of the provider's facility and so delay or reduce production, does the test assume the provider is compensated for this loss and assess that cost?) • Inefficiency costs? (Mandated expansions will be less efficient than voluntary expansions – see Box 10 below. Does the test recognise or ignore these inefficiency costs?) • Social costs? (If the natural monopoly test is not the same as the "social test", which, if any, social costs are assessed under the natural monopoly test?)
What information and techniques can be used to assess costs?	The Draft Report **does not** explain what information or techniques can (or would) be used. • The test assesses costs as a function of quantity produced. Businesspeople routinely consider how costs change over time, but not how costs change with quantity *and* time. How does the test assess these variations? What about other cost variations (eg cost increases associated with "hot" market conditions)? • The Commission itself has not evaluated critical costs of access (eg lost flexibility and additional maintenance) – how would Part IIIA decision makers do this under the natural monopoly test?

6.3 The natural monopoly test is unsound in principle

Even aside from its impracticality, the natural monopoly test is flawed as a matter of principle.

The Commission's Draft Finding 3.1 rightly identifies that:[38]

> In markets where two or more infrastructure service providers are able to provide the same service (or an effective substitute service), allowing competition between providers will generally be preferable to access regulation because regulation in such markets could reduce welfare.
>
> Access regulation is most likely to provide net benefits to the community where there is monopoly provision of infrastructure services.

Accordingly, Draft Finding 3.1 suggests that the critical question to identify whether access regulation "could reduce welfare" or is "likely to provide net benefits" is: are ***"two or more infrastructure service providers … able to provide the same service (or an effective substitute service)?"*** The private test, not the natural monopoly test, best asks and answers this question consistently with the Commission's own draft finding. The natural monopoly test produces results which are inconsistent with this draft finding.

BHP Billiton refers the Commission to its previous submission[39] and the economic analysis in Rio Tinto Iron Ore's previous submission,[40] on this point.

7. THE COMMISSION HAS NOT SOUGHT TO PREVENT THE EXTENSIVE COSTS OF IMPOSING ACCESS ON INTENSIVELY USED, TIGHTLY INTEGRATED INFRASTRUCTURE

7.1 The national interest imperative

A full cost benefit analysis would have revealed the clear national interest imperative of ensuring that intensively used, tightly integrated infrastructure is not declared for third party access. The Pilbara iron ore railways are the prime example of how Part IIIA has been applied to such infrastructure to date; as outlined above, this experience suggests that the costs from declaring these facilities could extend to $10 billion in lost export revenues and $4 – 6 billion in lost GDP (see Box 3). The Commission has barely considered, and has not proposed, any reforms that would promote the national interest by ensuring that such facilities are not declared.

These reforms are particularly important given that the High Court has limited the scope for the Tribunal to conduct a merits review, and in particular to review the Minister's decision on the public interest under declaration criterion (f). Previously, only the Tribunal had the time, resources and skill to undertake, and in fact undertook, the complex and rigorous cost benefit analysis which ensured that intensively used, tightly integrated infrastructure was not declared where the extensive costs of access were likely to outweigh any benefits. Now that the Tribunal's review powers on criterion (f) are more narrowly understood, it is imperative that the Commission identifies how Part IIIA will ensure that such infrastructure is not declared in future.

7.2 The Commission should recommend amending the definition of "service"

The Commission should further consider limiting the "services" which may be declared under Part IIIA. The Draft Report gives little consideration to this issue: it only cursorily considers the "production process" exception in s 44B, and does not consider other possible amendments.

There are serious shortcomings with the production process exception (see Box 7). However the Draft Report simply notes that the production process exception is "a useful initial filter for

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[38] Draft Finding 3.1, Draft Report, 34.

[39] BHPB Submission, Annexure C, 32-36.

[40] Rio Tinto Iron Ore, *Submission to the Productivity Commission's National Access Regime Review*, February 2013, 6-10.

the obvious cases where coordination costs will exceed any competition benefits", and is often associated with manufacturing.[41] It does not identify any evidence to support its assertion that there have ever been "obvious cases", or identify any cases where it considers that the exception has been useful in practice. The Commission does not analyse or propose reforms to address the shortcomings of this exception. It simply concludes that "it is difficult to define a broad exception".[42]

BHP Billiton submits that the production process exception would work more effectively if it simply applied to the use of any infrastructure which is operated as a material part of a production process, regardless of whether the declaration application concerns use of all or part of that particular *process*. The Commission does not appear to have considered this possibility.

