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BHP BILLITON IRON ORE

SUBMISSION ON APPLICATION FOR CERTIFICATION OF THE WESTERN AUSTRALIAN RAIL ACCESS REGIME

1. OVERVIEW

Introduction

1.1 This document contains BHP Billiton Iron Ore's (**BHPBIO's**) submission in relation to the Western Australian government's application to the National Competition Council (**NCC**) for a recommendation on the certification of the Western Australian rail track access regime (**WA regime**) under section 44M of the *Trade Practices Act 1974* (Cth) (**TPA**).

1.2 The WA regime is established by the *Railways (Access) Act 1998* (WA) (**Act**) and the *Railways (Access) Code 2000* (WA) (**Code**), and applies to both the formerly government-owned freight and passenger rail networks in Western Australia, and the privately developed, vertically integrated iron ore railway which forms part of Fortescue Metals Group Limited's (**FMG's**) iron ore business. This submission only addresses the WA regime insofar as it governs third party access to a railway operated as part of an integrated iron ore supply chain in the Pilbara.

1.3 BHPBIO gave extensive consideration to the design and application of third party access regulation to the vertically integrated Pilbara iron ore railways during its detailed engagement with the Western Australian government's Pilbara Rail Access Interdepartmental Committee between 2006 and 2008. More recently, BHPBIO has considered these issues, including with the benefit of extensive analysis by Australian and overseas rail, regulatory and economic expert witnesses, in the context of the Australian Competition Tribunal proceedings concerning FMG's applications for declaration of third party track access on BHPBIO's Pilbara railways. Further, the Australian Competition and Consumer Commission (**ACCC**) has recently considered analogous issues arising in the context of the Hunter Valley coal chain.

1.4 As set out below it is BHPBIO's position that the WA regime is not appropriate for the regulation of a Pilbara iron ore railway and accordingly the NCC should recommend to the Minister that the WA regime not be certified as an effective access regime.

1.5 BHPBIO is grateful for the opportunity to make this submission, and would be happy to engage in further consultation with the NCC in relation to the matters it addresses.

Executive summary

The certification framework

1.6 In deciding whether to recommend to the relevant Minister that the WA regime be certified as an effective access regime, the NCC must comply with the following three requirements under s 44M of the TPA (**certification requirements**).

(a) **The NCC must apply the relevant principles of the Competition Principles Agreement** (**CPA**) entered into by the members of the Council of Australian Governments. These principles are contained in clause 6 of the CPA, and address the objects of the regime, and the approach of the regime to negotiation and provision of access, access pricing, dispute resolution and the conduct of the access provider.

(b) **The NCC must have regard to the objects of Part IIIA of the TPA:** these objects are to:

(i) promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and

(ii) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry.

Notably, the CPA principles specifically require that an effective access regime must include an object clause that promotes the economically efficient use of, operation of and investment in, significant infrastructure, as described above.

(c) **The NCC must not consider** any other matters.

Application of the certification framework to the WA regime

1.7 BHPBIO submits that in considering the application of the certification framework to the WA regime, the NCC must have close regard to:

(a) the specific features of the Pilbara iron ore railways, including the challenges and complexities of imposing access regulation on those railways;

(b) the inevitable impact of the regime on the efficient operation of a Pilbara iron ore railway that is operated in the concept of a vertically integrated mine, rail and port supply chain; and

(c) the problems posed by access regulation of infrastructure operated in the context of integrated mine, rail and port supply chains generally, including:

(i) the benchmark set by the most sophisticated and up to date understanding available of the complexities of regulating such supply chains; and

(ii) the ongoing need to develop and improve that understanding.

1.8 This certification application is the NCC's first opportunity to consider the certification criteria in light of the evolving understanding of the impacts of third party access regulation on infrastructure operated in the context of a mine, rail and port supply chain, and to adopt the increasingly sophisticated understanding of these issues as a benchmark for its own decision making.

1.9 BHPBIO submits that, having regard to the factors outlined above, the WA regime:

(a) is a manifestly inappropriate regime to apply to a Pilbara iron ore railway, and one which fails to reflect or accommodate the current state of understanding of the consequences of applying third party access regulation to a railway operated in the context of a mine, rail and port supply chain, and the appropriate regulatory response to those challenges;

(b) does not satisfy the CPA principles;

(c) would frustrate rather than promote the objects of Part IIIA; and

(d) accordingly, cannot be considered to be an effective access regime in that context.

