SUBMISSION TO THE COUNCIL OF AUSTRALIAN GOVERNMENTS

Review of National Competition Policy

Australia's Export Infrastructure

BHP BILLITON IRON ORE PTY LTD

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PREFACE

1. On 3 June 2005, the Council of Australian Governments (**COAG**) agreed that COAG Senior Officials would undertake a review of the national competition policy (**NCP**) and provide a report by December 2005.[1]

2. As part of that review, COAG agreed to consider a simpler and consistent national system of regulation for ports and export-related infrastructure.[2]

3. BHP Billiton Iron Ore (**BHPBIO**) provides the following submission in order to assist COAG in its review of NCP and in particular its consideration of regulation of export-related infrastructure.

SUMMARY

4. Export-related infrastructure should not be subject to access regulation because, generally speaking, the benefits to Australians of such regulation are significantly less than the costs. Global markets, almost by definition, are competitive, and it is difficult to identify any Australian industry that can demonstrably affect global competition. Further any benefits of additional competition, were it to exist, would be concentrated in offshore markets.

5. The costs of regulation - and regulation enquiries – are commonly very large. These costs are incurred by Australians. Intangible costs – such as delays to expansions, delays to the introduction of new technology and new work practices, and the possible chilling effect on investment – are very significant.

6. Further, such regulation is fraught with error and uncertainty. This is in part caused by the failure of regulators to take into account **all** of the costs imposed upon an infrastructure owner in determining access pricing.

7. As a result of these problems, regulation of export-related infrastructure will impose significant costs on Australian society including reduced output, increased inefficiencies, decreased incentives to invest, diminished international competitiveness and increased opportunity costs due to lack of infrastructure-based competition. The offsetting benefits are minor.

8. These costs are amplified in circumstances in which vertically integrated supply, logistics or production systems are subject to third party access.

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[1] Council of Australian Governments, *Communique*, 3 June 2005, pp4-5.

[2] Council of Australian Governments, *Communique*, 3 June 2005, pp3-4.

9. The threat of regulatory intervention will also act as a deterrent to the investment in rail and port infrastructure because of the real risk that the benefits arising from the investment will be expropriated by third parties.

10. In light of the above, the best approach is to "stand aside" and facilitate private investment in infrastructure without fear of regulatory expropriation. That is, access to and investment in export-related infrastructure should be determined by the free forces of the market as is the case in the US and not by regulatory intervention which has been shown to impose significant costs on Australian society.

SUBMISSIONS

Regulatory concerns

11. BHPBIO agrees that the current regulatory framework for access to infrastructure is "adversarial, cumbersome, time consuming, inefficient and subject to gaming by participants."[3] As a result (and as demonstrated by recent experiences)[4] access regulation of export-related infrastructure is impeding the development of infrastructure that is necessary for Australia to realise its export potential.[5]

12. This is the case due to:

    (a) The complexity of the issues required to be considered under the current access to infrastructure regulations.

    (b) The obvious motives of profit-maximising firms, seeking to take advantage of regulatory options that become available to them due to the current regulatory framework.

    (c) The degree to which the current regulatory framework does not take into account many of the costs of providing access.

Complex issues – "adversarial, cumbersome, time-consuming"

13. Part IIIA of the Trade Practices Act 1974 (TPA) requires the regulator (the NCC and then the relevant Minister) to consider several factors in assessing an application for declaration of a "service". They include whether:

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[3] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at p2.

[4] See paragraphs 13-14 below.

[5] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at p2.

(a) declaration will promote competition in another market (be it within or outside of Australia[6])[7];

(b) it would be "uneconomical" for anyone to develop another facility to provide the service to be declared[8];

(c) access to the service can be provided without undue risk to human health and safety[9];

(d) access to the "service" is already the subject of an effective access regime[10]; and

(e) access to the "service" would be contrary to the public interest[11].

