Queensland Competition Authority

QCA Response to the Productivity Commission's Draft Report on the National Access Regime

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EXECUTIVE SUMMARY

The Authority welcomes the opportunity to provide this follow-up submission to the Productivity Commission (PC) regarding its draft report on the National Access Regime.

In its first submission, the Authority provided comment on the High Court's recent decision on the declaration criteria and investment incentives for facility owners of capacity constrained networks.

In that context, the Authority welcomes, and agrees with, the PC's draft recommendation 8.1 that:

> *The Australian Government should amend paragraphs 44G(2)(b) and 44H(4)(b) of the Competition and Consumer Act 2010 (Cwlth) such that criterion (b) is met where total market demand could be met at least cost by the facility. Total market demand should include the demand for the service under application as well as the demand for any substitute services provided by facilities serving the market. The assessment of costs under criterion (b) should include an estimate of the costs associated with additional maintenance and reduced operational flexibility imposed on the infrastructure service provider from coordinating multiple users of its facility.*

The Authority encourages the PC to maintain this recommendation in its final report.

As a result, the Authority will focus its comments on the PC's discussion and draft recommendations relating to the extension and expansion of network facilities. In particular, the Authority would like to offer further comment on the PC's draft conclusions on the power of the Australian Competition and Consumer Commission (ACCC) to direct extensions.

As noted in the Authority's first submission, the Authority believes there is good reason to maintain consistency between the access regimes administered by the states and the Commonwealth. In that regard, the Authority reiterates its view that it is too early to conclude that the arrangements in the National Access Regime (and the Queensland Access Regime) are ineffective in relation to investment matters. However, the Authority provides the following comments given our experience with the development of an investment framework and proposed standard user funding agreement for the rail sector.

QCA'S COMMENTS

Clarifying the ACCC's extension powers

In chapter 4 of its draft report, the PC says that the *Competition and Consumer Act 2010* (CCA) does not explicitly define whether the ACCC has the power to direct an extension of a facility – where the extension includes an expansion of a facility's capacity.

Of note, the *Queensland Competition Authority Act 1997* (QCA Act) was amended in 2010 to clarify the Authority's ability to direct an extension as well as an expansion of a network. This clarification comes by way of the definition of extension, which now states that an:

> ***extension**, of a facility, includes an enhancement, expansion, augmentation, duplication or replacement of all or part of the facility.*

A similar amendment would clarify the matter and is probably appropriate for the National Access Regime.

Directions to extend and expand facilities

The Authority welcomes the PC's view, expressed on page 135 of its draft report, that there is a rationale for the ACCC to have the power, in an access determination, to direct expansions to prevent service providers from undermining the efficiency objective of Part IIIA of the CCA. The Authority also agrees that a balance must be struck to ensure that the interests of both the service provider and the access seeker are protected should the ACCC direct such an investment.

As noted in the Authority's previous submission, many of the provisions contained in Part 5 of the QCA Act effectively mirror provisions contained in Part IIIA of the CCA. For the purpose of this discussion, section 119 of the QCA Act is akin to section 44W of the CCA and section120 of the QCA Act is akin to section 44X (for details, see Table 1 and Table 2).

However, the QCA Act was amended in 2010 to somewhat expand the circumstances in which the Authority can require an access provider to extend, or permit the extension, of a facility.

In particular, the Authority may direct a facility owner to pay some, or all of the costs, of extending its facility if the requirement is consistent with an access undertaking that has been voluntarily submitted to the Authority. This amendment only applies to access undertakings provided voluntarily to the Authority. This means that it is at the discretion of the access provider to decide whether to include a funding commitment of this nature in its access undertaking.

To put the timing of the amendment in context, at the time it was made, the Authority was evaluating Aurizon Network's (then QR Network's) 2010 draft access undertaking (which was subsequently approved by the Authority and is now Aurizon Network's current undertaking). That undertaking contains a voluntary obligation that Aurizon Network would fund up to $300 million of investments over the term of its undertaking – an obligation that could ultimately be binding on Aurizon Network.