2. APPLICATION OF THIRD PARTY ACCESS REGULATION TO VERTICALLY INTEGRATED IRON ORE SUPPLY CHAINS

Application of the WA regime to FMG's railway

2.1 The WA regime was originally developed as a common user regime to apply to the then government-owned, and subsequently privatised, freight and passenger railways in Western Australia.

2.2 The application of the WA regime was subsequently extended to include the iron ore railway that FMG has privately developed as part of the integrated mine, rail and port facilities it operates in the context of its Pilbara iron ore business.

2.3 Under the WA regime, the same third party access framework applies to FMG's railway as to the common user freight and passenger rail networks. In complying with this framework, FMG has developed and obtained regulatory approval of various regulatory instruments, which govern its provision of access under the WA regime. Accordingly, although no third party has yet used the WA regime to obtain track access to FMG's railway, there is already extensive information in the public domain concerning the manner in which the WA regime has been applied to a Pilbara iron ore railway.

2.4 In addition to considering the Act and Code, this submission refers to the following regulatory instruments that FMG has been required to develop, and which will govern the provision of access to FMG's railway, under the WA regime:

(a) the Train Management Guidelines, which describe the principles, rules and practices that FMG must apply in using its railway, so far as that use relates to the requirements imposed by the WA regime;

(b) the Train Path Policy, which governs the allocation of train paths on FMG's railway; and

(c) the Segregation Arrangements, pursuant to which FMG will segregate its access-related functions from the rest of its iron ore business.

Characteristics of the Pilbara iron ore railways

2.5 Iron ore is one of Australia's leading exports, and the continued efficient operation and expansion of Pilbara iron ore production to meet rapidly expanding demand, particularly from China, is a matter of vital importance to the interests of Western Australia, and the nation.

2.6 The Pilbara iron ore railways are unlike general freight and passenger rail networks. Rather, they are purpose-built, single-operator systems, developed and operated solely as part of customer-driven and tightly integrated mine, rail and port systems. The sole purpose of those systems is the production of iron ore.

2.7 A key feature of the iron ore supply chains is the interdependence of the mine, rail and port facilities. The integration of the mine, rail and port operations, and the owner's control of them, facilitates the flexible operation of the railways, which contributes to maximising the volume of iron ore production, and enables rapid expansion of the iron ore supply chains to meet growth in export demand. Any attempt to operate the railway on a "component" basis, without taking into account the "whole of system" orientation of the railway operations, will severely undermine the efficiency, and therefore productivity, of the entire system.

2.8 Any regime designed to impose third party access regulation on a vertically integrated Pilbara iron ore railway should be tailored to reflect the unique characteristics of these railways.

Impact of third party access regulation on Pilbara iron ore railways

2.9 The application of third party access regulation to a vertically integrated Pilbara iron ore railway has the potential to cause significant disruption to, and inefficiencies in, the operation of and investment in both the railway and the entire supply chain.

2.10 These consequences arise partly as a result of the fact that the owner and third party face different imperatives in relation to their use of the railway.

2.11 The owner's imperative is to provide track access in a way that does not diminish the efficiency of its integrated mine, rail and port system. This would require preserving the ability to operate the system flexibly, including to respond to unplanned events, and trial and implement new technologies and operating practices that might improve system efficiency.

2.12 However, a third party would seek to obtain a rail service that would enable it to coordinate track access with its own mine and port operations. For example, a third party would seek to require the owner to provide rail services, in order to achieve the third party's own production objective, without regard to the efficiency of the supply chain as a whole.

2.13 As a result of these conflicting imperatives, the application of third party access regulation to the Pilbara iron ore railways is likely to result in the following effects:

(a) loss of system flexibility, which translates into a loss of efficiency, and hence lost capacity and production;

(b) delays, impediments and other disincentives to improvements and expansions of the rail system and supply chain;

(c) appropriation of system capacity that the owner has invested in for its own business in order to service third parties; and

(d) under-compensation of the owner for the costs of providing access.

2.14 Mr Stephen O'Donnell provided evidence to the Australian Competition Tribunal on the impact of third party access regulation on BHPBIO's iron ore system.[1] Mr O'Donnell's evidence was that:

(a) it would not be possible to create an access regime which would give BHPBIO the same capacity performance and operational flexibility that it has under a single user system;

(b) the application of a third party access regime would result in a reduction of the overall capacity of the BHPBIO network;

(c) the quantum of the impact would depend on the detail of the access regime; and

(d) depending on the type of regime adopted, providing third party access could result in a reduction in capacity on BHPBIO's network by in excess of 20%.

