Submission to the Competition Policy Review Issues Paper

June 2014

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1 EXECUTIVE SUMMARY

Asciano welcomes the opportunity to respond to the Competition Policy Review Panel's Issues Paper.

Asciano is a national above rail freight operator through its subsidiary Pacific National and a national ports operator through its subsidiary Patrick. These rail and port operations mean Asciano is a major user of infrastructure which is subject to coverage under the various third party infrastructure access regimes enacted through the CCA and State based regimes. In particular, all of Asciano's above rail operations rely on third party access to below rail infrastructure owned by third parties, where this access is provided under various state and Commonwealth access regimes. The ongoing operational efficiency and regulatory certainty of these various rail access regimes is of critical importance to both Asciano, and to Australian supply chains more generally.

Asciano's interest in the Issues Paper focuses on whether the recommendations in the Productivity Commission's Report on the National Access Regime should be adopted and whether there is a need for further competition related reform in the transport sector.

Asciano welcomes the Productivity Commission's recommendation that the National Access Regime be retained. Asciano supports the proposed changes to the declaration criteria; the improvement to the role of the ACCC in capacity expansions and the clarification around certification uncertainty. However, Asciano has some concerns regarding the Productivity Commission's position on:

- the retention of the negotiate arbitrate framework without improvement; and
- a single approach to national rail access;

Asciano recommends that the Panel re look at the merits of the light-heavy regulatory model dismissed by Productivity Commission and look to incorporate improvements to the negotiate-arbitrate framework.

Asciano also believes that there would be significant economic benefits in moving to a single rail regulator and that the Productivity Commission's rejection of the concept was based on too narrow a view of the benefits which we believe would be

significant. We recommend that the Panel re look at introducing a single rail regulator.

In addition to the above comments in response to the Productivity Commission's report, Asciano believes that further reform could deliver significant benefits in the privatised ports and rail sectors.

There have been a number of major capital city container port privatisations in last few years. There are two key issues arising from the creation of these private port operator monopolies namely, vertical integration and monopoly pricing. The focus of these privatisations has been maximizing revenue from the sales rather than creating the structures and an ongoing regulatory environment which would enhance productivity and efficiency.

The private monopoly port operators, if vertically integrated, have the ability to anti-competitively discriminate against competing stevedores and other port users. Whether they have the incentive to leverage this power will depend on the degree of integration and relevant competitive dynamics. Current competition policy and law does not adequately deal with these issues in relation to capital city container ports. Asciano recommends regulation of these privatised ports such that any expansion by the Port Operator (via whatever means) into competitive stevedoring or other port services requires notification and, if appropriate, prior ACCC approval.

The private monopoly container port operators have an incentive to monopoly price especially given the high prices paid for their long term leases. Asciano has recently experienced significant increases in rent at its key ports. Again current competition law and regulation does not deal with this issue and a regulatory solution is required. Asciano recommends extending price regulation to privatised ports. Initially this regulation could be light handed price monitoring and if monopoly pricing was detected and not remedied more heavy handed regulation (such as building block price regulation) could be introduced.

Asciano has argued consistently that the Queensland rail access regime falls short of effective regulation of a vertically integrated monopolist and that the regime allows anti-competitive discrimination. This needs to be remedied. One avenue of doing this would be to add to the criteria for certification set out in the Competition

Principles Agreement. A criterion should be added to reflect situations where there is a vertically integrated monopolist and require effective regulation of the vertically integrated monopolist.

This submission is public.

2 ASCIANO & AREAS OF INTEREST

Asciano is a national above rail freight operator (through its subsidiary Pacific National) and a national ports operator (through its subsidiary Patrick). Asciano is a top 50 ASX company and employs over 8000 people throughout Australia and New Zealand. Asciano has four main divisions.

Pacific National transports via rail millions of tonnes of containerised freight including retail and refrigerated goods, cars and steel. We operate over 150 services per week across mainland Australia, from Cairns to Perth. Through our bulk operations we move bulk commodities such as grain, mineral concentrates, iron ore and construction materials. We also provide coal rail haulage services for the export and domestic coal markets in New South Wales, Queensland and South Australia. Pacific National facilitates the delivery of export coking coal for steelmaking, as well as thermal coal delivered to the seaborne export market and the domestic market for power generation. To service the haulage demand from our customers, we have an active fleet of 600 locomotives and 13,000 wagons.

