



CLAYTON UTZ

Submission to the ACCC on behalf of Toll/Patrick

Response to Draft Decision on ARTC Undertaking

February 15, 2002

Contents

1	Nature of ARTC's monopoly power and possible mechanisms through which they might use it, unless prevented by Undertaking	3
2	Service quality issues, and methods of incenting ARTC to meet customer needs	16
3	Constraints required on ARTC pricing strategy	18
4	Dispute resolution	28
5	Summary of recommendations	31
6	References	34

1 Nature of ARTC's monopoly power and possible mechanisms through which they might use it, unless prevented by Undertaking

This undertaking has been given by ARTC under Part IIIA of the TPA because of the characteristics which the rail network covered by the undertaking has as bottleneck infrastructure. A number of issues can arise with bottleneck infrastructure:

- (a) an owner/operator can deny access either entirely or selectively;
- (b) an owner/operator can price¹ the services at such a level that access is denied or discouraged;
- (c) an owner/operator can price its services to extract all the financial benefits created by downstream innovations, efficiency improvements, and strategies to improve asset utilisation.

It is to guard against these potential outcomes that bottleneck infrastructure is susceptible to regulation. It is not suggested that ARTC currently seeks to deny access or that its current indicative access charges are at a level that access is effectively denied, however, there are real concerns that ARTC has set present, and will set future, levels of access charges to extract all the financial benefits derived from downstream improvements and innovation. The future scenario carries with it an additional level of risk for access seekers. Whilst one can accept that currently ARTC is approaching the question of access with a view to increasing utilisation of the rail network, there is no certainty that will continue to be ARTC's motivation.

The Commission appears to have paid insufficient regard to the scope which ARTC has to exert monopoly power. The Commission's approach seems to be based on the view that ARTC's ability to exercise substantial market power over rail operators is effectively constrained by substitution possibilities from road freight in the end market for interstate

¹ The reference to price here includes both an actual increase in price and a degradation of service quality while price is maintained at constant levels.

non-bulk linehaul services.² Given this view, the Commission appears content with a light-handed approach to ARTC's undertaking—apparently believing that road substitution will provide a level of discipline which makes regulatory supervision unnecessary.

Furthermore, the Commission appears to have accepted ARTC's arguments that its poor returns on a DORC valuation of its assets demonstrate that it is not earning monopoly rents—and that therefore it is not exercising monopoly power.

We will demonstrate that this analysis of ARTC's market power is fundamentally incorrect. To the contrary, ARTC has a powerful monopoly position with regard to rail operators. These rail operators cannot exit the industry costlessly and transfer their customers and resources to road-based alternative delivery methods. Quite clearly, ARTC would be able to profitably impose a small but significant non-transitory increase in its access price (SSNIP) over its Adelaide to Kalgoorlie and Melbourne to Kalgoorlie routes. Road substitution would pose no effective constraint whatsoever, given that rail freight rates are currently 60% of road freight rates on the Melbourne – Perth and Sydney – Perth corridors³.

The undertaking in its present form does not prevent ARTC from imposing such a SSNIP—it could be done through the price indexation mechanism advocated by ARTC. Such a price increase would be highly problematic for the sustainability of rail operators' businesses particularly if the CPI-linked indexation diverged from the trend line in rail operators' market-determined freight rates.

It is true that ARTC would not be well served by pricing its rail operators out of business, and it would not be rational for ARTC to pursue such a course. Nevertheless, it would be rational for ARTC, as a lightly regulated monopolist, to adjust pricing so as to extract all the financial benefits created by rail operator innovations, efficiency improvements, and strategies to improve asset utilisation. Such an access pricing strategy would be profit maximising in the short term for ARTC, given the other constraints it faces. Unfortunately it would remove all incentives on rail operators to be innovative, to strive for efficiency and to improve asset utilisation.

² This appears at various points in the Draft Decision including pages 41, 46, 95 ("*competition provides a constraint on ARTC's behaviour regardless of the inclusion of formal provisions*").

³ ARTC Track Audit Final Report at page 38.

The renaissance which rail has enjoyed since 1996 and the projected benefits to be derived from the privatisation of National Rail Corporation Limited ("**NRC**") and Freight Rail Corporation ("**FreightCorp**") will disappear or be significantly diluted unless rail operators are able to share in the benefits which their own ingenuity and enterprise are able to create. Without a stronger regulatory constraint than the ARTC Undertaking in its current form, this benefit sharing is likely to give way to short term profit maximisation on ARTC's part—with detrimental long-term consequences for the industry and the economy. The timing here is crucial. The operations of NRC and FreightCorp are, consistent with the vendor governments sale objectives, likely to see significant efficiency improvements and innovations in the hands of Toll and Patrick. If the ARTC Undertaking does not operate to ensure that the rail operators receive the benefits of efficiency improvements which they are able to achieve, then a fundamental plank of the sale objectives will be frustrated. ARTC would itself benefit from these efficiency enhancements as they are likely to lead to greater utilisation of rail.

It is against this scenario that the Commission must assess the Undertaking and the impact it will have looking forward on the incentives facing rail operators and ARTC. Later in this submission Toll and Patrick will put forward a small number of simple, concrete amendments to the Undertaking which should substantially remedy the problems identified in this section.

1.1 Nature of ARTC monopoly power

This undertaking has been submitted by ARTC under s.44ZZA of the TPA because it is a provider of a service to which Part IIIA applies and that service is one which is likely to be subject to declaration under the mechanisms set out in Part IIIA. So much has properly been acknowledged by the Chief Executive Officer of ARTC when he said:

*"In my view, the probability of the track that ARTC [controls] being declared is extraordinarily high."*⁴

In other words, it is readily accepted by all interested parties, including the service provider, that:

⁴ ARTC Workshop 17 December 2001 at page 14.

- (a) access to the rail track service covered by the undertaking would promote competition in a market other than the market for the service of track access; and
- (b) it would be uneconomical to develop another facility to provide the services provided by the ARTC track.

In relation to the various markets in which interested parties participate, the above propositions involve an acknowledgement that there is a market for track access which is separate and distinct from the market or markets in which competition is promoted. This recognition is important in analysing the competitive dynamics in the markets in which ARTC operates and those in which rail operators using ARTC's network operate. It is also important in examining the nature and extent of any constraints which apply to pricing decisions made by participants in each of those markets.

As the Commission notes⁵, the boundaries of a market are usefully delineated by examining the scope and extent of demand and supply side substitution. In relation to supply side substitution, the Commission says:

*"The high sunk costs associated with building a rail network, the specialised nature of rail-track assets and the network economies associated with having a single network suggest that it is generally more efficient to have a single supplier of rail track in broad geographical areas. Not surprisingly, ARTC is the sole provider of interstate rail track in the regions under consideration and, consequently, train operators do not have the option of approaching an alternative network on which to run trains. Accordingly, the supply side options are limited."*⁶

In examining demand and supply side substitution, it is important to note that rail operations involve a range of separate layers of operations and of transactions:

- the rail track owner or operator ("**track access provider**") has control over the rail network and sells to train operators access to that network: those transactions

⁵ Draft Decision at page 96.

⁶ Draft Decision at page 96.

between the track access provider and the rail operator are in a market for the provision of track access;

- the train operator runs its trains and provides linehaul services, in the case of general freight usually to freight forwarders and, in the case of bulk freight usually to end customers. In some cases, of which Toll is an example, a linehaul service provider will be vertically integrated with freight forwarding operations. However, some linehaul providers operate as standalone linehaul providers and do not themselves offer freight forwarding services, examples include Freight Australia and Australian Railroad Group, as well as smaller operators such as Austrac and Silverton;
- freight forwarders and logistics operators offer freight movement solutions to customers, who are the owners of the goods being transported.

