



# Queensland Government Application for Certification of the Queensland Rail Access Regime

15 July 2010

## 1 Introduction

We have been asked to review from an economics and public policy perspective the Queensland Government application to the National Competition Council (NCC) for a recommendation on the effectiveness of the Queensland third party access regime for rail services provided by the Queensland intra-state rail network. In doing so, we are examining the economic and public policy issues which are contained within the matters to which the NCC must have regard in making an assessment of effectiveness for the purposes as set out in s.44G(3) of the Trade Practices Act (TPA).

Any analysis of the effectiveness of a regulatory regime presents a genuine intellectual challenge. Regulatory outcomes are influenced by a multitude of factors, which arise from a mix of regulatory rules, pragmatic exercise of regulatory discretion and organisational culture and capability of the regulatory body. The Competition Principles Agreement (CPA) emphasises that there are different ways of achieving the same competitive outcomes. The CPA does not aim to promulgate a uniform way of doing things, but rather to encourage diverse ways of achieving comparable outcomes. There are many ways to construct an effective regulatory regime out of the various possible components.

At the same time, it is obvious that some combinations of regulatory elements will be more effective than others. In analysing the effectiveness of a regulatory regime, the NCC is faced with a dual challenge:

- It needs to establish what competitive outcome any particular regime would deliver, and
- It needs to decide whether that particular outcome is good enough to meet the requirements of s.44G(3) of the TPA, namely the relevant principles set out in the CPA and the objects of Part IIIA.

This paper suggests an analytical framework for answering these questions and then uses that framework to review the Queensland regime.

## 2 Framework for Assessment

The approach taken in the Queensland Government submission is to describe the formal aspects of the regime. In essence, for every principle set out in the CPA, the Queensland

Government sets out the extent of provisions and processes which address the broad matters relevant to that principle.

In other words, the analytical framework used by the Queensland Government is to consider whether its third party access regime for rail services is sufficiently comprehensive to cover all the matters arising out of clause 6 principles. The Government's submission argues that Queensland has the most comprehensive and developed rail access regime in Australia. The regime, comprising primarily of the QCA Act, the QCA regulation and the QR Network's access undertaking, has something to say on all aspects of rail access. The essence of the Queensland Government's analytical approach is that as long as we can identify a component of the regime relevant to each clause 6 principle, and as long as that component is broadly pro-competitive, the regime as a whole complies with clause 6 principles and therefore the requirements of s.44G(3) of the TPA.

In our view, while it is important to know whether a regime is sufficiently detailed and developed, a mere enumeration of the detail can not be used to differentiate between an effective and ineffective regulatory regime. Not surprisingly, there are indeed aspects of the Regime (including elements of the Access Undertaking) which are relevant to (almost) each principle. However, the existence of the form is not the right way to assess whether the Regime complies with the CPA. There are a number of reasons for this:

- The existence of the form does not guarantee the substance of the outcome. For example, many countries which conduct elections can not be, by any stretch of the imagination, described as democracies. An assessment of whether a political regime is an effective democracy will require a much deeper understanding than simply asking whether there are democratic instruments, such as elections. Exactly the same logic applies to the analysis of regulatory regimes. The existence of the form of regulatory interventions or of declaratory statements in various instruments is not by itself informative. What matters is whether the form of regulatory intervention is appropriate to the underlying market conditions
- The overall regulatory regime is more than the sum of its components. In order to understand how the regime actually works, it is essential to understand how the components are likely to interact in practice. To consider whether a regime is effective, it is necessary to consider how the various instruments, which are apparently in place, are able to deliver effective regulatory outcomes when combined and implemented in the existing forms
- It is likely that any form of pro-competitive regulation would result in outcomes which are different to what would happen if the markets were left to themselves. However, simply knowing that a regulatory regime is likely to modify market behaviour does not inform us whether the outcomes would be sufficiently different to meet the CPA's pro-competitive objectives.