Patrick Terminals and Logistics is a national operator of shipping container terminals. We move significant proportion of our nation's containerised freight across Australian wharves and connect our customers with their markets by facilitating the movement of containers on and off ships and on and off road and/or rail.

Patrick Ports and Stevedoring specialises in the management of ports and supporting infrastructure and the provision of port related logistics at bulk and general ports across Australia and New Zealand. Our services include the stevedoring, transportation and storage of cargoes such as metal imports and exports; bulk ores and minerals, agricultural and forestry products; project cargo for major oil and gas, resources and construction projects; roll on / roll off vessel stevedoring; forestry marshalling and stevedoring; and other general cargo such as containers and livestock.

Patrick Autocare operates a 'shore to door' service for the automotive industry, offering an integrated service for the transportation, processing and storage of motor vehicles through to our customers' customer. We provide solutions for manufacturers, dealers, companies, small business and private users both locally and interstate across Australia. We operate out of wharf facilities in Queensland, New South Wales, Victoria, South Australia and Western Australia. Our services include processing and storage, transport and distribution and more recently we've moved into the post wholesale market with 'dealer services'.

Through these rail and port operations Asciano is a major user of infrastructure which is subject to coverage under the various third party infrastructure access regimes applying in Australia enacted through the CCA and State access regimes. In particular, all of Asciano's above rail operations rely on third party access to below rail infrastructure owned by third parties, where this access is provided under various state and Commonwealth access regimes. The ongoing operational efficiency and regulatory certainty of these various rail access regimes is of critical importance to both Asciano, and to Australian supply chains more generally.

We have particular interest in the following key questions raised in the Issues Paper

- "Should the recommendations in the Productivity Commission's report on the National Access Regime be adopted? Are there other changes that could be made to improve competition in the relevant markets? "[1]; and
- "Is there a need for further competition-related reform in infrastructure sectors with a history of heavy government involvement (such as water, energy and transport sectors)"[2]

We deal with each of these areas in turn below.

[1] Competition Review Panel, Competition Policy Review, April 2014. p 31

[2] Competition Review Panel (April 2014), p19

3 PRODUCTIVITY COMMISSION'S RECOMMENDATIONS ON THE NATIONAL ACCESS REGIME

During the Productivity Commission's review of the National Access Regime, Asciano made several submissions and attended a public hearing. In these submissions Asciano was advocating:

- the continuation of an effective third party access regimes in Australia;
- strengthening access regimes by including provisions relating to information provision, vertical separation, ring fencing and anti-competitive discrimination;
- increasing powers for regulators to monitor, audit and enforce access provisions; and
- rationalising access regimes and in particular introducing consistency between state and Commonwealth access regimes.

The National Access Regime Productivity Commission Inquiry Report (the "PC Report") recommended retention of the National Access Regime and the retention of the negotiate-arbitrate approach but recommended the following changes:

- amendments to the declaration criteria a, b, e and f;
- the exercise of ACCC power to direct extensions to infrastructure facilities should be more transparent;
- the certification process should be refined to improve transparency and certainty; and
- any additional industry specific access regimes must be based on a clear problem that is best addressed by industry access regulation.

Asciano welcomes the Productivity Commission's recommendation that the National Access Regime be retained. Asciano supports the proposed changes to the declaration criteria in section 44G of the Competition and Consumer Act (the "CCA") the improvement to the role of the ACCC and the clarification around certification uncertainty. However, Asciano has some concerns regarding the Productivity Commission's position on:

- the retention of the negotiate arbitrate framework without improvement; and
- a single approach to national rail access;

3.1 Retention of the Negotiate-Arbitrate Framework

The Productivity Commission Report found that the existing negotiate-arbitrate framework is appropriate and should be retained without amendment.[3]

Despite these conclusions, the Productivity Commission identified key issues surrounding the negotiate-arbitrate framework including regulatory gaming causing delay and information asymmetry.[4] It seems that a lack of hard evidence led the Productivity Commission to support the status quo.

However, being on the front line of access negotiations on an ongoing basis Asciano can confirm the problem of regulatory gaming and information asymmetry are real and lead to sub optimal outcomes. Negotiations with monopoly track providers where there is no regulatory approved standard access agreement are much more protracted and due to bargaining power imbalances and information asymmetry always conclude in outcomes more favourable to the monopolist.

