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Keeping Track of Static and Dynamic Incentives: The Australian approach to essential facilities

This Brief comments on the recent Decision of the Australian Competition Tribunal ('the Tribunal') in the Fortescue Metals Group ('FMG') case.[1] FMG is an iron ore mining operator in the Pilbara region of Western Australia. The case concerned separate applications by FMG under Part IIIA of the Trade Practices Act to obtain access to four railway lines: the Mount Newman and Goldsworthy lines owned by BHP Billiton; and the Hamersley and Robe lines owned by Rio Tinto, in order to transport iron ore from various locations in Pilbara to the sea ports that would take the iron ore to its export markets. BHP Billiton and Rio Tinto ('the owners') opposed the applications for access, choosing to continue to operate these lines as part of their own integrated iron ore businesses.

The Tribunal Decision considered three main questions:[2]

- Would it be 'uneconomical' for the applicant (or anyone else) to develop an alternative infrastructure?
- Would access to the facility in question 'promote a material increase in competition in at least one market other than the market for access services?'
- Would the granting of access to the facility be 'against the public interest'?

We consider how the Tribunal interpreted these questions, what implications this has for the underlying economic issues, and note how the Tribunal's approach to essential facilities under Part IIIA echoes some of the controversies that have arisen in the EU case law under Article 102.

Would alternatives to the railway facilities be 'uneconomical'?

The owners contended that the question of whether rival facilities would be 'uneconomical' should depend on whether it would be privately profitable for competing railway networks to co-exist with the owners' lines. This is in line with the test for essential facilities found in EU competition law, which requires that access to the contested facility must be indispensible to the applicant.[3] With respect to three of the four railway lines under consideration the Tribunal found that if access was not granted this 'privately profitable' test was satisfied: 'new railways would be built which could be used by many of the junior miners that might otherwise seek access to the owners' lines'.[4]

The Tribunal, however, did not accept that access to the facility needed to be indispensible. It stated that whether alternatives would be 'uneconomical' depended on whether the contested railway lines had natural monopoly characteristics. Further, it chose to adopt a technical definition of natural monopoly as a situation in which the key question was simply: 'Can each line provide society's reasonably foreseeable demand for the below rail service at a lower total cost than if provided by two or more lines?'[5] The Tribunal found that this test was satisfied for three of the four contested railway lines even if they would need to extend their capacities in order to meet the extra demands imposed by FMG's requirements.[6]

1
'In the Matter of Fortescue Metals Group Limited [2010] ACompT 2' (30 June 2010). Available at http://www.austlii.edu.au/au/cases/cth/ACompT/2010/2.html

2
Under Part IIIA of the Act, 6 criteria must all be satisfied before access can be determined. The three questions addressed by the Tribunal's Decision relate to criteria (b), (a) and (f). There was no disagreement that the other three criteria were satisfied.

3
The indispensability test comes from the Oscar Bronner Article 102 ECJ Judgment, and is described at para 82 of the EU Commission Guidelines on Article 102 enforcement issued in December 2008.

4
See para 14 of the Summary to the Tribunal Decision.

5
See para 850 of the Tribunal Decision.

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The exception was the Mount Newman line, and indeed the Tribunal found that FMG had already built a line that ran parallel with a large stretch of this line.

The problem with this narrow technical definition of natural monopoly is that it is a purely static test and consequently sets a very low bar for intervention. Almost any competitive rivalry involves the duplication of some fixed costs between the participants, whether that comprises rival R&D programmes in commercial aerospace or two competing grocery retailers' distribution vehicles passing one another on their ways to competing stores. The simple fact that a lower total cost for the industry might be achieved with a single supplier does not generally justify the conclusion that society is best served by having a single 'natural monopoly' operator. Instead, most competition policy regimes assume that, except in extreme cases, some element of duplication is a cost worth incurring in order to secure the dynamic benefits of rivalry and to avoid the need for hands-on regulatory interference to control monopoly provider discretion.