We agree with the Queensland Government that the content of the Access Undertaking needs to be considered in describing how the regime complies with the various clause 6 principles. However, this poses a further level of analytical complexity. The Access Undertaking is in the process of being reviewed, and the second version of UT3, submitted to the QCA in response to its draft decision, has not yet been accepted by the QCA.

The Access Undertaking is also a complex document. The more detailed and elaborate the provisions, the more subtle are the effects and the inter-actions between these

provisions. For example, it appears that market participants regard the competitive environment on the ARTC rail network as being different to the competitive environment on the Queensland intra-state rail network. Yet, an enumeration of provisions of the ARTC access undertaking alongside the provisions of the QR Network access undertaking would show that both are comprehensive and detailed documents, with both in some way addressing the issues posed by the CPA principles. However, that does not make them equally effective.

Given these problems, how should the NCC assess whether a regulatory regime meets the CPA principles? In our view, the right analytical framework is to test whether the regime would actually prevent possible anti-competitive outcomes that are clearly outside the range of outcomes which would be acceptable under the CPA.

The analytical approach we propose follows the logic of scientific enquiry. Karl Popper famously argued that evidence can never prove a theory, it can only falsify it. No matter how much facts appear to fit a theory, this is not sufficient because the same facts may also fit an alternative theory. Hence, the only way to advance knowledge is to consider whether there are facts which falsify a theory.

In our view, the same logical approach is required to assess the effectiveness of a regulatory regime. In looking at any set of regulatory provisions, it would be very difficult, if not impossible, to establish just how pro-competitive such provisions would be in practice. In other words, it is hard to prove effectiveness. But it is much more straight-forward to prove ineffectiveness: to do so, it would be sufficient to show that significant anti-competitive outcomes would be possible under those provisions.

Hence, the appropriate analytical framework for the NCC is to consider if it can falsify the claim of effectiveness. To do this, the question the NCC needs to ask is not whether there are legal forms which appear to address each principle, but whether it can identify sufficient examples of obviously anti-competitive conduct which would be possible under the regime.

Clearly, a single contrived example would not be sufficient to demonstrate that the regime is not effective. However, an accumulation of such examples would demonstrate that the form does not deliver the required substance.

In our previous submission, in support of an application for the declaration of the Queensland coal rail network under Part IIIA of the Trade Practices Act, we have examined a wide range of anti-competitive actions which appear possible under the Queensland regime. Our approach in that submission was as follows:

- Identify the typology of discriminatory and anti-competitive actions suggested by the economic literature given the incentives facing vertically integrated entities with market power in the upstream markets
- Consider which of these types of actions would be possible under the Queensland access regime.

We found that the Queensland regime allowed the full range of non-price discrimination actions identified by the literature. This strongly supports the view that the evidence falsifies the claim of effectiveness.

Below, we elaborate on our previous analysis having regard to the amendments which the Queensland Government has foreshadowed in its certification application will be made to the regime. These proposed amendments are taken into account in the views which are expressed. On further reflection and having regard to the proposed amendments, the key problem with the Queensland regime—and the reason why the full

range of the theoretically viable discriminatory actions appears to be possible under the regime—is that it does not effectively differentiate between the third party and related party access seekers. As a result, the apparent compliance with the CPA principles in form turns out to be non-compliance in substance.

### 3 Vertical Integration

The Queensland Government submission emphasises that the relative merits of vertical integration or vertical separation is not a matter for certification. Rather, each Clause 6 principle must be considered whether it is reasonably incorporated having regard to the presence of vertical integration. We strongly support this view. However, the Queensland Government submission fails to follow its own advice. It does not adequately consider how the specific form of vertical integration in place in the State influences how the regime delivers on Clause 6 principles.