Each of these layers represents a separate market with distinct participants and distinct transactions occurring at each level⁷. This separation is important when analysing the demand and supply side substitution possibilities, because at each of these layers, i.e. in each of these markets, there are distinct demand and supply side considerations. Any decision by the Commission which combined track access and rail linehaul services into a single functional market would be inconsistent with the Federal Court and NCC decisions mentioned in the footnote, and also inconsistent with the Commission's own approach to market delineation in examining the privatisation of NRC and FreightCorp.

The Commission's discussion of the supply side options in the Draft Decision⁸ is, in reality, a discussion of both demand and supply side considerations in relation to the market for track

⁷ This separation has been recognised by a series of determinations in relation to rail: see in particular the conclusions of the Full Federal Court in *Rail Access Corporation v New South Wales Minerals Council Ltd* [1998] 1266 FCA (9 October 1998) about the distinct services provided by track access providers and rail linehaul operators and the NCC's decisions in relation to Carpentaria Transport (NCC 1997 at page 16 to 21), Specialized Container Transport (NCC 1997b at pages 10 to 12), the NSW Rail Access Regime (NCC 1999 at page 6) and Freight Australia (NCC 2001 at page 12).

⁸ Draft Decision at page 96.

access. The "*high sunk costs associated with building a rail network*" and "*the specialised nature of the rail-track assets*" mean that ARTC cannot readily use its assets to supply a service other than a rail track service. This is the supply side substitution consideration in examining the market in which track access is made available by track providers. The demand side considerations in the provision of track access look at the options which a train operator has to purchase services from other providers. As the Commission notes, "*ARTC is the sole provider of interstate rail track in the regions under consideration and, consequently, train operators do not have the option of approaching an alternative network on which to run trains.*" This is a consideration of the demand side options which are available to a train operator.

The lack of options on both the demand and supply side in the provision of track access services is unsurprising. It is precisely because of this lack of choice by purchasers of track access services that these services are ones to which Part IIIA applies. This makes the probability of the ARTC network being declared "*extraordinarily high*".

In the next layer rail operators sell space on trains to those who wish to transport goods. Here a distinction between bulk and general freight is important. On the supply side, bulk freight generally requires wagons specialised for each commodity. This fact, together with a degree of commodity specialisation in loading and unloading facilities, tends to act as a barrier to entry among other potential rail operators.

This situation may be contrasted with general freight, which does not require the same high degree of rollingstock or terminal specialisation, making competitive entry somewhat easier in the rail operator level. It is in the general freight section of the rail operational layer where intermodal substitution poses the greatest threat.

In any event, an examination of the distinction between different types of freight is largely unnecessary in the context of the Draft Decision, as the majority of the freight moved on the ARTC network is general freight⁹. For this reason, one can accept that, on the demand side of the market for linehaul services, a potential acquirer does, in many cases, have the option

⁹ It should, however, be noted that there is some bulk freight transported, such as that proposed to be transported under the AuIron Access Application referred to above. There is also a significant volume of freight transported which is described as industrial products, including steel.

of substituting either road or sea transport. On the supply side, a rail operator because of the capital costs invested in rolling stock, terminals and other equipment cannot readily switch those assets to some alternate activity; for example, the trains cannot be used to provide road services. On the supply side, there is no scope for substitution but on the demand side there is scope for intermodal substitution and because of the demand side substitution on the demand side, there is said to be a linehaul market for the movement of general freight in which road and rail compete for the freight task.

This analysis reflects the different functional markets which are relevant to the Commission's consideration. There has been some debate in recent years as to how one determines whether different functional layers constitute separate markets.

In the NCC's Recommendation in relation to the Application for Declaration under section 44F of the TPA of the Hunter Railway Line service, the NCC adopted an approach which involved considering whether:

- (a) the functional layers being considered were separate from an economic point of view; and
- (b) there were assets that were specialised for each of the functional layers.

Considering the first issue in the context of the present case, the question essentially is whether the transaction costs of separate supply are so great that vertical integration is inevitable. Manifestly this is not the case in relation to rail track and linehaul services given the extent of vertical separation which exists in respect of these two services in Australia.

The supply of rail track services involves acquiring or leasing land on which the rail track and terminals are constructed; the construction and maintenance of the rail track, terminals and other associated facilities; acquiring, operating and maintaining signalling systems; and the employment of appropriate staff required to manage the rail network, including the track and the terminals. The supply of linehaul services involves obtaining access to the rail track required to provide linehaul services; obtaining access to terminals; acquiring, operating and maintaining rollingstock and other associate equipment; obtaining appropriate accreditation necessary to become a rail operator and employing appropriate staff to operate the trains.

While it is common in the United States and other jurisdictions for track access services and rail operational services to be vertically integrated within a single railroad company, experience in Britain, Australia, and other jurisdictions has demonstrated that vertical separation is feasible. Vertical separation does not necessarily give rise to transaction costs

which are so great as to render track access and rail operation effectively a single functional market.

Turning to the second issue, the key asset required to operate the ARTC rail track is the rail network which includes the track; associated track structure; supports; bridges; passing loops; terminals; train control; signalling and communications systems; sidings, refuges for rolling stock and roads and other facilities which provides access to the railway line route. As the key asset required by a rail track provider is the network, the assets are not of the type that can be acquired incrementally as and when a customer seeks access to the rail track service. The assets are highly specialised, must be acquired upfront, are expensive and the costs involved in acquiring them are sunk. The assets required to operate a linehaul service include locomotives and rollingstock and associated equipment and train drivers. Rollingstock is the key asset required by providers of linehaul services. Rollingstock can be acquired in small increments from a number of sources and through purchasing or leasing type arrangements.

The assets required for the provision of rail track services and those required for the provision of linehaul services clearly differ quite significantly in terms of their uses, how easily they can be acquired, their cost and the risk in acquiring them in terms of whether they can be used for other purposes in the event the acquirer decides to exit the market. The assets are specialised to each functional layer and no supply-side substitution exists between them.

Other tests have been proposed for delineating functional markets, including the approach taken by the Australian Competition Tribunal in the *Sydney Airports* case¹⁰. In this case, the Tribunal delineated the market for ground handling services on the basis of the scale of the economies of joint consumption or joint production between the services being considered. The Tribunal found that there was a cluster market for international services in the Sydney region and a series of separate markets for services required by international passengers and dedicated freight aircraft that were differentiated on the basis of function. The Tribunal recognised that two of the separate and distinct markets were for ramp handling services and cargo terminal operator services on the basis that there did not exist between these

¹⁰ Sydney Airports case 2000.

services the economies of joint consumption or joint production necessary to require the services to be performed by the one economic entity.¹¹

In other words, the transaction costs involved in providing the relevant services separately rather than as a bundled product were not so great as to prevent the separate provision of the services from being feasible. It is clear from the difference between the transaction costs involved in the provision of track access services and those involved in the provision of linehaul services, that track access providers and linehaul providers do not need to provide their services as a bundled product to be viable, it is feasible for the service to be provided separately.

Interestingly, the Tribunal used the similarities it considered existed between the provision of railway track and train services as a basis for analysing whether the services being considered were in the same functional market and said:

*"Though in the past usually vertically integrated, track services and the running of passenger or freight trains can be, and increasingly are, provided separately. As such, they operate in functionally distinct markets, even though there is perfect complementarity between them. To put it another way, these complementarities do not appear to give rise to economies of joint consumption or joint production that dictate the services must be performed within the same economic entity. The evidence presented to the Tribunal suggested similar considerations apply to the services provided by SIA's physical infrastructure and ramp handling and CTO services. In other words, just because there is a one for one relationship between airport aprons and ramp handling services does not mean that the supply of these two types of services are in functionally the same market."*¹²

The delineation of the functional layers into a market for the provision of rail track services that is separate from the market for the provision of linehaul services is also consistent with the ACCC's decision in the National Rail Corporation/FreightCorp privatisation.