In Asciano's opinion the light-full regulatory model dismissed by the Productivity Commission has merit.[5] The Productivity Commission basis its opinion on the view that the regulatory costs of creating standard terms and conditions are too high (although this conclusion is based on assumption rather than actual facts). However, it would seem that the Productivity Commission is under estimating the number of access agreements that will have to be negotiated especially given this is a repeated game with in most cases multiple access seekers. For example, if you take the ARTC which has a standard access agreement as part of its ACCC approved undertaking. The ARTC provides access to multiple rail companies using this access agreement and given standard agreements run for between 5 and 10 years this agreement with minimal change has been utilised a number of times for the same access seeker. The cost of producing the standard access agreement in the first instance would be small in comparison with the cost to ARTC of multiple stand alone negotiations which ARTC would have to have had in the absence of the regulatory approved standard access agreement.

It should be recognised that even if there is a standard access agreement in place, under the negotiate–arbitrate framework there remains an imbalance in the

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[3] Productivity Commission, National Access Regime, Productivity Commission Inquiry Report, October 2013, p128

[4] Productivity Commission (October 2013), Section 4.3

[5] Productivity Commission (October 2013), p 124

information held by both parties. Significantly, this information imbalance provides the infrastructure provider with an advantage in price negotiations and often results in costly and protracted access negotiations.

As such, Asciano believes that the access framework and access outcomes should be improved by requirements for infrastructure providers to supply a reasonable level of cost information to facilitate even handed price negotiations. Asciano recognises that the Productivity Commission discusses this issue and concludes that there is no compelling evidence that poor information disclosure is a weakness in the access regime. However, the Productivity Commission does not take account of the relative economic efficiency of prices negotiated under asymmetrical information and are more focussed on process efficiency. A price based on transparent cost information available to both negotiating parties is more likely to be both efficient and non-discriminatory than a price negotiated when one party has incomplete information. A negotiation where both parties have substantially complete information is much more likely to result in a price outcome which approximates the outcome that could be expected in a competitive market.

Asciano recommends that the Panel re look at the merits of the light-heavy regulatory model dismissed by Productivity Commission and look to incorporate improvements to the negotiate-arbitrate framework.

3.2 National Approach to Rail Access

The Productivity Commission did not support a national approach to rail access regulation given what it considered to be "limited evidence on costs of the current regime" and the considerable time and effort involved in the development of a national approach.[6] Asciano believes that the Productivity Commission took a too narrow approach, putting too much emphasis on administrative cost and benefits (the later we would argue would be significant) and ignoring the potential for much bigger benefits accruing from a more efficient regulatory regime and stable investment climate.

Asciano, along with other participants in the Inquiry such as the Australian Rail Track Corporation (the 'ARTC"), raised concerns with the Productivity Commission around

[6] Productivity Commission Report p273

the multiplicity of rail access regimes. The Table below demonstrates the regulatory complexity of rail in Australia.

Network	Service Provider	Regime	Regulator
Brisbane Metro and Qld Regional Network	Queensland Rail	State based regime using Access Undertaking.	QCA
Qld Coal Network	Aurizon	State based regime using Access Undertaking.	QCA
National Interstate	ARTC	Commonwealth regime using Access Undertaking	ACCC
HV Coal network	ARTC	Commonwealth regime using Access Undertaking	ACCC
Sydney Metro	Sydney Trains (Transport for NSW)	State based Regulatory Regime	IPART
NSW Regional	Country Rail Network (Transport for NSW)	State based Regulatory Regime	IPART
Melbourne Metro	MTM	State Based Access Undertaking	ESCV
Broad Gauge Regional Victoria	Vline	State Based Access Undertaking	ESCV
Broad Gauge Regional Victoria	Victrack	State Based Access Undertaking	ESCV
SA Regional	Genesee and Wyoming Australia	Sate Based Regulatory Regime	ESCOSA
Darwin to SA	Australian Railways	State Based Access Act	ESCOSA
WA Network	Brookfield	State Based Access Code	ERA

Asciano operates its above rail operations under six different access regimes with multiple access providers and multiple access regulators. This multiplicity of regimes adds costs and complexity to rail access for no benefit, particularly as many of the

access regulation functions are duplicated across states. Given this Asciano has advanced the concept of an industry specific national rail regime should be further considered.