A regulatory regime dealing with vertically integrated entities has two options:

- It can enforce a detailed regime of functional separation so that the structure of the business creates the basis for treating both third party access seekers and own downstream businesses in the same way. This approach allows the regulator to separate the conduct in the upstream and downstream markets
- It can assume that the vertically integrated business competes in the downstream market through elements of both its downstream and upstream business activities. In this context the regulatory regime has to focus on the overall conduct.

In our view, the key problem with the Queensland access regime is that it does neither. In important ways, the regime operates as if there is vertical unbundling. Two features stand out:

- Access agreements between QR Network and QR National are treated as binding third party contracts
- Prior contractual rights under such agreements are fully protected.

Such contractual protections would make sense in the absence of vertical integration. Clearly, in that case, all access contracts should be treated the same. However, in the presence of vertical integration, agreements with related parties must be treated differently to contracts with third party access seekers.

In fact, the whole purpose of an access regime is to constrain and modify interactions between the vertical components of a vertically integrated entity in order to achieve competitive outcomes. This is particularly important when a vertically integrated entity is able to compete in the downstream market through all aspects of its business. As we have discussed in our previous submission, in the absence of regulatory constraint, a vertically integrated entity would have the ability and the incentive to:

- Prioritise its below-rail investment program to favour its above-rail interests
- Provide preferential treatment to its above-rail interest.

Clearly, under the Queensland access regime, such conduct would not be allowed if it were carried out by a single vertically integrated entity. Yet, such conduct is effectively legitimised through the fiction that internal arrangements within the vertically integrated entity are arms-length third party contracts. For example, the latest version of the Access Undertaking (UT3.2) specifically states that QR National will not discriminate between

access seekers unless such discrimination is specifically provided for under an access agreement.

Overall, the Queensland Government submission describes the form of a regulatory regime based on the principle that:

- All above rail operators are subject to the same access regime
- Access agreements between third party above rail operators and the network, and between jointly owned above rail operator and the network, have the same contractual standing
- The absence of discrimination arises from the existence of similar access processes for all above rail operators.

While this would seem like a plausible description of a pro-competitive regime at a high level of abstraction, it creates significant potential for anti-competitive conduct precisely because of the specific form of vertical integration being proposed in Queensland. This form of vertical integration involves:

- Formal separation of above rail and below rail QR entities, but
- Substantial integration of commercial decision-making between these entities.

In this setting, treating contractual commitments with related entities in the same way as contractual commitments with third party access seekers achieves precisely the opposite effect: it enhances discrimination. We will expand on these issues in more detail in the following section.

By quarantining the provisions of contracts between entities, the Queensland regime effectively excludes important aspects of conduct by the vertically integrated entity from the regulatory oversight. As we have described in our previous submission, such freedom to engage in discriminatory conduct is not offset by any structural provisions, which could be used to reduce incentive to take advantage of the opportunity to discriminate.

## 4 Comment on Relevant CPA Clause 6 Principles

We now apply our analytical framework to considering if the Queensland rail access regime complies with the main principles of Clause 6 of the CPA. We broadly follow the structure of the Queensland Government submission. However, unlike the Queensland Government submission, for each relevant principle we ask:

- How does the regime address the realities of vertical integration, given the form in which it will be implemented in Queensland?
- Does evidence falsify the claim that the approach used in the Queensland regime is a reasonable approach to satisfy the principle? In other words, can we identify significant unaddressed opportunities for anti-competitive conduct, such that the objectives inherent in the principle would likely not be met?

In our view, the Queensland rail access regime, in its current form, does not satisfy the key Clause 6 principles, primarily due to not addressing the realities of vertical integration.

### 4.1 Clauses 6(4)(a)-(c): negotiated access

This clause emphasises the primacy of contractual negotiations. The Queensland Government submission argues that it complies with the clause because the terms and

conditions of access can be negotiated, and that any standard terms only apply if a commercial agreement can not be reached.

However, an ostensible compliance with this clause is actually at the root of the problem. The ability of QR Network to enter into binding contracts with related entities, and to vary the terms of those contracts from standard provisions, is precisely the enabler of discriminatory conduct.