Aurizon Network has recently submitted its voluntary 2013 draft access undertaking to the Authority for approval (this undertaking is intended to replace the existing undertaking). The voluntary commitment to fund up to $300 million in investments has been removed. This means that, should the Authority approve Aurizon Network's proposed DAU (as is), there would be no opportunity for the Authority to direct Aurizon Network to invest at its own cost in the next regulatory period.

The amendment made to the QCA Act in 2010 can therefore be seen as potentially beneficial in circumstances where an access provider has an interest in funding its own infrastructure, but of little use where it does not or refuses to.

Like the ACCC, the Authority can make an access determination to direct an access provider to extend, or permit the extension of, the facility. However, that power is constrained in that it must not:

(a) reduce the amount of service obtainable by an access provider;

(b) result in the access seeker, or someone else, becoming the owner of the facility (without the existing owner's consent); or

(c) require the access provider to pay some or all of the costs of extending a facility.

The access regime (whether it be the Queensland or the National Access Regimes) is based upon a negotiate/arbitrate model, so it is envisaged that an access dispute will only be referred to the regulator (i.e. the Authority or the ACCC) for determination, if the access seeker and the service provider are unable to reach commercial agreement on the terms and conditions of access. Once a dispute is referred to it, the regulator can make a binding determination, but the determination is constrained by the restrictions contained in the QCA Act (or CCA).

It remains unclear whether this process is sufficiently robust to result in a facility being extended (including additional capacity), where the service provider has shown it is unwilling to invest. This is because the regulator is constrained in its ability to direct an extension – in particular, as part of a determination, where an extension cannot be at the cost of the service provider and cannot result in ownership of any part of the facility transferring to someone else. In practice, these limitations may mean that a determination requiring a service provider to extend, or permit the extension, of its facility may not be enforceable at best and may be ultra vires at worst.

It remains highly questionable whether the Queensland and the National Access Regimes are effective in addressing the fundamental problem of the monopoly – and one where economic principles tell us that there already exists an incentive for the facility owner to under-invest. Whether the threat of regulatory intervention adds to this already existing incentive to under-invest is unclear, and ultimately it is an empirical question. However, recent trends in investment in regulated infrastructure (e.g. electricity networks Australia wide and the coal handling facility at Dalrymple Bay) suggest the opposite.

The Queensland and National Access Regimes have to deal with the problem of the monopoly and the inherent incentive for the facility owner to under-invest in order to create scarcity and increase profits. These access regimes are based on a negotiate-arbitrate model. The principles for any effective alternative dispute resolution framework, are that in the event that the two parties are unable to agree to a mutually acceptable outcome, the matter then goes to an independent party that has the power to effectively impose a solution. The Queensland and National Access Regimes lack the central feature of an effective dispute resolution process, as the regulator has limited degrees of freedom to resolve the already existing incentives for a monopolist to under-invest.

Given this, there must be a clear and defined framework to allow an arbitrator, which in this context is the regulator, to make a decision in an as unfettered a manner as possible, with minimal but realistic constraints placed on the decision-making powers. The powers afforded to the ACCC and the QCA in making an access determination, with regard to directing extensions or expansions, are not sufficient to effectively resolve a dispute where an access seeker is seeking new capacity and a monopolist service provider is refusing to invest in expanding capacity.

Do adequate safeguards exist?

The PC noted, on page 136 of its draft report, that the ACCC's power to direct extensions (and expansions) should be subject to robust and practical safeguards to protect the interests of all parties. The PC asked if the safeguards in place under sections 44W and 44X of Part IIIA of the CCA strike the right balance between the interests of infrastructure providers and access seekers.

In this context, it is noted that a regulator may be required to make an access determination to direct an extension, in the circumstances where:

(a) the facility owner will not extend its facility at the request of the access seeker;

(b) the facility owner will not allow an interconnection to its facility at the request of an access seeker; or

(c) the facility owner and access seeker cannot agree on terms and conditions for access to an extension.

It could be the case that such circumstances could arise if the infrastructure owner does not have sufficient incentives to invest in its network. However, as noted in the Authority's first submission, in the central Queensland coal region, coal companies and others have already indicated a willingness to invest in rail infrastructure at the regulated weighted average cost of capital (WACC). As indicated above, there are also many circumstances where the facility owner has been willing to invest at the regulated WACC. Increasing the WACC may not necessarily entice a regulated monopoly to invest in infrastructure, where it has a higher incentive not to invest. This strategic under-investment may be attractive to a regulated monopoly as it can signal capacity is scarce and attempt to charge monopoly prices. This is a likely sign that the framework is broken or, at least, is not effective in circumstances where facilities are capacity-constrained.