Hence, by adopting a static technical definition of natural monopoly in this first stage of the assessment, the Tribunal defined a very low threshold for intervention which tipped the scales sharply in favour of compulsory access.[7]

Would access 'increase competition'?

Identifying how access could benefit competition ought to be a core issue in any essential facilities intervention. The Tribunal looked at this question with respect to three separate 'markets' which could be affected by the Decision.

Interestingly, the Tribunal found that no material benefits to competition would arise in the downstream iron ore market. The Tribunal judged that this market was global in scope, and that no conceivable increase in future industry output arising from granting access to FMG would affect market prices or consumer welfare. Similarly, it judged that the upstream market for the rights to the land (or 'tenements') on which the iron ore mining took place was and would remain competitive irrespective of the outcome of the current case.

This led to a critical focus on whether a 'market' can be said to exist for the intermediate activity of 'rail haulage services for iron ore' on each of the four lines. The owners argued that it could not, since neither of them was involved in selling this rail haulage service to third parties – instead, rail haulage was simply one of a range of economic activities that they undertook in order to get their iron ore to market. However, the Tribunal concluded that a market could be defined as any activity that could in principle be unbundled and marketed to third parties.[8] This discussion mirrors the debate that has taken place in EU competition law regarding the definition of tying and the scope for unbundling.[9]

Since the Tribunal rejected the possibility of any material impact on either the downstream or upstream markets, however, the main substantive question was whether allowing FMG access to the intermediate activity of rail freight can generate any real competitive benefit. The Tribunal judged that, in respect of the three lines that passed its natural monopoly test, the very fact that the owners are currently 'monopoly' suppliers of haulage services whereas under compulsory access there will (if access offers are taken up) be competing suppliers is sufficient to meet this test.[10] This very narrow – almost circular – interpretation falls well short of identifying the kind of benefit to competition that would conventionally be sought in an effects-based competition regime, since the benefit arises essentially from using regulatory intervention to oblige the owners to share assets they would rather keep for themselves even if it leads to no benefit to downstream consumers.[11]

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The Tribunal is clearly aware of the conflict between dynamic and static efficiency considerations, but it chose to defer consideration of the dynamic arguments to a later stage in the assessment.

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See paras 1135 to 1138 of the Tribunal Decision, which rely on a description of prior case law developed in the Queensland Wire case.

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Para 50 of the EU's Article 102 Guidelines concludes that 'Two products are distinct if, in the absence of tying or bundling, a substantial number of customers would have purchased the tying product without also buying the tied product from the same supplier.'

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See paras 1145 and 1148 of the Decision.

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The Decision does, however, acknowledge that there could be a small output effect, if granting access to the railways provided an outlet for iron ore deposits that would otherwise be stranded.

The extent to which such intervention would shift rents between the owners and applicants must depend on the terms on which access should be granted, but the Decision is deliberately silent on this question since the Part IIIA provisions have a distinct follow-up process whereby, once it has been determined that access should be granted, the ACCC is tasked with determining the access price terms if a negotiated deal cannot be reached. The Decision describes this division of labour in terms of the Tribunal's duty to consider the 'big picture' question of whether access should be granted, leaving the ACCC to deal with 'the minutiae' of the precise access terms.[12]

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See para 1174 of the Decision. The ACCC has experience in access price regulation through its regulatory role in the utility sectors.

This explicit provision to determine access pricing terms places the Australian regime at a distinct advantage over its EU counterpart. The EU Commission has consistently evaded discussions on access pricing terms even when it has identified an essential facility and concluded that third party access must be granted, frequently leading to perverse outcomes. For example, having been told it must supply interoperability information that would allow the products of competing server software manufacturers to communicate with Windows PCs, Microsoft took so long to identify an acceptable access price that it was fined some €900m for the delay, considerably more than the penalty it received for the original offence.[13] The EU Commission insisted that it was inappropriate for it to become involved in access pricing because it is 'not a price regulator', but if a regulator feels competent to determine that access should be granted, it is untenable for that regulator to maintain that it cannot determine access prices.