¹¹ **Sydney Airports** case 2000 at pages 40,772 to 40,773.

¹² Sydney Airports case 2000 at paragraph 97 (page 40,772).

In the present case, it is difficult to see how anything turns on the precise formulation of any such test as whatever approach is adopted as it is clearly satisfied in relation to the distinction between rail track services and linehaul services.

When analysed by reference to the correct market delineation, it can be seen that ARTC is a monopoly provider of rail track services. It is precisely for this reason that it has offered an undertaking for acceptance by the Commission. There are therefore three potentially relevant markets:

- (a) the market for the provision of track access on the network covered by the proposed undertaking which may loosely be described as the east-west rail corridor (acknowledging that parts of the ARTC track in Victoria are used exclusively for north-south movement). This is a market in which ARTC is a monopoly provider of rail infrastructure and train operators are the acquirers of those services;
- (b) the market for the provision of linehaul services for general freight. ARTC is not a participant in this market. This represents a service of delivery between two points and does not, particularly in the context of rail transport carry with it the notion that there is pick up from the customers premises and delivery to the ultimate destination. These additional services are covered in the provision of freight forwarding or logistics solutions. The suppliers of linehaul services are both rail operators such as Toll and Freight Australia and road operators such as Linfox and small owner drivers who contract their linehaul services to freight forwarders. The customers of linehaul operators are principally freight forwarders but can be large end customers for particular types of freight such as steel¹³; and
- (c) the market for the provision of freight forwarding services to end customers. The freight forwarding services are more extensive than those provided as linehaul services and include consolidation and deconsolidation of freight,

¹³ In many respects freight of this type would fall outside the meaning usually accorded to the term general freight.

effecting insurance arrangements in relation to the freight, pickup and delivery of the goods involved.

Simply because ARTC's customers face intermodal competition on some corridors, it does not follow that this intermodal competition poses an effective constraint on ARTC's exercise of monopoly power.

Firstly, on the primary Eastern States – Perth corridors, rail's superior cost position weakens the potential impact of road competition. While coastal shipping is capable of competing on price with rail, its inferior service quality attributes for most types of freight limit its ability to constrain total freight rates (including rail access charges) on these corridors.

Secondly, rail operators are captive to the track owner as it is not feasible for a rail operator to rapidly transform rail-specific assets into assets suitable for road or sea freight. The rail operator's rollingstock and terminal investments are sunk to a significant degree. While the sunkedness of these investments can be mitigated somewhat by leasing train sets, if the track owner is imposing price increases, every potential rail operator (and rollingstock lessee) will be in the same situation—reducing the lessor's willingness to accept demand risk.

Thirdly, rail operators such as Toll, SCT, National Rail, and others must compete for business, whereas ARTC is the sole provider of track access services between Melbourne and Kalgoorlie. This fact permits ARTC to “squeeze” the rail operator when intermodal competition reduces the total returns to the rail industry. This type of “squeeze” on the part of ARTC through its price indexation proposals is precisely the type of exercise of monopoly power that Toll and Patrick are most concerned about.

It is the existence of this power that must be the starting point for the Commission's consideration of this issue. The way in which ARTC may seek to exercise its monopoly power and the extent of any constraints which exist on it are considered in further detail in the following sections of this submission.

1.2 Cost savings through reduction in service quality

In general it is recognised that firms with significant market power can improve profitability, even when their prices are regulated, by reducing their own costs by providing a service of lower quality. Such a strategy on the part of an infrastructure owner might take the form of:

- postponing non-essential track maintenance and renewal work and imposing temporary speed restrictions to maintain safe conditions;

- scheduling train services at a level of train density which is too high to allow recovery time for out-of-course running trains, and which generally imposes a level of congestion which makes it difficult to maintain the timetable unless everything goes well;
- delaying investments in track capacity until congestion reaches too high a level for consistent on-time running of trains.

We have been speaking so far of hypothetical strategies. ARTC's actual performance so far has been acceptable—although there is room for improvement. For example, the ARTC KPI report for Toll Rail for 2000-01 highlights the following outcomes:

- 96% of healthy trains exited on time, somewhat below the ARTC corporate target of 97%;
- 32% of unhealthy trains exited on time, below the ARTC corporate target of 40%; and
- 69% of all trains exited on time, somewhat below the network audit target of 70%.

It should be borne in mind that ARTC's Undertaking specifies reference prices for standard services, and these service standards would be meaningless unless they were tied to the performance targets to which ARTC refers in its regular KPI reports to operators.

Therefore, in order to guard against any future strategy of reducing service quality in order to reduce costs, it is fundamentally important that pricing be linked to service quality. The most obvious and straightforward method of doing this is to place a portion of the flagfall element of ARTC's price at risk in the event that its corporate targets for on-time exit of healthy and unhealthy trains are not met.

1.3 ARTC capture of entire benefit of entrepreneurial/innovative activity by above rail firms

Another possible manifestation of significant market power is the ability to capture any surpluses which are created in the rail business generally. Where a rail infrastructure monopolist faces several rail operators, the infrastructure monopolist would be in a position to seize any profit which might be created through the enterprise and innovation of the rail operators. The monopolist would do this, in the hypothetical case, by increasing access charges in line with the operators' increasing ability to pay. The increasing ability to pay

would arise from the operators' innovations, which might lead to higher levels of demand at current prices, or the ability to command premium prices for new value-added services.

Quite clearly, if the operators expect the infrastructure owner to increase prices to capture any profits which their ingenuity, vigorous efforts, and investment can create, then they will have dampened incentives to be efficient, and no incentive to incur the costs and risks of innovation, to develop new service offerings, or to invest in improved freight customer service. It is important to note that the significant customer service improvements on the East – West corridor in recent years have been driven to a large extent by very substantial capital investments by rail operators. The gains of recent years would be in jeopardy if operators were dis-incented from continuing to make such investments.

To some extent, ARTC's Undertaking can be seen as a voluntary restraint on future price increases. However, the mere existence of an Undertaking does not guarantee that the infrastructure monopolist will not capture all profits created by the operators' entrepreneurial activities. The critical issue in this connection is the manner and magnitude of access price escalation specified in the Undertaking.

ARTC has indicated it will increase access prices by no more than the greater of CPI – 2% or 2/3 of CPI. As this is an upper limit, ARTC would retain discretion as to whether and how much of this increase to apply in each year.

Toll and Patrick submit that this price escalation formula gives ARTC the ability to impose, in a discretionary manner, price increases which, at their maximum, would be completely at odds with the prevailing economic trends in the interstate non-bulk freight markets which they serve. ARTC's CPI-indexation of costs and asset values ignores their opportunities for future cost savings in infrastructure maintenance, and the benefits which they will enjoy from traffic growth in terms of asset utilisation and improved recovery of fixed costs. At the same time, and more seriously, ARTC's CPI-indexation of access prices ignores the strong downward pressure on nominal freight rates.

NECG has modelled the financial impacts on both ARTC and rail operators of the price path contained in the Undertaking, in order to put in perspective these various economic trends. This modelling demonstrates that ARTC's return on DORC valuation of assets would steadily increase over 10 years from its current 2% (for Melbourne – Parkeston) to 3%, while the operators' returns on assets would deteriorate dramatically.

This modelling approach has also been used to consider the impact of an alternative price escalation approach: constant nominal access prices. This alternative modelling

demonstrates that ARTC's return on DORC valuation of assets would remain stable at about 2%, while the operators' returns on assets would also stabilise over time.

The clear conclusion from this quantitative analysis is that ARTC's price escalation method seems likely to capture for ARTC all benefits created by the operators who, in the future scenarios we contemplate, based on current trends, would be simultaneously reducing freight rates, increasing traffic volumes, and reducing their own above-rail costs.

