



AUSTRALIAN COMPETITION & REGULATION UPDATE

FOR PORT & RAIL INFRASTRUCTURE OPERATORS AND USERS

In this update we touch on recent events in the competition and regulation space of relevance to port and rail infrastructure owners and access seekers, being:

- a recent decision of the Australian Competition Tribunal (**Tribunal**) in the energy context on the rate of return and gamma;
- the Australian Competition and Consumer Commission's (**ACCC's**) current focus on seeking to reform the regulation of monopoly infrastructure, including ports and railways;
- the status of Glencore Coal's application for declaration of the Port of Newcastle;
- a recent decision of the WA Court of Appeal on the validity of a proposal by Brockman Iron to access The Pilbara Infrastructure's (**TPI's**) railway; and
- a review of ring fencing guidelines being undertaken by the Australian Energy Regulator (**AER**).

TRIBUNAL DECIDES RATE OF RETURN AND GAMMA ISSUES

A recent decision of the Tribunal in the energy context could have implications for access prices for regulated rail and port infrastructure. After much anticipation the Tribunal has handed down its decisions on the applications for review lodged by NSW and ACT electricity distributors from decisions of the AER on their 2015-19 electricity distribution price reviews and Jemena Gas Networks' (**JGN's**) application for review of the AER's decision on its 2015-20 access arrangement.¹

The AER's approach to determining the rate of return and value of imputation credits (gamma) were key issues considered by the Tribunal.

Energy networks are highly regulated and subject to different regimes to ports and railways. However, the since the rate of return and gamma are relevant to the calculation of allowable revenue and thus access pricing, the Tribunal's decision may be influential in framing the access negotiations and guiding the approach of the relevant regulator (if applicable) more broadly, including in the context of access to ports and railways.

The principal rate of return and gamma issues determined by the Tribunal were:

- the AER's use of the Sharpe Lintner Capital Asset Pricing Model (**SL CAPM**) model as the 'foundation model' in determining the return on equity;
- the approach to transitioning from the 'on-the-day' approach to the trailing average approach in estimating the cost of debt; and
- the value for gamma in determining the cost of corporate income tax.

The AER has now sought judicial review of the Tribunal's decision in the Federal Court. We will keep you informed as to the outcome of that application.

¹ DLA Piper acted for ActewAGL Distribution in the proceedings. The lead decision to which the decisions on the separate applications before the Tribunal refer is: *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1.



The following table summarises the Tribunal’s conclusions on the key rate of return and gamma topics.

ISSUE	AER’S FINAL DECISION	NETWORKS’ POSITION	TRIBUNAL’S CONCLUSION
Return on equity	7.1%	10.15% (Ausgrid, Endeavour Energy and Essential Energy (NNSW)), 9.83% (ActewAGL Distribution (ActewAGL) and JGN) Error alleged with respect to: <ul style="list-style-type: none"> the use of a ‘foundation model’ and the SL CAPM as that ‘foundation model’; the equity beta; and the market risk premium. 	No error established
Return on debt transition	10 year trailing average approach with a 10 year transition from the on-the-day approach	10 year trailing average approach with no transition from the on-the-day approach (NNSW & ActewAGL). 10 year trailing average approach with no transition for the debt risk premium component and 10 year transition for the base rate component (Jemena).	Error established
Return on debt implementation issues		Error alleged with respect to the implementation of the AER’s return on debt methodology (NNSW and Jemena), including: <ul style="list-style-type: none"> the adoption of a benchmark credit rating of BBB+ rather than BBB; and the use of a simple average of the RBA curve and Bloomberg fair value curve. 	No error established
Gamma	0.4	0.25 The value of imputation credits is the investors’ determination of their worth as reflected in observable market behaviour, rather than their claimable or face value.	0.25 Error established

ACCC FLAGS CONCERN ABOUT ACCESS TO RAILWAYS AND PORTS

As part of its new increased focus on agriculture issues, at the recent ABARES Outlook Conference in Canberra ACCC Chairman Rod Sims flagged access regulation of monopoly infrastructure as an area of concern to the ACCC.² Chairman Sims comments indicate the ACCC considers that, in order to address monopoly pricing by infrastructure owners, there is a need for an alternative form of regulation of monopoly infrastructure to the National Access Regime in Part IIIA of the Competition and Consumer Act.