The purpose of the CPA is to introduce regulatory interventions which alter the relationship within the vertically integrated structure. In this context, the significance of clauses 6(4)(a)-(c) is that a third party access seeker should be able to negotiate an access agreement, and if such agreement can not be reached on the commercial basis, to enjoy an enforceable right to negotiate. However, providing the same right of negotiated access to related entities in effect negates the logic of this principle.

The ability to treat negotiations with related parties as part of the same process as negotiations with third party access seekers enables the vertically integrated entity to game the queuing arrangements for anti-competitive purposes. For example, if QR were treated as a single entity, and if it refused to negotiate with an access seeker because it wanted to try to secure an above rail contract for itself, such delay in negotiation would be treated as an unreasonable denial of access. However, it would be perfectly legitimate under the Queensland regime for QR National to be first in the queue to negotiate an access agreement, and for QR Network to refuse to engage with other access seekers until it concludes its negotiations with QR National.

In form, the second example appears to be quite different, since it involves apparently neutral queuing of various access seekers. In substance, however, the second example is no different to the first: QR as an integrated entity has good advance information on the expiration of the existing access contract or the emerging requirements for new access contracts, and can use that information to get one of its entity to enter the negotiation queue in order to delay negotiations with third parties. The effect is no different to delaying negotiations.

The corollary of giving primacy to contractual negotiations is the protection accorded to contractual rights. However, as we have explained, treating arrangements with related entities in the same way as third party contractual rights actually undermines the logic of the principle contained in this clause. The right for a third party access seeker to negotiate with a vertically integrated entity must mean that such an entity would have the flexibility to alter its internal arrangements. In particular, current practices at the interface between the upstream and downstream operations need not be an obstacle to the provision of access. In general, one would expect that the very purpose of negotiations is to figure out an efficient way to reconcile the incumbent and access seeker interests.

Overall, the Queensland access regime produces an odd result. The ability to negotiate with related entities gives QR the flexibility to discriminate against third party access seekers. However, the existence of contracts with related entities reduces QR's flexibility to respond to access seekers needs.

In our view, the Queensland Government emphasises the form of this principle, which actually undermines its substance. We believe that NCC can not find that the Queensland rail access regime, in its current form, satisfies the Clauses 6(4)(a)-(c) principles.

## 4.2 Clause 6(4)(f): negotiated access

The Clause 6(4)(f) principle is that access need not be on the same terms and conditions for all parties seeking access. Again, this principle needs to be seen within the context of the actual model of vertical integration adopted in Queensland.

It is clear how the logic of this principle applies to third party access seekers. Since a vertically integrated entity has no incentive to discriminate among non-related parties, there is an increase in efficiency without any loss in competition in enabling each third party access seeker to negotiate its own terms and conditions of access, even if that results in different terms and conditions between them.

However, marrying the ability to negotiate different access contracts with the ability to enter into binding contracts with related entities creates opportunities for discrimination. While sections 104 and 125 of the QCA Act<sup>1</sup> prohibit unfairly favouring an affiliated entity, we believe such prohibitions do not work as intended in situations where the contracts with affiliated entities bind future negotiations with third parties.

For example, consider the length of the contract. Let us assume that above rail operators prefer the term of the access contract to match the term of their haulage contract with a coal company. Clearly, if QR Network offers term-matching contracts to QR National, but does not do so for third parties, this would appear to be discriminatory, and is likely to be controlled by the regime.

However, QR Network and QR National would also have the option of entering into long-term access contracts, which generally exceed the term of the haulage contract. In that instance, QR Network would not apparently be discriminating against third party access seekers if it wanted them to commit for the same term. Yet, the economic effects would be quite different. The length of the access contract between QR National and QR Network is irrelevant to the QR as a vertically integrated body, since the contract can always be varied by agreement between two parties. In any case, any transfer of value under the contract is irrelevant to the overall shareholders. By contrast, long-term contracts expose third party access seekers to additional risks.