14. BHPBIO's own experience has been that an inquiry into these issues may be provoked simply by an access seeker filing an application for declaration of a "service" provided by a "facility", supported by bare propositions that the criteria above (and others) are made out. In response however, the infrastructure owner (which may have many millions – or in BHPBIO's case, billions – of dollars of sunk investment and future costs or inefficiencies at risk) is required to undertake very detailed and extensive inquiries, and to prepare lengthy submissions to the NCC in response.[12]

15. In BHPBIO's view:

(a) an application for declaration of an infrastructure "service" gives rise to an onerous, lengthy, complex and detailed inquiry process – one which has imposed on the infrastructure owner, particularly, a considerable and disproportionate burden; and

(b) the regulators' task of analysing the factors which are relevant to an application to declare a "service" is difficult and complex – it will necessarily be time consuming.

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[6] This leaves open the possibility that declaration of Australian infrastructure may deliver more competition in overseas markets, but not within Australia.

[7] See s44G(2)(a) and s44H(4)(a) of the TPA

[8] See s44G(2)(b) and s44H(4)(b) of the TPA

[9] See s44G(2)(d) and s44H(4)(d) of the TPA

[10] See s44G(2)(e) and s44H(4)(e) of the TPA

[11] See s44G(2)(f) and s44H(4)(f) of the TPA

[12] Even a fleeting comparison of the depth of analysis in the submissions filed by FMG and BHPBIO respectively, in the consideration by the NCC of the application for declaration of the Mt Newman and Mt Goldsworthy railway lines by FMG, will demonstrate this point. The submissions are available at *www.ncc.gov.au*.

Regulatory Options open to the Access Seeker

16. In the case of export related infrastructure such as ports and rail operations, there are obvious incentives for "access seekers" to seek to impose regulatory constraints on the infrastructure owner simply to assist in the negotiation of better commercial outcomes (in access prices and conditions) for access seekers.

17. Such a strategy will commonly impose costs or inefficiencies on others (be it the infrastructure owner, other users of the infrastructure, or commodity producers). However, that is likely to be of no concern to the profit-maximising access seeker.

18. It is clear that "gaming" of the regulatory framework may be a profit-maximising strategy for any one or more access seekers. However, that "gaming" strategy will potentially impose costs and diseconomies on many others.

Inefficient - Failure to take all costs into account

19. There are many costs and diseconomies involved in an application for access to infrastructure which are not taken into account. These are imposed, without compensation, on the infrastructure owner, and on the Australian economy.

Direct costs

20. First, simply responding to the application by an access seeker to declare an infrastructure service, can and will involve very significant costs – both direct costs (in procuring the necessary specialist consulting and legal assistance), and indirect costs in management time, disruption and distraction from productive work. For example, in BHPBIO's own experience, in responding to the FMG application, senior BHPBIO executives have been seriously distracted from developing plans to increase output from the Pilbara iron ore operations. In BHPBIO's own estimation, this has delayed BHPBIO's expansions by many weeks – at a cost, in terms of foregone revenue, of more than A$20 million per week, some of which would have been payable to the State of WA as royalties. Further delay is likely as the regulatory process continues[13].

These costs are not recoverable from the access seeker or any other person.

[13] It should be noted that an application to declare a "service" is just the first step. The Minister's decision (to declare or not to declare) may be appealed to the Australian Competition Tribunal (ACT). Once resolved, the parties must negotiate access terms and pricing. Failure to agree will result in an arbitration before the ACCC. The result of that arbitration may be appealed to the ACT. Decisions of the ACT may be appealed on questions of law, to the Federal Court. These processes may take many years to resolve.

Impacts on Vertically-integrated Infrastructure

21. Secondly, where the infrastructure "service" sought to be declared falls within a vertically integrated business operation (such as integrated supply, logistics or productions chains), the costs of regulation are exacerbated.[14]

22. This is because access seekers and regulators fail to consider the effect of their actions on the integrated operations as a whole.[15]

23. For example, in seeking declaration of a "rail track service" on rail infrastructure which is currently fully integrated with mine and port operations, the access seeker and regulator will focus on the capacity and capabilities of the rail assets alone. However, the rail infrastructure may have (viewed on its own) limited spare capacity (ie an ability to accommodate more trains), but when viewed within the entire system, the capacity of the rail line accommodates or facilitates smaller stock piles being retained at port and at the mine, or other such efficiencies. Alternatively, investment in further rail capacity by the access seeker, where it is necessary, may be highly inefficient within the context of an integrated system.