A more equitable sharing of the benefits from these activities, which are undeniably of value to the economy more broadly, would be achieved by imposing a constant nominal cap on ARTC's future pricing. Such a price escalation method would still permit ARTC to stabilise its return on DORC value, but it would also permit the operators to gain some of the benefit of their own productive activities. They must be able to enjoy some of these benefits if they are to maintain any incentive to create them. This does not mean that rail operators would be content with constant nominal access prices. Like every other aspect of the intermodal rail transport chain, operators would expect costs to be reduced in nominal terms over time

2 Service quality issues, and methods of incenting ARTC to meet customer needs

2.1 Potential problems

As things currently stand in the Undertaking, there is no explicit link between access pricing and service quality issues. The Commission has recognised the value of establishing such an explicit link in its draft decision:

*"access prices should provide ARTC with incentives to provide services at efficient levels of cost and quality and to undertake efficient investment."*¹⁴

*"a related issue is whether there exists an appropriate relationship between price and quality of service. That is, in a situation where an access provider has market power there may be an incentive to increase profitability by reducing quality of service."*¹⁵

¹⁴ Draft Decision at page 14

¹⁵ Draft Decision at page 15

While ARTC is currently providing a quality of service which is acceptable, the main concern relates to the mechanisms through which operators can ensure future quality performance remains adequate. In the view of Toll and Patrick, any such mechanism which does not impact on the price will be ineffective.

2.2 Concrete suggestions to address service quality and price linkage

Toll and Patrick propose that the following mechanism be incorporated into the Access Undertaking and the Indicative Access Agreement:

1. ARTC's current self-imposed target is that each month 97% of healthy trains exit their system on time. Recent performance indicates that this target is achievable.
2. Currently there is no financial penalty to ARTC for failing to meet this target. Without such a financial imperative, this target is somewhat meaningless. It lacks any tangible sense of commitment on the part of the access provider.
3. It is both conceivable and understandable that, with the best of intentions, this target may not be exactly met each month. Therefore we propose a 2% tolerance band around the target before penalties apply.
4. In the event that monthly on-time exit of healthy trains for an operator falls below 95% (i.e., 2% less than the ARTC's own self-imposed target), then penalties would begin to apply. Penalties would be larger for larger deviations from the target.
5. We propose that, on a monthly basis, the flagfall component of all access charges paid by an operator to ARTC be discounted by 1% for every 1% by which the on-time exit of healthy trains for that operator falls below 95%.
6. For example, if an operator's on-time exit of healthy trains fell to 91% in one month, then that operator's flagfall payments to ARTC in total would be discounted by $95\% - 91\% = 4\%$.

This rule would be straightforward to apply, as all the necessary statistics are already compiled by ARTC and provided to operators monthly. In our view it is a simple and effective response to the need to put some financial rigour into the service quality promises made by ARTC.

If ARTC continues to perform as well on quality as it has to date, then it would not be likely to suffer any loss of revenue. On the other hand, if service quality were to deteriorate in future, this proposal would give ARTC a signal to move towards restoring quality.

3 Constraints required on ARTC pricing strategy

Toll and Patrick submit that the price escalation proposal contained in the current Undertaking does not sufficiently constrain ARTC's exercise of significant market power. If this price escalation proposal were implemented, our modelling indicates that ARTC's returns would steadily rise, while the rail operators would rapidly become unsustainable. While it seems unlikely ARTC would go so far as to bankrupt rail operators, it is likely it would act to keep them at subsistence levels of profitability, while capturing for themselves all of the benefits of innovation and entrepreneurial activity by the operators. In such a situation obviously the operators would cease to innovate, and would instead focus their entrepreneurial energies in other markets—to the detriment of rail transport in the East-West corridor. This section outlines the quantitative basis for these conclusions.

An Access Undertaking represents a voluntary constraint on pricing by a monopolist. The critical question here is whether the Undertaking in its present form constrains ARTC future pricing sufficiently to permit competitive dynamics at the operator level to deliver the economic benefits it is capable of producing. The supporting evidence for this claim is provided in this section.

3.1 Floor and ceiling – why equity owner's intentions are important

ARTC justifies its current price level—and its intention to increase prices over time—on the strength of its current poor overall return relative to a DORC valuation of its assets. It is by now well recognised that pricing for specific sectors of a rail network must satisfy floor and ceiling revenue tests, on an individual and combined basis. Thus while ARTC's overall financial performance may be poor relative to the replacement cost of its assets, this is not necessarily the case on each of the sectors which it operates.

ARTC's Ceiling and Floor Limit Graphs, submitted along with its Draft Undertaking, show that projected revenues for Dry Creek – Parkeston (essentially Adelaide to Kalgoorlie), Dry Creek to Spencer Street (essentially Adelaide to Melbourne), and Spencer Street to Parkeston (essentially Melbourne to Kalgoorlie) lie approximately midway between the floor and ceiling. All other sectors for which ceiling and floor graphs were provided generated near or sub-floor revenues. This clearly demonstrates that on the Adelaide – Melbourne route,

where Patrick Rail operates, and on the Adelaide – Kalgoorlie and Melbourne – Kalgoorlie routes, where Toll Rail operates, ARTC makes all its money. On all its other sectors, ARTC makes a negative return on assets.

The table below represents an estimate of the returns which ARTC earned in FYE 01 on a corridor-specific basis. The underlying information has been gleaned from public sources, including the DORC valuation study performed for ARTC by Booz Allen and Hamilton, which was attached to the Draft Undertaking.

sector BAH no.	Adelaide to Parkeston 1	Crystal Brook to Broken Hill 2	Port Augusta to Whyalla 6	Dry Creek to Spencer St 3	Melbourne to Albury 5	Dry Creek to Outer Harbour 4	Appleton Junction to Appleton Dock 7	TOTAL	Mel - Kalgoorlie
gt	31,540,712	4,566,512	1,696,380	22,250,460	6,606,387	2,986,946	2,447,168		
km	1,991.50	372.00	73.00	792.66	307.10	19.30	2.30	3,557.86	2,784.16
'000 gtk	14,761,023	1,698,742	123,836	8,902,298	2,028,821	57,648	5,628	27,577,997	23,663,321
train mass '000 tonnes	3.2	2.4	2.4	2.4	2.4	2.4	2.4		2.84
train km /yr	4,612,820	707,809	51,598	3,709,291	845,342	24,020	2,345	9,953,225	8,322,110
Price (\$/'000gtk)	2.056	2.33	3.63	2.365	2.16				
Price (\$/km)	2.605	1.64	1.64	1.766	1.53				
flagfall revenue \$m	12.02	1.16	0.08	6.55	1.29	-	-	21.10	18.57
gtk revenue \$m	30.35	3.95	0.45	21.05	4.37	-	-	60.18	51.40
REVENUE \$m	42.37	5.11	0.53	27.60	5.66	0.00	0.00	81.28	69.97
COSTS \$m	31.11	8.11	1.63	13.89	6.14	0.32	0.09	61.51	45.00
DEPREC \$m	3.44	0.90	0.18	1.54	0.68	0.04	0.01	6.80	4.98
PROFIT \$m	7.82	(3.89)	(1.28)	12.18	(1.15)	(0.36)	(0.10)	12.97	19.99
DORC \$m	711.80	185.50	37.30	317.90	140.50	7.40	2.00	1,407.40	1,029.70
Return on DORC(%)	1.10	(2.10)	(3.42)	3.83	(0.82)	(4.85)	(4.85)	0.92	1.94
2000 Book value \$m								193.34	141.45
Return on book val (%)								6.71	14.13
DORC/km	0.36	0.50	0.51	0.40	0.46	0.38	0.87	0.40	0.37

Aspects of these estimated returns will be taken up in the subsections below.