A regime which treats all access contracts as if they were arms-length focuses any comparison of treatment on the terms of the contract, and makes it much more difficult to compare the underlying economic reality of how affiliated entities and third parties are treated.

Of course, this also means that even if the terms of the contract between a third party and an affiliated entity were identical, the economic effects could be quite different, and so discrimination could still occur. However, the problem is further exacerbated by the ability to negotiate different contracts. Since QR Network is able to discriminate when required by the terms of the existing access contracts, QR Network and QR National could enter into contracts which do not appear discriminatory at the time, but would enable discrimination in the future. For example, QR Network and QR National could use information jointly available to them (but not to access seekers) about the future expiry dates of the existing haulage contracts and of the below rail investment plans to change the terms of the existing access contracts in a way which maximises the hurdle for a future access seeker. Such changes would not be discriminatory at the time they are

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<sup>1</sup> In addition, there are provisions in clause 168A of the QCA Act (consistent with the requirement of clause 6(5)(b)(iii) of the CPA) that prohibit a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations except to the extent that the cost of providing access to other operators is higher.

made, since there would be no access seekers at that time. Their discriminatory effect at a future time may be impossible to stop, since when the time comes, an access seekers would ostensibly be treated no differently than the affiliated entity.

If the regulatory regime treated a vertically integrated entity as a single organisation with managerial discretion over both the upstream and the downstream operations, it would ignore any contractual commitments between the two, and would consider whether the vertically integrated business is discriminating against a third party through its actions. However, treating arrangements between upstream and downstream operations as if they were binding contracts on par with the contracts with third parties, locks in actions which may have discriminatory effects, but which were put in place in a form that does not appear to be discriminatory.

In fact, as we explained in our previous submission, non-price discrimination can be achieved by appearing to treat an affiliated entity less favourably. For example, QR Network may sign more onerous contracts with QR National as a means of increasing entry costs for third parties in the event that access rights need to be transferred to them.

Again, we believe that the NCC can not find that the clause 6(4)(f) principle is satisfied if the application of the principle becomes an enabler of anti-competitive conduct given the actual vertical integration arrangements.

### **4.3 Clause 6(4)(i): dispute resolution**

Among other factors, this principle is based on taking into account “(v) firm and binding contractual commitments”. Again, the fiction that contracts with related entities have the same significance as contracts with third party access seekers distorts the application of this principle. Yet, this fiction lies at the core of the Queensland regime. While QR is a fully integrated entity, any dispute resolution between QR Network and a third party access seekers would have to be undertaken on the basis that QR is fully bound by its existing commitments to its related parties.

While in danger of belabouring the point, we should emphasise that the Clause 6 principles, when applied to access issues, need to be seen in the context of the relationship between a vertically integrated infrastructure owner and third party access seekers. The principles provide the guidelines for the regulatory oversight of this relationship.

The Queensland access regime seeks to apply the same principles to dealings within the vertically integrated entity as if such entity had been unbundled. For example, it is significant that the Access Undertaking binds QR Network, rather than QR as a whole. However, such an “as if” approach does not work when, in fact, there is no vertical unbundling, and when even functional separation between the QR entities is, at best, minimal. In this instance, the regime is caught in a “no man’s land”: it does not ensure the quality of treatment through structural instruments, and it does not enforce non-discriminatory conduct because it does not adequately differentiate between related party and third party contracts and negotiation processes.

This is not an argument for vertical separation. However, it is a strong argument for making the regulatory regime consistent with the form of vertical integration. In our view, the clause 6(4)(i) principle is not satisfied because the dispute resolution process is unreasonably bound by the contractual commitment to the related parties. In effect, the regime sends the following message to the vertically integrated infrastructure owner: “if you were undertaking anti-competitive conduct through the exercise of managerial discretion, a third party access seeker would be able to address such conduct through the dispute resolution process; however, to the extent that you can remove such conduct

from managerial discretion and load it into contracts with related entities, it would be outside the reach of a dispute resolution process.”