The ACCC considers that monopolistic pricing by owners of natural monopoly infrastructure is particularly relevant to the agriculture sector which relies on rail and port infrastructure. Chairman Sims suggested that it should be

standard practice for monopoly infrastructure to be subject to economic regulation. He said that the threat of regulation under the National Access Regime was not acting as an efficient deterrent to monopoly pricing and other exercises of market power because:

- not all types of monopoly infrastructure services are vertically integrated into related markets, it is difficult to demonstrate that they have an incentive to deny access or set prices in a way that adversely affects competition in another market; and
- the costs of using monopoly infrastructure may only account for a small proportion of the delivered price of a good, therefore it can be difficult to demonstrate access will promote a material increase in competition in a related market.

² ACCC, Mr Rod Sims, Chairman, Increasing efficiencies in supply chains, ABARE Outlook Conference, Canberra, 2 March 2016.



Accordingly, Chairman Sims said that there was a need to seek alternative forms of regulation of monopoly infrastructure to the National Access Regime to address monopolistic pricing and rent transfers, which contribute to inefficient economic outcomes. One way Chairman Sims appeared to consider this could be achieved was by the government using the privatisation processes of significant infrastructure, for example port facilities, as an opportunity to put in place pro-competitive market structures.

The ACCC has also criticised Part IIIA in the context of the ACCC's inquiry into the competitiveness and structure of the east Australian gas industry.³ Transmission pipelines may be subject to access regulation under the National Gas Law and the test for regulation is similar to that under Part IIIA. Similar to his comments in the context of agriculture supply chains, Chairman Sims stated that the threat of regulation under the National Gas Law is not acting as an effective deterrent to monopoly pricing and other exercises of market power by owners of transmission pipelines. In particular, it appears the ACCC is concerned the requirement that access would promote a material increase in competition in upstream or downstream markets to the pipeline (criterion (a)) is difficult to satisfy where pipeline owners are not vertically integrated. The Australian Energy Market Commission has also suggested amending or removing this criterion from the coverage criteria for transmission pipelines – [see our 2 November 2015 update regarding this issue](#).

The ACCC will provide its report on the East Coast Gas Inquiry to the Government on 13 April 2016. It may be that the views the ACCC expresses in the report on access to transmission pipelines will be carried over into any views the ACCC expresses in respect of access to infrastructure in connection with its new focus on agriculture supply chains. We will keep you posted.

GLENCORE COAL'S PORT OF NEWCASTLE DECLARATION APPLICATION TO BE HEARD BY TRIBUNAL

In January this year the Acting Commonwealth Treasurer refused Glencore Coal's application for declaration of the shipping channel service at the Port of Newcastle under Part IIIA of the Competition and Consumer Act 2010. Consistent with the National Competition Council's recommendation, the Acting Treasurer determined that Glencore Coal's declaration application satisfied each of the declaration criteria, except for the requirement that access (or increased access) to the service would promote a material increase in competition in a market, other than the market for the service (criterion (a)).

One of the reasons for rejecting the declaration application was the cost of using the port service was a small component of the overall cost of the production and sale of coal for export. The National Competition Council also emphasised in its recommendation not to declare the service that Part IIIA cannot be used merely to impose price regulation, but rather the regime's focus is on the promotion of competition in markets where competition is otherwise limited by the lack of access to essential facilities. As set out in the discussion of the ACCC's stance on Part IIIA above, this is the very issue the ACCC takes with Part IIIA.

Glencore has sought review of the decision by the Australian Competition Tribunal. The main issue in the proceeding will be the application of declaration criterion (a). The matter will be heard by the Tribunal in early May this year. We will keep you posted.