3.1.1 Gifted assets

ARTC's 1999 Annual Report indicates that it is a very lowly geared firm, with virtually no long-term debt finance. Given the returns ARTC has earned in the past few years relative to the DORC valuation of its assets, and the unhappy financial history of its predecessor, Australian National Railways Commission, the lack of debt finance is understandable.

ARTC's asset backing is virtually 100% equity, supplied by the Commonwealth Government. A mechanistic application of the capital asset pricing model to calculate a required WACC for the Commonwealth would yield a very high hurdle rate—one which will never be achieved, given the nature of the interstate rail freight market. Clearly the Commonwealth did not invest in ARTC's assets with the intention of earning normal risk-weighted capital market return.

A more plausible explanation is that the Commonwealth invested in ARTC's assets, for social and economic policy reasons. Under this explanation, ARTC's assets should be interpreted as grant-funded policy investments, or 'gifts', whose purpose is not to earn a commercial return but rather to stimulate economic growth and strengthen the national transport infrastructure system—to facilitate the profitable development of private sector firms.

3.1.2 Returns on book value versus returns on DORC

Without denying the legitimacy of striving to earn a market return on DORC, it is certainly the case that ARTC's current returns on Melbourne – Kalgoorlie are not disastrously low relative to ARTC's actual balance sheet capital backing. In fact on that basis they are robust.

The 'gift' nature of ARTC assets does not mean that the Commonwealth should be denied any possibility of earning positive returns on its ARTC investments, if rail industry circumstances change for the better. It does mean, however, that the primary objective of these rail infrastructure investments by the Commonwealth should be to stimulate profitable growth of private enterprises. This objective should inform the price trajectory for access charges on ARTC's network over time.

Incidentally, it is worth noting that ARTC's overall return on DORC for FYE01 was estimated in the table above to be approximately 0.9%. Relative to the book value of its assets, this return is a substantially more healthy 6.7%. On the Melbourne – Kalgoorlie portion of ARTC's network, ARTC's return on DORC for FYE01 is a somewhat more encouraging 1.9%. This comprises a pre-tax return of \$19.99m. This Melbourne – Kalgoorlie return represents 10.3% on the book value of all of ARTC's assets, even though this route accounts for only 73% of the DORC valuation of ARTC's asset base. Correcting the book value by this 73% factor, the implied pretax return on the book value of the Melbourne – Kalgoorlie corridor is 14.1%.

3.2 End-market discipline on ARTC pricing – less strong than imagined by ACCC

As outlined in section 1 much of the Commission's approach to pricing seems to be based on two issues. First, that ARTC is materially constrained in its pricing decisions by prices charged by road based operators in the downstream market for the provision of linehaul services. Secondly, that ARTC is recovering at or close to floor on the pricing set out in its indicative access charges

3.2.1 The impact of downstream intermodal competition

As set out in section 1, the services which ARTC provides are in a different market from the linehaul services provided by rail operators to their customers. It is the latter market which would satisfy the "other market" requirement of s.44G(2)(a) of the Act if ARTC's track were to be the subject of a declaration application. The constraint which is provided on ARTC is therefore not a direct constraint. ARTC is not in competition with the Governments which own the highway running between Adelaide and Perth, nor is it in competition with road freight companies which provide linehaul services using that highway. The impact of intermodal competition in a downstream market is therefore only of limited impact. For reasons which are discussed in detail in section 1 the fact that there is downstream intermodal competition provides ARTC with an incentive not to price rail in a way which makes any rail operations unsustainable. That does not, however, mean that ARTC does not have incentives to price above efficient cost and in a way which will remove incentives from rail operators to innovate and improve efficiencies.

The Commission described well the principles which ARTC's Undertaking should reflect. These include the following principle:

"Access prices should provide incentives for efficient use of rail track infrastructure".¹⁶

This requires the prices to be set and escalated in a way which does not lead to ARTC capturing all innovation benefits. At a time when Toll and Patrick have been announced as the preferred bidders in the privatisation of NRC and Freightcorp (one of which operates predominantly on routes which incorporate track covered by this Undertaking) and significant reforms and efficiency improvements are being predicted for these businesses, it is particularly important that the incentives exist for rail operators.

3.2.2 ARTC's Current Recovery Rates

Another key factor which appears to have heavily influenced the Commission's thinking in relation to the extent of pricing regulation which is required is the view that current prices are generating revenues below the economic cost of providing the services. As has been demonstrated earlier in this section, the position of recovery is quite divergent depending

¹⁶ Draft Decision at page 14.

upon the particular sector at issue. In this regard, it is important to note the levels of recovery which ARTC is currently achieving on the Adelaide – Melbourne, Adelaide – Kalgoorlie and Melbourne – Kalgoorlie routes.

The ARTC rates are not proposed to be set "*on the basis of costs; rather, the floor/ceiling limits specify boundaries beyond which ARTC pricing will be constrained over the term of the undertaking*".¹⁷ The constraints which operate on ARTC's monopoly power come only to a limited extent from downstream competition in Linehaul. That competition will provide an incentive for ARTC not to make a train operators business so unprofitable that it ceases to operate but ARTC's monopoly position gives it a profit maximising strategy to increase rates to a level where it captures all the benefits which would otherwise accrue to a train operator from efficiency enhancements. In addition, whilst there is currently no reason to doubt ARTC's motivation is to increase utilisation and grant access on a non-discriminatory basis, the Commission cannot assume in assessing the Undertaking that ARTC's motivations and incentives will necessarily remain so. It is precisely the purpose of the undertaking to ensure that even if there is a shift in the incentives facing ARTC, train operators will be able to obtain access on fair and reasonable terms and conditions. The constraints to prevent ARTC exercising its monopoly power must come from the terms of the undertaking.

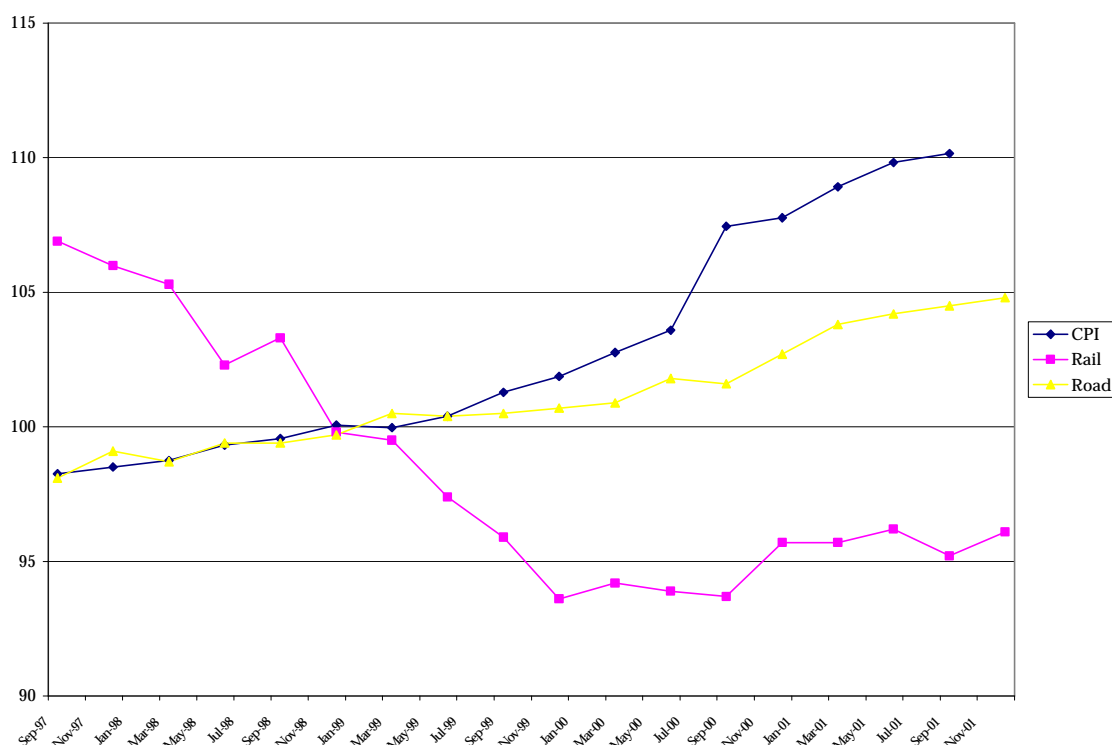
3.3 Consequent mismatch between ARTC intentions and end-customer expectations

If road freight pricing does not place an effective constraint on rail access pricing—and the previous section indicates that it does not for routes from the Eastern States to Perth—then there is no ‘invisible hand’ which will keep ARTC’s pricing ambitions in step with freight customer expectations.

