Minerals Council of Australia

1 May 2008

Mr John Feil
Executive Director
National Competition Council
PO Box 250
MELBOURNE VIC 3001

Dear Mr Feil,

Minerals Council of Australia Submission to the National Competition Council in consideration of applications for declaration of the Robe, Goldsworthy and Hamersley railways

This Submission is made by the Minerals Council of Australia (MCA).

The MCA is the peak industry organisation representing Australia's exploration, mining and minerals processing industry nationally and internationally in its contribution to sustainable development. The MCA's strategic objective is to advocate public policy and operational practice for a world-class industry that is safe, profitable, innovative, and environmentally and socially responsible attuned to its communities' needs and expectations.

It is from this perspective that the MCA makes submission in respect of these matters before the National Competition Council (NCC).

Summary

The Minerals Council of Australia strongly opposes declaration of the Robe, Goldsworthy and Hamersley railways under Part IIIA of the Trades Practices Act 1974 (TPA) on public policy grounds in the national interest, pursuant to the NCC's criteria.

The MCA considers that there is no sound economic or legal policy basis for declaration of the Pilbara private iron ore railways, because it would:

- be inconsistent with the origins and intent of Part IIIA of the TPA as prescribed in the Hilmer Report[1] - which sought to carefully limit the circumstances in which one business is required by law to make its facilities available to another – in this case, the mandating of third party access to privately owned and operated infrastructure within a closely integrated production process;

- be inconsistent with the original intent of the "production process exemption" of Part IIIA, and the economic orthodoxy of what constitutes "production", adding to the confusion and uncertainty manifest in the judicial ambiguity of the interpretation of this clause and the intent of Part IIIA – five Federal Court judges have delivered four conflicting decisions on the scope and content of the "production process exemption";

- be inconsistent with the "objects clause" of Part IIIA (inserted by the Trade Practices Act Amendment National Access Regime 2005) which contains both an economic efficiency objective and a competition objective – mandated third party access is not beneficial where the gains from competition as a result of third party access are small if not inconsequential relative to the efficiency losses third party access entails – in this case, a perceived improvement in competition will severely disrupt the complex highly integrated production processes leading to inefficient economic outcomes;

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[1] Report of the Independent Committee of Inquiry into Competition Policy in Australia, August 1993

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- significantly disrupt the economic operation of and investment in these vertically integrated production and supply chains by:
    - reducing the operational efficiency and system capacity of the railways by around 10-20%[2];
    - having a chilling effect on the incentive to invest in such infrastructure – both from the perspective of the investor required to share a facility with their rivals and by reducing or eliminating the incentive to invest on the part of the access seeker who can "free ride" on the access providers investment; and
    - lowering productivity through a decrease in operational efficiency on account of lower throughput, higher unit costs, and reduced capacity and flexibility in "accumulating and blending" various grades of product to meet product specifications.
- lead to a loss in Australia's market share of seaborne trade in iron ore (as a consequence of international producers expanding output in response to anticipated reductions in Australian exports);
- result in a significant loss in Australian wealth and revenue; and
- provide, at best, trivial offsetting benefits.

Inconsistencies between the origins and intent of Part IIIA of the TPA and its application....

Provisions for the access by third parties to infrastructure facilities are set out in Part IIIA of the Trade Practices Act 1974 (TPA).

The origins of Part IIIA of the TPA lie in the Hilmer Report which recommended the introduction of a system of statutory access rights in Australia. The reason for this was that the Hilmer Report considered that there was significant uncertainty in relation to whether the interpretation of other provisions of the TPA by Australian courts would establish an access doctrine akin to the "essential facilities" doctrine (EFD) established in US jurisprudence.

The "essential facilities doctrine" (EFD) requires the owner of a monopoly asset to allow third parties access to the facility in order to improve competition in a "related", for instance, a downstream market.

EFD overrides the property rights of the access provider imposing on the access provider transactions that it would not voluntarily have entered into, that is, it denies the owner/investor the fundamental premise that they may choose with whom to enter into commercial enterprise. Under the EFD, facilities are considered "essential" if:

- it constitutes a natural monopoly where it was physically impossible or prohibitively expensive to duplicate or otherwise construct substitute facilities – there must be no actual or possible sources of alternative supply;
- it constitutes a real "bottleneck";
- the owner of an essential facility need not expand its own capacity or reduce its own output in order to provide access to a competitor; and
- the facility must be **truly** essential to competition – it is not sufficient that the facility merely improves competition;

The United States has applied the EFD cautiously and in exceptional, although not necessarily consistent, circumstances which meet strict requirements. Indeed, the Seventh Circuit in *MCI Communications* [3] set down a stringent four stage test that has since been adopted by virtually every Court considering the EFD issue, vis:

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[2] Affidavit of Stephen O'Donnell, Australian Competition Tribunal, File number 5 of 2006, 2007.