A facility owner may be reluctant to make a particular investment because of the project specific risks associated with that project. Any such decision should be transparent and explainable through the standard project appraisal techniques based on reasonable assumptions. In the absence of such analysis, it is reasonable to suspect that the reluctance to invest is being driven by other factors, including a desire to earn monopoly profits.

Where the monopoly service provider is attempting to undermine the efficiency objective of Part IIIA of the CCA (or part 5 of the QCA Act) by strategically limiting capacity availability, the regulator should have access to tools to rectify this problem. The Authority considers that the principles set out in clause 6(4)(j) of the Competition Principles Agreement allow a regulator access to that tool.

Clause 6(4)(j) provides that the owner of a facility 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.

In the context of considering the scenario where a monopoly service provider may engage in strategic under-investment to restrict capacity and drive up prices, the Authority considers that the provision in the CPA strikes a better balance between the interests of infrastructure providers and access seekers than the existing provisions contained in Part IIIA of the CCA and Part 5 of the QCA Act. This is because the provisions in the CCA (and the QCA Act) go much further in constraining the regulator's power to direct extensions / expansions than envisaged by the CPA. In particular, the restrictions on the regulator's ability to make an access determination directing investment where there would be a cost to the service provider and / or part of the facility would become owned by a third party, has dictated the level of complexity contained in the current SUFA proposal and appears to create a significant hurdle to a workable user funding arrangement.

The PC noted in its draft report (at page 139) that, when directing an extension (or expansion), a regulator would effectively override the investment decision of the service provider and negotiations with access seekers. The Authority agrees with the views put forward by the ACCC (on page 49 of its submission) that, where possible, the infrastructure operator and access seekers should reach agreement on whether to extend the facility. Where agreement cannot be reached, it is only then that the regulator can evaluate whether to use its power to direct an extension/expansion. The power to direct an extension/expansion should be viewed more as a backstop to ensuring that a monopoly service provider does not take advantage of its position (with a constrained capacity network).

For instance, the PC also noted in its draft report (at page 123) that a party will only initiate an arbitration where it considers that a regulatory determination would deliver a better outcome than that available to it through negotiation. Further, if the opposing party to the dispute expects arbitration would produce a worse outcome for them than their preferred negotiating position, it is likely to moderate its negotiating position to avoid a regulatory determination. As a result, both parties will have an increased incentive to negotiate a private settlement thereby avoiding regulatory intervention.

Granting a regulator the power to direct a facility owner to invest, or to allow a third party to own part of the facility, may well act as the catalyst to force parties to negotiate in good faith to reach a suitable outcome for both parties. Under the provisions in both the CCA and the QCA Act, there is no 'worst case scenario' for the facility owner, whereas the worst case scenario for the access seekers could be either no capacity or capacity at monopoly inflated rates.

The PC said that increased discretion for the regulator to direct an investment may lead to increased regulatory risk for infrastructure service providers and could have a detrimental impact on their investment incentives (pages 143-4 of the draft report). The Authority believes that, in circumstances where a facility owner is following a policy of strategic under-investment, the investment incentives that a service provider may be responding to are already likely to be perverse.

Given this, and its experience with the SUFA development process, the Authority maintains the view (as expressed in its first submission) that the principle incorporated in the Competition Principles Agreement (CPA), with regard to a regulator's power to direct extension of a facility, is fair and reasonable for all parties. In contrast, the Authority considers that its experience with SUFA indicates that the existing provisions relating to the power to direct investment that are contained in the CCA and the QCA Act are biased in favour of the facility owner, as they have resulted in a proposed solution to the problem of under-investment that seems complicated, commercially impractical, and which may well not work in reality.

Thus, the Authority asks that the PC consider recommending in its final report that the relevant provisions in Part IIIA of the CCA be amended to be consistent with clause 6(4)(j) of the CPA. The Authority considers that such a change to the CCA would act to better enable effective funding arrangements for extensions and expansions directed by the regulator.

