Queensland Competition Authority

Submission

# Competition Policy Review

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# Table of Contents

# THE ROLE OF THE QCA – TASK, TIMING AND CONTACTS

The Queensland Competition Authority (QCA) welcomes the opportunity to respond to the Commonwealth's Competition Policy Review draft report. The QCA is an independent statutory authority established to promote competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements. In 2012, that role was expanded to allow the QCA to be directed to investigate, and report on, any matter relating to competition, industry, productivity or best practice regulation; and review and report on existing legislation.

The Queensland Office of Best Practice Regulation (OBPR) was established within the QCA by the Queensland Government in 2012. OBPR is responsible for ensuring best practice regulation (including building the capability of departments to produce good quality regulatory impact analyses) as a key initiative of the Queensland Government's commitment to reduce red tape.

Finally, the QCA is responsible for investigating competitive neutrality complaints lodged against state and local government owned enterprises.

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# EXECUTIVE SUMMARY

The Queensland Competition Authority (QCA) welcomes the draft report.

The review is a timely reminder to all Australians that greater competition in markets and greater contestability in the supply of government services will lift productivity and living standards. In our earlier submission, the QCA raised a number of overdue competition policy reforms. It is pleasing that the QCA and the review agree on nearly all of these issues.

To assist the review, the QCA will concentrate in this submission on other issues, in particular issues where the QCA has expertise and can offer a different perspective to the proposals floated in the draft report.

The most important of these issues is access regulation.

The QCA recognises the concerns raised in the review about the regulatory costs and uncertainty associated with access regimes. The QCA accepts that poorly designed or implemented access regimes could lead to under-investment in infrastructure. The QCA agrees that, as markets change, the nature and scope of access regulation should be reassessed to ensure efficient regulation.

However, the QCA does not believe a persuasive case for fundamental change has been made. The underlying market failure addressed by access regimes - the capacity of natural monopoly owners to extract rents through aggressive pricing and restricting supply - continues to exist. While markets have evolved since 1995, misuse of monopoly power by owners of essential facilities can still damage competition in upstream and downstream markets. These risks are evident in many infrastructure sectors, such as rail, water, ports, telecommunications, electricity and gas. Access regulation, or the plausible threat of an access declaration, mitigates these risks.

In the same vein, the QCA does not support the proposal to retain the private profitability test. The QCA believes that this test is not well grounded in economic principles and is unlikely to enhance competition. Applying the test will tend to encourage inefficient duplication of assets or strengthen the monopoly power of owners of essential facilities. The QCA is not aware of any strong evidence that access regulation has prevented the timely development of new infrastructure.

The QCA is concerned that the private profitability test could be used to roll back existing declarations. In such a case, users of the infrastructure could see their assets stranded as access conditions become more onerous.

Nevertheless, the QCA does not defend the status quo in access regulation. We have longstanding reservations about aspects of the national access regime. As mentioned in our earlier submission, the QCA is concerned that facility owners have the capacity to extract excessive returns (in terms of project risks and costs) by controlling the timing of network expansions. The Competition Principles Agreement (1995) provided that the facility owners would have their legitimate business interests protected if they were required to extend, or permit the extension of, their facility. The National Access Regime differs (also mirrored in the Queensland Access Regime), wherein a service provider can be required to expand or extend its facility, but not at its cost.

To address this issue, the QCA is working with Aurizon Network and its customers to create a contestable market for project finance for network expansions in the rail sector. The QCA has just released a draft decision on a standard user funding agreement (SUFA) which would allow a broad range of third parties, including network customers, to fund projects. Expanding the pool of potential investors should create competitive tension and exert downward pressure on project financing costs. It would remove the effective veto held by the facility owner. Unfortunately, the SUFA approach is likely to be too complicated and resource-intensive to be affordable for small projects (i.e. under $300 million).

The QCA notes that the review is considering institutional changes to integrate access and pricing regulation. The obvious risk in such a debate is that it will quickly degenerate into a turf war rather than an objective assessment of the strengths and weaknesses of different governance models. It will be important for the review to provide solid evidence of the merits of competing models. The QCA is aware of concerns across State jurisdictions that the transfer of some powers to national regulators has not delivered better outcomes; any proposal to further centralise regulatory responsibilities will need to address these concerns.