[3] MCI Communications v American Tel. & Co 708 F.2d 1081

- an essential facility must be in the control of a monopolist – the facility must be so essential that a competitor would be simply unable to compete with the monopolist without obtaining access – it is not sufficient that they simply have control over the facility itself but it must be shown that the firm is a monopolist over a properly defined antitrust market, entry into which depends on access to the essential facility;

- a competitor must be unable, practically or reasonably, to duplicate the facility – that is, the facility cannot be practically duplicated by either the access seeker or any other – the test here is not whether the exact asset can be replicated rather whether the benefits which can be derived from access to the alleged essential facility can be obtained from other sources;

- there must have been a denial of the use of the facility to a competitor (including a constructive denial through prohibitively high access prices) – it is difficult to claim that access is unreasonable, technically difficult or costly when that access has previously been provided voluntarily on commercial terms'

- the access seeker had to demonstrate the feasibility of providing access to the facility – antitrust law will not force a dominant firm to share an asset if such sharing would be impractical or would inhibit the defendant's ability to serve it's customers adequately – similarly, the US Courts consistently hold that the owner of an essential facility need not expand its own capacity or reduce its own output in order to provide access to a competitor.

The Hilmer Report invoked the concepts behind the essential facilities doctrine in making the case for a national access regime, arguing that:

> *Some economic activities exhibit natural monopoly characteristics in the sense that they cannot be duplicated economically ... Some facilities that exhibit these characteristics occupy strategic positions in an industry, and are thus 'essential facilities' in the sense that access to the facility is required if a business is to be able to compete effectively ...*

The Hilmer Report recommended the introduction of a system of statutory access rights in Australia to address these cases, because Australian courts had apparently rejected the proposition that Australian law recognised an "essential facilities" doctrine as it existed in US jurisprudence, and there were limits on, and considerable uncertainty surrounding the application of, the doctrine as it operated in the United States.

In noting these uncertainties as to the United States doctrine, the Hilmer Report did not contemplate that the national access regime it proposed would necessarily go beyond the principles of EFD. Indeed, the Report said that the US doctrine as it was being developed at the time seemed too loose, stating that:

> *The limits of the United States doctrine are not yet clear, and it has been observed that 'the doctrine has not developed with clarity, coherence or consistency, let alone with strong economic foundations.' Decisions which have relied on the doctrine have found essential facilities in situations ranging from local telephone networks to football and basketball stadiums.*

Rather, it was thought that a national access regime was needed to properly codify these principles and define the appropriate limits for third party access, the presumption being that such statutory codification was preferable to enforcing the doctrine purely on a judicial case law basis. Additionally, and highlighting the seriousness which the Report viewed as being associated with over-riding property rights through the mandatory granting of third party access rights, it was stressed that the granting of third party access should be a Ministerial decision, to which political responsibility would attach, with that decision to be made within the confines of tightly defined criteria.

Bearing this in mind, the Hilmer Report appended a number of qualifications to its proposal for an access regime by referring to:

- the need to "*carefully limit the circumstances in which one business is required by law to make its facilities available to another*", because the "failure to provide appropriate protection to the owners of such facilities has the potential to undermine incentives for investment";

- the need for access should be "essential" to permit effective competitive in a downstream or upstream market;

- the facilities and industries most likely to meet these requirements, which would be those where there was "traditional involvement of government in these industries, either as owner or regulator"; and

- the possible application of the access regime to privately owned access facilities, noting that "it would be appropriate to ensure that an obligation to provide access does not unduly impede an owner's right to use its own facility, including any planned expansion of utilisation or capacity ...".

While the final form of Part IIIA differed in important respects from the Hilmer recommendations, it retained the emphasis on imposing substantive hurdles on the granting of access – the substantive character of the gateway being most obvious in the need to meet all of the hurdles before a facility can be declared.

Australia however, has not applied the principles underpinning Part IIIA in its interpretation of Part IIIA – that is, the interpretation of relevant tests under Part IIIA is not undertaken with the same degree of rigour and warning foreshadowed by the Hilmer Report. Through the NCC, the Australian Competition Tribunal (ACT) and court interpretation, the test for declaration has been substantially diluted. Broadly speaking, facilities in Australia can now be declared in circumstances where:

- there is only a small probability that declaration will enhance competition; and related to that,

- there are economic substitutes to the facility in question.

In addition, and as Part IIIA has been interpreted, little or no weight is given to the adverse efficiency implications of third party access on the access provider, or to incentives to invest in the longer term. Accordingly, it is critical that the NCC and the Tribunal properly recognise the importance of the objects clause in Part IIIA and apply it with the rigour sought by the Hilmer Report.