ARTC’s pricing ambitions are set out in its Undertaking: at ARTC’s discretion, annual price increases may be applied of up to the greater of CPI – 2% or 2/3 of CPI.

End customer expectations are diametrically opposed to this “price up” mindset. It is widely recognised that rail costs have fallen dramatically in the post-Hilmer era. Road freight prices have also increased at rates which are significantly lower than CPI. The chart below illustrates how road and rail price trends have differed from CPI in recent times.

¹⁷ Draft Decision at page 102.



Source: ABS data.

To give these trends a more specific orientation, Toll has been forced to negotiate lower nominal freight prices on the East-West corridor for nine major customers, for two of whom the business was entirely lost by rail. The details are commercial in confidence, but may be supplied to the Commission on a confidential basis.

Patrick has experienced a four year declining trend in nominal container freight rates between Melbourne and Adelaide. These have averaged 1.3% decline per annum over that period.

Clearly, the rail operators' customers do not have an expectation of CPI-linked price increases. Therefore, ARTC's pricing ambitions are out of step with the end market. As the more specific quantitative analysis below will demonstrate, only the continuation of present nominal access prices would be consistent with stable returns to both ARTC and operators.

3.4 Concrete suggestion for benefit sharing between ARTC and operators

Toll and Patrick submit that only by restricting ARTC's access prices for Melbourne – Adelaide and Adelaide – Kalgoorlie to constant nominal levels will there be any prospect of

sustainable investment and innovation on the part of rail operators. Otherwise, as this section will demonstrate, the future returns to operators are likely to be so adverse that at best, the industry will plateau at its current level of demand, continuing price reductions for end customers will not be realised, and above rail cost savings will only grudgingly be achieved if at all, as entrepreneurial activity will be diverted elsewhere to where it would have more impact.

3.4.1 Input data for benefit sharing model

In order to model the sharing of future benefits above and below rail, NECG has built a model which captures the key drivers for both ARTC returns and rail operator returns on the Melbourne – Adelaide - Kalgoorlie (equivalently the Spencer Street – Dry Creek – Parkeston) route. This is a ten year model which takes FYE 01 as its starting point. The corridor-specific FYE 01 access prices, costs, DORC asset valuations, traffic volumes, revenues and profits are as stated in the table in section 3.1 above, which was deduced from public information regarding ARTC's business.

For the rail operators the assumed starting point is a break-even result, with assumed values for cost = \$100m plus access charges = revenue, and an assumed operator asset value of \$20m. Since we are interested in changes and trends, rather than absolute values, the operator starting point is not particularly important, although in fact a break-even situation is consistent with the actual experience of some operators on this route.

The inflation projection is based on the four year trend from September 1997 to September 2001 in CPI. This equates to a 2.75% per annum rate of increase. Over the same time period the rail cost index averaged a 2.60% per annum decrease. For comparison, although it is not used in the model, the road cost index increased at a rate of 1.42% per annum.

Rail freight rates are assumed to decrease by 1.3% per annum, based upon four year trends supplied by Patrick Rail on Melbourne – Adelaide.

ARTC's infrastructure maintenance and renewal costs are assumed to decline by 0.5% per annum in real terms. This figure was quoted by the Queensland Competition Authority in its report into Queensland Rail's Access Undertaking as a long-term average trend. Note that this is a higher rate of decline than that implied in ARTC's Explanatory Guide. ARTC projected a change in real costs from FYE 01 to FYE 06 from \$44.9m to \$44.4m, representing only a 0.2% per annum decrease. While ARTC compared its own maintenance costs favourably with World's Best Practice, this comparison is unlikely to have properly adjusted for the fact that ARTC's track is, in the main, straight and level in near desert conditions,

with low axle loads and low traffic densities by world standards—a situation which is ideal for minimising maintenance costs.

Traffic growth estimates were taken from the DORC valuation study by Booz Allen and Hamilton which was appended to ARTC's Draft Undertaking.

These trend rates were applied in the following manner. ARTC's initial (FYE 01) costs were indexed by the QCA infrastructure maintenance cost index plus CPI. ARTC's DORC value was also escalated by this index. The rationale for this step is that replacement costs are no different from renewal costs, and these should follow the QCA cost index, rather than the straight CPI. ARTC's costs are assumed to be largely insensitive to traffic levels. This assumption is consistent with experience on light to medium traffic railways, where fixed costs dominate.

ARTC prices depend upon the scenario being modelled. In the base case we assumed price escalation as per ARTC's current Undertaking. In the alternative case we assumed constant nominal access prices. To convert these access prices to revenues, traffic growth was also taken into account. Thus ARTC revenues grow doubly: through price indexation and volume growth.

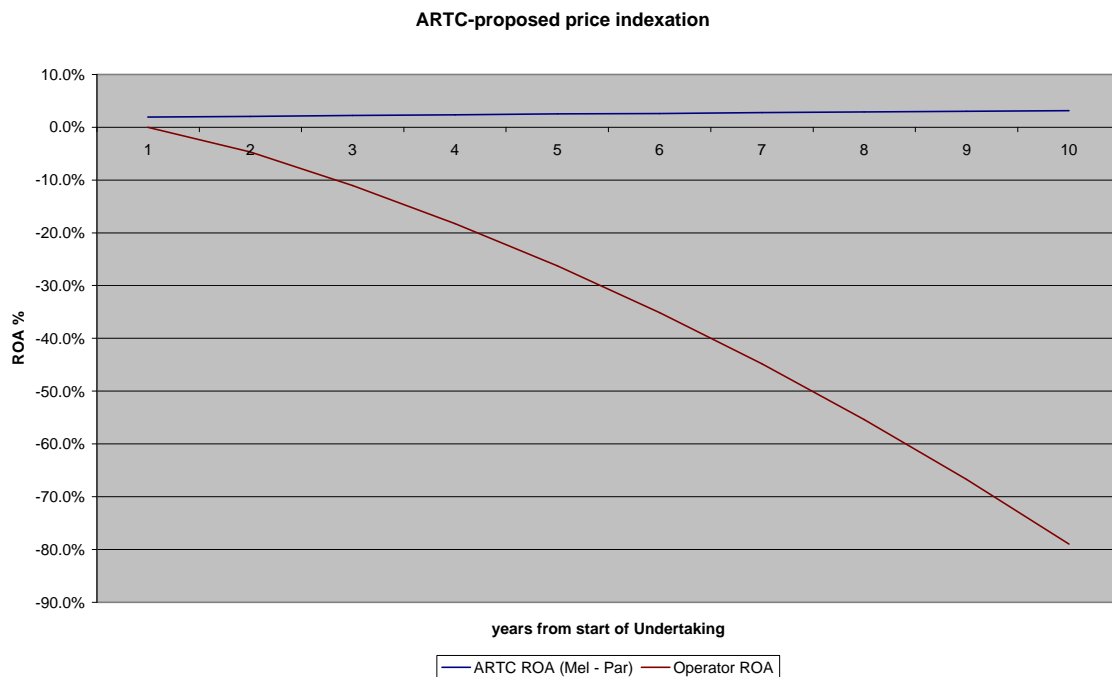
Operator revenues are assumed to grow with volume, but to decline with the assumed 1.3% per annum price reductions which customers expect. Operator costs consist of two elements: access charges, and other costs. Access charges will depend on the scenario, and correspond exactly with ARTC revenues. The other unit costs are assumed to follow the ABS rail cost index, which has averaged a 2.6% per annum decline over the past four years. These unit costs are translated to expenditure by taking traffic growth into account. The operator asset value is assumed to increase in proportion to traffic growth also, on the assumption that more rolling stock is required to move more freight.