Asciano does not, nor indeed does the ARTC, advocate a one size fits all approach to rail regulation. For example you would not expect that the appropriate access regime in a government owned and operated regional grain network would be the same regime required to regulate a vertically integrated monopolist track provider such as Aurizon in Queensland. However, having a single national regulator would have a number of advantages:

- *Reduced duplication of effort* – even with a number of tailored regimes (for example a regional network regime plus an interstate network regime) the number of regimes in operation would be significantly less than the current situation. In addition with one regulator making decision some key features of the regime would be common across networks. For example the approach to calculating the cost of capital or the approach to liabilities and indemnities which can currently vary significantly via jurisdiction, would be common. Having a single regulator would significantly reduce the regulatory resources required, saving both industry and Government significant resources. This proposal is consistent with the current Government's priority to reduce unnecessary red tape and cost.
- *Increased specialisation* – some regulators only deal with rail access issues intermittently, usually at the time an access undertaking comes up for renewal. Access undertakings are typically reviewed on a 5 or 10 year cycle. Thus it is difficult for these regulators to retain in house knowledge on rail issues. A national rail regulator with dedicated specialised rail staff would more likely to have the appropriate expertise and as such be more likely to come to efficient decisions.
- *Regulatory capture and independence* – the potential for regulatory capture will be reduced with a national regulator. Where a state based regulator, part of the state government bureaucracy, regulates a private company which is a significant contributor to state finances or even a state government owned entity, the commitment to independence and efficient regulatory decision making may be tested. These close relationships would be more arms length with a national regulator.

- *Improved regulatory certainty* – having a single regulator which as noted above would allow specialisation and also would implement decision consistently across networks would increase regulatory certainty compared with the status quo of multiple regulators and multiple access undertaking. The increase in regulatory certainly would reduce investment risk and all other things being equal expect to encourage more efficient investment decisions.
- *Co-ordination benefits* – having a single regulator approve technical rail documents such as network rules will increase consistently between network owners thereby reducing operators' costs. For example, rules regarding rolling stock approval or possession planning would likely become more consistent thereby reducing co-ordination and regulatory compliance costs of dealing with multiple regimes.

Asciano believe that there would be significant benefits to having a single rail regulator and that the Productivity Commission's rejection of the concept was based on too narrow a view of the benefits which we believe would be significant. We recommend that the Panel re look at introducing a single rail regulator.

4 THE NEED FOR FURTHER COMPETITION RELATED REFORM IN INFRASTRUCTURE SECTORS:

In addition to the above comments in response to the Productivity Commission's report Asciano believes that further reform could deliver significant benefits in the privatised ports and rail sectors.

4.1 Privatised Port Operator Regulation

There have been a number of capital city container port privatisations in the recent past. The table below outlines the recent privatisations.

	Date	Acquirer	Comments	Multiple of EBITDA
Port of Sydney & Port Kembla	2013	IFM, Australian Super, Q Super, Abu Dhabi Investment Authority		25x
Port of Newcastle	2014	Hastings Funds Mgt China Merchant Holdings	CML is a major port and stevedoring company	27x
Port Of Brisbane	2010	IFM, QIC and La Caisse	GIC initially owned a stake before selling to La Caisse	16.3x
South Australian Ports	2001	Flinders	Flinders is vertically integrated and operates stevedoring and ancillary services. Flinders vertically integrated post the privatisation	

In effect these private port organisations become the stevedore's landlord. There are two key issues arising from the creation of these private port operator monopolies namely, vertical integration and monopoly pricing. We describe these issues in turn below and describe why current competition policy and law does not adequately deal with these issues in the context of significant Australian container ports.

4.1.1 Vertical integration of Port Operator

Any degree of vertical integration will provide the privatised monopolist Port Operator with the ability to leverage its power in the markets in which it has a monopoly (port access and port services) into vertically related competitive markets such as stevedoring, terminal operation, rail operations and rail haulage.[7] Whether it has the incentive to leverage this power will depend on the degree of integration and relevant competitive dynamics.

The privatized Port Operator could have both the ability and the incentive to engage in competition distorting discriminatory behaviour towards third party stevedores. Ways in which this could occur include (but are not limited to) the Port Operator:

- reducing the quality of certain services provided to non-affiliated port users such as stevedores;

[7] We will use stevedoring as the most relevant port user service to Asciano. The arguments we make are equally valid for other port uses which are delivered competitively.