WA COURT OF APPEAL HAS CLARIFIED ACCESS PROPOSAL REQUIREMENTS UNDER WA RAILWAYS (ACCESS) CODE

A recent Court decision discloses that where access regimes follow an application–negotiate–arbitrate model consistent with the Competition Principles Agreement, it is not appropriate for an access provider to take a literal approach to an access application or proposal such as to require the applicant to have a definite intention to use the relevant infrastructure.

The WA Court of Appeal recently dismissed an appeal by Fortescue Metals Group's subsidiary, The Pilbara Infrastructure (TPI), from a Supreme Court decision that Brockman Iron had lodged a valid proposal for access to TPI's railway.⁴ In doing so the Court of Appeal clarified the requirements of an access proposal under section 8 of the Railways (Access) Code.

TPI alleged that the access proposal lodged by Brockman Iron on 15 May 2013 was invalid on the basis that it did not comply with section 8 of the Code. In essence, TPI alleged that this was because Brockman had no real, genuine, nor actual need for access to its railway infrastructure in late 2016 or any relevant time. Among other things, TPI asserted that section 8 required:

- an access seeker must have a definite intention to use the relevant railway infrastructure, which cannot be contingent on future events; and
- the sole purpose for a proposal must be the purpose of actually operating rail infrastructure on the railway.

³ ACCC, Mr Rod Sims, Chairman, Keynote address: Observations on the east Australian gas market, Australian Domestic Gas Outlook Conference, Sydney, 9 March 2016.

⁴ *The Pilbara Infrastructure Pty Ltd v Brockman Iron Pty Ltd* [2016] WASCA 36.



The Court dismissed TPI's appeal on the basis that TPI's arguments were not supported by a proper construction of the Code. The Court found that contrary to TPI's case, section 8 of the Code did not require an access seeker to have a real, genuine, or actual need for access at a particular time or an unconditional intention to use railway infrastructure when it makes an access proposal. However, the Court suggested that, at least arguably, the access seeker should have a subjective intention to enter into negotiations for an access agreement when it makes a proposal.

In doing so, the Court noted that under the Code the making of a valid proposal is a precursor to negotiations between the parties. However, the duty of the railway owner to negotiate is subject to the access seeker meeting certain requirements, for example that the access seeker has the necessary financial resources to carry on the proposed rail operations and they can be accommodated on the route. Further, negotiations may not necessarily result in the access seeker and the railway owner entering an access agreement.

TPI also alleged that in making its application under the Code Brockman Iron had the dominant motive of obtaining leverage over TPI with a view to making a haulage agreement with Fortescue. Accordingly, Brockman Iron did not have the sole purpose of carrying on rail operations as required by section 8(2)(b) of the Code. The Court decided that the 'purpose' under section 8(2)(b) is the expressed consequence or end as revealed by the proposal rather than the applicant's motive. The 'purpose' should be ascertained objectively having regard to the terms of the written proposal and the nature of the proposed transaction in the context of the Code. Having regard to the terms of Brockman Iron's proposal, the Court concluded that its proposal was for the sole purpose of carrying on the operation of rolling stock on a part of the railways network.

While this decision is concerned with section 8 of the Code in respect of access proposals, it also has broader implications for other access regimes which follow an application–negotiate–arbitrate model in that access providers may not be permitted to simply dismiss an application for access on the basis that the applicant's plans for accessing the infrastructure are contingent on future events.

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AER IS REVIEWING ELECTRICITY RING-FENCING GUIDELINES

During the course of this year the AER is undertaking a significant review of ring-fencing guidelines with a view to developing a national guideline for electricity distribution ring-fencing. The purpose of the guidelines will be to separate the competitive and regulated parts of network businesses to protect the long term interests of consumers. While the outcome of the review will be specific to the electricity industry, since it will involve a comprehensive review of the role and nature of ring fencing, it is likely to have a knock on effect on others with ring-fencing obligations.

Currently the AER relies on ring-fencing arrangements established by State regulators. It proposes to develop a new national guideline in collaboration with the Australian Energy Market Commission and State Government agencies. The AER has published an indicative timetable for the development of the guideline which includes steps for consultation commencing with the publication of a discussion paper, which the AER anticipated would occur in March 2016, and the publication of the final guideline in November 2016.

We will keep you posted.

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