24. Where an access seeker obtains access to such a "rail service", it will have very different incentives to the integrated infrastructure owner. The access seeker will be focussed simply on running its trains. The owner will be focussed on operating (and, over time, developing and investing in) the entire system as efficiently as possible. This conflict of interests can, and will, result in substantial inefficiency and costs. As each stakeholder designs its operations around its own requirements, the outcome is a lack of coordination which in turn constrains the chain and contributes to costly bottlenecks.[16] Such bottlenecks might be minimised with efficient logistics management that coordinates daily operations between all parties, but the access seeker will have a clear incentive to avoid (and dispute) any costs which it contends are not directly related to its train operations. Thus, many costs of accommodating the access seeker within the entire vertically-integrated chain may not be recoverable, and the process of determining which costs are recoverable will give rise to further costs.

25. The *Exports and Infrastructure Taskforce* advised the Prime Minister of the importance of not interfering with vertically integrated, tightly managed, logistics, supply or production chains on this basis. The Taskforce indicated that Part IIIA of the TPA should make it clear that the purpose of the "production process" exemption under is to prevent the

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[14] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at p2, 39-40; Australian Government Senior Officials Group, *Delivering Reliable Australian Coal Exports to the World : Coal Transport Infrastructure*, April 2005 at p21.

[15] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at p6.

[16] Australian Government Senior Officials Group, *Delivering Reliable Australian Coal Exports to the World : Coal Transport Infrastructure*, April 2005 at p21.

imposing of third party access in vertically integrated, tightly managed, logistics chains, especially those related to our export industries.[17] The Taskforce concluded that this would minimise the risk that access regimes would disrupt and undermine the very areas of the economy that have performed best in the management of export related infrastructure.[18]

Delayed use and expansion of infrastructure

26. There are potentially very serious costs of delayed use of an infrastructure service, or delayed expansion of the infrastructure to permit further use of it, due to the time required to resolve access disputes.

27. An example in which such serious costs arose is the delayed investment in the Dalrymple Bay Coal Terminal.

28. The Darymple Bay Coal Terminal (**DBCT**) and Hay Point Coal Terminal (**HPCT**) are located side by side at Hay Point in Queensland. The HPCT is "privately" owned, whereas the DBCT is subject to access regulation. Each terminal confronted demand for increased capacity from its users, in responding to the surge in the global demand for coal. The response by the DBCT, a regulated multi-user terminal, was considerably delayed due to a long-running dispute over tariffs – the expansion investment was not able to be financed until the tariff structure going forward was resolved. However, that process took some 22 months to resolve. By contrast, the HPCT expansion proceeded without any regulatory impact.

29. The regulatory delay at DBCT has resulted in lost export sales of coal of approximately A$1 billion per annum, significant demurrage costs, and significant adverse publicity for the Australian coal industry. These are costs caused by the access regulations prevailing over the DBCT, and the dispute among the users and owner of that facility over tariffs going forward.

30. Those direct costs and opportunity costs are not recoverable.

31. **Attachment 1** to this submission is a summary of the comparative responses of the DBCT and the HPCT.[19]

Incentive for reduced investment

32. Lost sales due to delayed expansion of infrastructure are a clear and visible manifestation of regulatory intervention. Less immediately visible, but just as real, are lost sales and

[17] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at pp39-40.

[18] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at pp39-40.

[19] Also see Attachment D to submission by BHPBIO to the National Competition Council dated 12 July 2005 (located at http://www.ncc.gov.au/publication.asp?publicationID=189&activityID=32).

production due to **under-investment** in infrastructure because of the threat of regulatory intervention.