3.4.2 Model results comparing ARTC pricing proposal with constant nominal prices

The table below illustrates the model results under the above assumptions and methods, for the two price escalation scenarios discussed here.

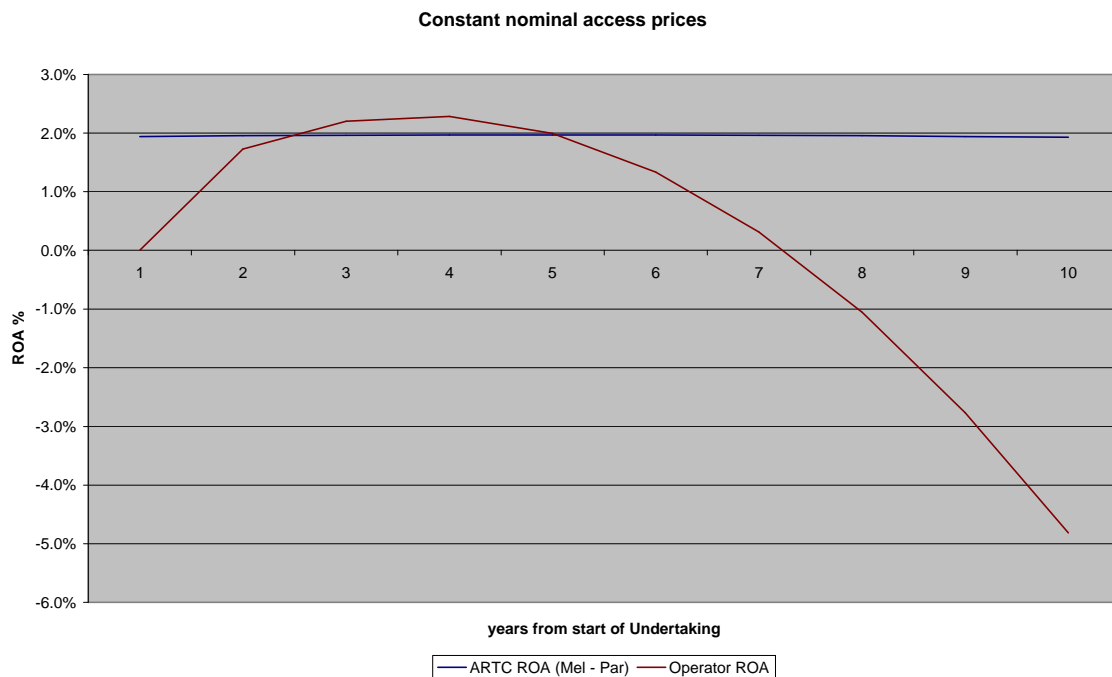
Year	FYE01	FYE02	FYE03	FYE04	FYE05	FYE06	FYE07	FYE08	FYE09
ARTC proposed pricing	\$m unless %								
ARTC rev (Mel - Par)	69.97	72.99	76.09	79.28	82.56	85.94	89.41	92.98	96.66
ARTC costs (Mel - Par)	49.98	51.10	52.25	53.42	54.62	55.85	57.10	58.38	59.69
ARTC EBIT (Mel - Par)	19.99	21.89	23.84	25.86	27.94	30.09	32.31	34.60	36.96
ARTC DORC (Mel - Par)	1,029.70	1,052.83	1,076.47	1,100.65	1,125.37	1,150.65	1,176.49	1,202.92	1,229.93
ARTC ROA (Mel - Par)	1.9%	2.1%	2.2%	2.3%	2.5%	2.6%	2.7%	2.9%	3.0%
Operator rev	169.97	171.79	173.54	175.20	176.80	178.32	179.77	181.14	182.46
Operator costs	169.97	172.75	175.80	178.94	182.17	185.50	188.92	192.45	196.08
Operator EBIT	-	0.96	2.26	3.73	5.37	7.18	9.16	11.30	13.62
Operator asset value	20	20.49	20.47	20.46	20.45	20.44	20.43	20.42	20.42
Operator ROA	0.0%	-4.7%	-11.0%	-18.2%	-26.3%	-35.1%	-44.8%	-55.3%	-66.7%
Sum of ARTC and operator EBIT	19.99	20.93	21.58	22.13	22.57	22.92	23.16	23.30	23.34
Alternative access pricing									
ARTC rev (Mel - Par)	69.97	71.67	73.38	75.08	76.78	78.49	80.19	81.90	83.60
ARTC costs (Mel - Par)	49.98	51.10	52.25	53.42	54.62	55.85	57.10	58.38	59.69
ARTC EBIT (Mel - Par)	19.99	20.58	21.13	21.66	22.17	22.64	23.09	23.51	23.91
ARTC DORC (Mel - Par)	1,029.70	1,052.83	1,076.47	1,100.65	1,125.37	1,150.65	1,176.49	1,202.92	1,229.93
ARTC ROA (Mel - Par)	1.9%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	1.9%
Operator rev	169.97	171.79	173.54	175.20	176.80	178.32	179.77	181.14	182.46
Operator costs	169.97	171.44	173.09	174.74	176.39	178.04	179.70	181.36	183.02
Operator EBIT	-	0.35	0.45	0.47	0.41	0.27	0.06	0.22	0.56
Operator asset value	20	20.49	20.47	20.46	20.45	20.44	20.43	20.42	20.42
Operator ROA	0.0%	1.7%	2.2%	2.3%	2.0%	1.3%	0.3%	-1.1%	-2.8%
Sum of ARTC and operator EBIT	19.99	20.93	21.58	22.13	22.57	22.92	23.16	23.30	23.34

In the first scenario, corresponding to ARTC's proposal, ARTC's return on DORC rises from 2% initially to above 3% in FYE 10. At the same time, the operators' return on assets declines from break-even to a severely negative result. Of the overall \$3.3m surplus (change in total EBIT) created over ten years, ARTC would capture \$19.4m, and the operators would suffer a \$16.1m reduction in EBIT. In simple terms, ARTC's pricing proposal would see ARTC doubling its EBIT over ten years while the operators suffered a \$16m reduction in EBIT.



In the second scenario, corresponding to freezing ARTC's current access prices in nominal terms, ARTC's return remains fairly constant at 2% of DORC. At the same time, the operators' return on assets maintains a slightly positive level until the last few years. The overall surplus is still \$3.3m improvement in total system EBIT over ten years, but this time ARTC's own EBIT increases by only \$4m, and the operators' EBIT remains nearly zero. In other words the result continues at approximately the present-day level of profit.

None of this discussion should be taken to indicate that operators would or should be content with zero EBIT. Operators would hope and expect that ARTC access pricing over time created opportunities to share in the profits generated through innovative and entrepreneurial activity. The reason for emphasising a constant nominal cap on future ARTC access prices was that it is readily implementable, and it represents a more satisfactory alternative to that proposed by ARTC in its Undertaking.



4 Dispute resolution

4.1 Nature of concern

The dispute resolution mechanisms proposed in version 4 of the undertaking give rise to a number of issues. Those of principal concern to Toll and Patrick are:

- the absence of any requirement that the arbitrator be appropriately qualified to resolve the matters in dispute between parties; and
- the lack of consistency of the dispute resolution mechanisms in the ARTC Undertaking with those in other regimes with which it interfaces, particularly the Western Australian Rail Access Regime.