At the same time, the Authority understands the PC's view that the ACCC's power to direct extensions (and expansions) should be subject to robust and practical safeguards to protect the interests of all parties, as the power could be seen to increase regulatory risk for service providers and, potentially, impact on investment incentives. In that regard, the Authority considers that the constraints on the power to direct that were envisaged by the CPA, with the obligation to extend, or permit the extension of, a facility limited by safety, feasibility, operational requirements, the owner's legitimate business interests and fair account being taken of the costs and benefits involved, would provide sufficient protection for the interests of all parties.

Nonetheless, if the direction power in Part IIIA was amended to be consistent with clause 6(4)(j) of the CPA, the Authority would see some benefit in the ACCC developing guidelines on how it would exercise a

power to direct in practice, so as to improve regulatory certainty. Such guidelines could focus on the practical interpretation of the clause 6(4)(j) constraints. However, guidelines should not be seen as a substitute for the legislative amendment needed to strike a better balance between the rights of facility owners and the incentive for strategic under-investment, but rather as an adjunct to much-needed statutory reform.

APPENDIX A

Table 1 Safeguards in place under 44W and s.119

The Commission must not make a determination that would have any of the following effects: *(44W)*	*The Queensland Competition Authority must not make an access determination that would have any of the following effects:* *(s. 119)*
1(a) prevent an existing user obtaining a sufficient amount of the service to meet its reasonable anticipated requirements, measure at the time when the dispute was notified 1(b) preventing a person from obtaining, by the exercise of a pre-notification right, a sufficient amount of the service to be able to meet the person's actual requirements 1(c) depriving any person of a protected contractual right 1(d) resulting in the third party becoming the owner (or one of the owners) of any part of the facility, or of extensions of the facility, without the consent of the provider 1(e) requiring the provider to bear some or all of the costs of extending the facility or maintaining extensions of the facility 1(f) requiring the provider to bear some or all of the costs of interconnections to the facility or maintaining interconnections to the facility	(2) (a) reduce the amount of the service able to be obtained by an access provider 2(b) result in the access seeker, or someone else, becoming the owner, or 1 of the owners, of the facility, without the existing owner's agreement 2(c) require an access provider to pay some or all of the costs of extending the facility.

Table 2 Safeguards in place under 44X and s.120

The Commission must take the following matters into consideration in making a final determination: *(44X)*	*Matters to be considered by the Authority in making access determination:* *(s. 120)*
1(aa) the objects of this part 1(a) the legitimate business interests of the provider and the provider's investment in the facility 1(b) the public interest, including the public interest in having competition in markets (whether or not in Australia) 1(c) the interests of all persons who have rights to use the service 1(d) the direct costs of providing access to the service 1(e) the value to the provider of extensions whose cost is borne by someone else 1(ea) the value to the provider of interconnections to the facility whose cost is borne by someone else 1(f) the operational and technical requirements necessary for the safe and reliable operation of the facility 1(g) the economically efficient operation of the facility 1(h) the pricing principles specified in section 44ZZCA	(a) the object of this part (b) the access provider's legitimate business interests and investment in the facility (c) the legitimate business interests of persons who have, or may acquire, rights to use the service (d) the public interest, including the benefit to the public in having competitive markets (e) the value of the service to – (i) the access seeker; or (ii) a class of access seekers or users (f) the direct costs to the access provider of providing access to the service, including any costs of extending the facility, but not costs associate with losses arising from increased competition (g) the economic value to the access provider of any extensions to, or other additional investment in, the facility that the access provider or access seeker has undertaken or agreed to undertake

The Commission must take the following matters into consideration in making a final determination: *(44X)*	*Matters to be considered by the Authority in making access determination:* *(s. 120)*
2. The Commission may take into account any other matters that it thinks are relevant	(h) the quality of the service (i) the operational and technical requirements necessary for the safe and reliable operation of the facility (j) the economically efficient operation of the facility (k) the effect of excluding existing assets for pricing purposes (l) the pricing principles mentioned in section 168A (2) The authority may take into account any other matters relating to the matters mentioned in subsection (1) it considers are appropriate.