The implication of these interpretations of Part IIIA is that a very small or speculative increase in competition is deemed to outweigh the costs of declaration, in terms of their effect on overall efficiency, including the costs of the associated regulatory regime in terms of deterred investment and innovation.

These concerns were highlighted in the Export Infrastructure Task Force report (2005)[4]. It recommended that there should be a means to exempt integrated facilities from the operation of Part IIIA of the TPA, and specifically:

- that there should be an "efficiency override" for applications for declaration of export related facilities under Part IIIA or its associated regimes. The Task Force highlighted that Part IIIA lacks any authorisation mechanism, based on efficiency, that could be used to limit the scope of access; and

- that the "production process exemption" should be amended so as to make it 'clear that the purpose of the exemption is to prevent the imposing of third party access in vertically integrated, tightly managed, logistics chains, especially those related to our export industries".

Regrettably, Government did not support all of the Export Infrastructure Task Force's recommendations, and those that were endorsed and enacted have been ineffective in addressing the fundamental contradictions in the interpretation of Part IIIA of the TPA.

Inconsistent interpretation of the "production process exemption"...

Part IIIA of the TPA provides a legal right for third parties to seek access to nationally significant infrastructure services. The key competition regulation issue has been differentiating a transport "service" from a purpose built and operated, integrated production "process".

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[4] Report, *Australia's Export Infrastructure*, May 2005, AGPS

The Hilmer Report recommended that declaration should apply to facilities and industries in which government had traditionally been involved, but not to "*products, production processes or most other commercial facilities*".[5] This context and the production process exemption was first considered by the Federal Court in the *Hamersley case*.[6] In that matter, an iron ore producer was attempting to obtain access to the privately owned iron ore railways in the Pilbara of Western Australia. Hamersley argued that the railway lines were part of a highly integrated sequence of "steps" for the production of iron ore. The Federal Court accepted this submission, and found that the railway line was "*integral and essential to the highly integrated series of operations that constitute Hamersley's production process*",[7] and that the production process exemption should therefore apply.[8]

In *BHP Billiton Iron Ore Pty Ltd v The National Competition Council*[9] – a case considering the same exemption, and also in the iron ore context – the Federal Court (at first instance) found that the Hamersley decision had been "*plainly wrong*" in the sense that a production process should be understood narrowly to define a process "*which in itself makes or creates one thing into another*".

The confusion resulting from the divergent views in Hamersley and the first-instance decision in BHPBIO has been compounded by the appellate court in the latter. The Full Court did not consider that either case had been correctly decided, yet applied a complex and expansive alternative which in effect means that if a service is a "step" in a production process, access can be granted to it.

The obvious criticism of this decision is that it leaves, to borrow an old phrase, the conveyor belts in Henry Ford's production line amenable to declaration. In response to this criticism, the Full Court added a qualifier: where the operation is *highly* integrated and the request for access would be "invasive and disruptive", the request for access to a single step of the production process is equivalent to access to the entire process. The exact scope of such a test, or how such a test would operate, was not explained by the Court and for that reason was strongly criticised in the dissenting opinion.

Furthermore, the Federal Court appears to be ignoring economic orthodoxy of what constitutes "production". The Federal Court, albeit inconsistently, determined that a production process can only relate to the physical transformation of a product hence ruling out any transportation arrangements – *"the transportation of one product from one location to another does not transform that product into something different.... even if an integral and essential part of an overall process.... does not make the use of the railway line the use of a production process".*[10] This is clearly at odds with the practical considerations of minerals extraction and transport to supply markets. The ore is only dirt while it is in the ground – it must be extracted, crushed, screened, blended and transported to market specifications – value add to the basic factors of productivity - labour and capital – is not confined to industrial transformation in any other economic consideration of industrial enterprise. In extracting ore reserves from the ground and transforming them in a production process to shipping ore at the port, the miner is adding form, place and time value. Form value is added by transforming the ore reserve in the ground to a product acceptable for processing. Place and time value is added as a consequence of moving the product from the mine to the port.

Of significance, and particularly relevant to the NCC's consideration of this case, five Federal Court Judges have now ruled on two cases regarding access to Pilbara iron ore railway systems which has resulted in four conflicting decisions (including the dissenting view in the Full Court case) - four very different but plausible judicial opinions expressed on the scope and content of the production process exemption. This creates unnecessary investment and operational uncertainty and clearly indicates confusion about the intent of Part IIIA. Little wonder that parties have sought leave to the High Court to appeal the Full Federal Court judgement, and proceedings are expected to commence late July.

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5 Report by the Independent Committee of Inquiry, p. 251.

6 *Hamersley Iron Pty Ltd v National Competition Council* [1999] 164 ALR 203.

7 *Hamersley Iron Pty Ltd v National Competition Council* [1999], para. 51.

8 *Hamersley Iron Pty Ltd v National Competition Council* [1999], para 41.