- refusing to grant long-term leases of terminals to unaffiliated stevedores, which will have the effect of stevedores becoming unwilling to invest sufficiently in capital to provide a more efficient service for its customers as they cannot secure long-term leases;
- making port planning decisions such as relocating existing lessees who have made significant investments in their leased terminals to less favourable locations within the port in order to benefit its own downstream port services business and cause substantial disruption to the unaffiliated lessee. In this situation, the existing lessee may be able to seek compensation for any loss which it suffers as a result of the relocation. However, it is doubtful that the compensation would cover the full extent of the loss;
- providing access on less favourable/discriminatory terms and conditions (ie by restricting the quay length/yard space allocated to third party users);
- denying requests by non-affiliated stevedores for additional access to port capacity or giving priority to its own downstream business if such additional capacity is available;
- charging discriminatory fees to unaffiliated stevedores;
- margin squeezing downstream competitors by increasing the costs borne by those companies through rent and other charges and setting prices for its own stevedoring operations that an efficient downstream competitor could not match;
- investing in the port in a way that favours its own operations, such as by reducing investment in common infrastructure;
- using confidential information on downstream competitors operations, which it obtains through to the terms of the leases which stevedores have at the port or under statutory mechanisms. For example, some Patrick leases require compliance with operational benchmarks such as truck turnaround times and provision of the certain resource levels which the monopolist Port Operator reviews. Such information could be used to the advantage of the Port Operator's own affiliated downstream.

A Port Operator with no downstream stevedore operations would have no incentive to engage in the non-price discriminatory practices described above.

There has been regulatory focus, including from the ACCC, at the time of the port privatisations in an attempt to address these vertical integration. This interest has

often been piqued by comments and interventions from interested parties. Often the vendor has been more interested in maximizing price than ensure effective competition post privatisation. With the exception of Flinders Ports which commenced stevedoring post-privatisation, there are currently no capital city container terminal operators who are vertically integrated. However, the concerns regarding vertical integration do not end at privatisation. Issues can occur post privatisation through the Port Operator subsequently:

- acquiring an established stevedoring or downstream business;
- entering into a joint venture with an existing stevedore business or other downstream business; or
- commencing its own stevedoring or downstream operation.

Although these subsequent actions may give the ACCC an opportunity to review transactions (eg the acquisition of an established stevedoring business) this is not true of them all. In particular the organic expansion into stevedoring would not be subject to ACCC scrutiny. For example, the decision by Flinders Ports to commence stevedoring. The likelihood of a Port Owner organically growing into stevedoring operations is increased when the owner already operates stevedoring operations elsewhere.

One option open to the stevedores to deal with vertical integration would be to seek declaration either under state (if available for example in Queensland) or under the declaration provisions of the CCA. However, even before the declaration criteria are assessed it must be established that that the relevant service amounts to a use of a facility. The Port Operators major service to the stevedores is as a landlord. Thus it is at best unclear if given the relevant service amounts to the use of a facility given it is essence the use of land. Previous decisions of the Australian Competition Tribunal have raised questions as to whether the use of land can be considered a facility.[8]

Even if it was accepted that access to land was use of a facility it would be arguable whether the conduct described above would be sufficient to trigger the declaration criteria. In any event, the declaration process is drawn out and may take years to conclude by which time the damage to competitors is done.

[8] Re Sydney International Airport (2000) ATPR

Similarly Section 46 may be an option for the stevedores. However, there is significant uncertainty about successful prosecution of a s46 case and as with declaration this is an ex-post solution and significant competitive damage could have be done before remedies are implemented. In addition if there are no regulatory information gathering powers or regulated KPIs (as is the case here) detection of discriminatory behavior is hard and it is even more difficult to gather proof to support a s46 case.

Asciano's recommended solution is to introduce a regulation of these privatised ports such that any expansion (via whatever means) into competitive stevedoring or other port services by the Port Operator requires prior notification to the ACCC and, if required, prior ACCC approval. The ACCC would assess whether there would likely be a reduction in competition as a result of the expansion. The Port Operator would be unable to proceed until ACCC approval had been obtained.