As a result, the dispute resolution process under the Queensland regime gives the owners of infrastructure dual consideration: it explicitly considers their legitimate interests, as described in the Queensland Government submission, and then again considers their interests locked into contracts with the related entities.

#### **4.4 Clause 6(4)(m): hindering access**

The Queensland Government submission argues that the current Queensland access regime is effective because it contains prohibitions on hindering access through unfair discrimination. The submission states that this is further reinforced by the proposed amendments under section 168C of the QCA Act, under which “a related access provider must not unfairly discriminate against users of the service in providing access”<sup>2</sup>. The submission neglects to highlight the fact that the amendment specifically allows such discrimination if it is expressly required or permitted under an existing access agreement, even if it is an agreement with the related party. Similar exception is included in the Access Undertaking.

Again, the apparent good intentions of the regime are negated through not having regard to the form of vertical integration. Given the actual form of vertical integration—where QR National and QR Network will have the ability and the incentive to act in concert in the overall interests of QR—it is important to recognise that market outcomes will be influenced through a mix of above-rail and below-rail decisions.

As a result, QR will have opportunities to hinder access without ostensibly discriminating against any access seekers, and thus without being prevented from doing so under the regime. For example, the regime prevents QR Network from using its investment program to discriminate against access seekers. However, the regime does not prevent QR Network from using the investment program to its advantage if no above rail access seekers are involved.

For example, a coal mining company may approach QR Network to construct an extension of the existing network to its new mine. The mining company had not yet entered into negotiations on haulage contracts and there is no above rail access seeker in the picture. In this case, QR Network would be entirely within its rights to indicate that its investment priorities may not allow such construction to take place within the time-frame required by the mining company, but that priorities could change if the mining company entered into a haulage contract with QR National. If such haulage contract is signed, QR National would be the only above rail access seeker, and hence there would be no discrimination.

In principle, the coal mining company could prevent this from happening by bidding out its haulage contract ahead of its investment negotiations with QR Network. In that case, QR Network could not explicitly change its investment priorities to favour its affiliated above rail provider. However, this would require an additional level of planning and organisation from the coal mining company, which itself may be a hindrance.

Similarly, the coal mining company has the option of constructing the network extension itself. However, it may be difficult and time consuming to mobilise the specialist skills required, and which in Queensland may be scarce outside of QR Network.

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<sup>2</sup> P59 of the submission

This problem is exacerbated by the fact that the current declaration and the Access Undertaking do not automatically apply to all new investments undertaken by QR Network. While there is a process to include those assets in the access regime, the likely delay will put access seekers at a disadvantage, and will provide QR (as a vertically integrated entity) with a grace period to lock any discriminatory arrangements into place.

Overall, it would be incorrect to conclude that the current Queensland access regime prevents hindering access. Significant opportunities to hinder access (in particular, by increasing the cost of entry and by making haulage contracts with new entrants less attractive) will exist under the regime. Hence, the NCC can not conclude that the regime, as it currently stands, will satisfy the clause 6(4)(m) principle.

## **5 Conclusion**

The evidence suggests that the Queensland rail access regime leaves significant opportunities for anti-competitive conduct by the future privately-owned and highly incentivised QR. The NCC needs to focus on these opportunities, rather than on considering whether the regime is comprehensive and developed in form. Applying an appropriate analytical framework to the provisions of the regime would lead the NCC to conclude that the regime does not satisfy Clause 6 principles of the CPA.

However, we would also emphasise that the root of the problem appears to be quite clear—the reason why the regime does not satisfy Clause 6 principles arises from the aspects of the regime which treat contracts with related parties as if they were contracts with third parties, and grant sanctity to those contracts. Relatively straight-forward amendments to the regime would remove opportunities for anti-competitive conduct arising from this “as if” approach.