These two issues are dealt with below.

4.2 Qualifications of Arbitrator

There can be no debate that disputes in relation to access agreements between ARTC and any train operator will involve issues of some complexity which require specialised skills to address. At present, there is no requirement contained in the ARTC Undertaking or in the Indicative Access Agreement that the arbitrator have any specific qualifications. The current arrangements provide for the arbitrator to be nominated by the President of the Institute of Commercial Arbitrators, if agreement cannot be reached on an appropriate arbitrator. The Commission has noted the importance of appropriate qualifications where, in discussing the provisions for appointment of a mediator by the President of the Law Society of South Australia it says this *"has the potential to result in the appointment of mediators not suitably skilled or qualified"*¹⁸. The need for appropriate qualifications is at the core of the Commission's decision to agree to accept a role as arbitrator in disputes arising under the ARTC Undertaking. In discussing this, the Commission says:

"Having a single arbitrator has an additional advantage in that it is likely to result in consistency of decisions over time. A combination of consistency and transparency should provide added certainty to the industry and encourage commercially negotiated outcomes.

There may be further benefits if this single arbitrator approach is the Commission itself. Resolve suggests that a key advantage of this approach is:

*...that [the Commission] is well qualified and experienced at weighing the criteria referred to in section 1.44X(1) of the Act, which are essentially the same considerations that arise under the undertaking."*¹⁹

The absence of any qualification requirements for the arbitrator is at odds with what currently exists under several rail access regimes²⁰ and under the current access agreements

¹⁸ Draft Decision at page 76.

¹⁹ Draft Decision at page 77.

²⁰ See for example the Western Australian Rail Access Regime, which specifies qualification thresholds and the New South Wales Rail Access Regime, which specifies arbitration by the Independent Pricing and Regulatory Tribunal.

which Toll and Patrick have in place. This is a critical issue, particularly if the Commission is not prepared to accept a role in arbitrating any disputes in relation to specific access agreements. To address this the Undertaking and the Indicative Access Agreement need to include provisions to the effect that the arbitrator:

- be appropriately qualified to determine the most appropriate means of determining and calculating fees for access to rail infrastructure services;
- not be an interested party to any access agreement with either the rail operator or ARTC;
- have a detailed understanding of and experience in dispute resolution practice and procedures; and
- have an understanding of the rail industry in Australia.

It appears from the comments made by David Marchant at the Workshop held by the Commission on 17 December 2001 that the only objection which ARTC has to this approach is that it may lead to a relatively small group of people being available for selection. It is the view of Toll and Patrick that the small field of potential arbitrators is overstated by ARTC and, in any event, as the Commission has noted there can be benefits in consistency of approach which come from a relatively small number of people determining these issues. This has not been seen as a major issue in other access agreements or in various access regimes.

The imposition of regulatory constraints necessarily involves an assessment of costs and benefits arising from those constraints. An inappropriate arbitration outcome because of an arbitrator's lack of appropriate qualifications presents the opportunity for significant costs for all involved. Qualification requirements which limit the people appropriate to carry out the arbitration task represent a small constraint outweighed by the resulting benefits.

4.3 Consistency with other arrangements

The ARTC network which is covered by the Undertaking is a component of the overall Australian interstate network. To enable the transport of goods to or from Western Australia, an operator must have access arrangements in place with WestNet Rail Pty Limited as well as with ARTC. In addition, for delivery of goods to or from Sydney, a train operator must have arrangements in place with Rail Infrastructure Corporation as well as with ARTC. Consistency amongst access arrangements covering interstate services has been

a critical objective in the development of rail access arrangements and something which has been highlighted in the recent major reviews of the rail industry²¹. In considering the certification of rail access regimes in various States of Australia, the interface issues have been of primary concern to the NCC²².

Toll and Patrick support the submission made by the Western Australian Department of Transport that an arbitrator who is to conduct an arbitration either under the ARTC Undertaking or an access agreement made pursuant to that undertaking should be qualified and acceptable to conduct an arbitration under the ARTC Access Undertaking and any other regime or undertaking affected by the proposed rail operations. Such an approach is consistent with the objectives which the Commission has sought to achieve in agreeing to accept an arbitration role in relation to the undertaking.

5 Summary of recommendations

The Commission's consideration of the ARTC Undertaking must operate from the clear fact that ARTC is the monopoly provider of track access services in a market for the provision of track access services over the relevant corridors. The service which ARTC offers is not in competition with road services. Therefore the constraints which exist on ARTC's monopoly power are indirect downstream constraints which for the reasons outlined earlier do not provide the level of constraint which the Commission has assumed will exist. To ensure that there are adequate constraints the following changes need to be made to the Undertaking:

- remove the CPI price escalation provision for the Melbourne - Adelaide and Adelaide Kalgoorlie corridors and replace it with a constant nominal price cap for the duration of the Undertaking. This is appropriate given the 5 year duration of the Undertaking;

²¹ See for example the Smorgon Report and the Productivity Commission's Report *Recent Developments in Rail*.

²² See the National Competition Council's Draft Recommendation and Updates in relation to the Western Australian Rail Access Regime and the decision of the Treasurer in the certification of the New South Wales Rail Access Regime.

- incorporate into the Undertaking and the Indicative Access Agreement a direct linkage between service quality and price such that:
 - On a monthly basis, an operator's flagfall component of access charges payable to ARTC would be discounted by 1% for every 1% the on-time exit of that operators' healthy trains falls below the ARTC standard of 97%, with 2% tolerance.
 - This means, for example that if an operator's healthy trains exited on time only 94% of the time, then its flagfall component of access charges for the month would be reduced by 1%.
- require that the arbitrator who determines any dispute under the Undertaking or under the Indicative Access Agreement:
 - be appropriately qualified to determine the most appropriate means of determining and calculating fees for access to rail infrastructure services;
 - not be an interested party to any access agreement with either the rail operator or ARTC;
 - have a detailed understanding of and experience in dispute resolution practice and procedures;
 - have an understanding of the rail industry in Australia; and
 - be qualified and acceptable to conduct an arbitration under the ARTC Access Undertaking and any other regime or undertaking affected by the proposed rail operations.

Glossary

ARTC	Australian Rail Track Corporation Ltd
Commission	Australian Competition and Consumer Commission
Patrick	Patrick Corporation and related companies
Toll	Toll Holdings Limited and related companies
TPA	<i>Trade Practices Act 1974</i> (Cth)
WACC	Weighted average cost of capital

6 **References**

ARTC Track Audit Final Report, ARIC Final Report Interstate Rail Network Audit, April 2001.

ARTC Workshop, *Auscript Transcript of the ACCC Forum - Australian Rail Track Corporation Undertaking, 17 December 2001*

Draft Decision, ACCC (Australian Competition and Consumer Commission) *Draft Decision on the ARTC Access Undertaking, November 2001*

NCC (National Competition Council)

- 1997a, *Recommendation in relation to the Application for Declaration of certain Rail Services on the Brisbane to Cairns Corridor, 3 June 1997*

- 1997b, *Reasons for Decision in relation to Specialized Container Transport Application for declaration of a Rail Service Provided by Rail Access Corporations, 16 June 1997*

- 1999, *Recommendation in relation to the Application for certification of the NSW Rail Access Regime, March 1999*

- 2001, *Recommendation in relation to the Application from Freight Victoria Limited (trading as Freight Australia) for declaration of the services provided by the rail networks it leases from the Victorian Government, December 2001*

Sydney Airports case 2000, Australian Competition Tribunal 2000, *Re Application for Review of the Declaration by the Commonwealth Treasurer published on 30 June 1997 of certain freight handling facilities provided by the Federal Airports Corporation at Sydney Airports Corporation Ltd, Australia Competition Tribunal, 1 March 2000 (2000) ATPR 41-754*