Box 7: Shortcomings of the production process exception

- The definition of the "services" which can be declared under Part IIIA specifically excludes the "use of a production process", except to the extent that that use is an integral but subsidiary part of the service sought to be declared (s 44B).
- The High Court has found that this exception did not prevent Fortescue from seeking declaration of a service comprising Fortescue's use of a railway track that BHP Billiton operated as part of its own production process.
- As a result, this exception has no useful application: the use of infrastructure which is part of the provider's production process may be declared, as long as an access seeker identifies a "service" with reference to a subset of production process infrastructure, rather than to the use of the provider's production process.
- The production process exception did not prevent declaration of the Newman and Hamersley iron ore railways, even though they were acknowledged to be "part of" a production process, and the Tribunal expected that access would cause billions of dollars in lost exports and GDP. Had this exception applied, significant time and cost associated with the Pilbara proceedings could have been avoided.

7.3 The Commission should rigorously assess the other proposals before it

It is not clear what, if any, regard the Commission has given to other proposals which would help to ensure that intensively used, tightly integrated infrastructure is not declared.

For example, BHP Billiton previously proposed that Part IIIA be amended to introduce:

(a) a new "economic cost/benefit criterion", which would require that declaration could only occur if the decision maker was satisfied that the likely economic costs of access would not outweigh the likely economic benefits of access;[43] and

(b) a new "capacity criterion", which would require the decision maker to be satisfied that the facility would have or be likely to have capacity to provide the service before declaring or recommending declaration of the service.[44]

These proposals would help to ensure that Part IIIA declaration did not occur where the costs of access were likely to be so extensive as to render access contrary to the national interest. BHP Billiton urges the Commission to consider them in its final report.

[41] Draft Report, 150.

[42] Draft Report, 150.

[43] BHPB Submission, 14.

[44] BHPB Submission, 15.

7.4 The Commission's draft recommendations on the other declaration criteria do not address this concern

The Commission’s draft recommendations concerning the other declaration criteria are sound in principle, but do not assist in preventing declaration of intensively used, tightly integrated infrastructure.

Box 8 – The Commission's other draft recommendations do not address the substantive issues

Criterion (a): that "access (or increased access) to the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service"

- The Commission proposes amending criterion (a) to require "a comparison of competition with and without access on reasonable terms and conditions through declaration".[45]
- This may usefully prevent declaration based on an abstract competition benefit, or a benefit which is already being achieved via unregulated access. However, it does nothing to prevent declaration of intensively used, tightly integrated infrastructure.
- Further, while the Commission rightly acknowledges that access is unlikely to increase efficiency where the provider is an export producer who has no power to set prices in world commodities markets,[46] its proposed amendments do nothing to ensure that the declaration criteria exclude declaration in this scenario, or to ensure that declaration can only occur where access would achieve a competition benefit which is itself nationally significant, or at least meaningful in the context of the nationally significant infrastructure which is the subject of declaration.[47]

Criterion (e): effective access regime

- Under criterion (e), a service cannot be declared if it is already the subject of an effective access regime.
- The Commission has usefully recommended that this issue be tested as a threshold issue rather than being incorporated into a declaration criterion.[48]
- This proposal does not assist to prevent declaration of intensively used, tightly integrated infrastructure.

Criterion (f): that "access (or increased access) to the service would not be contrary to the public interest"

- The Commission proposes amending this criterion to provide that a service may not be declared unless declaration promotes the public interest, and require decision makers applying this criterion to have regard to the effect of declaration on investment in markets for infrastructure services and dependent markets, and compliance and administrative costs associated with access.
- Raising the public interest threshold and mandating consideration of particular access costs usefully reforms criterion (f) in principle; however in practice, the Minister who applies this criterion will not have the time to undertake this complex analysis, the NCC is manifestly under-resourced for this task, and the Tribunal has limited scope to review the Minister’s decision. Accordingly, it is at best unclear whether this criterion will have any material impact in practice; it cannot be relied on to prevent declaration in inappropriate cases.

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[45] Draft Recommendation 8.3, Draft Report, 38.

[46] Draft Report, Box 2, 12.

[47] See BHPB Submission, 13.