33. Capital investment in infrastructure involves complex trade offers between factors such as:

- estimates/forecasts of future demand;
- costs of capital (especially where there is a risk of under-utilised infrastructure);
- opportunity costs of under-investment[20];
- physical constraints[21]; and
- underlying industry growth.

However, judgments made on those trade offers will be substantially altered where there is a significant risk that under-utilised capacity will attract regulatory intervention by way of access demand. The "excess" capacity may be expropriated by a competitor, or it will be the subject of a dispute with a third-party trying to gain access.. Further, access charges are unlikely to compensate the infrastructure owner for all opportunity and other costs to it of granting access, and access will most commonly be sought in periods of high pricing for the relevant end product. These factors materially reduce the potential pay-offs when the investment decision is being made and will result in a more conservative investment decision being taken. A national infrastructure owner will, *ceteris paribus*, avoid installing any under-utilised infrastructure.

34. And yet absent this threat of regulatory intervention, the over-development of infrastructure is likely to be in the interests of both the infrastructure owner and the national economy where an industry has long-term underlying growth. This is the case in the global iron-ore industry, for example, where absent the considerations referred to above, producers will be minded to err on the side of over-investment in capital infrastructure because:

- the benefits[22] to be won in times of unpredicted high demand can be very large; and
- the carrying costs of under-utilised capital infrastructure are relatively small, predictable and are likely to be finite due to underlying industry growth.

[20] These may be very large where future demand is under-estimated and production capacity is unable to meet demand in "boom" times (ie. where there is high demand and high prices).

[21] Physical infrastructure assets are often unitary – eg it is impossible to install half a rail car dumper.

[22] These include benefits to the producer (increased revenue and profit), increased employment, increased State royalties and increased Federal taxes.

35. However, the benefits of over-investment in capital infrastructure will be lost where a clear incentive to under-invest, due to the threat of regulatory intervention, prevails.

Third party access can impose significant costs on society

36. The submissions above address some of the costs and diseconomies of access to vertically-integrated, single-user export infrastructure – see also the submissions made by BHPBIO to the National Competition Council.[23]

37. **Attachment 2** to this submission is a summary of the effects of declaration of a "rail track service" on the Mt Newman railway, as a result of the application for declaration by FMG. An analysis of the table shows:

    (a) It is possible that there will be small savings in the capital costs of track construction if the "service" is declared. This is the only clear "benefit" of declaration.

    (b) There are many clear "costs" (be they direct costs, opportunity costs or other diseconomies or inefficiencies) of declaration identified in the table – some of which respond to the submissions set out above (which are in more general terms).

    (c) The "costs" of declaration identified are likely to be vastly greater than the "benefit" referred to above. While some of those "costs" are difficult to quantify, BHPBIO is firmly of the view that they will arise and will be highly significant.

38. Attachment 2 is provided to the Working Party to provide concrete examples of the costs and diseconomies which will be incurred by the infrastructure owner, and society, in these circumstances.

Promotion of competition

39. Efficient and productive regulation (by application of Part IIIA of the TPA) of export infrastructure is further frustrated when one considers that the focus of infrastructure regulation has been the level to which competition might be promoted as a result of access. But in export industries, this focus is misplaced.

40. First, promoting competition does not necessarily equate to increasing economic efficiency in Australia (or elsewhere).[24] That is, while third party access to vertically-integrated, tightly managed export infrastructure chains might conceivably promote competition in a downstream market (which will be a global or overseas market in the case of export

[23] See BHPBIO Submission to the NCC dated 3 June 2005.

[24] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at p39.

infrastructure), it is highly likely to come at the cost of efficiency and investment incentives in Australian export infrastructure.[25] Such an outcome is inappropriate and inconsistent with the rationale behind Australian third party access regulation – namely to benefit Australians.

41. Secondly, many export markets (such as the market for iron ore) are global and already highly competitive.[26] In such circumstances, not only is regulation likely to result in economically inefficient outcomes, but any benefits received from any increase in competition will either be insignificant and/or reaped by overseas consumers.