9 *BHPBIO*

10 *BHPBIO*

Adverse economic outcomes of mandated access...

The Part IIIA objects clause contains both an economic efficiency objective and a competition objective. Competition leads to efficient outcomes in many circumstances, but there are types of facilities that are open to being the subject of access requests – complex integrated production processes, which require substantial capital investments, such as rail facilities – for which this is not the case. This potential conflict has largely been disregarded in the interpretation of Part IIIA, which now focuses almost solely on whether or not access would promote, theoretically, competition, as opposed to whether access would improve economic efficiency.

Mandated third party access is not beneficial where the gains from competition as a result of third party access are small relative to the efficiency losses third party access entails, for instance, in this case as a result of disrupting closely integrated production processes. From an economic point of view competition is only a means to an end – that end is economic efficiency which simply means a situation in which society secures the greatest possible benefit from the scarce resources at its disposal, now and in the future;

Competitive markets generally promote efficiency, but there are many instances in which making the best use of resources clashes with that of promoting competition (where that is interpreted to mean "facilitating competitive entry"). There is a real trade-off between the potential loss in efficiency from regulatory intervention in vertically integrated activities (including those related to the facilities in question) to enable third party access, and the additional competitive pressures that may result from such third party access.

In considerations by the NCC and the Federal Court, the costs of third party access, in terms of foregone efficiencies to existing operational processes have received little recognition in access proceedings, discounting arguments that the provision of third party access would disrupt the highly integrated production processes that commence at the mine, end at port, and rely on close coordination of the line with these processes to maximise throughput.

Yet, improved competition from mandated third party access to these facilities stand to impose costs while delivering few material benefits:

- a loss of production efficiency/lower productivity (decrease in operational efficiency, leading to lower throughput and higher unit costs and therefore lower productivity of the whole supply chain) when efficient industrial processes are disrupted as a result of access when additional users of a facility reduce the flexibility or otherwise constrain the efficiency with which a facility can be operated - this applies when efficient production requires the close coordination of different parts of a firm's operations as is the case with these Pilbara operations;

- reduced and delayed investment (incumbents' or new entrants' incentive to invest can be significantly dampened due to the distortions in decision making that regulation can create), as a consequence of the disincentive to a potential access provider to invest or innovate in markets where a first mover investor may be deemed to have acquired market power and, conversely on the part of the access seeker who can gain by free-riding on the access provider's investment – the risk is that investment and innovation and then head-to-head competition are reduced over the longer term;

- declining global competitiveness (expectations of sustained global demand for commodities has intensified global competition and is creating a situation where only low-cost, large and "long-life" mines will be able to make sustainable returns that ensure inevitable price cycles and to justify very large sunk investments);

- Australian consumer surplus will not be affected (Australian consumers will not be directly affected by the effect of access regulation applying to the Australian producers in export-orientated bulk commodities).

Recommendations

The MCA recommends that the NCC in having proper regard to the national interest, embrace the following criteria in consideration of the applications for declaration before it:

- that competition be ***substantially*** promoted by declaration, as opposed to the current consideration where it is sufficient if the improvement in competition is non-trivial;

- that competition be promoted in a market that is ***substantial and of national significance***, other than the market in which the service is being provided, before the service is declared;

- that the declared service be ***essential to competition*** in the market in which competition will be promoted, where "essential" means that the facility is indispensable to participate in that market;

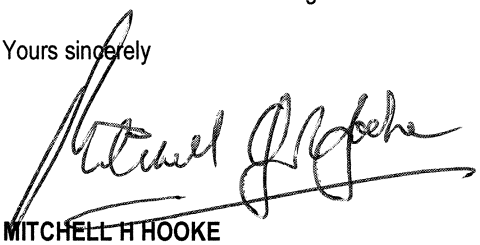
- that the production process exemption prohibit or strictly limit access where doing so would disrupt a vertically integrated production process; and

- be satisfied that granting access is in the public interest, including in terms of promoting economic efficiency, and in so doing, take account of the costs and risks of regulatory error.

Should you wish to discuss the Minerals Council's submission further please do not hesitate to contact me directly.

Given the public policy implications of your deliberations I have taken the unusual step of copying this submission to the Treasurer, the Assistant Treasurer, the Minister for Resources & Energy, the Minister for Finance, and the Minister for Small Business and Assisting the Finance Minister on Deregulation

Yours sincerely



MITCHELL H HOOKE
CHIEF EXECUTIVE OFFICER

cc The Hon Wayne Swan MP, Treasurer
The Hon Chris Bowen MP, Assistant Treasurer and Minister for Competition Policy & Consumer Affairs
The Hon Martin Ferguson AM MP, Minister for Resources & Energy
The Hon Lindsay Tanner MP, Minister for Finance
The Hon Dr Craig Emerson MP, Minister for Small Business and Assisting the Finance Minister on Deregulation