2.15 BHPBIO submits that it is imperative that any third party access regime to be applied to a Pilbara iron ore railway:

(a) acknowledges that the regime will adversely affect the efficient operation of the rail infrastructure to which access is to be granted, and of the iron ore supply chain as a whole;

(b) is designed and is able to be applied in a way that mitigates and seeks to minimise the adverse consequences of the regime on the iron ore supply chain, in a manner consistent with the best available understanding of the challenges, complexities and consequences of applying third party access regulation to mine, rail and port supply chains; and

(c) allows for continued improvement of the approaches to be taken to the mitigation and minimisation of the adverse effects of access regulation on the iron ore supply chain.

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[1] Mr O'Donnell is the former CEO of Pacific National, and was subsequently the consultant to the Queensland Government and the Queensland Resources Council responsible for undertaking an independent review of problems with the performance of the Goonyella Supply Chain. As such, Mr O'Donnell is uniquely qualified to address this point.

Current approach to the challenges of regulating multi user infrastructure in the context of a supply chain

2.16 The ACCC recently gave detailed consideration to issues raised by the application of third party access regulation to a railway operated as part of a supply chain, in its draft decision on the Australian Rail Track Corporation's (**ARTC**) access undertaking for the railway network operated as part of the Hunter Valley coal supply chain (**HVAU**).

2.17 In particular, the ACCC focussed on the need for regulation to occur in a way that achieved "alignment" between the operation of the railway and the other components of the Hunter Valley coal chain. It noted that:

> *a critical element of the long term solution is the development of mechanisms to ensure that contracts for capacity with all service providers across the coal chain are aligned, such that users and service providers enter contracts based on the capacity of the coal chain as a whole, rather than individual components of the chain.*

2.18 The ACCC considered that the following mechanisms (some of which were already included in the HVAU that the ARTC submitted to the ACCC) were appropriate means of facilitating alignment in the context of the Hunter Valley coal supply chain.

(a) The adoption of common "system assumptions", developed jointly by the ARTC and the port terminal provider, which would apply to measurement of and decisions about capacity under the HVAU, and would address matters such as the operating mode of and interface between the rail and port systems. The ACCC acknowledged that these assumptions should be dynamic, and capable of being amended and developed over time.

(b) A requirement for liaison and consultation between the ARTC and Hunter Valley Coal Chain Coordinator (**HVCCC**) on matters such as train scheduling, and capacity planning, allocation and expansion. The ACCC noted that this consultation was consistent with the principle of "determining existing and future needs of the whole supply chain in a harmonised and informed manner". Notably, the ACCC considered that the ARTC should be required to review and consider in good faith any operational concerns raised by the HVCCC in relation to maximising the efficiency of the supply chain as a whole.

(c) The adoption of a "network exit capability requirement", under which ARTC could require a coal producer to demonstrate the availability of sufficient port terminal capacity prior to the producer obtaining and using rights to access the rail network.

(d) A requirement that coal producers contract directly with the ARTC (as provider of below rail services), rather than contracting occurring solely between ARTC and the train operator without the involvement of the coal producer.

2.19 In considering these mechanisms, the ACCC recognised that supply chain alignment is a developing concept, and hence that there is a risk involved in locking in a particular standard of alignment that may impede a more efficient utilisation of the supply chain over time.

2.20 As the above discussion demonstrates, the ACCC considered that alignment was a key consideration in its assessment of the HVAU, and the ACCC specifically noted that this issue was one of the matters that it took into account pursuant to its obligation to have regard to the objects of Part IIIA in considering the HVAU. The ACCC's draft decision is the most sophisticated attempt yet by an Australian regulator to grapple with the complex issues raised by the imposition of third party access regulation on a railway operated as part of an integrated mine, rail and port supply chain. It also provides the best evidence of the current regulatory understanding of the complexities of applying third party access to mine, rail and port supply chains. While the ACCC's draft decision necessarily does not deal with the specific situation of the iron ore railways, it highlights the current state of thinking in relation to the system efficiency issues that are relevant considerations if regulation is to be applied to those railways, and the manner in which those issues might begin to be addressed.

3. THE WA REGIME IS NOT APPROPRIATE FOR THE REGULATION OF A PILBARA IRON ORE RAILWAY

Background: WA regime adopts a generic regulatory approach

3.1 The Act and Code that comprise the WA regime do not acknowledge or accommodate the need for regulation of a Pilbara iron ore railway to be tailored the specific circumstances of that railway, and the potential impact of third party regulation in that context. Rather, they apply the same access regulation framework to FMG's iron ore railway as it does to the passenger and freight railways in Western Australia, even to the extent that the regulatory instruments that apply to Westnet Rail's infrastructure have been used on several occasions,, under the WA regime, as a benchmark for determining the appropriate regulatory approach to be adopted in relation to FMG's railway.