These matters are the focus of our submission.

# 1 SUBMISSION: COMPETITION POLICY REVIEW

## 1.1 Support for the draft competition policy reforms

The QCA largely agrees with the competition policy recommendations in the draft report. Competition and enhanced consumer choice will fuel significant increases in productivity across many markets subject to excessive government controls or dominated by government provision of services. In particular, the Review has identified several markets where direct government intervention artificially limits entry and competition.

Arguments that restrictions on competition are necessary to protect consumers are seldom correct. In most cases consumer protection provisions can be achieved without restricting entry or otherwise controlling competition. In some cases blanket restrictions on competition can be replaced with more targeted restrictions designed at particular geographic or product markets to address market failures.

Given this, we support the review's focus on many traditional areas that are overdue for reform. These include reforms to retail trading hours, competitive neutrality requirements, taxi and pharmacy regulation as well as harmonisation of regulatory requirements for electricity retailers.

In this submission, we will focus on aspects of the regulatory environment which can encourage inefficient use of infrastructure or which leads to capacity bottlenecks in the economy. The submission is structured as follows:

- Section 1.2 – access regulation and the uneconomic to duplicate criterion: we outline shortcomings with the private profitability test and recommend a return to the natural monopoly test
- Section 1.3 – facility expansions and regulation: we consider the existing restrictions on a regulator to compel an extension of a regulated facility should be reviewed given existing controls in place in the Competition Principles Agreement
- Section 1.4 – concluding comments.

## 1.2 Access regulation

### Background

In 2012, the High Court changed the interpretation of the 'uneconomic to duplicate' criterion in Part IIIA of the CCA as part of its Pilbara ruling.

The High Court held that access need not be provided if any business (including the incumbent owner) would find it privately profitable to build another facility. Before this ruling regulators essentially applied a natural monopoly test: if provision of access to a facility improved economic efficiency by minimising the total cost to society of providing access, then access should be recommended.

The general view is that the effect of the High Court test is to substantially raise the hurdle for a third party to satisfy before a facility is declared and access granted.

The Productivity Commission reviewed the national access regime, including considering the effect of the Pilbara ruling (PC, 2013). Our submission to the PC review (amongst others) recommended reinstating the natural monopoly test. The PC's Final Report supported a modified version of the natural monopoly test which considered whether a facility can meet total foreseeable market demand for the service, which included the demand for substitute services (PC, 2013: 161).

The QCA has not formed a conclusive position on the PC's market-based approach though it acknowledges that the test seeks to improve economic efficiency by focussing on whether a facility can exert monopoly power.

In any event, the QCA considers that both the natural monopoly test and PC's market-based approach are superior to the existing private profitability test as they focus on the economic issues associated with market failure in a declining cost industry.

The draft report recommends retaining the private profitability test modified only to make clear that an argument by the incumbent access provider that it could profitably duplicate the facility is not relevant.

The logic of the draft report appears to rely on two key assumptions:

- access regulation is intrusive and the higher hurdle of the private profitability test may be appropriate for facilities not yet declared
- the need for further Part IIIA declarations is limited because access regimes are now in place for the specific monopoly infrastructure markets that were the primary target of the original Hilmer Review.

We do not consider that these assumptions apply to Queensland. Rather, we consider that the application of the private profitability test could reduce economic efficiency by requiring the costly duplication of existing infrastructure and/or enabling monopoly pricing for essential monopoly infrastructure in the mining supply chain. We elaborate our concerns on these matters in **Appendix A**.

Relevantly, the National Access Regime and the Queensland Access Regime both originated from the Competition Principles Agreement and have similar objectives. Given this, we are of the view that we would be obliged to apply the private profitability test in the absence of state-specific legislative amendments to restore the natural monopoly test. This is not ideal as it could lead to differing requirements across jurisdictions and provide scope for forum shopping. Given this, our preference is for this matter to be addressed at the Commonwealth level.

## The impact of the private profitability test on existing declarations

While the private profitability test raises the hurdle for declaration, it also applies in reverse to lower the hurdle for revocation of a declaration. This means that the private profitability test will provide for a declaration to be revoked where it is privately profitable to duplicate infrastructure that provides a declared service.