[48] Draft Recommendation 8.5, Draft Report, 36.

8. THE DRAFT RECOMMENDATIONS DO NOT ADDRESS THE SIGNIFICANT DEFICIENCIES IN THE PART IIIA DECLARATION PROCESS

Had the Commission undertaken a full analysis of the costs and benefits of access regulation, it may have been more concerned to ensure that Part IIIA decision makers were able and likely to make correct decisions on declaration applications.

In the absence of that analysis, the Commission has acknowledged but not addressed submissions[49] concerning the manifestly inadequate resourcing, skills and time available to Part IIIA decision makers (see Box 9). The Commission has not identified meaningful procedural or institutional reforms in response to the Terms of Reference which specifically require it to consider improvements to processes and decisions for access (for example, Term of Reference 4).[50] The Commission has done nothing to ensure that Part IIIA decision makers have the time, skills, and resources required to conduct a rigorous analysis of declaration applications, or to increase the likelihood that the Part IIIA process will produce correct declaration outcomes. BHP Billiton refers the Commission to BHP Billiton's previous submission on these matters.

Box 9 - BHP Billiton's previous submissions on the Part IIIA declaration process

Concerns identified[51]	Response in Draft Report
NCC	
Manifestly under-resourced; insufficient finances and expertise; cannot conduct the rigorous substantive analysis previously conducted by Tribunal	NCC should retain its current role – identifies but does not address NCC's inadequate resources.[52] Only suggested reforms: NCC staff secondments and lower quorum for NCC decisions.[53]
Insufficient time for parties to prepare necessary information	Nil
Minister	
Rigorous analysis is impossible within the Minister's 60 day time limit As a result, the Minister is not able to make a substantive and independent contribution to the declaration decision, and in practice is likely to rely on the NCC's fact finding and analysis	Nil change to time limit. Minister should be deemed to adopt NCC's recommendation if he/she does not make a decision in the 60 day time limit[54] - this would *increase* the influence of the NCC's fact finding and analysis on the declaration outcome
Tribunal	
Merits review is essential, but the Tribunal will provide a much narrower quality check on the NCC/Minister's analysis following 2010 legislative amendments and 2012 High Court decision[55]	"On balance", the status quo, including merits review, "should contribute to sound decision making".[56]

[49] See extracted submissions of BHP Billiton (Draft Report, 283), Rio Tinto (Draft Report, 284), the Law Council of Australia (Draft Report, 290), the Institute of Public Affairs (Draft Report, 283).

[50] Term of Reference 4, Draft Report, vii.

[51] BHPB Submission, 5–7, and 12.

[52] Draft Report, 286.

[53] Draft Report, 287.

[54] Draft Recommendation 9.1, Draft Report, 296.

[55] In 2010 amendments to Part IIIA were introduced which limited the materials before the Tribunal to the record which was before the Minister plus any additional information requested by the Tribunal by written notice, being information it considered "reasonable and appropriate" to its task (Section 44ZZOAAA of the CCA, amended by the *Trade Practices Amendment (Infrastructure Access) Act 2010* (Cth)). In 2012 the High Court held (in relation to the law as it stood before the 2010 amendments) that the Tribunal's task is to reconsider the Minister's decision with reference to the material before the Minister, supplemented, if necessary, by additional information obtained by exercise of the Tribunal's powers to require information or assistance from the NCC under s 44K(6) ([2012] HCA 36 (14 September 2012) at [65]).

[56] Draft Report, 307.

9. THE PROPOSAL TO ENTRENCH THE ACCC'S POWER TO DIRECT EXPANSIONS IS FUNDAMENTALLY MISCONCEIVED, AND WILL NOT WORK IN PRACTICE

Draft recommendation 8.7 proposes amending s 44V(2) of the CCA to confirm that the ACCC has the power, when arbitrating an access dispute, to require a provider to expand the capacity of and extend its facility.

Again, the Commission has not undertaken any cost benefit analysis associated with this intrusive power, or any substantive analysis of how it might operate in practice. Such analysis would have revealed that this power is likely to be completely unworkable, and will deter rather than facilitate infrastructure investment.