3.2 Further, several key attempts to ensure that the regulatory instruments that will apply specifically and solely to access to FMG's railway reflect the specific characteristics of that railway have been rejected on the basis that they are beyond the scope of the WA regime (as outlined in the following sections).

3.3 This generic approach to regulating passenger, freight and Pilbara iron ore railways is starkly inconsistent with the ACCC's recognition of the need to take specific account of the challenges and impact of third party access in relation to a railway operated in the context of a mine, rail and port supply chain, and to tailor its regulatory response accordingly. The WA regime's approach does not promote the efficient use of, operation of and investment in the facility, or even seek to contain or minimise the impact of third party access. Accordingly, it would be more likely to encourage than prevent the impacts of access outlined by Mr O'Donnell.

3.4 The approach taken by the WA regime is likely to have important operational and commercial consequences, as illustrated by the following examples.

Example 1: WA regime prohibits promotion of system efficiency

3.5 The WA regime regulates FMG's railway as though it were operated in isolation from FMG's business and supply chain, and does not acknowledge or accommodate the types of alignment considerations that the ACCC considered to be critical in relation to the HVAU.

3.6 The WA regime's component-based approach to regulation was particularly evident during FMG's development of its Train Path Policy and Train Management Guidelines.

3.7 The original versions of these instruments that FMG submitted for regulatory approval, stated that it was an object of both instruments to "maximise the efficient utilisation of [FMG's railway] … within the context of the overall supply chain". This object was also reflected in the instruments' substantive provisions. For example, FMG initially proposed to require that the weekly train plan be prepared "in consultation with the Port Operator", with regard to "stockpile management and shipping requirements". Further, it also proposed to require that, when considering allocation of a contested train path, or addressing disputes about train path usage, the requirements of FMG's port operations and the port train controller's instructions "acting to maximise the efficiency of the supply chain as a whole" should be taken into account.

3.8 However this approach was considered to be inconsistent with the WA regime, on the basis that the regime regulates FMG's rail infrastructure on a standalone basis. Accordingly, the object of maximising supply chain efficiency was replaced with an object of maximising the efficiency of the railway only, and FMG's Train Path Policy and Train Management Guidelines were required to "be amended by deleting all references to TPI's port, its port access regime and its supply chain".

3.9 As a consequence, the WA regime has been applied to FMG in a way that specifically prohibits consideration of system efficiency and the related concept of alignment, thereby exacerbating the likely detriment caused by third party access to the efficient operation of the integrated mine, rail and port iron ore production system.

Example 2: WA regime ignores the impact of access on the iron ore supply chain

3.10 As a result of the component-based approach outlined above, the WA regime does not acknowledge or address the possibility that rail access could have consequences for the non-rail elements of the supply chain. Accordingly, it does not take account of, let alone compensate for, the impact of third party access on the supply chain as a whole. For example, the concept of cost in the WA regime is defined with reference to the railway infrastructure. It does not, for example, include consideration of the costs of delayed or lost production, or of inefficiencies imposed on FMG's mine or port operations as a result of access to the railway. By denying the existence and magnitude of these potential impacts, the WA regime will inevitably fail to reflect the true costs and benefits of access.

3.11 This approach is apt to cause pricing distortions in the short term, by failing to take adequate account of the risks involved in providing access to an iron ore railway operated as part of an integrated production system (which risks do not arise in relation to a standalone common user freight or passenger railway). Consequently, the WA regime is likely to result in inefficiently low access prices, which will ultimately lead to inefficient operation of the system (as users will not bear the full cost of access, but rather will effectively be subsidised by the owner), and inefficient investment in the owner's iron ore business.

Example 3: WA regime requires extensive segregation of access functions from owner's iron ore business

3.12 The WA regime adopts an unnecessarily onerous approach to the segregation of the owner's access and other functions, which imposes extensive and intrusive obligations on the owner.

3.13 In particular, the extensive segregation arrangements that have been approved in relation to FMG's railway in many respects effectively require operational separation between FMG's below rail and other operations. These arrangements have been developed having only minimal regard to the fact that FMG's below rail function is necessarily integrated both with FMG's above rail operations, and with its integrated mine, rail and port production system. The application of such extensive obligations to an integrated iron ore business can be expected to significantly undermine the control and flexibility required to operate the supply chain supporting that business, resulting in a loss of system efficiency and, ultimately, production.

3.14 Further, while FMG specifically submitted that the WA regime should be applied in a way that would mitigate the likely impact of the WA regime's segregation arrangements on its integrated operations, this submission was rejected on the basis that it was inconsistent with the requirements of the WA regime.