Declarations must be reviewed on a regular basis. In Queensland, declarations must be reviewed every ten years.

The QCA may also receive revocation applications for the facilities or parts of the facilities that are declared. For example, the Central Queensland Coal Network (CQCN) infrastructure of Aurizon Network is declared for third party access under the *Queensland Competition Authority Act 1997* (see **Appendix B**). This requires Aurizon Network to provide miners with access to their rail network on fair terms and conditions as determined in an undertaking approved by us.

However, it could be open for Aurizon Network to argue that it may be privately profitable for another entity to develop a rail line that provided competing below rail services for all or part of the individual systems (that collectively form the coal network). On this basis, Aurizon Network could submit that it is therefore not uneconomical to duplicate parts of its declared infrastructure – i.e. revocation of declaration should occur for parts of the CQCN.

But Aurizon Network's rail network was privatised (via a long term lease) on the basis that an effective access regime would apply following privatisation. Coal miners in Queensland have made significant investments in their own operations in part on the basis that they would continue to receive access, on reasonable terms, to essential infrastructure facilities. Any revocation of declaration, particularly to the service provided by parts of Aurizon Network's infrastructure, would mean these miners would have no choice but to negotiate with a monopolist (i.e. be price takers), with the alternative being the potential stranding of their assets.

The QCA considers that such an outcome would clearly be against the intent of all of Part IIIA of the CCA, Part 5 of the *Queensland Competition Authority Act 1997* (QCA Act) and the Competition Principles Agreement. More particularly, it is hard to believe that this should be the intention of the National Access Regime going forward.

## Economic significance

The draft report cites the cost of declaration and subsequent regulation as a basis for applying the more restrictive private profitability test. However, the benefits of ongoing regulation of monopoly infrastructure in the mining supply chain are substantial.

For example, for Aurizon Network, we recently proposed to:

- provide for a maximum allowable revenue 19% lower than originally proposed—a reduction of almost $900 million for the regulatory period–yet to a level that is sufficient to compensate efficient costs ( QCA, 2014a)
- facilitate the development of a detailed legal and regulatory framework for third party funding of rail infrastructure on the CQCN (i.e. the Standard User Funding Agreements) (QCA, 2014b)
- encourage more transparency, trust and confidence between Aurizon Network and its customers—to encourage greater innovation and collaboration to get the most out of the existing CQCN infrastructure, as well as the infrastructure across other aspects of the supply chain.

Likewise, for Queensland Rail, we recently proposed to:

- provide for a 36% reduction to the western system coal tariffs compared to the original tariff proposals
- enable a more balanced investment framework for building network extensions
- allow for pricing certainty at contract renewals for the Mount Isa line, rather than allowing Queensland Rail to set prices at its discretion, creating the risk for asset stranding
- ensure that Queensland Rail's discretions in a range of areas be exercised reasonably, rather than it having absolute discretion (QCA, 2014c).

As our consideration of these issues is continuing, our final recommendations may well change. However, these matters illustrate the high stakes associated with access regulation for the Queensland mining industry.

We acknowledge that there are regulatory costs associated with regulation, but we believe that these costs are outweighed by the benefits that can accrue to users and the wider community. It should be noted that these costs are generally passed through by the facility owner to its customers. In our experience, customers are prepared to pay reasonable regulatory costs because the alternative would be even more costly for them. It is a modest insurance policy.

In this context, the QCA believes that regulation in its current form is in the public interest. The private profitability test should therefore not be used to justify changes to ongoing regulatory schemes.

## 1.3 Facility expansions and extensions

### Background

The Central Queensland Coal Network (CQCN) is the largest coal rail network in Australia. The CQCN has seen significant expansion over recent years to meet demand for increased railings for coal exports. Aurizon Network suggests that by 2016-17 the CQCN will have a built capacity of around 310 million tonnes, compared to 187 million tonnes in 2009-10.

While Aurizon Network has made significant investments in expanding the network, it has also said that, as a commercially listed company, it should not be obliged to expand the network. It has noted it has an obligation to meet its shareholders' legitimate expectations of achieving appropriate returns for infrastructure investments. The QCA understands this view.

The QCA Act, similar to the CCA, stipulates that under an access regime, a regulator cannot require an access provider, such as Aurizon Network, to pay some or all of the costs of extending its network[1]. Nonetheless, the QCA Act also allows the regulator to require an access provider to extend its network.