9.1 Commission's consideration of this issue

The Draft Report attempts to justify the power to direct expansions as being "in the interests of regulatory and investment certainty";[57] it notes that directing a provider to conduct expansion works to accommodate an access seeker "may be in the community's interests" where the provider is the most efficient party to do the required works,[58] and that this power may prevent a provider from foregoing or delaying expansion works required to accommodate access seekers in order to facilitate monopoly pricing, and/or forestall access.[59]

The Commission has acknowledged that this power "has the potential to increase regulatory risk", may undermine investment incentives, and "may require complex operational, commercial and legal considerations".[60] However the Commission has not thoroughly identified or evaluated those complex considerations, or considered whether any regulatory framework or the ACCC could possibly address them. Further, it has not meaningfully considered whether this power could be exercised without deterring investment, or whether it would in practice achieve the Commission's aim of preventing undersized investments.

The Commission has not foreshadowed that it will conduct this analysis; rather, it has simply made a draft recommendation that the ACCC should develop and publish guidelines on how it would exercise this power,[61] in the expectation that "greater transparency … would improve regulatory and investment certainty".[62]

The Commission has also observed that the power to order extensions/expansions "should be subject to robust and practical safeguards to protect the interests of all parties".[63] However, it has not yet attempted to identify what principles should underpin those safeguards, or what interests the safeguards should protect. Rather, it has called for further submissions, but provided no guidance on this point.

9.2 Any power to direct investment should be confined to a power to order a geographically limited interconnection to facilitate access

BHP Billiton recognises that the ACCC should have the power to direct the construction of a geographically limited interconnection of a provider's facility with an access seeker's infrastructure, in circumstances where access could not occur without that interconnection.

However any broader power, regardless of whether it is described with reference to an "extension" or an "expansion", will seriously interfere with the provider's business, will raise complex practical issues which will be incapable of resolution in the absence of agreement between the provider and access seeker, and is likely to be futile in practice.

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[57] Draft Report, 253.

[58] Draft Report, 134.

[59] Draft Report, 134.

[60] Draft Report, 136 and 253.

[61] Draft Report, Draft Finding 8.8, 37.

[62] Draft Report, 135.

[63] Draft Report, 136.

9.3 A broader power would seriously interfere with legitimate business conduct

The ACCC has expressed a preference, endorsed by the Commission, for extensions and expansions to be conducted by agreement rather than mandatory direction.[64] Accordingly, the extension/expansion power would only be exercised if the provider determined that it was not in its commercial interests (including the interests of its shareholders) to undertake the extension/expansion voluntarily. This could include, for example, circumstances where the provider's Board considered that the return from the expansion did not justify the associated risk (eg the disruption to the provider's own business, or the risk that the access seeker would not be able to fund the expansion to completion). Further issues would arise if the safeguard in s 44W(1)(e), which prevents the provider from being required to "bear some or all of the costs of extending the facility", was watered down. If that occurred, such that mandated expansions were financed using "take or pay" agreements, and the access seeker became insolvent before the expiry of such an agreement, the provider could be stranded with an asset which it did not want and which the access seeker had not fully funded.

Even more intrusive issues would arise where the provider was vertically integrated, only provided the service for its own purpose, and was not in any way involved in supplying the declared service or extension/expansion services to any other party. For example, where the provider was a vertically integrated producer of export commodities, an ACCC direction to expand would be tantamount to a government mandate that the provider become a supplier of construction and project management services, against its will, to the benefit of its competitors, notwithstanding that this formed no part of the provider's existing business.

The Commission's Draft Report has given scant consideration to these fundamental alterations to the rights of private firms and their shareholders.

9.4 The Commission has not considered the enormous practical challenges involved in exercising the ACCC's extension/expansion power

Compelling an individual or business to engage in ongoing behaviour which they would not otherwise pursue voluntarily raises extensive practical difficulties. This is well recognised as a matter of law, and reflected, for example, in the courts' general reluctance to grant and supervise mandatory injunctions.[65] It is similarly reflected in the ACCC's own informal merger clearance guidelines, which expressly prefer "structural" rather than "behavioural" merger remedies.[66] In the case of a provider being directed to conduct an expansion against its will, the associated legal, commercial, technical and operational considerations are likely to be intractable. The Commission's analysis of this issue identifies only a subset of the difficulties which are likely to arise (see Box 10).