4.1.2 Monopoly pricing

Given the monopoly position which the Port Operator enjoys, Asciano anticipates that the Port Operator will seek both to increase rentals and to introduce additional charges on port users such as Asciano. A monopoly provider of port services has an incentive to charge monopoly prices for its services, and this incentive is strengthened with a privatised leaseholder seeking to maximise its profits for shareholders.

In all the port privatisations to date there has been no mechanism introduced which will monitor, regulate or otherwise limit the charges which may be imposed by the Port Operator on any sub-lessees or other users of the Port, such as Patrick, for access to the port.

Rental charges have been significantly increased in the years prior to privatisation, fattening up the prize for sale. Further increases post port privatisation have occurred.

More increases are likely given the high prices paid for the ports and the return requirements of the Port Operators. For example, the successful bidders for Port Botany and Port Kembla paid 25 times EBITDA for these Ports. This implies a return with current profitability of 4% which is significantly below the required rate of return

of the owners. Thus profitability will need to increase and one of the key levers to influence profitability for monopolist is to raise prices.

It is clear that there is both ability and an incentive for the privatised capital city container Port Operator to engage in monopoly pricing as the lessee of an essential facility, in the event that sufficient pricing controls are not imposed on the Port Operator. This commercial reality has been recognised in South Australia, with the privatised port operator of the Port of Adelaide is subject to regulation in the form of price monitoring to discourage/prevent the abuse of market power and monopolistic rent seeking. Similarly, price monitoring exists for ports in Victoria. The main objective of the Port Operator is to maximise profits for its shareholders.

Declaration is not an option to combat monopoly pricing as the criteria requiring an increase in competition in a relevant market would not be satisfied. In any event, the declaration process under Part IIIA is likely to be too late to address the problem. As the Panel is aware, a declaration process takes considerable time and the declaration does not apply until all review options have been exhausted, significant commercial damage could have been suffered by Port Users by the time there is any meaningful outcome from a declaration application which the access seeker could actively seek to use in its negotiations.

Section 46 of the CCA is not an adequate remedy in these circumstances as it requires, as one of its essential elements, the Port Operator to have an anti-competitive purpose for engaging in monopoly pricing in order for a misuse of market power to have occurred. In these circumstances, the privatised Port Operator may simply be seeking to maximise returns for its shareholders by charging monopoly prices to port users, rather than doing so with the specific intention of damaging a competitor or preventing other companies from providing port services. As a result, it is possible for the Port Operator to engage in monopoly pricing without having a subjective anti-competitive purpose for doing so[9], thereby preventing s 46 from being used as a remedy.

The inability of both section 46 and the CCA generally to address monopoly pricing was explicitly recognised in the Hilmer Report[10]:

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[9] See *Queensland Wire Industries Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177 at 214.

[10] National Competition Policy Review (25 August 1993) (**Hilmer Report**).

> "Where the conditions for effective competition are absent — such as where a firm has a legislated monopoly or the market is otherwise poorly contestable — firms may be able to charge prices above efficient levels for periods beyond a time when a competitive response might reasonably be expected. Such "monopoly pricing" is detrimental to consumers and to the community as a whole. Nothing in the TPA addresses this issue..."[11]

Thus a regulatory solution is required. Asciano recommends extending price regulation to privatised ports. Initially this regulation could be light handed price monitoring and if monopoly pricing was detected and not remedied more heavy handed regulation (such as building block price regulation) could be introduced.

4.2 Vertical Integration in Rail

One of Asciano's key markets is Coal rail haulage in Queensland. In this market Asciano's key competitor is a vertically integrated monopolist Aurizon who own the network and competes for above rail haulage.

Rail in Queensland is regulated by the Queensland Competition Authority (the "QCA") and the QCA is currently reviewing Aurizon's UT4 – its fourth access undertaking. Asciano has been very active in the current and previous regulatory review processes. However, a constant concern through all the regulatory process is the lack of constraint upon Aurizon's ability to anti–competitively discriminate against its above rail competitors such as Asciano.

Aurizon's structure and market positioning has changed since it was privatised in 2010. Aurizon has moved to a more functional model whereby its monopoly Network business is less of a standalone business. Significant services, including notably strategy development, are undertaken at the centre for all of Aurizon including both above (competitive) and below (monopoly) rail operations.

[11] Hilmer Report at 186-187.