### Standard User Funding Agreements

In our final decision on Aurizon Network's[2] 2010 access undertaking (UT3), we required Aurizon Network to provide us with a proposed Standard User Funding Agreement (SUFA) and related amendments to UT3 to fully implement the investment framework amendments (Schedule J). SUFA is a suite of standard pro-forma agreements designed to facilitate alternative options to Aurizon Network funding rail infrastructure expansions on the CQCN.

The need for SUFA stems from what Aurizon Network's stakeholders described during its UT3 review as an unwillingness to fund expansions on its network at the regulated rate of return. At that time, coal project proponents wanted access to what was described by Aurizon Network as 'a capacity constrained network in need of expansion'.

Stakeholders were very concerned about protracted access negotiations and Aurizon Network's requests for higher than regulated returns, for what Aurizon Network perceived as higher risks for constructing expansions. Access seekers wanted us to require Aurizon Network to construct expansions at Aurizon Network's cost.

In October 2014 we released our draft decision on Aurizon Network's proposed SUFA, recommending changes we felt necessary to achieve a workable, bankable and credible framework. We consider a SUFA framework will work. However, due to the high transaction

[1] Unless the access provider has voluntarily agreed to do so within its access undertaking.
[2] then QR Network

costs associated with the complex SUFA documents it is only likely to be useful for the largest expansion projects.

Problems with negotiating smaller expansions are likely to persist. In this context, we consider there is benefit in reviewing the 'at no cost' requirement in the CCC Act as there are limited protections in place for smaller sized expansions. We note that, under clause 10 of the Competition Principles Agreement 1995, a state or territory access regime should incorporate the following principles:

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

We consider that these principles are fair and reasonable for all parties and recommend that the CCA Act be amended to remove potential future impediments to efficient investment in new infrastructure.

## 1.4 Concluding comments

To date, the Commonwealth and State access regimes have provided a relatively seamless division of responsibilities between those facilities that are regulated nationally and those that are regulated by the states.

Thus, the Queensland Access Regime, as embodied in Part 5 of the QCA Act, has many elements similar to the National Access Regime. These include similar objects clauses, provisions for declaration/revocation and for arbitration of access disputes.

Given this, we do not consider that the proposed move to a single regulator will generate any measurable cost savings. Indeed, it can be argued that the maintenance of state-based regimes provides a degree of flexibility that is not present in the Commonwealth regime. For instance, Part 5 of the QCA Act includes a requirement for an access provider of a declared facility to submit an access undertaking to us for approval. This goes beyond the voluntary regime that exists at the Commonwealth level and enables the QCA to approve a consistent set of terms and conditions by which access must be provided. This has the potential to avoid multiple and costly access disputes that may otherwise occur.

The focus of our submission has therefore not been on the institutions that administer access. Rather, our submission has sought to identify changes to the regulatory environment that will enable fair and timely access to significant infrastructure in a manner that promotes economic efficiency while protecting the legitimate interests of the access provider.

# GLOSSARY

| | |
|---|---|
| **C** | |
| CCA | the Competition and Consumer Act 2010 |
| CPA | the Competition Principles Agreement 1995, by Council of Australian Governments |
| CQCN | the Central Queensland Coal Network |
| **P** | |
| PC | the Productivity Commission |
| **Q** | |
| QCA | the Queensland Competition Authority |
| QCA Act / the Act | the Queensland Competition Authority Act 1997 |
| **S** | |
| SUFA | Standard User Funding Agreements |
| **U** | |
| UT3 | QR Network (now Aurizon Network) Access Undertaking 2010 |

# APPENDIX A: PRIVATE PROFITABILITY TEST AND ECONOMIC EFFICIENCY

The underlying purpose of an access regime should be to improve economic efficiency (QCA, 2013b). We consider the Pilbara Case private profitability test is inconsistent with this goal as it will restrict access to large facilities with natural monopoly characteristics, encouraging inefficient duplication by potential (large) access seekers while creating the risk of asset stranding for potential (small) access seekers.

Therefore the QCA believes that the natural monopoly test is superior to the existing private profitability test.