3.15 In particular, FMG submitted that its segregation arrangements should be implemented in two stages, where stage one would permit some information sharing between rail infrastructure and rail haulage operations, and stage two (full segregation) would apply following signing of the first access agreement. This approach was based on the regime governing the Tarcoola to Darwin railway, which FMG submitted was the most appropriate benchmark to use when considering segregation obligations in relation to a vertically integrated greenfield railway. FMG submitted that its proposed approach would recognise that the safety, operation and costs of a greenfields, vertically integrated operation could be adversely affected if it was subject to full segregation during early operations, and further address "the need for maximum interaction and sharing of information between rail infrastructure staff and haulage staff to achieve a safe and productive overall rail system".

3.16 However, this staged approach was considered to be inconsistent with the WA regime, and rejected on that basis.

Example 4: WA regime undermines owner's need for system flexibility

3.17 The WA regime undermines the owner's need to operate its railway flexibly, in order to maximise the efficiency of the integrated mine, rail and port system. Rather, the application of the WA regime to FMG's railway has imposed a highly prescriptive approach to the allocation and management of capacity on FMG's railway.

3.18 For example, under FMG's Train Management Guidelines, two types of traffic can operate on FMG's railway: "timetabled traffic" (defined in terms of specific train paths on a day and/or week) and "cyclic traffic" (defined in terms of a number of trains within a particular time period). Rather than accommodate a flexible approach to scheduling this traffic that would have regard to the efficiency of FMG's system, the WA regime imposes an intrusive and inflexible approach which would undermine the owner's flexibility. For example, under FMG's Train Management Guidelines, FMG is required to develop and apply three separate levels of train plan – a master train plan, a three monthly plan, and a fortnightly train plan – and to involve third party operators in the preparation and finalisation of both the fortnightly and three monthly train plans.

3.19 Rather than seek to adopt an approach that would preserve the owner's operational flexibility in relation to management of its railway in the context of its mine, rail and port system, this approach imposes a de facto timetable on the owner's operations.

4. THE WA REGIME IS NOT AN EFFECTIVE ACCESS REGIME

4.1 BHPBIO submits that the WA regime is an inappropriate regime to apply to a vertically integrated Pilbara iron ore railway.

4.2 In particular, BHPBIO submits that the WA regime would have severe commercial and operational consequences, as a result of the fact that the WA regime:

(a) fails to adopt a regulatory approach that acknowledges or addresses the specific characteristics of the Pilbara iron ore railways;

(b) has been applied in a way that prohibits rather than facilitates efficient co-ordination of mine, rail and port operations;

(c) ignores and does not compensate the owner for the full costs (in terms of lost production and reduced system efficiency) of providing access;

(d) imposes unduly onerous segregation obligations which unnecessarily restrict the ability of the owner to manage their railway operations in the context of their iron ore business as a whole; and

(e) impedes the flexibility of the owner's mine, rail and port system, by imposing a de facto timetable on the owner's railway operations.

4.3 In each of these respects, the approach of the WA regime does not acknowledge and would not accommodate a more sophisticated approach to regulation of supply chains, such as the approach that the ACCC is developing in the context of the Hunter Valley coal supply chain.

4.4 BHPBIO submits that the failure of the WA regime in this respect is such that the WA regime does not satisfy the CPA, would frustrate rather than promote the objects of Part IIIA, and should not be considered to be an effective access regime.

4.5 In particular, the WA regime:

(a) discourages rather than promotes the economically efficient use of, operation of and investment in significant Pilbara infrastructure, and therefore would frustrate the objects of Part IIIA to which the NCC must have regard;

(b) ignores the impacts of access on the owner's integrated system, and so:

(i) would not ensure that the owner generates revenue that is "at least sufficient to meet the efficient costs of providing access to the regulated service" (as required by CPA clause 6(5)(b)(i));

(ii) would not provide incentives to "increase productivity" (as required by CPA clause 6(5)(b)(iv)); and

(iii) would be unlikely to include a return on the owner's investment that is "commensurate with the regulatory and commercial risks involved" (as required by CPA clause 6(5)(b)(i)); and

(c) imposes segregation obligations that, in addition to being contrary to the efficiency objectives of Part IIIA, are significantly more onerous than those required by CPA clause 6(4)(n).

5. CONCLUSION

In light of the arguments outlined in this submission, BHPBIO submits that the NCC cannot be satisfied that the WA regime is an effective access regime.

Accordingly, BHPBIO submits that the NCC should recommend to the Minister that the WA regime should not be certified as an effective access regime.