Aurizon are modelling themselves on US Class 1 Railroads which are vertically integrated operations.[12] The influence of US Railroads in evident in their strategy, functional structure and employment of key ex Class 1 Executives most notably to head up their regulated business Aurizon Network.

Aurizon are clearly positioning themselves to reduce the regulatory impact on their business and to exploit being a vertically integrated monopolist. The market positioning and approach of Aurizon, which is seeking to reduce regulatory impact and to exploit its vertically integrated monopoly position, makes having an effective non discriminatory regulatory regime significantly more important now than it has been in the past. Without appropriate regulation we have the potential to lose the economic benefits that competition in above rail haulage has produced. This benefit includes demonstrated improvements in price efficiency, system volume and service improvements.

It is useful to understand the many and subtle forms of potential discrimination when assessing the appropriateness of regulatory regimes. We describe four example of discrimination below.

Example 1 - Timing of Investment

A coal company is developing a new mine and needs capacity expansion on the main line in order for it to move its projected tonnes. In responding, the vertically integrated monopolist indicates that given its current commitments it would be in a position to increase capacity within 18 months but if the coal company used the vertically integrated monopolist's coal haulage operator it could increase capacity within 9 months. This conduct in effect undermines competition in the above rail market. The type of discrimination will be facilitated where there is not separate management of vertically integrated monopolist and reinforces the need for strong audit and information gathering powers for the regulator.

[12] See for example Aurizon Investor Briefing 18 July 2013 p 21

Example 2 - Maintenance Timing

There is the potential for performance of the network to be used in subtle ways so that one rail haulage provider's service quality to its customers is degraded. For example, if a particular part of the network such as a spur line was used either exclusively or much more significantly by a third party operator than the vertically integrated monopolist’s above rail operator, then less frequent or inferior maintenance of that spur would have a differential impact on the third party operator.

Over time, the resulting lower performance of that part of the network could lead customers to regard the third party operator's service quality as inferior compared to vertically integrated monopolist. This would be through no fault of the third party operator but due to the way in which vertically integrated monopolist prioritised maintenance of different parts of the network. This type of discrimination is also an example of something which would not be immediately obvious to the third party operator.

The potential for this type of non-transparent discrimination is why there needs to be clear power given to the Regulator to monitor compliance with regulation to ensure that the potential discrimination can be detected. It also highlights the importance of compliance focussed KPIs which are transparently monitored and investigations are undertaken when KPIs indicate a potential issue.

Example 3 - Management of constraints

The management of incidents on the network is another area where there is the potential for vertically integrated monopolist to unfairly discriminate between rail operators. For example, if a portion of the track was washed away the vertically integrated monopolist would then have to decide how it should allocate the available constrained capacity. The vertically integrated monopolist could favour it related operator in the allocation.

Example 4 - Reducing access pricing

The vertically integrated monopolist could set access prices at a lower level should the coal company sign up with vertically integrated monopolist’s above rail operator. The vertically integrated monopolist could avoid being in breach of non discrimination regulations by also offering other above rail operators the same access price, but this is irrelevant as the above rail contract has already been committed to the vertically

integrated monopolist. This form of discrimination is rather elegant as often the regulatory regime allows the vertically integrated monopolist to increase prices elsewhere to make up for reducing their access prices to secure the above rail contract.

The ultimate way of preventing this discrimination from occurring is to not have vertically integrated monopolists. However, if that is not an option then in Asciano's opinion the regulatory regime should have as a minimum five key elements.

1. Ring Fencing

Appropriate ring fencing requires both the physical separation of people and systems between the monopoly and competitive parts of the business but also, and potentially more importantly, management independence. Indeed, the most effective way to prevent discrimination is to have management incentives aligned to compliance through significant consequences of breach and independent management of the network or monopoly business. Independent management requires that the management are remunerated only on the network's performance rather than vertically integrated monopolist as a whole (including the competitive above rail business). In this way they will take decisions in the best interests of network and not seek to exploit its monopoly vertically integrated power by discriminating in favour of its above rail business. Management independence comes through a number of ways:

- independent Board;
- independent executive management;
- limitations on staff exchange; and
- information control.