The draft report suggests that the access regime was intended to apply to the 'bottleneck' facilities identified in the original Hilmer Report and that these facilities are now regulated (albeit primarily outside the CCA access regime through state-based or specific industry-based schemes). The private profitability test is endorsed in the draft report because it helps to identify bottleneck facilities – those without which a competitor cannot enter unless access is available.

However, limiting access to only bottleneck facilities means that there will remain a range of natural monopolies with excess capacity which can more efficiently provide services rather than these services being duplicated. This is not an effective utilisation of resources.

The draft report notes that declaration proceedings are expensive and time consuming. There may also be concerns that subjecting an incumbent firm to access regulation may deter the initial investment or raise the costs of the incumbent facility owner. It is apparently for these reasons that the stricter bottleneck test is preferred over the natural monopoly test by the Competition Policy Review panel.

The cost of declaration proceedings and the cost of regulating access are real problems that must be recognised. So are the potential negative investment incentives associated with requiring an investor to share facilities it has built for its own use. However, the QCA is concerned that the recommendation in the draft report is too broad. As discussed below, the High Court's private profitability test will have consequences for existing monopoly infrastructure regulation and for the regulation of multi-user monopoly facilities that are currently being developed or that will be required in the future.

If an existing monopoly rail provider is able to avoid declaration, or have an existing declaration revoked by showing that an entrant could duplicate the facility and still be profitable, the result will be reduced competition in markets both upstream (i.e. mines) and downstream (i.e. rail transport providers).

The imaginary less-efficient facility will essentially provide a price umbrella for the incumbent firm. In the case where the product is sold into a local market, the profit-maximising strategy of the unregulated incumbent may be able to charge a price above cost but just low enough to deter construction of the new facility. If there is a credible threat of strategically dropping prices after entry, there is even a risk that the incumbent might charge a full monopoly price without attracting entry.

The private profitability test has implications for potential third party access to a range of current and planned infrastructure projects in Queensland, including those related to rail and export terminal infrastructure. It will now be easier for a facility owner to argue that they should not be required to provide third party access on the basis that it is privately profitable for a competing party to develop duplicate infrastructure. However, as noted above, the development of multiple and duplicate pieces of infrastructure are likely to impact on the development costs of an access seeker and significantly affect the investment decisions of small miners who may not have the resources to fund the development of mine supporting infrastructure (like railway lines or terminals) themselves.

Moreover, unnecessary duplication may also lead to increased costs of production while revocation of existing declarations could lead to mine asset stranding and the loss of royalty revenues. Unnecessary duplication of infrastructure may also have environmental impacts, including the unnecessary clearing of land, approvals of rail line easements, noise pollution, land resumptions, water flows and run-off.

# APPENDIX B: CENTRAL QUEENSLAND RAIL COAL NETWORK

**Box 1 Aurizon Network - Central Queensland Coal Network**

## Central Queensland Coal Network

The CQCN is made up of around 2670 km of track servicing around 49 mines, three power stations and five port terminals. There are four major coal systems:

- the Moura system—connecting the Moura mine to Gladstone—primarily services coal mines in the Moura region and Callide Basin, with all coal being hauled to Gladstone, either for use at domestic industrial plants, Gladstone Power Station or for export via the Port of Gladstone
- the Blackwater system—connecting Gregory, Rolleston and Minerva to Gladstone, including the part of the North Coast Line between Parana and Rocklands—primarily services coal mines in the central and southern Bowen Basin and carries the product through to Stanwell Power Station, Gladstone Power Station and the Port of Gladstone
- the Goonyella system—connecting Gregory, North Goonyella and Blair Athol mine to the Port of Hay Point—services coal mines in the central and northern Bowen Basin and carries product to the ports at Hay Point. The Goonyella System connects to the Blackwater System in the south and the Newlands system in the north
- the Newlands system—connecting Newlands to the Port of Abbott Point, including the part of the North Coast Line between Durroburra and Kaili—is located at the northern end of the Bowen Basin connecting to the port at Abbot Point. The system services mines located in the Newlands System, as well as an increasing number of mines located in the Goonyella System via the Goonyella to Abbot Point Expansion (GAPE) project.


*Source: Aurizon Network 2013 DAU, submission. See also section 250(3) of the QCA Act.*

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