The practical issues raised by a mandated extension/expansion may be able to be resolved by agreement where resolution is in both parties' commercial interests. They may also be able to be resolved effectively by arbitration where the value and complexity of the issues are low – this is the basis for BHP Billiton's submission that the ACCC should only have the power to direct the construction of geographically limited interconnections, and not a broader power (see 9.2 above). However, these complex issues are unlikely to be resolved where the value and/or complexity of the relevant issues is any more than minimal, and the parties do not judge it in their commercial interests to reach agreement on those issues.

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[64] See the comments of the ACCC and the Commission in the Draft Report at 139 and 253, respectively.

[65] See *J C Williamson Ltd v Lukey* (1931) 45 CLR 282 at 299, 300.

[66] ACCC, Merger Guidelines, November 2008, Appendix 3, [11, 20, 21].

Box 10 - Practical issues raised by the ACCC's extension/expansion power

Issue	Illustration
How will the extension/ expansion be designed?	The provider and access seeker may have different views on appropriate design standards (and hence costs), and there is not likely to be an "industry standard" the ACCC can rely on to resolve disputes. For example, an access seeker: • may use materially lighter weight rail sleepers for its railway than the provider uses (eg because it runs lighter trains); must the access seeker pay for heavier, more expensive sleepers, or must the provider compromise on its standards? • may use materially fewer sleepers per kilometre on its own railway than the provider uses (eg because it has a shorter investment horizon and designs for a 1 in 5 year flood event, whereas the provider has a longer horizon and designs for a 1 in 20 year flood event); must the access seeker adopt the provider's risk preferences? If not, must they compensate the provider for the increased incidence of flood damage over time?
How will the extension/ expansion works be contracted?	Mandated extension/expansion works will not be contracted as efficiently as if the provider was voluntarily extending/expanding. For example: • a provider might obtain long lead-time items in advance when planning its own expansion, but would not do this for an access seeker until the ACCC mandated the expansion and the access seeker provided full funding; • a provider would optimise its contracting strategy for voluntary extensions/ expansions, but would not incur cost or risk concerning a mandated extension/ expansion until it received the relevant funding – for example, if an access seeker provided funding in instalments, the provider would rationally conduct contracting and procurement in stages which matched those instalments. In both cases, an access seeker may object that the provider was proceeding less efficiently than if it was conducting works for itself; however a provider may justify its conduct as necessary to prevent it bearing any costs of the extension/expansion.
How will real time technical decisions be made while the extension/ expansion is built?	Extension and expansion works require ongoing discretionary decisions, on-site, in real time, based on an individual’s skill and experience. Reasonable minds can differ on whether decisions are preferable, let alone optimal. For example: • a provider may identify that construction works should proceed more slowly than scheduled, to allow additional quality checks; the access seeker may resist the associated cost and delay if they think the checks are unnecessary; • an infrastructure owner makes many decisions as to the quality of work performed by contractors and sub-contractors when conducting extensions/expansions for its own purposes. At times it will approve work that is not strictly compliant with specifications, as the differences can likely be corrected at a later stage. There will be limited incentive for a provider to make these judgement calls in the context of a mandated extension/expansion, since an access seeker may seek to challenge the provider for not complying with design specifications. However, if the provider does not make those judgement calls, the access seeker may object to any resulting delays. In a mandated extension/expansion, where the provider and access seeker have no incentive to reach agreement, who will make these decisions?
How will cost and risk be allocated?	The "safeguards" in Part IIIA prevent the provider from being required to bear the cost of an extension/expansion.[67] What does "cost" mean? For example: • Does it require only that the provider be reimbursed for costs incurred, or that the provider not be out-of-pocket at any point in time during the conduct and use of the extension/expansion works? • If mandated extension/expansion works constrain or delay the provider’s own operations or expansions, will the access seeker compensate the provider for the associated loss of export revenue and myriad other potential opportunity costs? What if the value of the loss is greater than the value of the access seeker’s business? Who would make up this shortfall? • Will the provider be compensated for other associated opportunity costs – for example, the diversion of management time away from its own business, for the benefit of its competitor? If not, will the ACCC allow the provider to deploy its most talented executives to work on its own business, so that it can at least mitigate the opportunity cost associated with a mandated extension/expansion?

[67] CCA, ss 44W(1)(e), as to extensions, and (f), as to interconnections.