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See 'Antitrust: Commission ensures compliance with 2004 Decision against Microsoft', Commission press release 22 October 2007, available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1567&format=HTML&aged=1&language=EN&guiLanguage=en.

Whilst the Australian system avoids this anomaly in the EU approach, the fact that the Tribunal is obliged to defer consideration of pricing terms leaves a huge hole in its Decisions. The terms on which access is granted fundamentally affects the economic outcomes. If prices are prohibitively high, then by definition access cannot have any impact on competition or economic efficiency. Conversely, if access is granted on extremely low price terms, then this will have adverse implications for dynamic competition, which are unlikely to be confined to the particular industry under consideration.

Public interest considerations

The third key question considered by the Tribunal was whether it was against the 'public interest' to mandate access. The Tribunal chose to use this potentially very wide criterion to take some account of the dynamic efficiency arguments that were suppressed by its narrow approach on natural monopoly and competitive benefits.

Since the Mount Newman line failed even the Tribunal's narrow test for a natural monopoly, the Tribunal concluded there was no case for granting access to that line. It also rejected the application for access to the Hamersley line despite the fact that duplication by FMG and other junior miners would be less efficient than allowing third party access to an extended facility. It concluded that the dynamic problems associated with coordinating increased and competing demands on this already congested line, and financing the required line extensions, would outweigh the static efficiency gains from allowing access.[14]

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Arguably, had the Tribunal taken a less static view in its approach, these considerations could have justified a conclusion that Hamersley was not a natural monopoly in the first place.

In contrast, the Tribunal judged that access should be granted to the (less congested) Goldsworthy and Robe railway lines. The Goldsworthy line verdict fits most easily with the conventional essential facilities cases, since this line had ample capacity to accommodate third party traffic, and the absence of viable alternatives meant that access to it was indispensible to third parties such as FMG. For the Robe line, however, the Tribunal reached the controversial conclusion that access should be granted even though alternatives would have been built if access was refused. It justified this highly interventionist approach on the grounds that the inefficiency associated with duplication was large relative to the disruption to Rio Tinto from accommodating an unwanted third party.

Assessment and conclusions

The Australian Part IIIA provisions for granting access provide a different legal framework for assessing essential facilities to that found in EU Article 102. The Tribunal's FMG Decision contains a very thorough discussion of the issues, and in doing so reveals a number of the controversies that have been debated in the EU cases in this area, but it is interesting to assess how the outcome of the Part IIIA process generates results that differ from the EU regime.

The explicit provision for the Australian regime to determine the price at which access should be granted should provide the basis for more transparent policy enforcement. But this potential benefit is dissipated by the fact that the pricing question is deferred to the decision of a separate regulator. Since the pricing terms can determine whether access takes place at all, and if so how the difficult balance is struck between static and dynamic incentives for efficiency, the Tribunal's inability to consider this question leaves its Decision strangely incomplete, and it is hard to see how this separation of powers can provide effective and timely regulation of access disputes.[15]

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Para 1350 of the Tribunal Decision itself comments on the undue complexity of the Part IIIA system and questions 'whether it is appropriate to collapse a rather complicated process'.

In light of the EU Article 102 debate on an effects-based regime, two further aspects of the Tribunal Decision are striking and controversial. First, the Tribunal Decision mandated access to two of the four railway lines despite acknowledging that this would bring no material benefit to consumers in the downstream market. Second, the Tribunal considered the case for compulsory access despite having satisfied itself that such access was not indispensible for the applicant, and (in the case of the Robe line) decided that such access should be granted even though a competitive market solution existed.

Both features reflect the Tribunal's strong faith in its ability to manage market outcomes better than competition would do. It defines a Part IIIA regime in which static efficiency considerations are given a surprisingly heavy weighting and in which firms can be required to share their facilities with rivals in a potentially very broad set of conditions, and not just in the extreme cases where competition has irretrievably broken down.