BHPBIO's experience

42. On 11 June 2004, Fortescue Metals Group Ltd (FMG) applied to the National Competition Council (**Council**) to have the services provided by BHPBIO's Mt Newman and Mt Goldsworthy railway lines located in the Pilbara in Western Australia "declared" under Part IIIA of the TPA.[27]

43. Those railway lines operate as one component of a privately owned, fully integrated, single user mine, rail and port production system for the export of iron ore.[28]

44. As a preliminary matter, BHPBIO submitted to the Council that the use of its railway lines by FMG (or any third party) would involve the "use of a production process" within the meaning of the term "service" under section 44B of the TPA.[29] Accordingly, it was argued, the services sought to be declared by FMG were not subject to Part IIIA.

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[25] Exports and Infrastructure Taskforce 2005, *Australia's Export Infrastructure*, Report to the Prime Minister, Canberra, May 2005 at p39.

[26] In relation to the iron ore market, see the BHPBIO Submission to the National Competition Council dated 3 June 2005, paragraphs 127-137 and the CRA Report, Section 2 (located at http://www.ncc.gov.au/publication.asp?publicationID=189&activityID=32)

[27] FMG Application dated June 2004 (located at http://www.ncc.gov.au/publication.asp?publicationID=189&activityID=32).

[28] See the BHPBIO Submission to the National Competition Council dated 3 June 2005.

[29] Section 44B of the TPA defines "service" as follows:

> *"**service**" means a service provided by means of a facility and includes:*
> *(a) the use of an infrastructure facility such as a road or railway line;*
> *(b) handling or transporting things such as goods or people;*
> *(c) a communications service or similar service;*
> *but does not include:*
> *(d) the supply of goods;*
> *(e) the use of intellectual property; or*
> *(f) the use of a production process;*
> *except to the extent that it is an integral but subsidiary part of the service."*

45. In November 2004, the Council determined that the use of the Mt Goldsworthy railway line constituted a "production process" but the use of the Mt Newman railway line did not.[30] FMG commenced proceedings against the Council in the Federal Court of Western Australia on the basis that the Council's decision in respect of the Mt Goldsworthy Line was incorrect.[31] BHPBIO commenced proceedings against the Council in the Federal Court of Victoria on the basis that the Council's decision in respect of the Mt Newman Line was incorrect.[32] These matters are yet to be resolved.

46. Despite the commencement and unresolved nature of these respective proceedings and on the basis that its preliminary decision on the "production process" issue was correct, the Council continued with the Part IIIA process in respect of the Mt Newman Line. As a result, the Council is now required to recommend to the Treasurer whether the declaration criteria under section 44G(2) of the TPA are met in respect of the services provided by the Mt Newman Line (the services provided by the Mt Goldsworthy Line not being subject to declaration under Part IIIA).[33]

47. The Council has received submissions from interested parties and is in the process of considering whether the relevant service satisfies the declaration criteria under section 44G(2) of the TPA.[34] The Council is now required to provide a draft recommendation to the Treasurer at its convenience.

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[30] *NCC Preliminary Matters*, Statement of Reasons (November 2004).

[31] *Fortescue Metals Group Ltd v NCC & Ors*, Federal Court Proceeding No WAD 39 of 2005.

[32] *BHP Billiton Iron Ore Pty Ltd v NCC & Ors*, Federal Court Proceeding No VID 1641 of 2004.

[33] Section 44G(2) provides:

> *"The Council cannot recommend that a service be declared unless it is satisfied of all of the following matters:*
>
> *(a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;*
> *(b) that it would be uneconomical for anyone to develop another facility to provide the service;*
> *(c) that the facility is of national significance, having regard to:*
> *(i) the size of the facility;*
> *(ii) the importance of the facility to constitutional trade or commerce; or*
> *(iii) the importance of the facility to the national economy;*
> *(d) that access to the service can be provided without undue risk to human health or safety;*
> *(e) that access to the service is not already the subject of an effective access regime;*
> *(f) that access (or increased access) to the service would not be contrary to the public interest."*

[34] See http://www.ncc.gov.au/publication.asp?publicationID=189&activityID=32).