The implementation of the independence provisions need to be effective. For example Aurizon does have a separate Network (its monopoly regulated business) board but each of the Directors with the exception the CEO of Aurizon Network also sits on the Aurizon Holdings board. [13] Each has a substantial holding of Aurizon shares and each receives significant remuneration from Aurizon holdings. Thus there is no independence of the Aurizon Network board and it is just a subset of the

[13] Source ASIC as at 11 September 2011 and Aurizon holding Annual Report 2013

Aurizon Holdings board and all its members are remunerated not on the performance of Aurizon Network but the performance of Aurizon Holdings including the performance of the competitive above rail operator.

2. Effective Non Discrimination provisions

Clear and robust non discrimination regulation provisions which provide clarity to the vertically integrated monopolist on what is and isn't permitted need to be implemented. These clear provisions then allow for, if given appropriate powers, the regulator to enforce and issue penalties where required.

3. Strong Regulator Enforcement Powers

It is vital that the regulator has the power to ensure compliance with the regulations. This requires:

- The regulator having strong information gathering powers
- an effective KPI regime to allow for potential discrimination to be highlighted. For example the KPIs need to include service performance of the monopoly network provider split by service to its own related operator and non related operator. This allows potential discrimination in service provision to be identified and investigated.
- Regular Third party audit of compliance with:
    - the auditor chosen by the regulator
    - the regulator given powers to direct the focus the audit
    - competitors of the vertically integrated monopolist allowed to input into focus of the audit
    - transparency of audit result
    - a requirement for auditor recommendations to be implemented by the vertically integrated monopolist

4. Penalty Regime

It is important that there are consequences for breach of regulatory provisions. Often regulatory regimes have extreme punishments (eg large fines through court action) but given the uncertainty surrounding court processes and the transaction costs this will only be used in extreme cases of breach. Smaller breaches would go without punishment. This gives the potential for access providers to consistently breach the regulation without punishment, potentially causing serious harm to its above rail competitors.

One approach that has some merits is the introduction of a penalty regime similar to the Infringement Notices regime used by the ACCC.[14] Infringement notices are designed to provide a timely, cost-efficient enforcement outcome in relation to relatively minor contraventions of the Act.

The ACCC may issue an infringement notice where it has reasonable grounds to believe that a person has contravened certain consumer protection provisions of the CCA. To be valid, the ACCC must issue an infringement notice within 12 months of the alleged contravention.

The penalty amount in each infringement notice will vary, depending on the alleged contravention, but in most cases is fixed at $10,200 for a corporation and $102,000 for a listed corporation.

The ACCC take into account a broad range of sometimes competing factors in considering whether to seek to resolve a matter through the issuing of an infringement notice. The ACCC is more likely to the use of an infringement notice where:

- the contravening conduct is relatively minor or less serious
- there have been isolated or non-systemic instances of non-compliance
- there have been lower levels of consumer harm or detriment
- the facts are not in dispute or where the ACCC considers the circumstances giving rise to the allegations are not controversial, and

[14] See ACCC (2013) "Guidelines on the use of infringement notices by the Australian Competition and Consumer Commission" available here http://www.accc.gov.au/system/files/Infringement%20notices%20-%20Guidelines%20on%20the%20use%20of%20infringement%20notices.doc

- where infringement notices form part of a broader industry or sectoral compliance and enforcement program following the ACCC raising concerns about industry wide conduct.

5. Strong Compliance Program

The regulator should require the vertically integrated monopolist to have a strong compliance program. A compliance program at a minimum should include:

- a effective internal audit process;
- Confidential reporting line (Whistleblower line);
- Complaint handling procedure;
- Breach disclosure;
- Internal declarations of compliance for all key individuals; and
- Issues Register;

Asciano has argued consistently that the Queensland regime falls short of these key features[15] despite being certified as effective. This needs to be remedied. One avenue of doing this would be to add to the criteria for certification set out in the Competition Principles agreement. A criterion should be added to reflect situations where there is a vertically integrated monopolist. This criterion should require the regulatory provisions identified above to be implemented prior to certification. In addition to assist the effectiveness of the certification process there should be a requirement to take into account the effectiveness of an access undertaking (as an indicator of how effective the regime is) and there should be a requirement to recertify when there is a material change in the regime of access undertaking.

[15] See for Example http://www.qca.org.au/getattachment/36b66d2a-9407-4da8-9a36-e70c3ef0521f/Asciano-Submission-to-the-QCA-on-Aurizon-Network's.aspx