9.5 Power to order an expansion will be futile

Where an extension/expansion occurs by agreement, because market forces (rather than regulation) dictate that this is an efficient outcome, practical matters are likely to be managed and determined by an agreed decision maker. However, where a provider is directed to undertake an extension/expansion against its will, the interests of the provider and access seeker (often a competitor) will by definition not be aligned. Both parties will be incentivised either to "take every point" (ie refer all disputes to arbitration) or to "work to rule" to prevent disputes. Both alternatives are cumbersome and impractical and will lead to increased costs. The cost and risk associated with addressing the myriad likely disputes will at best make mandated extensions/expansions significantly less efficient than other, consensual alternatives. Further, providers will still be incentivised not to invest in "spare" capacity, knowing that the need for the ACCC to exercise the extension/expansion power and deal with the associated complexities will likely delay the provision of access.

This analysis holds regardless of whether Part IIIA protects the provider from bearing any cost associated with an expansion.[68] However if Part IIIA is interpreted or amended to allow for the provider to be required to bear any such costs (eg opportunity costs of foregone production), the prospect of being required to subsidise access would be a fundamental deterrent to efficient infrastructure investment. It would strengthen the disincentives for providers to invest in spare capacity, and the imperative for providers to "take every point" so as to avoid being compelled to provide access on uncommercial terms.

Accordingly, entrenching the ACCC's extension/expansion power is unlikely to solve the Commission's concern about infrastructure owners under-sizing their investments, to the detriment of Australian welfare. Entrenching this intrusive and costly power will only heighten concerns about the impact of access on the national interest.

10. COMMISSION'S REQUESTS FOR FURTHER INFORMATION ABOUT THE NEGOTIATION/ARBITRATION REGIME

The Commission has requested information on the following matters:[69]

(a) "The adequacy and workability" of the Part IIIA safeguards concerning the ACCC's power to direct a provider to extend its facility, including whether they "strike the right balance" between the interests of providers and access seekers, and whether changes are necessary to enable "effective funding arrangements" for extensions/expansions that a provider is directed to undertake against its will.

(b) "The safeguards for the access rights of the infrastructure service provider in access determinations", including the appropriateness of the protections in ss 44W and 44X of the Act, and the implications for other service users of strengthening those safeguards".

BHP Billiton submits that there is little if any utility in the Commission considering the matters addressed in these information requests until it has completed a rigorous, real world analysis of the costs and benefits of access, and the limited potential for regulation to limit or avoid those costs or to deliver those benefits. Absent any such analysis, the Commission's response risks being hypothetical rather than practical.

Nonetheless, BHP Billiton makes the following observations to assist the Commission's consideration of these matters.

(a) The evidence before the Commission, including as cited in this submission, suggests that access regulation does not, in practice, occur in a way which "minimises" access costs or promotes efficient investment. This increases the imperative to ensure that Part IIIA access declaration cannot occur where the costs of access are likely to be high.

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[68] CCA, ss 44W(1)(e).

[69] Information Request 4.1, Draft Report, 34.

(b) In cases where Part IIIA correctly identifies that declaration is consistent with the national interest, it is *essential* to ensure that the terms of access do not deter efficient investment in infrastructure. To this end, BHP Billiton:

(i) Endorses the strengthening of provider's priority to use the service.[70] The shortcomings of the current "protections" were clearly identified in the Tribunal's decision in the Pilbara rail access case, and BHP Billiton's previous submission.[71] Failing to address those shortcomings will deter rather than promote efficient infrastructure investment.

(ii) Submits that the Commission should recommend:

(A) strengthening the rule that providers cannot be required to bear the costs of an extension/expansion or interconnection to accommodate an access seeker,[72] to confirm that this prevents the provider from bearing any direct, indirect or opportunity cost concerning the extension/expansion or interconnection; and

(B) strengthening the protection of the "provider's legitimate business interests"[73] – promotion of efficient infrastructure investment requires that "legitimate business interests" be <u>protected</u>, not merely be one of the many matters which the ACCC must take into account.[74]

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[70] CCA, ss 44W(1)(a) to (c).

[71] *In the matter of Fortescue Metals Group Limited* [2010] ACompT 2 (30 June 2010) at [597-603], and [1251–1254]; BHPB Submission, 18.

[72] CCA, ss 44W(1)(e), as to extensions, and (f), as to interconnections.

[73] CCA, s 44X(1)(a).

[74] [2010] ACompT 2 (30 June 2010) at [1173].